INDIANA SECRETARY OF STATE
SECURITIES DIVISION

STATEMENT OF POLICY REGARDING MORTGAGE BROKERS AND SUBPRIME LENDING

The Indiana Secretary of State and the Securities Commissioner ("Commissioner") have determined that it is appropriate and in the public interest to issue a Statement of Policy regarding mortgage brokers and subprime lending.

Statutory Context

Indiana Code § 23-2-5-10(c)(10) provides that the Commissioner shall have the power to deny, suspend, or revoke the license of a licensee or the registration of a registrant if the licensee, the registrant, or the ultimate equitable owner engages in dishonest or unethical practices in the loan broker business, as determined by the Commissioner. As part of a joint statement with the Indiana Department of Financial Institutions, the Indiana Secretary of State, Securities Division ("Division") adopts this Statement of Policy to illustrate examples of conduct the Commissioner considers to be dishonest or unethical.

Policy

This Statement of Policy addresses emerging issues and questions relating to subprime mortgage lending practices by loan brokers ("brokers"). The term "subprime" refers to the credit characteristics of individual borrowers, and 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" are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers. Generally subprime borrowers will display a range of credit risk characteristics that include one or more of the following:

- 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) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood; and/or

- 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 borrowers. Additionally, this definition may not match all market or institution specific subprime definitions, but should be viewed as a starting point from which the Division will expand examination efforts.

Borrowers may not fully understand the risks and consequences of obtaining products that can cause payment shock. Of most concern are certain adjustable-rate-mortgage (ARM) products typically offered to subprime borrowers that have one or more of the following characteristics:

- 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;

- 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; and/or

- 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 consumers, providers, and brokers. These risks are increased if borrowers are not adequately informed of the product features and risks, including their responsibility for paying real estate taxes and insurance, which may be separate from their monthly mortgage payments. 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 of the prepayment penalty period extends beyond the rate adjustment date; and losing their homes. Consequences to brokers may include, legal, compliance, and reputation risks due to the elevated risks inherent in these products.

Predatory Lending Considerations

Subprime lending is not synonymous with predatory lending, and loans with features described above are not necessarily predatory in nature. However, brokers should ensure that they do not engage in or facilitate predatory lending practices. Typically, predatory lending involves at least one of the following elements:

- Evaluating borrowers 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 earn additional fees each time the loan is refinanced ("loan flipping")

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

Loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound.

Consumer Protection Principles

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

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. 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. Brokers should not use such communications to steer consumers to specific products to the exclusion of other products offered by a lender for which the consumer may qualify and which would be suitable.

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.

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, they may be faced with the need for significant additional funds on short notice. 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 increase, including how the new payment will be calculated when the introductory fixed rate expires

- 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 payment 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

Brokers should develop strong internal control systems to monitor whether actual practices are consistent with their policies and procedures. Systems should address compliance and consumer information concerns, as well as safety and soundness, and encompass personnel and applicable third parties.

Important controls include establishing appropriate criteria for hiring and training loan originators and conducting initial and ongoing due diligence on third parties. Brokers also should design compensation programs that avoid providing incentives for originations inconsistent with sound 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 and which are suitable.

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

Supervisory Review

The Division will carefully review risk management and consumer compliance processes, policies, and procedures. The Division will take action against brokers that exhibit or facilitate predatory lending practices, violate the Act, engage in unfair or deceptive acts or practices, or otherwise engage in unsafe or unsound business practices.

DATED, this 17th day of August, 2007, at Indianapolis, Indiana.

INDIANA SECRETARY OF STATE
TODD ROKITA

O. WAYNE DAVIS
SECURITIES COMMISSIONER