RESCINDED

Subprime Lending Program

Replaced by Comptroller's Handbook - Installment Lending

EXAMINATION PROCEDURES

Use the following examination procedures to assess an institution's subprime lending activities. Choose only those procedures needed, based on the level of risk and size of the institution's subprime lending activities. Seldom will you need to perform all procedures. You should also coordinate the use of these procedures with procedures performed by other examiners to avoid duplication. **Furthermore, you should test and verify enough underlying transactions to confirm that the institution's actual practices are consistent with stated policies, practices, and management reports. Significant variances normally indicate a need for closer examination scrutiny.**

These procedures are generic so you may apply them to all types of lending. You will, however, need to add any specific procedures for the type of subprime lending you review. Finally, these procedures deal primarily with safety and soundness issues. Consumer compliance issues can also pose significant risk for institutions that engage in subprime lending. For additional guidance, examiners should refer to the Compliance chapter of the Examination Handbook.

LEVEL I

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The following Level I procedures will provide you with an overview of an institution's subprime lending activities and the risks involved. You should perform these procedures in institutions that have material amounts of subprime lending. You should perform only those procedures necessary to meet examination objectives. **Note: examinations seldom require all steps.**

1. Review the following information to understand the examination scope and history and the institution's level of subprime lending:

   - The scope memorandum issued by the examiner in charge.
   - The previous examination and subprime lending-related exceptions.
   - Comments of the external and internal auditors (including any quality control staff) and their reports to management.
   - Management's responses to examiner and auditor recommendations and comments. Determine whether management corrected deficiencies mentioned in prior examinations, audit reports, and management letters or supervisory correspondence.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

WKP. REF.

- Institution reports on subprime portfolios.

2. Review the Matters Requiring Board Attention and Corrective Actions from the three or four previous ROEs to ensure that the board and management have taken appropriate corrective action where necessary and persistent problems have not recurred.

3. Evaluate the content of the most recent management reports and reports prepared for the board of directors relating to subprime lending. Determine if the reports are adequate.

4. Review the monthly financial information provided to senior management, and evaluate its usefulness and accuracy. Review the most recent fiscal year-end and current year-to-date financial information for subprime products, and compare to budgets and forecasts. Discuss any significant variances with management.

5. Review management's budget and capital plan for subprime products. Assess reasonableness, trends, and actual versus projected performance for the respective products.

6. Assess the adequacy and reasonableness of the institution's lending policies and procedures used to manage subprime portfolios. Pay particular attention to any changes since the last examination. Review policies to ensure that they address:

- Lines of authority and segregation of duties
- Underwriting limits
- Concentrations of credit (for instance, geographic, product type, broker, source of recourse)
- Permissible types of loans

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

<u>WKP. REF.</u>

- Underwriting criteria (maximum acceptable debt-to-income, scorecard cutoffs, etc.)
- Required/eligible collateral
- Collateral valuation guidelines/methods
- Exception processes
- Credit grading ("A," "B," "C," etc. paper)
- Cure programs (for example, re-agings, extensions, renewals, rewrites)

7. Determine whether all appropriate staff use and adhere to the lending policies and procedures. Determine the adequacy of exception reporting.

8. Determine whether management and the board of directors review the policies at least annually in light of the portfolio's performance and the institution's strategic goals.

9. Evaluate the institution's staffing, training, and compensation plans for its subprime operations. Assess staff adequacy in light of portfolio volume and performance.

10. Review the institution's underwriting process to determine the level of automation, use of credit scoring models, and the override/exception process.

11. Review delinquency and loss reports on a product-by-product basis and by acquisition channel. Determine if delinquency levels are in line with projections.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

WKP. REF.

12. Review the institution's process for pricing subprime products, including:

- The use of risk-based pricing.
- How competitor pricing affects the institution's pricing.
- How pricing models are maintained.

13. Assess the process used by risk management to measure and monitor risk by product, vintage, solicitation, and account source. Ensure that a process exists to report problems to senior management and, if there are problems noted, that the institution promptly takes corrective action.

14. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

LEVEL II

The following Level II procedures require a more detailed examination of institution practices. You should perform only those procedures necessary to make an informed assessment of the institution's subprime lending activities. Not all procedures will be applicable for a given institution. Moreover, the examiner in charge may omit applicable procedures if the volume of subprime lending is small in relation to the institution's size or when the overall exposure to loss is low.

15. Review a sample of loans made during the review period (including some new accounts originated in the past quarter). Evaluate whether loans are consistent with current underwriting guidelines, and whether the institution notes and monitors exceptions and overrides in accordance with policy.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

WKP. REF.

16. Assess the adequacy of exception reporting, and determine if the institution's response to significant variations is appropriate. Determine whether the level of exceptions results in higher levels of delinquencies and losses, indicative of weaknesses in the underwriting process.

17. Determine the adequacy of the institution's verification procedures, and ensure that, at a minimum, they routinely confirm residence, employment, and income for subprime borrowers.

18. Evaluate the adequacy of management information systems (MIS), and reporting for subprime lending activities, and determine whether management monitors appropriate key measurements (for example, approval/override rates, etc.).

19. Review the institution's marketing process. Determine whether the institution:

- Tests new products before launching a large-scale lending program.
- Has controls and reporting in place to monitor marketing plans and activity.
- Uses application scoring models or other targeting techniques.

20. Determine whether the institution has guidelines that govern purchasing subprime loans originated elsewhere. Assess the reasonableness of those guidelines. Consider whether processes are in place to ensure that purchased loans are consistent with the institution's underwriting criteria, and the institution is able to reject loans that do not meet its criteria.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

WKP. REF.

21. Assess the adequacy of the process used to "approve" brokers and other origination sources. Be alert for any concentration risks and insider or affiliate relationships. Ensure that:

- Management maintains a current and complete list of all vendors.
- The institution actively manages vendor relationships including:
  - Maintenance of current and complete contracts (inclusion of appropriate clauses, receipt of audit reports, financial statement requirements, etc., monitoring for adherence to terms/performance guidelines; information for renegotiation).
  - Annual review of vendor audit reports and financial condition.
  - Development of necessary controls (for example, restricting access to institution information).

22. Assess the adequacy of the documentation supporting pricing decisions and models. Determine that assumptions used are reasonable and complete, and that it appropriately captures all relevant income and expense categories.

23. Determine the adequacy of the institution's quality control and internal audit processes (for example, frequency, scope, accuracy, and meaningfulness of conclusions).

24. Determine the adequacy (substance and timing) of management response and follow-up on audit and quality assurance findings. Evaluate the training and qualifications of quality control staffing, and evaluate the reasonableness of reporting lines.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

WKP. REF.

25. Determine if the institution uses and properly applies credit scoring in the subprime lending functions.

26. Assess the structure, management, and staffing of the collections department. Assess the appropriateness of the institution's collection strategies.

27. Evaluate various cure programs used, such as re-aging, fixed payment, Consumer Credit Counseling Services, and forgiveness. Specifically:

- Determine what programs are in place or planned and review written policies.
- Verify that management monitors and analyzes the performance of each program.
- Assess the current and potential impact of such programs on reported performance and profitability, including allowance implications.

28. Evaluate the adequacy of the institution's classification and charge-off policy by:

- Determining that it adheres to the guidance of the FFIEC Uniform Retail Credit Classification Policy.
- Reviewing automated data processing parameters used for classification and charge-offs. These parameters should correspond to those described in the charge-off policy. (If not, discuss the differences with management and request appropriate corrective action.)
- Determining how the institution loads accounts scheduled for charge-off into a charge-off queue or other system for loss. Specifically:
  - Determine the circumstances, if any, that would delay a charge-off.
  - Determine when the institution recognizes losses (daily, weekly, or monthly).

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

WKP. REF.

29. Evaluate whether the allowance for loan and lease loss policy specifically identifies subprime lending portfolios. Determine if:

    - The institution has a written description of the process used to determine the adequacy of the allowance.
    - The analysis documents the factors considered in evaluating subprime portfolios.
    - Charge-off policies are consistent with the FFIEC's Uniform Retail Credit Classification and Account Management Policy.

30. Review the institution's most recent quarterly evaluation of the allowance. Determine whether the institution's allowances for subprime portfolios are reasonable and supported.

31. Determine whether the institution funds subprime lending portfolios by securitizing the receivables.

32. Evaluate the performance of institution-issued securities supported by subprime loans. Determine whether:

    - Performance trends are stable, improving, or deteriorating.
    - Early amortization or other credit enhancement triggers are nearing their set-off points. If so, discuss with management the potential cash flow and reputation risk issues.

33. Discuss with management how the institution determines accounting treatment for securitized assets. Review the institution's process for valuing residual assets associated with securitized subprime portfolios. Determine whether:

    - Assumptions (prepayment speeds, loss forecasts, and discount rates) are reasonable and conservative.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

WKP. REF.

- The institution uses the cash-out method for valuing cash flows.
- The institution uses static pool cash collection analysis to support cash flow assumptions.

34. Determine whether any recourse provisions (such as over-collateralization) are in the securitization agreement or if the institution has provided recourse through non-contractually required credit support. For example, does the institution routinely repurchase past-due loans from securitized asset pools. If so, the examiner should investigate the risk-based capital and recourse implications with examiners performing the review of capital adequacy.

34. Review a sample of investor account reconciliations. Determine whether monthly investor reports are accurate and promptly submitted.

35. Ensure that the examination meets the Objectives of this Handbook Section. State your findings and conclusions, including:

- The level of risk in the institution's subprime lending activities, including:
  - — Credit quality of the subprime portfolios, taking into account trends in portfolio performance, delinquencies, and losses.
  - — Compliance with established guidelines.
  - — Compliance with applicable laws, rulings, and regulations.
- Quality of risk management, including:
  - — Adequacy of policies and underwriting standards.
  - — Adequacy of processes, including planning.
  - — Management's ability to conduct its retail lending in a safe and sound manner.
  - — Adequacy of control systems, including loan review, audit, and management information systems.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

WKP. REF.

- Deficiencies noted during the examination.

36. In consultation with the examiner in charge, determine whether the risks identified are significant enough to merit bringing them to the board's attention in the Report of Examination (ROE). If so, prepare examination comments, including any necessary corrective measures, discuss these with management, and record management's comments in the ROE. If you determine deficiencies are not significant enough to include them in the ROE, discuss them and any recommendations you may have with management and record them along with management's response in the work papers.

37. Prepare a memorandum or update the work program with any information that will facilitate future examinations. Organize and reference work papers in accordance with OTS guidance.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	