Remarks by
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In recent years, subprime lending to consumers has received a lot of attention. It has drawn attention from the industry as a new market. It has drawn attention from consumers, as we can see from its growth. And, it has drawn attention from us at the FDIC -- as a supervisor and insurer.

Today, I would like to talk about why subprime lending is important, the concerns that I have about the industry, and what the FDIC is doing to address these concerns. At the outset, however, I want to frame the issue in terms of defining what, in this context, subprime is and what it is not.

By subprime lending, I am referring to lending that attracts higher yielding, lower credit quality borrowers. This lending, often in a separately managed lending portfolio, is geared toward high yields, yet may leave high levels of risk at the doorstep of the deposit insurance funds. Subprime lending can also achieve high returns by taking advantage of consumers - what we know as predatory lending.

In referring to subprime loans, I am NOT referring to all loans underwritten using non-conventional credit standards. Loans with a community development purpose, such as affordable housing, are often underwritten using non-conventional underwriting standards. Loans are also sometimes made to borrowers who may be considered marginal under customary underwriting standards. Those loans - made on an exception basis -- may be made to first-time homebuyers, low- and moderate-income persons with limited credit histories, emerging small businesses or long-time customers with a limited number of problem credits. We do not define those to be subprime loans, nor do we wish to impede the ability of a financial institution to serve its entire community in a safe and sound manner.

And I am not talking about a large universe of institutions. I am talking about programs currently engaged in by less than two percent of the industry -- only 150 banks and thrifts have subprime lending portfolios exceeding 20 percent of capital. Altogether, these 150 institutions hold approximately 5 percent of industry assets and about 6 percent of total insured deposits.

It is currently a small universe.

But all of us should be concerned.

Why?

If there are problems, you may end up paying for them.

That small universe of institutions absorbs a disproportionate share of our supervisory resources and creates extremely high costs for the deposit insurance funds when institutions engaged in these programs fail. Nearly 20 percent of all institutions currently rated CAMELS 4 or 5 have subprime lending portfolios that exceed their equity capital. This demonstrates that thrifts and banks with significant subprime operations are far more likely to get into serious financial trouble. Indeed, five of the nine banks that failed in 1998 and so far this year have had significant subprime portfolios.

Institutions have failed to properly assess or control the risks associated with subprime lending, and have suffered or are suffering substantial losses. In some cases, the losses have brought into question the very viability of the institution.

I'll give you an example: a community bank that had been well managed and profitable for years.

In 1998, the bank started making subprime used car loans, primarily through two area dealers. As a result of rapid growth, those loans now total about half of the bank's assets. It is severely understaffed to service these high-maintenance loans. Delinquencies and losses have become excessive and the collateral, for the most part, is not worth pursuing. The bank is losing money because of large loan loss provisions, and recapitalization is needed. The bank is now on our problem list and is subject to supervisory action. This all transpired in a little over a year. Management is seeking a buyer. If losses continue to accelerate, they will run out of time. Rapid growth is always a red flag - and deserves a close look. Growth can exceed management's expertise and ability.

One example is one example.

But data from industry analysts show that the percentage of seriously delinquent mortgages in the best subprime risk grade - A minus - is several times higher than for prime mortgages.

And our own experience is that net credit losses for insured depository institutions engaged in subprime lending have been more than seven times higher than credit losses for all insured institutions -- and more than double the losses of insured consumer lending specialists that are not involved in subprime lending . . .

And those losses have come in the best economy in living memory.

Given such losses, why has subprime lending grown so dramatically?

There are a number of reasons.

First, as all of you know, there is intense competition for borrowers. One response to competition is greater risk-taking, which is especially tempting in a long economic expansion -- like the one we are in.

Second, as you all know as well, there is heightened investor expectation for increasing earnings, and the promise of higher rates and fees in subprime lending is attractive to many institutions.

At the same time, many banks and thrifts are purchasing subprime specialty finance companies, which are searching for strategic partnerships to reduce their dependence on market sources of funding.

In other words, these nonbank lenders are looking for the relatively cheaper and more stable source of funds that insured deposits provide.

In fact, some industry analysts predict that insured depository institutions will overtake finance companies as the leaders in the subprime industry.

While subprime lending offers potentially higher returns, it is a high-risk activity.

We are concerned that many lenders are attracted to the higher rates on these loans without understanding the inherent risks and costs that accompany this strategy.

You may be saying to yourself: I'm not a subprime lender, so what does this mean to me?

To the extent the insurance funds indirectly backstop categorically greater asset risks, the risks are transferred to the FDIC and the costs of problems will be borne by those who ultimately pay for operating the deposit insurance system. That means you.

Moreover, while most banks involved in the subprime business originate and hold the credits for their own portfolios, a few pool the assets and securitize the pools. To market such securities, the risks to investors must be reasonably measurable and acceptable at the price offered. To accomplish this, the seller often takes on additional risk, disproportionate to that of investors, through various means. The seller may place better credits in the pools and retain the poorer ones. Also, the originator often provides credit enhancements in the form of recourse obligations or subordinated positions such as interest-only strips and residuals. The more protection offered the investor, the more risk that is retained by the originator. Here is where the unexpected losses are magnified. Concentrations of these largely unmarketable strips and residuals bring into question the integrity of a bank's capital; the slightest error can cause staggering losses.

Clearly, in subprime lending, managing the risk is critical.

And that brings me to what subprime lenders should be doing given the risks they face.

We view the supervision of subprime lending in terms of an institution's overall subprime program, rather than in terms of the individual loans within the bank's portfolio.

A successful subprime lending program requires three critical elements.

The absence of any one of these elements puts a thrift or a bank in peril.

The first element, of course, is that the activity must be conducted safely and soundly, with proper underwriting standards, in a clearly defined, carefully planned, and properly controlled program.

In March of this year, the federal banking agencies issued the Interagency Guidance on Subprime Lending.

We expect insured institutions engaging in subprime lending to employ the prudent risk management standards outlined in that guidance.

Making subprime loans in any significant volume outside such a clearly defined and well-controlled program is not truly subprime lending; it is simply a poor selection of lending risks, which the FDIC considers an unsafe and unsound practice.

Let me be clear. If a bank conducts its subprime business poorly, we will object and take action so that corrections are made.

We have a specific program to review all subprime lenders under our primary supervision.

The second element of a well-managed subprime lending program is to ensure that the allowance for loan and lease losses is large enough to cover the embedded losses in the portfolio - losses such as those I talked about a few moments ago - a loss history quite high in relation to lending in general, and even consumer lending in particular.

Because the evidence shows that there is greater risk in subprime lending, those losses are a good indicator of how much the loan loss reserve should be -- identifiable risk of loss should be reflected in the institution's reserve levels.

Our examiners will be closely reviewing loan loss reserves to check whether the levels are appropriate given the risk - and if they are not we will, again, take supervisory action.

The third element of a prudent subprime program is capital.

Loan loss reserves cover expected losses.

Capital covers losses that are unexpected.

And those of you who were in the savings industry in the 1980s remember that unexpected losses can be sudden - and severe - especially when the economy heads downward.

I believe thrifts and banks with high concentrations of subprime loans should be required to hold more capital than the current rules now dictate.

A lot more.

At the FDIC, our thoughts are that the amount in the highest risk cases should be several times greater than the current requirement.

Requirements would vary from institution to institution - many institutions engaged in this business already have the capital to support it adequately.

Those that do not should begin looking at their capital allocation models.

We will be working with other regulators to refine those requirements and we ultimately will be seeking comments on various topics, including a possible phase-in of capital increases that would be called for under new interagency standards.

Our proposal will include a common supervisory definition for what is - and what is not - subprime lending.

And it will tie capital adequacy to the types and levels of risks that individual subprime lenders have in their portfolios.

We hope that capital for subprime lending will ultimately be included in new standards that regulators are developing - but we cannot wait for the comprehensive standards to be revamped to address this issue - we need to act now.

I have directed my staff to share our proposal with our fellow regulators later this month and seek their comment.

We will be working together with them to refine a final approach to the issue.

And we will seek public comment on any final proposal.

From safety and soundness to consumer protection, subprime lending is giving financial institution regulators much to think about - and to act on.

We all - regulators and financial institutions - share an interest in assuring that this new frontier for banking receives the attention it deserves.

Thank you.
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