Consumer Lending

OTS defines consumer credit as credit extended to individuals for personal, family, or household purposes. Consumer credit includes the financing or refinancing of:

- automobiles
- mobile homes
- boats
- personal use aircraft
- other recreational vehicles
- furniture and appliances
- other consumer durable goods.

LINKS
Program
Questionnaire
Appendix A
Appendix B

Consumer credit also includes loans for other personal financial needs, including the granting of overdraft lines of credit and the purchase of consumer loan accounts from retailers or other lenders.

Savings associations also grant home improvement and home equity loans for consumer purposes. Because these are typically large-dollar, long-term loans secured by real estate, OTS classifies them as real estate loans.

Some institutions may also originate small-dollar, business-purpose installment loans based on the credit capacity of the borrower rather than an in-depth analysis of the business. These loans are sometimes underwritten and processed in the same department with the consumer loans, so therefore, may be part of the consumer loan review during examinations. However, for purposes of determining a thrift's investment limits under the Home Owners' Loan Act (HOLA) Section 1464, Part 5(c), the thrift must categorize these small-dollar, business purpose installment loans as business loans. To assess the borrower's total liability to the thrift, aggregate these small-dollar, business purpose installment loans with any other commercial loans to the same borrower.

REGULATORY CONSIDERATIONS

HOLA limits a federal savings association's investment in consumer loans to 35 percent of assets when aggregated with the institution's commercial paper and corporate debt securities. The institution may only invest amounts in excess of 30 percent of assets in loans made directly by the institution.

For the purpose of determining compliance with the lending and investment limitations under HOLA, a federal association does not have to aggregate its consumer loans with education loans, home improvement loans (even when made without real estate security), deposit account loans, and credit card loans or extensions of credit made in conjunction with credit cards.[1] HOLA provides a separate authority and investment limit for each of those loan types.

OTS's lending and investment rule (12 CFR Part 560) requires each savings association to conduct its lending activities prudently and use lending standards that meet the following objectives:

- Are safe and sound.
- Ensure adequate portfolio diversification.
- Are appropriate for the size and condition of the institution, the nature and scope of its operations, and conditions in its lending market.

The regulation also requires that each association monitor the condition of its portfolio and the adequacy of any collateral securing the loans.

A consumer lending portfolio comprises many small amortizing loans with relatively short maturities. Since consumer loans are generally small, your review should focus on the following areas:

- Overall policies, procedures, and internal controls
- System support
- Management and staff capabilities
- Product pricing
- Portfolio performance.

You should structure your examination review to determine whether the institution has identified and is monitoring and controlling the risks associated with its consumer lending programs.

You will generally review a sample of loans to test compliance with internal guidelines and requirements. The depth of such sampling will depend on the adequacy of the internal loan review

[1] While people often use credit card accounts for consumer purposes, a federal savings association's ability to invest in them is authorized under a separate section of the HOLA. See Handbook Section 218 for a discussion of credit card accounts.

process and the scope of the internal audit program. (Refer to Examination Handbook Section 209, Sampling.) It is often unproductive to analyze a large number of individual credit files to determine portfolio asset quality. Your review of overall portfolio performance, including delinquency and charge-off reports, is more effective for this purpose. Such reports can also be used as a basis for classifying assets.

In addition to evaluating the current portfolio condition, you should also identify potential problems that could result from any of the following practices:

- Overly permissive lending policies.
- Lack of adherence to established policies.
- Poor internal controls.
- Potentially dangerous concentrations.
- Poor collection procedures.
- Failure to act promptly when changes in economic or market conditions call for changes in lending standards or procedures.

PORTFOLIO CHARACTERISTICS

Consumer loans may be secured or unsecured, open-end or closed-end, direct or indirect. These characteristics affect the level of risk and type of underwriting procedures required.

Secured versus Unsecured

With secured loans, the institution requires the borrowers to pledge assets as collateral for the loan. Institutions usually base the collateral required on the level of risk, the borrower's credit history, and the lender's policy. Typically, when a consumer loan finances the purchase or refinance of an asset, the collateral will consist of the item being purchased. However, institutions cannot use "household goods" [defined at § 535.1(g)] to secure a loan, other than when credit is used to purchase the items secured.

If the institution obtains collateral, it should perfect its security interest in the collateral. The institution should recognize that the market value of personal property such as automobiles and recreational vehicles will likely decline over time, and lenders typically receive only a wholesale price for repossessed property. Therefore, it is prudent to match the loan amortization period to the estimated depreciation or useful life of the security property.

With regard to unsecured loans, the institution is depending on borrowers' promise and ability to repay their loans. Therefore, institutions usually limit unsecured loans to borrowers with sound credit backgrounds. Moreover, because an individual's financial condition may change over time, institutions generally grant unsecured loans for shorter time frames than secured loans.

For both unsecured and secured consumer loans, the borrower's cash flow is the primary repayment source. This may come from the borrower's employment, business, investments, or other reliable sources, including social security, other government benefits, child support, and alimony.

Open-end versus Closed-end Loans

OTS defines open-end credit as a credit in which the creditor takes the following steps:

- Extends credit under a plan that contemplates repeated transactions.
- Imposes a periodic finance charge on any outstanding unpaid balance.
- Provides a reusable credit line. (In other words, the customer can re-borrow any repaid portion of the outstanding balance.)

Credit cards, home equity lines of credit, and checking overdraft lines of credit are the most common forms of open-end credit. We refer to most other consumer credit with fixed payment terms as closed-end or installment credit.

Direct versus Indirect

Consumer loans may also be direct or indirect. When an institution originates the loan, it is a direct loan. If a seller of retail goods (dealer) originates the loan and then sells it to the institution, it is an indirect loan. Satisfactory performance of indirect lending often stems from the structure of the agreement with the dealers and the institution's oversight of the performance of loans from each dealer. Examination Handbook Section 216, Floor Plan and Indirect Lending, discusses the basic characteristics of indirect lending.

Organizational Structure

Institutions generally divide their consumer loan departments into four functional areas: acquisition, servicing, payment processing, and collection.

- The acquisition area originates loans. The personnel handle applications from individuals or through dealers (sellers of retail goods). They also gather and review credit information and decide to approve or reject the loans.
- The servicing area disburses loan proceeds; processes loan forms; prepares payment books; controls notes, collateral, and documentation; and prepares various reports (such as reports on delinquencies, extensions, renewals, and irregular payments).
- The payment area receives, processes, and posts all payments the institution receives.
- The collection area provides the follow-up, adjustment, and other activities involved with delinquent loans.

Consumer lending requires a trained and experienced staff. The level of required expertise depends on the degree of risk and complexity of the lending activity. Manufactured-home and time-share lending, for example, are areas that require substantial expertise.

Consumer Lending Policies and Procedures

The success of a consumer lending operation depends on the institution's policies, procedures, systems, and controls. When reviewing an institution's consumer lending activities, you should determine that management has implemented policies and procedures to identify, measure, monitor, and control the credit and other risks associated with its consumer lending program.

The board of directors plays a critical role in the development of the institution's lending policies and procedures. The board should adopt policies that require comprehensive written procedures for the following areas:

- Reviewing and approving loan applications.
- Determining credit lines.
- Providing acceptable documentation standards.

The board should regularly review these policies to determine whether they are adequate and compatible with changing strategies and market conditions.

An institution should also align its consumer lending policy with the goals of its business plan. Management should perform a cost-benefit analysis that evaluates the required and probable return, amount of capital the institution will invest in start-up costs, and expected operating expenses and credit losses under various economic conditions.

The loan underwriting policy should clearly identify the following elements:

- The types of loans the institution will and will not accept.
- Any unique risks or characteristics of particular types of loans.
- Specific lending authority for each officer and group of officers.

The board of directors should set loan approval criteria based on the borrower's credit history, ability to pay, stability of income, and debt-to-income ratios. Other items that the board should address include loan-to-value ratios, collateral values, and loan terms. The primary consideration is always the creditworthiness of the borrower.

The institution's underwriting policies for consumer credit should also consider the borrower's overall debt load, generally measured by the borrower's total monthly payment obligations divided by gross monthly income. While some lenders establish a relatively low maximum allowable debt-to-income ratio (such as 40 percent, for example), others may establish a higher acceptable limit (such as 50 percent). The board of directors should establish effective underwriting standards, including debt-to-income ratios that are prudent and appropriate for the products offered in the institution's lending area. You should review these policies for adequacy and effectiveness in producing a quality loan portfolio that does not expose the institution to inordinate levels of credit risk.

Adequate loan pricing is also an essential element of a consumer loan policy. In defining its loan pricing, the institution should reflect market conditions, credit and interest rate risks, funding costs, direct and indirect operating expenses, expected credit losses, and desired profit margin. An institution should reevaluate its loan pricing formula when market conditions change or any time its loans fail to provide a reasonable profit relative to the risks undertaken.

Sound underwriting policies are not sufficient without other portfolio management guidelines. The board should require management to monitor the application of policies and procedures, including internal loan review. Senior management and the board should receive adequate reports to monitor portfolio composition, delinquencies, and losses.

In addition, institutions should develop sound policies for the collection and timely charge-off of delinquent consumer loans. Effective collection procedures can minimize losses. The timely reporting of delinquency and credit losses allow management and the board to monitor the effectiveness of the institution's underwriting standards and controls. Effective collection procedures also assist them in evaluating the success of consumer products and the overall lending operation.

Delinquency and loss trend analysis allows for early correction of developing problems and provides a basis for determining the adequacy of the Allowance for Loan and Lease Losses (ALLL).

Classification

Because most consumer loans are small, homogeneous, and uniformly underwritten, they are generally classified based on their payment status rather than an individual review of each loan. This relieves you and institution staff from the burden of having to individually review each retail credit.

OTS adopted the Interagency Uniform Retail Credit Classification and Account Management Policy, issued by the Federal Financial Institutions Examinations Council (FFIEC).

The policy statement provides guidance on:

- Standards for re-aging delinquent accounts.
- The classification of accounts when the borrower is deceased or filed for bankruptcy protection, or the account involves fraud.
- The classification of loans secured by one- to four-family residential mortgages.

The guidance states that institutions should classify closed-end consumer credit as:

- Substandard when loans become contractually delinquent 90 to 119 cumulative days.
- Loss when they become contractually delinquent 120 days or more.

Institutions should classify their open-end consumer credit as:

- Substandard when loans become contractually delinquent 90 to 179 days.
- Loss when they are 180 days or more contractually delinquent.

These classification standards are not absolute, however. If management can clearly demonstrate that a delinquent loan is *well-secured and in the process of collection*, they do not have to classify the loan. See CEO Memo No. 103 for the Uniform Retail Credit Classification Policy.

CHARACTERISTICS OF SPECIFIC TYPES OF CONSUMER LOANS

There are many types of consumer loans, each having unique characteristics and risks. We provide a brief overview of the major categories below.

Debt Cancellation Contracts

Institutions may directly provide debt cancellation contracts on originated loans, subject to certain safeguards. Debt cancellation typically provides for the repayment of a loan in the event of the borrower's death or disability, with exceptions for late payments, late charges, loans in default and deaths due to suicide.

The association should not retain any recourse related to debt cancellation if it sells such loans. In addition, an association offering debt cancellation must either obtain insurance to cover its loss exposure or establish reasonable actuarial reserves (or some combination of reserves and insurance) for the loss risk.

Housing-Related Consumer Loans

Housing-related consumer loans may include equity term loans and lines of credit, home improvement loans, and manufactured-home loans. Interest on consumer loans secured by qualified residences (such as second mortgage and home equity loans) is generally deductible in calculating federal income taxes if the loan does not exceed the borrower's basis in the home. Because of their favorable tax treatment, home equity loans have become very popular.

Home improvement loans differ from home equity loans. Home improvement loans may only be used to repair, equip, alter, or improve residential real property. In addition, home improvement loans may be conventional or Federal Housing Administration (FHA)-insured. Most importantly, thrifts may invest in home improvement loans without limitation under a separate authority under the HOLA. The thrift does not aggregate home improvement loans with other consumer credit to determine compliance with the HOLA's investment limitations.

Under the HOLA, a thrift may also invest in manufactured home loans without limitation. For reporting purposes, the thrift classifies manufactured-home loans on the Thrift Financial Report as either real estate loans or mobile home loans, depending on the documentation of the collateral value. If the home is fixed to a permanent site on which the lender holds a mortgage, the institution can classify it as a real estate loan.

The value of the manufactured home can fluctuate more than traditional housing, and they often depreciate more rapidly. This type of lending poses greater risks than conventional home lending due to the collateral value uncertainties and the mobility of the housing unit. Examination Handbook Section 216, Floor Plan and Indirect Lending, provides general guidelines for manufactured-home lending.

Although institutions grant home improvement and home equity loans for consumer purposes, they typically secure the loans with real estate and classify them as real estate loans. The Real Estate Lending Standards rule, 12 CFR §§ 560.100-101, requires an institution to establish prudent written real estate lending standards that consider the supervisory loan-to-value ratio (LTV) limits in the Interagency Real Estate Lending Guidelines appended to that rule. Any loan secured by a one- to four-family residence with an LTV of 90 percent or higher should have private mortgage insurance or readily marketable collateral and other credit strengths that offset the higher risks associated with loans with low borrower equity. Such loans, when aggregated with other loans in excess of the supervisory LTV limit, will receive increasing regulatory scrutiny and should not exceed 100 percent of total capital.

A loan secured by real estate is normally a real estate loan for purposes of 12 CFR §§ 560.100-101 and is subject to the Real Estate Lending Standards rule, whether it is fully or partially secured by real estate. The real estate lending standards rule lists nine exceptions, for example, when such loans are sold promptly without recourse and when the real estate collateral is taken as an abundance of caution.

A real estate secured loan may qualify for the abundance of caution exception and be considered a consumer loan if it is well-supported by other collateral and the value of the real estate is small in relation to the other assets securing the loan.

Abundance of caution does not include cases where the borrower's credit is sufficiently strong that the institution does not deem it necessary to take collateral, but does so anyway. See Handbook Section 212, One- to Four-Family Residential Real Estate Lending.

Direct Auto Loans

Direct auto loans represent one of the largest categories of consumer loans. Some of the primary considerations you should consider for auto loans are:

- Borrower credit debt-load requirements.
- Acceptable loan-to-value ratios.
- Verification of the condition and market value of the vehicle.
- Acceptable age of autos taken as collateral.

- Acceptable maturities.
- Pricing to reflect all costs relating to the lending program.
- Insurance requirements.
- Lien perfection.

The auto loan files should contain the application, a copy of the sales agreement, a current credit report on the borrower, income verification, evidence of current property insurance coverage, and proof of lien perfection. Depending on state law, this likely includes the original certificate of title with the institution's lien recorded on the document. Institutions engaging in auto lending should have policies and procedures for the recovery of collateral from delinquent accounts and the sale of repossessed vehicles.

You should confer with the examiner assigned to the Lending Overview section. Evidence of significant auto loan charge-offs, delinquencies, or increases in delinquencies should alert the reviewer to weaknesses in the lending program. This includes inappropriate underwriting policies, collection efforts, or repossession activities.

Other Secured Loans

Other categories of secured consumer loans include boat and recreational vehicles, aircraft, savings accounts, and loans secured by other collateral, including furniture, appliances, and jewelry. Savings account loans typically exhibit the least credit risk because the borrower's savings account fully secures the loan. The other types of secured loans can pose significant risk because the collateral may have a low resale value and can be difficult to repossess. Two key factors when originating these types of loans are the borrower's ability and willingness to repay the debt.

Boats, recreational vehicles, and farm equipment (particularly small tractors and related implements) can exhibit collateral values highly dependent on local market conditions. For these types of secured credits, the institution should base collateral valuation techniques on regional valuation reference guides and local, rather than national, conditions.

Unsecured Consumer Lending

Unsecured consumer loans include open-end credit (including overdraft protection and credit cards) and personal loans. While people often think of credit cards to individuals for household purposes as consumer loans, HOLA authorizes them under a separate lending authority. Thus, the institution does not aggregate credit cards with other consumer loans to determine compliance with HOLA's percentage of assets limitations. Refer to Examination Handbook Section 218, Credit Card Lending, for further detail.

If improperly underwritten, unsecured loans are among the riskiest types of loans due to the absence of security. Moreover, the institution has limited control over the consumer's overall debt level given the abundance of available consumer credit. Institutions must carefully evaluate the creditworthiness of the borrower because there is no collateral to fall back on should the borrower default. Some institutions often require a creditworthy cosigner or guarantor when making loans to borrowers with limited or marginal credit histories. If there is a cosigner, § 535.3 of the regulations imposes specific disclosure requirements on member institutions. (Refer to the Examination Handbook Section 1355, Unfair or Deceptive Acts, for further detail.)

Education Loans

Federal savings institutions may invest in education loans under a separate HOLA authority. Therefore, institutions do not have to aggregate education loans with other consumer loans to determine compliance with HOLA's lending limits. Education loans can be either relatively safe high-yield investments or risky specialized consumer loans. The risk depends on whether a government agency guarantees the debt and whether the institution is in compliance with the insuring agency's rules regarding the program.

Government insurance is available because students typically have low incomes and unproven credit histories, making them unattractive credit risks. The Student Loan Marketing Association (Sallie Mae) came into being in 1972 to further this purpose, and serves as a secondary market and warehouse facility for student loans. The Commissioner of Education, or a state or a nonprofit private institution with which the Commissioner has an agreement, insures the loans.

Institutions should verify that the borrower is attending the school indicated and paying tuition bills.

Time Share Loans

Time share loans represent the financing of a consumer's purchase of a shared interest in vacation or resort property. Purchasers will then "own" a week in their favorite vacation resort and may return to the resort each year on the particular week. Once purchased, the owner only pays a fee for maintenance and membership in a national registry that allows owners to trade their week for visits to other resorts. Often, however, these fees are very high.

Developers frequently sell time shares to buyers for many times the aggregate value of the units. For example, a week in a typical resort will sell for $8,000 to $15,000, depending on the season. Thus, total sales may be $500,000 or more for a unit the resort manager paid less than $200,000 to build. As a result, time share resale prices are a fraction of what the buyer/borrower paid for them. If borrowers have to sell the property, they often do so at a substantial loss. Moreover, some resorts sell time shares with no clear or definable interest in the real estate.

Time share lending combines features of real estate investment, consumer lending, and hotel management. The hybrid nature of the time share and its untested legal status make the value of the collateral questionable. The negative publicity surrounding time share operations and misrepresentations of lien positions by developers or loan brokers further complicates this situation. Time share lending requires considerable expertise due to its complexity and risk. In addition, end loan lenders should evaluate both the overall viability of the time share project and the creditworthiness of the end loan borrower.

Subprime Lending

Subprime lending is the practice of extending credit to individuals with poor credit histories. In a joint interagency policy statement on subprime lending, dated March 1, 1999, OTS, together with the banking agencies stated, "If the risks associated with this activity are not properly controlled, the agencies consider subprime lending a high-risk activity that is unsafe and unsound." (See the Interagency Policy Statement in Appendix A.)

The interagency policy statement defines subprime lending as the practice of extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers. The institution typically measures risk of default by credit/repayment history, debt-to-income levels, or credit scores.

Subprime borrowers represent a broad spectrum of debtors. They range from those who exhibit repayment problems due to an adverse event, such as job loss or medical emergency, to those who persistently mismanage their finances and debt obligations. Subprime lending does not include making loans to borrowers who have had minor, temporary credit difficulties but are now current; nor does it include loans to borrowers with normal credit histories that subsequently deteriorate.

In addition to direct extensions of credit, this guidance also applies to the purchase of the following:

- Subprime loans from other lenders, including delinquent or credit-impaired loans purchased at a discount.
- Subprime automobile or other financing "paper" from lenders or dealers.
- Loan companies that originate subprime loans.

Many institutions entering the subprime lending business have discovered that they grossly underestimated the default rates and collection costs associated with these loans. Furthermore, several experienced non-bank subprime specialists have suffered material losses despite their considerable expertise in this field of lending. Because an economic downturn will tend to adversely affect subprime borrowers earlier and more severely than standard risk borrowers, the institution should determine if it is prudent to begin or expand a subprime lending program at the current stage of the economic cycle.

Due to their higher risk, subprime loans command higher interest rates and loan fees than those offered to standard risk borrowers. These loans can be profitable, provided the lender charges a price sufficient to cover higher loan loss rates and overhead costs related to underwriting, servicing, and collecting the loans.

The ability to securitize and sell subprime portfolios at a profit while retaining the servicing rights has made subprime lending attractive to a larger number of institutions, further increasing the number of subprime lenders and loans. A number of financial institutions, however, have experienced significant losses attributable to ill-advised or poorly structured subprime lending programs. This has brought greater supervisory attention to subprime lending and the ability of insured depository institutions to manage the unique risks associated with this activity.

Institutions should recognize the additional risks inherent in subprime lending and determine if these risks are acceptable and controllable given the institution's staff, financial condition, size and level of capital support. Institutions that focus on subprime lending or enter the subprime lending business as anything more than an occasional, exception-based activity, should have board-approved policies, procedures and internal controls that identify, measure, monitor, and control these additional risks.

A separate, formal subprime policy is not necessary if institutions only occasionally grant subprime loans. However, a formal procedure should be in place for approving, documenting, and monitoring such exceptions to policy.

In light of the risks associated with this type of lending, OTS may impose higher minimum capital requirements or place investment limitations on institutions engaging in subprime lending. You should determine whether their subprime lending program is safe and sound, based on the following criteria:

- Magnitude of the risks assumed.
- Controls the institution has in place.
- Capital available to support this activity.

Business Loans

It may be more effective for you to review loans to small businesses when you review the consumer loan portfolio, particularly those with relatively small balances. Although institutions may underwrite these loans as consumer loans, they exhibit risk and underwriting elements distinct from most consumer loans.

Confirming a reliable source of repayment is critical to the small business loan underwriting process. A small business, along with a small business owner with no other income source, is dependent on the enterprise to generate adequate revenues to cover its cost of goods and operating expenses. Therefore, underwriting guidelines should consider the stability of the borrower's or business' cash flows, key operating trends, adequacy of capital to cover risks, and management's ability to react to its particular operating niche.

Financial data can be sketchy, as small enterprises may employ limited accounting systems and records. Even so, the institution should obtain a complete copy of the business' or owner's last three Federal income tax returns and recent credit report. The institution should also analyze any other available business-related financial statements.

Along with revenue, expense and net income trends, you should be alert to slow inventory turnaround or increasing accounts receivables. Depending on the size of the credit, the institution should have available a recent copy of the business' aging list for accounts receivable. Also, depending on the size of the loan and the institution's underwriting standards, you should inquire about insurance coverage, outstanding litigation, franchise requirements, lease terms and obligations, and management depth.

CREDIT SCORING

Credit scoring systems assess the credit-worthiness of potential borrowers and simplify/streamline the underwriting process for small-balance consumer loans. Thrifts often use credit scoring systems that assign numerical rankings to individuals based on available financial and demographic data. The credit scoring models then convert these rankings into scores, with higher scores indicating lower risk. The most widely used scoring systems are external systems available through credit bureaus. However, thrifts can purchase or develop a system to use internally and often use an internal and external system in conjunction.

Scoring systems can be an effective lending tool if the institution uses them properly. Before implementing a scoring system, a thrift must thoroughly study the characteristics of its loan product and customer base and what it expects the scoring system will achieve. The thrift then uses this information to adapt the system to their needs. This can be quite a complicated process and requires expertise to be effective. Following implementation, periodic review of the system, called validation, is necessary as the system ages and the customer base changes. Management should not implement scoring unless they are willing to devote the time and attention necessary to ensure that the system performs as expected and remains effective.

LAWS AND REGULATIONS AFFECTING CONSUMER LOANS

You should be familiar with all applicable consumer regulations. Section 1300 of this Handbook discusses consumer regulations in detail. See the References at the end of this section for other OTS regulations, memoranda, and policy statements that apply to consumer loans. State usury laws establish maximum interest rates on loans. If an institution violates the state usury law, it may suffer some penalty such as forfeiture of interest. Consult state law to determine compliance. OTS has preempted most state usury laws for "federally related loans," which may include some consumer loans. Consult Part 590 of the regulations to review federal preemption of state usury statutes.

REFERENCES

United States Code (12 USC)

§1464(c)(2)(D)	Consumer Lending Authority
§1464(c)(3)(A)	Education Loans Authority

Code of Federal Regulations (12 CFR)

Part 535	Prohibited Consumer Credit Practices
§560.1	General Lending Standards

§560.2	Applicability of Law: (Preemption of State Usury Laws)
§560.3	Definitions
§560.30	General Lending and Investment Powers of Federal Savings Associations
§560.31	Election Regarding Categorization of Loans or Investments
§560.93	Lending Limitations
§560.101-102	Real Estate Lending Standards