1-27-2010

Lisa Madigan Follow Up From Thomas Greene

Thomas Greene

Deborah Hagan

January 27, 2010

Via FedEx
The Honorable Lisa Madigan
Attorney General
State of Illinois
100 West Randolph Street
Chicago, IL 60601

Re: Financial Crisis Inquiry Commission Hearing on January 14, 2010

Dear Attorney General Madigan:

On January 20, 2010, Chairman Angelides and Vice Chairman Thomas sent you a letter thanking you for testifying at the January 14, 2010 hearing and informing you that the staff of the FCIC might be contacting you to follow up on certain areas of your testimony and to submit written questions and requests for information related to your testimony. During the hearing, some of the Commissioners asked you to answer certain questions in writing. Please answer the questions listed below and provide any additional information requested by February 26, 2010.

1. Please provide rate sheets and other documentation to support your testimony that brokers were incentivized to push consumers into higher-priced, riskier loans.

2. Please provide any data that you have on the pervasiveness of mortgage fraud from 2000 to present. Please provide any data or studies that would assist the Commission in assessing the dimension of fraud in subprime lending.

3. Please provide any data regarding the amount of prime loans and pay-option-arms that were securitized by Wall Street firms from 2000 to the present.

4. Please provide information/statistics, if available, that would give the Commission further insight into the universe of current foreclosures and assist in classifying the borrowers into four categories: 1) victims (people who were defrauded into taking out a loan that they never should have taken; 2) borrowers who knew they were taking a risk; 3) speculators or gamblers; and 4) fraudulent borrowers.

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5. Please provide data to support your testimony that national banks funded 21 of the 25 largest subprime issuers and that national banks, federal thrifts and their subsidiaries were responsible for almost 32 percent of subprime loans, 41 percent of the Alt –A loans, and 51 percent of the pay-option and interest-only ARMS in 2006 (*see* Hearing 1 Transcript, page 160). Please provide that data for any additional years from 2000 to present, if available.

6. Please provide data on the number of cases that you referred to federal regulators when the state was preempted from taking action. What action did the federal agency pursue in those cases?

The Commissioners and staff of the FCIC sincerely appreciate your continued cooperation with this investigation. If you have any questions or concerns, please do not hesitate to contact Chris Seefer at (202) 292-2799, or cseefer@fcic.gov.

Sincerely,

Thomas Greene
Executive Director

cc: Phil Angelides, Chairman, Financial Crisis Inquiry Commission

Bill Thomas, Vice Chairman, Financial Crisis Inquiry Commission

OFFICE OF THE ATTORNEY GENERAL
STATE OF ILLINOIS

Lisa Madigan
ATTORNEY GENERAL

April 27, 2010

By Electronic Mail and First Class Mail
Financial Crisis Inquiry Commission
1717 Pennsylvania Avenue, NW
Suite 800
Washington, DC 20006-4614

Re: Financial Crisis Inquiry Commission Hearing on January 14, 2010

Dear Commissioners:

Pursuant to your January 27, 2010 letter, the Office of the Illinois Attorney General has prepared responses to the six questions that you posed after Attorney General Madigan's January 14, 2010 oral and written testimony before the Financial Crisis Inquiry Commission.

1. Please provide rate sheets and other documentation to support your testimony that brokers were incentivized to push consumers into higher-priced, riskier loans.

Rate sheets obtained by our Office show that lenders incentivized brokers to push borrowers into higher-priced, riskier loans, even though the brokers are hired by and purportedly work on behalf of the borrowers – not the lenders. Borrowers can compensate brokers in two ways: lump sum fees paid directly by borrowers at the origination of a loan and/or yield spread premiums. The lump sum fee that a broker will charge is disclosed to a borrower prior to closing. The borrower must either bring money to the closing to pay this fee or increase the loan she is obtaining so that it will cover the fee. A yield spread premium, on the other hand, is paid indirectly by the borrower. Typically, the YSP is based on a broker selling a borrower a loan with a higher interest rate than the "par rate" for which the borrower qualified. The YSP is calculated as a percentage of the borrower's loan amount and is paid directly by the lender to the broker and is sometimes referred to as the loan's "rebate" or "price." Lenders provide brokers with rate sheets that show the pricing available for each loan product, as well as the amount the YSP will vary depending on the borrower's credit and property characteristics.

In theory, YSPs offer borrowers the ability to finance closing costs and fees and to avoid bringing money to the loan closing or increasing the loan amount to cover these costs and fees. But, borrowers are typically not told either the interest rate of the loan for which they were actually qualified or the amount of the YSP the lender is paying to the broker. Borrowers are also not given access to lenders' rate sheets. Therefore, the borrower is completely unable to evaluate whether it makes more financial sense to compensate the broker through lump sum fees or YSPs. Moreover, our Office has seen that many borrowers ultimately paid brokers both lump sum fees and YSPs – an illogical proposition if the point of YSPs is to cover the borrower's closing costs. Even worse, we have seen cases in which borrowers paid additional monies at closing to "buy down" the interest rate of their loan, while the broker also increased the interest rate of the loan to earn YSPs. This appears to be only a subterfuge that hides the broker's compensation from the borrower. While the broker is putting the borrower in a loan with a higher interest rate to earn a YSP, the broker is also charging the borrower "points" to bring the rate back down to where it was originally. As discussed below, by manipulating the YSP a broker would earn for selling different loan products, lenders incentivized brokers to sell loans that were unnecessarily costly, risky and inappropriate for their clients' circumstances. It is critical to remember that, although brokers certainly maximized their compensation through YSPs, it was lenders that created this incentive structure.

Yield Spread Premiums Incentivized Higher Priced, Risky Loans

There can be no question that yield spread premiums incentivized brokers to sell borrowers costlier loans. The higher the interest rate on a loan, the more compensation the broker earned from the lender. This is illustrated in the December 15, 2006 rate sheet attached as Exhibit A. The chart titled "30 Year Fixed Conforming" provides the interest rates available for a fixed interest rate loan amortized over a 30-year period that conforms with Fannie Mae and Freddie Mac's purchase guidelines. The left side of the chart lists the available interest rates and the top of the chart lists the periods for which a borrower can "lock" the interest rate. The numbers in the middle of the chart show the YSPs available for selling loans with certain interest rates and lock periods. If the number is positive, the broker would have to pay that amount in order to obtain that particular loan for a borrower – a cost that is always passed along to the borrower. If the number is negative, that is the amount the broker will receive from the lender.

As the chart shows, the par rate for a 30-year fixed interest rate conforming loan with a 30-day interest rate lock was 6%. But, if the broker placed the borrower in a loan with a 6.375% interest rate, the lender would pay the broker a yield spread premium of 1% of the loan amount. If the broker placed the borrower in a loan with a 7% interest rate, the lender would pay the broker a yield spread premium of 2.25% of the loan amount. If the broker could get the borrower to accept a loan with a 7.75% interest rate, the broker would receive 3.25% of the loan balance as a YSP. Lenders clearly incentivize brokers to sell loans with as high an interest rate as possible, in order to earn the largest commission, regardless of whether the borrower qualified for a lower rate.

Our investigations have shown that brokers could earn handsome sums for putting borrowers in worse loans than that for which they qualified. For example, one Illinois broker received YSPs from Countrywide ranging from $4185 to $11,310 per loan in the month of March 2006. During that one month, the broker received a total of at least $100,000 from Countrywide in the form of yield spread premiums.

Even though most lenders capped the YSP that they would pay to a broker, brokers were still incentivized to put borrowers in loans with the highest YSPs – even if the YSP was over what the brokers would ultimately be paid. As an illustration, HSBC capped the maximum YSP a broker could earn on 30-year fixed interest rate mortgages that were eligible for purchase by Fannie Mae at 3%. *See* Exhibit B (HSBC refers to YSPs as the loan's "price"). Nonetheless, HSBC's rate sheet lists YSPs as high as 3.659% for a 30-year loan with a 6.875% fixed interest rate and a 30-day interest rate lock and 3.219% for the same loan with a 6.75% fixed interest rate. The broker still has an incentive to put the borrower in the higher interest rate loan with a higher YSP, even though the YSP paid to the broker is capped at 3%. Specifically, if there were any adjustments made to the YSP due to borrower credit or property characteristics, it would be more beneficial for the broker to have the highest possible start value on the YSP. If the borrower wanted to get cash out during a refinance and the loan would be over 80% of the value of the property, for example, HSBC would deduct .75% from the YSP. The available YSP would now be 2.909% for the higher interest rate loan or 2.469% for the lower interest rate loan. In short, even with YSP caps, lenders still incentivized brokers to sell loans with higher interest rates. Thus, a YSP cap does not really provide protection for borrowers.

Loan Balance-Based Compensation Incentivized Brokers to Push Larger Loans

Lenders incentivized brokers to encourage borrowers to take out loans that were larger than what the borrower necessarily needed. First, because YSPs are calculated as a percentage of the borrower's loan balance, brokers obviously earned proportionally more as the loan amount increased. Second, some loan products would pay more if they were coupled with factors that increased their riskiness. This is illustrated by Indymac's home equity line of credit (HELOC) and closed-end seconds pricing. Indymac would pay brokers more if they convinced borrowers to draw down lines of credit – thereby decreasing the borrowers' home equity. The maximum YSP a broker could earn if the borrower drew less than 24.99% of the line of credit was 0.5%, but the broker could earn a 2% YSP if the borrower drew at least 75% of the line of credit. *See* Exhibit C.

Brokers Earned More by Selling Loans with Prepayment Penalties

The attached rate sheets show that lenders put a premium on selling loans with prepayment penalties that predictably trapped borrowers in high cost adjustable interest rate loans. As the attached Indymac rate sheet from December 20, 2006 shows, a broker could earn more for selling a loan with the longest possible prepayment penalty. For a three year adjustable rate mortgage with a starting interest rate of 6.50%, the lender would pay a YSP of 0.625% if the loan did not have a prepayment penalty. *See* Exhibit D. But, the lender would pay twice as much, a YSP of 1.25%, if the loan had a three year

prepayment penalty. Diminishing the duration of the prepayment penalty from three years to one or two years would decrease the broker's compensation by 0.375% or 0.250%. *Id.* In addition, the presence of a prepayment frequently impacted the maximum YSP available. If the Indymac loan described above had a three year prepayment penalty, the maximum YSP was 2.5%. *Id.* Any shorter prepayment penalty decreased the maximum YSP to 2.0%. *Id.*

Although prepayment penalties are touted by lenders as a bargaining tool for consumers, analysis has revealed that subprime borrowers generally received no appreciable benefit in exchange for accepting a loan with a prepayment penalty.[1] Even if borrowers realized that they could qualify for a loan with more favorable terms, they were locked into a higher cost loan by the prepayment penalty imposed by the brokers and lenders. In addition to harming borrowers, this also inhibited healthy market competition. Lenders did not have to worry about competing with each other on interest rates, if they were able to trap borrowers in bad loans. Even more troubling, research shows that the existence of a prepayment penalty on a loan increases the borrower's risk of default or foreclosure.[2] And, at least one broker has informed our Office that, although he was paid more for a loan with a prepayment penalty, there was no appreciable benefit to a prime consumer for taking a loan with a prepayment penalty. Apparently, the only point of this risky feature was to generate additional profit for lenders and brokers because investors would pay more for loans with prepayment penalties.

Riskier Adjustable Rate Mortgages Paid More than Fixed Rate Loans

While mortgages with interest rates that adjust are riskier for borrowers, brokers were sometimes incentivized to place borrowers in loans with adjustable interest rates, as opposed to fixed interest rate loans. An Indymac ratesheet for December 20, 2006 shows that brokers could earn 0.576% for placing a borrower in a three year adjustable rate mortgage with a 5.75% start rate. *See* Exhibit G. The broker would not earn a YSP for placing the borrower in a fixed rate loan at that interest rate; rather the broker would have to charge the borrower 0.195% for that rate. Likewise, the broker could earn 0.777% for placing the borrower in an adjustable interest rate loan with a start rate of 5.875%, but would earn less than half that amount, only 0.332%, for a loan with a fixed interest rate of 5.875%.

The March 6, 2010 rate sheet for CitiMortgage shows the same incentives to place borrowers in adjustable rate mortgages, as opposed to fixed rate mortgages. A broker would earn a 0.003% YSP for selling a conforming 30-year mortgage with a fixed interest rate of 5.875% and a 30-day interest rate lock. *See* Exhibit H. At the same interest rate, the available YSP was higher for one year adjustable rate mortgages

[1] Keith Ernst, Center for Responsible Lending, Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages (Jan. 2005), http://www.responsiblelending.org/mortgage-lending/research-analysis/rr005-PPP_Interest_Rate-0105.pdf (attached as Exhibit E).

[2] Munpyung O, University of California at Santa Barbara, The Effect of Prepayment Penalties on Subprime Borrowers' Decisions to Default: A Perfect Storm (Nov. 16, 2009), http://www.econ.ucsb.edu/jobmarket/O,%20Munpyung%20-%20Research%20Paper.pdf (attached as Exhibit F).

(1.080% to 1.196%), three year adjustable rate mortgages (0.527% to 0.572%), five year adjustable rate mortgages (0.468% to 0.596%), seven year adjustable rate mortgages (0.046% to 0.375%), and even for ten year adjustable rate mortgages with a Treasury index (0.239%). *See* Exhibit I. In short, CitiMortgage's YSPs incentivized brokers to sell almost anything except a 30-year fixed interest rate conforming mortgage.

Toxic Pay Option ARMs Paid More Than Fixed Rate Loans

Lenders structured the YSP for option ARMs in a manner that virtually guaranteed that brokers who were more concerned with getting the highest YSP possible than getting their borrowers the best loan would steer borrowers into these risky products. Plainly put, it was easier to obtain higher commissions for option ARMs as opposed to other traditional mortgage products. Ordinarily a broker would need to increase the interest rate over a borrower's par rate on a loan in order to receive a higher YSP. If a borrower did comparison shopping, she could realize that the broker was offering a loan with a higher interest rate than available from other brokers or lenders. But, the factors that increased a broker's compensation with option ARMs are completely opaque.

An option ARM has a teaser interest rate, typically for the first month of the mortgage, and an adjustable interest rate based on the loan's index and margin thereafter. Although the actual interest rate on the loan adjusts upward after the first month, the borrower is permitted to continue making payments based on the teaser interest rate for a certain period of time. During that time, the difference between the interest due each month and the interest covered by the borrower's payment is added to the loan's balance. The fraud associated with pay option adjustable rate mortgages is well documented and summarized in our response to Question 2. Suffice it to say, these loans were appropriate for few, if any, owner-occupied residential mortgage borrowers.

The YSP for an option ARM is based on the amount of the margin that is used to calculate the loan's interest rate after the first month and the existence of a prepayment penalty. The rate sheet for December 15, 2006 attached as Exhibit J shows how this calculation worked. The available margin for the loan ranged from 2.4% to 3.45% and the product could be offered with up to a three-year prepayment penalty. As shown on the rate sheet, the broker could earn up to 4.05% of the loan amount by selling an option ARM with a 3.45% margin and a three-year prepayment penalty. The start rate for the loan was still 1%, however, and at least one lender advised its employees to "sell the payment." Selling the payment in the case of this toxic product would serve only to obfuscate the true nature of the loan. Borrowers were very unlikely to notice what the margin for the subsequent interest rate on the mortgage was or realize that they were able to negotiate this term. The fully indexed interest rate on the loan on December 15, 2006 was actually 8.333% (4.883%, the amount of the index on that day, plus 3.45%, the amount of the margin).

Brokers were incentivized to sell this toxic product because it would have been impossible to obtain the same YSP on any other loan product. The highest YSPs available for prime loans from this lender were 3.375% for a 30-year fixed interest rate

loan and 1.75% for a 7-year adjustable rate mortgage. *See* Exhibit A. Both of these loan products were considerably less risky for borrowers than an option ARM because they had lower fully-indexed interest rates (7.875% and 7.25%, respectively). Moreover, neither of these loan products trapped borrowers with prepayment penalties. Nonetheless, brokers were incentivized by lenders' YSPs to put borrowers in the riskiest, most toxic product available.

Other lenders presented brokers with these same perverse incentives. For example, on December 20, 2006, Indymac's highest YSP for an option ARM was 4.00%. *See* Exhibit K. This loan had a very high 8.283% fully indexed interest rate and a three year prepayment penalty. Fixed interest rate and adjustable interest rate loans at 7.375% were available – and these loans had no prepayment penalties. *See* Exhibit G. But, the highest available YSPs were 3.791% for the fixed interest rate loan and 3.139% for the adjustable interest rate loan.

Volume-Based Compensation Drove the Use of Reduced Documentation Underwriting, Without Countervailing Incentives to Sell Full Documentation Loans

Since brokers could earn YSPs on each loan that they sold, they were incentivized to sell as many loans as possible. If borrowers could be qualified for a loan with reduced-documentation underwriting, brokers and underwriters would be able to submit and process loan applications much more quickly. During our Office's investigation of Countrywide Home Loans, for example, we found that it took as little as 30 minutes to underwrite some reduced-documentation loans, and some loans closed the same day the application was taken from the borrower. Using risky reduced-documentation underwriting was therefore a way that brokers and underwriters could maximize the incentives created by lenders.

While some lenders attempted to mitigate the impact of this risky incentive by decreasing the amount of compensation brokers and underwriters would earn on reduced-documentation loans, lenders did not always do so. For example, Indymac offered the same broker YSP on option ARMs regardless of documentation level. *See* Exhibit K. The broker could sell a "NINA" loan, which prohibited disclosure of employment, income and assets on the loan application, and receive the same compensation as selling a full-documentation loan. The difference was that the margin on the reduced-documentation loan would increase slightly and, even more importantly, there would be no debt-to-income calculation to verify that the loan was affordable for the borrower. This allowed the brokers to sell loans they might not otherwise have been able to sell. Another lender treated loans in which borrowers' income was not verified just the same as full-documentation loans, as long as the total loan-to-value ratio was under 80%. *See* Exhibit G.

2. Please provide any data that you have on the pervasiveness of mortgage fraud from 2000 to present. Please provide any data or studies that would assist the Commission in assessing the dimension of fraud in subprime lending.

The FBI defines mortgage fraud as "the intentional misstatement, misrepresentation, or omission by an applicant or other interested parties, relied on by a lender or underwriter to provide funding for, to purchase, or to insure a mortgage loan."[3] While our Office certainly agrees that this conduct equates to mortgage fraud, we believe that this definition of what constitutes mortgage fraud is too narrow. Our Office believes that *the sale of unaffordable or structurally unfair mortgage products to borrowers is also mortgage fraud.* This is one of the primary theories in the lawsuit we filed against Countrywide Home Loans in June 2008. The means for committing this type of mortgage fraud varied, but the main methods included the severe erosion of underwriting standards and allowing the layering of risky features on one loan, combined with incentives to sell risky or unaffordable loans without sufficient checks on abuses. An example of this type of mortgage fraud can be found in our lawsuit against Countrywide. There we describe just one Countrywide borrower, a 64-year-old widow on a fixed income who was refinanced by Countrywide into a mortgage with a three-year fixed "teaser" interest rate and interest-only period, after which the loan became adjustable. The borrower was unable to afford the payments on this mortgage even *before* the end of the fixed-rate and interest-only period (i.e. before year three).

A quote from a letter from Countrywide to the Office of Thrift Supervision, set out in our Office's lawsuit against the company, provides a sense of how prevalent the practice of selling unaffordable loans to subprime borrowers had become by 2006. In reference to the fourth quarter of that year Countrywide writes, ". . . we know that almost *60%* of the borrowers who obtained subprime hybrid ARMs [from Countrywide] would not have qualified at the fully indexed rate" (emphasis added).[4] Testimony by Martin Eakes, CEO for the Center for Responsible Lending and Center for Community Self-Help (CRL), provides additional examples of lenders who utilized underwriting standards that would qualify borrowers for ARMs at less than fully-indexed rates.[5] These examples demonstrate how pervasive this type of poor underwriting was in the industry, and, thus, how prevalent this type of mortgage fraud on borrowers was.

This fraud was most prevalent in the subprime market, but was also present in the prime and Alt-A markets. As an illustration, pay option ARM loans were considered a "prime" product, but one in which we saw an enormous amount of fraudulent conduct. A section of our Countrywide complaint details the unfair and deceptive nature of the company's pay option ARM loan product.[6] The core features of an option ARM – multiple payment options, negative amortization and automatic recasting of loan terms – make the product much riskier than traditional mortgages. But lenders proceeded to layer the product with

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[3] Dep't of Hous. and Urban Dev., Report to Congress on the Root Causes of the Foreclosure Crisis 39 (Jan. 2010) ("HUD Report") (*citing* Federal Bureau of Investigation).

[4] People of the State of Illinois v. Countrywide Financial Corporation et al at ¶4, No. 08 CH 22994 (Circuit Court of Cook County, Illinois June 25, 2008) ("Countrywide Compl.") (attached as Exhibit M).

[5] *Preserving the American Dream: Predatory Lending Practices and Home Foreclosures: Hearing Before S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. 14 (Feb. 7, 2007) (written statement of Martin Eakes, Chief Executive Officer, Center for Responsible Lending and Center for Community Self-Help) (identifying Option One Mortgage Corp, Fremont Investment & Loan, and New Century as lenders who underwrote ARMs at less than fully-indexed rates) (attached as Exhibit N).

[6] Countrywide Compl. at ¶¶123-208 (Ex. M).

features that made it exceptionally risky, placing borrowers at risk of losing equity in their homes or even their homes. These features include: illusory teaser interest rates, prepayment penalties, high loan-to-value ratios and/or reduced documentation underwriting guidelines. As one former Countrywide loan originator explained, Countrywide's "option ARMs were built to fail."[7] Despite the structural unfairness of the loan, we described how Countrywide marketed the product indiscriminately to all borrowers, pushed its employees and brokers who sold Countrywide loans to sell the product inappropriately and failed to provide disclosures to ameliorate borrowers' confusion about the mortgage they were obtaining.[8] Between January 1, 2005 and July 31, 2007, Countrywide originated thousands pay option ARM loans in Illinois alone.

Moreover, Countrywide's incentive structure, loose underwriting guidelines and complete lack of oversight enabled and facilitated its broker business partners to commit fraud in the sale of both pay option ARMs and other loan products.[9] For example, we sued a broker who specialized in selling pay option ARMs for predatory lending practices that would not have been possible absent Countrywide's own malfeasance.[10] This broker, who had five felony convictions, was a Countrywide business partner from April 8, 2004 through December 26, 2007. As detailed in the complaint we filed against the broker, borrowers who purchased pay option ARMs were subjected to predictable harms such as sales techniques that including telling consumers the amount of only one payment – the minimum payment – and not that the initial low interest rate was merely a one month teaser rate or that negative amortization would occur if the consumers paid only the minimum payment. In addition, there was rampant fraud on borrowers' loan applications without the consumers' knowledge, and which Countrywide then completely failed to detect and even enabled due to reduced documentation underwriting. Countrywide incentivized the broker's misconduct with yield spread premiums. During one month, the broker received at least $100,000 from Countrywide in the form of yield spread premiums. Countrywide, through this one Illinois broker, sold numerous consumers loans that were in all likelihood predatory, inappropriate and ultimately unaffordable. This constitutes fraud.

We also refer you to a report by the CRL on the lender Indymac, a traditionally Alt-A lender (as opposed to subprime).[11] The Indymac report describes much of the same conduct we describe in our Countrywide complaint, including the massive use of stated income loans and poor underwriting that resulted in borrowers receiving unaffordable loans. The report notes that the description of Indymac's loans and origination practices are from lawsuits filed against the company and interviews of former employees

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[7] *Id.* at ¶136.
[8] *Id.* at ¶¶158-171.
[9] *Id.* at ¶¶172-193.
[10] *Id.* at ¶¶194-208; The People of the State of Illinois v. One Source Mortgage, Inc. et al, No. 07 CH 34450 (Circuit Court of Cook County, Illinois Nov. 26, 2007) (attached as Exhibit 0).
[11] Mike Hudson, Center for Responsible Lending, Indymac: What Went Wrong? How an "Alt-A" Leader Fueled its Growth with Unsound and Abusive Mortgage Lending (June 30, 2008) http://www.responsiblelending.org/mortgage-lending/research-analysis/indymac-what-went-wrong.html (attached as Exhibit P).

conducted by CRL and that Indymac denies much of the conduct. This report exemplifies just how difficult it is to quantify fraud in the mortgage market.

While it is difficult to quantify the amount of this type of fraud that occurred in the past decade, we point you to the HUD Report's summation of the literature available on the causes of the current foreclosure crisis: ". . . [I]t seems clear from the literature that the sharp rise in mortgage delinquencies and foreclosures is fundamentally the result of rapid growth in loans with a high risk of default—due both to the terms of these loans and to loosening underwriting controls and standards."[12] We believe that placing borrowers in loans they cannot afford equates to mortgage fraud.

In addition to the fraud described above is the more traditionally-defined form of mortgage fraud, i.e., intentional misstatements or misrepresentations made by a borrower or broker/lender. The recent HUD Report on the Root Causes of the Foreclosure Crisis attempts to provide some estimate of the amount of this type of fraud in the mortgage market. We refer you to that report for its findings. The HUD Report noted a steep increase in the number of FBI Suspicious Activity Reports between 2003 (6,939) and 2007 (46,717).[13] The HUD Report also cites an analysis by BasePoint Analytics, a private firm specializing in detecting mortgage fraud, as estimating that *9 percent of loan delinquencies* are associated with some form of fraud.[14] In our opinion, these figures likely underestimate the amount of mortgage fraud in the marketplace in the last decade. The HUD Report acknowledges several reasons why these reports of fraud may be underestimated. First, not all lending institutions make Suspicious Activity Reports. Second, and more importantly, mortgage fraud can be very difficult to identify, particularly when the adverse consequences of an overly expensive or unsustainable loan, which might otherwise trigger a review for fraud, are masked by the borrower's decision to refinance into another loan or to sell their home to get out from under a fraudulent mortgage. This was often the case during the heyday of the subprime market: housing prices were rising, and many, if not most, borrowers were able to get out of a fraudulent mortgage either by refinancing into another mortgage or by selling their home for enough to extinguish the fraudulent mortgage. It was only when borrowers' equity was so tapped that they could no longer refinance, and a slowing housing market had eliminated the option of selling for many struggling borrowers, that the massive delinquencies and foreclosures we have recently seen began to appear. Thus, we believe these figures are a very conservative estimate in the amount of mortgage fraud that was occurring prior to the collapse of the subprime market.

It is also important to note that, as found in the HUD Report, the FBI has estimated that about *80 percent* of what they consider to be mortgage fraud is fraud "for profit," meaning it is *fraud committed by a mortgage broker/lender* in order to make money on the loan (as opposed to fraud committed by a borrower in order to obtain financing for a home).[15] The HUD Report also notes that BasePoint Analytics "has concluded that most

[12] *Id.* at 29.
[13] *Id.* at 39.
[14] *Id.*
[15] *Id.*

fraud is driven by mortgage brokers in their efforts to earn profits by originating loans."[16] This estimate comports with what we have seen in our work in this area. We mainly witness borrowers who have been the unknowing victims of mortgage broker/lender fraud. We have seen very little in the way of fraud committed by borrowers on their own in order to obtain financing for a home.

The HUD Report cites studies by BasePoint Analytics, the Mortgage Asset Research Institute, and Fitch Ratings Agency demonstrating that the majority of mortgage fraud involves the misrepresentation of income, employment, or occupancy of the home on loan applications. Our experience supports these analyses. We believe that the rise of no- and low-documentation loans allowed this type of fraud to become pervasive in the mortgage market. The HUD Report pointed out that the growth of these types of loans "appears to be highly related to the growth in fraud."[17]

As you may be aware, stated income loans earned the nickname "liar loans" in the industry because they were routinely used to qualify borrowers for loans based upon inflated incomes. In our review of mortgage complaints and in our investigation of Countrywide, we discovered that the use of stated income loans was systemically used to inflate borrowers' incomes, with most borrowers unaware that their income was being inflated.[18] A Mortgage Asset Research Institute review of 100 stated income loans compared the income on the loan documents with the borrowers' tax documents and found that almost 60% of the income amounts were inflated by more than 50% and that 90% of the loans had inflated income of at least 5%.[19]

For a sense of the pervasiveness of the use of these loan products in the years leading up to the mortgage market meltdown, we would point you to our statement in the lawsuit our Office filed against Countrywide that from 2005 through the first half of 2007, a *majority* of all Countrywide's loans were stated income loans.[20] Countrywide sold stated income loans to "subprime" borrowers and to wage earners—i.e., those borrowers who could have documented their income with W-2s.[21] A 2006 report by Fitch states that loans with less than full documentation standards make up more than half of the subprime market.[22] In our opinion, the massive sale of these products demonstrates how extensive this type of fraud was in the market leading up to its collapse.

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[16] *Id.* at 40-41.
[17] *Id.* at 40.
[18] *See* Countrywide Compl. at ¶¶95-96 (Ex. M).
[19] Mortgage Asset Research Institute, Inc., Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association 12 (Apr. 2006), http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf.
[20] Countrywide Compl. at ¶81 (Ex. M).
[21] *Id.* at ¶¶84-85.
[22] *Preserving the American Dream: Predatory Lending Practices and Home Foreclosures: Hearing Before S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. 14 (Feb. 7, 2007) (written statement of Martin Eakes, Chief Executive Officer, Center for Responsible Lending and Center for Community Self-Help) (citing *Structured Finance: U.S. RMBS Criteria for Subprime Interest-Only ARMs*, Fitch Ratings Credit Policy, Oct. 4, 2006) (attached as Ex. N).

3. Please provide any data regarding the amount of prime loans and pay-option-arms that were securitized by Wall Street firms from 2000 to the present.

Aside from data available from the Securities and Exchange Commission, our Office's investigation of Countrywide Financial Corporation and its subsidiaries and affiliates provided insight into the securitization of residential mortgages. Exhibit B is a list of all Countrywide securities offerings from 2005 to 2007. As the document shows, Countrywide had over 170 securities offerings in 2005, over 160 offerings in 2006, and more than 70 offerings in 2007. Although option ARM loans may be included in other offerings, option-ARM-specific offerings are identified by "OA" in the deal name. By our review, over 20 of these offerings included option ARM loans.

4. Please provide information/statistics, if available, that would give the Commission further insight into the universe of current foreclosures and assist in classifying borrowers into four categories: 1) victims (people who were defrauded into taking out a loan that they never should have taken; 2) borrowers who knew they were taking a risk; 3) speculators or gamblers; and 4) fraudulent borrowers.

In terms of information and/or statistics regarding mortgage fraud, we refer you to the HUD Report to Congress on the Root Causes of the Foreclosure Crisis generally. Specifically, HUD's Report noted that the FBI has estimated that about 80 percent of what it considers mortgage fraud is fraud "for profit," meaning it is fraud committed by a mortgage broker/lender in order to make money on the loan (as opposed to fraud committed by a borrower in order to obtain financing for a home). BasePoint Analytics also concluded that most fraud was committed by mortgage brokers in an effort to earn profits by originating loans. To support this conclusion, BasePoint Analytics relied on the high correlation between the incidence of fraud and above-average interest rates and fees on loans as well as the fact that about ten percent of brokers accounted for all cases of fraud it uncovered in a database of three million loans. These estimates and conclusions comport with what we have seen in our review of mortgage complaints and investigations of lenders and mortgage brokers. Thus, we believe a greater number of foreclosures involved borrowers who were victims of fraud (category 1), as opposed to borrowers who knew they were taking a risk or were themselves engaged in fraud (categories 2 and 4).

5. Please provide data to support your testimony that national banks funded 21 of the 25 largest subprime issuers and that national banks, federal thrifts and their subsidiaries were responsible for almost 32 percent of subprime loans, 41 percent of the Alt-A loans, and 51 percent of the pay-option and interest-only ARMS in 2006 (*see* Hearing 1 Transcript, page 160). Please provide that data for any additional years from 2000 to present, if available.

As noted in Attorney General Madigan's written testimony, the Center for Public Integrity found that national banks/thrifts funded 21 of the 25 largest subprime issuers.[23]

[23] First Public Hearing of the FCIC: Hearing Before the Financial Crisis Inquiry Commission, 111th Cong. 10 n.14 (Jan. 14, 2010) (written testimony of Lisa Madigan, Attorney General, State of Illinois) (citing the

The statistics regarding the percentage of loan originations in 2006 are found in a study conducted by the National Consumer Law Center. For residential mortgage loans originated in 2006, the study found that banks were responsible for 31.5% of the subprime loans, 40.1% of the Alt-A loans, and 51% of the pay option arm and interest-only loans.[24]

Data regarding other years is available from the Federal Reserve and Inside Mortgage Finance, among other sources. In its annual analysis of Home Mortgage Disclosure Act data, the Federal Reserve found that depository institutions (combined with their subsidiaries and other affiliates) originated about half of subprime and Alt-A mortgages made in 2004 and 2005, 54% in 2006, and 79% in 2007.[25] Inside Mortgage Finance ("IMF"), a company that provides news and statistics for the residential mortgage business, has collected data on the top 50 lenders for 2008 to 2009, the top 40 lenders for 2005 to 2007, the top 30 lenders for 1994 to 2004, and the top 25 lenders for 1991 to 1993.

Our Office understands that certain regulators cite other statistics in support of the proposition that state-regulated lenders were largely responsible for the origination of subprime and Alt-A mortgage loans. These other statistics do not take into account whether the state-regulated lenders were affiliates of or funded by a national bank or thrift. The core underlying premise is that national banks and thrifts bear no responsibility for their affiliates, subsidiaries or the companies that they financially support. Federal regulators' aggressive stance on preemption issues, however, created an environment in which states had to exercise caution even when dealing with non-bank affiliates and subsidiaries of national banks and thrifts.

My Office is currently facing this exact issue in our litigation against Countrywide Financial Corporation ("CFC"), a holding company, Countrywide Home Loans, a state-licensed lending subsidiary of CFC, and the companies' founder, Angelo Mozilo. In addition to its state-licensed entities, CFC also had a subsidiary that was a national bank regulated by the OCC that became a thrift regulated by the OTS in March 2007. Our lawsuit was not against the bank/thrift, but rather sought to hold the holding company, state-licensed entity and Mozilo accountable for their predatory lending practices. In response, Countrywide and Mozilo relied heavily on *Watters v. Wachovia Bank*, N.A., 550 U.S. 1 (2007), and argued that

> ...Plaintiff's attempt to avoid preemption by failing to name Countrywide Bank, N.A. the OCC regulated entity or Countrywide Bank, F.S.B., the OTS regulated entity is unavailing. The scope of federal preemption of banking activities is not limited by formal corporate structure nor limited

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Center for Public Integrity, Who's Behind the Financial Meltdown? (May 6, 2009), http://www.publicintegrity.org/investigations/economic_meltdown/).

[24] *See* National Consumer Law Center, Preemption and Regulatory Reform: Restore the States' Traditional Role as 'First Responder' 11-13 and tbls. 1-3 (Sept. 2009) (attached as Exhibit R).

[25] *See* Robert B. Avery et al, "The 2007 HMDA Data," Federal Reserve Bulletin A124-25 and tbl. 11 (Dec. 2008) (attached as Exhibit S).

> to the entity specifically regulated by the OCC or OTS, but looks instead to the *activity* at issue...
>
> ...The fact that Plaintiff has failed to name the entity that conducted much of Countrywide's mortgage lending business and funded substantial portions of that business during the time covered by the Complaint is immaterial to the preemption analysis.

Although our Office firmly believes that state-licensed entities are subject to state regulation, there is no escaping the fact that the federal regulators' actions leave the door open for arguments on even that simple proposition. It is disingenuous at best for federal regulators to now disclaim all responsibility for the dysfunctional regulatory environment they created.

Finally, even taking the numbers presented by one of the federal regulators at face value, it is inescapable that a significant portion of the subprime and Alt-A lending between 2005 and 2007 was done by federally-regulated institutions. Specifically, federally-regulated institutions directly originated 42.9% of all subprime and Alt-A loans during this period.[26] Of the loans originated during this time period, 26.9% of the loans originated by OTS-regulated entities experienced a foreclosure start and 22.0% of the loans originated by OCC-regulated entities experienced a foreclosure start.[27] These numbers do not support a conclusion that a failure of state regulation was the leading cause of the foreclosure crisis.

6. Please provide data on the number of cases that you referred to federal regulators when the state was preempted from taking action. What action did the federal agency pursue in those cases?

Generally, our practice has not been to refer "cases" to federal regulators because, in our experience, they have not provided any assistance to our consumers. First, it is important to note that, although the OCC and OTS attempted to greatly expand their preemptive authority over state laws during the past decade, whether or not a particular investigation or "case" is, in fact, preempted has often been a matter of debate. As is apparent from the recent Supreme Court ruling in *Cuomo v. Clearing House Assn., L.L.C.*, 129 S.Ct. 2710 (2009), even where federal regulators believed states were preempted, that did not mean we actually were preempted from taking action. Thus, simply because a financial institution, or even a federal regulator, claimed states were preempted did not mean we necessarily agreed with that position or felt we could not take action to protect our consumers where necessary. What it did mean to us, however, was that any such action we would undertake would require an added layer of work for our Office because we would not only be attempting to investigate a claim of wrongdoing, but we would also

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[26] Subprime Lending and Securitization and Government-Sponsored Enterprises: Hearing Before the Financial Crisis Inquiry Commission, 111th Cong. Appendix B: Activities of National Banks Related to Subprime Lending at 4 (Apr. 8, 2010) (written testimony of John C. Dugan, Comptroller, Office of the Comptroller of Currency).

[27] *Id.* at 9.

have to fight with the financial institution, and likely the federal regulator, about whether we *could* investigate the allegation. This had the effect of stymieing claims we might otherwise have pursued, had they been alleged against a state-regulated entity, because we did not have the resources to fight the extra fight on preemption.

Second, our experience with federal financial regulators has historically been that they are very antagonistic towards the states and are not very interested in protecting our consumers from abuses. The *Cuomo* case is a very good example of the reasons why Illinois and other states have not trusted federal regulators to investigate allegations of consumer abuses. In *Cuomo*, the New York Attorney General had concerns over HMDA data showing racial disparities in the lending practices of some lenders that were federally regulated. When the New York Attorney General sent letters to those lenders requesting additional data to investigate these concerns, he was sued not only by the lenders, but by the OCC itself. Instead of working with the New York Attorney General to investigate his concerns, the OCC spent its resources fighting whether the investigation was proper and attempting to stop New York's investigation. Unfortunately, the OCC's attitude towards state law enforcement efforts is nothing new.

History of the State Attorneys General's Relationship with the OCC

During the early 2000s, our Office, along with the Minnesota Attorney General and several others, was investigating marketing companies and federal financial institutions involved in preacquired account marketing, business relationships in which third-party vendors paid national banks for use of the bank's name and access to bank customers' accounts in order to market club memberships offering certain products and services to bank credit card holders. Because the financial institutions were regulated by the OCC, the Minnesota Attorney General's Office organized a meeting of several other state attorneys general offices and the OCC in May 2001. The state attorney general group went to the meeting to describe the problems they were seeing in this area to the OCC, and hoped that the OCC, once they understood the issue, would help the states in their efforts to stop the consumer abuses they were seeing.

The assistant attorneys general at the meeting explained the preacquired account marketing problem and other consumer protection concerns, and requested for help in addressing these matters. The OCC's response was to lecture the assistant attorneys general about the preeminent position of the OCC and national banks. The states were told that the OCC would welcome receiving information they possessed, but that it would be in the sole authority of the OCC to decide whether and how to proceed. The OCC rejected the idea of a joint investigation and enforcement action. The assistant attorneys general were warned that the OCC might oppose any state attorney general actions against national banks under state consumer fraud statutes on the grounds that the OCC had the exclusive authority to bring such actions.

An example of this OCC opposition is Minnesota v. Fleet Mortgage Corporation, 181 F.Supp.2d 995 (D. Minn. 2001). In 2001, the Minnesota Attorney General sued Fleet Mortgage Corporation, a non-bank subsidiary of a national bank, for violations of the

Telemarketing Sales Rule ("TSR"), 16 C.F.R. §§310.1-310.7. Minnesota alleged that Fleet's participation in preacquired account marketing resulted in unauthorized charges to Fleet's customers' mortgage accounts. The OCC petitioned the court and was allowed to file an *amicus* brief in support of Fleet's motion to dismiss. The OCC argued that neither Minnesota nor the Federal Trade Commission had authority to enforce the TSR against Fleet because national banks are exempt from the TSR, and this exemption extended to non-bank subsidiaries of national banks such as Fleet.

In August 2001, we received a Memorandum from the OCC setting out its procedures for processing referrals it received from state attorneys general and other state officials. A copy of this Memorandum and cover letter is attached as Exhibit T. The Memorandum set out the OCC's internal procedures for handling referrals from state officials. Nowhere in this Memorandum is there any provision to discuss with the state official what action should or should not be taken. The states strongly disagreed with the OCC's position that the states had *no* enforcement authority over national banks concerning consumer fraud matters. This memorandum was not an agreement or understanding. Rather, it was the OCC's position and stated policy concerning how states were to communicate with the OCC regarding national banks.

After meeting with the OCC concerning the preacquired account marketing problem, and the OCC's refusal to work with or help the states in any way on this issue, the states continued their investigation of this practice by two national banks. The OCC continually advised these banks *not* to cooperate or settle with the states. Nonetheless, in 2002 our Office and 27 other states were able to reach an agreement with Citibank and Bank One and entered into voluntary compliance agreements with them, over the OCC's objections. As evidence of the ongoing dispute between the states and the OCC, the compliance agreement contains the following provision:

> The States acknowledge that it is the position of the Bank and the OCC that only the OCC may exercise visitorial powers over the Bank. The Bank and the OCC believe that these exclusive visitorial powers include, but are not limited to, the regulation, examination and supervision of Bank and Bank activities as well as the enforcement of applicable federal and state consumer protection laws, rules and regulations. Accordingly, the Bank expressly reserves the right to claim and/or argue that the power to supervise or enforce this Assurance and/or to examine for compliance with this Assurance resides solely with the OCC. The Bank acknowledges that it is the position of the States that the States may enforce applicable federal and state consumer protection laws, rules and regulations against the Bank. Accordingly, the States expressly reserve the right to seek to enforce this Assurance and/or to seek to examine for compliance with this Assurance, and the Bank expressly reserves its right to respond by asserting the visitorial powers argument and/or defense described above.

Following the settlements with Citibank and Bank One the OCC issued an advisory letter in November 2002. One of the stated purposes of this letter was to advise its regulated

entities "to consult with the OCC if state officials contact them concerning the potential application of a state law, or if these officials seek information concerning a national bank's operations."[28] In addition to advising OCC-regulated entities to let the OCC know if they were contacted by a state official, the advisory letter also stated:

> State officials are urged to contact the OCC if they have any information to indicate that a national bank may be violating federal or an applicable state law or if they seek information concerning a national bank's operations. *The OCC will review any such information and, if appropriate, take supervisory action, which may include an enforcement action, if it concludes that a national bank has violated an applicable law.*[29]

Thus, by early in the last decade, the OCC had made it clear to the states and to the entities the OCC regulates that the OCC was going to run interference on any issues the states may have with national banks. The OCC was not proposing a cooperative venture with state attorneys general to combat consumer abuses. Instead, the OCC was going to decide, in its sole discretion, whether action needed to be taken concerning any particular consumer protection issue.

This attitude applied equally, if not even more forcefully, to state attempts to reign in predatory lending. The OCC stymied states' attempts to investigate predatory lending and proactively aided national lenders fighting to avoid compliance with state anti-predatory lending laws. For example, in 2002, the OCC stopped Washington's investigation into National City Mortgage's mortgage practices.[30] And, in 2003, the OCC issued a ruling exempting national banks from Georgia's anti-predatory lending law upon request by First Franklin and National City Bank (First Franklin's subsidiary).[31] The OCC has even attacked the usefulness of state anti-predatory lending laws generally.[32]

A recent study of the impact of state anti-predatory lending laws shows the impact of preemption.[33] The study shows that the default rates for national lending institutions became worse after the lenders were exempted from state anti-predatory lending laws. The study also shows that these national lenders' mortgages also contained more risky features after the lenders were exempted from state anti-predatory lending laws.[34] This

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[28] Questions Concerning Applicability and Enforcement of State Laws: Contacts from State Officials, OCC Advisory Letter (AL 2002-9) at 1 (Nov. 25, 2002) (attached as Exhibit U).
[29] *Id.* at p. 4 (emphasis added).
[30] A description of the OCC's action is in a Seattle Post-Intelligencer investigative report (Eric Nalder, *Mortgage System Crumbled While Regulators Jousted*, Oct. 11, 2008), attached as Exhibit V.
[31] Preemption Determination and Order, Office of the Comptroller of the Currency, 68 Fed. Reg. 46,264 (Aug. 5, 2003).
[32] *See Economic Issues in Predatory Lending* (Office of the Comptroller of the Currency Working Paper, July 30, 2003) (attached as Exhibit W).
[33] Center for Community Capital, The Preemption Effect: The Impacts of Federal Preemption of State Anti-Predatory Lending Laws on the Foreclosure Crisis (Mar. 29, 2010), http://www.ccc.unc.edu/documents/preemption.effect.revised.3.29.10.pdf (attached as Exhibit X).
[34] *Id.* at 16-21.

demonstrates that while the OCC was attacking state attempts to reign in predatory and abusive lending, it was doing nothing to fill the void it was creating.

In 2003, the OCC proposed broad preemption rules, which the state attorneys general vehemently opposed. The attorneys general for all 50 states, the District of Columbia and the US Virgin Islands sent joint comments, attached as Exhibit Y, spelling out their opposition to the OCC's preemption rules. The comments spell out the states' opposition to the OCC's aggressive preemption of state laws and its interference with state consumer protection enforcement generally. The comments also specifically voice the state attorneys general's concern that the OCC's preemption rules would undermine state efforts to combat predatory lending.[35]

Despite the state attorneys general's opposition, the OCC adopted its proposed preemption rules in 2004. Following these rules, the OCC continued to aggressively interfere with state enforcement efforts to protect consumers. For example, as described above, the OCC sued the New York Attorney General to stop an investigation into potential discriminatory lending by national banks in 2005.

We are aware that in late 2006 the OCC and the Conference of State Bank Supervisors agreed upon a form Memorandum of Understanding to be entered into between state banking regulators and the OCC in order to better share consumer complaint information. However, to our knowledge, state attorneys general were not parties to these agreements. More importantly, these agreements did not appear to alter, in any meaningful way, the OCC's attitude and conduct towards the states or towards consumer protection.[36]

The OCC continued its antagonistic attitude towards the states even after the subprime market collapsed and the current foreclosure crisis began. In the fall of 2007, a group of state attorneys general and state banking regulators formed a working group to begin discussions with the largest servicers of subprime mortgages in hopes of getting in front of the oncoming tsunami of foreclosures and helping push forward more reasonable loan modifications. The working group made requests to the top 20 largest servicers of subprime mortgages for data on the performance of the loans they serviced and the types of modifications and other workout solutions being offered. In response, the OCC

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[35] *See* Comments on Docket No. 03-16, 12 CFR Parts 7 and 14, National Association of Attorneys General (Oct. 6, 2003) at. 9-12 (attached as Exhibit Y).

[36] *See* Ryan Chittum, *Angelides, The Audit, and Unfair Lending*, Columbia Journalism Review (Apr. 16, 2010) (quoting John Ryan of CSBS as "strongly disagree[ing]" with John Hawke's testimony to the Commission that the OCC received "zero" referrals of evidence of national banks involved in predatory lending and stating: "That statement doesn't reflect what we [state banking regulators] experienced [. .] There were tons of consumer complaints referred to the OCC by the states. I was regularly hearing from state regulators that sending complaints to the OCC was equivalent to a black hole. . . . The agreement they sent the states was not meant to be cooperative. It required the states to say 'we surrender, we have no authority.' Their focus was not on cracking down on lending practices but rather facilitating the subprime business model of the biggest banks. The actions of the OCC weren't meant to create a cooperative atmosphere.") (attached as Exhibit Z).

advised national banks not to provide this data to the state working group.[37] The letter sent from Chase to the state working group illustrates the impact of the OCC's advice:

> With respect to your request that we complete and submit monthly the detailed servicer call report you provided, I'm sure you appreciate that Chase is a national bank, chartered under authority of federal law, and is supervised and regulated exclusively by an agency of the federal government – the Office of the Comptroller of the Currency (OCC). The call report requests information about the bank, its loans and its servicing practices subject to this federal oversight, and as such, this kind of detailed information would ordinarily be available only to the OCC. *We have consulted with the OCC and they have advised us that it would be inconsistent with the OCC's exclusive oversight and examination of a national bank for information of the kind required to complete the call report to be provided to officials other than the OCC.* As a result, Chase must respectfully decline your request for the call report and supplements which would contain detailed information about loan performance, loss mitigation efforts, and foreclosures. The OCC has advised us that you should feel free to discuss with the OCC.[38]

The state working group never received data from any of the national banks to whom it made requests, except Bank of America, which has provided data for Countrywide mortgages. Thus, even in the aftermath of the lending abuses, the OCC has interrupted efforts by the states to aid our citizens and has refused to allow national banks to work with us in this endeavor.

Examples of State Referrals to the OCC and the OCC's Inaction

As described above, the OCC did very little in response to the preacquired account marketing issue raised and handled by the State Attorneys General. The OCC issued an "advisory letter on unfair or deceptive acts or practices" in 2002.[39] However, to our knowledge, the OCC has never taken a formal action, beyond the advisory letter, in response to the state attorneys general's concerns.

This inaction extended to other matters. For example, we received a complaint from a consumer about a federal lending institution's practice of universal default. This is holding someone in default on their credit card when that person is in default, delinquent, or behind on other debt obligations. We believed this practice was a consumer abuse that warranted investigation. This was shortly after the meeting with the OCC on preacquired account marketing described above and we decided that, instead of attempting to remedy the abuse, we would refer the matter to the OCC for it to handle. The issue our Office

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[37] *See* Dec. 19, 2007 Letter from Chase Home Finance (attached as Exhibit AA); *see also* Dec. 13, 2007 Letter from Wells Fargo Home Mortgage (attached as Exhibit BB).

[38] *Id.* (emphasis added).

[39] Guidance on Unfair or Deceptive Acts or Practices, OCC Advisory Letter (Mar. 22, 2002), http://www.occ.treas.gov/ftp/advisory/2002-3.txt.

sent to the OCC was whether the universal default provision was a deceptive or unfair practice under Section 5 of the FTC Act, which the OCC claims to enforce. After reviewing our information, the OCC informed us that it had determined this was *not* an abusive practice and that it would not be taking any action.

In 2004 our Office forwarded complaints we had received concerning a national bank's involvement with an unlicensed third-party company allegedly providing computer certification training to students to the OCC. The bank made student loans for the program, paying the total loan proceeds directly to the company, which ended up declaring bankruptcy and failed to provide the promised training to many students. The OCC again declined to take any action, instead informing our Office that it did not believe any of the bank's conduct was a violation of federal or Illinois law. We did not agree with the OCC's interpretation of our state consumer protection laws. The OCC sent letters to our consumers advising them that they were not able to conclude that the bank had violated any law, that the OCC could not help in the matter, and that the consumers may wish to consult with an attorney.

Not surprisingly, the OCC's attitude threatened even informal mediation efforts. Our Office sends out voluntary mediation letters when we receive a consumer complaint.[40] Following the OCC's November 2002 advisory, we began receiving letters like the one attached as Exhibit CC from National City. In the letter, National City cited the OCC's advisory letter and requested that we send any future inquiries to the OCC. Due to the OCC's actions, and the type of responses we received to our informal mediation attempts with national banks, we instituted a new policy to forward complaints we received concerning national banks to the OCC's Texas office. Despite the OCC's advisory letter, most national banks do cooperate at least somewhat with our Office in our informal mediation, although at least one bank does not. Nearly all of the complaints we forward to the OCC involve credit card issues. We have received thousands of such complaints. Sometimes we refer these complaints to the OCC after we have attempted to resolve the matter through our informal mediation process but are unsuccessful in achieving any relief for our consumer. Other times we copy the OCC before we begin mediation. We are not aware of what actions, if any, the OCC has taken in response to the consumer complaints we have forwarded to them.

We know that other state attorneys general have their own examples of referrals made to the OCC, with no action taken by the OCC in response. And, according to John Ryan of the Conference of State Bank Supervisors, state banking regulators had similar experiences, describing sending consumer complaints to the OCC as equivalent to a "black hole."[41] One example of press reports on this issue, citing a litany of situations in which the OCC took the side of its banks over that of consumers, is attached as Exhibit Z.

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[40] As a "first-responder" for consumer issues in the State of Illinois, our Office receives tens of thousands of consumer complaints each year. In order to assist consumers and businesses in attempting to find a resolution to these complaints, we have an informal mediation process whereby we attempt to get both sides to come to an agreement on how to resolve the problem.

[41] Ryan Chittum, *Angelides, The Audit, and Unfair Lending*, Columbia Journalism Review (Apr. 16, 2010) (attached as Exhibit Z).

The article gives a sense of how the OCC was viewed by those trying to protect consumer interests. We shared the same concerns.

We hope this gives context for why we have not referred more matters to federal regulators. Unfortunately, our past experience is that these regulators are often almost as antagonistic as the targets of our investigations. We have not found the federal regulators to be very protective of consumers, but rather, have found them to be highly protective of the institutions they regulate.

Unfortunately, it was during the last decade's very tumultuous and antagonistic period with federal banking regulators that the bulk of the subprime lending abuses were occurring. As we outlined in General Madigan's initial written testimony, the state attorneys general spent countless resources on investigating, attacking and beating back predatory lending. However, we did not view the federal banking regulators as partners in this endeavor. Instead, we viewed the federal regulators as being both opposed to us and unwilling to take aggressive action to stop abuses by their regulated entities.

Please do not hesitate to contact me if you have any further questions about the information provided in this letter or Attorney General Madigan's January 14, 2010 oral and written testimony.

Very truly yours,

Deborah Hagan /me

Deborah Hagan
Chief, Consumer Protection Division
Office of the Illinois Attorney General

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30 Year Fixed Conforming - Program 1694

Rate	15 Day	30 Day	60 Day
5.875	0.250	0.375	0.625
6.000	(0.125)	0.000	0.250
6.125	(0.500)	(0.375)	(0.125)
6.250	(0.875)	(0.750)	(0.500)
6.375	(1.125)	(1.000)	(0.750)
6.500	(1.375)	(1.250)	(1.000)
6.625	(1.625)	(1.500)	(1.250)
6.750	(2.000)	(1.875)	(1.625)
6.875	(2.375)	(2.250)	(2.000)
7.000	(2.375)	(2.250)	(2.000)
7.125	(2.625)	(2.500)	(2.250)
7.250	(2.875)	(2.750)	(2.500)
7.375	(3.250)	(3.125)	(2.875)
7.500	(3.250)	(3.125)	(2.875)
7.625	(3.250)	(3.125)	(2.875)
7.750	(3.375)	(3.250)	(3.000)
7.875	(3.500)	(3.375)	(3.125)

20 Year Fixed Conforming - Product 1695

Rate	15 Day	30 Day	60 Day
5.875	(0.125)	0.000	0.250
6.000	(0.500)	(0.375)	(0.125)
6.125	(0.875)	(0.750)	(0.500)
6.250	(1.125)	(1.000)	(0.750)
6.375	(1.375)	(1.250)	(1.000)
6.500	(1.625)	(1.500)	(1.250)
6.625	(1.750)	(1.625)	(1.375)
6.750	(1.750)	(1.625)	(1.375)
6.875	(2.125)	(2.000)	(1.750)
7.000	(2.125)	(2.000)	(1.750)
7.125	(2.375)	(2.250)	(2.000)
7.250	(2.625)	(2.500)	(2.250)
7.375	(3.000)	(2.875)	(2.625)
7.500	(3.000)	(2.875)	(2.625)
7.625	(3.000)	(2.875)	(2.625)
7.750	(3.125)	(3.000)	(2.750)
7.875	(3.250)	(3.125)	(2.875)

15 Year Fixed Conforming - Program 1696

Rate	15 Day	30 Day	60 Day
5.250	1.625	1.750	2.000
5.375	1.250	1.375	1.625
5.500	0.750	0.875	1.125
5.625	0.500	0.625	0.875
5.750	0.125	0.250	0.500
5.875	(0.250)	(0.125)	0.125
6.000	(0.625)	(0.500)	(0.250)
6.125	(1.000)	(0.875)	(0.625)
6.250	(1.250)	(1.125)	(0.875)
6.375	(1.625)	(1.500)	(1.250)
6.500	(1.750)	(1.625)	(1.375)
6.625	(2.125)	(2.000)	(1.750)
6.750	(2.375)	(2.250)	(2.000)
6.875	(2.750)	(2.625)	(2.375)
7.000	(2.750)	(2.625)	(2.375)
7.125	(2.750)	(2.625)	(2.375)
7.250	(2.750)	(2.625)	(2.375)

Adjustments for All Conforming Fixed

Locks	
45 days (vs 60 day)	(0.094)
90 Days (vs 60 day)	0.375
Products	
1694, 1695, 1696, 2294 >=700 < 730	0.250
1694, 1695, 1696, 2294 >=680 <= 699	0.500
Codes 1694, 1695 & 1696 Min Crdt Score 680	
Codes 2075, 2076 & 2077 Min Crdt Score 730	
Loan Amount	
Loan Amount $25,000 - $39,999	1.500
Loan Amount $40,000 - $50,999	0.750
Loan Amount $80,000 - $99,999	0.125
Ln Amt 100K-$149,999	0.125
LTV/CLTV	
75-20-5	0.250
80-15-5	0.250
90-5-5	0.500
Investment Property <= 75%	1.500
Other	
I/O (30YR ONLY W/ 10YR I/O) - 2294	0.875

FOR LTV / CLTV 90.01 - 95% USE CODES 2075, 2076, 2077

30 Year Fixed Conforming - Program 2075

Rate	15 Day	30 Day	60 Day
5.875	0.375	0.500	0.750
6.000	0.000	0.125	0.375
6.125	(0.375)	(0.250)	0.000
6.250	(0.750)	(0.625)	(0.375)
6.375	(1.000)	(0.875)	(0.625)
6.500	(1.250)	(1.125)	(0.875)
6.625	(1.500)	(1.375)	(1.125)
6.750	(1.875)	(1.750)	(1.500)
6.875	(2.250)	(2.125)	(1.875)
7.000	(2.250)	(2.125)	(1.875)
7.125	(2.500)	(2.375)	(2.125)
7.250	(2.750)	(2.625)	(2.375)
7.375	(3.125)	(3.000)	(2.750)
7.500	(3.125)	(3.000)	(2.750)
7.625	(3.125)	(3.000)	(2.750)
7.750	(3.250)	(3.125)	(2.875)
7.875	(3.375)	(3.250)	(3.000)

20 Year Fixed Conforming - Product 2076

Rate	15 Day	30 Day	60 Day
5.875	0.000	0.125	0.375
6.000	(0.375)	(0.250)	0.000
6.125	(0.750)	(0.625)	(0.375)
6.250	(1.000)	(0.875)	(0.625)
6.375	(1.250)	(1.125)	(0.875)
6.500	(1.500)	(1.375)	(1.125)
6.625	(1.625)	(1.500)	(1.250)
6.750	(1.625)	(1.500)	(1.250)
6.875	(2.000)	(1.875)	(1.625)
7.000	(2.000)	(1.875)	(1.625)
7.125	(2.250)	(2.125)	(1.875)
7.250	(2.500)	(2.375)	(2.125)
7.375	(2.875)	(2.750)	(2.500)
7.500	(2.875)	(2.750)	(2.500)
7.625	(2.875)	(2.750)	(2.500)
7.750	(3.000)	(2.875)	(2.625)
7.875	(3.125)	(3.000)	(2.750)

15 Year Fixed Conforming - Program 2077

Rate	15 Day	30 Day	60 Day
5.250	1.750	1.875	2.125
5.375	1.375	1.500	1.750
5.500	0.875	1.000	1.250
5.625	0.625	0.750	1.000
5.750	0.250	0.375	0.625
5.875	(0.125)	0.000	0.250
6.000	(0.500)	(0.375)	(0.125)
6.125	(0.875)	(0.750)	(0.500)
6.250	(1.125)	(1.000)	(0.750)
6.375	(1.500)	(1.375)	(1.125)
6.500	(1.625)	(1.500)	(1.250)
6.625	(2.000)	(1.875)	(1.625)
6.750	(2.250)	(2.125)	(1.875)
6.875	(2.625)	(2.500)	(2.250)
7.000	(2.625)	(2.500)	(2.250)
7.125	(2.625)	(2.500)	(2.250)
7.250	(2.625)	(2.500)	(2.250)

State Pricing Adjustments for Conforming Fixed Rate Products

OR	(0.250)
HI	(0.125)
AZ, NV, WA, UT	0.00

ALL loans require a 4506

ABC PRIME EXPRESS JUMBO FIXED

30 Year Jumbo Fixed Rate - 1047

RATE	15 Day	30 Day	60 Day
6.000	1.125	1.250	1.500
6.125	0.500	0.625	0.875
6.250	(0.250)	(0.125)	0.125
6.375	(0.625)	(0.500)	(0.250)
6.500	(0.875)	(0.750)	(0.500)
6.625	(1.125)	(1.000)	(0.750)
6.750	(1.250)	(1.125)	(0.875)
6.875	(1.375)	(1.250)	(1.000)
7.000	(1.500)	(1.375)	(1.125)
7.125	(1.750)	(1.625)	(1.375)
7.250	(1.875)	(1.750)	(1.500)

Valid for loan amts <= $2M

Adjustments

45 days (vs 60 day)	(0.094)
Loan Amount $650,001 - $1 Million	0.125
Loan Amount > $1 Million	0.500

Please Note:

ALL LOANS MUST CLOSE WITH A 4506T
MIN CDT SC 700 FOR PROD 1047
2 UNIT PROPERTIES 730 MIN CDT SC & $1M MAX LN AMT
CASH OUT TO 70%

ABC PRIME EXPRESS CONFORMING ARMS

5/1 Conforming ARM - Product 2293, I/O 2298

Rate	15 Day	30 Day	60 Day
5.500	1.000	1.125	1.375
5.625	0.750	0.875	1.125
5.750	0.500	0.625	0.875
5.875	0.250	0.375	0.625
6.000	0.000	0.125	0.375
6.125	(0.250)	(0.125)	0.125
6.250	(0.500)	(0.375)	(0.125)
6.375	(0.750)	(0.625)	(0.375)
6.500	(0.875)	(0.750)	(0.500)
6.625	(1.125)	(1.000)	(0.750)
6.750	(1.250)	(1.125)	(0.875)
6.875	(1.250)	(1.125)	(0.875)
7.000	(1.375)	(1.250)	(1.000)
7.125	(1.500)	(1.375)	(1.125)
7.250	(1.750)	(1.625)	(1.375)

Caps: 5/2/5; Margin: 2.50

7/1 Conforming ARM - Product 2296, I/O - 2299

Rate	15 Day	30 Day	60 Day
5.500	1.375	1.500	1.750
5.625	1.000	1.125	1.375
5.750	0.750	0.875	1.125
5.875	0.375	0.500	0.750
6.000	0.000	0.125	0.375
6.125	(0.250)	(0.125)	0.125
6.250	(0.625)	(0.500)	(0.250)
6.375	(0.875)	(0.750)	(0.500)
6.500	(1.000)	(0.875)	(0.625)
6.625	(1.000)	(0.875)	(0.625)
6.750	(1.125)	(1.000)	(0.750)
6.875	(1.375)	(1.250)	(1.000)
7.000	(1.500)	(1.375)	(1.125)
7.125	(1.750)	(1.625)	(1.375)
7.250	(1.875)	(1.750)	(1.500)

Caps: 5/2/5; Margin: 2.50

10/1 Conforming ARM - Product 2297, I/O 2300

Rate	15 Day	30 Day	60 Day
5.500	2.000	2.125	2.375
5.625	1.500	1.625	1.875
5.750	1.125	1.250	1.500
5.875	0.750	0.875	1.125
6.000	0.375	0.500	0.750
6.125	0.125	0.250	0.500
6.250	(0.125)	0.000	0.250
6.375	(0.375)	(0.250)	0.000
6.500	(0.750)	(0.625)	(0.375)
6.625	(1.000)	(0.875)	(0.625)
6.750	(1.125)	(1.000)	(0.750)
6.875	(1.250)	(1.125)	(0.875)
7.000	(1.500)	(1.375)	(1.125)
7.125	(1.750)	(1.625)	(1.375)
7.250	(1.875)	(1.750)	(1.500)

Caps: 5/2/5; Margin: 2.50

Adjustments

Loan Amount	
$80,000 - $99,999	0.250
< $80,000	0.500
Property Type	
Investment Property <= 75%	1.500
Other	
45 days (vs 60 day)	(0.094)
Credit Score > 700 <= 730	0.250
Credit Score >=680 <= 699	0.625
I/O	0.250
Margin Buydowns 25 BPS	0.125

ALL loans require a 4506
Minimum Credit Score of 680
Pricing valid for Loan Amounts up to $417,000

Access our Rate Lock Policy at www.abconduit.com.

Check guidelines for availability. Pricing grids/adjustment sections may not reflect all prod guidelines

This rate sheet is a communication between the lender and professionals in the real estate industry. Rates Subject To Change Without Notice. ahm51

EXHIBIT
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A

HSBC

Broker - Fannie Mae Programs

CALIFORNIA

Customer Relations: 800-273-7039 | Webloan Help Desk: (877) 433-4722 | HSBC Website: https://wrbloan.us.hsbc.com

Pricing Effective: 10:00 AM EST 03/7/07 Until 09:59 AM EST 3/8/07

Rates shown are current market only and are subject to change

Extended Locks Fee (Applies to 60 Day Price)	Fixed	Arms	Locks Expiration Dates	
90 Day Up front Fee	0.125%	0.125%	15 Days	3/22/2007
120 Day Up front Fee	0.250%	0.250%	30 Days	4/6/2007
150 Day Up front Fee	0.500%	0.500%	60 Days	5/7/2007
180 Day Up front Fee	0.750%	0.750%		

Fannie Mae Conforming Fixed Rate Programs

30 Year Conforming

Rate	15 Day	30 Day
5.625%	0.551%	0.676%
5.750%	-0.019%	0.106%
5.875%	-0.569%	-0.464%
6.000%	-1.049%	-0.924%
6.125%	-1.319%	-1.394%
6.250%	-1.889%	-1.864%
6.375%	-2.459%	-2.334%
6.500%	-2.584%	-2.459%
6.625%	-3.024%	-2.899%
6.750%	-3.344%	-3.219%
6.875%	-3.784%	-3.659%

20 Year Conforming

Rate	15 Day	30 Day
5.625%	0.491%	0.616%
5.750%	-0.009%	0.116%
5.875%	-0.509%	-0.384%
6.000%	-0.969%	-0.844%
6.125%	-1.379%	-1.254%
6.250%	-1.779%	-1.654%
6.375%	-2.189%	-2.064%
6.500%	-2.314%	-2.189%
6.625%	-2.694%	-2.569%
6.750%	-3.044%	-2.919%
6.875%	-3.314%	-3.189%

15 Year Conforming

Rate	15 Day	30 Day
5.375%	0.256%	0.383%
5.500%	-0.142%	-0.017%
5.625%	-0.542%	-0.457%
5.750%	-1.022%	-0.897%
5.875%	-1.392%	-1.267%
6.000%	-1.582%	-1.457%
6.125%	-2.002%	-1.877%
6.250%	-2.392%	-2.267%
6.375%	-2.782%	-2.657%
6.500%	-2.907%	-2.782%

Maximum Price	-3.00%

Additional Lock Terms	Fee
90 Day - add to 30 Day	0.125%

Overlays DU/DO	Fee
2 UNIT > 90%	0.500%
Cashout 70.01-80.0%	0.500%
Cashout > 80.01%	0.750%
LTV 95.01 - 97%	0.500%
LTV 97.01 - 100% & FICO<680	1.250%
LTV 97.01 - 100% & FICO >= 68	0.750%
75/20/5	0.250%
80/10/10	0.000%
80/15/5	0.250%
90/5/5	0.750%
80/20 and FICO<680	1.500%
80/20 and FICO >=680	1.000%
75/25 and FICO <680	1.000%
75/25 and FICO >=680	0.750%
40 Year Amortization	0.750%
FICO <620 DU Accept	0.375%
Loan Amts <$125K	0.250%
NOO with Impound Waivers	0.250%

SIVA LTV	FICO	Fee
<=75%	680 - 699	0.750%
	700 - 719	0.375%
	>=720	0.250%
75.01 - 90	680 - 699	Ineligible
	700 - 719	0.750%
	>=720	0.375%

Additional Overlay	Fee
2 - Units	0.750%

Quick & EZ (SISA) FICO	Fee
< 680	N/A
680 - 699	0.375%
>= 700	0.000%

Quick & EZ Interest Only (Added to base Quick & Easy Overlays) FICO	Fee
>=680	0.875%
LTV >75 w/2nd	0.250%

Fannie Expanded Approval	Rate
EA1	0.750%
EA2	1.000%
EA3	1.375%
	Fee
Level 2 Cashout Condo	0.500%

Fannie Mae Int. First	Fee
10 / 20	0.875%
15 / 15	0.875%
LTV>75 w/ 2nd	0.250%

MyCommunity Mortgage	Rate	Fee
MCM Mortgage Program	0.375%	0.000%
Interest Only	0.000%	0.500%
Subordinate Financing	0.000%	0.750%
40 year Amortization	0.000%	0.375%

** No additional Overlays Apply**

AAP / Lite Doc Fee Overlays FICO:	Missing-619	620-659	660-699	700-719	720+
LTV					
<=60%	1.125%	1.125%	0.500%	0.500%	0.500%
60.01 - 70.00	1.125%	1.125%	1.125%	0.500%	0.500%
70.01 - 75.00	1.750%	1.125%	1.125%	0.500%	0.500%
75.01 - 80.00	1.750%	1.250%	1.250%	0.500%	0.500%
80.01 - 90.00	NA	NA	NA	0.500%	0.500%

Fannie Mae NOO Fee Overlays	15 Year Term		> 15 Year Term	
	<=75 LTV	>75 LTV	<=75 LTV	>75 LTV
<720 FICO	0.750%	1.750%	<720 FICO 1.750%	2.000%
>=720 FICO	0.500%	1.500%	>=720 FICO 1.000%	1.875%

*A DU/DO Approve/Eligible on Fannie Mae Conforming Loans is required (Excluding AAP & Lite Doc).

Fannie Mae Conforming Fixed Term LIBOR Arms

3/1 LIBOR 2/2/6

Rate	15 Day	30 Day
5.125%	0.665%	0.790%
5.250%	0.415%	0.540%
5.375%	0.175%	0.300%
5.500%	-0.065%	0.060%
5.625%	-0.315%	-0.190%
5.750%	-0.565%	-0.440%
5.875%	-0.765%	-0.660%
6.000%	-1.005%	-0.880%
6.125%	-1.165%	-1.040%
6.250%	-1.325%	-1.200%
6.375%	-1.485%	-1.360%

5/1 LIBOR 5/2/5

Rate	15 Day	30 Day
5.250%	0.333%	0.458%
5.375%	-0.007%	0.118%
5.500%	-0.317%	-0.192%
5.625%	-0.627%	-0.502%
5.750%	-0.897%	-0.772%
5.875%	-1.157%	-1.042%
6.000%	-1.387%	-1.262%
6.125%	-1.607%	-1.482%
6.250%	-1.797%	-1.642%
6.375%	-1.927%	-1.802%
6.500%	-2.077%	-1.952%

7/1 LIBOR 5/2/5

Rate	15 Day	30 Day
5.250%	1.100%	1.225%
5.375%	0.740%	0.865%
5.500%	0.390%	0.515%
5.625%	0.040%	0.165%
5.750%	-0.310%	-0.185%
5.875%	-0.660%	-0.535%
6.000%	-0.820%	-0.795%
6.125%	-1.180%	-1.055%
6.250%	-1.420%	-1.295%
6.375%	-1.660%	-1.535%
6.500%	-1.650%	-1.725%

10/1 LIBOR 5/2/5

Rate	15 Day	30 Day
5.375%	1.321%	1.446%
5.500%	0.891%	1.016%
5.625%	0.461%	0.586%
5.750%	0.011%	0.136%
5.875%	-0.439%	-0.314%
6.000%	-0.809%	-0.684%
6.125%	-1.179%	-1.054%
6.250%	-1.449%	-1.324%
6.375%	-1.719%	-1.594%
6.500%	-1.889%	-1.774%
6.625%	-2.079%	-1.954%

Maximum Price for all ARM Products:	2.000%

FNMA AGENCY LIBOR Arm Overlays	Rate	Fee
Interest Only (not available for all loan scenarios)	0.125%	0.000%
Cashout 75.01-80.0%	0.000%	0.250%
Cashout 80.01-85.0%	0.000%	0.500%
Cashout 85.01-90.0%	0.000%	0.750%
1 unit w/ LTV > 90.00% <95.01	0.000%	0.250%
LTV 95.01% - 97%	0.000%	0.500%
LTV 97.01 - 100% & FICO<680	0.000%	1.000%
LTV 97.01 - 100% & FICO >= 680	0.000%	0.500%
TLTV > 90% or 80/15/5	0.000%	0.250%
80/20 - FICO<680 (3/1, 7/1 10/1 fully amort & purch only)	0.000%	1.000%
80/20 - FICO >=680 (3/1, 7/1 10/1 fully amort & purch only)	0.000%	0.500%
2 UNIT > 80%	0.000%	0.500%
NOO w/ <=75 LTV and >=720 FICO	0.000%	1.000%
NOO w/ <=75 LTV and <720 FICO	0.000%	1.250%
NOO w/ >75 LTV and >=720 FICO	0.000%	1.875%
NOO w/ >75 LTV and <720 FICO	0.000%	2.000%
Quick & EZ (SISA) - FICO < 680	N/A	N/A
Quick & EZ (SISA) - FICO 680 - 699	0.000%	0.375%
Quick & EZ (SISA) - FICO > 700-719	0.000%	0.250%
Quick & EZ (SISA) - FICO >= 720	0.000%	0.000%
Quick & EZ Interest Only (Add to Base Quick & EZ overlays)		
FICO >= 680	0.125%	0.000%
40 Year Amortization	0.000%	1.250%
NOO with Impound Waivers	0.000%	0.250%

Fannie Mae MyCommunity Mortgage 5's, 7's & 10's	Rate	Fee
My Community Mortgage Program	0.250%	0.000%
5/1 ARM w/LTV > 90	0.000%	0.250%
Interest Only	0.000%	0.250%
Subordinate Financing	0.000%	0.500%
40 year Amortization	0.000%	0.125%
* No Additional Overlays Apply		

Fannie Expanded Approval 7's & 10's	Rate	Fee
EA 1	0.625%	0.000%
EA 2	0.875%	0.000%
EA 3	1.250%	0.000%

Stated Income (Fully Amortizing Only) 5's, 7's, & 10's	Rate	Fee
LTV <= 75 and Fico 680 - 699	0.000%	0.500%
LTV <=75 and Fico 700 - 719	0.000%	0.125%
LTV > 75 and Fico 700 - 719	0.000%	0.500%
LTV > 75 and Fico >= 720	0.000%	0.125%
LTV <=75 and Fico >=720	0.000%	0.000%
O/O 2 unit	0.000%	0.750%

AAP / Lite Doc Fee Overlays - 5/1, 7/1 & 10/1 FICO:	Missing-619	620-659	660-699	700-719	720+
LTV					
<=60%	1.125%	1.125%	0.500%	0.500%	0.500%
60.01 - 70.00	1.125%	1.125%	1.125%	0.500%	0.500%
70.01 - 75.00	1.750%	1.125%	1.125%	0.500%	0.500%
75.01 - 80.00	1.750%	1.250%	1.250%	0.500%	0.500%
80.01 - 90.00	NA	NA	NA	0.500%	0.500%

Additional Lock Terms	Fee
90 Day - add to 30 Day	0.125%

All LIBOR Arms	
1 Yr LIBOR as of 2/15/07	5.368%
Base Margin	2.250%

Issued By HSBC Mortgage Corporation (USA)

EQUAL HOUSING LENDER

EXHIBIT B

tabbies

Indymac Bank

HELOC/Closed End Seconds - Wholesale

Effective: 12/20/06 8:59 AM
e-MITS Help Desk: 1-888-88e-MITS

www.indymacb2b.com
e-MITS Lock Hours: 7:00AM - 5:00PM PST

Home Equity Line of Credit Base Margins (HELOC)

FULL DOC

Per Price Based on 60 day Best Effort		740+	720-739	700-719	680-699	660-679	640-659	620-639
HELOC 10/10	<=70% CLTV	(0.250)	(0.250)	(0.250)	(0.250)	0.000	0.500	1.500
	70.01 - 80% CLTV	(0.250)	(0.250)	(0.250)	(0.250)	0.125	1.000	2.000
	80.01 - 90% CLTV	(0.250)	(0.125)	0.000	0.000	0.250	2.250	3.500
	90.01 - 95% CLTV	0.375	0.500	0.500	0.750	2.875	3.750	4.500
	95.01 -100% CLTV***	0.750	0.875	0.875	1.000	3.250	n/a	n/a

STATED INCOME

Per Price Based on 60 day Best Effort		740+	720-739	700-719	680-699	660-679	640-659	620-639
HELOC 10/10	<=70% CLTV	0.000	0.000	0.000	0.500	0.500	1.750	n/a
	70.01 - 80% CLTV	0.000	0.000	0.000	0.500	0.500	2.250	n/a
	80.01 - 90% CLTV	0.000	0.000	0.250	0.500	1.750	3.500	n/a
	90.01 - 95% CLTV	0.500	0.750	0.875	1.750	3.000	n/a	n/a
	95.01 -100% CLTV***	1.000	1.125	1.750	3.250	n/a	n/a	n/a

***Purchase Only

HELOC Margin Adjustments	
Adjustment	Margin
Line Amount < $25,000	1.000
Line Amount $150,000-$249,999	(0.250)
Line Amount >=$250,000	(0.375)
DTI >45%	0.250
Second Home	0.250
Investment Property	0.500
All 1st lien Pay Option Arm (Neg Am)	0.500
Start Rate for 1st month after closing on all HELOCs	4.990
Fully Indexed Rate = Prime Rate + Margin	
Prime Rate	8.250

Margin Floor: (0.500%); Premium floor: 100.000

Premium (2:1)	Add to Margin
0.000 Point Rebate	0.000
1.000 Point Rebate	0.500
1.500 Point Rebate	0.750
2.000 Point Rebate	1.000

Max Premium Based on Initial Draw Percentage	
Initial Draw 0-24.99% of Line Amount	100.500
Initial Draw 25-49.99% of Line Amount	100.750
Initial Draw 50-74.99% of Line Amount	101.000
Initial Draw 75-100% of Line Amount	102.000

HELOC Highlights

- 1st liens now available in e-MITS
- Minimum payments are "interest only" or $100, whichever is greater
- Platinum credit card access included along with blank checks
- Qualify using Interest Only payment
- FastForward available at Full Doc margins for credit scores >700 with no additional adjustment (max 95% CLTV; concurrent transactions only)
- Refer to Lending Guide for additional program guidelines and restrictions
- No gross-up calculation up to 95% CLTV behind all Pay Option ARMs with maximum potential negative amortization up to 125%

Additional HELOC Program Guidelines

- Concurrent table funding fee: $0 Doc Prep fee: $0
- Standalone table funding fee: $125
- Early Termination Fee: $500 if closed within first 3 years, or as applicable by state law
- Annual fee is $75, waived the first year

Closed End Seconds Base Rates (CES)

FULL DOC

Per Price Based on 45 day Best Effort		740+	720-739	700-719	680-699	660-679	640-659	620-639
30/15 Fixed 15/15 Fixed (0 Yr PPP)	<= 80% CLTV	7.000	7.125	7.375	7.625	9.125	8.875	10.375
	80.01-90% CLTV	7.500	7.625	7.750	7.875	8.625	10.250	11.125
	90.01-95% CLTV	8.000	8.125	8.250	8.500	9.500	10.750	11.500
	95.01-100% CLTV	(N/A for standalones. Refer to 80/20 ratesheet for pricing on concurrent transactions)						

STATED INCOME

Per Price Based on 45 day Best Effort		740+	720-739	700-719	680-699	660-679	640-659	620-639
30/15 Fixed 15/15 Fixed (0 Yr PPP)	<= 80% CLTV	7.750	7.375	7.825	7.875	8.375	9.000	10.500
	80.01-90% CLTV	7.875	8.000	8.125	8.500	9.250	10.825	11.500
	90.01-95% CLTV	8.375	8.500	8.625	9.125	10.125	11.125	11.875
	95.01-100% CLTV	(N/A for standalones. Refer to 80/20 ratesheet for pricing on concurrent transactions)						

NO RATIO

Per Price Based on 45 day Best Effort		740+	720-739	700-719	680-699	660-679	640-659	620-639
30/15 Fixed 15/15 Fixed (0 Yr PPP)	<= 80% CLTV	8.250	8.375	8.625	8.875	9.375	10.000	11.500
	80.01-90% CLTV	8.875	9.000	9.125	9.500	10.250	11.625	12.500
	90.01-95% CLTV	9.375	9.500	9.625	10.125	11.125	12.750	13.750
	95.01-100% CLTV	(N/A for standalones. Refer to 80/20 ratesheet for pricing on concurrent transactions)						

Closed End Second Rate Adjustments	
Adjustment	Rate
3-4 units	0.500
Loan Amount < $20,000	0.500
Loan Amount >= $100,000 FICO >=680	(0.250)
Stand Alone 2nd <$50,000	0.750
All 1st lien Pay Option ARM (Neg Am) - (Concurrent Only)	1.000
>=680 or CLTV <=80%	
2 Yr HARD PPP	(0.125)
3 Yr HARD PPP	(0.250)
<680 and CLTV >80%	
2 Yr HARD PPP	(0.375)
3 Yr HARD PPP	(0.500)

Rebate (2:1)	Add to Rate
0.000 Point Rebate	0.000
0.500 Point Rebate	0.250
1.000 Point Rebate	0.500
2.000 Point Rebate	1.000
2.500 Point Rebate	1.250

Max Rebate		
Loan Amount	2 & 3 Yr PPP	No Prepay
<=$50,000	(2.500)	(1.500)
$50,001 - $99,999	(2.000)	(1.000)
$100,000 - $500,000	(1.500)	(0.500)

Closed End Second Highlights

- FastForward available at Full Doc margins for credit scores >700 with no additional adjustment (max 80% CLTV; concurrent transactions only)
- No gross-up calculation up to 95% CLTV behind all Pay Option ARMs (Concurrent)

Additional Closed End Second Program Guidelines

- Concurrent table funding fee: $0 Doc Prep fee: $0
- Standalone table funding fee: $125
- The posted rates do not ensure that the loan will pass any federal or state predatory lending tests. This can only be determined on the date the loan is closed with all the applicable fees and costs.

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Alt-A Products - Wholesale Conforming

Loan Amounts <= $ 417,000

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	3/1 LIBOR ARM 2/2/6 Caps 2.75 Margin		5/1 LIBOR ARM 5/2/5 Caps 2.75 Margin		7/1 LIBOR ARM 5/2/5 Caps 2.75 Margin		10/1 LIBOR ARM 5/2/5 Caps 2.75 Margin		30 Year Fixed		Interest Only 30 Year Fixed		15 Year Fixed	
	30 BE		30 BE		30 BE		30 BE		30 BE		30 BE		30 BE	
Rate	0-Yr Prepay	3-Yr Prepay	0-Yr Prepay	3-Yr Prepay	0-Yr Prepay	3-Yr Prepay	0-Yr Prepay	3-Yr Prepay	0-Yr Prepay	3-Yr Prepay	0-Yr Prepay	3-Yr Prepay	0-Yr Prepay	3-Yr Prepay
7.625	(2.125)	(2.875)	(2.875)	(4.125)	(2.500)	(3.625)	(3.000)	(3.750)	(2.875)	(3.250)	(2.500)	(2.875)	(3.000)	(3.375)
7.500	(2.000)	(2.750)	(2.750)	(4.000)	(2.375)	(3.500)	(2.750)	(3.500)	(2.750)	(3.000)	(2.375)	(2.625)	(2.875)	(3.250)
7.375	(1.875)	(2.625)	(2.500)	(3.750)	(2.125)	(3.250)	(2.500)	(3.250)	(2.500)	(2.875)	(2.125)	(2.500)	(2.750)	(3.125)
7.250	(1.750)	(2.375)	(2.375)	(3.500)	(2.000)	(3.125)	(2.250)	(3.000)	(2.375)	(2.625)	(2.000)	(2.250)	(2.750)	(3.125)
7.125	(1.500)	(2.250)	(2.125)	(3.375)	(1.750)	(2.875)	(2.000)	(2.750)	(2.250)	(2.500)	(1.875)	(2.125)	(2.625)	(3.000)
7.000	(1.375)	(2.125)	(2.000)	(3.125)	(1.625)	(2.625)	(1.750)	(2.500)	(2.125)	(2.250)	(1.750)	(1.875)	(2.375)	(2.750)
6.875	(1.125)	(1.875)	(1.750)	(3.000)	(1.375)	(2.375)	(1.500)	(2.125)	(1.875)	(2.125)	(1.500)	(1.750)	(2.125)	(2.500)
6.750	(1.000)	(1.625)	(1.500)	(2.750)	(1.125)	(2.125)	(1.125)	(1.750)	(1.750)	(1.875)	(1.375)	(1.500)	(1.875)	(2.250)
6.625	(0.750)	(1.375)	(1.250)	(2.500)	(0.875)	(1.875)	(0.875)	(1.500)	(1.375)	(1.500)	(1.000)	(1.125)	(1.625)	(2.000)
6.500	(0.625)	(1.250)	(1.125)	(2.250)	(0.625)	(1.625)	(0.500)	(1.125)	(1.125)	(1.125)	(0.750)	(0.750)	(1.250)	(1.625)
6.375	(0.375)	(1.000)	(0.875)	(2.000)	(0.375)	(1.250)	(0.250)	(0.750)	(0.750)	(0.875)	(0.375)	(0.500)	(0.875)	(1.250)
6.250	(0.250)	(0.750)	(0.625)	(1.625)	(0.125)	(0.750)	0.000	(0.500)	(0.500)	(0.500)	(0.125)	(0.125)	(0.500)	(0.875)
6.125	0.000	(0.625)	(0.375)	(1.250)	0.125	(0.375)	0.625	0.125	0.125	0.125	0.500	0.500	(0.250)	(0.625)
6.000	0.125	(0.375)	(0.125)	(0.875)	0.500	0.000	1.125	1.125	0.875	0.875	1.250	1.250	0.250	0.000
5.875	0.375	(0.125)	0.125	(0.500)	0.750	0.375	1.500	1.500	1.500	1.500	1.875	1.875	0.625	0.500
PRICE Adjustments (Apply to 3-Year Prepay Price)														
1-Year Hard Prepay	0.375		0.375		0.375		0.375		N/A		N/A		N/A	
2-Year Hard Prepay	0.250		0.250		0.250		0.250		N/A		N/A		N/A	

Doc Type PRICE Adjustments

LTV		<= 65	65.01-70	70.01-75	75.01-80	80.01-85	85.01-90	90.01-95
Full Doc	>= 720	(0.250)	(0.250)	(0.250)	(0.250)	(0.250)	(0.125)	(0.125)
	719-700	(0.125)	(0.125)	0.000	0.000	0.000	0.125	0.125
	699-680	0.000	0.000	0.000	0.125	0.125	0.250	0.250
	679-660	0.000	0.000	0.125	0.250	0.250	0.375	0.375
	659-620	0.000	0.125	0.250	0.375	0.375	0.500	0.500
Stated Income	>= 720	(0.250)	(0.125)	0.000	0.000	0.125	0.375	0.375
	719-700	0.000	0.000	0.250	0.375	0.500	0.750	0.750
	699-680	0.000	0.125	0.375	0.500	0.625	0.875	1.125
	679-660	0.000	0.250	0.500	0.625	0.750	1.000	1.250
	659-620	0.000	0.375	0.625	0.750	0.875	1.125	1.375
No Ratio	>= 720	(0.250)	0.000	0.125	0.125	0.250	0.500	0.750
	719-700	0.000	0.125	0.500	0.625	0.750	1.000	1.250
	699-680	0.000	0.250	0.625	0.750	0.875	1.125	1.375
	679-660	0.000	0.375	0.750	0.875	1.000	1.250	N/A
	659-620	0.000	0.500	0.875	1.000	1.125	1.375	N/A
NINA	>= 720	(0.250)	0.125	0.375	0.375	0.500	0.750	1.000
	719-700	0.000	0.250	1.000	1.125	1.250	1.500	1.750
	699-680	0.000	0.375	1.125	1.250	1.375	1.625	1.875
	679-660	0.125	0.500	1.250	1.375	N/A	N/A	N/A
	659-620	0.250	0.625	1.375	1.500	N/A	N/A	N/A
No Doc	>= 720	(0.250)	0.250	0.675	1.125	1.250	1.500	1.750
	719-700	0.000	0.375	1.250	1.625	1.750	2.000	2.250
	699-680	0.000	0.500	1.375	1.750	1.875	2.125	2.375
	679-660	0.125	0.625	1.500	1.875	N/A	N/A	N/A
	659-620	0.375	0.750	1.625	2.000	N/A	N/A	N/A

Interest Only RATE Adjustments - ARMs Only

Doc Type	Credit Score	<= 65	65.01-70	70.01-75	75.01-80	80.01-85	85.01-90	90.01-95
Full Doc	>= 700	0.000	0.000	0.000	0.000	0.000	0.000	0.125
	699-660	0.000	0.000	0.000	0.000	0.000	0.000	0.250
	659-620	0.000	0.125	0.125	0.125	0.125	0.125	0.250
All Other Doc Types	>= 700	0.000	0.000	0.000	0.000	0.000	0.000	0.250
	699-660	0.000	0.125	0.125	0.125	0.125	0.125	0.250
	659-620	0.000	0.250	0.250	0.250	0.250	0.250	0.250
All ARMs>90% LTV (Adjustment to Rate)		N/A	N/A	N/A	N/A	N/A	N/A	0.250

Property Type PRICE Adjustments

LTV	<= 65	65.01-70	70.01-75	75.01-80	80.01-85	85.01-90	90.01-95
Co-Op (NYC only)	0.000	0.250	0.250	0.250	0.250	0.375	0.500
Low Rise Condo	0.000	0.000	0.000	0.125	0.125	0.250	0.375
High Rise Condo	0.000	0.250	0.375	0.500	0.500	0.625	0.625
2 Units	0.000	0.000	0.000	0.125	0.125	0.250	0.375
3-4 Units	0.000	0.500	0.750	1.000	1.000	1.125	1.125

Other PRICE Adjustments

LTV	<= 65	65.01-70	70.01-75	75.01-80	80.01-85	85.01-90	90.01-95
40 due in 30 Amortization (RATE)	0.375	0.375	0.375	0.375	0.375	0.375	0.375
Cash Out	0.000	0.250	0.375	0.500	0.500	0.750	1.000
Second Home	0.000	0.125	0.250	0.375	0.375	0.625	0.750
Investment	0.000	0.500	1.000	1.250	1.250	1.500	1.750
DTI >50	0.000	0.125	0.125	0.250	0.250	0.250	0.375
Foreign National (Except Stated Income)	0.000	0.000	0.250	0.250	N/A	N/A	N/A
Foreign National (Stated Income Only)	0.125	0.125	0.500	0.625	N/A	N/A	N/A

State Adjustments

Tier 1	TX			
Tier 2	AL, AR, IN, LA, MI, MS, NC, ND, OK, SC, TN, WV			
Tier 3	AK, CO, CT, DE, FL, GA, IA, ID, KS, KY, MD, ME, MN, MO, MT, NJ NE, NM, NY, OH, OR, PA, SD, VA, WA, WI, WY			
Tier 4	AZ, CA, DC, HI, IL, MA, NH, NV, RI, UT, VT			
Loan size	Tier 1	Tier 2	Tier 3	Tier 4
>=$400,001	(0.750)	(0.625)	(0.500)	(0.375)
$400,000-$332,001	(0.625)	(0.500)	(0.375)	(0.250)
$332,000 - $275,001	(0.500)	(0.375)	(0.250)	(0.125)
$275,000 - $150,001	(0.375)	(0.250)	(0.125)	0.000
$150,000 - $100,001	(0.250)	(0.125)	0.000	0.125
$100,000 - $75,001	(0.125)	0.000	0.125	0.250
$75,000 - $50,001	0.250	0.375	0.500	0.625
<=$50,000	1.125	1.250	1.375	1.500

Maximum Rebates

	< 3Yr. Hard PPP	3 Yr. Hard PPP
Primary Residence	(2.000)	(2.500)
Investor/2nd Home	(1.500)	(2.000)

Rate Lock PRICE Adjustments

Period	Best Efforts
15 Days	(0.125)
45 Days	0.125
60 Days	0.375

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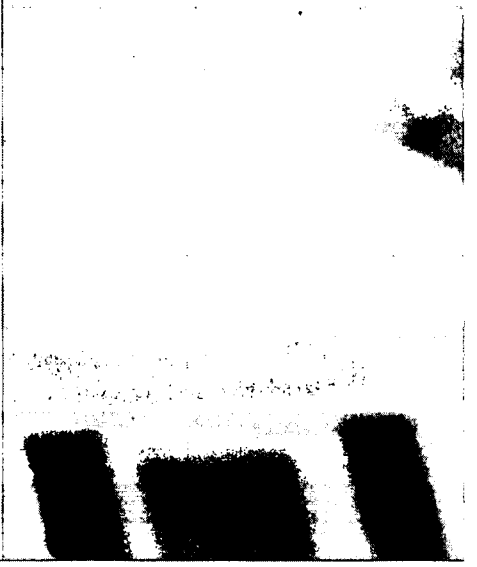

Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages

A research report by the
Center for Responsible Lending

Principal Investigator: Keith S. Ernst

January 2005

CENTER FOR RESPONSIBLE LENDING

www.responsiblelending.org

Introduction

Homeownership not only supplies families with shelter, it also provides a means of savings, allowing borrowers to build wealth and economic security. Home equity accounts for 76 percent of the median net worth of American households.[1] For those in the subprime market, however, prepayment penalties on home loans can cancel out the positive wealth-building effects of homeownership. When borrowers with subprime loans qualify for a more affordable loan during a prepayment penalty's effective period, they face a choice between depleting savings or staying locked in a higher-cost loan. Understanding the impact of prepayment penalties in subprime home loans on wealth-building is critical, because up to 80 percent of subprime mortgage loans include prepayment penalties, in contrast to only two percent of mortgages in the prime market.[2]

Industry representatives have long argued that borrowers with subprime loans are compensated for the negative effects of prepayment penalties by receiving a lower interest rate than otherwise would be available. To test this claim, the Center for Responsible Lending (CRL) investigated whether prepayment penalties convey benefits to borrowers commensurate with their costs. The evidence presented here shows that, in fact, borrowers with subprime loans fail to receive lower interest rates and, in some cases, actually pay a **higher** rate than similarly situated borrowers with subprime loans without prepayment penalties. Because a prepayment penalty makes it more difficult for other lenders to refinance a borrower into a better-priced loan, the fact that borrowers receive no interest savings makes prepayment penalties unfair and anticompetitive.

Key Findings

To assess how prepayment penalties affect interest rates in the subprime market, researchers from the Center for Responsible Lending (CRL) examined loan-level data from approximately half a million subprime loans.[3] Using multivariate regression models, CRL researchers analyzed fixed-rate, 30-year loans originated during a three-year period. We believe the research presented here is the most complete to date examining this aspect of prepayment penalties:

- In refinance loans, prepayment penalties produced **no statistically significant difference** in the interest paid by borrowers with subprime loans. In other words, borrowers with prepayment penalties paid similar interest rates to similarly situated borrowers who did not have penalties.
- For purchase loans, borrowers who had subprime loans with prepayment penalties paid **higher** interest rates than similarly situated borrowers who had subprime loans without prepayment penalties. For example, in 2002, borrowers with a 30-year, fixed-rate subprime purchase mortgage paid an interest rate that was **40 basis points (0.40%) higher** if their loan included a prepayment penalty than if it did not. As shown in the chart on page 5, these trends were consistent over the three-year period.
- For an estimated 380,000 borrowers that received subprime purchase loans in 2003, the lifetime cost of this higher interest rate is up to $881 million.

Background

Given the higher interest rates attached to subprime loans compared with prime loans, many prepayments are triggered when borrowers have established a stronger credit history. Prepayment is therefore a positive step for these borrowers, signaling the ability to qualify for a loan with more favorable terms. In the subprime market, however, prepayment penalties may alter this dynamic and harm borrowers in several ways:

1. Draining equity. Many homeowners with subprime loans have worked hard for years to accumulate equity in their homes. A prepayment penalty, routinely amounting to thousands of dollars, directly drains home equity when a borrower refinances.

2. Creating a high-cost trap. Sometimes borrowers simply cannot afford the cost of the prepayment penalty. In such cases, they may be forced to continue paying a higher interest rate when they could otherwise refinance and qualify for a more affordable loan.

3. Providing an incentive for kickbacks. When brokers deliver loans at a higher interest rate than the lender requires, the lender typically pays the broker a kickback, known as a "yield spread premium." Because lenders want to recoup the cost of the kickback even if the borrower pays off early, they are more willing to pay yield spread premiums on loans with prepayment penalties. For this reason, prepayment penalties facilitate brokers charging higher interest rates for borrowers who could otherwise qualify for lower rates.

Prepayment penalties have become increasingly common in the subprime market in recent years, at a level far out of proportion to the prime mortgage market. The wide disparity between the two markets raises substantial doubts as to whether consumer choice explains the prevalence of prepayment penalties in the subprime market, especially given these borrowers' incentive to build a good credit history and refinance as soon as feasible.

Prepayment rates are a significant issue for investors in both the prime and subprime markets, yet the two sectors manage prepayments in different ways. Those who originate, invest in, and purchase loans base their decisions on anticipated cash flows. Mortgage prepayments disrupt the expected stream of income and make it more challenging to project revenues over time. In the competitive prime market, where refinances are commonplace and prepayment penalties are rare, the market adjusts the pricing on loans and securities to account for prepayments. In the subprime market, lenders choose to manage early payoffs by using prepayment penalties to lock borrowers into loans or ensure additional revenues (through the cash received from the penalty itself) if borrowers do refinance.

In the prime mortgage market, prepayment risk is allocated among all borrowers, lenders and investors, and borrowers who can qualify for more affordable loans can do so without paying a penalty. In the subprime market, lenders and investors are able to minimize their own

prepayment risk at the expense of a large subset of borrowers who receive the burden of penalties without any offsetting interest rate benefit.

Current Regulation of Prepayment Penalties

Numerous states have passed laws and issued regulations that prohibit or restrict the use of prepayment penalties in the mortgage market. Currently, laws banning prepayment penalties are effective in at least nine states, including states that allow for limited exceptions.[4] Other states have imposed specific limits, including limits on (1) the amount of fees associated with the penalties; (2) permissible loan types; or (3) additional lender disclosure requirements.

A recent regulatory decision by the Office of Thrift Supervision has ensured that such state laws are in effect for state-based mortgage lenders, such as finance companies. Freddie Mac and Fannie Mae both have announced that they will not invest in subprime home loans with prepayment penalties that remain in effect for more than three years. These restrictions have had no discernible effect on the availability of subprime mortgages or the rapid growth of the subprime market. In 2000, the subprime mortgage market was $138 billion. Only three years later, the market had more than doubled, reaching $332 billion.[5] Today, one in every five mortgages is a subprime loan.[6]

Data and Methodology

To measure the effect of prepayment penalties on subprime mortgage interest rates, CRL researchers used multivariate regression models to estimate separate results for each year 2000-2002 and for fixed-rate loan products (30-year purchase mortgages and 30-year refinances). The study relied on a relevant subset from the Loan Performance Asset-Backed Securities Database (ABS Database) of securitized subprime loans.[7] The database contains an array of variables at the loan level, including many variables not available in other national mortgage databases such as FICO scores, loan-to-value ratios, debt-to-income ratios, and the length of prepayment penalty terms.

A potential confounding factor is that borrowers may choose a particular loan-to-value ratio (LTV) to achieve a desired interest rate. To better isolate the association between interest rates and prepayment penalties, it was necessary to use a specific statistical technique (least squares instrumental variables estimation) to better estimate the effect of variables correlated with LTV. This method increases confidence that the results accurately reflect relationships between prepayment penalties and loan pricing, rather than the effects of LTV.

Characteristics of Subprime, 30-Year, Fixed Rate Mortgages in ABS Database

Number of loans	1,190,500
Origination period	2000 – 2002
Refinances	65%
Single-family residences	74%
Mean loan amount	$171,956
Loans with prepayment penalties	40%

Variables*

- Geography
- Loan-level underwriting factors, (e.g., credit score, LTV)
- Individual loan characteristics (e.g., loan amount, adjustable vs. fixed, level of documentation)
- Residence type

* For a complete list of variables, see Appendix 1.

Findings

Interest Rate Effects of Prepayment Penalties

For 30-year, fixed-rate subprime purchase loans, the prepayment penalty coefficient is positive and statistically significant in all models, indicating that the presence of a prepayment penalty is associated with an increase in interest rates. For 30-year, fixed-rate subprime refinances, the presence of a prepayment penalty had no consistent, meaningful impact on interest rates.

For complete results on both types of loans, see Appendix 2.

The Effect of Prepayment Penalties on Subprime Mortgage Interest Rates

Interest Rate Changes Associated with Penalties (in rounded basis points)

Loan Type	2000	2001	2002
30-yr. FRM refinances	-9*	+2	0
30-yr. FRM purchases	+39*	+51*	+40*

*Statistically significant at a 99.9% confidence level (p< 0.001 level).

These initially counter-intuitive results contrast with the other variables analyzed, which consistently produce the expected results. For example, FICO scores and interest rates have a strong negative relationship: a 100-point increase in a FICO score decreases the interest rate by 90 - 120 basis points, all other things equal. Similarly, LTVs and debt-to-income ratios were positively associated with interest rates on loans, meaning that higher LTVs and debt-to-income ratios increased rates borrowers received.

The Costs of Higher Interest Rates Associated with Prepayment Penalties

Higher interest rates associated with prepayment penalties on subprime purchase loans impose significant additional cost on families over time. Assuming a 30-year subprime purchase loan of $120,000 with a fixed interest rate of 8.4 percent (versus the 8 percent rate the borrower likely would have received without a prepayment penalty), borrowers would pay more than $2,000 in additional interest over a five-year period if their loan included a prepayment penalty. If held to maturity, borrowers would pay more than $12,000.

The cost implications become even more compelling when considered in the context of the entire subprime market. We estimate that borrowers who took out subprime purchase loans with prepayment penalties in 2003 will pay up to $881 million in extra interest alone over the life of their loans, without even considering the cost of the prepayment penalty fee.

This estimate is derived from an analysis of a subset of the ABS Database,[8] which shows that 60,000 borrowers would pay $139 million in extra interest over the life of their loans.[9]

Extending that result to the larger ABS Database and then to the subprime market as a whole, and adjusting for actual market volume,[10] we arrive at the estimate of up to $881 million in extra interest for borrowers with subprime purchase loans.

This extra cost is imposed on borrowers who must, in addition, pay a substantial fee if they refinance during the penalty term. While this analysis does not project the total prepayment penalty fees borrowers with subprime loans will incur as a result of early loan payoffs, we note that 2003 borrowers' total exposure to potential subprime prepayment penalties is $7.0 billion.[11]

Even for subprime refinance mortgages, which showed neither an interest benefit nor a cost associated with subprime prepayment penalties, CRL's findings stand in sharp contrast to claims touting the benefits of such penalties. For example, Countrywide Financial Corporation is among the lenders who imply that prepayment penalties help keep interest rates relatively low for subprime borrowers, and that eliminating penalties will contribute to "significantly higher interest rates and monthly payments for borrowers who can least afford them."[12] However, our analysis shows that borrowers in the subprime market fail to realize the purported interest rate benefits of prepayment penalties while relinquishing valuable savings from their home equity.

Conclusion and Comments

While lenders may discount interest rates to brokers for loans with prepayment penalties, this research suggests that borrowers in the subprime market do not receive these benefits. In fact, prior research has identified a "principal-agent" issue that finds brokers seizing on similar benefits for themselves at the expense of borrowers.[13] With respect to prepayment penalties, the expense is also shared by other lenders that will find it more difficult, if not impossible, to compete to offer a rate low enough to entice a rational borrower with a prepayment penalty to refinance. In this light, prepayment penalties operate to reduce competition in the mortgage market.

One interesting aspect of our findings is the marked difference in the results for subprime purchase and refinance loans. Prepayment penalties are associated with a significant increase in interest rates on subprime purchase loans, but have no meaningful impact on subprime refinances. One possible explanation for this difference lies in the typical financial positions of borrowers in the purchase and refinance markets. Borrowers who seek purchase loans in the subprime market likely have the minimum amount of assets needed to get a loan.[14] Faced with the reality that the borrower has little or no excess equity, brokers and others involved in the transaction have a strong motive to seek alternative ways to get paid, including yield-spread premiums based, at least indirectly, on prepayment penalties. For refinancing borrowers, the motivation to seek such forms of compensation may be weaker, since the borrower typically has accumulated equity that can be used as a resource to pay up-front fees. Still, findings show that in a subprime refinance transaction, borrowers are receiving no benefit from the prepayment penalty in the form of reduced interest.

CRL's findings strongly suggest that prepayment penalties in subprime loans are not serving borrowers' best interests. The data here indicate that the purported tradeoff between prepayment penalties and interest rates in subprime loans is essentially nonexistent as borrowers receive the burdens of penalties without compensating benefits. Once the penalty is in place, the borrower's ability to build wealth is significantly hampered since the borrower either continues to pay excess interest or gives up accumulated home equity to get a better loan.

Finally, we believe the issue of prepayment penalties should be viewed in light of longstanding policies designed to support and facilitate affordable mortgage credit. Homeownership provides one of the most accessible ways that lower-income, working families can achieve sustainable economic security. By burdening such families with prepayment penalties, the subprime mortgage market perpetuates a practice that is directly counter to these important national priorities.

About the Center for Responsible Lending

The Center for Responsible Lending is a nonprofit, nonpartisan research and policy organization dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions.

For additional information, please visit our website at **www.responsiblelending.org**.

Notes

[1] Shawna Orzechowski and Peter Sepielli, "Net Worth and Asset Ownership of Households: 1998 and 2000," U.S. Department of Commerce, Economics and Statistics Administration – U.S. Census Bureau (P70-88), May 2003, p. 15.

[2] *See* Standard & Poor's, "NIMS Analysis: Valuing Prepayment Penalty Fee Income," at http://www.standardandpoors.com (January 3, 2001); *see also* Standard & Poor's, "Legal Criteria Reaffirmed for the Securitization of Prepayment Penalties," at http//www.standardandpoors.com (May 29, 2002); "Prepayment penalties prove their merit for subprime and 'A' market lenders," http://www.standardandpoors.com (January 3, 2001); *see also* "Freddie offers a new A-, prepay-penalty program," *Mortgage Marketplace*, at 1-2 (May 24, 1999); see *also* Joshua Brockman, "Fannie revamps prepayment-penalty bonds," *American Banker* at 16 (July 20, 1999).

[3] The regression analyses in this report were performed by Christopher A. Richardson. The conclusions presented are those of the Center for Responsible Lending and should not be attributed to Mr. Richardson. Our data source was the Loan Performance Asset-Backed Securities database (ABS database). For more information on this data set, *see* John Farris and Christopher A. Richardson, "The Geography of Subprime Mortgage Prepayment Penalty Patterns" in *Housing Policy Debate* (Fannie Mae Foundation), vol. 15, issue 3 (2004).

[4] For example, in North and South Carolina, the ban on prepayment penalties is limited to loan amounts less than $150,000.

[5] *Mortgage Statistical Annual*, March 2004.

[6] *Inside Mortgage Finance's Inside B&C Lending*, November 15, 2004 (vol. 9, issue 23), p. 3.

[7] *See* note 3.

[8] Fixed-rate, 30-year subprime loans originated in 2003 and recorded in the database.

[9] We assume an average loan life of 3.6 years based on subprime prepayment curves from Standard & Poor's and Fitch Ratings.

[10] To extend the analysis to the full ABS Database, we assume that the remaining purchase loans not studied exhibit the same increase in interest rates. Next, to extend the results to the full market, we multiply this figure by the proportion of total estimated 2003 subprime volume (as listed in the Mortgage Statistical Annual) divided by the total volume of loans in the ABS Database.

[11] This figure is calculated as the product of the following three conservative estimates: $332 billion total subprime market volume in 2003, 70 percent of subprime loans with prepayment penalties, three percent average maximum prepayment penalty fee. In 2001, CRL estimated that borrowers of subprime home loans cumulatively paid $2.3 billion in penalties each year. *See* Eric Stein, "Quantifying the Economic Cost of Predatory Lending," Coalition for Responsible Lending (2001) at http://www.responsiblelending.org).

[12] *See, e.g.*, testimony of Sandy Samuels on behalf of Countrywide Financial Corporation and the Housing Policy Council of the Financial Services Roundtable before the Subcommittees on Financial Insititutions and Housing – U.S. House of Representatives, March 30, 2004.

[13] *See, e.g.*, Howell E. Jackson & Jeremy Berry, "Kickbacks or Compensation: The Case of Yield Spread Premiums" (January 2002) at http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf. *See also* William C. Apgar and Allen J. Fishbein, "The Changing Industrial Organization of Housing Finance and the Changing Role of Community-Based Organizations," (May 2004) at www.jchs.harvard.edu/publications/finance/babc/babc/_04-9.pdf, p.9.

[14] In fact, among loans examined for this study, borrowers with refinances had almost twice as much equity available as the purchase loan borrowers.

APPENDIX 1

Definition of Variables

Variable Name	Description
Prepayment Penalty	
PPP	Loans with prepayment penalty
Borrower's Creditworthiness	
FICO	Borrowers' credit score at origination
DTI	Borrowers' debt to income ratio
Borrower's Share of Equity	
LTV	Origination loan to value ratio
Jumbo Mortgages	
Jumbo	Loans with amounts larger than the Fannie Mae/Freddie Mac conforming loan limit, which is $300,700, $275,000, and $252,700 for 2002, 2001 and 2000, respectively.
Minority Concentration	
Min%	Percentage of residents in each zip code who are, not single-race Caucasian. Latinos and multiracial individuals are classified as minority even if one of the races they self-identify as is Caucasian. Zip code information is from LP database. Minority percentage is from the Summary File 2 (SF2) database of the 2000 Census.
Loan Documentation Level	
Low-doc	Low loan documentation level
No-doc	No loan documentation
Mortgage Property Type	
Condo	Condo
Coop	Coop
2-4 unit	2-4 unit residence
TH	Townhouse
PUD	Planned unit development
MH	Manufactured housing
Origination Seasonal Effects	
Feb-Dec	February to December dummies

APPENDIX 2

Full results for the ordinary least squares (OLS) and instrumental variables (IV) regressions are presented on the following pages. For reasons detailed in the methodology sections, the reported results in the paper rely on the output from the IV regressions.

In each case, the reported coefficients represent the estimated change in interest rate for a one-unit change in each variable. In the case of variables with a continuous distribution, such as FICO scores, results should be understood to mean changes in interest rate holding other variables constant. In the case of dummy variables (variables that describe discreet categories, such as whether or not a loan has a prepayment penalty), the coefficient represents the estimated change in interest rate when the dummy variable changes from an omitted reference category to the indicated status holding other variables constant.

For example, since the IV coefficient for 30-year fixed rate purchase loan borrowers with prepayment penalties in 2002 (PPP in the third column of the first table of Appendix 2) is 0.403, we can say that the model estimates that these borrowers' interest rates were 0.403 percentage points higher than those of borrowers without prepayment penalties. In other words, the change in status here associated with the dummy variable is from a loan without a prepayment penalty to a loan with a prepayment penalty.

For each coefficient, it is also interesting to observe the associated confidence level, revealed by the t-statistic. A t-statistic with an absolute value of 3.3 indicates that the estimated coefficient differs from zero by a statistically significant amount at a 99.9 percent confidence level. Similar measurements of 2.6 and 2.0 indicate that the measurement is different from zero by a statistically significant amount at a 99 and 95 percent confidence level, respectively.

Finally, readers wishing to understand the extent to which variables in the models explain the variation in interest rate on home loans in the dataset should review the line at the bottom of each regression set that lists the associated adjusted R-squared measurement. For example, looking again at the first IV regression column in the first table, the adjusted R-squared measurement of 0.536 indicates that the model explained 53.6% of all variation in interest rates. This suggests that while the model could benefit from the inclusion of other unknown variables that may also explain differing interest rates, it nonetheless explains a majority of the variation in interest rates.

Appendix 2 (cont.)

30-Year Fixed Rate Purchases

	2002				2001				2000			
	OLS		IV		OLS		IV		OLS		IV	
	Coeff.	t-stat	Coeff.	t-stat	Coeff.	t-stat	Coeff.	t-stat	Coeff.	t-stat	Coeff.	t-stat
Const.	13.45	146.2	12.288	105.7	15.292	105.4	13.532	75.1	14.713	104.6	13.263	77.4
PPP	0.411	59.5	0.403	57.2	0.474	48.5	0.507	49.4	0.374	34.5	0.386	34.6
FICO*	-0.009	-174.0	-0.009	-168.4	-0.01	-144.0	-0.011	-134.8	-0.009	-119.3	-0.009	-108.4
LTV*	0.02	72.1	0.035	37.0	0.018	46.7	0.042	29.3	0.01	23.6	0.032	21.7
DTI*	0.002	6.8	0.002	9.9	0.004	11.4	0.005	16.0	0.006	18.7	0.007	20.2
Jumbo	-0.102	-11.5	-0.047	-4.9	-0.225	-19.7	-0.145	-11.5	-0.188	-15.0	-0.121	-8.9
Min%*	0.302	20.6	0.24	15.6	0.447	23.2	0.361	17.6	0.36	17.7	0.291	13.6
Low	0.21	31.1	0.294	34.7	0.219	22.1	0.364	27.7	0.128	12.1	0.247	18.7
No	0.665	52.2	0.735	53.9	0.675	33.6	0.803	36.5	0.706	26.6	0.825	29.1
Condo	0.05	4.5	0.0526	4.6	0.069	4.5	0.077	4.9	0.07	4.2	0.088	5.1
Coop	0.518	8.2	0.625	9.7	0.332	5.5	0.512	8.1	0.515	8.3	0.691	10.6
2-4 unit	0.124	9.6	0.119	9.0	0.161	8.8	0.159	8.4	0.044	2.4	0.032	1.7
TH	0.046	1.2	0.029	0.8	0.032	0.7	0.014	0.3	0.047	1.2	0.062	1.6
PUD	-0.151	-17.5	-0.14	-15.8	-0.156	-13.1	-0.136	-11.1	-0.142	-10.1	-0.111	-7.6
MH	0.378	12.3	0.429	13.6	0.425	12.3	0.487	13.6	0.355	10.4	0.427	12.1
Feb	-0.105	-6.1	-0.109	-6.2	-0.22	-9.8	-0.218	-9.5	0.033	1.5	0.012	0.5
Mar	-0.214	-13.0	-0.223	-13.3	-0.339	-16.1	-0.333	-15.3	0.081	3.7	0.062	2.7
Apr	-0.198	-12.5	-0.21	-13.0	-0.431	-20.5	-0.425	-19.6	0.102	4.5	0.062	2.7
May	-0.34	-21.9	-0.346	-21.9	-0.425	-20.9	-0.421	-20.0	0.251	11.7	0.207	9.2
Jun	-0.49	-31.9	-0.507	-32.3	-0.408	-20.2	-0.411	-19.7	0.264	12.7	0.218	10.1
Jul	-0.635	-41.5	-0.658	-42.0	-0.48	-24.0	-0.495	-23.9	0.219	10.3	0.17	7.6
Aug	-0.786	-51.4	-0.805	-51.5	-0.576	-29.7	-0.583	-29.1	0.181	8.5	0.133	6.0
Sep	-0.922	-59.7	-0.945	-59.8	-0.714	-35.0	-0.72	-34.2	0.133	6.1	0.076	3.4
Oct	-1.012	-65.9	-1.03	-65.6	-0.926	-46.7	-0.944	-46.1	0.061	2.8	0.002	0.1
Nov	-1.046	-65.9	-1.064	-65.5	-1.08	-53.7	-1.102	-52.9	0.048	2.2	-0.003	-0.1
Dec	-1.099	-70.6	-1.113	-70.0	-0.871	-42.7	-0.904	-42.8	-0.116	-5.3	-0.175	-7.6
# obs.	77,491		77,491		60,806		60,806		50,636		50,636	
Adj. R^2	.556		0.536		.556		.536		.537		0.522	

Appendix 2 (cont.)

30-Year Fixed Rate Refinances

	2002				2001				2000			
	OLS		IV		OLS		IV		OLS		IV	
	Coeff.	t-stat	Coeff.	t-stat	Coeff.	t-stat	Coeff.	t-stat	Coeff.	t-stat	Coeff.	t-stat
Const.	15.621	170.2	14.424	141.3	18.302	124.7	16.96	103.4	17.516	123.0	14.84	73.4
PPP	0.033	4.8	-0.001	-0.1	0.023	2.7	0.015	1.6	-0.043	-3.6	-0.092	-6.8
FICO*	-0.011	-260.4	-0.012	-254.3	-0.013	-237.4	-0.014	-229.6	-0.012	-147.6	-0.012	-132.6
LTV*	0.009	50.2	0.027	45.4	0.005	18.8	0.023	25.0	-0.004	-12.3	0.037	18.6
DTI*	0	2.5	-0.001	-2.9	0.002	7.0	0.001	5.3	-0.002	-5.7	-0.003	-9.3
Jumbo	-0.231	-28.3	-0.223	-26.4	-0.302	-28.7	-0.289	-26.7	-0.335	-19.2	-0.369	-19.1
Min%*	0.321	27.1	0.268	21.7	0.474	33.4	0.443	30.2	0.489	27.7	0.431	21.9
Low	0.139	23.4	0.22	33.0	0.174	21.5	0.273	28.5	0.139	11.6	0.371	21.6
No	0.271	15.4	0.355	19.3	0.535	20.0	0.64	22.9	0.482	10.4	0.768	14.5
Condo	0.084	5.9	0.064	4.4	0.111	5.3	0.104	4.8	0.115	3.5	0.065	1.8
Coop	0.964	10.0	1.064	10.7	0.628	6.4	0.813	8.1	0.815	6.2	1.256	8.5
2-4 unit	0.042	3.3	0.072	5.5	0.109	5.8	0.151	7.8	0.006	0.3	0.065	2.5
TH	0.085	2.2	0.069	1.7	0.144	3.7	0.136	3.4	0.355	9.5	0.31	7.5
PUD	-0.142	-13.6	-0.158	-14.8	-0.118	-8.2	-0.129	-8.7	-0.136	-5.4	-0.178	-6.4
MH	0.477	23.7	0.516	24.8	0.443	19.2	0.481	20.3	0.307	11.7	0.363	12.5
Feb	0.083	5.7	0.075	5.0	-0.321	-17.8	-0.315	-17.0	0.034	1.6	0.046	2.0
Mar	0.044	3.1	0.039	2.7	-0.496	-29.1	-0.493	-28.1	0.133	6.5	0.139	6.1
Apr	0.019	1.4	0.013	1.0	-0.62	-36.3	-0.612	-34.8	0.219	10.0	0.225	9.3
May	-0.019	-1.4	-0.029	-2.0	-0.675	-40.2	-0.662	-38.4	0.27	12.5	0.267	11.2
Jun	-0.128	-9.2	-0.145	-10.1	-0.649	-38.0	-0.638	-36.3	0.371	17.1	0.365	15.3
Jul	-0.249	-18.4	-0.279	-20.0	-0.655	-39.1	-0.645	-37.4	0.384	17.4	0.38	15.5
Aug	-0.441	-33.8	-0.471	-35.0	-0.737	-44.3	-0.737	-43.1	0.337	15.8	0.318	13.4
Sep	-0.527	-41.7	-0.559	-42.8	-0.832	-46.7	-0.834	-45.6	0.358	16.3	0.343	14.1
Oct	-0.663	-52.6	-0.692	-53.2	-1.081	-64.1	-1.088	-62.8	0.237	11.3	0.218	9.4
Nov	-0.744	-59.6	-0.771	-59.8	-1.225	-70.9	-1.224	-69.0	0.185	8.8	0.159	6.8
Dec	-0.838	-68.2	-0.854	-67.4	-1.194	-69.2	-1.187	-67.0	0.116	5.5	0.088	3.8
# obs.	141,661		141,661		103,229		103,229		66,538		66,538	
Adj. R^2	.559		.544		.611		.598		.480		.432	

The Effect of Prepayment Penalties on Subprime Borrowers' Decisions to Default: A Perfect Storm

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Abstract

We present a continuous time option pricing model for mortgage valuation to examine the effects of a prepayment penalty on the default and the prepayment decision of subprime borrowers. We show that the options embedded in the mortgage contract have significant positive values to the mortgage borrower. In particular, the value of the prepayment option to the subprime mortgage borrower is significant. The prepayment penalty prevalent in subprime mortgage contracts has two effects on the subprime borrower's mortgage termination decision: First, the prepayment penalty makes prepayment or refinancing difficult. Second, the prepayment penalty increases the likelihood of default by subprime borrowers because it reduces the option values of mortgage contracts. Because of these two effects, the default decision of the subprime borrower becomes more susceptible to house price depreciation. Consequently, there was a sharp increase of default in the subprime mortgage market with a drastic house price depreciation in 2006.

JEL classification: G01, G21, D53
Keywords: Subprime mortgages, prepayment penalty, default, option values

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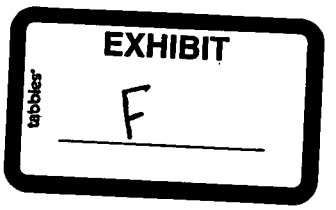

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1 Introduction

We are in the middle of an economy-wide financial crisis with the subprime mortgage market at the epicenter of the crisis. The first sign of trouble was a sudden increase of default in the subprime mortgage market with a drastic house price depreciation in 2006. What caused this sudden increase in default rates in the subprime mortgage market after many years of high prepayment rates? This paper is an attempt to answer this question. This is of interest to academics, policy makers, and the general public.

We present a continuous time version of an option pricing model for mortgage valuation to examine the effects of a prepayment penalty on the default and the prepayment decision of subprime borrowers. Our study shows that a sudden increase of default in the subprime market is caused by the prepayment penalty, that is prevalent in subprime mortgage contracts, along with house price depreciation. These two together have generated a perfect storm in subprime mortgage market.

This paper demonstrates that the prepayment penalty has two effects on the subprime borrower's mortgage termination decisions. The prepayment penalty makes prepayment or refinancing prohibitively costly. Equity extraction from house price appreciation is the key to the subprime mortgage design. And this equity extraction from house price appreciation is only possible through the prepayment. With a high prepayment penalty, this prepayment option is not available to the subprime mortgage borrowers.

The options embedded in mortgage contracts add economic value to the mortgage borrower since these options provide partial protection from the volatility of house prices. In particular, the value of the prepayment option to the subprime mortgage borrower is signif-

icant. The prepayment penalty increases the likelihood of default by subprime borrowers because the penalty reduces the option values of mortgage contract. By these two effects of the prepayment penalty, the subprime borrowers become more vulnerable to default caused by the house price depreciation. This inability to refinance mortgage loans and the high default point, induced by the prepayment penalty translated into a high rate of mortgage defaults and foreclosures. Consequently, borrower default began to increase as house price started to depreciate in 2006.

The paper is organized as follows. In section 2, we consider mortgages as financial assets that generate dividends in the form of the housing services. We characterize a mortgage as a fixed income derivative with two options- default and prepayment. We formulate a general mortgage valuation model as a stochastic control problem in continuous time and reformulate the problem as an optimal stopping problem reducing it to a free-boundary problem. We then derive the Hamiltonian-Jacobi-Bellman equation for the stochastic control problem. In section 3, we consider the simplest case where the mortgage contract only has the default option. We derive an explicit functional form for optimal default and other important expressions related to mortgages such as loan to value (LTV) ratio, yield and recovery rate (RR). We also show how optimal default is affected by the parameters. In section 4, we consider the case when the borrowers also have a prepayment option, as this is essential to the analysis of the subprime mortgages. In section 5, we investigate the option values embedded in the mortgage contract to show how these option values affect the default decision of mortgage borrowers. It turns out that the default and prepayment decisions are both closely related to the value of options. Because one of the distinctive characteristics of subprime mortgages is the prevalence of prepayment penalties, we include the prepayment penalty in section 6. We analyze how its inclusion affects the default decision of subprime borrowers. Section 7 concludes.

2 Mortgage valuation

The most prominent contractual feature of mortgage loans, compared to other loan contracts, are the length of maturity and the possibility of early termination, through either prepayment or default. A mortgage lender does not just lend money but also gives the borrower the right and the option to default or to prepay. Thus the borrower can decide whether to continue the mortgage contract by paying the periodic payment or to terminate the contract by exercising the given options. This possibility of early termination of the mortgage contract becomes a serious risk to the lender. Quantifying and managing these risks is essential for the mortgage lender. In this section, we present a mortgage valuation model that captures these unique features of the mortgage contract.

The financial asset, the house generates housing services, x, as dividends. Housing services can be interpreted as the difference between rental income and other expenses owning house. We assume that the housing service follows a geometric Brownian motion with drift.

$$dx = \alpha x\, dt + \sigma x\, dz, \tag{1}$$

where α is the growth rate of housing services, σ is the volatility parameter of the housing services, and dz is the increment of the standard Wiener process. We capture the uncertain future stochastic economic environment or the underlying source of uncertainty by this stochastic process.

The price of housing equals the expected present value of future housing services.

$$P(x(t)) = \mathbb{E}_t \left[\int_{\tau=t}^{\infty} e^{-\rho(\tau-t)} \, x(\tau) \, d\tau \right] = \frac{x(t)}{\rho - \alpha} , \tag{2}$$

where $\mathbb{E}_t$ denotes the expectation based on the information as of time t, and ρ denotes an exogenous discount rate. We set $x(0)$, the value of housing services at the mortgage origination date, equal to 1.

We consider the mortgage as a derivative asset whose value is derived from the value of the underlying asset, the house. The price of a house is determined by the housing services from equation (2). Thus the value of mortgage $M(x(t))$ is also determined by the housing services.

Given the housing price in equation (2), the house owner minimizes her mortgage liability by choosing an optimal time to exercise termination options. This is equivalent to maximize her equity since her equity on housing is the difference between housing price and the mortgage liability.[1]

$$E(x(t)) = P(x(t)) - M(x(t)) \tag{3}$$

We formulate the home owner's problem as a stochastic control problem in continuous time and reformulate the problem as an optimal stopping problem and reduce the problem to a free-boundary problem. In general, optimal stopping problems are two-dimensional in the sense that they consist of finding the unknown value function and the unknown optimal boundaries (or unknown expiration date T) simultaneously; the value function can be seen as a function of unknown stopping boundaries. We find the solution in reverse order: First, we find the free-boundaries of the differential equation. Second, we find the optimal stopping level of the state variable, that is, we determine the optimal default point and the optimal

[1] Home equity is the current market value of a house minus the outstanding mortgage balance.

prepayment point. Finally, we solve the initial continuous time stochastic control problem.

We assume that the termination of contract occurs solely for financial considerations. We denote two thresholds as x_{**} and x^*: the default point x_{**}, is the level of housing services where the house owner optimally exercises the default option; prepayment point x^*, is the level of housing services where the house owner optimally exercises the prepayment option.[2] Thus these options are at the money at x_{**} and at x^* respectively.

We define the optimal stopping time of default as

$$T(x_{**}) = \inf \{ t \geq 0, x(t) \leq x_{**} \}$$

and the optimal stopping time of prepayment as

$$T(x^*) = \inf \{ t \geq 0, x(t) \geq x^* \}$$

The random time variables $T(x_{**})$ and $T(x^*)$ denote the first passage times that the housing services x hits the down-barrier x_{**} and up-barrier x^*, respectively. Let's define a random variable $T = T(x_{**}) \wedge T(x^*)$ as the first time the process $x(t)$ reaches default point x_{**} or prepayment point x^*. Thus T is the optimal stopping time of the mortgage contract, i.e., the optimal termination time of mortgage contract.

The home owner's decision problem is to choose the level of x where she optimally exercises the options and terminates the mortgage contract. She has to decide whether the future expected gain from maintaining the mortgage contract will outweigh the loss due to terminat-

[2] x_{**} is a down barrier and x^* is a up barrier for this stochastic process. The two barriers are so called absorbing barriers, since the process x is killed as soon as it hits one of the barriers. Therefore, the mortgage is a knock-out type double barrier option.

ing mortgage contract. Therefore her optimization is with respect to the choice of threshold values x_{**} and x^*.[3] The home owner is confronted with the following optimization problem. The principle of optimality implies that E satisfies the Bellman equation.

$$
\begin{aligned}
E(x) = \sup_{x_{**},\, x^*} \Bigg\{ & \mathbb{E}_x \left[\int_{\tau=0}^{T} e^{-\rho\tau} \left(x(\tau) - c\right) d\tau \right] \\
& + \mathbb{E}_x \left[e^{-\rho T} \mid x(T) = x_{**} \right] E(x_{**})\, Pr[\, x(T) = x_{**}\,] \\
& + \mathbb{E}_x \left[\, e^{-\rho T} \mid x(T) = x^* \,\right] E(x^*)\, Pr[\, x(T) = x^*\,] \Bigg\} \\
\text{subject to} \quad & dx = \alpha x\, dt + \sigma x\, dz \quad \text{and} \quad x(0) = 1\,,
\end{aligned}
\tag{4}
$$

where x is a state variable for this stochastic control problem and $E(x)$ denote the expected discounted equity from following an optimal policy given the initial state $x(0) = 1$. Thus, the equity function $E(x)$ is the value function. The first term in equation (4) is the expected present value of equity for the periods before the home owner terminates mortgage contract. The second term is the expected present value of equity when the home owner defaults. The last term is the expected present value of equity when the home owner prepays. $E(x)$ is the sum of three terms.

The default point x_{**} and prepayment point x^* are the optimal stopping levels of x. These thresholds or cutoff points x_{**} and x^* separate the whole range of x into three regions: region below x_{**}, region between x_{**} and x^*, and the region above x^*. The region between x_{**} and x^* is called inaction or continuation region where the continuation of payment is optimal and no option is exercised. Other two regions, the region below x_{**} and the region above x^* are optimal stopping or the mortgage termination region. In the region below x_{**}, exercising the

[3] The advantage of this dynamic programming over the other methods is that it is possible to use this approach when the constraints are stochastic but usually the solution is a nonlinear PDE.

default option is optimal and in the region above x^* exercising prepayment option is optimal for the house owner.

For the continuation region where the home owner doesn't exercise options, i.e., for the open interval (x_{**}, x^*), or for the time periods $[0, T)$, we can make the probability of reaching either threshold arbitrarily small by setting dt sufficiently small.

Thus from equation (4), we have

$$E(x(t)) = \mathbb{E}_x \left[\int_{\tau=0}^{t} e^{-\rho\tau} \left(x(\tau) - c\right) d\tau \right] \quad \text{for } x \in (x_{**}, x^*) . \tag{5}$$

Notice that there is no maximization operator on the right hand side since no action is taken, i.e., no option is exercised in the interval (x_{**}, x^*). In this inaction region, the homeowner just pays a periodic payment c and receives the housing services x without exercising any mortgage option.

It follows from (5) and from the principle of optimality that

$$E(x) = (x - c)\, dt + e^{-\rho\, dt}\, \mathbb{E}_x[E(x')] \qquad \forall\, x \in (x_{**}, x^*) \tag{6}$$

where x' is the next period housing services so $x' = x + dx$. We dropped time t from the equation since this equation is independent from time. The equation holds for all t as far as x is in (x_{**}, x^*). Therefore the value function $E(x)$ is common to all $t \in [0, T)$. The current state $x(t)$ matters, but the calender date t by itself has no effect.

The first term on the right-hand side is the immediate net housing service from holding the mortgage contract. The second term constitutes the continuation value of the mortgage

holding. The important point here is that the home owner maximizes her equity considering not just the immediate payout, net housing service $(x-c)\,dt$, but also the future value of equity $\mathbb{E}_x[E(x')]$. Therefore, the homeowner's mortgage termination decision depends on the net housing services and on the future expected value of equity.

By expanding the right hand side of (6) we have

$$E(x) = (x-c)\,dt \;+\; (1-\rho\,dt+O(dt))\;\mathbb{E}_x\,[\,E(x)+dE(x)\,],$$

where $O(dt)$ is the sum of higher-order terms in dt. We omit $O(dt)$ and rearrange terms in the equation to have following stochastic differential equation

$$\rho\,E(x)\,dt = (x-c)\,dt + \mathbb{E}[dE(x)]. \tag{7}$$

The left hand side of equation (7) measures the normal return that the home owner would require for holding the house. The right hand side of the equation measures the expected total return from holding the house, that is, the sum of net housing services and the expected rate of capital appreciation. This is also the opportunity cost of exercising an option today. Thus, this equality is the return equilibrium condition[4]. These two must be equal, otherwise the mortgage would be improperly valued. The equality becomes a no-arbitrary or equilibrium condition, expressing the homeowner's willingness to hold the house.[5]

If we rearrange equation (7), we have

$$\rho\,E(x)\,dt + c\,dt = x\,dt + \mathbb{E}[dE(x)]. \tag{8}$$

[4]It is also called asset equilibrium condition

[5]The equity function $E(x)$ satisfies the stochastic differential equation by the martingale property.

The left hand side of equation is the marginal cost of holding the mortgage contract and the right hand side of the equation is the marginal benefit of holding mortgage contract. Thus, the equation shows that the marginal cost and the marginal benefit of holding a mortgage contract should be same at the optimum.

Again we rearrange equation (7), we have

$$E(x) = \frac{1}{\rho} \left[(x - c) + \frac{1}{dt} \mathbb{E}[dE(x)] \right].$$

The first term of the right hand side of equation is an immediate payout or net dividends from the house and the second term is its expected rate of capital gain. Therefore the home equity is essentially the amount of ownership that has been built up by the holder of mortgage through the periodic payments and the house price appreciation.

By using Ito's lemma, we can rewrite the the second term of right-hand side in equation (8) as

$$\mathbb{E}[dE(x)] = \alpha x\, E'(x)\, dt + \frac{1}{2}\, \sigma^2 x^2\, E''(x)\, dt. \tag{9}$$

The expected value of the change of future equity or capital appreciation depends not just on the trend of housing services, α, but also the volatility of housing services, σ, that is the source of option value in mortgages.

Substituting this equation (9) into equation (8) leads to the ordinary differential equation[6]

$$\frac{1}{2}\sigma^2 x^2 E''(x) + \alpha x E'(x) - \rho E(x) = -x + c. \tag{10}$$

[6]This equation is a nonconstant (variable) coefficients, nonhomogeneous, second order linear differential equation. Also this type of differential equation is called a Cauchy-Euler equation.

This is the Hamilton-Jacobi-Bellman equation for the above stochastic continuous time dynamic programming problem (4). It is the necessary and sufficient condition for the optimum.[7] The optimal value function E satisfies the equation (10) in the continuation region, the interval (x_{**}, x^*).

This second order ordinary differential equation has the solution.

$$E(x) = e_1 x^{m_1} + e_2 x^{m_2} + \frac{x}{\rho - \alpha} - \frac{c}{\rho}, \tag{11}$$

$$\text{where } m_1, m_2 = \frac{-(\alpha - \frac{1}{2}\sigma^2) \mp \sqrt{(\alpha - \frac{1}{2}\sigma^2)^2 + 2\sigma^2\rho}}{\sigma^2}$$

are the two roots of the characteristic equation of the differential equation (10).

To complete the solution of this equation we have to specify two free boundaries, $E(x_{**})$ and $E(x^*)$ of the above equation. These two free boundaries, x_{**} and x^* are determined by requiring that E and E' be continuous at x_{**} and x^*. These conditions, called value matching and smooth pasting, reproduce the solution obtained by maximizing equation (4). In a free-boundary problem, the solution of the differential equation and the domain over which the differential equation must be solved, need to be determined simultaneously.

From the equations (2), (3) and (11), we can derive the explicit mortgage value function as the difference between house price and equity :

$$M(x) = P(x) - E(x) = -e_1 x^{m_1} - e_2 x^{m_2} + \frac{c}{\rho}, \tag{12}$$

[7] This is the stochastic analog to a continuous-time Bellman equation. The difference is that the variance term makes the HJB equation a second order ordinary difference equation, while the Bellman equation is first order.

Thus the house price , the equity, and the economic value of the mortgage are all functions of the housing service x.

3 Model with only default option

For this section we assume that the home owner does not have the prepayment option. When there is no prepayment option, the homeowner can terminate the mortgage contract only by defaulting. Thus the homeowner has a binary decision problem at every instant. She maximizes her equity over the binary choice: terminate the mortgage contract by exercising the default option or maintain the mortgage contract by continuing to pay the periodic payment c.

The equity function $E(x)$ satisfies the Bellman equation

$$E(x) = \max_{a \in \mathbb{A}} \left\{ E(x_*)\,,\ (x-c)\,dt \ + \ e^{-\rho\, dt}\, \mathbb{E}\,[\,E(x')\mid x\,] \right\}\,, \tag{13}$$

$$\text{subject to} \quad dx = \alpha x\,dt + \sigma x\,dz \quad \text{and} \ \ x(0) = 1\,,$$

where $\mathbb{A} = \{$ exercise default option, pay periodic payment $\}$ is the set of home owner's possible actions and x_* denotes default point when we have only default option. We distinguish x_* with x_{**}, the default point when we have both options. Accordingly, we denote the termination payoff as $E(x_*)$ when there is only default option. The first term in the bracket is the equity when the home owner exercises the default option or the termination payoff. The second term is the equity when she does not exercise the option or the payoff when she postpones exercising the option.

Since $E(x)$ is increasing in x, the optimal policy of the home owner is

$$a^* = \begin{cases} \text{exercise default option} & \text{if } x \le x_* \\ \text{pay periodic payment} & \text{if } x > x^*\,. \end{cases} \tag{14}$$

The threshold x_* separates the whole range of x into two regions: the region below x_* and the region above x_*. Therefore $x_* \leq x(0) = 1 \leq x^*$. For x lower than x_*, stopping payment is optimal and for x higher than x_*, continuing payment is optimal. That is, the region below x_* is the optimal stopping region and the region above x_* is the continuation region.

The solution of equation (13) can be written as

$$E(x) = E(x_*) \cdot \mathbb{1}_{[0,\, x_*]}(x) + \left\{ (x-c)\, dt \; + \; e^{-\rho\, dt}\, \mathbb{E}\, [\, E(x') \mid x\,] \right\} \cdot \mathbb{1}_{\,(x_*, \infty)}(x)\,, \qquad (15)$$

where $\mathbb{1}_A(x)$ is an indicator function. The first term, $E(x_*) \cdot \mathbb{1}_{\,[0,\, x_*]}(x) = 0$ in the continuation region, $(x_*,\, \infty)$. Thus

$$E(x) = (x-c)\, dt \; + \; e^{-\rho\, dt}\, \mathbb{E}\, [\, E(x') \mid x\,] \quad \text{for } (x_*, \infty)\,. \qquad (16)$$

As shown in the previous section, the solution of this equation is

$$E(x) = e_1 x^{\,m_1} + e_2 x^{\,m_2} + \tfrac{x}{\rho - \alpha} - \tfrac{c}{\rho}\,.$$

We have three unknowns in this case: two constants of integration, e_1 and e_2 from the equation, and a free boundary, i.e., the unknown default point x_*. To determine these three unknowns, we need three conditions that $E(x)$ must satisfy.

We have the first condition from the fact the equity can not grow to infinity. Thus the coefficient e_2 in the differential equation should be zero. Otherwise, $E(x)$ is not defined at the large value of x.

Thus when the default option is not exercised, i.e., for $x \in (x_*,\, \infty)$, or for $t \in [0,\, T\,)$, the

solution of the stochastic Bellman equation (13) is

$$E(x) = e x^{m_1} + \frac{x}{\rho-\alpha} - \frac{c}{\rho} \tag{17}$$

$$m_1 = \frac{-(\alpha-\frac{1}{2}\sigma^2)-\sqrt{(\alpha-\frac{1}{2}\sigma^2)^2+2\sigma^2\rho}}{\sigma^2},$$

where m_1 is the negative root associated with the differential equation (10).

To determine the remaining two unknowns, the constant of integration e and a free boundary x_*, we need two more boundary conditions.

The first boundary condition is the value matching condition:

$$E(x_*) = e x_*^{m_1} + \frac{x}{\rho-\alpha} - \frac{c}{\rho} = 0\,. \tag{18}$$

This condition implies that the home owner defaults when the housing price equals the mortgage value, $P(x) = M(x)$. That is, she defaults when the value of equity on the mortgage becomes zero, $E(x) = 0$. This condition matches the value of the unknown function $E(x) = 0$ to those of the known termination payoff function $E(x_*)$. But the boundary x_* itself is an unknown.

The second boundary condition is the smooth pasting condition:

$$E'(x_*) = e m_1 x_*^{m_1-1} + \frac{1}{\rho-\alpha} = 0\,. \tag{19}$$

This boundary condition implies that the value of $E(x)$ and $E(x_*)$ should meet tangentially at the boundary x_*. The value matching and smooth-pasting conditions determine the free

boundary x_* that separates the continuation region from the stopping region.

With these boundary conditions (18) and (19), we can get the analytical expression of the constant of integration e and the default point x_*. That is, we determine the unknown functional form of $E(x)$ and the unknown default point x_* from equations (18) and (19) simultaneously.

$$e = \frac{1}{m_1(\alpha-\rho)} \left[\frac{c}{\rho} \left(\frac{m_1(\rho-\alpha)}{m_1-1} \right) \right]^{1-m_1} \tag{20}$$

$$x_* = \left(\frac{c}{\rho} \right) \left[\frac{m_1(\rho-\alpha)}{m_1-1} \right] . \tag{21}$$

Using equations (20) and (21) we draw the house price $P(x)$, the mortgage value $M(x)$, the equity function $E(x)$, and the default point x_* for specific parameter values in figure (1).

We also derive the analytical expression of the loan to value ratio (LTV), recovery ratio (RR), and yield as functions of the parameters, α, σ, ρ, and c. All these variables x_*, LTV, RR, and *yield* are endogenously determined.

$$\begin{aligned} LTV &= \frac{M(1)}{P(1)} = (l + \tfrac{c}{\rho})(\rho - \alpha) , \\ RR &= \frac{P(x_*)}{M(1)} = \left[\left(\frac{c}{\rho} \right) \left(\frac{m_1}{m_1-1} \right) \right] \left(l + \frac{c}{\rho} \right)^{-1} , \\ Yield &= \frac{c}{M(1)} = c \cdot \left(l + \frac{c}{\rho} \right)^{-1} , \end{aligned} \tag{22}$$

$$\text{where } l = \frac{1}{\rho-\alpha} x_*^{1-m_1} - \left(\frac{c}{\rho} \right) x_*^{-m_1} .$$

The following table summarizes the comparative statics analysis results and shows how the endogenous variables, x_*, LTV, *Yield*, and RR are affected by changes in the exogenous parameters c, σ, α, and ρ[8].

[8]These results are all under the conditions, $\alpha > 0$, $\rho > 0$ and $\rho > \alpha$

Table 1: Comparative statics analysis of x_*, LTV, $Yield$, and RR

	$\Delta\, x_*$	$\Delta\, LTV$	$\Delta\, Yield$	$\Delta\, RR$
$\Delta\, c$	$(+)$	$(+)$	$(+)$	$(+)$
$\Delta\, \sigma$	$(-)$	$(-)$	$(+)$	$(-)$
$\Delta\, \alpha$	$(-)$	$(-)$	$(-)$	$(?)$
$\Delta\, \rho$	$(+)$	$(+)$	$(+)$	$(+)$

The signs $(+)$ and $(-)$ in the table show the signs of the partial derivatives of endogenous variables with respect to the parameters. For example, the $(+)$ sign in first row and first column in the table shows the positive sign of partial derivative, $\frac{\partial x_*}{\partial c}$ and it can be interpreted as higher periodic payment c induces higher default point x_*. Similarly, the $(-)$ sign in the table denotes the negative sign of the partial derivatives.

If we substitute equation (9) to (8), we have

$$\rho\, E(x)\, dt + c\, dt = x\, dt + \underbrace{\alpha x\, E'(x)\, dt + \tfrac{1}{2}\, \sigma^2 x^2\, E''(x)\, dt}_{\mathbb{E}[dE(x)]}\,. \tag{23}$$

We can interpret the results of the comparative statics analysis with the equation above. If c increases, the left hand side of equation (23) becomes larger than the right hand side of the equation, x^* should be higher to equalize the marginal cost and the marginal benefit of holding mortgages implying $\frac{\partial x_*}{\partial c} > 0$. Similarly, if the discount factor ρ increases, the left hand side becomes greater than the right hand side, so the house owner defaults at higher x_* or defaults more quickly implying $\frac{\partial x_*}{\partial \rho} > 0$. If α increases, the expected future equity value that is a part of the economic value of equity $E(x)$ increases, so the house owner holds the mortgage longer, i.e., $\frac{\partial x_*}{\partial \alpha} < 0$. Thus if the house owner predicts future house price appreciation, she defaults at a lower x_*, that is, she holds the mortgage longer. Because future expected equity value is higher when σ is large, $\frac{\partial x_*}{\partial \sigma} < 0$. If the house owner expects volatile

future house price movement, she holds mortgage longer.[9] Basically the exogenous parameters c, σ, α, and ρ affect not just immediate payoff $(x-c)\,dt$ but also the expected future value of equity $\mathbb{E}[dE(x)]$.

Initial mortgage rates in the subprime market are significantly higher than prime mortgage rates. While this is true for interest rates on fixed-rate mortgages (FRMs), it is also true, contrary to popular belief, on teaser rates of hybrid adjustable rate mortgages (ARMs)(Bhardwajy and Sengupta 2008). For numerical calculation we use $c = 1.75$ as periodic payment of subprime mortgages and $c = 1.25$ as periodic payment of prime mortgages. Since $\frac{\partial x_*}{\partial c} > 0$, subprime mortgage borrower defaults faster than prime mortgage borrower.

From the equations (21) and (22), we can calculate numerical values of x_*, LTV, $Yield$, and RR for various values of c and σ. For these calibrations, we assume that $\alpha = 0.03$, $\rho = 0.07$. Given values for parameters, α, σ, ρ, and c, we can get the numerical values of the default point x_*, LTV, $Yield$, and RR explicitly. We report this calibration results in table (2). We are able to confirm the results from our comparative statics analysis with this numerical exercise.

[9] In the continuation region, (x_*, ∞), $E(x)$, $E'(x)$, and $E''(x)$ are all positive.

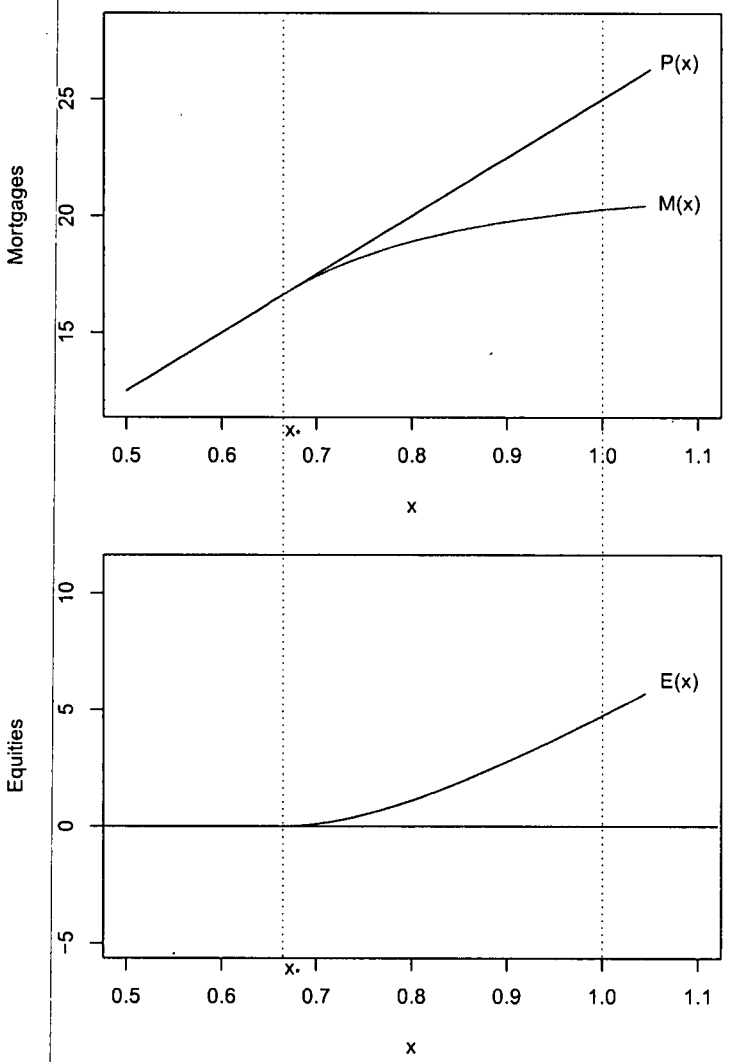
Table 2: x_*, LTV, $Yield$, and RR for various value of c and σ

	c	x_*	$LTV(\%)$	$Yield(\%)$	$RR(\%)$
$\sigma = 0.10$	1.00	0.500	57.09	7.01	87.59
	1.25	0.625	71.10	7.03	87.91
	1.50	0.750	84.28	7.12	88.99
	1.75	0.875	95.09	7.36	92.02
	2.00	1.000	100.00	8.00	100.00

	c	x_*	$LTV(\%)$	$Yield(\%)$	$RR(\%)$
$\sigma = 0.15$	1.00	0.443	56.38	7.10	78.65
	1.25	0.554	69.37	7.21	79.91
	1.50	0.665	81.04	7.40	82.07
	1.75	0.776	90.69	7.72	85.56
	2.00	0.887	97.40	8.21	91.05

	c	x_*	$LTV(\%)$	$Yield(\%)$	$RR(\%)$
$\sigma = 0.20$	1.00	0.389	54.72	7.31	71.15
	1.25	0.487	66.55	7.51	73.13
	1.50	0.584	77.06	7.79	75.78
	1.75	0.681	85.97	8.14	79.25
	2.00	0.779	92.95	8.61	83.76

Figure 1: $P(x)$, $M(x)$, $E(x)$, and x_* with only default option



4 Model with both options

Mortgage contracts are based on the borrower's ability to repay the mortgage loan. In the prime mortgage case this ability is based on well documented, proven future income. Thus, the prime mortgage lending is based on borrowers future income. However, the subprime mortgage design is based on the fact that the dominant form of wealth of low-income household is potentially their home equity since the subprime borrowers have a lower income than the prime borrowers and their ability to repay the mortgage loan is not proven, sometimes not documented properly. Thus, the subprime mortgages are closely linked to appreciation of the underlying asset, the house. No other consumer loan has the contractual feature that the borrowers ability to repay is so sensitively linked to appreciation of the underlying asset. The equity extraction from the house price appreciation is the key to the subprime mortgage contract design.[10] And this equity extraction from house price appreciation is only possible through the borrower's prepayment option. Thus, the prepayment option is the integral part of the subprime mortgage design.

If borrowers prepay the current mortgage contract and move to a lower interest mortgage contract, they can pay a smaller periodic payment. This is the prepayment incentive to both prime and subprime mortgage borrowers. Subprime mortgage borrowers have another incentive to prepay mortgage: by their credit improvement, they can step up to prime borrower status. Even if there is no change in interest rate as we assumed here, subprime borrower has an incentive to prepay. Therefore including prepayment option in our model is crucial to examine the behavior of subprime borrowers.

In the previous section we assume that borrowers do not have the prepayment option.

[10] While equity extraction is common in the prime mortgage market, it is even more prevalent in the subprime mortgage market. Chomsisengphet and Pennington-Cross (2006) show that a higher proportion of subprime refinancing involve equity extraction, compared to prime refinancing.

Thus they have only two choices; being current on payment or default and terminate the mortgage contract. Therefore if they do not default on the contract, their payment is a perpetuity. This is a very unrealistic assumption, especially for subprime mortgages. In this section, the borrowers have three choices on their mortgage contract: pay the periodic payment, default or prepay. We show how the default point x_{**} is affected by the inclusion of the prepayment option in the model.

When the options are not exercised, i.e., for the continuation region $x \in (x_{**}, x^*)$, the solution of the Bellman equation (4) is

$$E(x) = e_1 x^{m_1} + e_2 x^{m_2} + \frac{x}{\rho - \alpha} - \frac{c}{\rho} ,$$

$$\text{where } m_1, m_2 = \frac{-(\alpha - \frac{1}{2}\sigma^2) \mp \sqrt{(\alpha - \frac{1}{2}\sigma^2)^2 + 2\sigma^2 \rho}}{\sigma^2} .$$

When we have a prepayment option in the model, both constants of integration e_1 and e_2 are not zero. Thus we have four unknowns, the constants of integration of the equation e_1, e_2, the default point x_{**} and the prepayment point x^*. To determine these four unknowns, we need four boundary conditions: the value matching conditions and smooth pasting conditions at x_{**} and at x^* respectively.

The value matching condition at the default point x_{**} is

$$E(x_{**}) = 0 \tag{24}$$

and the smooth pasting condition at the default point x_{**} is

$$E'(x_{**}) = 0\,. \tag{25}$$

These are the same conditions for the default point x_* in equations (18) and (19).

The value matching condition at the prepayment point x^* is

$$M(1) + E(x^*) + k_p = P(x^*)\,. \tag{26}$$

The left hand side of equation is the total cost of exercising prepayment option at x^* that is the sum of $M(1)$, the mortgage value at the origination date and $E(x^*)$, the equity at the prepayment point and k_p, the required prepayment penalty. The right hand side of equation (26) is the benefit from exercising prepayment option at x^*, the housing price $P(x^*)$. Thus the home owner exercises the prepayment option only when the benefit from exercising it exceeds the total cost of prepayment, that is, when the option is in the money.[11]

The smooth pasting condition at the prepayment point x^* is

$$E'(x^*) = \frac{1}{\rho - \alpha}\,. \tag{27}$$

The smooth pasting condition is a necessary condition for optimal exercise of the options since the default point and prepayment point are free boundaries. It requires $M(x)$ to be tangent to $x/(\rho - \alpha)$ at x_{**}. And also that the slope of $E(x)$ at x^* should be equal to the slope of $P(x)$. Figure (2) shows that the house price $P(x)$, the mortgage value $M(x)$, the equity function $E(x)$, default point x_{**}, prepayment point x^* and these boundary conditions graphically.

[11] Borrowers will prepay only when the value of their mortgages exceed their origination value $M(1)$ by at least k_p, i.e., $M(x^*) = M(1) + k_p$

From above four boundary conditions, we have following system of equations;

$$\begin{aligned}
&e_1 x_{**}^{m_1} + e_2 x_{**}^{m_2} + \tfrac{x_{**}}{\rho-\alpha} - \tfrac{c}{\rho} = 0 \\
&m_1 e_1 x_{**}^{m_1-1} + m_2 e_2 x_{**}^{m_2-1} + \tfrac{1}{\rho-\alpha} = 0 \\
&e_1 x^{*\,m_1} + e_2 x^{*\,m_2} - e_1 - e_2 + k_p = 0 \\
&m_1 e_1 x^{*\,m_1-1} + m_2 e_2 x^{*\,m_2-1} = 0 \,.
\end{aligned} \tag{28}$$

This is a system of four nonlinear equations with four unknowns, e_1, e_2, x_{**}, and x^*. The unknown functional form of $E(x)$ and the two unknown free boundaries are determined simultaneously by these system of equations. Since the system of equation (28) can not be solved analytically, we solve this system of equations numerically by the Newton-Raphson method.[12] We set $\rho = 0.07$ and $\alpha = 0.03$ for these numerical calculation. Before we consider the effect of prepayment penalty, we examine the effect of the inclusion of prepayment option in the model. Thus, at this point we set $k_p = 0$.

Now we can see the effects of inclusion of prepayment option to the model. The numerical calculations are reported in table (3).

The default point, x_{**}, in the model with the prepayment option, is lower than the default point, x_*, in the model without the prepayment option. Thus, the house owner holds the mortgage longer when we include the prepayment option in the model. The difference, $(x_* - x_{**})$, widens as the periodic payment c increases, since the prepayment option is more valuable to the subprime mortgages borrower. For example, when $c = 1.75$ and $\sigma = 0.2$, the percentage change in the default point is as high as 11.31%. The subprime borrowers have a bigger incentive for prepayment since they are paying a higher periodic payment c. After prepaying the mortgage, the subprime borrower can step up to a prime mortgage contract by

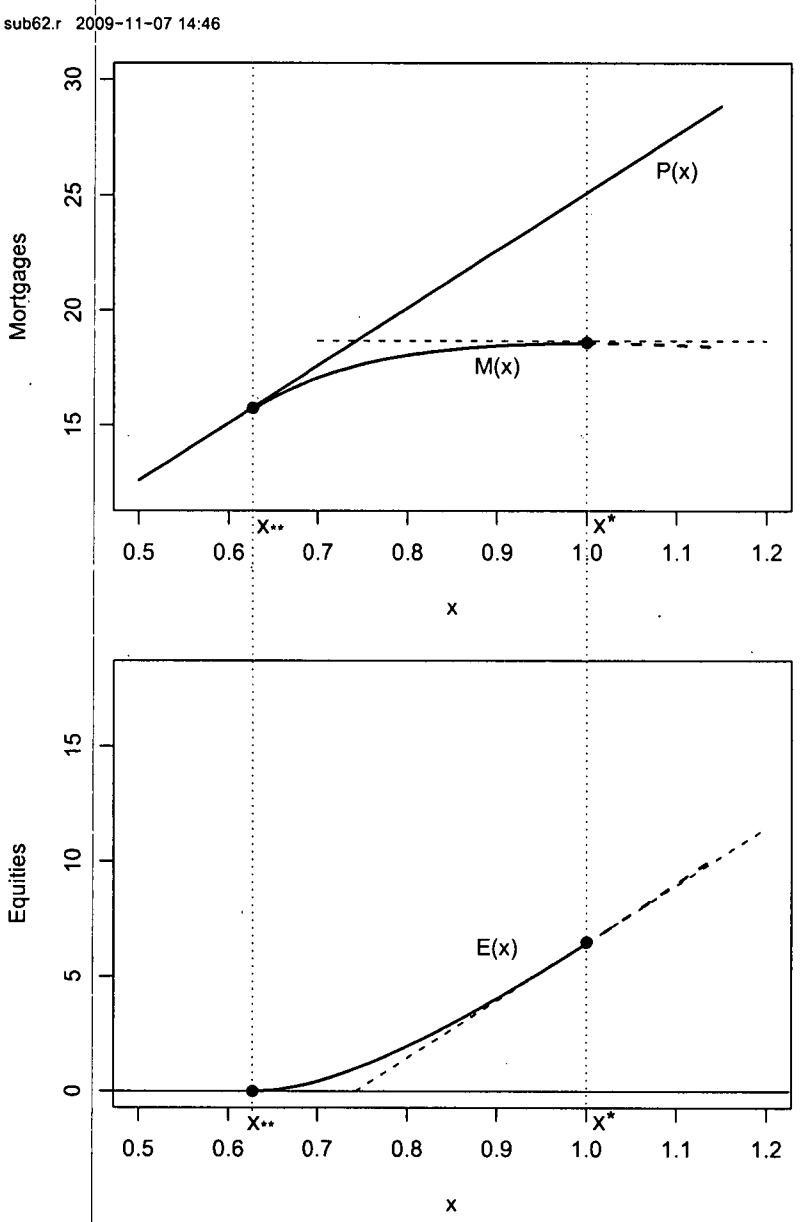
[12]The error tolerance for the approximation is 10^{-8}. The number of maximum iteration is 10^5.

Table 3: The change in the default point for different c and σ

c	σ	x_*	x_{**}	% change
1.25	0.05	0.687	0.687	0.00
	0.10	0.625	0.620	0.80
	0.15	0.554	0.540	2.53
	0.20	0.487	0.466	4.31
1.50	0.05	0.824	0.823	0.12
	0.10	0.750	0.726	3.20
	0.15	0.665	0.627	5.71
	0.20	0.584	0.541	7.36
1.75	0.05	0.962	0.917	4.68
	0.10	0.875	0.803	8.23
	0.15	0.776	0.696	10.31
	0.20	0.681	0.604	11.31

the improvement of her credit rating. The prepayment option is more valuable to the sub-prime borrowers. The higher σ, the larger the difference, $(x_* - x_{**})$. When $c = 1.75$ and $\sigma = 0.05$, the percentage change in default point is 4.68% but it is 11.68% when $c = 1.75$ and $\sigma = 0.20$. In the model with only default option, the borrower never prepays since they do not have that option. However, in the model with a prepayment option, the borrower prepays whenever $x \geq 1$. In the next section, we investigate why and how the inclusion of the prepayment option in the mortgage contract affects the default decision of the mortgage borrowers.

Figure 2: $P(x)$, $M(x)$, $E(x)$, and x_{**} with both options



5 Default decision and option values

In the previous sections, we show that the default point x_{**} is greatly affected by the inclusion of termination options. In this section we investigate how the options embedded in the mortgage contracts influence the borrower's mortgage default decision by calculating the economic values of the options embedded in the mortgage contract explicitly.

We define M^0 as the mortgage value without termination options, and $M(x)$, the mortgage value with termination options. If there is no termination option in the mortgage contract, the mortgage is a perpetuity. That is, the mortgage is just a fixed income security to the lender. Since the borrower pays a periodic payment c forever, M^0 is $\frac{c}{\rho}$. Notice that this mortgage value is independent to the level of housing services x and house price.

As we showed in the previous section, the mortgage value with termination options $M(x)$ is a function of the housing services x. The difference between the mortgage value without termination option M^0 and the mortgage value with termination option $M(x)$ is the option value $OV(x)$ embedded in the mortgage contract defined as

$$OV(x) = M^0 - M(x) \tag{29}$$

Since the option has a positive value to the borrower, the mortgage liability $M(x)$ decreases by the inclusion of the options. Rearranging the terms of (29) leads to

$$M(x) = M^0 - OV(x)\ . \tag{30}$$

When there is only a default option, the total option value, $OV(x)$, is just $DOV(x)$, the value

of the default option. We denote the mortgage value with the default option, $M^d(x)$, as

$$M^d(x) = M^0 - DOV(x) \,. \tag{31}$$

When there are both options, the total option value, $OV(x)$, is the sum of the default option value, $DOV(x)$, and the prepayment option value, $POV(x)$. We denote the mortgage value with both options, $M^p(x)$, as

$$M^p(x) = M^0 - (DOV(x) + POV(x)) \,. \tag{32}$$

The borrower does not want to have a mortgage liability bigger than the market value of house, which would imply negative home equity. That is, a home owner defaults her mortgage contract when her home equity becomes zero. Since the home equity is the difference between the house price and the mortgage liability, a home owner makes her default decision by comparing the price of her house and the value of the mortgage. Thus, given the house price, the home owner's default decision depends on the mortgage value.

As in equation (30), the mortgage value is the difference between the mortgage value without termination options M^0 and the option values embedded in the mortgage contract. Since the mortgage value without termination options, M^0, is given by the specified periodic payment c, the mortgage value depends on the option value $OV(x)$. Thus given c, the periodic payment, the borrowers default decision is determined by the option values.

To get the numerical option values, we derive the three different equity functions from the above three different types of mortgage values.

The equity without termination options can be written as

$$E^0(x) = P(x) - M^0 = \frac{x}{\rho - \alpha} - \frac{c}{\rho} \,. \tag{33}$$

Figure 3: Mortgage value and equity without option

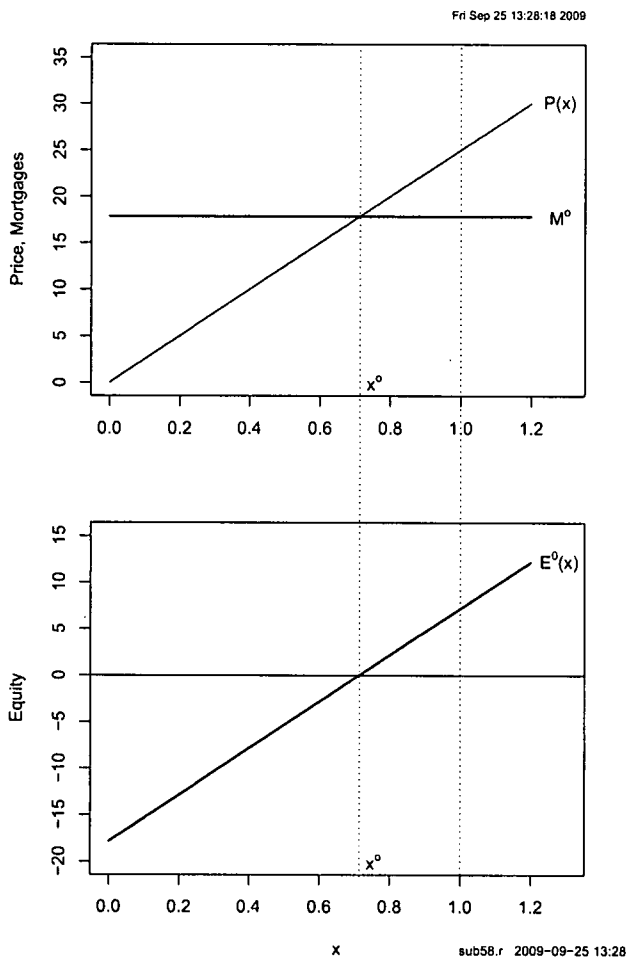


Figure (3) shows the mortgage value without options M^0 and the equity without options $E^0(x)$. We denote x^0 as the level of housing service where the equity without termination option is zero, i.e., $E^0(x^0) = 0$. At x^0, the house price, $P(x)$, equals M^0, the mortgage value

without termination options. Thus $x^0 = \left(\frac{\rho-\alpha}{\rho}\right) \cdot c$. Notice that $E^0(x)$ can be negative if $x < x^0$. The option value depends on σ, the volatility of housing service and the housing price as well as α and ρ. However x^0 depends on the parameters α and ρ but not on σ since it is unrelated to the option.

The equity with termination options is the sum of $E^0(x)$ and the option values embedded in mortgage contract. From equations (12) and (30), we have

$$E(x) = E^0(x) + OV(x) \; . \tag{34}$$

We denote $E^p(x)$ as the equity when borrowers have both the default option and the prepayment option:

$$E^p(x) = e_1 x^{m_1} + e_2 x^{m_2} + \frac{x}{\rho-\alpha} - \frac{c}{\rho} \; . \tag{35}$$

$E^d(x)$ is the equity when borrowers have only the default option.

$$E^d(x) = e x^{m_1} + \frac{x}{\rho-\alpha} - \frac{c}{\rho} \; . \tag{36}$$

The first two plots in figure (4) shows the different mortgage functions M^0, M^d, and M^p, as well as the three different equity functions E^0, E^d, and E^p. The distinction of the above three different equity functions E^0, E^d, and E^p is critical to measure the values of the default and prepayment options. We can express the option values in terms of equity functions, $E^0(x)$, $E^d(x)$, and $E^p(x)$. We derive the explicit expressions for the option values from the equations (33) – (36).

The value of the default option is the difference between the two equity functions $E^d(x)$

and $E^0(x)$:

$$\begin{aligned} DOV(x) &= E^d(x) - E^0(x) \\ &= ex^{m_1} . \end{aligned} \tag{37}$$

The value of the prepayment option is the difference between the two equity functions $E^p(x)$ and $E^d(x)$:

$$\begin{aligned} POV(x) &= E^p(x) - E^d(x) \\ &= (e_1 - e)x^{m_1} + e_2 x^{m_2} . \end{aligned} \tag{38}$$

The value of both options is the sum of two values.

$$\begin{aligned} OV(x) &= POV(x) + DOV(x) \\ &= e_1 x^{m_1} + e_2 x^{m_2} . \end{aligned} \tag{39}$$

All these option values are functions of σ as well as α and ρ. Figure (4) shows the values of these options. The value of the default option is the vertical distance between the two equity functions $E^d(x)$ and $E^0(x)$ (between M^0 and $M^d(x)$) and the value of prepayment option is the vertical distance between the two equity functions $E^p(x)$ and $E^d(x)$ (between $M^d(x)$ and $M^p(x)$). Figure (4) shows the following:

1. As the housing services, x, increases, the default option value decreases exponentially, since the probability of using the default option decreases as x increases.

2. As the housing services, x, increases, the prepayment option value increases since the probability of using the prepayment option increases.

3. As the housing services, x, increases, the total option value decreases. Since the fall of the default option value offsets the increase of the prepayment option value.

Given parameter values, we can calculate numerical option values from equation (37)–(39). Table (4) shows the calculated values of both options and the mortgage values for different value of c and σ at x^0. The numbers in the parentheses in the default column and the prepayment column show the option values as a percentage of the total option value. We list the mortgage values at x^0 in the last column of the table. In this table, we can see that mortgage values are affected by changes in the option value. In turn, these changes in mortgage value affect the default decision of the borrower. The values of both options increase as σ increases since the option is a partial protection against the fluctuation of x and p. Thus, the higher σ, the larger the option values, the smaller mortgage liability, and the lower x_{**}. Thus, $E(T(x_{**}))$, the expected optimal stopping time is larger when σ is higher. That is, the borrower holds the mortgage longer on average when σ is bigger. For example, when $c = 1.75$, if the volatility σ increases from 0.05 to 0.2, $OV(x)$, the option value increases from 1.404 to 6.503. The option value with $\sigma = 0.2$ is about four times larger than the option value with $\sigma = 0.05$. Accordingly, the mortgage liability of the borrower decreases from 23.596 to 18.497. Thus the borrower defaults at $x_{**} = 0.604$ instead at $x_{**} = 0.917$. That is, $E(T(x_{**}))$, the expected optimal stopping(default) time is larger. This shows a cascade effect, the default decision depends on the mortgage value, the mortgage value depends on the option values, and the option values depends on the volatility of the housing services. Thus, the default decision depends exclusively on the volatility of housing services and the housing price through the option values via the mortgage values.

This table also shows that the inclusion of the prepayment option in mortgage contract gives additional value to the mortgage contract. As a result the home owner will choose to exercise the default option at a lower x, i.e., $x_{**} < x_*$. For example, when $c = 1.75$ and $\sigma = 0.1$, the option value is 1.227 and the borrower defaults at $x_* = 0.875$ when there is no prepayment option. However, the prepayment option adds 1.984 to the total option value and

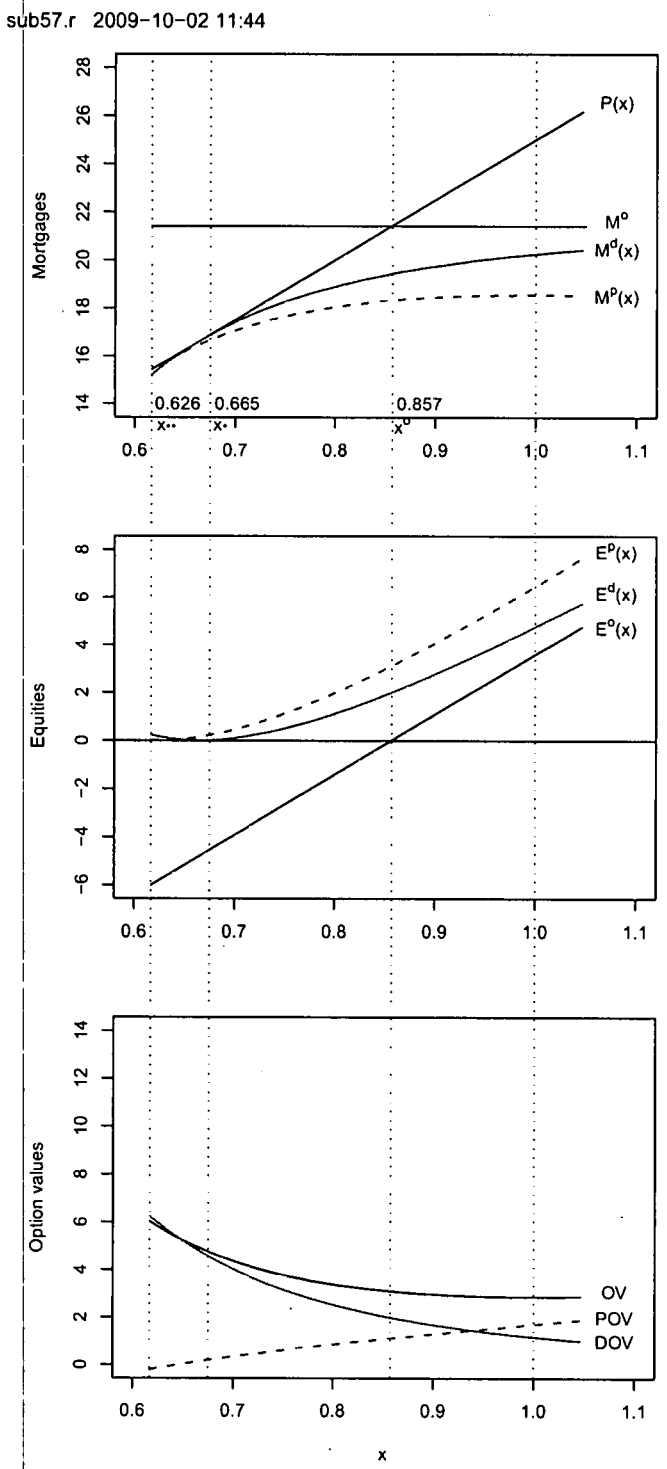
Table 4: The value of options and the mortgages for different c and σ at x_0

					option values			
c	σ	x_0	x_*	x_{**}	default (%)	prepayment(%)	both	$M^p(x^0)$
1.25	0.05	0.714	0.687	0.687	0.255 (100.0)	≈ 0 (0.00)	0.255	17.602
	0.10		0.625	0.620	0.877 (89.9)	0.099 (10.1)	0.976	16.880
	0.15		0.554	0.540	1.662 (81.4)	0.381 (18.6)	2.043	15.814
	0.20		0.487	0.466	2.506 (79.0)	0.667 (21.0)	3.173	14.685
1.50	0.05	0.857	0.824	0.823	0.306 (90.6)	0.032 (9.4)	0.339	21.090
	0.10		0.750	0.726	1.052 (65.5)	0.555 (34.5)	1.607	19.822
	0.15		0.665	0.627	1.994 (64.2)	1.110 (35.8)	3.104	18.324
	0.20		0.584	0.541	3.007 (66.4)	1.523 (33.6)	4.530	16.899
1.75	0.05	1.000	0.962	0.917	0.358 (25.5)	1.046 (74.5)	1.404	23.596
	0.10		0.875	0.803	1.227 (38.2)	1.984 (61.8)	3.211	21.789
	0.15		0.776	0.696	2.327 (47.2)	2.603 (52.8)	4.930	20.070
	0.20		0.681	0.604	3.508 (53.9)	2.995 (46.1)	6.503	18.497

the borrower defaults at the lower $x_{**} = 0.803$. The existence of the prepayment option affects the value of mortgages even if interest rates are taken to be nonstochastic and constant, as is the case here.

As we have mentioned, the equity extraction is very important for subprime borrowers and that equity extraction is possible only through prepayment. Thus, this prepayment option value is prominent in the subprime mortgage case. Table 4 shows this fact clearly. When $c = 1.25$ and $\sigma = 0.1$ the prepayment option value is only 0.099 that is 10.1% of the total option value. But when $c = 1.75$ and $\sigma = 0.1$, the prepayment option value is 1.984, or 61.8% of the total option value. Thus in the subprime mortgage case, the prepayment option adds a significant value to the mortgage.

Figure 4: Value of options



6 Model with prepayment penalty

Subprime borrowers are protected from large losses from decreases in property values because of the default option and the low level of their equity. With the default option, they have a limited liability instead of a unlimited liability for the loan. This means that when a bad event occurs, like a drastic housing price depreciation, they can exercise the default option for hedging purposes. But lenders, on the other hand, are subjected to big default losses if house values drop. When house prices rise, borrowers can prepay and extract the accumulated equity from the appreciation. They can use the prepayment option for speculation purposes as usual option exercising practice. As shown in the previous section, the prepayment option gives a substantial economic value to the subprime mortgage borrower. But due to the prepayment option, lenders are unlikely to benefit from any gains if the house prices rise. For the lender the prepayment option given to the borrower becomes an another source of risk, prepayment risk, associated with the early unscheduled return of principal. Therefore, lenders are likely to lose money whether house prices increase or decrease, as lenders are subject to two risks: default risk and prepayment risk.

Because of default risk, lenders require very large periodic payments for subprime mortgage borrowers. In order to mitigate the prepayment risk, subprime lenders typically include prepayment penalties or fees as part of the mortgage contract. One of the distinctive characteristics of subprime mortgages, relative to the prime mortgages, is the size and prevalence of the prepayment penalties.[13] These penalties are seldom imposed in the conventional mortgage market. From an economic standpoint, prepayment penalties can be thought as a premium added to mortgages to compensate the lender for the supposedly high prepayment risk generated by the subprime loan. The lender uses prepayment penalties to prevent prepayment

[13] See, e.g., Farris and Richardson (2004). Fannie Mae estimates that 80 percent of subprime mortgages have prepayment penalties, while only two percent of prime mortgages have prepayment penalties (see Zigas, Parry, and Weech (2002)).

and to offset losses from prepayment. Thus subprime mortgages typically have significantly higher periodic payments and higher prepayment penalties than prime mortgages, in which case they are typically zero.

If there is no prepayment penalty or fee, a house owner could make a profit out of the mortgage contract by prepaying the mortgage whenever x is higher than 1. In this section, we include a positive prepayment penalty, $k_p > 0$, to avoid this unrealistic prediction of the model. Thus, the subprime mortgage lenders impose positive penalties on prepayments.

However, there is a maximum prepayment penalty k_p^* that the lender can impose to the borrowers. The borrower prepays only when the total cost of prepayment, $M(1) + k_p$, is less than the benefit from prepayment, $M(x^*)$.[14] Thus, $M(1) + k_p \leq M(x^*)$. Since the maximum of $M(x^*)$ is $\frac{c}{\rho}$, the upper limit for k_p is

$$k_p^* = \frac{c}{\rho} - M(1) \,. \tag{40}$$

If $k_p^* > \frac{c}{\rho} - M(1)$, the borrower would never prepay ($x^* = \infty$). The table (5) shows the upper limit values of k_p for different values of c and σ.

Table 5: k_p^*, the upper bound of the prepayment penalty for different values of c and σ

c	$\sigma = 0.05$	$\sigma = 0.10$	$\sigma = 0.15$	$\sigma = 0.20$
1.25	0.000	0.083	0.518	1.221
1.50	0.006	0.358	1.169	2.163
1.75	0.358	1.227	2.327	3.508

To examine the effect of the prepayment penalty on the borrowers mortgage termination decisions, we solve the system of equations (29) numerically and report the optimal default

[14] $M(1) = M(x(0))$ is the origination value of the mortgage, i.e., the initial mortgage value at $t = 0$. It is the book value of the mortgage.

points x_{**}, the optimal prepayment points x^*, and the option values for the different periodic payment c and the prepayment penalty k_p in table (6). The bold numbers in the second column of the table shows the the upper bound of k_p for different values of c. Figure (5) shows that the mortgage functions $M(x)$, with and without the prepayment penalty, when $c = 1.75$ and $\sigma = 0.15$. As shown in the table and the figure, the prepayment penalty affects both on prepayment decision and also on default decision.

Table 6: Default points, prepayment points, and option values with the prepayment penalties

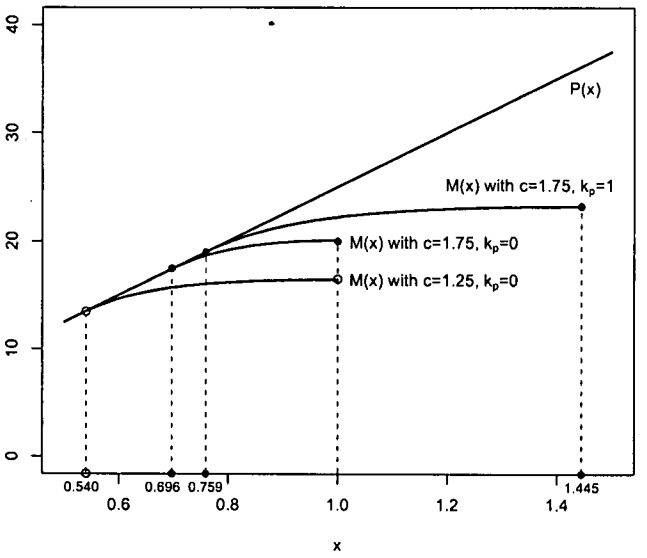
c	k_p	x^0	x_*	x_{**}	x^*	*DOV*	*POV*	*OV*
	0.000	0.714	0.554	0.540	1.000	1.662	0.381	2.043
1.25	0.250	0.714	0.554	0.552	1.475	1.662	0.052	1.714
	0.500	0.714	0.554	0.554	3.514	1.662	0.001	1.663
	0.518	0.714	0.554	0.554	∞	1.662	0.000	1.662
	0.000	1.000	0.776	0.696	1.000	2.327	2.603	4.930
	0.250	1.000	0.776	0.730	1.157	2.327	1.344	3.671
	0.500	1.000	0.776	0.742	1.250	2.327	0.930	3.257
	0.750	1.000	0.776	0.752	1.343	2.327	0.656	2.983
1.75	1.000	1.000	0.776	0.759	1.445	2.327	0.456	2.782
	1.250	1.000	0.776	0.764	1.565	2.327	0.304	2.630
	1.500	1.000	0.776	0.769	1.719	2.327	0.188	2.514
	1.750	1.000	0.776	0.772	1.939	2.327	0.100	2.427
	2.000	1.000	0.776	0.774	2.322	2.327	0.039	2.366
	2.250	1.000	0.776	0.776	3.599	2.327	0.004	2.331
	2.327	1.000	0.776	0.776	∞	2.327	0.000	2.327

First, we consider the effect of the prepayment penalty k_p on the borrower's prepayment decision. When there is a positive penalty, the borrowers do not prepay right away at $x^* = 1$, i.e., the prepayment point is higher than 1, i.e., $x^* > 1$. Also the table shows that the bigger the penalty k_p is, the higher x^* is. For example, when $c = 1.75$, without prepayment penalty ($k_p = 0$), the borrower prepays her loan at $x = 1$. But with $k_p = 0.5$, the borrower prepays at the higher x, i.e., at $x = 1.25$ and at $x = 2.322$ with $k_p = 2$. The borrowers hold mortgages longer and prepay at the higher x since the high prepayment penalty implies the high price of

the prepayment. Therefore, the prepayment penalties are effective deterrents of prepayment. Imposing the prepayment penalty on the subprime mortgage makes refinancing difficult. The table also shows that the value of prepayment option is reduced by the increase of the prepayment penalty. Particularly for the subprime mortgage, the reduction of prepayment option value by the prepayment penalty is drastic. For example, if the lender impose the penalty $k_p = 1$ when $c = 1.75$, the prepayment option value decreases by 2.147, which is more than two years worth of the housing services. If the lender imposes the maximum prepayment penalty k_p^*, the prepayment option value disappears completely and the total option value is just the default option value. The prepayment is not an available option anymore for the borrower since it is prohibitively costly. The borrower is trapped in the mortgage contract with a high periodic payment. Thus, the mortgage contract with an extremely high prepayment penalty is the same as the mortgage contract without the prepayment option. Thus, the prepayment does not happen, i.e., $x^* = \infty$. Refinancing is not possible for the subprime borrowers.

The prepayment penalty affects not only the prepayment decision but also the default decision. Table (6) shows the effect of the prepayment penalty, k_p on the default point, x_{**}: The higher k_p is, the higher x_{**} is. This is because the value of the mortgage depends on not only the value of default option but also on the value of the prepayment option. When the prepayment penalty is big, the value of prepayment is small, and so is the mortgage value. The prepayment penalty takes the value of prepayment option away from the mortgage borrowers. This reduction of the option value induced by the penalty affects the default decision of the subprime borrowers. Thus, borrowers default more quickly or at the higher default point when the prepayment penalty is large. That is, the expected optimal default time, $E(T(x_{**}))$ becomes smaller. For instance, when c is 1.75, where k_p is 0.5, the option value is 3.257 and when k_p is 2, the option value is 2.366. Accordingly, for $k_p = 0.5$ and 2, the default points are

Figure 5: Mortgage value with and without the prepayment penalty



0.742 and 0.774 respectively. Figure (5) shows that the loans with prepayment penalties are significantly more likely to default than those without prepayment penalties. When $c = 1.25$ without the penalty, which we consider being as the prime mortgage, the default point is as low as 0.540 and for the subprime mortgage, $c = 1.75$ with the penalty $k_p = 1$, x_{**} is 0.759. The difference is as large as 0.219.[15] As k_p increases, x_{**} converges to the x_*. Thus, at k_p^*, the default point in the model with prepayment option is same as the default point in the model without the prepayment option, i.e., $x_{**} = x_*$.

For the financially distressed subprime borrower, defaulting is an optimal choice when the prepayment penalty, the cost of prepayment, is high relative to the cost of default. In this sense, the default option is a substitute to the prepayment option. When house prices rise, subprime borrowers can accumulate home equity from the price appreciation. Thus,

[15]Roberto G. Quercia, Michael A. Stegman, and Walter R. Davis (2007) showed that, controlling for other risk factors, the odds of foreclosure for loans with prepayment penalties were about 20 percent higher than for loans without prepayment penalties.

a financially distressed borrower could avoid default by prepaying the loan even if there is a prepayment penalty. Hence there was a sustained high prepayment rates of the subprime mortgages in the first part of this decade.[16] However, the prepayment option is no longer available when prices depreciate since the optimal prepayment point x^* with a positive prepayment penalty is always above 1. Prepaying at 1 or below 1 is not an optimal prepayment decision as shown in table (6) and figure (5). Thus, the subprime borrowers can be trapped in the mortgage contract with high periodic payment. Also the default point of the subprime borrower is higher with a positive prepayment penalty. This high default point makes the subprime borrower much more vulnerable to the price depreciation. Therefore, this inability to refinance the mortgage loans and the high default point induced by the prepayment penalty translated into the high rate of mortgage defaults and foreclosures. Consequently, borrower default began to increase as house price started to depreciate in 2006.

7 Conclusion

We characterize the mortgage as a fixed income security with two options, the default option and the prepayment option. By transforming this characterization of mortgages into the optimal stopping time framework, we are able to examine the effects of prepayment penalties on the termination decision of subprime borrowers.

We identify two effects of the prepayment penalty on subprime borrowers' mortgage termination decisions. One is that a high prepayment penalty deters the prepayment. As shown in the model, the prepayment penalty makes the optimal prepayment point higher. In other words, it makes refinancing more difficult. The prepayment penalty affects not only the pre-

[16]The prepayment rate of the fixed rate mortgages up to five years after the origination dates are 50%, 55%, 60%, 68%, 70% in years 1998, 1999, 2000, 2001, 2002, 2003 respectively. The prepayment rate of the adjustable mortgage rates are much higher than these numbers.

payment decision but also the default decision of subprime borrowers. The options embedded in the mortgage contracts add economic values to the mortgage contracts since these options provide a partial protection from the volatility of the house prices. In particular, the value of the prepayment option to the subprime mortgage borrower is significant. The prepayment penalty increases the likelihood of default by subprime borrowers because the penalty reduces the option values of the mortgage contracts.

By these two effects of prepayment penalty on mortgage termination decision, the default decision of the borrower becomes more susceptible to the house price depreciation. When house price depreciates, the subprime borrowers are trapped in the mortgage contract with high periodic payments. Thus, financially distressed borrowers have only one option: default. With an enough house price fall, even if subprime borrowers are not financially distressed, defaulting becomes an optimal decision.

The existence of the prepayment penalty in subprime mortgage contract amplifies the effect of housing price decline on mortgage default. This is the one of the reason why there was a sharp increase of the default and foreclose rates in the subprime mortgage market after 2006.

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Indymac Bank

Agency Conforming Products - Wholesale

*** No Adjustment for FastForward***

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	3/1 LIBOR ARM 2/2/6 Caps 2.25 Margin	5/1 LIBOR ARM 5/2/5 Caps 2.25 Margin	7/1 LIBOR ARM 5/2/5 Caps 2.25 Margin	10/1 LIBOR ARM 5/2/5 Caps 2.25 Margin	15 Year FRM	30 Year FRM	30 Year FRM I/O
Rate	30 BE	30 BE	30 BE	30 BE	30 BE	30 BE	30 BE
7.375	(2.581)	(2.927)	(3.139)	(3.085)	(3.914)	(3.791)	(3.010)
7.250	(2.317)	(2.733)	(2.915)	(2.945)	(3.692)	(3.584)	(2.793)
7.125	(2.281)	(2.553)	(2.740)	(2.712)	(3.455)	(3.356)	(2.554)
7.000	(2.241)	(2.374)	(2.565)	(2.480)	(3.202)	(3.098)	(2.285)
6.875	(2.097)	(2.222)	(2.407)	(2.284)	(3.477)	(3.071)	(2.277)
6.750	(1.954)	(2.071)	(2.247)	(2.086)	(3.242)	(2.827)	(2.020)
6.625	(1.831)	(1.920)	(2.053)	(1.850)	(2.974)	(2.550)	(1.729)
6.500	(1.706)	(1.765)	(1.857)	(1.612)	(2.681)	(2.230)	(1.395)
6.375	(1.529)	(1.554)	(1.593)	(1.317)	(2.427)	(1.881)	(0.924)
6.250	(1.352)	(1.341)	(1.328)	(1.021)	(2.146)	(1.565)	(0.593)
6.125	(1.164)	(1.115)	(1.047)	(0.687)	(1.829)	(1.197)	(0.211)
6.000	(0.975)	(0.887)	(0.763)	(0.350)	(1.479)	(0.789)	0.212
5.875	(0.777)	(0.630)	(0.429)	0.080	(1.111)	(0.332)	0.799
5.750	(0.576)	(0.371)	(0.094)	0.510	(0.756)	0.195	1.508

Fixed Adjustments

Maximum Price - 103.00

	Price Adjustment
FastForward (Additional Guideline Restrictions May Apply)	0.000
Unit Properties	
2 Units: >90% - 95%:	0.500
Non-Owner Fees - Purchase/ No Cash out:	
LTV 0 to 75%	1.500
LTV >75% ≤80%	2.000
LTV >80% ≤90%	2.500
Secondary Financing:	
80/10/10	0.000
75/20/5	0.250
80/15/5 or 90/5/5	0.250
Cash Out Refi - Owner Occupied	
LTV >70% ≤80%	0.500
LTV >80% ≤90%	0.750
Cash Out Refi - Non-Owner Occupied, 1-2 Units	
LTV 0 - 70%	1.500
LTV >70% ≤75%	2.000
LTV >75 ≤80%	2.500
LTV >80%	3.250
Cash Out Refi - Non-Owner Occupied, 3-4 Units	
LTV ≤70%	1.500
Credit Score	
FICO 679-620	0.125
FICO < 620	1.000
Interest Only 30 FRM	
LTV > 75% with subordinate financing	0.250
LTV > 90%	0.250

ARM/FRM State Adjustments

Tier 1	AL, AR, MS, ND, TX, WV
Tier 2	IN, LA, MI, NC, OH, OK, SC, TN
Tier 3	AK, DE, GA, IA, ID, KS, KY, MN, MT, NE, NM, PA, SD
Tier 4	CO, CT, FL, IL, ME, MD, MO, NH, NJ, NY, OR, RI, VA WA, WI, WY
Tier 5	AZ, CA, DC, HI, MA, NV, UT, VT

Loan Size	Tier 1	Tier 2	Tier 3	Tier 4	Tier 5
<$50,000	0.750	0.875	1.000	1.125	1.250
$50,001 - $100,000	0.375	0.500	0.625	0.750	0.875
$100,001 - $150,000	(0.375)	(0.250)	(0.125)	0.000	0.125
$150,001 - $175,000	(0.500)	(0.375)	(0.250)	(0.125)	0.000
>=$175,001	(0.500)	(0.375)	(0.375)	(0.250)	(0.125)

ARM Adjustments

10/1 LIBOR Max price 101.50 All other ARM's 102.00

	Price Adjustment
FastForward (Additional Guideline Restrictions May Apply)	0.000
Property Type	
Condo - California	0.000
Primary Residence Purchase, 1 unit, LTV >90%	0.250
Primary Residence Purchase, 2 unit, LTV >90%	0.750
3-4 Units	0.000
Doc Type	
Stated Income	0.750
Second Home	
SFR, LTV >80% ≤95%	0.250
Non-Owner Fees - Purchase/ No Cash out:	
LTV 0 to 75%	1.500
LTV >75% ≤80%	2.000
LTV >80% ≤90%	2.500
Secondary Financing:	
80/10/10	0.000
75/20/5	0.250
80/15/5 or 90/5/5	0.250
Cash Out Refi - Owner Occupied	
LTV >70% ≤80%	0.500
LTV >80% ≤90%	0.750
Cash Out Refi - Non-Owner Occupied, 1-2 Units	
LTV 0 - 70%	1.500
LTV >70% ≤75%	2.000
LTV >75 ≤80%	2.500
LTV >80%	3.250
Cash Out Refi - Non-Owner Occupied, 3-4 Units	
LTV ≤70%	1.500
Credit Score	
FICO 679-620	0.250
FICO < 620	1.000

ARM Guidelines

Stated Doc: 1-Unit/Primary Residence only

Occ/Purpose	LTV	Min FICO
O/O, 2nd, Purch/RT	LTV ≤70%	620
O/O, 2nd, Purch/RT	LTV >70% ≤95%	660
N/O/O, Purch/RT	LTV ≤75%	680
N/O/O, Purch/RT	LTV >75% ≤90%	720
All Cash out	LTV ≤70%	680
All Cash out	LTV > 70% ≤90%	720
Prop/Doc Type	**LTV**	**Min FICO**
3-4 Units	LTV ≤75%	680
Stated Doc Purch	LTV ≤75%	720

Ratelock Price Adjustments

Period	Best Efforts
15 Days	Refer to e-MITS for Rate Lock Adjustments
45 Days	
60 Days	

EXHIBIT 6

tabbies

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Spotlight

Explore These Changes to Our Expanded Lending Rate Sheet

- Pricing for LTV is now down to 65%
- Adjustor changes for: High-Rise Condo, 2 - 4 Family, Second Home & Non-Owner Occupied

Look for more exciting changes to our Expanded Lending product guidelines in the coming days.

Visit our Web Site at https://broker.citimortgage.com or contact your Account Executive for additional details.

FIXED RATE PRODUCTS

Conforming Programs

30 Year FRM

Note Rate	15-Day	30-Day	45-Day	60-Day
6.750	(2.368)	(2.366)	(2.293)	(2.268)
6.625	(2.178)	(2.140)	(2.077)	(2.042)
6.500	(1.885)	(1.842)	(1.779)	(1.744)
6.375	(1.493)	(1.450)	(1.393)	(1.381)
6.250	(1.234)	(1.210)	(1.158)	(1.142)
6.125	(0.923)	(0.894)	(0.847)	(0.826)
6.000	(0.526)	(0.490)	(0.449)	(0.423)
5.875	(0.044)	(0.003)	0.034	0.065
5.750	0.430	0.509	0.540	0.555
5.625	0.870	0.954	0.980	1.000
5.500	1.394	1.484	1.505	1.529
5.375	1.958	2.094	2.110	2.139

30 Year FRM - 10 Year Interest Only

Note Rate	15-Day	30-Day	45-Day	60-Day
7.125	(2.538)	(2.556)	(2.466)	(2.424)
7.000	(2.244)	(2.256)	(2.172)	(2.125)
6.875	(2.147)	(2.122)	(2.043)	(2.023)
6.750	(2.019)	(1.987)	(1.914)	(1.889)
6.625	(1.799)	(1.762)	(1.694)	(1.663)
6.500	(1.462)	(1.419)	(1.356)	(1.321)
6.375	(1.063)	(1.017)	(0.959)	(0.948)
6.250	(0.759)	(0.735)	(0.683)	(0.667)
6.125	(0.420)	(0.391)	(0.343)	(0.323)
6.000	0.018	0.053	0.095	0.121
5.875	0.507	0.548	0.585	0.616

15 Year FRM

Note Rate	15-Day	30-Day	45-Day	60-Day
6.625	(2.444)	(2.404)	(2.339)	(2.320)
6.500	(2.213)	(2.167)	(2.108)	(2.083)
6.375	(1.821)	(1.770)	(1.715)	(1.685)
6.250	(1.511)	(1.455)	(1.406)	(1.401)
6.125	(1.330)	(1.269)	(1.225)	(1.214)
6.000	(1.029)	(0.963)	(0.924)	(0.908)
5.875	(0.604)	(0.532)	(0.488)	(0.476)
5.750	(0.261)	(0.184)	(0.155)	(0.142)
5.625	0.016	0.099	0.122	0.140
5.500	0.353	0.440	0.458	0.483
5.375	0.836	0.929	0.941	0.972

20 Year FRM

Note Rate	15-Day	30-Day	45-Day	60-Day
6.750	(2.326)	(2.297)	(2.226)	(2.205)
6.625	(2.116)	(2.080)	(2.014)	(1.988)
6.500	(1.817)	(1.776)	(1.715)	(1.684)
6.375	(1.440)	(1.424)	(1.368)	(1.381)
6.250	(1.187)	(1.165)	(1.115)	(1.103)
6.125	(0.868)	(0.881)	(0.816)	(0.798)
6.000	(0.518)	(0.484)	(0.444)	(0.422)
5.875	(0.069)	(0.029)	0.005	0.032
5.750	0.382	0.438	0.468	0.480
5.625	0.759	0.841	0.866	0.883
5.500	1.251	1.339	1.358	1.380
5.375	1.800	1.894	1.908	1.935

40 Year FRM

Note Rate	15-Day	30-Day	45-Day	60-Day
7.125	(2.347)	(2.365)	(2.278)	(2.233)
7.000	(2.088)	(2.099)	(2.016)	(1.968)
6.875	(1.957)	(1.931)	(1.853)	(1.832)
6.750	(1.810)	(1.779)	(1.706)	(1.680)
6.625	(1.663)	(1.626)	(1.558)	(1.528)
6.500	(1.471)	(1.428)	(1.366)	(1.330)
6.375	(0.984)	(0.915)	(0.858)	(0.817)
6.250	(0.658)	(0.634)	(0.587)	(0.566)
6.125	(0.356)	(0.327)	(0.280)	(0.259)
6.000	0.023	0.058	0.100	0.126
5.875	0.564	0.606	0.642	0.673

10 Year FRM

Note Rate	15-Day	30-Day	45-Day	60-Day
6.625	(2.364)	(2.326)	(2.264)	(2.254)
6.500	(2.163)	(2.120)	(2.083)	(2.047)
6.375	(1.796)	(1.748)	(1.696)	(1.674)
6.250	(1.487)	(1.434)	(1.387)	(1.389)
6.125	(1.331)	(1.272)	(1.231)	(1.227)
6.000	(1.047)	(0.983)	(0.947)	(0.937)
5.875	(0.647)	(0.578)	(0.548)	(0.532)
5.750	(0.267)	(0.188)	(0.163)	(0.153)
5.625	(0.005)	0.074	0.094	0.110
5.500	0.337	0.421	0.436	0.458
5.375	0.763	0.852	0.862	0.890

Non Conforming Programs

30 Year FRM

Note Rate	15-Day	30-Day	45-Day	60-Day
7.250	(2.574)	(2.463)	(2.352)	(2.344)
7.125	(2.382)	(2.275)	(2.170)	(2.157)
7.000	(2.196)	(2.094)	(1.994)	(1.976)
6.875	(1.990)	(1.894)	(1.798)	(1.776)
6.750	(1.774)	(1.683)	(1.593)	(1.566)
6.625	(1.555)	(1.469)	(1.384)	(1.352)
6.500	(1.280)	(1.200)	(1.120)	(1.083)
6.375	(0.953)	(0.877)	(0.803)	(0.781)
6.250	(0.575)	(0.505)	(0.436)	(0.389)
6.125	0.060	0.125	0.189	0.239
6.000	0.697	0.757	0.815	0.870

15 Year FRM

Note Rate	15-Day	30-Day	45-Day	60-Day
6.750	(1.628)	(1.536)	(1.499)	(1.410)
6.625	(1.559)	(1.472)	(1.431)	(1.347)
6.500	(1.462)	(1.381)	(1.334)	(1.255)
6.375	(1.328)	(1.252)	(1.199)	(1.126)
6.250	(1.137)	(1.066)	(1.008)	(0.940)
6.125	(0.901)	(0.835)	(0.772)	(0.709)
6.000	(0.618)	(0.556)	(0.490)	(0.432)
5.875	(0.271)	(0.215)	(0.142)	(0.090)
5.750	0.120	0.170	0.248	0.296
5.625	0.754	0.800	0.861	0.924
5.500	1.387	1.427	1.513	1.550

20 Year FRM

Note Rate	15-Day	30-Day	45-Day	60-Day
7.250	(2.774)	(2.663)	(2.552)	(2.544)
7.125	(2.582)	(2.475)	(2.370)	(2.357)
7.000	(2.396)	(2.294)	(2.194)	(2.176)
6.875	(2.190)	(2.094)	(1.998)	(1.978)
6.750	(1.974)	(1.883)	(1.793)	(1.766)
6.625	(1.755)	(1.669)	(1.584)	(1.552)
6.500	(1.480)	(1.400)	(1.320)	(1.283)
6.375	(1.153)	(1.077)	(1.003)	(0.961)
6.250	(0.775)	(0.705)	(0.636)	(0.589)
6.125	(0.140)	(0.075)	(0.011)	0.039
6.000	0.497	0.557	0.615	0.670

10 Year FRM

Note Rate	15-Day	30-Day	45-Day	60-Day
6.750	(1.938)	(1.846)	(1.809)	(1.720)
6.625	(1.869)	(1.782)	(1.741)	(1.657)
6.500	(1.772)	(1.691)	(1.644)	(1.565)
6.375	(1.638)	(1.562)	(1.509)	(1.436)
6.250	(1.447)	(1.376)	(1.318)	(1.250)
6.125	(1.211)	(1.145)	(1.082)	(1.019)
6.000	(0.928)	(0.868)	(0.800)	(0.742)
5.875	(0.581)	(0.525)	(0.452)	(0.400)
5.750	(0.190)	(0.140)	(0.062)	(0.014)
5.625	0.444	0.490	0.571	0.614
5.500	1.077	1.117	1.203	1.240

Government Programs

FHA/VA 30 Year FRM

Note Rate	15-Day	30-Day	45-Day	60-Day
7.000	(2.479)	(2.462)	(2.388)	(2.345)
6.875	(2.141)	(2.125)	(2.051)	(2.007)
6.750	(2.316)	(2.282)	(2.224)	(2.197)
6.625	(2.057)	(2.017)	(1.964)	(1.932)
6.500	(1.690)	(1.650)	(1.597)	(1.565)
6.375	(1.282)	(1.242)	(1.188)	(1.157)
6.250	(1.044)	(1.017)	(0.980)	(0.963)
6.125	(0.703)	(0.670)	(0.638)	(0.618)
6.000	(0.251)	(0.219)	(0.187)	(0.164)
5.875	0.228	0.260	0.292	0.314
5.750	0.724	0.774	0.791	0.809
5.625	1.153	1.209	1.221	1.244

FHA/VA 15 Year FRM

Note Rate	15-Day	30-Day	45-Day	60-Day
7.000	(2.540)	(2.576)	(2.449)	(2.409)
6.500	(2.015)	(2.031)	(1.925)	(1.900)
6.000	(1.062)	(1.057)	(0.972)	(0.957)
5.500	0.425	0.451	0.516	0.541
5.000	1.914	1.961	2.005	2.054

REFER TO PAGE 3 FOR ALL APPLICABLE PRICING ADJUSTMENTS

EXHIBIT
tabbies
H

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Eye to Eye Service
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REMINDER: OUR PRICE INCENTIVE FOR ALL PURCHASES IS STILL .25%. REFER TO OUR NORTHERN CALIFORNIA WEEKLY UPDATE FOR LOCK DELIVERY POLICY AND CURRENT TURNTIMES.

Conforming ARM Programs

6 Month Treasury
Margin: 2.750 Caps: 1/1/6 Index: 4.950

Note Rate	15-Day	30-Day	45-Day	60-Day
7.000	(2.212)	(2.072)	(1.963)	(1.854)
6.875	(2.150)	(2.015)	(1.911)	(1.808)
6.750	(2.088)	(1.956)	(1.857)	(1.759)
6.625	(2.017)	(1.892)	(1.799)	(1.706)
6.500	(1.948)	(1.826)	(1.738)	(1.650)
6.375	(1.872)	(1.757)	(1.674)	(1.597)
6.250	(1.794)	(1.684)	(1.607)	(1.529)
6.125	(1.713)	(1.609)	(1.536)	(1.464)
6.000	(1.629)	(1.530)	(1.463)	(1.398)
5.875	(1.418)	(1.324)	(1.262)	(1.200)

1 Year Treasury
Margin: 2.750 Caps: 2/2/6 Index: 5.050

Note Rate	15-Day	30-Day	45-Day	60-Day
7.000	(2.115)	(1.975)	(1.866)	(1.757)
6.875	(2.023)	(1.888)	(1.785)	(1.681)
6.750	(1.932)	(1.802)	(1.704)	(1.605)
6.625	(1.842)	(1.717)	(1.623)	(1.530)
6.500	(1.751)	(1.631)	(1.543)	(1.455)
6.375	(1.661)	(1.546)	(1.464)	(1.381)
6.250	(1.571)	(1.462)	(1.384)	(1.306)
6.125	(1.358)	(1.254)	(1.181)	(1.109)
6.000	(1.266)	(1.168)	(1.100)	(1.033)
5.875	(1.174)	(1.080)	(1.019)	(0.957)

1 Year LIBOR
Margin: 2.250 Caps: 2/2/6 Index: 5.330

Note Rate	15-Day	30-Day	45-Day	60-Day
7.000	(2.181)	(2.041)	(1.932)	(1.823)
6.875	(2.090)	(1.955)	(1.851)	(1.748)
6.750	(2.000)	(1.870)	(1.772)	(1.673)
6.625	(1.910)	(1.785)	(1.692)	(1.599)
6.500	(1.820)	(1.701)	(1.613)	(1.525)
6.375	(1.730)	(1.616)	(1.533)	(1.450)
6.250	(1.640)	(1.531)	(1.453)	(1.375)
6.125	(1.548)	(1.444)	(1.372)	(1.299)
6.000	(1.386)	(1.287)	(1.220)	(1.153)
5.875	(1.290)	(1.196)	(1.134)	(1.072)

3/1 Treasury
Margin: 2.750 Caps: 2/2/6 Index: 5.050

Note Rate	15-Day	30-Day	45-Day	60-Day
6.250	(1.258)	(1.210)	(1.162)	(1.115)
6.125	(0.987)	(0.924)	(0.906)	(0.864)
6.000	(0.791)	(0.753)	(0.730)	(0.693)
5.875	(0.604)	(0.572)	(0.551)	(0.519)
5.750	(0.402)	(0.375)	(0.353)	(0.326)
5.625	(0.197)	(0.175)	(0.148)	(0.127)
5.500	0.019	0.035	0.067	0.083
5.375	0.261	0.273	0.309	0.320
5.250	0.490	0.496	0.538	0.543
5.125	0.725	0.727	0.773	0.773

3/1 LIBOR
Margin: 2.250 Caps: 2/2/6 Index: 5.330

Note Rate	15-Day	30-Day	45-Day	60-Day
6.250	(1.212)	(1.164)	(1.116)	(1.069)
6.125	(0.922)	(0.879)	(0.861)	(0.819)
6.000	(0.748)	(0.709)	(0.685)	(0.648)
5.875	(0.559)	(0.527)	(0.506)	(0.474)
5.750	(0.357)	(0.330)	(0.308)	(0.281)
5.625	(0.152)	(0.130)	(0.103)	(0.082)
5.500	0.064	0.080	0.112	0.128
5.375	0.307	0.319	0.356	0.366
5.250	0.536	0.542	0.584	0.589
5.125	0.772	0.774	0.820	0.820

FNMA 3/1 I/O LIBOR
Margin: 2.250 Caps: 2/2/6 Index: 5.330

Note Rate	15-Day	30-Day	45-Day	60-Day
6.250	(1.238)	(1.190)	(1.142)	(1.095)
6.125	(0.969)	(0.926)	(0.908)	(0.866)
6.000	(0.789)	(0.751)	(0.728)	(0.691)
5.875	(0.587)	(0.556)	(0.538)	(0.506)
5.750	(0.385)	(0.358)	(0.337)	(0.310)
5.625	(0.177)	(0.155)	(0.128)	(0.107)
5.500	0.054	0.071	0.102	0.118
5.375	0.300	0.311	0.348	0.358
5.250	0.528	0.533	0.574	0.579
5.125	0.779	0.780	0.826	0.826

5/1 Treasury
Margin: 2.750 Caps: 5/2/5 Index: 5.050

Note Rate	15-Day	30-Day	45-Day	60-Day
6.250	(1.386)	(1.334)	(1.317)	(1.267)
6.125	(1.171)	(1.124)	(1.103)	(1.058)
6.000	(0.945)	(0.903)	(0.876)	(0.837)
5.875	(0.633)	(0.596)	(0.565)	(0.530)
5.750	(0.373)	(0.342)	(0.317)	(0.288)
5.625	(0.155)	(0.129)	(0.099)	(0.075)
5.500	0.141	0.162	0.197	0.216
5.375	0.525	0.540	0.580	0.593
5.250	0.895	0.905	0.950	0.958
5.125	1.204	1.209	1.258	1.261

5/1 LIBOR
Margin: 2.250 Caps: 5/2/5 Index: 5.330

Note Rate	15-Day	30-Day	45-Day	60-Day
6.250	(1.259)	(1.207)	(1.190)	(1.140)
6.125	(1.044)	(0.997)	(0.976)	(0.931)
6.000	(0.817)	(0.775)	(0.748)	(0.709)
5.875	(0.505)	(0.468)	(0.437)	(0.402)
5.750	(0.246)	(0.215)	(0.190)	(0.161)
5.625	(0.027)	(0.001)	0.029	0.053
5.500	0.269	0.290	0.325	0.344
5.375	0.652	0.667	0.707	0.720
5.250	1.018	1.028	1.073	1.081
5.125	1.328	1.332	1.381	1.384

FNMA 5/1 I/O LIBOR
Margin: 2.250 Caps: 5/2/5 Index: 5.330

Note Rate	15-Day	30-Day	45-Day	60-Day
6.875	(2.346)	(2.268)	(2.230)	(2.154)
6.750	(2.132)	(2.059)	(1.993)	(1.922)
6.625	(1.848)	(1.780)	(1.743)	(1.676)
6.500	(1.623)	(1.560)	(1.518)	(1.458)
6.375	(1.642)	(1.585)	(1.573)	(1.518)
6.250	(1.403)	(1.351)	(1.334)	(1.284)
6.125	(1.190)	(1.143)	(1.121)	(1.077)
6.000	(0.912)	(0.870)	(0.844)	(0.804)
5.875	(0.578)	(0.541)	(0.510)	(0.476)
5.750	(0.357)	(0.325)	(0.301)	(0.271)

7/1 Treasury
Margin: 2.750 Caps: 5/2/5 Index: 5.050

Note Rate	15-Day	30-Day	45-Day	60-Day
6.750	(2.434)	(2.382)	(2.330)	(2.259)
6.625	(2.139)	(2.073)	(2.036)	(1.970)
6.500	(1.880)	(1.818)	(1.777)	(1.717)
6.375	(1.554)	(1.498)	(1.475)	(1.420)
6.250	(1.351)	(1.299)	(1.281)	(1.231)
6.125	(1.123)	(1.077)	(1.053)	(1.009)
6.000	(0.815)	(0.775)	(0.748)	(0.707)
5.875	(0.411)	(0.375)	(0.342)	(0.308)
5.750	(0.042)	(0.011)	0.014	0.043
5.625	0.263	0.288	0.318	0.342

7/1 LIBOR
Margin: 2.250 Caps: 5/2/5 Index: 5.330

Note Rate	15-Day	30-Day	45-Day	60-Day
6.750	(2.104)	(2.032)	(2.000)	(1.929)
6.625	(1.810)	(1.743)	(1.706)	(1.641)
6.500	(1.550)	(1.488)	(1.447)	(1.387)
6.375	(1.224)	(1.168)	(1.147)	(1.091)
6.250	(1.022)	(0.970)	(0.952)	(0.902)
6.125	(0.793)	(0.748)	(0.724)	(0.679)
6.000	(0.486)	(0.446)	(0.417)	(0.378)
5.875	(0.082)	(0.046)	(0.013)	0.021
5.750	0.288	0.319	0.344	0.373
5.625	0.594	0.619	0.649	0.673

FNMA 7/1 I/O LIBOR
Margin: 2.250 Caps: 5/2/5 Index: 5.330

Note Rate	15-Day	30-Day	45-Day	60-Day
7.375	(3.795)	(3.697)	(3.624)	(3.527)
7.250	(3.521)	(3.429)	(3.351)	(3.259)
7.125	(2.873)	(2.785)	(2.734)	(2.648)
7.000	(2.571)	(2.489)	(2.433)	(2.352)
6.875	(2.677)	(2.600)	(2.573)	(2.497)
6.750	(2.317)	(2.245)	(2.213)	(2.142)
6.625	(2.030)	(1.963)	(1.927)	(1.861)
6.500	(1.730)	(1.668)	(1.627)	(1.567)
6.375	(1.420)	(1.364)	(1.351)	(1.296)
6.250	(1.215)	(1.163)	(1.145)	(1.095)

10/1 Treasury
Margin: 2.750 Caps: 5/2/5 Index: 5.050

Note Rate	15-Day	30-Day	45-Day	60-Day
6.750	(2.832)	(2.756)	(2.720)	(2.645)
6.625	(2.436)	(2.364)	(2.323)	(2.254)
6.500	(2.124)	(2.057)	(2.011)	(1.947)
6.375	(1.735)	(1.673)	(1.623)	(1.563)
6.250	(1.393)	(1.337)	(1.312)	(1.258)
6.125	(1.097)	(1.046)	(1.017)	(0.968)
6.000	(0.745)	(0.699)	(0.664)	(0.621)
5.875	(0.260)	(0.239)	(0.200)	(0.161)
5.750	0.152	0.187	0.218	0.249
5.625	0.538	0.568	0.602	0.630

10/1 LIBOR
Margin: 2.250 Caps: 5/2/5 Index: 5.330

Note Rate	15-Day	30-Day	45-Day	60-Day
6.750	(2.555)	(2.479)	(2.443)	(2.368)
6.625	(2.180)	(2.109)	(2.068)	(1.998)
6.500	(1.854)	(1.788)	(1.742)	(1.677)
6.375	(1.462)	(1.400)	(1.350)	(1.291)
6.250	(1.138)	(1.081)	(1.057)	(1.003)
6.125	(0.837)	(0.786)	(0.757)	(0.708)
6.000	(0.460)	(0.414)	(0.380)	(0.336)
5.875	(0.002)	0.039	0.078	0.117
5.750	0.430	0.465	0.494	0.527
5.625	0.816	0.846	0.880	0.908

FNMA 10/1 I/O LIBOR
Margin: 2.250 Caps: 5/2/5 Index: 5.330

Note Rate	15-Day	30-Day	45-Day	60-Day
7.375	(4.587)	(4.484)	(4.411)	(4.310)
7.250	(4.284)	(4.186)	(4.108)	(4.012)
7.125	(3.393)	(3.300)	(3.246)	(3.156)
7.000	(3.045)	(2.958)	(2.899)	(2.814)
6.875	(3.169)	(3.087)	(3.056)	(2.976)
6.750	(2.698)	(2.621)	(2.585)	(2.510)
6.625	(2.316)	(2.244)	(2.203)	(2.133)
6.500	(1.970)	(1.904)	(1.858)	(1.794)
6.375	(1.561)	(1.499)	(1.449)	(1.390)
6.250	(1.223)	(1.167)	(1.143)	(1.089)

Government ARM Programs

FHA 1 Year ARM
Margin: 2.750 Caps: 1/1/5 Index: 5.050

Note Rate	15-Day	30-Day	45-Day	60-Day
5.750	0.447	0.754	0.773	0.772
5.625	0.478	0.793	0.807	0.810
5.500	0.578	0.897	0.906	0.914
5.375	0.841	1.167	1.171	1.184
5.250	1.112	1.444	1.442	1.460
5.125	1.385	1.721	1.714	1.737
5.000	1.595	1.936	1.923	1.951
4.875	1.872	2.218	2.200	2.233
4.750	2.040	2.391	2.368	2.405
4.625	2.270	2.626	2.598	2.640

Government ARM Change Dates

	Purchased by		
Product	02/26/07	06/25/07	08/25/07
1yr ARM	04/01/08	07/01/08	10/01/08
3/1 ARM	04/01/10	07/01/10	10/01/10

FHA/VA 3/1 ARM
Margin: 2.000 Caps: 1/1/5 Index: 5.050

Note Rate	15-Day	30-Day	45-Day	60-Day
6.000	0.232	0.548	0.589	0.607
5.875	0.574	0.894	0.930	0.953
5.750	0.931	1.256	1.287	1.315
5.625	1.145	1.475	1.501	1.518
5.500	1.231	1.566	1.587	1.607
5.375	1.608	1.947	1.963	1.988
5.250	1.997	2.342	2.352	2.382
5.125	2.519	2.900	2.905	2.939
5.000	2.728	3.113	3.113	3.153
4.875	3.131	3.522	3.518	3.560

REFER TO PAGE 4 FOR ALL APPLICABLE PRICING ADJUSTMENTS

A member

EXHIBIT
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abc American Brokers Conduit

AMERICAN BROKERS CONDUIT
ABC WEST - IRVINE WHOLESALE RATESHEET
WWW.ABCONDUIT.COM

Effective Date: 12/15/06
Effective Time: 10 18 AM
Rate-sheet Code: abcwest-51-3110

12 MO MTA 4.883

ABC POWER ARMS (30 & 40 Yr Am) Full Doc and Stated, Possible Neg Am MTA ARMs

		Base Pricing (60 Day)			
Start Rate	Margin	No PPP	1 YR PPP	2 YR PPP	3 YR PPP
1.000	2.400	0.125	0.000	(0.625)	(1.250)
1.000	2.450	0.000	(0.125)	(0.750)	(1.375)
1.000	2.500	(0.125)	(0.250)	(0.875)	(1.500)
1.000	2.550	(0.250)	(0.375)	(1.000)	(1.625)
1.000	2.600	(0.375)	(0.500)	(1.125)	(1.875)
1.000	2.650	(0.500)	(0.625)	(1.250)	(2.000)
1.000	2.700	(0.625)	(0.750)	(1.375)	(2.250)
1.000	2.750	(0.750)	(0.875)	(1.500)	(2.375)
1.000	2.800	NA	(1.000)	(1.625)	(2.625)
1.000	2.850	NA	(1.125)	(1.750)	(2.875)
1.000	2.900	NA	(1.250)	(1.875)	(3.000)
1.000	2.950	NA	NA	(2.000)	(3.125)
1.000	3.000	(1.000)	NA	NA	(3.250)
1.000	3.050	NA	NA	NA	(3.375)
1.000	3.100	NA	NA	NA	(3.500)
1.000	3.150	NA	(1.500)	(2.250)	(3.625)
1.000	3.200	NA	NA	NA	(3.750)
1.000	3.250	(1.250)	NA	NA	(3.850)
1.000	3.300	NA	NA	NA	(3.900)
1.000	3.350	NA	NA	(2.500)	(3.950)
1.000	3.400	NA	(1.750)	NA	(4.000)
1.000	3.450	NA	NA	NA	(4.050)

Fully Indexed Rate = Margin + Index

Program Notes	Program Notes for all LPMI (Lender Paid MI)
OO Life Cap 9.95%, NOO Life Cap 10.35%	Life Cap 10.55%
Max Broker rebates are as shown	
Refer to Guidelines for SIFA/SISA Max LTV	Refer to Guidelines for Max LTV
3-4 Units Not Available for SISA	
Refer to Guidelines for State Availability	Cash-Out Not Allowed on SISA
Ineligible states: AR, ME, NH, ND, WV	
No PPP: NJ, VT, IA, NM, AK	No PPP: NJ, VT, IA, NM, AK
SC <$180K, NC <$150K, PA <$50K	SC <$180K, NC <$150K, PA <$50K
MD if APR at closing is >= 8%	MD if APR at closing is >= 8%
IL if Fully Indexed Rate is > 8%	IL if Fully Indexed Rate is > 8%

QUALIFICATION RATES

Qualification Rates for 1 MO
Loans With Potential for Negative Amortization
(Use the P&I and Qualify at the Higher of the Start Rate or)

Primary & Second Homes	4.25% for LTV <= 90%
	4.95% for LTV > 90%
LPMI (Lender Paid MI) Primary & Second Homes	4.750%
Investment Properties	4.50%

Exceptions (FIFA & SIFA only):
Loans Amount >$650K and <=$1.0M & LTV is >80% Fully Indexed Rate

PRODUCT CODES	1 MO Fix Pmt 1 Yr		1 MO Fix Pmt 5 Yrs	
NON NY PROPERTIES	30 YR	40 YR	30 YR	40 YR
FIFA	1291	1292	2129	2130
FIFA > 95% LTV	2643	2644	N/A	N/A
FIFA w/LPMI <=95% LTV	1295	1296	2139	2140
FIFA w/LPMI >95<=100% LTV	1453	1459	2139	2140
FIFA NOO - Life Cap 10.35%	1349	1350	2134	2135
Non-Warrantable New Constr Condo	1365	N/A	2136	N/A
SIFA	1323	1324	2143	2144
SIFA w/LPMI <=95% LTV	2373	2377	2390	2391
SIFA - NOO, Life Cap 10.35%	1357	1358	2147	2148
SISA	1376	1380	2149	2150
SISA - NOO	1384	1388	2151	2152
SISA w/LPMI	2631	2632	2634	2635

LPMI ADJUSTMENTS TO RATE AND MARGIN FOR ALL PRODUCTS

	FICO	80.01-85%	85.01-90%	90.01-95%	95.01-100%	80.01-85%	85.01-90%	90.01-95%	95.01-100%	80.01-85%	85.01-90%	All Eligible LTV's	
		FIFA LPMI				SIFA LPMI				SISA LPMI		2nd home	Cashout**
M	<=659	0.500	0.750	1.125	N/A	0.875	1.250	N/A	N/A	N/A	N/A	0.250	0.250
a	660-679	0.500	0.750	1.125	N/A	0.875	1.250	N/A	N/A	N/A	N/A	0.250	0.250
r	680-699	0.500	0.625	0.875	N/A	0.750	1.000	1.375	N/A	0.875	1.000	0.140	0.100
g	700-719	0.375	0.625	0.750	1.125	0.500	0.750	1.125	N/A	0.625	0.875	0.140	0.100
i	720-739	0.375	0.500	0.625	1.000	0.500	0.625	0.875	N/A	0.500	0.625	0.140	0.100
n	>=740	0.375	0.500	0.625	1.000	0.500	0.625	0.875	N/A	0.500	0.625	0.140	0.100
Rate	All FICO	0.375	0.375	0.375	1.000	0.625	0.625	0.875	N/A	0.500	0.625	0.140	0.100

**LPMI SISA Not Eligible for Cash out

All Adjustments are Cumulative

ADJUSTMENTS TO MARGIN FOR ALL PRODUCTS

LTV %	<=65	65.01-70	70.01-75	75.01-80	80.01-85	85.01-90	90.01-95	95.01-100
Program Description								
FICO								
>=720	(0.050)	(0.050)	(0.050)	(0.050)	(0.050)	(0.050)	(0.050)	(0.050)
680-699	0.000	0.000	0.050	0.050	0.050	0.050	0.050	N/A
660-679	0.000	0.050	0.100	0.100	0.100	0.100	0.100	N/A
<659	0.050	0.100	0.150	0.150	0.150	0.150	0.150	N/A
Purpose								
Cash-Out	0.050	0.100	0.150	0.150	0.150	0.150	0.150	N/A
Property Type								
Coop	0.000	0.050	0.050	0.050	0.050	0.050	0.050	0.050
3 Unit	0.100	0.250	0.250	0.250	0.250	0.250	0.250	N/A
4 Unit	0.100	0.250	0.250	0.250	0.250	0.250	0.250	N/A
Occupancy								
Second Home	0.000	0.100	0.150	0.150	0.150	0.150	0.150	0.150
Investor *	0.200	0.300	0.400	0.400	0.400	0.400	N/A	N/A
Loan Size								
<=$35K	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000
$35,001-$50K	0.625	0.625	0.625	0.625	0.625	0.625	0.625	0.625
$50,001-$60K	0.250	0.250	0.250	0.250	0.250	0.250	0.250	0.250
$650,001-$1MM	0.000	0.050	0.050	0.050	0.050	0.050	N/A	N/A
>$1MM-$1.5MM	0.000	0.100	0.150	0.150	N/A	N/A	N/A	N/A
>$1.5MM-$2.5MM *	0.150	0.250	0.250	0.25 (<=2M)	N/A	N/A	N/A	N/A
>$2.5MM *	0.250	0.375	0.375	N/A	N/A	N/A	N/A	N/A
Doc Type								
SISA > 720 *	0.250	0.250	0.250	0.750	0.250	0.250	N/A	N/A
SISA <= 720 *	0.250	0.250	0.250	1.125	0.250	0.250	N/A	N/A
Term								
40 Year Term *	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100

ADJUSTMENTS TO RATE FOR ALL PRODUCTS

LTV %	<=65	65.01-70	70.01-75	75.01-80	80.01-85	85.01-90	90.01-95	95.01-100
Program Description								
1 MO Neg w/ Min Pay for 5 Years *	0.900	0.900	0.900	0.900	0.900	0.900	0.900	0.900
Occupancy								
Investor *	0.200	0.300	0.400	0.400	0.400	0.400	N/A	N/A
Loan Size								
>$1.5MM-$2.5MM *	0.250	0.250	0.250	0.25 (<=2M)	N/A	N/A	N/A	N/A
>$2.5MM *	0.375	0.375	0.375	N/A	N/A	N/A	N/A	N/A
Doc Type								
SISA > 720 *	0.250	0.250	0.250	0.750	0.250	0.250	N/A	N/A
SISA <= 720 *	0.250	0.250	0.250	1.125	0.250	0.250	N/A	N/A
Term								
40 Year 3-4 Units *	0.500	0.500	0.500	0.500	0.500	0.500	0.500	N/A

* Feature has both rate and margin adjustments.

Access our Rate Lock Policy at www.abcondult.com.
Check guidelines for availability. Pricing grids/adjustment sections may not reflect all prod guidelines
This rate sheet is a communication between the lender and professionals in the real estate industry. Rates Subject To Change Without Notice. shm51

EXHIBIT 5

tabbies

Indymac Bank

12 MAT Pay Option ARM - Wholesale

Effective: 12/20/06 6:59 AM — www.indymacb2b.com

e-MITS Help Desk: 1-888-50e-MITS — e-MITS Lock Hours: 7:00AM - 8:00PM PST

Start Rate	Margin	30-Day	45-Day	PrePay	LifeCap
1.000	2.550	0.000	0.125	None	9.95%
1.000	2.650	(0.500)	(0.375)	None	9.95%
1.000	2.750	(0.750)	(0.625)	None	9.95%
1.000	2.875	(1.000)	(0.875)	None	9.95%
1.000	2.500	0.000	0.125	1 Year Hard	9.95%
1.000	2.600	(0.250)	(0.125)	1 Year Hard	9.95%
1.000	2.700	(0.500)	(0.375)	1 Year Hard	9.95%
1.000	2.800	(0.750)	(0.625)	1 Year Hard	9.95%
1.000	2.900	(1.000)	(0.875)	1 Year Hard	9.95%
1.000	3.000	(1.250)	(1.125)	1 Year Hard	9.95%
1.000	3.100	(1.500)	(1.375)	1 Year Hard	9.95%
1.000	3.300	(2.000)	(1.875)	1 Year Hard	9.95%
1.000	3.400	(2.250)	(2.125)	1 Year Hard	9.95%
1.000	2.700	0.000	0.125	2 Year Hard	9.95%
1.000	2.700	(1.250)	(1.125)	2 Year Hard	9.95%
1.000	2.800	(1.500)	(1.375)	2 Year Hard	9.95%
1.000	2.900	(1.750)	(1.625)	2 Year Hard	9.95%
1.000	3.000	(2.000)	(1.875)	2 Year Hard	9.95%
1.000	3.100	(2.250)	(2.125)	2 Year Hard	9.95%
1.000	3.300	(2.750)	(2.626)	2 Year Hard	9.95%
1.000	2.100	0.000	0.125	3 Year Hard	9.95%
1.000	2.400	(1.000)	(0.875)	3 Year Hard	9.95%
1.000	2.500	(1.500)	(1.376)	3 Year Hard	9.95%
1.000	2.600	(2.000)	(1.875)	3 Year Hard	9.95%
1.000	2.700	(2.250)	(2.125)	3 Year Hard	9.95%
1.000	2.800	(2.500)	(2.375)	3 Year Hard	9.95%
1.000	2.900	(2.750)	(2.625)	3 Year Hard	9.95%
1.000	3.000	(3.000)	(2.875)	3 Year Hard	9.95%
1.000	3.200	(3.500)	(3.376)	3 Year Hard	9.95%
1.000	3.400	(4.000)	(3.876)	3 Year Hard	9.95%
Current Index (MTA)			4.883		
Qualifying Rate	Greater of fully indexed rate or 4.50%				

12 MAT ADJUSTMENTS		Start Rate	Margin	Price
Loan Amount	<=$75,000	-	0.125	0.250
	>$417,000<=$500,000*		(0.150)	
	>$500,000<=$650,000*		(0.200)	
	>$650,000<=$1MM*	-	(0.250)	-
	>$1 MM <=$1.5MM*	-	(0.300)	-
	> $1.5 MM	0.500		
	*Credit applies when selecting 3Yr Hard Prepay			
Owner Occupied	2nd Home LTV >70%	-	0.100	-
	2-Unit LTV > 70%		0.100	
	3-4 Units LTV > 65%	0.400	0.400	-
	High-rise Condo LTV > 80%	-	0.200	-
	> 80% - 90% LTV	1.000	-	-
	> 90% - 95% LTV	1.750	-	-
Non Owner Occupied	SFR, PUD, Condos & 2 Unit	-	0.400	-
	3-4 Units > 70%	1.000	1.000	-
	3-4 Units < = 70%	0.500	0.500	-
	All Non Owner	1.000	-	-
Misc.	Cash Out, LTV >70%	0.200	0.200	-
	Cash Out Proceeds >$500,000		0.100	
	>=720 FICO (with 3 Yr Prepay)		(0.050)	
	Stated Income LTV > 80% LTV	0.750		
	Stated Income LTV > 70%, <680 FICO	0.250	0.100	-
	NINA, LTV <=70% CLTV	-	0.200	-
	NINA, LTV > 70% CLTV	1.000	0.250	-
	Full Doc >=680 FICO (with 3 Yr Prepay)	-	(0.050)	-
	40-Year Amortization	0.250	0.250	
	Non Permanent Resident Alien	-	0.375	0.500
Credit Score	>= 660 < 680, LTV > 85%	0.250	0.200	
	>= 640 < 660, LTV > 80%	1.000	0.300	
	>= 620 < 640, LTV > 80%	1.250	0.500	-

Maximum Rebates	
No Prepay	(1.000)
1 Yr Hard Prepay	(2.250)
2 Yr Hard Prepay	(2.750)
3 Yr Hard Prepay <= $1MM	(4.000)
3 Yr Hard Prepay - NINA	(3.750)
3 Yr Hard Prepay - <680 FICO	(3.750)
3 Yr Hard Prepay 40 Yr Amrt <$1MM	(3.750)
3 Yr Hard Prepay > $1MM	(3.250)
3 Yr Hard Prepay 40 Yr Amrt > $1MM	(3.250)

[illegible]

Rates, commitments, fees and programs are subject to change without notice. [illegible]

[illegible]

Equal Housing Lender
Member FDIC

[illegible]

EXHIBIT
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AMERICAN BROKERS CONDUIT
ABC WEST - IRVINE WHOLESALE RATESHEET
WWW.ABCONDUIT.COM

Effective Date 12/15/06
Effective Time 10 18 AM
Rate-sheet Code abcwest-51-3110

12 MO MTA 4.883

Power Fixed 5-Year ARM

PRICING IS 30 DAYS

	Rate	30 Day			
		3 Yr PPP	2 Yr PPP	1 Yr PPP	No PPP
Margin	3.250				
Payment Rate	1.250				
Accrual Rate	6.625	(0.125)	0.375	0.625	0.750
Accrual Rate	6.750	(0.500)	0.000	0.250	0.500
Accrual Rate	6.875	(0.875)	(0.375)	(0.125)	0.250
Accrual Rate	7.000	(1.250)	(0.625)	(0.250)	0.125
Accrual Rate	7.125	(1.625)	(1.000)	(0.500)	(0.125)
Accrual Rate	7.250	(1.875)	(1.250)	(0.750)	(0.375)
Accrual Rate	7.375	(2.250)	(1.500)	(0.875)	(0.500)
Accrual Rate	7.500	(2.500)	(1.750)	(1.000)	N/A
Accrual Rate	7.625	(2.750)	(2.000)	(1.125)	N/A
Accrual Rate	7.750	(3.000)	(2.250)	N/A	N/A
Accrual Rate	7.875	(3.250)	(2.500)	N/A	N/A
Accrual Rate	8.000	(3.500)	N/A	N/A	N/A
Accrual Rate	8.125	(3.625)	N/A	N/A	N/A

QUALIFICATION RATES

Loans With Potential for Negative Amortization (Use the P&I and Qualify at the Higher of the Start Rate or)	NO PPP
Primary & Second Homes 4.25% for LTV <= 80% / 4.75% for LTV > 80%	NJ, VT, IA, NM, AK SC <$180K, NC <$150K, PA <$50K MD if APR at closing is >= 8% IL if Fully Indexed Rate is > 8%
Exception (Full Doc Only) Loan Amounts >$650K and <=$1.0M & LTV is >80% - Fully Indexed Rate	

PRODUCT CODES - NON NY PROPERTIES

	3 Yr PPP	2 Yr PPP	1 Yr PPP	No PPP
FIFA LTV <= 90	2451	2450	2449	2447
FIFA LTV >90 <=100	2458	2457	2456	2455
SIFA ALL LTV's	2462	2461	2460	2459

PRODUCT CODES - NY PROPERTIES

	3 Yr PPP	2 Yr PPP	1 Yr PPP	No PPP
ALL LTV's	2454	2453	2452	2448
SIFA ALL LTV's	2466	2465	2464	2463

Max Rebate After Adjustments

	3 Yr PPP	2 Yr PPP	1 Yr PPP	No PPP
Max Rebate	(3.500)	(2.750)	(1.375)	(0.750)

Payment Rate, Accrual Rate and Margin Adjustments

LTV	<=65%	65.01-70	70.01-75	75.01-80	80.01-85	85.01-90	90.01-95	95.01-100
LTV	0.000	0.000	0.000	0.000	0.250	0.500	0.750	1.125
FICO <680	0.000	0.000	0.125	0.125	0.125	0.125	0.125	NA
SIFA	0.000	0.000	0.000	0.000	0.375	0.375	N/A	NA
Cash Out	0.000	0.000	0.000	0.000	0.125	0.125	0.125	NA
2nd Home	0.000	0.000	0.000	0.000	0.125	0.125	0.125	0.125
CLTV >80%	0.375	0.375	0.375	0.375	0.375	0.375	N/A	NA

Accrual Rate Adjustments

LTV	<=65%	65.01-70	70.01-75	75.01-80	80.01-85	85.01-90	90.01-95	95.01-100
$60k - $99,999	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125
> $1.0M<=$2.0M	0.125	0.125	0.125	0.125	NA	NA	NA	NA
> $2.0M<=$3.0M	0.250	0.250	0.250	0.250	NA	NA	NA	NA
> $3.0M<=$4.0M	0.375	0.375	NA	NA	NA	NA	NA	NA
> $4.0M<=$5.0M	0.500	NA	NA	NA	NA	NA	NA	NA

Points Adjustments

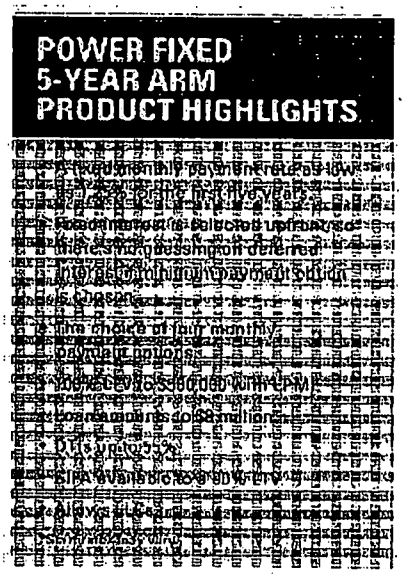
LTV	<=65%	65.01-70	70.01-75	75.01-80	80.01-85	85.01-90	90.01-95	95.01-100
<$1.5MM, FICO >=720	(0.250)	(0.250)	(0.250)	(0.250)	(0.250)	(0.250)	(0.250)	0.000
SIFA	0.375	0.375	0.375	0.375	0.375	0.375	NA	NA
Cash Out	0.000	0.250	0.250	0.250	0.250	0.250	0.250	NA
2nd Home	0.000	0.500	0.500	0.500	0.500	0.500	0.500	0.500
2 Unit	0.000	0.500	0.500	0.500	0.500	0.500	0.500	0.500
3-4 Unit	0.000	0.750	0.750	0.750	0.750	0.750	0.750	NA
Coop - Where Permitted	0.250	0.250	0.250	0.250	0.250	0.250	0.250	0.250
FICO <660	0.000	0.000	0.250	0.250	0.250	0.250	0.250	NA
45 days (vs 30 day)	0.094	0.094	0.094	0.094	0.094	0.094	0.094	0.094
60 days (vs 30 day)	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125
90 days (vs 30 day)	0.500	0.500	0.500	0.500	0.500	0.500	0.500	0.500

Program Notes

The Pricing Adjustments above are not meant to be an indication as to the acceptability of any particular guideline, please refer to the product summaries for eligibility
PRICING IS 30 DAYS 30 Yr Terms Only

Use fully indexed rate to qualify for loan amounts > $650K - <= $1.0M if LTV is > 80%
Pricing includes LPMI for LTV's over 80%

POWER FIXED 5-YEAR ARM PRODUCT HIGHLIGHTS



Access our Rate Lock Policy at www.abconduit.com.
Check guidelines for availability. Pricing grids/adjustment sections may not reflect all prod guidelines
This rate sheet is a communication between the lender and professionals in the real estate industry. Rates Subject To Change Without Notice. ahm51

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Atty. No. 99000

IN THE CIRCUIT COURT OF COOK COUNTY, STATE OF ILLINOIS
COUNTY DEPARTMENT - CHANCERY DIVISION

FILED - 2
2008 JUN 25 AM 10: 18
CIRCUIT COURT OF COOK
COUNTY, ILLINOIS
CHANCERY DIV.
DOROTHY BROWN CLERK

THE PEOPLE OF THE STATE OF ILLINOIS,

Plaintiff,

v.

COUNTRYWIDE FINANCIAL CORPORATION, a Delaware corporation; COUNTRYWIDE HOME LOANS, INC., a New York corporation also d/b/a Full Spectrum Lending; FULL SPECTRUM LENDING, a California corporation formerly doing business in Illinois; COUNTRYWIDE HOME LOANS SERVICING, LP, a Texas partnership; and ANGELO R. MOZILO, individually and in his capacity as Chief Executive Officer of Defendant COUNTRYWIDE FINANCIAL CORPORATION;

Defendants.

08CH22994

COMPLAINT FOR INJUNCTIVE AND OTHER RELIEF

NOW COMES the Plaintiff, THE PEOPLE OF THE STATE OF ILLINOIS, by LISA MADIGAN, Attorney General of the State of Illinois, and complains of Defendants COUNTRYWIDE FINANCIAL CORPORATION, a Delaware corporation, COUNTRYWIDE HOME LOANS, INC., a New York corporation also doing business as Full Spectrum Lending, FULL SPECTRUM LENDING, a California corporation formerly doing business in Illinois, COUNTRYWIDE HOME LOANS SERVICING LP, a Texas partnership, and ANGELO R.

EXHIBIT
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MOZILO, individually and in his capacity as Chief Executive Officer of Defendant COUNTRYWIDE FINANCIAL CORPORATION.

Countrywide, in pursuit of market share, engaged in unfair and deceptive practices including the loosening of underwriting standards, structuring unfair loan products with risky features, engaging in misleading marketing and sales techniques, and incentivizing employees and brokers to sell more and more loans with risky features. Countrywide's business practices resulted in unaffordable mortgage loans and increased delinquencies and foreclosures for Illinois homeowners.

Countrywide's explosive growth was paralleled by the demand for loans with non-traditional risky features on the secondary market. Through the securitization process, Countrywide shifted the risk of the failure of these non-traditional loans to investors. Moreover, securitization allowed Countrywide to gain much needed capital to fuel the origination process and reach its goal of capturing more and more market share. As the risky Countrywide loans began to fail, it was forced to repurchase or replace the failing loans in the investor pools. This created further pressure to increase the volume of loan origination.

To facilitate the increase in loan origination volume, Countrywide relaxed its underwriting standards and sold unaffordable and unnecessarily expensive loans. Reduced documentation underwriting guidelines were heavily used to qualify many borrowers for unaffordable loans. Countrywide created so-called "affordability" loan products, such as adjustable rate mortgages and interest-only loan products, that only required qualifying borrowers at less than the full interest rate for the loan products. Countrywide pushed products that containing layers of unduly risky features, such as pay option ARMs and mortgage loans for 100% of the value of borrowers' homes. Unfair and deceptive advertising, marketing and sales

practices were utilized to push mortgages, while hiding the real costs and risks to borrowers. These practices included enticing borrowers with low teaser rates, low monthly payments and "no closing cost" loans that failed to make clear and conspicuous disclosures of the products' risks. Finally, Countrywide engaged in unfair and deceptive acts and practices while servicing borrowers' loans, such as requiring borrowers to make initial payments without regard to whether a loan repayment plan or loan modification was even possible.

JURISDICTION AND VENUE

1. This action is brought for and on behalf of THE PEOPLE OF THE STATE OF ILLINOIS, by LISA MADIGAN, Attorney General of the State of Illinois, pursuant to the provisions of the Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/1 *et seq.*, the Illinois Fairness in Lending Act, 815 ILCS 120/1 *et seq.*, and her common law authority as Attorney General to represent the People of the State of Illinois.

2. Venue for this action properly lies in Cook County, Illinois, pursuant to Section 2-101 of the Illinois Code of Civil Procedure, 735 ILCS 5/2-101, in that the Defendants are doing business in Cook County, Illinois.

PARTIES

3. Plaintiff, THE PEOPLE OF THE STATE OF ILLINOIS, by LISA MADIGAN, Attorney General of the State of Illinois, is charged, *inter alia,* with the enforcement of the Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/1 *et seq.* and the Illinois Fairness in Lending Act, 815 ILCS 120/1 *et seq.*

4. Defendant ANGELO R. MOZILO is a co-founder of Defendant COUNTRYWIDE FINANCIAL CORPORATION, which was formed as Countrywide Credit Industries in 1969.

5. Defendant MOZILO participates in, manages, controls, and has knowledge of the day-to-day activities of Defendant COUNTRYWIDE FINANCIAL CORPORATION. He has been the Chairman of Defendant COUNTRYWIDE FINANCIAL CORPORATION'S Board since March 1999 and Chief Executive Officer of the company since February 1998. Defendant MOZILO was also President of the company from March 2000 through December 2003 and has served in other executive capacities since the company's formation.

6. Defendant MOZILO has stated that he has "devoted [his] life to building from the ground up a mortgage banking company focused on providing homeownership opportunities to all Americans" for the last four decades.

7. Although Defendant MOZILO resides in California, his companies conduct business in Illinois and, on at least two occasions, he has engaged in purposeful activity to further the interests of Defendant COUNTRYWIDE FINANCIAL CORPORATION (and its subsidiaries) while in the State of Illinois.

8. Specifically, during an April 27, 2006 earnings conference call, Defendant MOZILO reported that he had just finished a tour of the offices of the subsidiary that handles the securitization of mortgage loans originated by Defendant COUNTRYWIDE FINANCIAL CORPORATION. As he reported, one of those offices was in Chicago.

9. In addition, during October 1998, Defendant MOZILO appeared at the Mortgage Banker's Association of America's annual convention in Chicago. At this appearance, Defendant MOZILO discussed the turbulence in the mortgage business and stated that only big firms with adequate resources to maintain access to bank lenders and the capital markets would survive. He predicted that Defendant COUNTRYWIDE FINANCIAL CORPORATION would be a beneficiary of the market turbulence.

10. Defendant COUNTRYWIDE FINANCIAL CORPORATION is a thrift holding company. It has numerous subsidiaries that originate, purchase, securitize, sell and service residential and commercial loans; provide loan closing services such as credit reports, appraisals and flood determinations; conduct fixed income securities underwriting and trading activities; provide property, life and casualty insurance; and manage a captive mortgage reinsurance company.

11. Since December 23, 1980, Defendant COUNTRYWIDE HOME LOANS, INC., a wholly-owned subsidiary of Defendant COUNTRYWIDE FINANCIAL CORPORATION, has been a registered foreign corporation in the State of Illinois. Defendant COUNTRYWIDE HOME LOANS, INC. is a licensed Illinois mortgage bank, holding mortgage banker license MB.0000139, which is issued by the Illinois Department of Financial and Professional Regulations, Division of Banking. Since 2004, Defendant COUNTRYWIDE HOME LOANS, INC. has also done business in Illinois as Full Spectrum Lending.

12. Defendant FULL SPECTRUM LENDING, INC., was a registered foreign corporation in the State of Illinois from October 3, 1996 through April 25, 2005. FULL SPECTRUM LENDING, INC. was a licensed Illinois mortgage bank, holding mortgage banker license MB.0004910, which was issued by the Illinois Department of Professional Regulations, Division of Banking. Defendant FULL SPECTRUM LENDING, INC. became a division of Defendant COUNTRYWIDE HOME LOANS, INC. in 2004. In April 2005, FULL SPECTRUM LENDING, INC. withdrew as a registered foreign corporation and began operating in Illinois as Full Spectrum Lending, a division of COUNTRYWIDE HOME LOANS, INC.

13. In its annual reports from 1999 to 2006, Defendant COUNTRYWIDE FINANCIAL CORPORATION emphasized that mortgage banking, which has historically been conducted

through Defendant COUNTRYWIDE HOME LOANS, INC. for prime loan originations and Defendant FULL SPECTRUM LENDING, INC. for subprime loan originations, was its core business. Defendant COUNTRYWIDE FINANCIAL CORPORATION has stated that the company is engaged primarily in residential mortgage lending and that Defendant COUNTRYWIDE HOME LOANS, INC. is its primary subsidiary.

14. During the entire time period from 1999 to 2006, there was a significant identity in the corporate governance and managing directors of Defendant COUNTRYWIDE FINANCIAL CORPORATION and Defendant COUNTRYWIDE HOME LOANS, INC. For example, between 1999 and 2005, Stanford Kurland was the Chief Executive Officer for Defendant COUNTRYWIDE HOME LOANS, INC. and he was also the Chief Operating Officer for Defendant COUNTRYWIDE FINANCIAL CORPORATION. In 2006, David Sambol became Chairman of the Board and Chief Executive Officer for Defendant COUNTRYWIDE HOME LOANS, INC. and President and Chief Operating Officer of Defendant COUNTRYWIDE FINANCIAL CORPORATION.

15. There was also overlap between the management of Defendant FULL SPECTRUM LENDING, INC., when it was a separate company, and Defendant COUNTRYWIDE FINANCIAL CORPORATION. Specifically, Gregory Lumsden has been the President and Chief Executive Officer for Defendant FULL SPECTRUM LENDING, INC. from 2001, when it was a separate company, to the present day, when it is a division of Defendant COUNTRYWIDE HOME LOANS, INC. He has been and is currently a managing director for Defendant COUNTRYWIDE FINANCIAL CORPORATION.

16. Defendant COUNTRYWIDE FINANCIAL CORPORATION issues consolidated annual reports and SEC filings with Defendant COUNTRYWIDE HOME LOANS, INC. Additionally,

Defendant COUNTRYWIDE FINANCIAL CORPORATION files a consolidated federal income tax return and a combined state income tax return in California with Defendant COUNTRYWIDE HOME LOANS, INC. and Defendant FULL SPECTRUM LENDING, INC. Defendant COUNTRYWIDE FINANCIAL CORPORATION also issued consolidated earnings statements and balance sheets for itself, Defendant COUNTRYWIDE HOME LOANS, INC. and Defendant FULL SPECTRUM LENDING, INC.

17. Defendant COUNTRYWIDE FINANCIAL CORPORATION controls the policies and operations and profits from the activities of Defendant COUNTRYWIDE HOME LOANS, INC. and Defendant FULL SPECTRUM LENDING, INC. Defendant COUNTRYWIDE FINANCIAL CORPORATION arranged and profited from the securitization and/or sale of loans originated and serviced by Defendant COUNTRYWIDE HOME LOANS, INC. and Defendant FULL SPECTRUM LENDING, INC.

18. Because they acted cooperatively in carrying out the conduct alleged in this Complaint, Defendants ANGELO R. MOZILO, COUNTRYWIDE FINANCIAL CORPORATION, COUNTRYWIDE HOME LOANS, INC. and FULL SPECTRUM LENDING, INC. are collectively referred to as "Countrywide," unless otherwise specified, and each is responsible for the unlawful conduct alleged herein.

19. Defendant COUNTRYWIDE HOME LOANS SERVICING, LP is a licensed mortgage bank, holding mortgage banker license MB.0006041, which was issued by the Illinois Department of Financial and Professional Regulation, Division of Banking. Defendant COUNTRYWIDE HOME LOANS SERVICING, LP is a Texas limited partnership directly owned by two wholly-owned subsidiaries of Defendant COUNTRYWIDE HOME LOANS, INC. Defendant COUNTRYWIDE HOME LOANS SERVICING, LP services loans originated

by Defendant COUNTRYWIDE HOME LOANS, INC., the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Government National Mortgage Association (Ginnie Mae), the United States Department of Housing and Urban Development, and the United States Veterans Administration.

20. Any allegation about any acts of Defendants COUNTRYWIDE HOME LOANS, INC., COUNTRYWIDE FINANCIAL CORPORATION, FULL SPECTRUM LENDING, INC. or COUNTRYWIDE HOME LOANS SERVICING, LP, means that the entities did the acts alleged through their officers, directors, employees, agents and/or representatives while they were acting within the actual or ostensible scope of their authority.

COMMERCE

21. Section 1(f) of the Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/1(f), defines "trade" and "commerce" as follows:

> The terms 'trade' and 'commerce' mean the advertising, offering for sale, sale, or distribution of any services and any property, tangible or intangible, real, personal, or mixed, and any other article, commodity, or thing of value wherever situated, and shall include any trade or commerce directly or indirectly affecting the people of this State.

22. Defendants are and were, at all relevant times hereto, engaged in trade and commerce in the State of Illinois, in that they offered mortgage lending services to the general public of the State of Illinois.

23. The Attorney General's Office has received over 200 complaints related to Countrywide since 2005.

COUNTRYWIDE'S BUSINESS PRACTICES RESULTED IN UNAFFORDABLE MORTGAGE LOANS AND INCREASED FORECLOSURES IN ILLINOIS

Countrywide's Domination of the Mortgage Industry

24. Both Countrywide Financial Corporation ("CFC") and Countrywide Home Loans, Inc. are based in Calabasas, California. CFC was formed by David Loeb and Angelo Mozilo as Countrywide Credit Industries in 1969. The company went public shortly thereafter. Loeb retired in 2000. The company restructured in 2001 and assumed its current name in 2002.

25. Through its numerous subsidiaries, CFC is involved in virtually every segment of the residential mortgage industry. The company sells, purchases, securitizes and services residential and commercial loans; provides loan closing services such as credit reports, appraisals and flood determinations; conducts fixed income securities underwriting and trading activities; provides property, life and casualty insurance; and manages a captive mortgage reinsurance company.

26. CFC's primary subsidiary, Countrywide Home Loans, Inc., offers loans to consumers through three production channels. The first channel is comprised of Countrywide's prime consumer-direct (retail) lending locations, referred to as the Consumer Markets Division, and nonprime consumer-direct (retail) lending locations, referred to as Full Spectrum Lending. The second channel is wholesale lending through a network of mortgage loan brokers and other financial intermediaries. The third channel is correspondent lending through which Countrywide provides lines of credit to financial institutions such as independent mortgage companies, commercial banks, savings and loans and credit unions, purchases the mortgages made pursuant to the lines of credit, and then arranges for the securitization of these loans.

27. Today, Countrywide is America's largest mortgage lender. In the first quarter of 2008, the company originated $73 billion dollars nationally in mortgage loans. Countrywide has also been a significant originator of subprime mortgages. By the first quarter of 2007, Countrywide

had become the largest originator of subprime loans, with a total subprime loan volume of roughly $ 7,881,000,000.

28. Countrywide is also the nation's largest loan servicer. The company administers $1.5 trillion in loans made by both it and other institutions. Countrywide's servicing operation generated $1.4 billion in revenue in the first quarter of 2008.

29. Countrywide has a significant presence in Illinois. At the peak of its presence in Illinois, Countrywide operated approximately 100 retail branch offices and its mortgage loan products were offered by numerous mortgage brokers licensed to do business in Illinois. Countrywide also purchased loans through a network of some 2,100 correspondent lenders.

30. Countrywide was the largest lender in Illinois in 2004, 2005, and 2006. During these years, Countrywide sold approximately 94,000 loans to Illinois consumers.

31. In addition, Countrywide is the largest lender in the Chicago area. In 2006, for example, Countrywide made over 21,000 loans to consumers in the seven county Chicago area.

The Explosive Growth of a Market for Loans with Non-Traditional Risky Features

32. Countrywide's growth paralleled and was fueled by the rise of private-label securitization in the mortgage industry.

33. Securitization of mortgage loans is a relatively recent phenomenon. Historically, mortgages were long-term, fixed rate, amortizing products sold by depository institutions. From the post-World War II era to 1973, savings and loan institutions held the majority of all mortgages.

34. The privatization of the Federal National Mortgage Association (Fannie Mae) in 1968 and the creation of the Federal Home Loan Mortgage Corporation (Freddie Mac) in 1970 laid the groundwork for securitization of mortgages and the secondary market's role in the mortgage

industry. Fannie Mae and Freddie Mac, also known as government-sponsored entities ("GSEs"), began purchasing loans from financial institutions. These financial institutions were required to make limited representations and warranties regarding the quality of the loans. Any remaining risk passed on to the GSEs.

35. After purchase, the GSEs bundled the mortgages into pools in order to sell the income stream to investors. An asset-backed or mortgage-backed security is ultimately created from such a pool of loans. The entire process is generally referred to as securitization. As used by the GSEs, the primary purpose of securitization was to create liquidity for funding more residential mortgage loans.

36. There are limits on the types of loans that Fannie Mae and Freddie Mac purchase. The loans they purchase are subject to certain standards regarding loan amount and credit risk, which generally must be demonstrated through written documents showing the borrower's credit score, income, assets and liabilities and the value of the home securing the loan. Loans that meet the underwriting standards are referred to in the mortgage industry as "conforming loans." Like other mortgage lenders, Countrywide marketed and sold conforming loans to borrowers and then sold these loans to the GSEs.

37. Until the early 1990s, "non-conforming loans," or loans that did not meet the GSEs' underwriting standards, were rare and expensive. Borrowers who were considered subprime (due to credit profiles riskier than the minimum required for conforming loans) or were unable to document income and assets, or who wanted loan amounts in excess of the GSEs' underwriting guidelines had few options. This situation would soon change.

38. In the early 1990s, banking regulators adopted new rules at a time when banks were under considerable financial stress from the 1991 recession. For the first time, the new rules

measured bank health through the use of a capital to asset ratio. Unable to raise new capital to increase the ratio, banks found it easier to reduce assets instead, and securitization proved particularly useful for that task. These assets included mortgage loans.

39. Once banks had an incentive to divest assets, and with securitization enabling them to pass at least part of the risk of a loan's failure to investors, financial institutions became less wary of making riskier non-conforming loans. Securitization was no longer just a tool to create liquidity in the conforming mortgage industry. Instead, mortgage originators could employ it as a way of shedding much of the credit risk associated with non-conforming loans that they originated.

40. Wall Street became aware of the potential cash flow from the securities backed by non-conforming mortgage loans. Investors were attracted to these securities because they assumed that non-conforming mortgage-backed securities would share the same stable performance of the conforming mortgage-backed securities issued by the GSEs. The favorable investment grade ratings given to the securities by the various ratings agencies – which allowed institutional investors such as state pension funds to buy the products – seemed to corroborate this assumption.

41. In addition, the yields on the non-conforming loan securities were attractive. While subprime loans – a type of non-conforming loan – carry greater risks, they also produce higher returns. For a time, the large returns on subprime mortgage-backed securities outpaced (and concealed) high failure rates of loans in securitization pools.

42. Investors paid a premium for certain types of loans and certain loan features, such as loans with high interest rates (i.e., subprime loans) or loans with prepayment penalties. Indeed, investors' growing appetite for mortgage-backed securities fueled a surge in the origination of

subprime mortgage lending. Between 1994 and 2005, subprime mortgage lending grew from $35 billion to $625 billion. By the first quarter of 2007, subprime mortgage-backed securities were being sold at a rate of $100 billion per quarter. The explosive growth in subprime mortgage lending also marked a shifting away from traditional underwriting standards.

43. Lenders, such as Countrywide, were aware of the types of loans and loan features for which investors would pay a premium. Investor demand and secondary market valuation, therefore, became the primary concern when determining what types of loans to market and sell and at what price, rather than the consumers' ability to repay the loans. Countrywide sought to place greater numbers of borrowers into loans laden with these premium-enhancing features.

44. Countrywide had already established a small presence in the subprime lending field in the late 1990s, when it formed its retail subprime lending unit, Full Spectrum Lending. Following David Loeb's retirement in 2000, Countrywide became more aggressive in growing its business in an effort to be the nation's largest mortgage lender. Countrywide expanded the range of non-conforming loan products that it offered to consumers and began to concentrate more on subprime lending and exotic mortgage products. For example, in 2002, Countrywide originated roughly $9 billion in subprime loans. In 2005, that number shot up to over $44 billion.

45. Countrywide also changed its corporate strategy to focus on increasing loan volume, which would in turn generate more loan origination fees for the company. Instead of focusing on fixed rate loans to creditworthy borrowers, the company began to emphasize reduced documentation loans and adjustable rate products. For example, in 2003, only 18% of the loans originated by Countrywide had adjustable interest rates. In 2004, however, that number had grown to 49%.

46. By 2005, Countrywide's growth in both revenue and number of loans originated was fueled by the company's origination of a menu of risky loan products, such as reduced documentation loans, option ARMs, and loans for 100% of a home's value.

Record Numbers of Foreclosures Nationally and in Illinois

47. For many years, rising home prices concealed the consequences of Countrywide's increased drive to sell loans regardless of the borrower's credit risk and ability to repay the loan. Borrowers were often lured into expensive home loans with the promise that they could refinance if the loan became unaffordable. As long as housing prices continued to rise and credit remained available, many borrowers followed this strategy. Predictably, with the collapse of the mortgage market and concomitant drop in housing prices, the days when borrowers could refinance out of an unaffordable mortgage ended, and, as has been widely documented, defaults and foreclosures nationwide are rapidly rising.

48. In the third quarter of 2007, 24% of all outstanding subprime loans and 30% of subprime ARMs were either delinquent or in foreclosure. The Center for Responsible Lending has projected that 2.2 million homeowners nationwide will lose their homes as a result of failed subprime home loans originated from 1998 through 2006. This number could very well grow larger, as the projection was made before subprime default rates skyrocketed in 2007.

49. In the Chicago area, the foreclosure crisis resulting from subprime loan origination will likely linger longer than in other parts of the country. In 2006, the Chicago metropolitan area had more "high-cost" (i.e., subprime) mortgages than any other metropolitan area in the country, according to a *Chicago Reporter* study. This marked the third year in a row that the Chicago metro area claimed the nation's top spot for high-cost mortgages. Countrywide led the way with high-cost loans in Chicago – in 2006 it was the leader in high-cost lending.

50. Ultimately, although homeownership for subprime borrowers increased during recent years, it appears that there will be a net loss in homeownership nationwide. With the number of completed subprime foreclosures from 1998 to 2006 exceeding the number of homebuyers who used a subprime loan to enter the marketplace, the Center for Responsible Lending estimates that subprime mortgage lending has resulted in a net loss in homeownership of 900,000 homes nationwide. According to federal government figures, in 2007 homeownership suffered the biggest one-year drop on record.

51. The failure of subprime loans explains only part of the homeownership crisis. Risky loan origination practices used in the prime mortgage market, such as volatile loan products like option ARMs and lax underwriting standards, also contributed to the current situation. Nationally, roughly 243,000 homes were in some stage of the foreclosure process in April 2008. This is up 65% from April 2007. The nationwide delinquency rate on mortgage payments grew to 6.35% in the first quarter of 2008, the highest since 1979.

52. Illinois' home foreclosure rates have ranked among the highest in the nation for more than a year. Illinois experienced a 46% increase in the number of unique properties in foreclosure from 2006 to 2007 – 64,310 properties in 2007 as compared with 44,047 the year before. Lenders filed 9,670 foreclosures in May of this year alone, placing the state eighth in the number of new foreclosures filed. This represents a 41.71% increase from May 2007.

53. The external costs of the mortgage collapse, in terms of declining property values and shrinking tax bases, are estimated to run over $200 billion nationally, with urban centers hit hardest. In Illinois, the loss is projected to be $15 billion, with $13 billion in Chicago.

Countrywide's Role in the Foreclosure Crisis Nationally and in Illinois

54. The delinquency rate on the mortgage loans of America's biggest mortgage lender and servicer, Countrywide, was 9.27% by the end of March 2008. The company originated $7 billion nationally in mortgage loans in *one quarter* of 2008. The March 2008 9.27% delinquency rate was an increase from 5.02% at the end of 2006 and 3.68% in March 2006.

55. The incidence of "seriously delinquent" loans – loans that are 90 days or more past due or in foreclosure – is also increasing. Countrywide's latest financial filing says that 4.81% of the loans it services were seriously delinquent as of the end of March 2008. This serious delinquency rate was up almost four times from 1.70% at the same time in 2007.

56. In terms of actual foreclosures, the percentage of Countrywide loans in foreclosure at the end of March 2008, 1.28%, had almost doubled from 0.69% at the end of March 2007.

57. Countrywide's subprime loans have failed even more frequently. By the end of the first quarter of 2008, 35.88% of the subprime loans serviced by Countrywide were delinquent, up from 19.62% in the first quarter of 2007. Slightly over 21% of all Countrywide subprime loans serviced by the company were seriously delinquent by the end of March 2008, up from 7.82% in March 2007.

58. The number of Countrywide foreclosure filings in Illinois is troubling. From 2006 to 2007, all foreclosure complaint filings in Cook Country increased by 46%. For this same period, however, Countrywide Home Loans, Inc.'s foreclosure complaint filings increased by 117%. From January 2004 through June 2008, Countrywide Home Loans, Inc. has foreclosed upon at least 2,534 Cook County homeowners. Note that this number does not include foreclosures filed by Full Spectrum Lending or any other Countrywide entity.

Securitization Sleight of Hand Masked Countrywide's Systemic Loan Origination Issues

59. Countrywide's delinquency and foreclosure numbers show that there were systemic problems with the company's loan origination standards. These loosened loan origination standards came into place due to Countrywide's securitization practices.

60. Countrywide's quest for domination in the mortgage lending industry is well-documented. During a May 24, 2005 investor conference, Defendant and Countrywide CEO Angelo Mozilo stated: "I am going to – little question – it's a question of dominance, you have heard this before we – we have [no] intention to structure the company to be at second place or third place." This sentiment was echoed by then-Countrywide President and Chief Operating Officer Stanley Kurland, who stated: "In the past, we talked about origination market share reaching 30% by 2008 and, as we've noted, this was intended to be a stretch goal as it is part of our culture, part of our nature to set aggressive targets." Ultimately, this quest for market domination created a self-perpetuating cycle in which Countrywide raced against time to originate loans of decreasing quality to cover up the failure of its prior loan originations.

61. This cycle began with Countrywide's attempt to gain market share. The company had to acquire capital to fund loans and find borrowers to buy the loans. To find borrowers, Countrywide both expanded its menu of nonconforming mortgage products and loosened the standards for selling its products to reach untapped consumers. To gain capital, Countrywide relied on securitizing the loans that it made from its menu of nonconforming mortgage products and loosened loan origination standards.

62. Securitization allowed Countrywide to generate capital using one of two methods. In one method, Countrywide sold the loans it made to third parties who then aggregated the loans into pools and sold the income streams from the pooled loans to investors. In this arrangement, a

party other than a Countrywide-controlled entity had an opportunity to evaluate the quality of the loans being aggregated. This party was able to enforce any representations and warranties that Countrywide made when selling the mortgage loans.

63. In the other method, Countrywide eliminated the third-party intermediaries and completed the securitization process by itself. Countrywide Financial Corporation created numerous subsidiaries for this exact purpose. These subsidiaries purchased loans from Countrywide entities, pooled them, and issued securities that were later sold through a brokerage house. Securitization done through affiliated entities reduced any potential for delay in the process.

64. This second method allowed Countrywide to control the entire origination and securitization process. In other words, Countrywide sold the loans itself, purchased and aggregated the loans itself, and issued the securities itself.[1] The same corporate executive could even sign off on securitization contracts as both the originator of the underlying mortgage loans and the purchaser of the same loans.

65. Countrywide had strong incentives to securitize its loans quickly. In order for an asset-backed security to meet the Securities and Exchange Commission's requirements, it may not have non-performing loans and delinquent loans may not constitute 50% or more of the pool on the date the pool is readied for sale.[2]

66. The securitization process was beneficial for Countrywide because it both generated capital and allowed Countrywide to shed "credit risk" from the possible failure of the underlying

[1] In this self-dealing method, it is unclear how the required representations and warranties regarding the quality of the underlying loans would be enforced. Moreover, the Bank for International Settlements issued a 1992 report noting that "[t]here is at least a potential conflict of interest if a bank originates, sells, services and underwrites the same issue of securities." BIS is an international organization established in 1930 which fosters international monetary and financial cooperation and serves as a bank for central banks.

[2] Under this analysis, pay-option ARMs would have been among the most desirable products to satisfy this element since, with their very low teaser rate and option to make less than full interest payments for a certain period, they are unlikely to experience early payment defaults.

mortgage loans. Credit risk is the potential for financial loss resulting from the failure of a borrower to pay on a mortgage loan. As CFC noted in its annual regulatory filing for 2003, it managed "mortgage credit risk principally by securitizing substantially all mortgage loans that we produce, and by only retaining high credit quality mortgages in our loan portfolio." In comments to federal regulators, Countrywide advised that any guidance on nontraditional mortgage products "contain explicit acknowledgement that the risk profile of a lender who *effectively transfers the economic risks of a loan to the secondary market* is lower than that of a portfolio lender" (emphasis added).

67. By selling loans onto the secondary market, Countrywide created loan pooling agreements through which it sought to limit its responsibility for the performance of the loans. For instance, Countrywide is required to repurchase the loan from investors under these agreements only in the event of documentation errors, underwriting errors, fraud, or early payment defaults (i.e., the borrower defaults within one or two months after the loan sale).

68. Although Countrywide attempted to shed the risk of originating loans of lower quality, it retained some credit risk due to the representations and warranties that it is required to make when selling mortgage loans to either third parties or itself for securitization. As a result, investors still have some level of recourse against the company for defective loans.

69. This recourse generally takes one of two forms. In some cases, these agreements required Countrywide to indemnify the investors for the defective loans. In other cases, however, Countrywide could simply swap in new loans for the defective loans through the "removal of accounts provisions" included in some of its securitization agreements. Swapping loans was preferable to lenders because it does not them to actually give investors cash.

70. Under this approach, a lender, like Countrywide, needed to generate more loans if it both wanted to continue securitizing and needed to replace the defaulting loans removed from the securitized pools. In addition, the lender, who is not able to transfer the defaulted loans it takes back from the pools to anyone else, will want to hold more good loans on its balance sheet to offset the increasing numbers of bad loans it is holding. The lender must originate more loans to hold on its books – in the hope that a sufficient number of the new loans will not default – to offset the bad loans. Countrywide admitted that it did as much in its December 31, 2005 10-K filing, in which the company disclosed that "[t]he impact in the increase of the allowance for [delinquent option] loan losses will be partially mitigated by the addition of new loans to our portfolio."

71. As Countrywide well knew or should have known, the loans that underpinned Countrywide's securitizations were unstable. In fact, the loans began to fail at a precipitous rate. As the company observed in 2007, the volume of claims for breaches of its representations and warranties grew due to the deterioration in credit performance of its loans. Thus, Countrywide had to accelerate origination to satisfy increased investor claims at precisely the time when it was already increasing origination to simply obtain capital to maintain its market position.

Defendants' Unfair and Deceptive Underwriting Standards, Loan Products, Sales Techniques and Servicing Practices

72. Countrywide's need to accelerate loan originations compelled the company to develop a business model that, beginning in at least 2003 or 2004 and lasting into 2007, reflected the company's indifference to whether homeowners could afford its loans. As part of this model, Countrywide: (a) originated mortgage loans to borrowers who did not have the ability to repay the loan; (b) originated mortgage loans with multiple layers of risk that exposed borrowers to an unnecessarily high risk of foreclosure or loss of home equity; (c) originated unnecessarily more

expensive mortgage loans to unknowing borrowers; and (d) engaged in unfair and/or deceptive marketing and advertising acts or practices.

73. Also, Countrywide implemented a compensation structure that incentivized broker and employee misconduct without exercising sufficient oversight to ensure that misconduct did not occur due to:

a. Implementing a compensation structure that incentivized employees to maximize loan sales without proper oversight, resulting in the sale of unaffordable and/or unnecessarily expensive loans;

b. Failing to adequately supervise and/or implement proper underwriting guidelines to see whether brokers used and sold reduced documentation loans to avoid revealing borrowers' true income and assets;

c. Rewarding brokers for selling loans with certain risky loan features such as prepayment penalties without ensuring that borrowers received a benefit from the risky features; and

d. Structuring the compensation for option ARMs in such a way that brokers were incentivized to sell this riskier loan product – to the exclusion of other products – in order to obtain the maximum yield spread premium possible.

74. Countrywide's servicing division, Countrywide Home Loans Servicing, LP, unfairly and deceptively required borrowers to make additional payments just to consider whether they would qualify for a loan repayment or modification plan – regardless of the potential feasibility or affordability of such a plan.

75. Former employees commented on Countrywide's increasing disregard for a borrower's ability to repay a mortgage loan. For example, a former Full Spectrum Lending Division

employee stated that the division (which was Countrywide's subprime lending arm) had underwriting guidelines that would approve virtually any loan. Likewise, an underwriter in Countrywide's Wholesale Lending Division said that her supervisor would approve most of the loans that she herself did not feel comfortable approving.

76. Even though former employees noted that Countrywide had loose underwriting standards, the company also had a system to grant exceptions to those standards. A Countrywide wholesale account executive said that in the beginning of 2006, Countrywide became very aggressive in granting exceptions to their underwriting criteria – further diluting borrower protections.

77. This employee also explained that she was pushed to sell more "Expanded Criteria" loans. Another wholesale account executive remarked that Countrywide paid its employees more to sell "Expanded Criteria" loans. Expanded Criteria loans included loans with reduced documentation underwriting, higher loan-to-value ratios and other risky loan features.

78. Countrywide itself observed in its first quarter 2008 10-Q the consequences of this expansion into risky products and practices. It disclosed that, since 2007, it had "observed a marked decline in credit performance (as adjusted for age) for recent vintages, especially those loans with higher risk characteristics, including reduced documentation, high loan to value ratios or low credit scores."

79. As described, Countrywide's expansion into riskier products and practices became apparent in a number of ways.

Countrywide Sold Unaffordable and More Expensive Loans to Borrowers Due to its Lax Underwriting Standards

80. For the reasons described above, Countrywide relaxed its underwriting standards in recent years. These relaxed underwriting standards allowed the mass selling of reduced

documentation loans and the failure to ensure borrowers had sufficient capacity to repay the mortgages Countrywide sold them.

A. Countrywide Inappropriately Sold Reduced Documentation Loans

81. Countrywide's relaxation of traditional underwriting standards is evident in its increased reliance on reduced documentation loans. From 2005 through the first half of 2007, a majority of the Countrywide mortgages sold in Illinois were reduced documentation loans, often called "stated-income" or "liar's loans." Countrywide underwrote these loans with less documentation and, consequently, less verification, of borrowers' income and assets than traditional mortgages.

82. The four types of reduced documentation loans sold by Countrywide from at least 2004 through the first half of 2007 are described as follows:

a. The "Stated Income Verified Assets" loan, often referred to as a "SIVA," required the disclosure of employment, income and assets on the loan application. Employment and assets were verified, but income was not verified by Countrywide. A debt-to-income ratio was calculated based on the stated income and it typically had to meet certain requirements. This product was the most commonly sold reduced documentation loan. In addition to the SIVA product, Countrywide sold a product known as the "Fast 'n' Easy" that had similar underwriting criteria. Borrowers whose credit score exceeded a certain threshold could qualify for the Fast 'n' Easy as opposed to the SIVA product.

b. The "No Ratio" loan, often called a "NIVA," required the disclosure of employment and assets on the loan application, both of which were verified. However, income could not be disclosed on the loan application, and

Countrywide did not calculate debt-to-income ratios in qualifying borrowers for these loans.

c. A "Stated Income Stated Assets" loan, or "SISA," required that employment be disclosed and verified, but neither income nor assets were verified by Countrywide.

d. A "No Income No Assets No Employment" loan, also called a "No Doc" or "NINA" loan, prohibited disclosure of employment, income and assets on the loan application. No debt-to-income ratio was calculated to qualify the borrower.

83. The various types of reduced documentation loans sold by Countrywide are collectively referred to in this Complaint as "reduced documentation" or "stated income" loans.

84. Countrywide sold reduced documentation loans to prime borrowers and some types of reduced documentation loans to subprime borrowers. Over time, Countrywide actually lowered the minimum credit score for which it would approve a reduced documentation loan to include a broader set of borrowers. Countrywide also lessened underwriting standards for reduced documentation loans sold to subprime borrowers, increasing the numbers of subprime borrowers who were eligible to receive these loans. In fact, during recent years, a significant percentage of the subprime loans Countrywide sold to Illinois borrowers were reduced documentation loans.

85. Because a majority of the loans sold in Illinois in recent years were reduced documentation loans, Countrywide employees and brokers clearly sold reduced documentation loans to borrowers regardless of the borrowers' ability of the borrower to document income and assets. In fact, Countrywide sold some of its reduced documentation loans to salaried borrowers who received W-2's from their employment. Countrywide had no rules restricting the sale of reduced documentation loans to borrowers who had difficulty documenting their income.

Rather, they could be sold to borrowers regardless of the ease or difficulty of documenting their income, employment or assets.

86. Countrywide had very few safeguards on the use and underwriting of reduced documentation loans. The only check on fraudulent income was a reasonableness standard allegedly used by Countrywide. Early on, Countrywide employees merely used their judgment in deciding whether or not a stated income loan seemed reasonable. In or around 2005 or 2006, Countrywide required its employees to use salary.com – a website that provides a salary range for a given job title or profession in a certain zip code – to determine whether the income stated on the loan application appeared reasonable. However, if the stated income fell outside of the range provided by salary.com, Countrywide underwriters could still approve the loan.

87. In addition to a lack of controls on these risky underwriting guidelines, Countrywide pushed their sales employees, both retail and wholesale, and their underwriters to sell and close large volumes of loans without due regard for the risk to borrowers as quickly as possible. Countrywide fired employees for low production when they failed to originate and close sufficient numbers of loans.

88. To encourage the fast origination of loans, Countrywide compensated its sales employees, at least in part, on the volume of loans sold. The more loans its employees sold, the more money Countrywide paid them. Countrywide sales employees were paid on a tiered bonus system that compensated them more for each tier of sales volume they reached during the month. Once an employee sold enough loans to put him in the next tier for that month, he would earn more on *each* loan he had sold during that month. A substantial portion of the salary of Countrywide sales employees, both retail and wholesale, was based on sales volume. In fact, wholesale account executives—Countrywide employees who dealt with brokers—were paid only

on commission, they had no base salary. Countrywide employees, therefore, had incentives to sell as many loans as possible – regardless of credit risk.

89. Countrywide's underwriters were also compensated based on the number of loans they underwrote. They were paid a base salary, but a large percentage of their total salary was a bonus payment based on the number of loans underwritten. In addition, the goal for underwriters who reviewed broker files was to approve and process purchase files in 24 hours and refinance files in 48-72 hours. One underwriter stated that, for a period of time, she was required to underwrite 25 loan files a day during the week and 25-35 loan application files over the weekend. Thus, Countrywide underwriters also had a large incentive to underwrite as many loans as possible as quickly as possible, and Countrywide pushed them to do so.

90. In addition to these compensation incentives for its own employees, Countrywide enticed its mortgage brokers to sell reduced documentation loans with advertisements proclaiming

> Expanded Criteria: More ways to say yes! Qualify more of your borrowers with Expanded Criteria programs from Countrywide®, America's Wholesale Lender®. Countrywide offers some of the most flexible documentation guidelines in the industry. Our extensive Expanded Criteria programs provide you with solutions that help you close more loans. You'll see that when it comes to lower documentation loans; no one delivers like Countrywide.

91. Countrywide also enticed brokers with advertisements that said "Designed to deliver Low Doc and No Doc solutions to meet the needs of virtually every type of borrower," "NO INCOME NO ASSETS DOC OPTIONS," "Reduced Doc – Simplified and Enhanced!," and "Low down payment, low documentation solutions."

92. The lack of rules and oversight on stated income loans, and the push for employees to sell more loans and to close loans quickly, facilitated rampant fraud in the sales of reduced documentation loans. Countrywide sales employees and brokers used reduced documentation loans as a way to qualify borrowers for loans they could not afford. One former Countrywide

employee has estimated that approximately 90% of all reduced documentation loans sold out of the branch where he worked in Chicago had inflated incomes.

93. As noted in a Chicago Tribune article, the Mortgage Asset Research Institute reviewed 100 stated income loans, comparing the income on the loan documents with the borrowers' tax documents. The review found that almost 60% of the income amounts were inflated by more than 50%, and that 90% of the loans had inflated income of at least 5%.

94. Countrywide sales employees sometimes received income documentation (e.g. W-2's or tax returns) and determined that the borrower could not qualify for the loan based on their real income. The employee would then submit the loan as a stated income loan, inflating the borrower's income to qualify him for the loan. Countrywide "stretch[ed] the income" on reduced documentation loans as far as possible.

95. In the review of one Illinois mortgage broker's sales of Countrywide loans, the vast majority of the loans had inflated income, almost all without the borrowers' knowledge.

96. Many Countrywide borrowers were not aware they were receiving a reduced documentation loan, and did not realize they were being sold a loan they could not afford and were not qualified to receive.

97. In addition to a lack of rules concerning what borrowers were appropriate for reduced documentation loans, Countrywide failed to have sufficient controls concerning what loan programs could be sold as reduced documentation loans. Many of the riskier exotic and "affordability" products offered by Countrywide were sold with reduced documentation. For example, Countrywide's option ARM and interest-only products could be sold with reduced documentation underwriting. Countrywide also sold loans with very high loan-to-value ratios with reduced documentation underwriting.

98. Countrywide pushed these products in advertisements to its mortgage brokers like: "Check Out Countrywide's Expanded Criteria 80/20 Loans with Reduced Documentation!"; "Low down payment, low documentation solutions. Qualify more borrowers with high LTVs and low doc options from Countrywide®, America's Wholesale Lender®;" "Stated Income Program Enhancements. Up to 100% LTV;" and "The PayOption ARM from Countrywide®, America's Wholesale Lender® offers your qualified borrowers reduced paperwork with the Stated Income/Stated Assets (SISA) documentation option."

99. Not surprisingly, reduced documentation loans have higher delinquency rates than full documentation loans, further suggesting the prevalence of fraud in these loans.

100. Countrywide acknowledged the existence of higher default rates for reduced documentation loans in its 10-Q filing for the first quarter of 2008:

> We attribute the overall increase in delinquencies in our servicing portfolio from March, 31, 2007 to March 31, 2008, to increased production of loans in recent years with higher loan-to-value ratios and reduced documentation requirements, combined with a weakening housing market and significant tightening of available credit and to portfolio seasoning.

101. Even if income was not inflated, Countrywide charged many borrowers more for reduced documentation loans. Countrywide employees used reduced documentation loans because they were faster, easier to sell, and to underwrite. It took as little as 30 minutes to underwrite some reduced documentation loans, and some loans closed the same day the application was taken from the borrower. This scheme enabled Countrywide employees to sell more loans and make more money. So, some borrowers who could easily have documented their income were sold more expensive reduced documentation loans by Countrywide employees and brokers.

102. In short, Countrywide's sale of reduced documentation loans put many Illinois borrowers into unnecessarily riskier and more costly loans and, for many borrowers, loans that they could not afford.

B. Countrywide Inappropriately Qualified Borrowers For Adjustable Rate and Interest-Only Mortgages Based on Less than a Fully-Indexed Rate or Less Than Fully-Amortizing Payments

103. In addition to increased sales of reduced documentation loans, in recent years Countrywide also increased its sale of "affordability" products. These loans allowed borrowers to obtain a loan with low initial payments that would not continue for the life of the loan. Countrywide qualified borrowers at this initial low payment knowing that they would not be able to repay the loan in its entirety.

104. One affordability product Countrywide sold was an interest-only loan. An interest-only loan allows borrowers to make payments covering only the interest on their loan during the first years of the loan, usually the first 3, 5, 7 or 10 years. After this initial period, borrowers must make fully-amortizing payments to pay off their principal balance plus interest over the remaining life of the loan. The interest-only payments at the beginning of the loan are much lower than the later fully-amortizing payments.

105. According to an article by the New York Times published on November 11, 2007, Countrywide was the second leading originator of interest-only loans from 2006 through the second quarter of 2007.

106. Countrywide sold interest-only loans to prime and subprime borrowers as stated income loans. In 2005 and 2006, Countrywide's interest-only loan was sold to a borrower with a credit score as low as 560, and as a stated income loan to a borrower with a credit score as low as 620.

107. In 2007, Countrywide qualified non-prime borrowers to receive interest-only loans for up to $1 million with a minimum credit score of 600 and up to $850,000 with a minimum credit score of 580. Interest-only loans in lesser amounts were also available to non-prime borrowers as stated income loans. One Countrywide ad to brokers touts "Interest-Only loans from Countrywide®, America's Wholesale Lender® offer low monthly payments for the initial loan period, possibly helping your non-prime customers qualify for a bigger loan amount."

108. During at least part of the time from 2003 through 2007, Countrywide qualified its borrowers at less than fully-amortized payments on its interest-only products. According to comments Countrywide provided to federal regulators concerning the proposed Interagency Guidance on Nontraditional Mortgage Products, Countrywide stated that "[i]nterest-only loans are designed to be an affordability product, allowing borrowers to qualify at the 'minimum' or lower non-amortizing interest only payment for a fixed and extended term. We [Countrywide] believe that it is appropriate to qualify borrowers based on the interest only payment."

109. Countrywide advertised these loose underwriting standards to its brokers in ads like "Maximize your borrower's cash flow with Interest-Only loans. Qualify based on the Interest-Only payment."

110. The practice of qualifying borrowers at low interest-only payments, which, under the terms of the mortgage, can only be paid during a certain period of the loan and then a higher, fully amortizing payment will be required, places borrowers into loans that they ultimately may not be able to afford. Such a practice implicitly relies on borrowers either changing their financial circumstances or being able to sell their home or refinance their loan.

111. Moreover, these interest-only loans could be given using the loose standards of a Stated Income; No Ratio; Stated Income, Stated Asset; and a No Income, No Assets or Employment (No Doc) loan, creating even more risk that the borrower would not be able to afford the loan.

112. Countrywide advertised its "flexible qualifying criteria" even to brokers selling this product to subprime borrowers. In one ad to brokers titled "Interest Only Now Available for Non-Prime Stated Wage Earners," Countrywide told its brokers that their "Interest Only loan options give Stated Wage Earners more flexible qualifying criteria." Countrywide went on to entice brokers to "learn more about how our Non-Prime Interest Only loan programs can help you increase your business and qualify more borrowers for their dream home . . .". This interest-only product could be sold as a stated income loan to a borrower with a credit score as low as 620.

113. The interest-only loan advertised above could also be a hybrid ARM. Borrowers who took out this loan as a hybrid adjustable rate mortgage ("ARM") received a loan that (1) allowed them to pay only the interest portion of their full payment for the first years of the loan, and (2) came with a discounted interest rate that would likely increase after the first few years. Such borrowers were set up for a payment shock once the discounted fixed rate term and interest-only portion of their loan was over.

114. Countrywide used these products to entice unsuspecting borrowers with low monthly payments and to qualify more borrowers for loans – often loans that they might not be able to afford long-term.

115. Another affordability product sold by Countrywide was the hybrid ARM. These loans typically have a two-or three- year fixed rate followed by 28 or 27 years of a variable rate, and are often referred to as a 2/28 and 3/27. These loans usually came with low, discounted interest

rates during the short fixed-rate period. After the fixed-rate period ended, the rate would adjust—but could only adjust up, not down—every six months to a year, based on an index plus a margin. Countrywide sold these loans to prime and subprime borrowers.

116. Countrywide also qualified its borrowers at less than fully-indexed rates on its 2/28's and 3/27's, meaning that Countrywide qualified the borrowers based on low rates that would adjust upward in two or three years without regard to whether the borrowers could afford the higher rates. This scheme forced borrowers into unaffordable payments once the fixed rate period of their loans terminated because they were not qualified at these higher payments.

117. One Illinois consumer's experience provides an example of Countrywide's business practice of placing borrowers in unaffordable hybrid ARM loans. Countrywide was the servicer for a 64 year-old widow's mortgage loan. This widow lived on a fixed income. At the time Countrywide purchased the servicing rights for her loan, the widow had a 30-year fixed-rate mortgage with a monthly payment of approximately $300. In January 2005, Countrywide refinanced this 64 year-old borrower into a 3/27 interest-only loan with a fixed rate for only the first three years of the loan. The consumer's monthly payment more than doubled to approximately $800 a month. Even before this consumer's loan reset, however, she was unable to afford her mortgage payment – showing that Countrywide refinanced her into an unaffordable adjustable rate mortgage.

118. Countrywide acknowledged in a May 7, 2007 letter to the Office of Thrift Supervision commenting on a proposed federal Statement on Subprime Mortgage Lending that: "Specifically looking at originations in the fourth quarter of 2006, we know that almost 60% of the borrowers who obtained subprime hybrid ARMs [from Countrywide] would not have qualified at the fully indexed rate." Countrywide also acknowledged that "almost 25% of the borrowers would not

have qualified for any other [Countrywide] product." Even removing the added risk layers of reduced documentation and high loan-to-value ratios, Countrywide knew that a majority of the borrowers who received their hybrid ARMs, at least during this period, were likely unable to afford the loans unless they refinanced by the time the introductory fixed period expired.

119. Countrywide did not inform its borrowers who were qualified at less than a fully-indexed rate or less than a fully-amortizing payment, that they were not qualified at the higher payments after the loans reset.

120. Countrywide made loans to borrowers that they ultimately would not be able to afford, relying on the premise that borrowers would be able to continue to refinance out of their unaffordable loans into new loans – and without making clear to borrowers the costs and risks of such loans.

Countrywide Pursued Market Share With Products That Layered Borrowers' Loans with Unnecessary Additional Risk

121. Even as it was relaxing its underwriting standards to increase loan origination, Countrywide also sought to increase its market share by offering new products packed with features that compounded risk to the borrower. These included option ARM mortgage products and loans for all or close to all of a homeowner's equity in a home.

122. The New York Times aptly described Countrywide's increasing origination of exotic products during the period from 2005 into 2007 with a quote from a former Countrywide executive that: "To the extent that more than 5 percent of the market was originating a particular product, any new alternative mortgage product, then Countrywide would originate it."

A. Countrywide's Combined its PayOption ARM with Unnecessary Layers of Risk, Improper Marketing, Confusing Disclosures, Inappropriate Sales Incentives and Inadequate Oversight

123. Countrywide's marketing and selling of option ARM mortgage loans exemplifies the company's increasing reliance on unfair and deceptive loan products and sales techniques to increase its market share.

124. From their inception, option ARMs were intended to be "a niche product aimed at sophisticated and well-heeled borrowers who wanted flexibility." Starting in 2003, however, option ARM origination grew beyond this narrow market, particularly at Countrywide.

125. Option ARMs, frequently referred to as "exotic" mortgage products, have three core features that sharply contrast with traditional mortgage loan products.

126. First, for a certain period of time, borrowers have four options as to which payment to make each month. These payment options are (1) a minimum payment that covers none of the principal and only part of the interest normally due each month; (2) an interest-only payment; (3) a payment that is amortized to pay off the loan in 30 years; and (4) a payment that is amortized to pay off the loan in 15 years.

127. Second, an option ARM may result in negative amortization – meaning that the amount owed increases over time. The amount of accrued interest that is not paid each month is added onto the borrower's loan balance. Therefore, the balance of the borrower's loan will actually increase by the amount of the unpaid interest if the borrower makes only minimum payments.

128. Traditionally, failure to pay the amount of accrued interest on a loan each month results in default and, ultimately, foreclosure. This outcome is a negative event for both the borrower and the lender. With option ARMs, however, Countrywide was able to neutralize this negative

event – at least for itself. Countrywide simply added this uncollected interest to the borrower's loan as additional principal and calculated the interest on this new, higher amount of principal.

129. There was, however, a cap to the amount of unpaid interest growing from negative amortization that could be added to the principal of the loan. Once the loan balance hit a certain ceiling – typically 115% of the loan's value – the minimum and interest-only payment options were removed and the borrower had to make fully-amortizing principal and interest payments. This "recasting" of the loan is the third core feature of a option ARM.

130. The fully-amortizing payments that borrowers must make after recast are far more than the minimum payment that the borrowers had been previously making. Taking one consumer's loan as an example, the monthly minimum payment was $751, but the fully amortizing payment was $1834. The payment shock experienced by option ARM borrowers when the interest rate on their adjustable rate mortgage fluctuated was small compared to the payment shock from a loan recasting to require the fully-amortizing payment. Assuming steady interest rates, recasting for consumers who consistently make the minimum required payment will occur approximately three to four years after origination of the loan.

131. Countrywide quickly became a leader in this profitable and growing part of the mortgage market. Option ARMs increased from approximately 3% of the company's loan production during the quarter ended June 30, 2004, to approximately 21% of its production during the quarter ended June 30, 2005.

132. The reason for Countrywide's increasing origination of option ARMs is clear: profit. An investigation by the New York Times revealed that option ARMs "were especially lucrative. Internal company documents from March [2007] show that Countrywide made gross profit

margins of more than 4 percent on such loans, compared with 2 percent margins earned on loans backed by the Federal Housing Administration."

133. At the same time that Countrywide touted the profitability of these loans, it also acknowledged that they were riskier for borrowers. The company said in its June 30, 2005 10-Q filing, "[w]hen the monthly payments for pay-option loans eventually increase, borrowers may be less likely to pay the increased amounts and, therefore, more likely to default on the loan, than a borrower using a normal amortizing loan." Angelo Mozilo even acknowledged that "it isn't clear how successful borrowers ultimately will be in paying off their option ARMs."

134. As discussed below, it is now clear that many borrowers will not only fail to pay off their option ARMs, but will lose equity in their homes and perhaps the ownership of their homes altogether. The full breadth of the problem has yet to emerge, but the numbers show that borrowers are losing ground. During the nine months ended September 30, 2007, 76% of borrowers elected to make less than full interest payments – much less than a payment that would cover any amount of the outstanding loan principal. This represents a 10% increase over the number of borrowers making less than full interest payments during the same period in 2006.

135. While attention is now focused on the meltdown in the subprime mortgage industry, option ARMs – which are classified as "prime" loan products – are ticking time bombs contained in lenders' prime loan portfolios and in securitized loan pools. According to Moody's Economy.com, monthly payments on roughly $229 billion of option ARMs will recast to include market-rate interest and principal from 2009 to 2011.

1. Countrywide Inappropriately Coupled its Volatile PayOption ARM Loan Product with Teaser Interest Rates, Prepayment Penalties, High LTVs and Reduced Documentation Underwriting

136. The core features of an option ARM – multiple payment options, negative amortization and automatic recasting of loan terms – make the product much riskier than traditional mortgages. But Countrywide typically did not sell its option ARM (typically called a PayOption ARM) with just these three features. Instead, it proceeded to layer the product with features that made it exceptionally risky, placing borrowers at risk of losing equity in their homes or even their homes. These features include: illusory teaser interest rates, prepayment penalties, high loan-to-value ratios and/or reduced documentation underwriting guidelines. As one former Countrywide loan originator explained, Countrywide's "options ARMs were built to fail."

137. Countrywide frequently combined its PayOption ARMs with illusory "teaser" interest rates. These "teaser" interest rates could be as low as 1%, but were illusory in that they were generally only valid for the first month or first three months of the loan.

138. After the illusory teaser interest rate expired, the interest rate on the loan would adjust to a true interest rate that typically had a cap of 9.95%. After the initial interest rate adjustment, the interest rate on the loan would continue to adjust each month. Therefore, the borrower would only have the benefit of the interest rate for one to three months of the 30 to 40 years of the life of the loan.

139. An interest rate that was only in effect for one month conferred no real benefit to a borrower. Thus, the marketing emphasis on the teaser interest rate of Countrywide's PayOption ARM was inherently misleading.

140. Interviews with former Countrywide employees and brokers and an examination of Countrywide's advertisements confirmed that the teaser interest rate was used to mislead

borrowers and obfuscate the true interest rate of the loan. A former Countrywide Account Executive, who was assigned to work with brokers in selling Countrywide products, was encouraged to tell her brokers to sell the loan based on the low monthly payment. A former employee who worked at Countrywide's prime retail locations confirmed that loan originators sold the product by highlighting the low payment on the option ARM, although it was based on an illusory teaser interest rate.

141. Countrywide's advertisements highlighted the teaser interest rate. For example, a television advertisement promoting the product emphasized "[a]nd 1 percent, you can't beat that. So pick up the phone, call Countrywide, or just visit your local branch today." Despite legal disclaimers, this emphasis on the teaser interest rate shows the company's intent to use the teaser to market the product.

142. Countrywide also generally coupled its option ARM loans with a three year prepayment penalty. In order for a consumer to refinance an option ARM during the first three years of the loan, the consumer would be required to pay the equivalent of six months' interest on the loan. Consequently, even if borrowers became aware of the risky features of their mortgage, they were effectively trapped in a loan with a payment that could adjust upward and become unaffordable.

143. Although prepayment penalties are touted by lenders as a bargaining tool for consumers, analysis has revealed that subprime borrowers generally received no appreciable benefit in exchange for accepting a loan with a prepayment penalty. At least one broker indicated that, although he was paid more for a loan with a prepayment penalty, there was no appreciable benefit to a prime consumer for taking a loan with a prepayment penalty. Therefore, the only point of this risky feature was to generate additional profit for Countrywide because investors would pay more for loans with prepayment penalties.

144. Another risky feature that Countrywide layered onto its PayOption ARM allowed a borrower to mortgage 90-95% of a home's value with a PayOption ARM first mortgage for the bulk of the amount and a second mortgage for the remainder.

145. According to a UBS survey conducted on behalf of The Wall Street Journal:

> Countrywide also allowed borrowers to put down as little as 5% of a home's price and offered "piggyback mortgages," which allow borrowers to finance more than 80% of a home's value without paying for private mortgage insurance. By 2006, nearly 29% of the option ARMs originated by Countrywide and packaged into mortgage securities had a combined loan-to-value of 90% or more, up from just 15% in 2004, according to UBS.

146. Although higher loan-to-value ratios are inherently riskier than lower loan-to-value ratios, that risk is compounded when the underlying mortgage product is an option ARM. If a borrower has an option ARM mortgage with a high loan-to-value ratio or during a time when the housing market depreciates (or both), the borrower could easily end up owing more on a home than it was worth because of the possibility of negative amortization on this product.

147. Finally, the vast majority of the PayOption ARMs sold by Countrywide were underwritten with reduced documentation requirements. Prudent underwriting is how borrowers are protected from the risk that they will be given a mortgage that they will not be able to repay. In the case of a PayOption ARM, Countrywide purportedly mitigated the risk that borrowers would not be able to repay their risky loans by requiring that its underwriters qualify borrowers at the full principal and interest payment for the option ARM. This process became a meaningless protection, however, when Countrywide failed to require full documentation for its underwriting.

148. When Countrywide designed its mortgage products, it also determined what underwriting documentation requirements it would attach to the product. As discussed above, these

requirements could vary from full documentation to no documentation at all. Countrywide apparently decided that its underwriting for an option ARM did not require full documentation.

149. This decision led to underwriting guidelines that allowed a borrower to mortgage 95% or more of the value of a home with a PayOption ARM underwritten with stated income and stated assets.

150. Countrywide's decision to allow reduced documentation underwriting resulted in the vast majority of its PayOption ARMs being sold with less than full documentation. Of the option ARMs Countrywide sold in 2007, 82% were reduced documentation mortgages in which the borrower did not fully document income or assets.

151. One former Countrywide manager noted that the loans were an easy sell because they could use stated income – presumably to ensure that the borrower's income (at least what was stated as the borrower's income) was sufficient to qualify for the mortgage.

152. As discussed above, low or no documentation loans are likely to contain material misrepresentations and/or fraud that will result in increased default rates. Risk of default is compounded when a lessened underwriting standard is coupled with "nontraditional" mortgages such as option ARMs. Regulators and analysts have counseled against this type of risk layering.

> Banking regulators say that lenders are increasingly relying on unverified income to qualify borrowers for so-called nontraditional mortgage loans. Those products – such as pay-option adjustable-rate mortgages and interest-only loans – allow borrowers to defer payment of principal and sometimes interest. Many analysts see such a combination of nontraditional products and nontraditional underwriting processes as presenting another layer of risk to those who could be hurt by defaults, including consumers, shareholders in mortgage lenders and investors in securities backed by mortgage loans.

153. Combining a PayOption ARM with any of the risk-layering features described above results in a product that is significantly increases a borrower's risk of loosing home equity or ending up in foreclosure.

154. Delinquency reports support this conclusion. Statistics show that consumers are becoming increasingly delinquent on option ARMs. Countrywide securitized roughly three quarters of its option ARMs, but held the loans most likely to be high performing in its portfolio. Of the option ARMs that Countrywide held in its bank portfolio, 9.4% of the option ARMs were at least 90 days past due in April 2008, up from 5.7% at the end of December 2007 and 1% a year earlier. As this input likely includes many option ARMs that have not recast, these delinquencies are particularly alarming as they show consumers are not even able to make the minimum payment on these loans. In other words, borrowers somehow received option ARMs when they were unable to make even the minimum payments, much less the fully-amortizing payment.

155. These numbers show that option ARMs are failing at a troubling rate, but that has not led Countrywide to stop layering the product with risky features. In fact, an analysis of only those option ARMs that Countrywide held in its own portfolios (i.e., the least risky option ARMs) shows a steady decrease in loan quality. For example, the loan-to-value ratio for the product increased from 73% in 2004 to 76% in 2007. The average credit score, a general indicator of creditworthiness, dropped from 730 in December 2004 to 716 in September 2007. Even though external indicators should have provided Countrywide with ample notice that it needed to tighten option ARM underwriting criteria, the company continued to relax its standards in selling increasingly risky loans.

156. Former Countrywide employees and brokers who sold Countrywide products have stated that option ARMs are risky products.

157. Some of Countrywide's own former employees found the product unsound for anyone. Brokers who sold the product opined that it should never be paired with either a prepayment

penalty or reduced documentation underwriting due to the dramatic increase in risk to the borrowers. Another broker referred to the product as a "ticking timebomb" and another former Countrywide employee referred to it as "dangerous."

2. Countrywide Improperly Mass Marketed Its PayOption ARMs and Failed to Provide Borrowers with Adequate Disclosures About the Product's Risks

158. Despite the structural unfairness of the PayOption ARM described above, Countrywide marketed the product indiscriminately to all borrowers, pushed its employees and brokers who sold Countrywide loans to sell the product inappropriately and failed to provide disclosures to ameliorate borrowers' confusion about the mortgage they were obtaining.

159. With all of its risky features, the PayOption ARM should have been marketed cautiously – if at all. That was not, however, Countrywide's approach. For example, Countrywide sent direct mailers to consumers whose loans it serviced to market the product. In one such mailer, Countrywide advised the consumer that he had an "excellent payment record" and might now qualify for "our best 'A' level mortgage interest rates – such as our PayOption ARM."

160. Likewise, Countrywide sent direct mailers to consumers advising them to call Countrywide for a one year anniversary loan check-up. The direct mailer also touted Countrywide's option ARM product.

161. Countrywide provided its brokers with sample advertisements that they could use to entice borrowers to get option ARMs. One of these advertisement exemplars asks borrowers "[w]ho doesn't need more options?" The implication of the ad is that an option ARM is appropriate for anyone who would simply like "more options."

162. The disclosures that Countrywide gave borrowers provided little help in explaining their actual mortgages because they were the epitome of "information overload." For example, in 2007, one disclosure entitled the "Home Loan Application Disclosure Handbook" (Handbook)

was 123 pages long and had 63 pages concerning all of the available Countrywide loan products, not just the products in which borrowers were interested.

163. Regardless of whether borrowers applied for loans through a broker or a retail division, Countrywide sent borrowers various disclosures, such as this handbook, prior to closing loans. Often acknowledgment forms accompanied the disclosures. For some borrowers, Countrywide required consumers to sign acknowledgement forms prior to processing the loan application. At this point, what types of loans they could even afford. Without this information, it was difficult for borrowers to assess the various mortgage products and their options. For other borrowers, Countrywide required borrowers to sign acknowledgment forms at closings, along with many other closing documents.

164. For borrowers wanting to learn about PayOption ARMs, in the Handbook, there were eight pages about different PayOption ARMs buried in the middle of other disclosures. Each of these had confusing titles such as "PayOption Adjustable Rate Mortgage Loan Program Disclosure Monthly Treasury Average ("MTA") Index-Payment Caps All States Except New York."

165. Not only did this Handbook bury explanations of Countrywide PayOption ARMs and use confusing titles to describe them, it also failed to adequately warn borrowers about the possible pitfalls of negative amortization with option ARMs, like depreciation of home values. The Handbook defined negative amortization as ... "the interest shortage in a [consumer's] payment is automatically added to the loan balance and then interest may be charged on that amount). [The consumer] might therefore owe the lender more later in the loan..." It then stated, "However, an increase in the value of your home may make up for the increase in what you

owe." Yet, it never stated that if the market failed or the value of the homes depreciated, consumers would owe more than the value of their homes.

166. By overloading borrowers with irrelevant information and using confusing language, Countrywide's disclosures hid the very information that they were supposed to disclose to consumers—the relevant details about their actual mortgages.

167. Notably, a number of former Countrywide employees remarked that they did not feel comfortable selling the products because they either did not understand the product themselves or did not feel comfortable explaining it to someone else.

168. Although Countrywide may have created training materials for the product, at least one former employee did not recall receiving any training on it at all – although she was authorized to sell option ARMs. Brokers authorized to sell Countrywide products similarly recalled that the company failed to provide any training materials on option ARMs.

169. With their risk and complexity, option ARMs should have been sold with discretion and only with proper disclosures of risks. Countrywide knew from its own empirical evidence that its mass-marketing of this product would place many homeowners into unsustainable loans.

170. When consumers made only the minimum payment, Countrywide carried the negative amortization that resulted on its books as uncollected "income." In 2004, the accumulated negative amortization "income" was only $29 thousand. For the year ending 2007, however, accumulated negative amortization from pay option ARMs that Countrywide was holding on its books had grown to $1.215 billion. The negative amortization had steadily – and markedly – increased from $29 thousand to slightly over a billion dollars by rising to $74.7 million in 2005 and $654 million at year end 2006,.

171. Despite all of these warning signs and the widespread acknowledgement among analysts and even its own former employees that this product is unsuitable for most borrowers, Countrywide is still promoting its option ARM products on its website to this day.

3. Countrywide Incentivized and Facilitated Improper Sales Techniques without Providing Adequate Guidelines for Selling its PayOption ARMs

172. Countrywide further increased the risks associated with this product by incentivizing mortgage brokers to sell PayOption ARMs over more traditional mortgage products. The company then failed to provide the brokers with sufficient parameters for selling the product, facilitated deceptive sales tactics and did not exercise sufficient oversight over brokers' conduct.

173. As Angelo Mozilo stated during an April 26, 2005 investor conference call, the product was "a good product for both us, the lender, and for the mortgage broker." Countrywide left consumers out of this analysis.

174. As an initial matter, Countrywide provided financial incentives for brokers and its employees to inappropriately sell its PayOption ARMs.

175. Brokers are compensated in two ways. First, borrowers may compensate brokers directly through loan origination, underwriting, processing and other fees. The second way that brokers are compensated, however, is through "yield spread premiums" ("YSPs").

176. A yield spread premium is the cash rebate paid to a mortgage broker by a lender. Typically, the YSP is based on a broker selling a borrower a loan with an interest rate above the wholesale par rate. The par rate is the actual interest rate a borrower qualifies for with a given lender. For example, a mortgage broker could earn a YSP for selling a borrower a loan with an interest rate of 6.25% when the borrower's par rate is 6%. This fee is paid by the lender directly to the broker as a "rebate." Although the consumer is not charged the fee directly, the consumer

pays the fee indirectly by paying a higher interest rate. The YSP is typically a percentage of the loan amount, therefore, the larger the loan, the larger the fee that the broker earns.

177. Countrywide structured the YSP for option ARMs in a manner that virtually guaranteed that brokers who were more concerned with getting the highest YSP possible than getting their borrowers the best loan possible would steer borrowers into these risky loans. Plainly put, it was easier to obtain higher commissions for option ARMs as opposed to other traditional Countrywide mortgage products.

178. Ordinarily a broker would need to increase the interest rate over a borrower's par rate on a loan in order to receive a higher YSP. A borrower would notice, of course, that a broker was offering a loan with a higher interest rate.

179. With option ARMs, the YSP was based on three factors which helped obscure the true cost of the loan: the amount of the teaser interest rate, the amount of the margin that was used to calculate the product's interest rate, and the existence of a prepayment penalty.

180. First, the teaser rate was so low, borrowers would not notice a material difference between 1%, for example, and 1.25%.

181. Second, as far as the margin, borrowers were unlikely to notice what the margin was and realize that they were able to negotiate this term. Once the one-month teaser rate has expired, the PayOption ARM's interest rate is calculated each month by adding a margin—e.g. 4%—on top of on an index (such as the monthly United States Treasury average yield). The margin remains the same throughout the life of the loan, while the index changes monthly. The higher the margin, the higher the borrower's interest rate would be from month to month after the one-month teaser rate expired. Both the standard used for the index and the margin amount could be negotiated by the borrower. But because brokers sold the low monthly payment and the teaser

interest rate, the fact that there were other features that could be adjusted – to the borrower's detriment – often went unnoticed and was buried in the midst of the voluminous disclosures that borrowers received. Thus, borrowers would not typically notice if their broker increased their loan's margin to the maximum sold by Countrywide (around 4%) in order to increase his YSP.

182. Finally, brokers often added a three-year prepayment penalty to the loan. As discussed above, borrowers frequently did not receive any benefit for accepting a loan with a prepayment penalty – if they were even aware the loan had a prepayment penalty.

183. By slightly increasing an already low "teaser" rate, increasing the margin, and adding a three-year prepayment penalty, brokers could maximize the YSP Countrywide paid them.

184. Notably, because PayOption ARMs were considered "prime" loan products, borrowers who qualified for the loan would also have qualified for fixed rate and adjustable rate mortgages with favorably low interest rates. The true interest rate on a PayOption ARM was typically higher than the rates on either of these products. In other words, borrowers paid a premium for a product that most of them did not understand and that did not provide them with any benefits in return for this premium.

185. Therefore, Countrywide provided brokers with a financial incentive to sell option ARMs with a high margin and the worst prepayment penalty possible. Although the possible fraud that this financial incentive would motivate should have been clear, Countrywide then failed to institute appropriate checks on its sale or to adequately oversee its brokers.

186. A mortgage broker's primary contact within Countrywide was its assigned Account Executive, a Countrywide employee. Account Executives gave brokers selling tips on option ARMs to emphasize the meaningless one-month teaser rate. One former Countrywide Account

Executive was encouraged to tell her brokers to sell the loan based on the low monthly payment, since rising property values would offset negative amortization.

187. Countrywide also gave its Account Executives materials, like flyers, which they could use to promote certain loan products to brokers or that they could give brokers to use to promote Countrywide products to borrowers. Almost all of the flyers that Account Executives gave to brokers highlighted that reduced documentation could be used to qualify borrowers for the product and also emphasized the illusory teaser interest rate for the product.

188. Not surprisingly, after receiving materials emphasizing the illusory teaser interest rate, brokers used the rate to obfuscate the true cost and interest rates of an option ARM.

189. One broker, for example, placed a full-page advertisement in the Chicago-Sun Times for a closed-end line of credit of $235,000.00 for a monthly payment amount of $656.05. The advertisement does not disclose that the interest rate upon which the payment is based is only applicable for the first month of the mortgage loan.

190. Another example is a direct mailing that a broker used to advertise an option ARM product. The broker solicited consumers through a direct mailing for a closed-end line of credit of $681,182.00 for a monthly payment amount of $1,898.54. Again, the direct mailing does not disclose, in readily understandable terms, that the interest rate upon which the payment is based is only applicable for the first month of the mortgage loan.

191. Countrywide also failed to create any checks on who received a Countrywide option ARM. Due to the complexity of the product and the likelihood of severe negative consequences to the borrower – such as loss of home equity, this product was not appropriate for most borrowers. As described above, the option ARM was initially designed for sophisticated borrowers – people who were investing in or building homes or properties for resale.

Countrywide took this niche product and mass marketed it to the general public, often through mortgage brokers, without instituting any parameters for its sale.

192. Based on the materials that Account Executives gave brokers regarding the product, it would seem that the product was appropriate for any borrower who wanted "options," regardless of their actual financial circumstances. This lack of rules enabled Countrywide's brokers to misuse the product and to sell this Countrywide product to unsuspecting borrowers looking for a good, long-term, sustainable loan.

193. Given Countrywide's critical reliance upon mortgage brokers to sell option ARMs, the complexity of the product, and huge potential for borrower harm, Countrywide should have developed, employed and facilitated proper – not deceptive – sales techniques. Countrywide also should have instituted parameters on what borrowers could receive this product. Countrywide did not.

4. Countrywide's Relationship with One Source Mortgage, Inc.

194. Countrywide's use and abuse of the option ARM product is clearly illustrated by the relationship between the company and an Illinois broker who specialized in selling Countrywide PayOption ARM loans, One Source Mortgage, Inc. ("One Source").

195. Countrywide should have been aware of potential issues with One Source Mortgage, Inc. when it first approved the broker to work as its business partner in Spring 2004. At the time Charles Mangold, the owner of One Source, submitted the company's broker application to Countrywide, he had no fewer than five felony convictions in the State of Illinois. Specifically, between 1989 and 2000, Mangold was convicted and sentenced to jail time for improperly communicating with a juror, multiple occurrences of felony possession and use of a weapon or firearm, and driving with a suspended or revoked license.

196. In terms of actual conduct, One Source used the illusory one month teaser rate that Countrywide coupled with its option ARM exactly as one would expect – to commit fraud. For example, when describing the PayOption ARM to consumers, One Source told consumers the amount of only one payment – the minimum payment. One Source also did not adequately describe to consumers the distinctive characteristics of PayOption ARMS: the fact that the initial low interest rate was merely a one month teaser rate or that negative amortization would occur if the consumers pay only the minimum payment.

197. One Source frequently did not disclose to consumers any interest rate for the mortgage loan at all or described only the illusory teaser rate.

198. One Source told a consumer that his minimum payment of $700 covered all the interest on his loan. In reality, the consumer would have had to pay $1816 a month to make even an interest-only payment on his loan.

199. To the extent that Countrywide or One Source provided disclosures to consumers, they were ineffectual. Consumers reported that they did not learn that One Source's representations about their mortgage loans were false until they began to receive statements from Countrywide.

200. Countrywide handsomely compensated One Source for its fraudulent conduct. One Source received YSPs from Countrywide ranging from $4185 to $11,310 per loan in the month of March 2006. During that one month, One Source received a total of at least $100,000 from Countrywide in the form of yield spread premiums.

201. One Source engaged in rampant fraud on borrowers' loan applications without the consumers' knowledge, and which Countrywide then completely failed to detect. Consumers typically told One Source their monthly income and even provided pay stubs and tax returns to verify their income. On some consumers' loan applications, however, their monthly income was

increased to sometimes even double the correct amount. Because Countrywide coupled PayOption ARMs with reduced documentation underwriting, the company failed to discover this fraud.

202. For example, One Source listed one consumer's monthly income as $8000 on his mortgage loan application. In fact, this consumer earned only approximately $3400 to $4000 a month and provided pay stubs and tax returns to One Source to verify his income. This consumer was unaware that One Source listed his income as $8000.

203. Countrywide's purported fraud detection programs failed to catch any of these issues. Along with this failure, Countrywide repeatedly bent the rules for One Source Mortgage. Although it was supposedly against company policy, Charles Mangold treated three Countrywide employees (his primary underwriter, the manager of the branch he dealt with, and the closer on his loans) to flowers and expensive gifts, such as Coach handbags.

204. In addition, Countrywide's stated general policy is that broker files are assigned to underwriters randomly. This policy was not followed in the case of One Source Mortgage. One underwriter who worked in Countrywide's Lisle office was often assigned to underwrite One Source files and, in 2006, this underwriter was designated as One Source's primary underwriter.

205. This underwriter was disciplined time and again for errors in her underwriting. Prior to being assigned to One Source, the underwriter had been counseled several times for, among other things, quality of work. Eventually, Countrywide terminated the underwriter. Despite the documented problems with One Source's primary underwriter, Countrywide failed to detect the systemic fraud in the One Source loan files.

206. Countrywide did nothing to curb the rampant abuses inflicted by this broker. In fact, Countrywide did not even terminate its relationship with the broker until December 2007 – after

the Attorney General's Office sued the broker for fraud and served Countrywide with a subpoena seeking documents related to the broker's conduct.

207. As the One Source example illustrates, Countrywide's inducements to brokers combined with its lack of loan parameters or any real oversight resulted in brokers steering borrowers to loans that were exceptionally risky and routinely qualifying borrowers for loans they could not actually afford.

208. As a result of Countrywide's inappropriate marketing, selling and risk layering of its option ARM product, Illinois borrowers who thought they were refinancing into beneficial loan product are now facing the possibility of losing all the equity they had built up in their homes or losing their homes entirely.

B. Countrywide Indiscriminately Sold Mortgages With High Loan-to-Value Ratios Regardless of the Loans' Risky Features

209. In addition to risky products like option ARMs, Countrywide aggressively sold loans with very high loan-to-value ratios. In recent years, the loan-to-value ratio on many Countrywide loans – that is, the ratio of the home's appraised value to the amount of the loan – reached as high as 100%. Loans with 100% loan-to-value ("LTV") ratios were sold as a single loan, or separated into two concurrent loans: a first-lien loan paired with a simultaneously originated second-lien loan that, together, had a combined loan-to-value ratio of 100%.

210. These simultaneous second-lien loans were often referred to as "piggyback" loans, and the combination of a first- and second-lien loan with a 100% loan-to-value ratio was commonly referred to as an "80/20" or "combo" loan.

211. Countrywide regularly paired the first-lien loan in the 80/20 loans with a second-lien loan in the form of a product type known as a Home Equity Line of Credit, or "HELOC."

212. The HELOC second-lien loans were sold as open-end revolving lines of credit. But, in order to avoid exorbitant add-on charges, borrowers were generally required to draw down the principal amount of the HELOCs fully at the time both the first and second-lien loans were originated, and Countrywide required HELOC borrowers to maintain a "minimum" average daily balance for several years thereafter to keep the "minimum" balance intact.

213. This loan structure could be comprised of a first-lien loan for 80% LTV piggybacked with a simultaneous second-lien HELOC for 20% LTV.

214. Countrywide could also achieve this 100% LTV structure with a simultaneously written second-lien fixed-rate loan. Countrywide boasted to its brokers that it has a "Greater variety of high LTV, low doc options for more borrowers: Enhanced 80/20 Options."

215. This conduct was profitable. Countrywide applied a higher rate of interest to loans in the second lien position than the rate of interest applied to senior first-lien loans. This rate structure produced a correspondingly higher monthly payment (and income stream for investors) due to the higher interest rate applied to the outstanding principal balance on the junior second-lien loans.

216. Countrywide's simultaneous second-lien HELOCs often came with some variation of an interest-only period. Many of Countrywide's HELOCs had a five-year interest-only period that could be extended for another five years – this was called the "draw" period – even if the loan was already fully drawn.

217. For the interest-only period, the required payment would only cover interest. As a result, a borrower would neither pay down any of the loan principal nor increase the amount of equity in the home during this time. Even if the borrower stayed current on monthly payments in these loans, they could find themselves owing the entire original loan balance at the end of the interest-

only period of the loan term. In fact, Countrywide even had HELOCs that were interest only for the entire term of the loan.

218. The length of loan term of the second-lien HELOC loans was generally shorter than the length of the loan term on the first-lien loans. Countrywide often paired junior second-lien HELOCs that contained abbreviated 15-25 year terms with senior first-lien loans containing 30-year terms.

219. In these shorter-term HELOCs that had interest-only features, the loan "reset" after the interest-only period expired, five or ten years into the loan term. The loan then began to amortize. Because these loans also often had a balloon feature at the end of the loan term, however, they did not amortize fully. This meant that a borrower was set up to experience payment shock twice. First, the borrower would experience payment shock due to the reset to a partially amortizing payment amount. Next, the borrower would experience payment shock at the end of the loan term, when the balloon came due. Consequently, at the end of the term, the borrower was faced with paying the total outstanding unpaid principal amount of the junior loan, which came due before the end of the term of the underlying first-lien senior loan.

220. To the uninitiated borrower, this balloon payment would arrive deep into the term of the first-lien loan and could undermine the borrower's ability to maintain payments on the underlying first-lien loan. This set-up was typical of Countrywide's 30/15 Balloon mortgage loan. A "30/15 Balloon" was available on second loans with 100% financing. Countrywide prompted its brokers to "Qualify more borrowers for 100% financing with our new 30/15 Balloon options on Seconds."

221. All of these features of Countrywide HELOCs and piggyback loans, especially when paired with a loan with a combined LTV of 100%, had the potential to force borrowers into foreclosure or otherwise harm them.

222. Loans with loan-to-value ratios of 100% combined with low introductory interest-only payments, or with a balloon feature, are very risky. These features increase the risk that borrowers cannot afford the loan payments at all or will be unlikely to build any equity in their homes when faced with stagnant or a slight reduction in home value. Such borrowers are at risk of losing their homes if they cannot make the increased payments or cannot refinance. In either case, borrowers will have little or no equity with which to work in order to refinance, and may have to pay out-of-pocket just to sell their homes.

223. Not surprisingly, loans with piggyback second-lien loans are more likely to fail. Defaults on the riskier, higher-rate second lien loans expose the entire mortgage structure, both first and second lien loans, to failure. Standard & Poor's, the largest securities rating agency, analyzed over a half million first-lien mortgages sold with HELOCs or fixed rate seconds between 2002 and 2004 and found that borrowers were 43% more likely to default on those liens than comparable first mortgages without piggybacks.

224. Lending at 100% LTV is particularly dangerous with subprime borrowers who, as demonstrated by their shaky credit history, are more likely to be without financial breathing room, with no budgetary margin of error or an adequate safety net to help them weather and get past even minor life events, like the need to replace a water heater or an unusually high energy bill. If they begin to miss payments and, as a consequence, have servicing penalties and late fees added to their mortgage payments, they get turned "upside down" on the equity in their property and quickly owe more on the Countrywide mortgage than their home is worth.

225. This risk is magnified when paired with reduced documentation underwriting or other features that further increase the likelihood that the borrower will be unable to afford the loan.

226. In 2005, Countrywide qualified borrowers with credit scores as low as 580 for single loans with loan-to-value ratios of 100% and for 80/20 piggyback loans. On the first-lien loan in an 80/20 piggyback loan combination, borrowers could be sold an interest-only option, whereby the borrower would make payments only on the interest for a certain period of time. During the period in which the borrower was paying only the interest, the principal balance on first-lien loan would remain the same – at 80% of fair market value. In 2007, a non-prime stated self-employed or salaried borrower could qualify for an 80/20 loan for as much as $850,000 with a minimum credit score of 640 and could qualify for a loan up to $1 million with a minimum credit score of 680. As Countrywide told its brokers in an ad, "Countrywide®, America's Wholesale Lender®, Specialty Lending Group delivers more options to your Non-Prime Stated Income borrowers!"

227. A self-employed borrower with a minimum credit score of 640 could get a "100% 'One Loan' Stated" for up to $700,000. A stated wage earner with a minimum credit score of 640 could also mortgage 100% of a home's value with an 80/20 loan.

228. Countrywide told borrowers that there was "GOOD NEWS! Now you can qualify for up to 100% financing without a recent bankruptcy affecting your FICO score." Countrywide proclaimed "Low credit scores allowed" and "Hard to prove income acceptable."

229. Countrywide also had 80/20 loan programs that could be paired with a hybrid ARM—even a hybrid ARM with an interest-only feature.

230. Countrywide loans made at 100% loan-to-value were imprudently made and were unsound as written because they were unsustainable and unaffordable for borrowers, even borrowers in a stable housing market.

Countrywide Utilized Unfair and Deceptive Advertising and Sales Pitches to Push Mortgages, While Hiding Costs and Risks to Consumers

231. To further its aggressive loan origination practices, Countrywide engaged in unfair and deceptive sales practices through telemarketing, direct mailings, newspaper advertisements, and television and radio commercials in Illinois. Countrywide generally lead consumers to believe that they could offer consumers the best loan at the lowest price. Countrywide's advertisements to consumers often hid or obscured the risks associated with different mortgage products and refinancing.

A. Personalized Direct Mailings Pushed Consumers to Refinance into Risky Products

232. Countrywide sent direct mailings to consumers in an effort to push certain mortgage products and to induce current Countrywide borrowers to refinance within a short period of time after finalizing their loan. Often, the direct mailing appeared to be a personalized letter or email, including information about consumers' present loans, which deceptively compared present loans with new offers, and instructed consumers to contact Countrywide quickly.

233. For example, on or about April 15, 2005, Countrywide sent borrowers a direct mailing to refinance into a PayOption ARM and directed borrowers to contact Countrywide on Saturday, April 23, 2005. Next to the consumer's name and address was a highlighted box which stated the "estimated initial payment savings" as $15,132 assuming the consumer refinanced into a PayOption ARM.

234. This "estimated initial payment savings" was misleading because it was based on the consumer paying the initial rate of 1% for an entire year. But with a PayOption ARM, after the first month, merely paying the initial rate of 1% would not have covered the principal and interest of the mortgage, resulting in negative amortization. Thus, if a consumer opted to refinance into the advertised program, the consumer would not actually save any money on their

payments. To emphasize the "savings," Countrywide hid the method for calculating the estimated savings and the negative amortization that would result in a tiny font text after the signature of Countrywide's personal loan consultant at the bottom of the page.

235. The text of the mailing touted to consumers the benefits of a PayOption ARMs, such as "free up cash..., paying off high interest credit card debt, invest in income property, saving cash for the purpose of a new home and afford a larger home." However the mailing failed to disclose clearly and conspicuously the many risks and negative ramifications of a PayOption ARM product.

236. The promise of "afford a larger home" was deceptive because PayOption ARMs were not necessarily cheaper than fixed rate mortgages. While a consumer may have been able to obtain a larger mortgage with a PayOption ARM, it did not mean that she could afford to pay it off. An option ARM merely allowed a consumer to choose the amount of a monthly payment. Thus, some payments could be smaller than those with a fixed rate mortgage, but to prevent negative amortization, the consumer had to make much larger payments.

237. Another direct mailing about refinancing into PayOption ARMs emphasized the amount the consumer could cash-out if he refinanced from a 30-year fixed rate loan to a PayOption ARM. Again, next to the consumer's name and address was a highlighted box with "Up to $65,380" and then under it, "Please Call Now, 1-800-598-1129."

238. In the text, it promised that the consumer could access as much as $65,380 in home equity through refinancing into an option ARM with a 4.250% fully indexed interest rate. Further the mailer stated that this interest rate is lower than the rate of the borrower's current fixed-rate mortgage.

239. This statement failed to clearly and conspicuously disclose the interest rate and how Countrywide calculated the consumer's home equity, whether it was based on a computer program or an actual appraisal. Further, since the rate on this option ARM product would fluctuate monthly after the one-month teaser interest rate expired, the interest rate and payment could increase to more than the consumer's current mortgage rate and payment. To sweeten the offering, Countrywide offered, "Fasttrack Cash-out Refinancing" which promised to "cut down on the amount of qualifying and application paperwork."

240. Yet, this mailing did not clearly and conspicuously disclose the risks of refinancing into a PayOption ARM. At the bottom of the mailing, after the signature of the personal loan consultant and in tiny font, the mailing made a reference to the introductory period. It instructed the consumer to see another footnote on the second page for an explanation of that footnote. By burying this information after the signature, using tiny font and referring the consumer to another footnote for an explanation, Countrywide obscured the significant risks of refinancing into a PayOption ARM.

B. Emails Touting Complimentary Loan Reviews Deceptively Induced Consumers to Refinance

241. Besides paper mailings, Countrywide also emailed personalized mailings to current customers on their loan anniversaries, which offered "free" or "complimentary" loan reviews.

242. For example, in 2006, Countrywide sent emails to current Full Spectrum Lending Division consumers with the subject line "It's Your Anniversary!" In the heading with large bold font, it stated "Happy Anniversary! Enjoy your complimentary loan review" and then to the immediate right it had printed Countrywide's telephone number and "Click Here to Get Started," which linked the consumer to an on-line loan application.

243. By placing the telephone number and the link immediately after the complimentary loan review, the email led the consumer to believe that contacting Countrywide would result in an informational review, not a sales pitch for refinancing.

244. After the heading, the email congratulated the consumer for being a current customer. Then it proclaimed that "many home values skyrocketed over the past year. That means that you may have thousands of dollars of home equity to borrow from—at rates much lower than most credit cards." This statement led the customer to believe that the value in her home skyrocketed to allow her "thousands of dollars of home equity." Yet, the email failed to clearly and conspicuously disclose how Countrywide calculated the consumer's equity in her home.

245. Then the email offered an "exclusive interest rate discount of 1/2 %" because the consumer was a current customer. At the end of the email, it emphasized that Countrywide wanted to provide the "right" home financing situations to meet the consumer's needs and stated "Call us now at 1-866-253-2352 or Click Here."

246. If the consumer did not respond to this email, Countrywide sent a follow up "Your Anniversary Review Reminder" which stated "If you haven't called for your free Anniversary Loan Review yet, there is still time." The follow up email created a false sense of urgency, in which the consumer had to act fast to avoid losing a supposedly great deal.

C. Television and Radio Commercials: Deceptively Advertise No Closing Cost Refinancing

247. Besides direct mailings and newspaper ads, Countrywide also used deceptive television and radio commercials to induce consumers to purchase loans and refinance their mortgages or obtain home equity lines of credit.

248. For example, in November 2005, Countrywide ran a television commercial called "Guess What A" which offered a "no closing cost debt consolidation loan." During the commercial, a

man informed consumers to "act fast" to consolidate their high interest credit cards while mortgage interest rates were low. Although a legal disclaimer disclosed that refinancing or taking a HELOC may increase the total number of payments and total amount paid, it did not disclose that consumers paid for the "no closing costs" through a higher interest rate. Rather, it just referred consumers to Countrywide's website for information on closing costs.

249. Similarly, in July 2007, Countrywide ran a television commercial which again offered a "refinance with no closing costs." The man in the commercial stated "That's right. At closing you'll pay absolutely no closing costs. This means more cash for you."

250. Again, the legal disclaimer obfuscated the truth that consumers paid for "no closing costs" through a higher interest rate. Rather, it stated that "borrowers who choose to pay lender fees and closing costs upfront may qualify for a lower rate."

251. Countrywide engaged in similar confusing and deceptive advertising in its "Dueling Announcers" radio commercial. In that commercial, Countrywide offered a "no closing cost" refinance loan and again the legal disclaimer obfuscated the truth that consumers paid for no closing costs through a higher interest rate. At the end of the commercial, it said that borrowers who choose to pay lender fees upfront may qualify for a lower rate. Then it stated "recent trends show home values flattening or even declining in some areas." The commercial urged consumers "[s]o tap into your home's available equity now."

252. In addition, this commercial emphasized the benefits of refinancing such as: cash from the equity, a lower fixed rate, and paying credit card bills. Yet, this commercial failed to disclose clearly and conspicuously the danger that by removing equity at a time when home values are stagnant or declining, consumers could owe more than the value of their homes.

D. Countrywide Used Deceptive Sales Pitches to Push Risky Mortgages

253. After receiving advertisements, many consumers contacted Countrywide account executives, who were trained to use deceptive sales scripts to originate mortgages for purchases and refinancing.

254. According to an interview with a former account executive in Countrywide's retail division, Countrywide instructed employees to sell the "low" monthly payments of each product and to down play the total cost of the mortgage, the interest rate, adjustable rate, prepayment penalty or any other risks associated with the products.

255. If consumers questioned the terms of the offered mortgage, account executives would offer to refinance consumers into better mortgages at later date, such as in loans with ARMs often before the rates adjusted. It was a deceptive promise because the account executives could not predict consumers' ability to refinance, which often depended on whether housing values continued to appreciate.

256. According to an interview with a former account executive in the Full Spectrum Lending Division (Countrywide's subprime retail division), Countrywide used scripted telemarketing to solicit both new borrowers and current Countrywide borrowers for subprime mortgages.

257. These potential consumers, or sales "leads," included prime borrowers who mistakenly called Full Spectrum, consumers with prime mortgages serviced by Countrywide but who were late in their payments at least 30 days, consumers who called Countrywide's prime retail lending division and whose credit scores were below a certain level, and current Countrywide subprime borrowers whose loans had adjustable rate mortgages, balloons or other variable terms.

258. Countrywide required employees to memorize sales scripts, prior to attending intensive sales training in Illinois or California. Countrywide instructed account executives to use the

sales scripts for every conversation with consumers. In fact, the scripts covered the entire loan origination process, from intake to closing, for refinance, purchase and home equity mortgages.

259. By using the sales scripts, Countrywide employees deceived and confused consumers so that consumers would not understand the true costs associated with the new loans.

260. As described in the New York Times' article, *Inside the Countrywide Lending Spree*, Countrywide used a "seductive sales pitch" to convince consumers that Countrywide aspired to provide consumers with "the best loan possible." Rather than actually providing the best loan possible, Countrywide led consumers into "high-cost and sometimes unfavorable loans that resulted in richer commissions for Countrywide's smooth talking sales force."

261. For example, according to one former Full Spectrum account executive, Countrywide's subprime divisions did not offer FHA loans to consumers who could have qualified for them and instead frequently offered costlier or riskier subprime loans.

262. As compared to subprime loans, FHA loans have historically allowed lower income consumers to borrow money for the purchase of homes. FHA loans are insured by the Federal Housing Authority for consumers with "less than perfect credit" histories and allow for down payments as low as 3%. The majority of FHA loans are 30-year fixed rate loans, rather than ARMs.

263. A former account executive provided the following comparison for a consumer with a down payment of 5% (or 95% LTV) seeking a $100,000 loan. With an FHA loan, the consumer could have received a fixed interest rate of 6% for 30 years (with an additional insurance fee of 1½ %). Yet, through Full Spectrum, the account executive sold the same consumer a subprime loan with 8-10% interest rate and layered with additional risks, such as a prepayment penalty.

264. The deception of providing the best loan for the consumer started right from the beginning of the sales script with the first telephone call. In fact, according to an interview with a former Full Spectrum employee, the 2005 script prohibited employees who spoke with prime borrowers who were merely 30 days late from mentioning the purpose of their phone call, e.g., to refinance into more costly subprime mortgages.

265. By misrepresenting the purpose of the call and obscuring consumers' possible weakened credit, Countrywide led consumers to believe that the call was to discuss servicing issues or even refinancing into a prime loan, rather than refinancing into a more expensive subprime mortgage.

266. Even if consumers were uninterested in obtaining new mortgages, the sales script provided ways for sales representatives to persuade reluctant consumers. For example, if a consumer stated that she had paid off a first mortgage, the script advised the account executive to ask about a home equity loan. "Don't you want the equity in your home to work for you? You can use your equity for your advantage and pay bills or cash out. How does that sound?"

267. Another method utilized in the scripts led consumers into believing that the account executives were their friends, interested in providing the best loans to consumers. This method is exemplified by the Full Spectrum sales script that instructed account executives to build an emotional connection known as the "Oasis of Rapport" with consumers before discussing rates, points and fees. The immediate objective was to get to know the consumer, "look for points of common interests, and to use first names to facilitate a friendly helpful tone."

268. Countrywide also coached employees to ask questions about the consumer's financial situation, then lie that the account executive had another customer with the same problems and say that it was difficult for this other, similar, customer to get a loan from other lenders.

269. By scripting an emotional connection with consumers, Countrywide led consumers to believe that account executives understood their financial situations and Countrywide would provide consumers with the best possible mortgages. As a result, consumers were more likely to accept refinancing, fees, points, higher interest rates, adjustable rate mortgages, and very risky products, such as option ARMs.

Countrywide Home Loans Servicing LP Utilizes Unfair and Deceptive Practices in the Servicing of Borrowers' Residential Mortgage Loans

270. When consumers fall behind on their mortgage loan payments, they call Countrywide Home Loans Servicing LP ("Countrywide Servicing"), the Countrywide entity that services consumers' mortgages. Consumers who ask what can be done to avoid foreclosure proceedings are often shuffled from person to person and even department to department before reaching someone who can actually address their concerns.

271. Countrywide Servicing generally demands an initial payment from the consumers prior to even discussing whether anything can be done to keep the consumers in their homes. Because Countrywide Servicing demands this payment prior to doing any analysis of the consumers' situations, this scheme often results in consumers paying money to Countrywide Servicing when there is no chance of negotiating a workable plan. The money used for "initial payments" could have been used by consumers to pay for moving expenses or finding new housing in the event that foreclosure was inevitable.

272. Countrywide Servicing also requires consumers to send their initial payments via certified checks. If a consumer's check is not certified, Countrywide Servicing will refuse it without even attempting to verify whether there are sufficient funds to cover the check. This needless bureaucracy has led to Countrywide Servicing rejecting initial payments made on consumers' behalf by non-profits and state agencies.

273. For example, one consumer fell behind on her mortgage payments when she was being treated for breast cancer. Trying to help the consumer, her church raised funds to make her delinquent payment. A check, drawn on the church's account, was sent to Countrywide Servicing. It was rejected.

274. After receiving the initial payment, instead of doing an analysis on what would be necessary to allow consumers to stay in their homes, Countrywide Servicing's first offer to consumers is typically to put them on repayment plans. These repayment plans require consumers both to remain current on their existing mortgage loan payments and also pay an additional amount to cover any past due payments and fees the consumers have incurred.

275. A repayment plan is often an unworkable and unaffordable solution to most consumers' mortgage payment problems. Plainly put, if consumers are having problems making their current payments, there is absolutely no reason to think that the consumers will be able to make even larger payments in the future.

276. One consumer's experience illustrates the problem. The consumer's monthly mortgage payment was $1600. She fell behind and, in an attempt to salvage the situation, repeatedly called Countrywide Servicing to try to find a solution. Although the consumer was already having difficulty making her $1600 monthly payment, Countrywide Servicing's solution was to increase the consumer's payment to $2500 to cover both the existing payment and the past due payments and fees.

277. Predictably, the consumer was unable to keep up with the repayment plan and fell even further behind on her mortgage. After trying to work with Countrywide Servicing for almost six months, the company demanded (and received) a payment of over $5000 from the consumer before it would complete an analysis and consider the file for loan modification.

278. Even when Countrywide Servicing comes up with a loan modification plan, the company often fails to discuss the plan with the consumer to confirm it is affordable or to send timely documentation to the consumer regarding the specific details of the plan.

279. For example, a consumer called Countrywide Servicing on five separate occasions seeking assistance with mortgage payments that she was having difficulty making. The consumer had a loan with an initial teaser interest rate of 9.375% that had jumped to 12.625%. During the fifth call, the consumer learned that Countrywide Servicing had decided to reduce the interest rate on her loan back to the teaser interest rate for an additional five years. Although Countrywide Servicing attempted to provide relief to the consumer, it failed to actually discuss with the consumer whether this plan would be affordable. The consumer had sent Countrywide Servicing financial documents, so it should have known that the plan was unaffordable. Moreover, it took Countrywide Servicing an additional month to send the consumer documentation of her loan modification, resulting in the consumer making an incorrect mortgage payment based on what she had been told on the phone.

280. Countrywide Servicing representatives have also been difficult to reach when consumers are trying to catch up on their mortgages. For example, a consumer who fell behind in her mortgage sent Countrywide Servicing additional checks for 10 months with the designation that they were to be applied to her past due payments and fees. When her statements did not appear to reflect the additional payments, the consumer repeatedly called Countrywide Servicing to deal with the problem. She was put on hold and transferred from person to person when she called and was never able to talk to a Countrywide Servicing representative who could help her figure out the problems with her account.

281. Consumers will sometimes try to refinance their Countrywide mortgages in an attempt to save their homes. Consumers have complained that Countrywide Servicing fails to send them the payoff statements necessary to complete the refinance in a timely manner. Because the refinance is delayed, the consumers end up falling even further behind on their Countrywide mortgages.

282. On occasion, consumers who fall behind in their mortgages and other debt payments are forced to declare bankruptcy. Countrywide Servicing has been sued by United States Bankruptcy Trustees in four states over its practices with consumers in bankruptcy. These trustees allege, among other things, that Countrywide Servicing may have filed inaccurate proofs of claims, filed unwarranted motions for relief from the bankruptcy stay, inaccurately accounted for funds and made unfounded payment demands to consumers after the discharge of their bankruptcy.

283. Countrywide Servicing has also acted illegally towards borrowers in foreclosure actions. In a particularly egregious case, a consumer whose Countrywide mortgage was in foreclosure returned home to find that Countrywide Servicing had changed her locks and boarded her home. At the time it boarded the owner-occupied property, Countrywide Servicing had filed a foreclosure complaint against the consumer, however, no judgment for foreclosure had been entered and no sale conducted. The consumer's attorney made numerous attempts to contact Countrywide Servicing to rectify the situation. It took a week and the intervention of the Attorney General's Office for the consumer to regain access to her home and possessions.

284. There are also occasions when Countrywide Servicing acts inappropriately towards consumers who are not in foreclosure, but have a problem with the application of funds from an escrow account.

285. In one situation, a consumer whose Countrywide mortgage included an escrow for real estate taxes mistakenly paid her tax bill herself, even though Countrywide Service also paid the bill. Once this error was discovered, the consumer's overpayment should have been refunded directly to her. Instead, Countrywide Servicing decided to keep a portion of the overpayment in the consumer's escrow account, purportedly as a "cushion." Countrywide Servicing had no authority to arbitrarily keep a portion of the consumer's overpayment and only returned the funds after mediation through the Attorney General's Office.

STATUTORY PROVISIONS

286. Section 2 of the Illinois Consumer Fraud and Deceptive Business Practices Act (815 ILCS 505/2) provides that:

> Unfair methods of competition and unfair or deceptive acts or practices, including but not limited to the use or employment of any deception, fraud, false pretense, false promise, misrepresentation or the concealment, suppression or omission of any material fact, with intent that others rely upon concealment, suppression or omission of such material fact, or the use of employment of any practice described in Section 2 of the "Uniform Deceptive Trade Practices Act," approved August 5, 1965, in the conduct of any trade or commerce are hereby declared unlawful whether any person has in fact been misled, deceived or damaged thereby. In construing this section consideration shall be given to the interpretations of the Federal Trade Commission and the federal courts relating to Section 5(a) of the Federal Trade Commission Act.

287. Section 7 of the Consumer Fraud Act, 815 ILCS 505/7, provides in relevant part:

> a. Whenever the Attorney General has reason to believe that any person is using, has used, or is about to use any method, act or practice declared by the Act to be unlawful, and that proceedings would be in the public interest, he may bring an action in the name of the State against such person to restrain by preliminary or permanent injunction the use of such method, act or practice. The Court, in its discretion, may exercise all powers necessary, including but not limited to: injunction, revocation, forfeiture or suspension of any license, charter, franchise, certificate or other

evidence of authority of any person to do business in this State; appointment of a receiver; dissolution of domestic corporations or association suspension or termination of the right of foreign corporations or associations to do business in this State; and restitution.

b. In addition to the remedies provided herein, the Attorney General may request and this Court may impose a civil penalty in a sum not to exceed $50,000 against any person found by the Court to have engaged in any method, act or practice declared unlawful under this Act. In the event the court finds the method, act or practice to have been entered into with intent to defraud, the court has the authority to impose a civil penalty in a sum not to exceed $50,000 per violation.

c. In addition to any other civil penalty provided in this Section, if a person is found by the court to have engaged in any method, act, or practice declared unlawful under this Act, and the violation was committed against a person 65 years of age or older, the court may impose an additional civil penalty not to exceed $10,000 for each violation.

288. Section 10 of the Consumer Fraud Act, 815 ILCS 505/10, provides that "[i]n any action brought under the provisions of this Act, the Attorney General is entitled to recover costs for the use of this State."

289. Section 2 of the Illinois Fairness in Lending Act, 815 ILCS 120/2, provides that

(a) "Financial institution" means any bank, credit union, insurance company, mortgage banking company, savings bank, savings and loan association, or other residential mortgage lender which operates or has a place of business in this State.

...

(d) "Equity stripping" means to assist a person in obtaining a loan secured by the persons' principal residence for the primary purpose of receiving fees related to the financing when (i) the loan decreased the persons' equity in the principal residence and (ii) at the time the loan is made, the financial institution does not reasonably believe that the person will be able to make the scheduled payments to repay the loan. "Equity stripping" does not include reverse mortgages as defined in Section 5a of the Illinois Banking Act, Section 1-6a of the Illinois Savings and Loan Act of 1985, or subsection (3) of Section 46 of the Illinois Credit Union Act.

290. Section 3 of the Illinois Fairness in Lending Act, 815 ILCS 120/3 provides in relevant part that:

> No financial institution, in connection with or in contemplation of any loan to any person, may:
> ...
> (e) Engage in equity stripping or loan flipping.

291. Section 5 of the Illinois Fairness in Lending Act, 815 ILCS 120/5(c), provides in relevant part that:

> An action to enjoin any person subject to this Act from engaging in activity in violation of this Act may be maintained in the name of the people of the State of Illinois by the Attorney General or by the State's Attorney of the county in which the action is brought. This remedy shall be in addition to other remedies provided for any violation of this Act.

Count I

Violations of Section 2 of the Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/2

292. The allegations contained in Paragraphs 1 through 291 of the Complaint are re-alleged and incorporated herein by reference.

293. As described above, Countrywide's conduct has contributed to the high number of foreclosures in Illinois and caused significant harm to the public, the market, and scores of Illinois borrowers and homeowners.

294. Countrywide engaged in unfair and/or deceptive acts or practices by originating mortgage loans to borrowers who did not have the ability to repay their loans through practices such as, but not limited to:

a. Using reduced documentation underwriting guidelines to qualify borrowers who did not have sufficient income or assets to afford the Countrywide loans they were sold;

b. Promoting the use of reduced documentation underwriting guidelines to qualify borrowers who did not have sufficient income and assets for the Countrywide loans they were sold;

c. Inflating borrowers' income on loan applications to qualify the borrowers for Countrywide loans;

d. During a certain period of time, qualifying subprime borrowers for hybrid ARM mortgage loans using less than the full- indexed rate;

e. During a certain period of time, qualifying borrowers for mortgage loans that had an interest-only payment option using less than the fully-amortizing payment;

f. Originating loans that were not designed for long term viability, but for short term refinancing, as employees and brokers frequently represented that borrowers could refinance the loan;

g. Promoting serial refinancing without regard to the increased cost to the borrower or the affordability of the loan, and without disclosing that the ability to refinance relied on a perpetual increase in home valuation;

h. Loosening certain underwriting guidelines over time, resulting in the sale of unaffordable loans;

i. Originating loans with multiple layers of risk, resulting in the sale of unaffordable loans; and

j. Allowing exceptions to underwriting guidelines, resulting in the sale of unaffordable loans.

295. Countrywide engaged in unfair and/or deceptive acts or practices by originating mortgage loans that exposed borrowers to an unnecessarily high risk of foreclosure or loss of home equity through practices such as, but not limit to:

a. Originating option ARM mortgage loans with one or more of the following characteristics: illusory introductory teaser interest rates, prepayment penalties, high loan-to-value ratios, and reduced documentation underwriting;

b. Mass marketing and selling option ARM mortgage loans to the general public that were only beneficial to specific sophisticated segments of the borrower population;

c. Marketing and selling option ARM mortgage loans as a beneficial refinance loan product to current customers in good standing, when that was not the case; and

d. Originating mortgage loans with 100% loan-to-value or combined loan-to-value ratios that included other risky features.

296. Countrywide engaged in unfair and/or deceptive acts or practices by originating unnecessarily more expensive mortgage loans to unknowing borrowers through practices such as, but not limited to:

a. Originating more expensive reduced documentation loans to borrowers who could have documented their income and assets, without informing borrowers of the increased cost; and

b. Attaching prepayment penalties to borrowers' loans, without ensuring that the borrowers actually received any benefit from the added risk of the penalty.

297. Countrywide engaged in unfair and/or deceptive acts or practices by deceptively marketing and/or advertising its mortgage loans through practices such as, but not limited to:

a. Leading consumers to believe that Countrywide would obtain for them the best possible loan terms, when, in fact, they did not;

b. Avoiding discussing the interest rate or APR of a loan by shifting the focus to the monthly payment in an effort to confuse consumers about the true cost of the loan;

c. Representing that refinancing into an option ARM could save the borrower money when, in fact, the claim of savings was false;

d. Advertising the one-month teaser interest rates for an option ARM without clearly and conspicuously disclosing that the rate would increase dramatically the following month;

e. Representing to consumers that option ARMs were beneficial for consumers in good standing on their current Countrywide loans when, in fact, refinancing into the product was not beneficial for most consumers;

f. Failing to properly inform a borrower of the potential of owing more on his home than what it is worth due to negative amortization if the borrower's house did not continue appreciating or depreciated in value;

g. Inflating borrowers' income information on their loan applications in order to qualify borrowers for Countrywide mortgages when their income would not have qualified them for the loan they received;

h. Representing to borrowers that they should not worry about the interest rate of their Countrywide mortgage because the loans could be refinanced before they became unaffordable;

i. During a certain period of time, failing to disclose to subprime borrowers that they were qualified at less than the fully-indexed rate for hybrid ARM mortgage loans and not at a rate sufficient to repay the loan in its entirety;

j. During a certain period of time, failing to disclose to borrowers that they were qualified at less than a fully-amortizing payment for mortgage loans with an interest-only payment option and not at a rate sufficient to repay the loan in its entirety;

k. Advertising that a Countrywide mortgage had "no closing costs" when the closing costs were incorporated in the features of the loan;

l. Representing to current Countrywide borrowers that Countrywide offered "Complimentary" or "Free Loan" reviews when in fact, it was a sales pitch to refinance current subprime borrowers into other subprime mortgages;

m. Hiding the purpose of subprime sales calls to prime borrowers with late payments, which was, in actuality, to refinance borrowers into subprime loans; and

n. Advertising that because the housing market is stagnant or declining, borrowers should refinance their homes and take cash out or pay debts, without informing borrowers of the risk of owing more than the value of their homes.

298. Countrywide engaged in unfair and/or deceptive acts or practices by implementing a compensation structure that incentivized broker and employee misconduct and failed to exercise sufficient oversight to ensure that such misconduct did not occur through practices such as, but not limited to:

a. Implementing a compensation structure that incentivized employees to maximize sales of loans without proper oversight, resulting in the sale of unaffordable and/or unnecessarily expensive loans;

b. Failing to provide adequate parameters for the sale of option ARMs, resulting in the product being sold to inappropriate groups of borrowers;

c. Failing to adequately supervise and/or underwrite brokers' use and sale of reduced documentation loans resulting in the sale of unaffordable or unnecessarily more expensive loans;

d. Facilitating and/or instructing brokers' emphasis of the low teaser rate when selling option ARMs;

e. Rewarding brokers for selling loans with certain risky loan features such as prepayment penalties without ensuring that borrowers received a benefit from the risky features; and

f. Structuring the compensation for option ARMs in such a way that brokers were incentivized to sell a product that was riskier than necessary – to the exclusion of other products – in order to obtain the maximum yield spread premium possible.

299. Countrywide Home Loans Servicing, LP engaged in unfair and/or deceptive acts or practices during the servicing of residential mortgage loans through practices such as, but not limited to:

a. Inducing borrowers to pay Countrywide Servicing monies under the premise that Countrywide Servicing would be able to assist distressed borrowers, even though Countrywide Servicing has not done any analysis to determine whether assistance was feasible in light of the borrowers' particular factual circumstances;

b. Misleading borrowers into paying Countrywide Servicing additional monies under a repayment plan or loan modification plan that Countrywide Servicing knew or should have know was unaffordable; and

c. Recklessly facilitating the foreclosure of borrowers' homes by misleading borrowers or failing to respond to borrowers' requests for assistance.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff respectfully prays for the following relief:

A. A finding that Defendants have engaged in and are engaging in trade or commerce within the meaning of Section 2 of the Illinois Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/2;

B. A finding that Defendants have engaged in and are engaging in acts or practices that constitute violations of Section 2 of the Illinois Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/2;

C. An order preliminarily and permanently enjoining Defendants from the use of acts or practices that violate the Consumer Fraud and Deceptive Business Practices Act including, but not limited to, the unlawful acts and practices specified above;

D. An order rescinding, reforming or modifying all mortgage loans between Defendants and all Illinois consumers who were affected by the use of the above-mentioned unlawful acts and practices;

E. An order requiring Defendants to make restitution to all consumers who were affected by the use of the above-mentioned unlawful acts and practices in the origination of Countrywide residential mortgage loans whose homes were lost due to foreclosure on their Countrywide mortgage loans;

F. An order requiring Defendants to make restitution to all consumers who were affected by the use of the above-mentioned unlawful acts and practices in the origination of Countrywide residential mortgage loans who refinanced their mortgage loans with Defendants or another residential mortgage lender;

G. An order requiring Defendants to make restitution to all consumers who were affected by the use of the above-mentioned unlawful acts and practices in the origination of Countrywide residential mortgage loans who are unable to modify their Countrywide mortgages to a sustainable level and are forced to relinquish ownership of their homes;

H. An order requiring Defendants to repurchase owner-occupied residential mortgage loans for all Illinois consumers who were affected by the use of the above-mentioned unlawful acts and practices that have been sold, transferred or assigned to investors and then to rescind, reform or modify any such mortgage loans;

I. An order enjoining Defendants from:

1) further selling, transferring or assigning mortgage loans originated by Countrywide by the use of the above-mentioned unlawful acts and practices that are secured by owner-occupied residential properties in Illinois;

2) further selling, transferring or assigning any legal obligations to service Illinois owner-occupied residential mortgage loans originated by the use of the above-mentioned unlawful acts and practices; and

3) initiating or advancing a foreclosure, as an owner or servicer, on any owner-occupied residential mortgage loan originated by the use of the above-mentioned unlawful acts and practices and secured by an Illinois

property, without first providing the Attorney General a 90-day period to review each such loan so that, upon the expiration of the 90 days, the Attorney General may object to a foreclosure based upon unfair or deceptive origination or servicing conduct by Countrywide and Countrywide Home Loans Servicing, LP in order to provide the borrower with a meaningful opportunity to avoid foreclosure. In the event of the Attorney General's objection, no foreclosure sale shall go forward absent court approval.

J. An order requiring Defendants to establish a "Distressed Property Reserve" to cover costs incurred by municipalities due to vacant foreclosed properties that secured owner-occupied residential mortgage loans originated by Countrywide;

K. An order imposing a civil penalty in a sum not to exceed $50,000 against any Defendant found by the Court to have engaged in any method, act or practice declared unlawful under this the Illinois Consumer Fraud and Deceptive Business Practices Act;

L. An order imposing a civil penalty in a sum not to exceed $50,000 against any Defendant found by the Court to have engaged in any method, act or practice declared unlawful under the Illinois Consumer Fraud and Deceptive Business Practices Act committed with the intent to defraud;

M. An order imposing an additional civil penalty not to exceed $10,000 for each violation of the Illinois Consumer Fraud and Deceptive Business Practices Act committed against a person 65 years of age or older, as provided in Section 7(c) of the Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/7(c);

N. An order requiring Defendants to pay the costs of this action and any costs related to the 90-day Attorney General review period described above; and

O. An order granting such further relief as this Court deems just, necessary, and equitable in the premises.

Count II

Violation of the Illinois Fairness in Lending Act, 815 ILCS 120/4

300. The allegations contained in Paragraphs 1 through 299 of the Complaint are re-alleged and incorporated herein by reference.

301. Countrywide violated Section 3 of the Illinois Fairness in Lending Act, 815 ILCS 120/3 by engaging in equity stripping when refinancing consumers into mortgage loan products that Countrywide knew or should have known were unaffordable and that decreased the borrowers' equity in their homes, with the primary purpose of receiving fees for the refinancing.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff respectfully prays for the following relief:

A. A finding that Defendants have violated the Illinois Fairness in Lending Act;

B. An order preliminarily and permanently enjoining Defendants from the use of acts or practices that violate the Illinois Fairness in Lending Act including, but not limited to, the unlawful acts and practices specified above;

C. An order requiring Defendants to make restitution to all consumers affected by the use of the above-mentioned unlawful acts and practices;

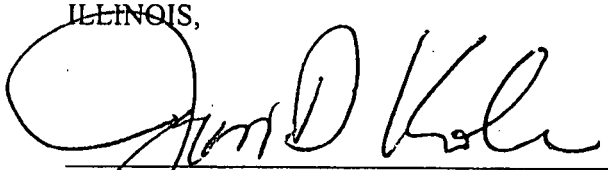
D. An order rescinding or reforming all contracts, loan agreements, notes or other evidences of indebtedness between Defendants and all Illinois consumers who were affected by the use of the above-mentioned unlawful acts and practices;

E. An order requiring Defendants to pay the costs of this action; and

F. An order granting such further relief as this Court deems just, necessary, and equitable in the premises.

Respectfully submitted,

LISA MADIGAN, IN HER OFFICIAL CAPACITY AS ATTORNEY GENERAL OF ILLINOIS,



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Testimony of Martin Eakes, CEO
Center for Responsible Lending and Center for Community Self-Help

Before the U.S. Senate Committee on Banking, Housing and Urban Affairs
"Preserving the American Dream: Predatory Lending Practices and Home Foreclosures"

February 7, 2007*

Mr. Chairman and members of the Committee, thank you for holding this hearing to examine the problems of foreclosures and predatory lending in the subprime market, and thank you for the invitation to speak today.

I testify as CEO of Self-Help (www.self-help.org), which consists of a credit union and a non-profit loan fund. For the past 26 years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans. Self-Help has provided over $4.5 billion of financing to over 50,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across the country, with an annual loan loss rate of under one percent. We are a subprime lender. In fact, we began making loans to people with less-than-perfect credit in 1985, when that was unusual in the industry. We believe that homeownership represents the best possible opportunity for families to build wealth and economic security, taking their first steps into the middle class. I emphasize this point because expanding access to homeownership has been central to Self Help's mission and it would be counter to everything I believe to recommend any policies that would diminish beneficial credit to families seeking a better future.

I am also CEO of the Center for Responsible Lending (CRL) (www.responsiblelending.org), a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL began as a coalition of groups in North Carolina that shared a concern about the rise of predatory lending in the late 1990s.

The subprime mortgage market today is a quiet but devastating disaster. The ultimate effects are very much like Hurricane Katrina, as millions of citizens lose their homes and the fabric of entire communities is threatened. The difference is that this disaster in the subprime market is occurring every single day across the country, house by house and neighborhood by neighborhood. Our analysis of subprime mortgages made in recent years shows that 2.2 million families will lose their home to foreclosure—foreclosures that were, for the most part, predictable and entirely avoidable through more responsible lending practices. As housing appreciation slows down in many areas of the country, it is clear that the problem will only grow worse. All indications are that subprime mortgage loans are headed toward the worst rate of foreclosures in modern mortgage market history.[1]

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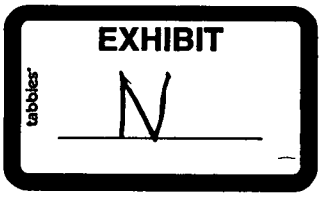
* Editor's note: This copy includes a minor technical correction made after the report was submitted to the Committee.



Why does a foreclosure epidemic in the subprime mortgage market matter? First, subprime mortgages are no longer a niche market; they have become a significant share of all new mortgages made in America, now making up well over 20 percent of all home loans originated and currently representing $1.2 trillion of mortgages currently outstanding.[2] Second, homeownership is the best and most accessible way most families have to acquire wealth and economic security. If home loans are actually setting citizens back rather than helping them build for the future, there are serious ramifications for local economies and the nation as a whole. The problem is particularly serious for communities of color, since more than half of African-American and 40 percent of Latino families who get home loans receive them in the subprime market.[3] If current trends continue, it is quite possible that subprime mortgages could cause the largest loss of African-American wealth in American history.

Under typical circumstances, foreclosures occur because a family experiences a job loss, divorce, illness or death. However, the epidemic of home losses in today's subprime market is well beyond the norm. Subprime lenders have virtually guaranteed rampant foreclosures by approving risky loans for families while knowing that these families will not be able to pay the loans back. There are several factors driving massive home losses:

- **Risky products**. Subprime lenders have flooded the market with high-risk loans, making them appealing to borrowers by marketing low monthly payments based on low introductory teaser rates. The biggest problem today is the proliferation of hybrid adjustable-rate mortgages ("ARMs," called 2/28s or 3/27s), which begin with a fixed interest rate for a short period, then convert to a much higher interest rate and continue to adjust every six months, quickly jumping to an unaffordable level.

- **Loose underwriting**. It is widely recognized today, even within the mortgage industry, that lenders have become too lax in qualifying applicants for subprime loans.[4] Especially troubling is the practice of qualifying borrowers without any verification of income, not escrowing for property taxes and hazard insurance, and failing to account for how borrowers will be able to pay their loan once the payment adjusts after the teaser period expires.

- **Broker abuses**. Today's market includes perverse incentives for mortgage brokers to make high-risk loans to vulnerable borrowers. Brokers often claim that borrowers engage them for their knowledge and generally believe that brokers are looking for the best loan terms available. Yet brokers also claim they do not need to serve the borrower's best interests.

- **Investor support**. Much of the growth in subprime lending has been spurred by investors' appetite for high-risk mortgages that provide a high yield. The problem is that the investor market reaction occurs only after foreclosures are already rampant and families have lost their homes.

- **Federal neglect**. Policymakers have long recognized that federal law—the Home Ownership and Equity Protection Act of 1994 (HOEPA)—governing predatory lending is inadequate and outdated. Although the Federal Reserve Board (hereinafter, the "Board") has the authority to step in and strengthen relevant rules, they have steadfastly refused to act in spite of years of large-scale abuses in the market. For the majority of subprime mortgage providers, there are no consequences for making abusive or reckless home loans.

I respectfully submit that there are simple and effective policy solutions to stop destructive lending practices in the subprime market and return to sound lending practices. CRL makes the following five recommendations:

1. Restore safety to the subprime market by imposing a borrower "ability to repay" standard for all subprime loans. Recently federal banking regulators issued "Guidance on Nontraditional Mortgage Product Risks," which recognizes the danger posed by risky loan products and imprudent underwriting practices.[5] This Guidance should apply to all subprime ARM loans and non-traditional products. Specifically, the agencies should affirm that this Guidance covers the most widely destructive type of loan today: hybrid adjustable-rate mortgages in the subprime market (2/28s and 3/27s). These loans now make up the vast majority of subprime loans, and they have predictable and devastating consequences for the homeowners that receive them.

2. Require mortgage brokers to have a fiduciary duty to their clients. This simply means giving brokers the explicit responsibility of serving the best interests of the people who pay them. Brokers are now managing the most important transaction most families ever make. Their role is at least as important as that of lawyers, stockbrokers and Realtors—professions that already have fiduciary standards in place.

3. Require the Federal Reserve to act, or address abuses through the Federal Trade Commission. The major federal law designed to protect consumers against predatory home mortgage lending is HOEPA, which has manifestly failed to stem the explosion of harmful lending abuses that has accompanied the recent subprime lending boom. As I will describe below, through HOEPA, Congress did provide the Board with significant authority to address these problems through regulation, but to date the Board has not used this authority. Given the Board's record, Congress should give parallel authority to the Federal Trade Commission to address mortgage lending abuses that have gone on for too long.

4. Require government-sponsored enterprises to stop supporting abusive subprime loans. Currently Fannie Mae and Freddie Mac are purchasing the senior tranches of mortgage-backed securities backed by abusive subprime loans. By doing so, they are essentially supporting and condoning lenders who market abusive, high-risk loans that are not affordable. This is clearly counter to the mission of those agencies. The agencies should cease purchasing the securities, the Office of Federal Housing Enterprise Oversight (Ofheo) should prohibit their purchase, and the U.S. Department of Housing and Urban

Development (HUD) should stop providing credit for these securities under HUD's affordable housing goals.

5. Strengthen protections against destructive home lending by passing a strong national anti-predatory lending bill. HOEPA has not kept up with the evolution of abuses in the market, and needs to be updated and strengthened. However, the mortgage market is constantly changing, and it is impossible for any single law to cover all contingencies or to anticipate predatory practices that will emerge in the future. Any new federal law must preserve the right of the states to supplement the law, when necessary, to address new or locally-focused lending issues.

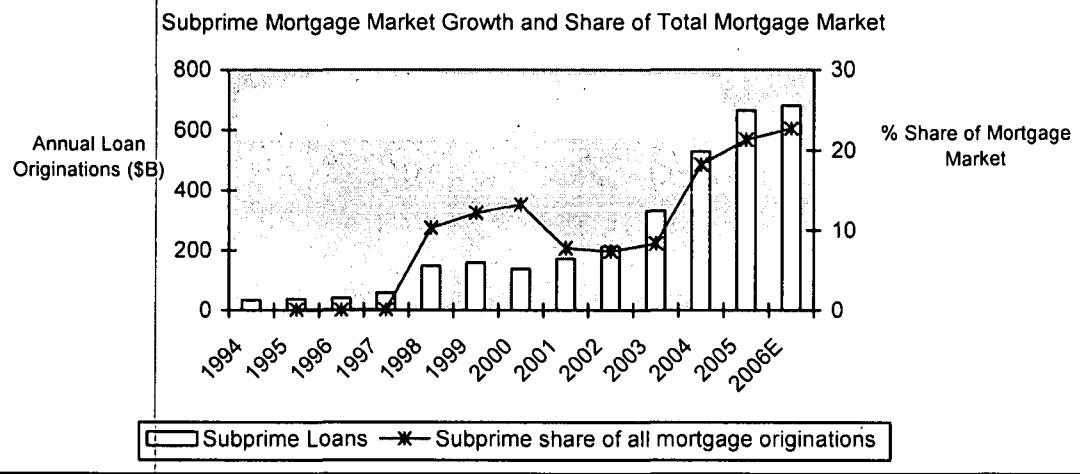
While there is a strong need for comprehensive reforms of the subprime mortgage market, including weeding out abuses in how mortgage servicers handle monthly payments, my primary focus in these comments will be on loan origination practices and how high-risk loans in the subprime market are supported and regulated.

I. Background: The Subprime Market and the Evolution of Predatory Lending[6]

A. The Subprime Market and the Evolution of Predatory Lending

The subprime market is intended to provide home loans for people with impaired or limited credit histories. In addition to lower incomes and blemished credit, borrowers who get subprime loans may have unstable income, savings, or employment, and a high level of debt relative to their income.[7] However, there is evidence that many families—a Freddie Mac researcher reports one out of five—who receive subprime mortgages could qualify for prime loans, but are instead "steered" into accepting higher-cost subprime loans.[8]

As shown in the figure below, in a short period of time subprime mortgages have grown from a small niche market to a major component of home financing. From 1994 to 2005, the subprime home loan market grew from $35 billion to $665 billion, and is on pace to match 2005's record level in 2006. By 2006, the subprime share of total mortgage originations reached 23 percent.[9] Over most of this period, the majority of subprime loans have been refinances rather than purchase mortgages to buy homes. Subprime loans are also characterized by higher interest rates and fees than prime loans, and are more likely to include prepayment penalties and broker kickbacks (known as "yield-spread premiums," or YSPs).



Source: Inside Mortgage Finance

When considering the current state of the subprime market, it is useful to understand how predatory lending has evolved over the past 15 years. When widespread abusive lending practices in the subprime market initially emerged during the late 1990s, the primary problems involved equity stripping—that is, charging homeowners exhorbitant fees or selling unnecessary products on refinanced mortgages, such as single-premium credit insurance. By financing these charges as part of the new loan, unscrupulous lenders were able to disguise excessive costs. To make matters worse, these loans typically came with costly and abusive prepayment penalties, meaning that when homeowners realized they qualified for a better mortgage, they had to pay thousands of dollars before getting out of the abusive loan.[10]

In recent years, when the federal government failed to act, a number of states moved forward to pass laws that address equity-stripping practices. Research assessing these laws has shown them to be highly successful in cutting excessive costs for consumers without hindering access to credit.[11] The market has expanded at an enormous rate during recent years even while states reported fewer abuses targeted by new laws. In addition, the leadership shown by states has helped encourage the adoption of best practices by responsible lenders and leaders in the mortgage industry. Today, for example, single premium credit insurance has virtually disappeared from the market, upfront fees are much lower than they used to be, and prepayment penalties have become less costly, on average, and last for a shorter period of time.

In spite of these successes, no one would say that predatory lending has been eliminated. Prepayment penalties continue to be imposed on 70 percent of all subprime loans,[12] and many other "old" predatory practices are still alive and well in today's marketplace: "Steering," when predatory lenders push-market borrowers into a subprime mortgage even when they could qualify for a prime loan; kickbacks to brokers (yield-spread premiums) for selling loans with an high interest rate higher than the rate to which the

borrowers actually qualified; and loan "flipping," which occurs when a lender refinances a loan without providing any net tangible benefit to the homeowner.

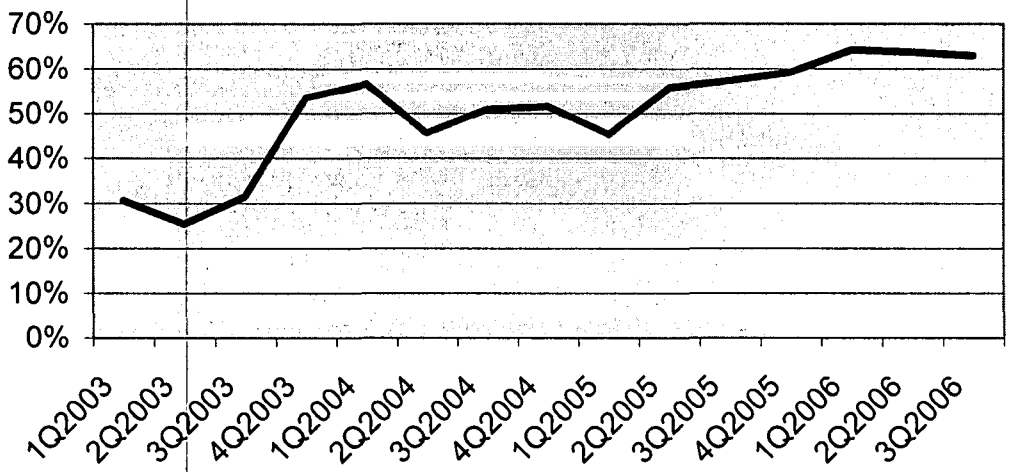
In addition, we now have a second generation of subprime lending abuses: high-risk loan products that were never intended for families who already have credit problems (discussed in more detail later in this testimony). The risks posed by these loans are magnified further because they are designed to generate refinances. These loans typically begin with a low introductory interest rate that increases sharply after a short period of time (one to three years) and fails to account for escrows for required taxes and insurance. The very design of these loans forces struggling homeowners to refinance to avoid unmanageable payments. In other words, the prohibition against flipping that many states instituted has been defeated by the design of a particular subprime mortgage product that has dominated the market in recent years.

While multiple refinances boost volume for lenders, these transactions often provide only temporary relief for families, and almost inevitably lead to a downward financial spiral in which the family sacrifices equity in each transaction. These dangerous subprime hybrid ARM loan products and the ensuing refinances make a high rate of foreclosures not only a risk, but also a certainty for far too many families. And the likelihood of foreclosure will only increase as housing prices slow and accumulated equity is no longer available to refinance or sell under duress.

B. Foreclosures in the Expanding Subprime Market

In the United States, the proportion of mortgages entering foreclosure has climbed steadily since 1980, with 847,000 new foreclosures filed in 2005.[13] In 2006, lenders reported 318,000 new foreclosure filings for the third quarter alone, 43 percent higher than the third quarter of 2005.[14] In the past 18 months, there have been frequent stories in the media about risky lending practices and surges in loan defaults, especially in the subprime market.[15]

Subprime Foreclosure Starts as a Percent of Total Conventional Foreclosure Starts



Source: MBA National Delinquency Surveys

Figure 2 shows that foreclosure filings on subprime mortgages now account for over 60 percent of new conventional foreclosure filings reported in the MBA National Delinquency Survey. This fact is striking given that only 23 percent of current originations are subprime, and subprime mortgages account for only 13 percent of all outstanding mortgages.

Some have applauded the growth in subprime lending as a positive break-through in extending credit. To be sure, the community reinvestment movement, civil rights activists, and others—including Self Help—have fought for years to bring investment to communities that have lacked access to vital capital.

Yet this increased access has come at great cost to many families, given current subprime lending practices. The pressing issue today is less the availability of home-secured credit than the terms on which it is offered. For the average American, building wealth through homeownership is the most accessible path to economic progress, but progress is not achieved when a family buys or refinances a home only to lose the home or get caught in a cycle of escalating debt.

For most families, foreclosure is a last resort, often coming in the wake of unemployment, illness, divorce, or some other personal event that causes a drop in income. However, in recent years there has been a surge in subprime foreclosures that cannot be explained by a change in employment levels or other factors that typically drive foreclosures. Instead, as widely discussed in the press during recent months, the consequences of loose underwriting practices in the subprime market are now exacerbated by a general slow-down in housing appreciation.

Researchers have examined the relationship between subprime lending and foreclosures, and the effects on local communities. Some of the strongest research has been conducted by the Woodstock Institute, which has analyzed subprime foreclosures in the Chicago area. Woodstock researchers have found high concentrations of subprime lending in zip-code areas that have a high proportion of minority residents.[16] Woodstock also has shown that "increases in high cost subprime mortgage lending have been the leading driver of skyrocketing foreclosure levels across the Chicago region."[17] Dan Immergluck (formerly on Woodstock's staff, now a professor at the Georgia Institute of Technology) and Geoff Smith of Woodstock also investigated the effects of subprime lending and foreclosures on neighborhoods. They found that in Chicago a foreclosure on a home lowered the price of other nearby single-family homes, on average, by 1.44 percent.[18] They also reported that the downward pressure on housing prices extended to houses that sold within two years of the foreclosure of a nearby house.

About two months ago my organization, the Center for Responsible Lending, published a report that represents the first comprehensive, nationwide research conducted on foreclosures in the subprime market. The report, "Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners," is based on an analysis of over six million subprime mortgages, and the findings are disturbing. Our results show that despite low interest rates and a favorable economic environment during the past several years, the subprime market has experienced high foreclosure rates comparable to the worst foreclosure experience ever in the modern prime market. We also show that foreclosure rates will increase significantly in many markets as housing appreciation slows or reverses. As a result, **we project that 2.2 million borrowers will lose their homes and up to $164 billion of wealth** in the process. That translates into foreclosures on one in five subprime loans (19.4 percent) originated in recent years. Taking account of the rates at which subprime borrowers typically refinance from one subprime loan into another, and the fact that each subsequent subprime refinancing has its own probability of foreclosure, this translates into projected foreclosures for **more than one-third of subprime borrowers**.

Another key finding in our foreclosure report is that subprime mortgages typically include characteristics that significantly increase the risk of foreclosure, regardless of the borrower's credit. Since foreclosures typically peak several years after a loan is originated, we focused on the performance of loans made in the early 2000s to determine what, if any, loan characteristics have a strong association with foreclosures. Our findings are consistent with other studies, and show what responsible lenders and mortgage insurers have always known: increases in mortgage payments and poorly documented income substantially boost the risk of foreclosure. For example, even after controlling for differences in credit scores, these were our findings for subprime loans made in 2000:

- Adjustable-rate mortgages had 72 percent greater risk of foreclosure than fixed-rate mortgages.
- Mortgages with "balloon" payments had a 36 percent greater risk than a fixed-rate mortgage without that feature.

- Prepayment penalties are associated with a 52 percent greater risk.
- Loans with no documentation or limited documentation of the applicant's income were associated with a 29 percent greater risk.
- And buying a home with a subprime mortgage, versus refinancing, puts the homeowner at 29 percent greater risk.

A full copy of the "Losing Ground" foreclosure study and an executive summary appear on CRL's website at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189.

C. Disparate Impacts of Foreclosures

The costs of subprime foreclosures are falling heavily on African-American and Latino homeowners, since subprime mortgages are disproportionately made in communities of color. The most recent lending data submitted under the Home Mortgage Disclosure Act (HMDA) show that over half of loans to African-American borrowers were higher-cost loans, a measurement that serves as a proxy for subprime status.[19] For Latino homeowners, the portion of higher-cost loans is also very high, at four in ten. The specific figures are shown below:

Share of Higher Cost Mortgages by Race
Based on 2005 Data Submitted Under the Home Mortgage Disclosure Act

Group	No. of Higher-Cost Loans	% for Group	% of Total
African American	388,741	52%	20
Latino	375,889	40%	19
White	1,214,003	19%	61

Given the projected foreclosure rate of approximately one-third of borrowers taking subprime loans in recent years, this means that subprime foreclosures could affect approximately 12 percent of recent Latino borrowers and 16 percent of African-American borrowers. If this comes to pass, it is potentially the biggest loss of African-American wealth in American history.

However, while the negative impact of foreclosures falls disproportionately on communities of color, the problem is not confined to any one group. In absolute terms, white homeowners received three times as many higher-cost mortgages as African-American borrowers, and therefore will experience a significant number of foreclosures as well.

II. Factors Driving Foreclosures in the Subprime Market

A. Risky Products: 2/28 "Exploding" ARMs

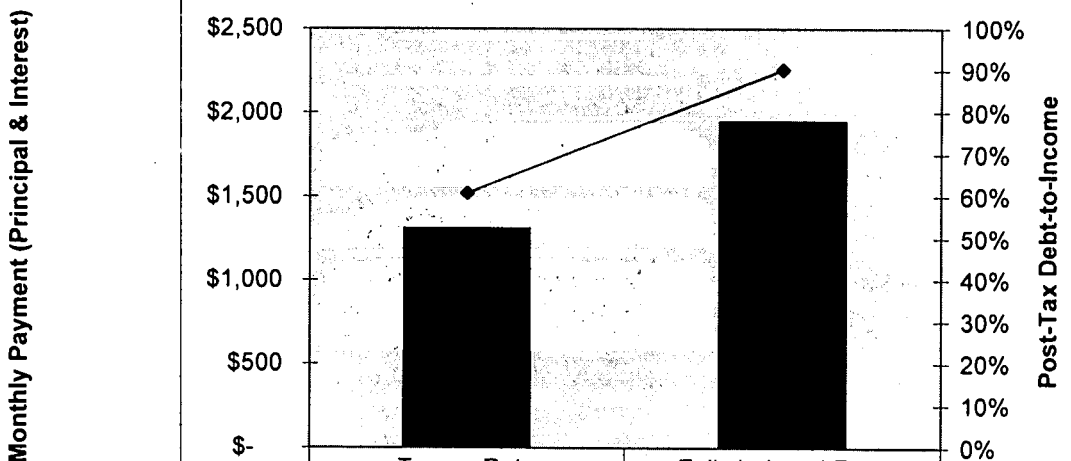
Subprime lenders are routinely marketing the highest-risk loans to the most vulnerable families and those who already struggle with debt. Because the subprime market is

intended to serve borrowers who have credit problems, one might expect the industry to offer loan products that do not amplify the risk of failure. In fact, the opposite is true. Lenders seek to attract borrowers by offering loans that start with deceptively low monthly payments, even though those payments are certain to increase. As a result, many subprime loans can cause "payment shock," meaning that the homeowner's monthly payment can quickly skyrocket to an unaffordable level.

Unfortunately, payment shock is not unusual, but represents a typical risk that comes with the overwhelming majority of subprime home loans. Today the dominant type of subprime loan is a hybrid mortgage called a "2/28" that effectively operates as a two-year "balloon" loan.[20] This ARM comes with an initial fixed teaser rate for two years, followed by rate adjustments in six-month increments for the remainder of the term of the loan.[21] Commonly, this interest rate increases by between 1.5 and 3 percentage points at the end of the second year, and such increases are scheduled to occur even if interest rates in the general economy remain constant; in fact, the interest rates on these loans generally can only go up, and can never go down.[22] This type of loan, as well as other similar hybrid ARMs (such as 3/27s) have rightfully earned the name "exploding" ARMs.

Let me provide an example of the severity of payment shock that can occur on the typical exploding ARM for a $200,000 loan:

Subprime Adjustable Rate Mortgage Payment Shock
(No Change in Interest Rates)



	Teaser Rate	Fully Indexed Rate
Monthly Payment	$1,311	$1,948
Post-Tax DTI	61%	90%

For the 2/28 ARM shown in the chart above, we are making conservative assumptions that correspond with typical mortgages of this type. To make the example even more conservative, we are assuming no general increase in interest rates, even though rates have increased substantially in the past three years. The example is based on an

introductory teaser rate of 6.85 percent and a fully indexed rate of 11.50 percent.[23] The loan amount used in this example was $200,000, and, given the common practice of extending loans where the pre-tax debt-to-income ratio is 50 to 55 percent, we assume that this homeowner had a pre-tax income of $31,452, which equates to a post-tax income of $25,901.

At the end of the introductory rate period, this homeowner's interest rate rose from 6.85 percent to 9.85 percent, and the monthly payments jumped from $1,311 to $1,716, and again six months later to $1,948, an increase of over $600 a month.[24] This would be a large increase for most families, and is a huge burden for a family that already struggles with debt. At $1,948, this leaves only $210/month for all other expenses – including property taxes and hazard insurance, food, utilities, transportation, healthcare, and all other family needs.

Sadly, and all too commonly, this hypothetical homeowner had credit scores that would have qualified him or her for a fixed rate loan at 7.5 percent, which would have translated to monthly payments of $1,398—a challenging debt-load to be sure, but far more sustainable than the $1,948 fully-indexed monthly payment associated with the 2/28 loan illustrated above, a payment that can easily increase as interest rates rise.

One would hope that this type of loan would be offered judiciously. In fact, hybrid ARMs (2/28s and 3/27s) and hybrid interest-only ARMs have become "the main staples of the subprime sector."[25] Through the second quarter of 2006, hybrid ARMs made up 81 percent of the subprime loans that were packaged as investment securities. That figure is up from 64 percent in 2002.[26]

Because of the proliferation of these loans, payment shock for subprime borrowers is a serious and widespread concern. According to an article in the financial press that ran a year ago, homeowners face increased monthly payments on an estimated $600 billion of subprime mortgages that will reset after their two-year teaser rates end.[27] Fitch Ratings calculated that by the end of 2006, payments would have increased on 41 percent of the outstanding subprime loans.[28]

Another key point about 2/28s in the subprime market is that they typically come with large up-front fees compared to adjustable-rate mortgages in the prime market.[29] Very few borrowers in the subprime market can pay these fees directly, so they are paid by financing them as part of the loan. This cuts into homeowners' equity, essentially reducing their share of ownership. In other words, subprime ARMs routinely find borrowers trading equity, or ownership, in exchange for the temporary benefit of lower interest payments.

Previously I mentioned that regulators recently issued proposed "Guidance on Nontraditional Mortgage Product Risks" that was a strong attempt to address concerns about high-risk loan products. However, the Guidance does not explicitly address 2/28s or other hybrid loans in the subprime market. This is a serious omission that runs counter to the Guidance's intent, which is to require lenders "to effectively assess and manage the

risks" on loan products with the same characteristics as 2/28s. In particular, the Guidance focuses on loan products that defer interest payments.[30] On 2/28s and other subprime hybrid mortgages, the change in interest rates is typically so large when the introductory rate ends that these loan terms may properly be characterized as a contingent deferral of interest from early years to later years of the loan term.[31]

The magnitude of the interest rate deferral on subprime hybrid ARMs is significantly larger than that typically found in prime ARM loans. Just last month, Federal Reserve Board Governor Susan Bies reached a similar conclusion, stating, "Let's face it; a teaser loan really is a negative [amortization] loan because you don't pay interest up front."[32]

Other federal policy-makers have concluded that the Guidance should be extended to 2/28 hybrid ARMs. Federal Deposit Insurance Corporation Chair Sheila Bair recently stated:

> The underwriting standards in the alternative-mortgage guidance should apply to those [2/28s,] and lenders should make sure there's an ability to pay. .... [2/28s] were the type of mortgage that certainly was intended to be within the spirit of the alternative-mortgage guidance.[33]

It is important to note the insidious effect of limiting the Guidance to non-traditional mortgage products such as interest-only loans and option payment ARMs, to the exclusion of 2/28s. Interest-only loans made up only 21.7 percent of the subprime mortgage-backed securities in 2006, and subprime option ARMs have yet to be evidenced in substantial numbers.[34] In contrast, 2/28s and 3/27s are the dominant product in the subprime market – the market where the vast majority of abusive lending occurs and where HMDA data shows minorities to be disproportionately represented. By limiting the Guidance's protections to products that exist predominantly in the prime market, while failing to cover the most common product in the subprime market, the regulators have left a disproportionate share of minority borrowers without protection.

We recently analyzed a randomly selected sample of North Carolina deeds of trust to compare the potential payment shock of loans eligible for the Guidance and subprime loans that currently are not. We found that the payment shock of non-interest-only suprime hybrid ARMs exceeded that of prime interest-only loans, not to mention prime hybrid ARMs. In addition, we found three characteristics of subprime hybrid ARMs that make the payment shock worse than that of prime loans – the initial rate serves as a floor (i.e. the loan rates can only adjust higher), while the interest rates on prime loans can fall as well as increase; the loans fully adjust an average of 2.5 years after origination, versus 5 years for prime loans; and the loans adjust every six months after the teaser expires, versus every year for prime loans. Our findings suggest that subprime hybrid ARMs carry scheduled payment shocks that present formidable and often insurmountable hurdles to borrowers.[35]

I would like to thank the six members of the Banking Committee who sent a letter in early December to the federal regulators who issued the Guidance and to the CSBS

expressing the view that "these [2/28] mortgages have a number of the same risky attributes as the interest-only and option-ARMs and, therefore, should be covered by the new Guidance."[36] Industry associations have largely opposed this change. I would respectfully disagree with many of the industry assertions about subprime ARMs, and a coalition of civil rights and consumer groups have recently sent a critique of the industry claims to this Committee (Attached as Appendix B).

Finally, before leaving the topic of 2/28s, I want to address the common assertion that consumers demand these types of loans and should carry all the responsibility for receiving unsuitable loan products. Through our experience at Self Help and CRL, we have seen that homeowners with subprime ARMs or other types of risky loans were almost never given a choice of products, but were instead automatically steered to these loans, and were given little or no explanation of the loan's terms.

Subprime lenders have indicated that the types of products they offer and how they underwrite them is largely investor-driven. Consider the frank acknowledgement by the chief executive of Ownit Mortgage Solutions, a state-licensed non-bank mortgage lender that recently filed for bankruptcy protection after investors asked it to buy back **well over one hundred million dollars worth** of bad loans. Ownit's chief executive, William D. Dallas "acknowledges that standards were lowered, but he placed the blame at the feet of investors and Wall Street, saying they encouraged Ownit and other supbrime lenders to make riskier loans to keep the pipeline of mortgage securities well supplied. 'The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans,' he said. 'What would you do?'"[37]

These mortgage products are complicated financial instruments that are not widely understood outside the financing and investment communities. For most families, buying or refinancing a house is a rare event. Very few consumers have facility with concepts such as "fully-indexed rate," "negative amortization," "prepayment penalties," "yield-spread premiums," and "hybrid ARMs." Very few people are qualified to assess the implications of the reams of papers they sign when they close on a new loan. Mortgage brokers and lenders are the experts, and consumers should be able to trust them for sound advice and a suitable loan.

It is not hard to find examples of trust that was betrayed. One prominent example appeared recently in *The Washington Post*, which published an article about a barely literate senior citizen who was contacted by a mortgage broker every day for a year before he finally took an "alternative" mortgage against his interests.[38] Recently we at CRL informally contacted a few practicing attorneys in North Carolina and asked them to provide examples of inappropriate or unaffordable loans from their cases. In less than 48 hours, we received a number of responses, including the cases briefly described in Appendix A. We also are aware of cases in which the borrower requested a fixed-rate mortgage, but received an ARM instead. The industry itself has asserted that borrowers placed in subprime hybrid ARMs could have received fixed-rate loans, and that the rate difference is "commonly in the 50 to 80 basis point range."[39] This rate bump is **less** than

the increase in rates many borrowers are unknowingly charged by their mortgage brokers in order to provide a hefty yield-spread premium to the broker.

B. Loose Qualifying Standards and Business Practices

The negative impact of high-risk loans could be greatly reduced if subprime lenders had been carefully screening loan applicants to assess whether the proposed mortgages are affordable. Unfortunately, many subprime lenders have been routinely abdicating the responsibility of underwriting loans in any meaningful way.

Lenders today have a more precise ability than ever before to assess the risk of default on a loan. Lenders and mortgage insurers have long known that some home loans carry an inherently greater risk of foreclosure than others. However, by the industry's own admission, underwriting standards in the subprime market have become extremely loose in recent years, and analysts have cited this laxness as a key driver in foreclosures.[40] Let me describe some of the most common problems:

Not considering payment shock: Lenders who market 2/28s and other hybrid ARMs often do not consider whether the homeowner will be able to pay when the loan's interest rate resets, setting the borrower up for failure. Subprime lenders' public disclosures indicate that most are qualifying borrowers at or near the initial start rate, even when it is clear from the terms of the loan that the interest rate can (and in all likelihood, will) rise significantly, giving the borrower a higher monthly payment. For example, as shown in the chart below, publicly available information indicates that these prominent national subprime lenders do not adequately consider payment shock when underwriting ARMs:

Sample Underwriting Rules For Adjustable Rate Mortgages[41]

LENDER	UNDERWRITING RULE
OPTION ONE MORTGAGE CORP	Qualified at initial monthly payment.
FREMONT INVESTMENT & LOAN	Ability to repay based on initial payments due in the year of origination.
NEW CENTURY	Generally qualified at initial interest rate. Loans to borrowers with FICO scores under 580 and loan-to-value ratios of more than 80% are qualified at fully indexed rate minus 100 basis points.

These underwriting rules indicate that lenders routinely qualify borrowers for loans based on a low interest rate when the cost of the loan is bound to rise significantly—even if interest rates remain constant. In fact, it is not uncommon for 2/28 mortgages to be originated with an interest rate four percentage points under the fully-indexed rate. For a loan with an eight percent start rate, a four percentage point increase is tantamount to a 40 percent increase in the monthly principal and interest payment amount.

Failure to escrow: The failure to consider payment shock when underwriting is compounded by the failure to escrow property taxes and hazard insurance.[42] In stark contrast to the prime mortgage market, most subprime lenders make loans based on low

monthly payments that do not escrow for taxes or insurance.[43] This deceptive practice gives the borrower the impression that the payment is affordable when, in fact, there are significant additional costs. Given that the typical practice in the subprime industry is to accept a loan if the borrower's debt is at or below 50 to 55 percent of their pre-tax income, using an artificially low monthly payment based on a teaser rate and no escrow for taxes and insurance virtually guarantees that a borrower will not have the residual income to absorb a significant increase whenever taxes or insurance come due during the first year or two, or certainly not when payments jump up after year two.

A recent study by the Home Ownership Preservation Initiative in Chicago found that for as many as one in seven low-income borrowers facing difficulty in managing their mortgage payments, the lack of escrow of tax and insurance payments were a contributing factor.[44] When homeowners are faced with large tax and insurance bills they cannot pay, the original lender or a subprime competitor can benefit by enticing the borrowers to refinance the loan and pay additional fees for their new loan. In contrast, it is common practice in the prime market to escrow taxes and insurance and to consider those costs when looking at debt-to-income and the borrower's ability to repay.[45]

Low/no documentation: Inadequate documentation also compromises a lender's ability to assess the true affordability of a loan. Fitch recently noted that "loans underwritten using less than full documentation standards comprise more than 50 percent of the subprime sector . . . ."[46] "Low doc" and "no doc" loans originally were intended for use with the limited category of borrowers who are self-employed or whose incomes are otherwise legitimately not reported on a W-2 tax form, but lenders have increasingly used these loans to obscure violations of sound underwriting practices. For example, a review of a sample of these "stated-income" loans disclosed that 90 percent had inflated incomes compared to IRS documents, and "more disturbingly, almost 60 percent of the stated amounts were exaggerated by more than 50 percent."[47] It seems unlikely that all of these borrowers could not document their income, since most certainly receive W-2 tax forms, or that they would voluntarily choose to pay up to 1.5 percent higher interest rate to get the "benefit" of a stated-income loan.[48]

Multiple risks in one loan: In addition, regulators have expressed concern about combining multiple risk elements in one loan, stating that "risk-layering features in loans to subprime borrowers may significantly increase risks for both the...[lender] and the borrower."[49] Previously I described a brief overview of the increased risk associated with several subprime loan characteristics, including adjustable-rate mortgages, prepayment penalties, and limited documentation of income. Each of these items individually is associated with a significant increase in foreclosure risk, and each has been characteristic of subprime loans in recent years; combining them makes the risk of foreclosure even worse.

C. Broker Abuses and Perverse Incentives

Mortgage brokers are individuals or firms who find customers for lenders and assist with the loan process. Brokers provide a way for mortgage lenders to increase their business without incurring the expense involved with employing sales staff directly. Brokers also

play a key role in today's mortgage market: According to the Mortgage Bankers Association, mortgage brokers now originate 45 percent of all mortgages, and 71 percent of subprime loans.[50]

Brokers often determine whether subprime borrowers receive a fair and helpful loan, or whether they end up with a product that is unsuitable and unaffordable. Unfortunately, given the way the current market operates, widespread abuses by mortgage brokers are inevitable.

First, unlike other similar professions, mortgage brokers have no fiduciary responsibility to the borrower who employs them. Professionals with fiduciary responsibility are obligated to act in the interests of their customers. Many other professionals already have affirmative obligations to their clients, including real estate agents, securities brokers and attorneys. Buying or refinancing a home is the biggest investment that most families ever make, and particularly in the subprime market, this transaction is often decisive in determining a family's future financial security. The broker has specialized market knowledge that the borrower lacks and relies on. Yet, in most states, mortgage brokers have no legal responsibility to refrain from selling inappropriate, unaffordable loans, or not to benefit personally at the expense of their borrowers.[51]

Second, the market, as it is structured today, gives brokers strong incentives to ignore the best interests of homeowners. Brokers and lenders are focused on feeding investor demand, regardless of how particular products affect individual homeowners. Moreover, because of the way they are compensated, brokers have strong incentives to sell excessively expensive loans. They earn money through up-front fees, not ongoing loan payments. To make matters worse for homeowners, brokers typically have a direct incentive to hike interest rates higher than warranted by the risk of loans. In the majority of subprime transactions, brokers demand a kickback from lenders (known as "yield spread premiums") if they deliver mortgages with rates higher than the lender would otherwise accept. Not all loans with yield-spread premiums are abusive, but because they have become so common, and because they are easy to hide or downplay in loan transactions, unscrupulous brokers can make excessive profits without adding any real value.

Experts on mortgage financing have long raised concerns about problems inherent in a market dominated by broker originations. For example, the chairman of the Federal Reserve Board, Ben S. Bernanke, recently noted that placing significant pricing discretion in the hands of financially motivated mortgage brokers in the sales of mortgage products can be a prescription for trouble, as it can lead to behavior not in compliance with fair lending laws.[52] Similarly, a report issued by Harvard University's Joint Center for Housing Studies, stated, "Having no long term interest in the performance of the loan, a broker's incentive is to close the loan while charging the highest combination of fees and mortgage interest rates the market will bear."[53]

In summary: Mortgage brokers, who are responsible for originating over 70 percent of loans in the subprime market, have strong incentives to make abusive loans that harm

consumers, and no one is stopping them. In recent years, brokers have flooded the subprime market with unaffordable mortgages, and they have priced these mortgages at their own discretion. Given the way brokers operate today, the odds of successful homeownership are stacked against families who get loans in the subprime market.

D. The Role of Investors

Lenders sometimes claim that the costs of foreclosing give loan originators adequate incentive to avoid placing borrowers into unsustainable loans, but this has proved false. Lenders have been able to pass off a significant portion of the costs of foreclosure through risk-based pricing, which allows them to offset even high rates of predicted foreclosures by adding increased interest costs. Further, the ability to securitize mortgages and transfer credit risk to investors has significantly removed the risk of volatile upswings in foreclosures from lenders. In other words, high foreclosure rates have simply become a cost of business that is largely passed onto borrowers and sometimes investors.

It is clear that mortgage investors have been a driving force behind the proliferation of abusive loans in the subprime market. Their high demand for these mortgages has encouraged lax underwriting and the marketing of unaffordable loans as lenders sought to fill up their coffers with risky loans. For example, approximately 80 percent of subprime mortgages included in securitizations issued the first nine months of 2006 had an adjustable-rate feature, the majority of which are 2/28s.[54]

It is particularly disturbing to note that not all of the investment support has come from private Wall Street firms. Even though Fannie Mae and Freddie Mac, the government-sponsored enterprises (GSEs), have a mandate to help families achieve homeownership, and over the years have made a significant contribution , they have been purchasing a significant share of securities backed by highly questionable subprime loans—i.e., loans that were made without considering low- and moderate-income families' ability to repay. The GSEs bought about 25 percent of total subprime mortgage-backed securities sold in the first nine months of 2006.[55] This is an enormous investment in loans that are producing record-level foreclosures, and destroying the economic stability of African-American and Latino families.

It is disappointing that Fannie and Freddie have not shown leadership in this area, but instead have competed with other investors to buy securities backed by high-risk subprime loans that hurt consumers and reverse the benefits of homeownership. The GSEs, with their public mission, should not be permitted to purchase loans to distressed or minority or low-to-moderate income families that do not meet an "ability to repay" standard. Moreover, the GSEs should not receive credit from the Department of Housing and Urban Development to meet their affordable housing goals[56] for investing in loans that generate massive foreclosures and violate a majority of the GSEs' own published guidelines against predatory mortgage lending. These strong guidelines include, for example, standards on the ability to repay, the requirement of escrow accounts for taxes and insurance, and a prohibition on prepayment penalties. The GSEs apply these

guidelines to loans purchased directly from loan originators, but not to the loans that they purchase as securities.

Further, by investing in loans that lack these basic protections, the GSEs not only contravene their mission, but they actually compound the disadvantages that minority borrowers face. This is because the loans subject to the predatory lending guidelines are prime, fixed-rate mortgages where white borrowers disproportionately receive their loans, while African-American and Latino families disproportionately receive their loans from the market where the GSEs have participated in without applying the guidelines.

Giving the GSEs HUD goals credit for these purchases defeats the very purpose for which the goals were set, namely to incent the GSEs to develop products and outreach that give borrowers less abusive products than those already available in the subprime marketplace. Rewarding the GSEs with goals credit for these purchases would be like giving banks credit under the Community Reinvestment Act for making abusive loans to low-wealth families. To be fair to the GSE's, however, HUD should remove these loans from both the numerator and the denominator of the overall mortgage market when calculating the percentage of the affordable housing market that the GSEs meet. Otherwise, if they stop purchasing the securities, and the loans are taken out of the numerator, it would likely be impossible for them to meet their percentage affordable housing goals, because subprime loans currently comprise such a large portion of the market.

Recently, as foreclosure rates have sharply increased, investors are looking more closely at underwriting practices that have produced foreclosure rates far higher than predicted, and in some instances have demanded the repurchase of loans that defaulted extremely quickly. In a few highly publicized cases, lenders have been forced out of business as a result.[57] However, defaults that occur after a designated three to six month period are not the responsibility of the lender. And while recent investor attention may force lenders to make some adjustments to accommodate investor concerns, it will not help those borrowers who are in 2/28s now, many of whom will lose their homes, their equity and their credit ratings when lenders foreclose on loans that never should have been made.

E. Federal Neglect

When Congress passed HOEPA in 1994, subprime loans made up only a very small share of the total mortgage market, and predatory lending practices were not nearly as prevalent as they were to become a few years later. It would have been helpful to update HOEPA to keep pace with the rashes of innovative predatory lending practices that occurred after the law passed, but with the pace of change in the mortgage market and the challenges of passing major legislation, that has not been—and never will be—feasible.

On the federal level, one regulatory agency was given explicit authority to take action: the Federal Reserve Board. The Board's primary authority comes through HOEPA, which provides the Board with broad authority to prohibit unfair or deceptive mortgage

lending practices and to address abusive refinancing practices. Specifically, the Act includes these provisions:

> (l) DISCRETIONARY REGULATORY AUTHORITY OF BOARD.--
> (2) PROHIBITIONS.--The Board, by regulation or order, shall prohibit acts or practices in connection with--
> (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and
> (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.[58]

While HOEPA generally applies to a narrow class of mortgage loans, it is important to note that Congress granted the authority cited above to the Board for all mortgage loans, not only loans governed by HOEPA (closed end refinance transactions) that meet the definition of "high cost." Each of the substantive limitations that HOEPA imposes refer specifically to high-cost mortgages.[59] By contrast, the discretionary authority granted by subsection (l) refers to "mortgage loans" generally.[60]

The legislative history makes clear that the Board's discretionary authority holds for all mortgage loans. The HOEPA bill that passed the Senate on March 17, 1994, and the accompanying Senate report, limited the Board's authority to prohibit abusive practices in connection with high-cost mortgages alone.[61] However, this bill was amended so that the bill that ultimately passed both chambers, as cited above, removed the high-cost-only limitation, and the Conference Report similarly removed this restriction.[62] The Conference Report also urged the Board to protect consumers, particularly refinance mortgage borrowers.[63]

The Board has been derelict in the duty to address predatory lending practices. In spite of the rampant abuses in the subprime market and all the damage imposed on consumers by predatory lending—billions of dollars in lost wealth—the Board has never implemented a single discretionary rule under HOEPA outside of the high cost context. To put it bluntly, the Board has simply not done its job.

III. Solutions

Congress has a long, proud history of strong policies to support homeownership, but that task has become more complicated than ever. Supporting homeownership continues to involve encouraging fair lending and fair access to loans. But supporting homeownership also means refusing to support loans that are abusive, destructive and unnecessarily risky.

A few years ago, the problem of subprime foreclosures likely would have received scant attention from policymakers, since subprime mortgages represented only a small fraction of the total mortgage market. Today subprime mortgages comprise almost one quarter of all mortgage originations. The merits of this expanding market are widely debated, but

one point is clear: Subprime mortgage credit—and the accompanying foreclosures—have become a major force in determining how and whether many American families will attain sustainable wealth.

There are simple, known solutions to help preserve the traditional benefits of homeownership and to address many of the problems I have mentioned today. Here I reiterate our five recommendations:

1. Restore safety to the subprime market by imposing a borrower "ability to repay" standard for all subprime loans. The recently-issued Guidance on nontraditional mortgage products should apply to all subprime hybrid ARM loans and non-traditional products. Specifically, the agencies should affirm that this Guidance covers the most widely destructive type of loan today: 2/28s in the subprime market. We also recommend that they include the requirement that lenders escrow for property taxes and hazard insurance on subprime loans, and include these payments in the calculation of the borrower's ability to repay the loan. Further, the Guidance points out the problems with no-doc loans, and should affirmatively require that lenders verify and document all sources of income using either tax or payroll records, bank account statements or other reasonable third-party verification.

2. Require mortgage brokers to have a fiduciary duty to their clients. We know it is both feasible and desirable to require mortgage brokers to serve the best interests of the people who pay them. Brokers manage the most important transaction most families ever make. Their role is at least as important as that of stock brokers, lawyers and Realtors—professions that already have fiduciary standards in place.

3. Require the Federal Reserve to act, or address abuses through the FTC. HOEPA, the major federal law designed to protect consumers against predatory mortgage lending, has manifestly failed to stem the explosion of harmful lending abuses that has accompanied the recent subprime lending boom. Congress has provided the Federal Reserve Board with discretionary authority to address these problems for all mortgage loans, but to date the Board has not taken advantage of this authority. Given the Board's record, Congress should seriously consider enlisting the Federal Trade Commission's assistance in addressing abuses that have gone on too long.

4. Require government-sponsored enterprises to stop investing in abusive subprime loan securities. Currently Fannie Mae and Freddie Mac are purchasing mortgage-backed securities that include high-risk subprime loans. By doing so, they are essentially supporting and condoning lenders who market abusive, high-risk loans that are not truly affordable. This is clearly counter to the mission of those agencies. They should voluntarily stop investing in these securities. In addition, HUD should stop giving them affordable goals credit for purchasing these AAA securities (take them out of both the numerator and denominator in assessing the market), and Ofheo should prohibit the agencies from adding these securities to their portfolios.

5. Strengthen protections against destructive home lending by passing a new national anti-predatory lending bill. Federal law has clearly not kept up with the abuses in the changing mortgage market. HOEPA needs to be extended and updated to address the issues that are driving foreclosures today. Even should this happen, we need to realize that it is impossible for any single law to cover all contingencies or to anticipate predatory practices that will emerge in the future. Any new federal law must therefore preserve the right of the states to supplement the law, when necessary, to address new or locally-focused lending issues. While HOEPA is weak, it did recognize the limits of federal law, and therefore functions as a floor, not a ceiling. If HOEPA had not allowed states to take action, today's disastrous levels of foreclosures would be even worse.

Thank you very much for the opportunity to testify before you today. I would be happy to answer any questions you may have.

APPENDIX A

To illustrate the unfortunate realities of inappropriate and unaffordable 2/28 adjustable rate mortgages (ARMs), recently the North Carolina Justice Center informally contacted a few practicing attorneys in North Carolina to provide examples from their cases. They received a number of responses, including these described below.

1. **From affordable loan to escalating ARM .**
   Through a local affordable housing program, a homeowner had a 7% fixed-rate, 30-year mortgage. A mortgage broker told the homeowner he could get a new loan at a rate "a lot" lower. Broker originated a 2/28 ARM with a starting rate of 6.75%, but told borrower that it was a fixed-rate, 30-year mortgage. At the 24th month, the loan went up to 9.75%, following the loan's formula of LIBOR plus 5.125% and a first-change cap maximum of 9.75%. Loan can go up to a maximum of one point every six months, with a 12.75% total cap. Now borrower cannot afford the loan and faces foreclosure.

2. **Temporary lower payments—a prelude to shock.**
   Homeowner refinanced out of a fixed-rate mortgage because she wanted a lower monthly payment. The homeowner expressly requested lower monthly payments that included escrow for insurance and taxes. Mortgage broker assured her that he would abide by her wishes. Borrower ended up in a $72,000 2/28 ARM loan with first two years monthly payments of $560.00 at a rate of 8.625%. This initial payment was lower than her fixed-rate mortgage, but it did not include escrowed insurance and taxes. After two years, loan payments increased every six months at a maximum one percent with a cap of 14.625%. At the time of foreclosure, the interest rate had climbed to 13.375% with a monthly payment $808.75. If the loan had reached its maximum interest rate, the estimated monthly payment would be close to $900.00.

3. **Unaffordable from the start.**
   Homeowner had a monthly payment of $625 and sought help from a mortgage broker to lower monthly payment. Broker initially said he could lower the payment, but before closing said the best he could do was roughly $800. He assured borrower that he could refinance her to a loan with a better payment in six months. Previously he had advised homeowner not to pay her current mortgage payment because the new loan would close before the next payment due date. In fact, closing occurred after the payment was due, and borrower felt she had to close. Loan was a 2/28 ARM with an initial interest rate of 11% and a ceiling of 18% at an initial monthly payment of $921. Interest at first change date is calculated at LIBOR plus 7%, with a 12.5% cap and a 1.5% allowable increase/decrease at each 6-month change date. First change date is June 1, 2008. By approximately the third payment, however, borrower could not afford mortgage payments and is now in default.

APPENDIX B

February 5, 2007

The Honorable Christopher Dodd
448 Russell Senate Office Building
United States Senate
Washington, D.C. 20510-0702

The Honorable Jack Reed
728 Hart Senate Office Building
United States Senate
Washington, D.C. 20510- 3903

The Honorable Wayne Allard
521 Dirksen Senate Office Building
United States Senate
Washington, D.C. 20510-0605

The Honorable Jim Bunning
316 Hart Senate Office Building
United States Senate
Washington, D.C. 20510-1703

The Honorable Charles Schumer
313 Hart Senate Office Building
United States Senate
Washington, D.C. 20510-3203

Dear Senators,

On January 2nd, the Consumer Mortgage Coalition (CMC) wrote a letter to Senators Sarbanes, Allard, Dodd, Bunning, Reed, and Schumer arguing that it would be inappropriate to apply the October 4th Interagency Guidance on Nontraditional Mortgage Product Risks to subprime 2-28 ARM loans. On January 25th, the Coalition for Fair & Affordable Lending (CFAL) wrote a letter to similar effect to the heads of the federal banking regulators. Their arguments are similar in many respects, and, we respectfully submit, both are equally without merit. Subprime 2-28 mortgages (and other hybrid ARMs with similar characteristics such as subprime 3-27 mortgages) present the full array of risks that drove regulators to issue the Guidance, and should be covered. We address CMC's arguments below, and then, to the extent CFAL has raised any further points meriting response, we address those briefly as well.

Although the CMC tries to link 2-28 subprime ARMs to more established prime hybrid ARMs, the reality remains that 2-28 subprime ARMs present a radically different risk to borrowers and can be covered under the Guidance without introducing new standards on lower-risk prime ARMs. Indeed, the most recent Mortgage Bankers Association *National Delinquency Survey* found that subprime ARMs are starting foreclosure at more than seven times the rate of prime ARMs in the third quarter of 2006.[1]

Many subprime lenders still find such lending profitable, however, because of two factors. First, the advent of risk-based pricing allows them to offset even high rates of

[1] Mortgage Bankers Association, *National Delinquency Survey, Third Quarter 2006*, (Sept. 30, 2006).

predicted foreclosures by adding increased interest costs. Second, the ability to securitize mortgages and transfer credit risk to investors has largely removed the risk of volatile upswings in foreclosures from lenders. In other words, high foreclosure rates have simply become a cost of business that is passed onto borrowers and, sometimes, investors.

One of the primary purposes of the Guidance is to protect borrowers against payment shock. 2-28s almost invariably entail a substantial payment shock because of the way they are designed, underwritten and marketed today. Typical practice in the subprime industry is to accept a loan if the borrower's debt is at or below 50 to 55% of pre-tax income, using an artificially low monthly payment based on a teaser rate and no escrow for taxes and insurance. This virtually guarantees that a borrower will not have the residual income to absorb a significant increase whenever taxes or insurance come due during the first year or two, or when the teaser rate resets.

The harm inflicted by these loans impacts even more borrowers than those affected by the non-traditional mortgages because, first, of the explosion in the subprime market -- from 1994 to 2005, it grew from $35 billion to $665 billion, and from 1998 to 2006, the subprime share of total mortgage originations climbed from 10 percent to 23 percent.[2] The second reason is that 2-28s are by far the most common product in the subprime market today;[3] through the second quarter of 2006, hybrid ARMs made up 81 percent of the subprime loans that were packaged as investment securities.[4]

Moreover, 2-28s and 3-27s are having a particularly damaging impact on communities of color. According to the most recent HMDA data, a majority of loans to African-American borrowers were so-called "higher-rate" loans,[5] while four in ten loans to Latino[6] borrowers were higher-rate, the substantial portion of which are 2-28s and 3-27s. By contrast, approximately 80% of home loans during this time period to white families were conventional loans, the sector clearly protected by the Guidance.[7]

We have seen that borrowers with subprime ARMs were almost never given a choice of products, but were instead automatically steered to an ARM and were given little or no explanation of the ARM's terms. These borrowers should have the same right to receive

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[2] Subprime Mortgage Origination Indicators, Inside B&C Lending (November 10, 2006).

[3] Hybrid ARMs and hybrid interest-only ARMs have become "the main staples of the subprime sector ." *See* Mike Hudson and E. Scott Reckard, More Homeowners with Good Credit Getting Stuck in Higher-Rate Loans, L.A. Times, p. A-1 (October 24, 2005).

[4] *See* Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs, p. 4; Lehman Brothers, *Cause for Al-ARM – A Comprehensive Tool for Understanding the Recent Development of the Adjustable Rate Mortgage and Determining the Implications on Credit Risk of its Growing Popularity*, (June 15, 2005) at 9.

[5] 54.7 percent of African-Americans who purchased homes in 2005 received higher-rate loans. 49.3 percent received such loans to refinance their homes.

[6] 46.1 percent of Latino white borrowers received higher-rate purchase loans. 33.8 percent received higher-rate refinance loans. For the purpose of this comment, "Latino" refers to borrowers who were identified as racially white and of Latino ethnicity.

[7] *See e.g.*, Debbie Gruenstein Bocian, *Center for Responsible Lending Comment on Federal Reserve Analysis of Home Mortgage Disclosure Act Data* (September 28, 2006).

"information that is designed to help them make informed decisions when selecting and using these products" as recommended by the Guidance.

CMC & CFAL Assertions Answered

ASSERTION: 2-28 subprime ARMs are "well-established" with "default rates that are comparable to or sometimes better than those on 30-year fixed rate loans."

ANSWER: The first-lien subprime market is less than a decade old and is only now being tested for the first time as waning house price appreciation exposes weaknesses that are projected to lead to 1 in 5 subprime loans ending in foreclosure.[8]

EVIDENCE:

- Using housing price forecasts from Moody's Economy.com, a recent Center for Responsible Lending report, *Losing Ground*, projected that 1 in 5 (19.4%) of subprime loans originated in 2006 will end in foreclosure and that subprime ARM loans have a greater risk of foreclosure than subprime fixed-rate loans.[9] For example, the report found that subprime ARM loans originated in 2002 had a 78% greater risk of foreclosure than subprime fixed-rate loans after controlling for credit score.
- Multivariate regression analysis from the University of North Carolina showed that subprime ARMs had a 49% greater risk of foreclosure than subprime fixed-rate mortgages after controlling for FICO score, loan-to-value ratio, strength of income documentation, and economic conditions.[10]
- According to the Mortgage Bankers Association National Delinquency Survey, subprime ARMs have much higher delinquency rates than prime ARMs and subprime fixed rate loans. The 2006 third quarter data showed that the delinquency rate for subprime ARMs was 13.22 percent, compared to 9.59 percent for subprime fixed rate loans and just 3.06 percent for prime ARMs.[11]

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[8] Center For Responsible Lending, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners* (Dec. 2006) at 3-5, available at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189.

[9] We have been pleased to receive informal confirmation of our projections from various sources, including major investment firms. The attached Baltimore Sun article provides a good summary of the paper's findings and perspective from multiple market participants.

[10] Roberto G. Quercia, Michael A. Stegman and Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, Center for Community Capitalism, University of North Carolina at Chapel Hill (January 25, 2005) at 28-9.

[11] Mortgage Bankers Association, *National Delinquency Survey, Third Quarter 2006*, (Sept. 30, 2006) at 7, 9.

ASSERTION: "[I]f the Guidance were extended to 2/28 mortgages, [m]any first-time borrowers would lose the opportunity to own a home."

ANSWER: Loans that borrowers cannot afford do not lead to lasting homeownership opportunities. Moreover, the loans in the subprime market are typically debt consolidation refinance loans and do not create new homeownership opportunities.

EVIDENCE:

- Assessing subprime lending from 1998-2004, CRL reports in *Losing Ground* that refinance loans were a majority of all subprime originations.[12]
- A survey published in *Housing Policy Debate* in 2004 by staff from Opinion Research Corporation, Freddie Mac, and Equitec revealed that only 14.2% of subprime borrowers reported taking their loan to purchase a first home.[13] Further, with projected default rates of 19.4% for recent subprime loans, subprime lending appears to be on pace to result in a net loss in homeownership in its current form. Finally, most of the borrowers in a cohort of subprime loans refinance into further subprime loans, and many of these will also be foreclosed upon; following the borrower through subsequent loans rather than just looking at that first loan cohort, CRL roughly estimates in *Losing Ground* actual subprime borrower foreclosure rates over 35%.

ASSERTION: "The type of deep discount below the fully-indexed rate that Mr. Calhoun [of CRL] addressed in his testimony is not common." (Referencing testimony before the Senate Banking Committee regarding Nontraditional Mortgages on September 20, 2006)

ANSWER: High payment shock is absolutely typical of 2-28 subprime ARMs.

EVIDENCE:

- A December 11, 2006 presentation by Fannie Mae Chief Economist David Berson at the Office of Thrift Supervision reported that 2006 subprime ARM loans in mortgage-backed securities carried an average initial interest rate of 7.95% and an average fully-indexed rate of 11.29% as of year-end (margins averaged 5.93% over 6-month USD LIBOR)[14]. For a 2-28 subprime ARM this differential represents a payment shock of 32% between the initial rate and the fully-indexed rate.
- A mid-year 2006 analysis from Fitch Ratings similarly reported that 2-28 subprime ARMs carried a built-in payment shock of 29% even if interest rates

[12] Center For Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners (Dec. 2006) at 3-5, available at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189 at 46.
[13] Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, "Subprime Lending: An Investigation of Economic Efficiency", Housing Policy Debate 15:3 (2004).
[14] David Berson, VP & Chief Economist at Fannie Mae, *Challenges and Emerging Risks in the Home Mortgage Business,* presented at the National Housing Forum at the Office of Thrift Supervision (December 11, 2006).

remain unchanged, with LIBOR remaining at 4.27%. With year-end LIBOR at 5.36%, the Fitch analysis suggests payment shocks of 48%.[15]

ASSERTION: "We note that both of these features [subprime prepayment penalties and low-documentation loans] can benefit borrowers.... Lenders are able to offer low-documentation loans because the technology of predicting loan performance has improved..."

ANSWER: Both of these features are associated with higher foreclosure risk on subprime loans and should certainly be scrutinized in the context of the Guidance. Limited documentation loans often are used to make loans where it is known that the borrower's income is insufficient to cover the scheduled payments.

EVIDENCE:

- UNC researchers found that prepayment penalties and limited documentation loans in subprime loans nationally were features associated with a 16-20% and a 15% increase in foreclosure risk, respectively, after controlling for credit score, loan-to-value ratio, economic conditions, and several other variables.[16]
- The CRL *Losing Ground* report finds that prepayment penalties and limited documentation on subprime loans nationally were associated with increased foreclosure risk. For example, for loans originated in 2001, controlling for credit score, the increased foreclosure risk for prepayment penalties and limited documentation features on subprime loans were 36% and 26% respectively.[17]
- Similarly, on a set of subprime loans from the Chicago area, OCC researcher Morgan Rose reported that subprime loans with prepayment penalties and low-income documentation were more likely to lead to a foreclosure starts for subprime refinance ARM loans.[18]
- A report from the Mortgage Asset Research Institute (MARI) examined a sample of stated-income loans and found that 90 percent of borrowers had incomes higher than those found in IRS files and "more disturbingly, almost 60 percent of the

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[15] Structured Finance: U.S. RMBS Criteria for Subprime Interest-Only ARMs , FITCH RATINGS CREDIT POLICY (New York, N.Y), October 4, 2006.

[16] Roberto G. Quercia, Michael A. Stegman and Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, Center for Community Capitalism, University of North Carolina at Chapel Hill (January 25, 2005)

[17] Center For Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners (Dec. 2006) at 3-5, available at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189 at 22.

[18] Morgan Rose, OCC Working Paper #2006-1, "Foreclosures of Subprime Mortgages in Chicago: Analyzing the Role of Predatory Lending Practices."

stated income amounts were exaggerated by more than 50 percent."[19] Similarly, a survey of 2,140 mortgage brokers (constituting a national sample) found that 43 percent of brokers who use low documentation loan products know that their borrowers "can't qualify under standard [debt-to-income] ratios" because they did not have enough income for the loan.[20]

ASSERTION: "Investors set limits on the extent to which loan underwriting can take this initial "teaser" rate into account. They sometimes ... [require] that loans with an aggressive initial discount be underwritten at the fully-indexed rate."

ANSWER: To protect both borrowers and responsible lenders who require underwriting at the fully indexed rate, it is important that regulators level the playing field by making this standard applicable to all 2-28 subprime ARMs. It is clear that major subprime lenders do not underwrite to the fully-indexed rate.

EVIDENCE:

- A 2005 Option One prospectus shows that the lender underwrote loans to the lesser of one percentage point over the start rate or the fully-indexed rate.[21] Yet, under this "lesser of" formulation, the latter would typically never apply to 2-28 subprime ARMs.
- As summarized in a November 2006 release, New Century's strongest underwriting practice, which is applied only to borrowers with a credit score under 580 and a loan-to-value ratio over 80 percent, is to evaluate the borrower's ability to repay the mortgage at an interest rate equal to the fully indexed rate minus one percentage point. Other borrowers have their ability to repay screened at the initial interest rate.[22]

Additional Assertions By CFAL Answered

ASSERTION: The Guidance "does not take into account an individual's income growth over the years."

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[19] Mortgage Asset Research Institute, Inc., *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association*, p. 12, available at http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf (April 2006).

[20] "How Mortgage Brokers View the Booming Alt A Market," survey conducted by Campbell Communications cited in Inside Mortgage Finance, Volume 23, Number 42 (November 3, 2006 available at http://www.imfpubs.com/issues/imfpubs_imf/23_42/news/1000004789-1.html and cited in Harney, Kenneth, *"The Lowdown on Low-Doc Loans,"* The Washington Post 11/25/2006 page F-1 (November 25, 2006), available at http://www.washingtonpost.com/wp-dyn/content/article/2006/11/24/AR2006112400503_pf.html

[21] *See* Option One Prospectus, Option One MTG LN TR ASSET BK SER 2005 2 424B5 May 3 2005, S.E.C. Filing 05794712 at S-50.

[22] *See Adoption of Additional Lending Best Practices,* included in "New Century Financial Corporation Reports Third Quarter 2006 Results and Provides Outlook for 2007," (November 2, 2006) *available at* http://news.moneycentral.msn.com/ticker/article.aspx?Symbol=US:NEW&Feed=PR&Date=20061102&ID=6163344.

ANSWER: Subprime lenders' public filings make clear that the lenders do not consider whether the borrower is likely to experience any income growth whatever, but rather qualify the borrower with a focus on the initial years of payment.[23] In the vast majority of cases, the lenders have no reasonable basis for assuming that the borrowers receiving subprime 2-28s and 3-27s will experience any increase in income.

ASSERTION: The Guidance "does not appear to recognize that market forces, including secondary market purchasers' requirements, generally do a better job than regulators at managing nontraditional risks."

ANSWER: This proposition is negated by industry leaders' own statements. Consider the frank acknowledgement by the chief executive of Ownit Mortgage Solutions, William D. Dallas, who "acknowledges that [underwriting] standards were lowered, but he placed the blame at the feet of investors and Wall Street saying they encouraged Ownit and other supbrime lenders to make riskier loans to keep the pipeline of mortgage securities well supplied. 'The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans,' he said. 'What would you do?'"[24]

ASSERTION: "Traditional hybrid ARMs offer a significantly lower monthly payment for the initial fixed–rate period than an equivalent traditional fixed-rate loan. The rate difference is commonly in the 50 to 80 basis point range."

ANSWER: This assertion reveals a great tragedy confronting many of the families currently losing their homes in foreclosure: for an additional 50 – 80 basis points at the outset, they could have been holding sustainable 30-year fixed rate loans. Gaining little more than a 50 basis point short-term discount, borrowers are being lured into loans that will increase by up to 3% at the beginning of the 25th month, cost them substantial equity stripped through refinancing costs and fees, or force them to lose their home altogether.

Compare the fixed rate cost with the 50 – 100 basis point bump up that roughly half of borrowers pay for not documenting their income, even though most are employees fully able to provide W-2's. Or compare it with the extra interest borrowers pay to give their mortgage brokers, who originate 71% of subprime loans,[25] a yield-spread premium/kickback. For example, for brokers who increase a borrower's interest rate beyond what they qualify for by an extra 1.25%, a recent New Century rate sheet rewards the broker with 2% of the loan amount as a yield-spread premium.

ASSERTION: "The traditional hybrid ARM structure is especially well suited to the needs of nonprime consumers who are looking for a more affordable transitional product as they reestablish their credit and financial footing."

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[23] *See* discussion of Option One and New Century underwriting standards, above.
[24] Vikas Bajaj and Christine Haughney, *Tremors At the Door -- More People with Weak Credit Are Defaulting on Mortgages*," New York Times (Fri. Jan. 26, 2007) C1, C4.
[25] MBA Research Data Notes, "Residential Mortgage Origination Channels," September 2006.

ANSWER: This observation relates to the hybrid ARMs in the prime market, where the introductory rate typically lasts at least 5 years, where lenders escrow for taxes and insurance, and where borrowers are not subject to prepayment penalties. It is directly contrary to the facts associated with subprime 2-28 and 3-27 loans, as shown in the data discussed above.

ASSERTION: "[Pre-payment] penalties, in fact, generally terminate automatically when the loan adjusts to the fully-indexed rate. This allows most consumers to achieve a substantial savings through two or three years of the lower rate, rebuild their credit and then to move promptly to a new lower rate loan without incurring a penalty or having to pay the higher adjusted rates for any extended period."

ANSWER: The experience of most 2-28 and 3-27 borrowers is contary to the circumstances alleged by CFAL. As CFAL acknowledges, the loans are designed so that the pre-payment penalty remains in effect until the time that the rate resets. This means that the borrower can almost *never* avoid both the pre-payment penalty and the increased rate. As described above, these loans are typically underwritten to so that a substantial proportion of 2-28 and 3-27 borrowers predictably will not be able to afford the loan when the rate resets, and so must choose between paying the penalty and defaulting when the payment shock hits. The latter most definitely does not improve the borrower's credit rating and increases the pressure on the borrower to refinance on the lender's terms.

ASSERTION: "[F]oreclosures for nonprime loans, including hybrid ARMs, are dramatically less than the grossly inaccurate 20% rate ('1 in 5' loans) that some consumer groups have been claiming. Industry data indicate, for example, that the foreclosure inventory rate during the third quarter of 2006 for subprime loans was about 3.9% and the percent of new nonprime loan foreclosures was around 1.8%"

ANSWER: The CFAL figure is misleading in that it represents reflects the percentage of outstanding loans that are in foreclosure at a specific point in time, while the 20% rate is a cumulative rate that reflects the perecentage of loans originated during a year that will eventually end in foreclosure over time. Further, the 20% anticipated foreclosure rate on subprime 2-28 loans is in fact a conservative estimate based on conservative assumptions applied to objective loan-level data, and corresponds to data compiled from industry sources, as detailed in our *Losing Ground* report, described above. In fact, the numbers are hardly inconsistent. If 1.8% of subprime loans foreclose each quarter over three years, that would be 21.6% cumulative foreclosure starts. And the 20% number increases substantially when one tracks the subprime borrower through subsequent subprime refinancings, each of which has its own risk of foreclosure.

Conclusion

The steep payment shocks on 2-28 subprime ARMs that follow from dramatic scheduled increases in the interest charges just two years into the loan represent precisely the sort of "deferral of interest" on loans to "a wider spectrum of borrowers who may not otherwise

qualify for more traditional mortgages" addressed by the Guidance. In the case of 2-28 subprime ARMs, the change in interest rates is typically so large at year two that they may properly be characterized as a contingent deferral of interest from early years to later years of the loan term.[26] The magnitude of this deferral is significantly larger than typically found in prime ARM loans.

Federal Reserve Board Governor Susan Bies reached a similar conclusion, recently stating, "Let's face it; a teaser loan really is a negative [amortization] loan because you don't pay interest up front."[27] In addition to being consistent with the notion that these subprime hybrid ARMs present a deferral of interest, this quote also illustrates a second dimension on which subprime ARMs tend to differ from their prime counterparts. Specifically, low introductory rates on subprime ARMs are typically associated with high up-front financed fees whereas fees on prime ARMs tend to be much lower.[28] In other words, subprime ARMs routinely find borrowers trading equity in exchange for dramatically lower interest payments—thereby producing the same result as negative amortization.

In addition, this deferral of interest is being presented to borrowers with weaker credit histories who have not traditionally been faced with such large payment shocks. For these reasons, it remains critical that regulators clarify that the Guidance applies to 2-28 and 3-27 subprime ARMs.[29]

We recognize that this issue is emblematic of the widespread abuses in the mortgage market that require Congressional action. We look forward to working with you all on a response to these problems.

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[26] The contingent nature of the deferral (borrowers have to stay in the loan until adjustment to experience its effects) are much like the contingent nature of the deferral of interest in payment option ARMs (where borrowers only feel the effects if they pay less than the full amount of interest due). In either case, the Guidance should require that lenders underwrite the loan to standards that ensure the borrower can payoff the loan should these contingencies occur.

[27] Richard Cowden, *Bies Says Regulators to Consider Principles, Not Products, if They Revise Loan Guidance*, BNA Banking Report, vol. 88 no. 02 (Jan. 15, 2007) at 56.

[28] Freddie Mac reports that the most common prime hybrid ARM (5/1 ARMs), had an average initial discount rate of 1.76 percentage points and fees and points amounting to 0.5% of the loan amount. *Freddie Mac Releases Results of its 23rd Annual ARM Survey*, Freddie Mac (January 3, 200) available at http://www.freddiemac.com/news/archives/rates/2007/20070103_06armsurvey.html. An article detailing a survey of borrowers reported that subprime borrowers paid higher fees than prime borrowers. Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency*, 15 Housing Policy Debate 3, pp571533 (2004).

[29] While some have pointed to a reference in footnote 1 in the guidance as evidence that these loans should not be included, that footnote does not clearly address 2-28 subprime ARMs. In it, the regulators explicitly exclude "fully amortizing residential mortgage loan products." However, in the Appendix to the Guidance they also make clear that "fully amortizing" refers both to principal and interest. They use an example where they specifically qualify the term as follows: "a fully amortizing principal and interest payment."

Sincerely,

Center for Responsible Lending
National Consumer Law Center
Consumer Federation of America
Consumer Action
National Lawyers Committee for Civil Rights Under the Law
Rainbow Push
Opportunity Finance Network
U.S. PIRG
National Community Reinvestment Coalition
National Association for the Advancement of Colored People
Acorn
NACA

CC:

The Honorable Sheila Bair, Chairman, Federal Deposit Insurance Corporation
The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System
The Honorable John C. Dugan, Comptroller of the Currency, Office of the Comptroller of the Currency
The Honorable JoAnn Johnson, Chairman, National Credit Union Administration
The Honorable Neil Milner, President and CEO, Conference of State Banking Supervisors
The Honorable John M. Reich, Director, Office of Thrift Supervision

End Notes

[1] Our research finds that one out of every five (19 percent) subprime loans made in recent years will fail. This rate is far worse than the ten-year default rate (14.9%) arising from the "Oil Patch" disaster of the 1980s. See Ellen Schloemer, Keith Ernst, Wei Li and Kathleen Keest, "Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners," December 2006 available at www.responsiblelending.org, note 18.

[2] Inside B&C Lending (Sept. 1, 2006); *see* also INSIDE MORTGAGE FINANCE MBS DATABASE, 2006.

[3] Nearly 55 percent of African Americans who purchased homes in 2005 received higher-rate loans; 49 percent received such loans to refinance their homes. Slightly more than 46 percent of Latino borrowers received higher-rate purchase loans; about 34 percent received higher-rate refinance loans. See CRL internal analysis of HMDA, www.responsiblelending.org/pdfs/HMDA-Comment-9-28-06.pdf.

[4] *See*, e.g., Vikas Bajaj and Christine Haughney, "Tremors at the Door – More People with Weak Credit are Defaulting on Mortgages," *The New York Times*, citing *Inside Mortgage Finance* (January 26, 2007).

[5] *See* 71 Fed. Reg. 58609 (October 4, 2006) for the federal Interagency Guidance on Nontraditional Mortgage Product Risks, issued by the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Department of the Treasury and the National Credit Union Administration. The Conference of State Banking Supervisors and the American Association of Residential Mortgage Regulators (AARMR) followed suit by issuing draft model guidance for state regulators, which has been implemented in at least 20 states. For a summary of state issuances, *see* http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/FederalAgencyGuidanceDatabase/State_Implementation.htm.

[6] Much of the following material originally appeared in the "Losing Ground" report, cited in note 1.

[7] Ira Goldstein, *Bringing Subprime Mortgages to Market and the Effects on Lower-Income Borrowers*, p.2 Joint Center for Housing Studies, Harvard University (February 2004) at http://www.jchs.harvard.edu/publications/finance/babc/babc_04-7.pdf.

[8] Mike Hudson and E. Scott Reckard, *More Homeowners with Good Credit Getting Stuck in Higher-Rate Loans*, L.A. Times, p. A-1 (October 24, 2005). For most types of subprime loans, African-Americans and Latino borrowers are more likely to be given a higher- cost loan even after controlling for legitimate risk factors. Debbie Gruenstein Bocian, Keith S. Ernst and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending, (May 31, 2006) at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=29371010; S*ee also* Darryl E. Getter, *Consumer Credit Risk and Pricing*, Journal of Consumer Affairs (June 22, 2006); Howard Lax, Michael Manti, Paul Raca, Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency*, 533, 562, 569, Housing Policy Debate 15(3) (2004).

[9] *Subprime Mortgage Origination Indicators*, Inside B&C Lending (November 10, 2006).

[10] *See, e.g.*, Eric Stein, *Quantifying the Economic Costs of Predatory Lending*, Center for Responsible Lending (2001).

[11] Roberto G. Quercia, Michael A. Stegman and Walter R. Davis, *Assessing the Impact of North Carolina's Predatory Lending Law*, Housing Policy Debate, (15)(3): (2004); Wei Li and Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms* (2006) *available at* http://www.responsiblelending.org/pdfs/rr010-State_Effects-0206.pdf.

[12] *See, e.g.* David W. Berson, *Challenges and Emerging Risks in the Home Mortgage Business: Characteristics of Loans Backing Private Label Subprime ABS*, Presentation at the National Housing Forum, Office of Thrift Supervision (December 11, 2006).

[13] The rate of new foreclosures as a percent of all loans rose from 0.13 in 1980 to 0.42 in 2005, as reported in the *National Delinquency Survey*, Mortgage Bankers Association. 2005 new foreclosure filings statistic from Realty Trac in *Home Foreclosures on the Rise*, MoneyNews (February 23, 2006) at http://www.newsmax.com/archives/articles/2006/2/23/134928.shtml.

[14] National Foreclosures Increase 17 Percent In Third Quarter, Realty Trac (November 1, 2006) at http://www.realtytrac.com/ContentManagement/PressRelease.aspx?ItemID=1362

[15] *See, e.g.*, Saskia Scholtes, Michael Mackenzie and David Wighton, *US Subprime Loans Face Trouble*, Financial Times (December 7, 2006); *Nightmare Mortgages*, Business Week (September 11, 2006).

[16] Geoff Smith, *Key Trends in Chicago Area Mortgage Lending: Analysis of Data from the 2004 Chicago Area Community Lending Fact Book*, Woodstock Institute (March 2006) available on the Woodstock Institute website.

[17] Dan Immergluck and Geoff Smith, *Risky Business: An Econometric Analysis of the Relationship Between Subprime Lending and Neighborhood Foreclosures*, Woodstock Institute (2004).

[18] Dan Immergluck and Geoff Smith, "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values," p. 57, 69, 72, 75 *Housing Policy Debate* (17:1) Fannie Mae Foundation (2006).

[19] The Home Mortgage Disclosure Act requires most lenders to file annual reports containing specified information about the "higher-cost loans" they originated. "Higher-cost loans" are those for which the APR exceeds the rate on a Treasury security of comparable maturity by 3 percentage points for first liens, and 5 percentage points for second liens. FRB analysis of 2005 HMDA data indicates that non-Hispanic whites received over 1.2 million higher-cost loans, compared to 388,471 for African-Americans and 375,889 for Latinos. Authors' calculations from data reported in Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *Higher-Priced Home Lending and the 2005 HMDA Data*, Federal Reserve Bulletin A123, A160-161 (Sept. 8, 2006), at http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf.

[20] A balloon loan is one that is not repayable in regular monthly installments, but rather requires repayment of the remaining balance in one large lump sum. While 2/28s are not balloon loans, the impact of higher interest rates at the end of the two-year teaser rate period, resulting in higher monthly payments, may force a borrower to seek refinancing.

[21] *See, e.g. Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs*, p. 2 Fitch Ratings Credit Policy (August 21, 2006).

[22] Here we are describing the 2/28 because it is by far the most common product in the subprime market, but the concerns are the same with the 3/27, which differs only in that the teaser rate remains in effect for three years.

[23] The typical 2/28 rises to 6-month LIBOR (now 5.35 percent) plus an index of 6.5 percent, or almost 12 percent.

[24] Typically the rate increase at the first adjustment is capped somewhere between 1.5 and 3 percentage points. On this loan, the rate reached the fully indexed rate at the second adjustment two-and-a-half years into the loan.

[25] *See Structured Finance*, note 21.

[26] *See Structured Finance*, note 21.

[27] Jonathan R. Laing, *Coming Home to Roost*, p. 26 Barron's, February 13, 2006.

[28] *See Structured Finance*, note 21.

[29] Freddie Mac reports that the most common prime hybrid ARM (5/1 ARMs), had an average initial discount rate of 1.76 percentage points and fees and points amounting to 0.5% of the loan amount. *Freddie Mac Releases Results of its 23rd Annual ARM Survey*, Freddie Mac (January 3, 200) available at http://www.freddiemac.com/news/archives/rates/2007/20070103_06armsurvey.html. An article detailing a survey of borrowers reported that subprime borrowers paid higher fees than prime borrowers. Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency*, 15 Housing Policy Debate 3, pp571533 (2004).

[30] *See* Interagency Guidance on Nontraditional Mortgage Product Risks at p. 9.

[31] The contingent nature of the deferral (borrowers have to stay in the loan until adjustment to experience its effects) are much like the contingent nature of the deferral of interest in payment option ARMs (where borrowers only feel the effects if they pay less than the full amount of interest due). In either case, the Interagency Guidance should require that lenders underwrite the loan to standards that ensure the borrower can payoff the loan should these contingencies occur.

[32] Richard Cowden, *Bies Says Regulators to Consider Principles, Not Products, if They Revise Loan Guidance*, BNA Banking Report, vol. 88 no. 02 (Jan. 15, 2007) at 56.

[33] Joe Adler, *In Brief: FDIC May Treat 2/28s Like Other Exotics*, American Banker, vol 171, no. 220 (November 15, 2006); Patrick Rucker, *U.S. bank regulators eye new mortgage guidance* (January 10, 2007).

[34] *See* David W. Berson, *Challenges and Emerging Risks in the Home Mortgage Business: Characteristics of Loans Backing Private Label Subprime ABS*, Presentation at the National Housing Forum, Office of Thrift Supervision (December 11, 2006).

[35] January 29, 2006 letter from CRL to North Carolina Office of the Commissioner of Banks, at 11. Available at CRL's website at http://responsiblelending.org/policy/regulators/.

[36] December 7, 2006 letter from U.S. Senators Paul S. Sarbanes, Wayne Allard, Christopher J. Dodd, Jim Bunning, Jack Reed, and Charles Schumer to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner, at 2.

[37] Vikas Bajaj and Christine Haughney, *Tremors At the Door -- More People with Weak Credit Are Defaulting on Mortgages*," New York Times (Fri. Jan. 26, 2007) C1, C4.

[38] Kirstin Downey, "Mortgage-Trapped: Homeowners with New Exotic Loans Aren't Always Aware of the Risk Involved," Washington Post (January 14, 2007).

[39] January 25, 2007 letter from CFAL to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner, at 3.

[40] *See e.g.*, Office of the Comptroller of the Currency, National Credit Committee, *Survey of Credit Underwriting Practices 2005.*The Office of The Comptroller of Currency (OCC) survey of credit

underwriting practices found a "clear trend toward easing of underwriting standards as banks stretch for volume and yield," and the agency commented that "ambitious growth goals in a highly competitive market can create an environment that fosters imprudent credit decisions." In fact, 28% of the banks eased standards, leading the 2005 OCC survey to be its first survey where examiners "reported net easing of retail underwriting standards." *See also* Fitch Ratings, 2007 Global Structured Finance Outlook: Economic and Sector-by-Sector Analysis (December 11, 2006).

[41] *See* Option One Prospectus, Option One Mortgage Loan Trust 2006-3 424B5 (October 19, 2006) available at: http://www.sec.gov/Archives/edgar/data/1378102/000088237706003670/d581063_424b5.htm; Fremont Investment and Loan Prospectus, Fremont Home Loan Trust 2006-1 424B5 (April 4, 2006) available at: http://www.sec.gov/Archives/edgar/data/1357374/000088237706001254/d486451_all.htm ; Morgan Stanley Prospectus, Morgan Stanley ABS Capital I Inc. Trust 2007-NC1 Free Writing Prospectus (January 19, 2007) available at: http://www.sec.gov/Archives/edgar/data/1385136/000088237707000094/d609032_fwp.htm; *Best Practices Won't Kill Production at New Century*, p. 3 Inside B&C Lending (November 24, 2006).

[42] *See, e.g.* "B&C Escrow Rate Called Low," *Mortgage Servicing News Bulletin* (February 23, 2005) "Servicers of subprime mortgage loans face a perplexing conundrum: only about a quarter of the loans include escrow accounts to ensure payment of insurance premiums and property taxes, yet subprime borrowers are the least likely to save money to make such payments....Nigel Brazier, senior vice president for business development and strategic initiatives at Select Portfolio Servicing, said only about 25% of the loans in his company's subprime portfolio have escrow accounts. He said that is typical for the subprime industry."

[43] *See*, e.g., "Attractive Underwriting Niches," Chase Home Finance Subprime Lending marketing flier, at http://www.chaseb2b.com/content/portal/pdf/subprimeflyers/Subprime_AUN.pdf (available 9/18/2006) stating " Taxes and Insurance Escrows are NOT required at any LTV, and there's NO rate add!", (suggesting that failing to escrow taxes is an "underwriting highlight" that is beneficial to the borrower). 'Low balling' payments by omitting tax and insurance costs were also alleged in states' actions against Ameriquest. *See, e.g.* State of Iowa, ex rel Miller v. Ameriquest Mortgage Co. et al, Eq. No. EQCE-53090 Petition, at ¶ 16(B) (March 21, 2006).

[44] *Partnership Lessons and Results: Three Year Final Report*, p. 31 Home Ownership Preservation Initiative, (July 17, 2006) at www.nhschicago.org/downloads/82HOPI3YearReport_Jul17-06.pdf.

[45] In fact, Fannie Mae and Freddie Mac, the major mortgage investors, require lenders to escrow taxes and insurance.

[46] See *Structured Finance*, note 21, p. 4.

[47] Mortgage Asset Research Institute, Inc., *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association*, p. 12, available at http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf (April 2006); *see also* 2007 Global Structured Finance Outlook: Economic and Sector-by Sector-analysis, FITCH RATINGS CREDIT POLICY (New York, N.Y), December 11, 2006, at 21, commenting that the use of subprime hybrid arms "poses a significant challenge to subprime collateral performance in 2007."

[48] Traditional Rate Sheet effective 12/04/06 issued by New Century Mortgage Corporation, a major subprime lender, shows that a borrower with a 600 FICO score and 80% LTV loan would pay 7.5% for a fully-documented loan, and 9.0% for a "stated wage earner" loan.

[49] *See* Interagency Guidance on Nontraditional Mortgage Product Risks, note 42.

[50] MBA Research Data Notes, "Residential Mortgage Origination Channels," September 2006.

[51] About one-third of the states have established, through regulation or case law, a broker's fiduciary duty to represent borrowers' best interests. However, many of these provisions are riddled with loopholes and provide scant protection for borrowers involved in transactions with mortgage brokers.

[52] Remarks by Federal Reserve Board Chairman Ben S. Bernanke at the Opportunity Finance Network's Annual Conference, Washington, D.C. (November 1, 2006).

[53] Joint Center for Housing Studies, "Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations," Harvard University at 4-5. Moreover, broker-originated loans "are also more likely to default than loans originated through a retail channel, even after controlling for credit and ability-to-pay factors." Id. at 42 (citing Alexander 2003).

[54] *Inside B&C Lending*, Inside Mortgage Finance, p. 2 (November 24, 2006).

[55] *Inside The GSEs* (Jan. 3, 2007), p. 4.

[56] Because of the Congressional charters of Fannie Mae and Freddie Mac, Congress requires each corporation to achieve public purposes that include the requirement that the GSEs devote a percentage of their business to three specific affordable housing goals: the Low- and Moderate-Income Housing Goal, which targets families with incomes at or below the area median income, the Special Affordable Housing Goal, which targets very low income families, and the Underserved Areas Housing Goal, which targets families living in low-income census tracts or in low- or middle-income census tracts with high minority populations. See http://www.hud.gov/offices/hsg/gse/gse.cfm

[57] Patrick Crowley, *Repurchases Stinging Subprime Sector*, MortgageDaily.com (Jan. 5, 2007).

[58] 15 USC Section 1639(l)(2).

[59] These limitations concern certain prepayment penalties, post-default interest rates, balloon payments, negative amortization, prepaid payments, ability to pay, and home improvement contracts. See subsections 129(c)-(i). High cost mortgages are those "referred to in section 103(aa)."

[60] Most subprime abuses occur with refinance loans rather than loans used to purchase a house (what HOEPA calls a "residential mortgage transaction", Sec. 152(aa)(1)). HOEPA's enumerated protections are limited to closed end refinance loans that meet the high cost standard. However, section (l) refers to "mortgage loans" generally, which would include purchase-money loans. The fact that section (l)(2) prohibitions are directed at two separate types of loans -- (A) those the Board finds to be unfair, deceptive, or designed to evade HOEPA, and (B) abusive refinancings -- provides evidence that subsection (A) includes purchase money loans as well.

[61] See S.1275, Section 129(i)(2): "PROHIBITIONS--The Board, by regulation or order, shall prohibit any specific acts or practices in connection with high cost mortgages that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section." Reported in 140 Cong. Rec. 3020, S3026. According to the Senate Report, No. 103-169, p. 27, "the legislation requires the Federal Reserve Board to prohibit acts or practices in connection with High Cost Mortgages that it finds to be unfair, deceptive, or designed to evade the provisions of this section."

[62] See House Conf. Rep. No. 103-652, p. 161, "the Board is required to prohibit acts and practices that it finds to be unfair, deceptive, or designed to evade the section and with regard to refinancing that it finds to be associated with abusive lending practices or otherwise not in the interest of the borrower."

[63] "The Conferees recognize that new products and practices may be developed to facilitate reverse redlining or to evade the restrictions of this legislation. Since consumers are unlikely to complain directly to the Board, the Board should consult with its Consumer Advisory Council, consumer representatives,

lenders, state attorneys general, and the Federal Trade Commission, which has jurisdiction over many of the entities making the mortgages covered by this legislation.

"This subsection also authorizes the Board to prohibit abusive acts or practices in connection with refinancings. Both the Senate and House Banking Committees heard testimony concerning the use of refinancing as a tool to take advantage of unsophisticated borrowers. Loans were "flipped" repeatedly, spiraling up the loan balance and generating fee income through the prepayment penalties on the original loan and fees on the new loan. Such practices may be appropriate matters for regulation under this subsection." Id.

Atty. No. 99000

IN THE CIRCUIT COURT OF COOK COUNTY, STATE OF ILLINOIS
COUNTY DEPARTMENT -- CHANCERY DIVISION

THE PEOPLE OF THE STATE OF ILLINOIS,	
Plaintiff,	
v.	
ONE SOURCE MORTGAGE, INC. and CHARLES G. MANGOLD, individually and as President of One Source Mortgage, Inc.	07CH34450
Defendants.	

COMPLAINT FOR INJUNCTIVE AND OTHER RELIEF

NOW COMES the Plaintiff, THE PEOPLE OF THE STATE OF ILLINOIS, by LISA MADIGAN, Attorney General of the State of Illinois, and complains of Defendants, ONE SOURCE MORTGAGE, INC. and CHARLES G. MANGOLD, individually and as President of One Source Mortgage, Inc. and respectfully states as follows:

JURISDICTION AND VENUE

1. This action is brought for and on behalf of THE PEOPLE OF THE STATE OF ILLINOIS, by LISA MADIGAN, Attorney General of the State of Illinois, pursuant to the provisions of the Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/1 *et seq.*, and her common law authority as Attorney General to represent the People of the State of Illinois.

2. Venue for this action properly lies in Cook County, Illinois, pursuant to Section 2-101 of the Illinois Code of Civil Procedure, 735 ILCS 5/2-101, in that the Defendants are doing business in Cook County, Illinois.

PARTIES

3. Plaintiff, THE PEOPLE OF THE STATE OF ILLINOIS, by LISA MADIGAN, Attorney General of the State of Illinois, is charged, *inter alia.*, with the enforcement of the Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/1 *et seq.*

4. Defendant ONE SOURCE MORTGAGE, INC. is a licensed Illinois mortgage brokerage company, holding mortgage broker license MB. 6759222 issued by the Illinois Department of Financial and Professional Regulations, Division of Banking. ONE SOURCE MORTGAGE has an office at 5372 North Milwaukee Avenue in Chicago, Il.

5. Defendant CHARLES G. MANGOLD is the President and sole officer of ONE SOURCE MORTGAGE. MANGOLD participates in, manages, controls, and has knowledge of the day-to-day activities of One Source Mortgage, including residential mortgage loan brokering activities and placement of advertisements in newspapers and direct mail solicitations. MANGOLD is sued individually and also in his capacity as President of ONE SOURCE MORTGAGE.

6. MANGOLD holds an Illinois loan originator certificate of registration (#031.0012220) issued by the Illinois Department of Financial and Professional Regulations, Division of Banking.

7. There exists and, at all time relevant hereto, has existed a unity of interest between ONE SOURCE MORTGAGE and CHARLES G. MANGOLD such that any individuality and separateness have ceased to exist. To adhere to such a fiction would sanction fraud and promote and injustice.

COMMERCE

8. Section 1(f) of the Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/1(f), defines "trade" and "commerce" as follows:

> The terms 'trade' and 'commerce' mean the advertising, offering for sale, sale, or distribution of any services and any property, tangible or intangible, real, personal, or mixed, and any other article, commodity, or thing of value wherever situated, and shall include any trade or commerce directly or indirectly affecting the people of this State.

Defendants are and were, at all relevant times hereto, engaged in trade and commerce in the State of Illinois, in that they offer mortgage brokerage services to the general public of the State of Illinois.

ONE SOURCE MORTGAGE, INC. AND CHARLES G. MANGOLD'S BUSINESS PRACTICES

9. Charles G. Mangold operates a mortgage loan brokering business, One Source Mortgage, Inc., that engages in unfair and/or deceptive acts and practices that violate Section 2 of the Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/2 and Section 2X of the Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/2X.

10. Since at least October 2003, Defendants have engaged in, and are presently engaged in, the business of offering mortgage brokerage services to the general public of the State of Illinois.

Advertising Practices

11. Defendants advertise their mortgage brokerage services, which include refinancing, to those who wish to obtain mortgage loans for the purchase of homes or lower their monthly mortgage payments.

12. Defendants solicit consumers through print advertisements and direct mailings.

13. For example, Defendants placed a full page advertisement in the Chicago-Sun Times for a closed-end line of credit of $235,000.00 for a monthly payment amount of $656.05. In small

print, the advertisement states "(with as little as 10% down, 620 full doc & 660 stated)." The advertisement also states, in even smaller print, "95% LTV, 40 yr AMTZ, OAC, 6.2% apr." This particular advertisement ran on or about December 5, 2005. This advertisement also represented that obtaining a mortgage loan from One Source would lower a consumer's monthly payments 40-50%. This advertisement is attached as Exhibit 1.

14. The advertisement does not disclose that this mortgage loan has an adjustable interest rate, so the interest rate will increase throughout the life of the mortgage loan.

15. The advertisement also does not disclose that the interest rate upon which the payment is based is only applicable for the first month of the mortgage loan.

16. In fact, if the borrower continues to make the advertised payment after the first month, the borrower will not pay any of the principal of the mortgage loan and will not even pay all of the interest that will accrue on the mortgage loan each month. This is not disclosed on the advertisement.

17. The advertisement does not disclose that, if the consumers fails to pay all the interest that accrues on the mortgage loan each month, the unpaid interest will be added to the balance of the mortgage loan due to negative amortization.

18. Likewise, on or about November 15, 2006, Defendants solicited consumers through a direct mailing for a closed end line of credit of $681,182.00 for a monthly payment amount of $1,898.54. At the top of this direct mailing was a simulated check in the amount of $681,182.00. The back of this direct mailing states, in small print, "**Based on 1 mth MTA Pay Option Arm 1.45% start rate, 40 yr amortization, adj. rate based on mthly MTA index + margin – (no taxe [sic], no ins.)." This direct mailing is attached as Exhibit 2.

19. This direct mailing does not disclose the annual percentage rate applicable to the advertised offer, it only discloses the simple interest rate for the offer.

20. This direct mailing also does not disclose the amount or percentage of the down payment required to obtain the advertised offer.

21. The direct mailing does not disclose, in readily understandable terms, that the interest rate upon which the payment is based is only applicable for the first month of the mortgage loan.

22. The direct mailing does not disclose that, after the first month, the payment of $1898.54 will not pay any of the principal of the mortgage loan and that it will not even cover all of the interest that accrues on the mortgage loan each month.

23. The direct mailing does not disclose, in readily understandable terms, that the unpaid interest will be added to the principal balance of the mortgage loan, causing negative amortization, or an increase in the mortgage loan balance, to occur.

Steering Consumers into Pay Option ARMS

24. Some consumers contact Defendants and are interested in particular types of mortgage loan products. Some of these consumers are first-time home buyers and other consumers are interested in refinancing their current mortgage loan. Of these consumers, some are interested in a mortgage loan with a fixed interest rate.

25. Defendants tell these consumers that fixed rate mortgage loans are too expensive for them.

26. Defendants promise that, if consumers accept a different type of mortgage loan, Defendants will refinance them into a fixed rate mortgage loan in a year or so.

27. With few exceptions, Defendants steer all of their consumers into one type of mortgage loan product for first lien mortgages: pay option adjustable rate mortgages. As sold by Defendants, this mortgage loan product has two distinctive features.

28. The first of these features is a one month "teaser" interest rate. This interest rate is extremely low, generally between 1 and 2%. This is only the interest rate on the mortgage loan for the first month of the loan. After that, the interest rate on the mortgage loan can change every month. The interest rate is based on a variable index plus a fixed margin. The product sold by Defendants typically uses the "MTA" index, also known as the 12 Month Treasury Average. This index is calculated by averaging the 12 previous monthly values of the actively traded United States Treasury Securities.

29. The second distinctive feature of the pay option ARM that Defendants originated is the possibility of negative amortization. With pay option ARMS, consumers are allowed to choose which among three payment types they will make each month. These payments are: principal and interest (fully amortizing the cost of the mortgage loan so that it will be paid off within the specified loan term); interest only (no principal paid); or the minimum payment.

30. The minimum payment is less than the amount of interest on the principal amount of the loan that accrues each month. If the minimum payment is made, negative amortization will occur. In other words, the difference between the amount of interest that the consumer pays and the amount of accrued interest will be added onto the principal balance of the mortgage loan each month. If a consumer makes the minimum payment, she will end up with a principal balance higher than the amount for which she originally contracted.

31. In addition to the one month teaser rate and negative amortization, Defendants' pay option ARMS generally have penalties for paying off the mortgage loan within the first three

years of origination. If a consumer pays off the mortgage loan within this time period, she will have to pay a penalty, generally six months interest. This penalty can be well over $10,000.

Up-Selling

32. Defendants engage in "up-selling." They steer credit-worthy borrowers into certain mortgage loans when the borrowers' credit history and profile would qualify the borrowers for better rates or lower costs. This also includes steering borrowers who qualify for "prime" mortgage loans into "subprime" mortgage loans.

Misrepresentations and Omissions Regarding Disclosure of Mortgage Loan Terms

33. Defendants misrepresent the terms of mortgage loans they broker in order to induce consumers to complete loan transactions. Consumers therefore enter into mortgage loan agreements based on the representations made by Defendants.

Interest Rate and Monthly Payment

34. When describing the pay option ARM to consumers, Defendants tell consumers the amount of only one payment, the minimum payment.

35. Defendants do not adequately describe to consumers the distinctive characteristics of pay option ARMS: the fact that the initial low interest rate is merely a one month teaser rate or that negative amortization will occur if the consumers pay only the minimum payment.

36. Defendants frequently do not disclose to consumers any interest rate for the mortgage loan at all.

37. On those occasions when Defendants do describe an interest rate, the only rate that they generally describe is the teaser rate.

38. Based on the Defendants' descriptions, some consumers believe that the teaser rate lasts beyond the first month of the mortgage loan. Some consumers even believe that the teaser rate is the interest rate for the life of the loan.

39. For example, Defendants told one consumer that he would have an interest rate of 0.0950% for the first year of his loan. After that, the interest rate would be 6.820%. In reality, the consumer's interest rate went up to 7.500% after the first month of the loan and, as of the date that this Complaint was filed, was at 9.125%.

40. Defendants told one consumer, for example, that the principal and interest payment on her first mortgage loan was $1196.22 and the principal and interest payment on her second mortgage loan was $161.25. As of August 2007, the principal and interest payment on this consumer's first mortgage loan is actually $2306.16 and the principal and interest payment on her second mortgage loan is $310.

41. Defendants told another consumer that the minimum payment covered all the interest on his loan. The consumer's minimum payment is roughly $700 a month. The consumer would have to pay $1816 to make even an interest only payment on his loan.

42. Consumers do not learn that Defendants' representations about their mortgage loans are false until they begin to receive bills from their mortgage lenders.

43. After the first monthly statement, consumers who have pay option ARMS generally receive a bill that has three payment coupons. The different coupons have amounts listed for a fully amortizing principal and interest payment, a payment that covers interest only, and a minimum payment.

44. The only payment that is close to the payment described by Defendants is the minimum payment.

45. Therefore, because Defendants told the consumers at loan origination that their payment would be a certain amount and the only payment close to that amount is the minimum payment, some consumers pay that amount, not understanding the consequences of that payment, that it will cause negative amortization.

46. On occasion, some consumers contact Defendants to figure out why their bills have multiple payment coupons. Instead of explaining the ramifications of the different payment coupons, Defendants tell the consumers to pay the amount closest to the payment Defendants promised while selling the loan.

Amortization

47. In addition to not adequately disclosing the interest rates and payments associated with consumers' mortgage loans, Defendants also misrepresent and omit facts about the negative amortization associated with pay option ARMS.

48. In the case of most consumers, Defendants do not tell them anything about the negative amortization feature of pay option ARMs and that negative amortization will result if the consumers make only the low monthly payment promised by Defendants.

49. Defendants do not even use the phrases "negative amortization" or "principal increase" while describing pay option ARMS to consumers.

Prepayment Penalties

50. Also, in some cases, Defendants either do not inform consumers about prepayment penalties associated with the consumers' loans or misrepresent the terms of the prepayment penalties.

51. Consumers are sometimes told that there are no prepayment penalties associated with their mortgage loans. Some consumers are told that it would be "no problem" for them to

refinance their loans, leaving the consumers with the impression that the loans had no prepayment penalty whatsoever.

52. In other cases, some consumers are told that their prepayment penalties are in effect for only one or two years.

53. When these consumers attempt to refinance their loan, they learn that there are prepayment penalties associated with their mortgage loans and/or that the prepayment penalty exists for three years and is as high as six months interest on the principal loan amount.

54. Many consumers are now unable to refinance mortgage loans brokered by Defendants because of these prepayment penalties.

55. Other consumers have managed to refinance mortgage loans brokered by Defendants, but had to pay thousands of dollars in penalties in order to do so.

Broker Compensation

56. Finally, Defendants do not disclose the compensation that they will receive from lenders in exchange for placing consumers in certain mortgage loans until the time of the closing.

57. This compensation is noted on consumers' final HUD-1 Settlement Statement – a document that the consumers do not receive until closing – as a YSP or "yield spread premium."

58. A yield spread premium is the cash rebate paid to a mortgage broker based on selling an interest rate above the wholesale par rate for which the consumer qualifies. The par rate is the actual interest rate a borrower qualifies for with a given lender. For example, if a mortgage broker offers a consumer a loan of $100,000 at an interest rate of 6.25%, and the consumer's par rate is 6%, the broker may earn a yield spread premium equal to 1.0% of the loan amount. This $1,000.00 fee is paid by the lender directly to the broker as a "rebate." Although the consumer is

not charged the fee directly, the consumer does pay the fee indirectly by paying a higher interest rate.

59. In the month of March 2006, for example, Defendants received at least $195,000 from lenders in the form of yield spread premiums.

60. In addition to the compensation Defendants receive indirectly from the borrowers, Defendants are also directly compensated by the borrowers for brokering their mortgage loans through loan origination fees. This compensation ranges from approximately $500 to well over $6000 in the form of fees at closing.

61. For example, one consumer paid Defendants $3095 in fees for brokering her mortgage loan. On the same loan, Defendants also received a $7800 yield spread premium payment from the lender of the loan.

62. Similarly, another consumer paid Defendants $4267.50 in fees for brokering her mortgage loan. On the same loan, Defendants also received $6035 yield spread premium from the lender.

63. Even at closing, Defendants do not explain what "yield spread premiums" are to consumers or that the payments are in exchange for putting the consumers into a mortgage loan at a higher interest rate than that for which they are qualified.

High Pressure Sales Tactics

64. Defendants rush consumers through the closing on their mortgage loans. Therefore, consumers do not have the opportunity to read the documents about their loans or ask questions about the features of their mortgage loans.

65. On average, most consumers' closings are less than thirty minutes. Some consumers had closings that lasted only ten or fifteen minutes.

66. When some consumers attempt to ask questions about their mortgage loans or review their mortgage loan documents, they are told that there is no need to pay attention to the documents.

67. One consumer was even told that "it would take two days to explain everything [about the mortgage loan] and we do not have two days" to complete the closing.

68. Because of Defendants' tactics, consumers feel pressure to complete the closing without understanding or even reading the mortgage loan documents they receive.

Refinancing Mortgage Loans into Loans with Less Favorable Terms

69. Defendants refinance consumers' mortgage loans multiple times.

70. Consumers are deceived into refinancing their mortgage loans by Defendants' promises that the new mortgage loans have lower payments or will allow them to use equity from their homes to pay off other debts.

71. As described above, Defendants do not adequately disclose the details about these consumers' mortgage loans to them. Defendants refinance many consumers into mortgage loans that have less favorable terms than their previous mortgage loans.

72. Consumers receive no benefit from refinancing their mortgage loans multiple times with Defendants.

73. Those consumers who refinance for a lower interest rate only receive that rate for one month, then the interest rate on their new mortgage loans has the potential to exceed the rate those consumers had on their original mortgage loan.

74. On at least one occasion, Defendants' errors caused a consumer's mortgage loan to be refinanced multiple times. For example, Defendants promised to broker a mortgage loan for a consumer in order to pay off his credit cards. Defendants were to arrange for the credit card

payoffs through disbursements from the mortgage loan proceeds. Defendants, however, failed to pay all of the creditors as promised. Although this was Defendants' error, Defendants told the consumer that he would have to refinance again in order to pay off additional credit cards. Defendants received thousands of dollars in fees for this second refinance. After the second refinance with One Source, Defendants again contacted the consumer, stating that they had found additional creditors. Defendants told the consumer he would have to go through a third refinance in order to pay off the newly found creditors. As before, Defendants received thousands of dollars in fees for this third refinance.

75. The only parties to truly benefit from these multiple transactions are Defendants, who receive thousands of dollars in compensation each time they refinance a mortgage loan.

Promises of Refinancing

76. Defendants promise to refinance the mortgage loans that they broker or originate to consumers at a later date into another mortgage loan on better terms and conditions.

77. Defendants generally do not follow through on their promise. Even if they do refinance a consumer's loan, they frequently put the consumer into another pay option ARM, instead of a fixed rate mortgage.

Misrepresentations on Loan Applications

78. Defendants falsify income information on consumers' Form 1003 loan applications without the consumers' knowledge.

79. Consumers typically tell Defendants their monthly income and even provide pay stubs and tax returns to Defendants to verify their income. On some consumers' loan applications, however, their monthly income is higher than what they tell Defendants, sometimes even double the correct amount.

80. For example, Defendants listed one consumer's monthly income as $9000 on her mortgage loan application. This consumer makes approximately $2200 a month and provided pay stubs and tax returns to Defendants to verify her income. This consumer was unaware that Defendants listed her income as $9000 and was surprised to find out that was the figure on her mortgage loan application.

STATUTORY PROVISIONS

81. Section 2 of the Illinois Consumer Fraud and Deceptive Business Practices Act (815 ILCS 505/2) provides that:

> Unfair methods of competition and unfair or deceptive acts or practices, including but not limited to the use or employment of any deception, fraud, false pretense, false promise, misrepresentation or the concealment, suppression or omission of any material fact, with intent that others rely upon concealment, suppression or omission of such material fact, or the use of employment of any practice described in Section 2 of the "Uniform Deceptive Trade Practices Act," approved August 5, 1965, in the conduct of any trade or commerce are hereby declared unlawful whether any person has in fact been misled, deceived or damaged thereby. In construing this section consideration shall be given to the interpretations of the Federal Trade Commission and the federal courts relating to Section 5(a) of the Federal Trade Commission Act.

82. Section 2X of the Illinois Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/2X, provides that

> It is an unlawful practice for any person to promote or advertise any business, product or interest in property by means of distributing documents designed to simulate checks or other negotiable instruments unless such instrument has printed upon both its front and back, the following statement: "This is not a Check". However, it is not an unlawful practice under this Section for a person to distribute for commercial purposes a sample or specimen of a check or other instrument which is used to solicit orders for the sale of that instrument and which is clearly marked as a non-negotiable sample or specimen.

83. Section 7 of the Consumer Fraud Act, 815 ILCS 505/7, provides in relevant part:

> a. Whenever the Attorney General has reason to believe that any person is using, has used, or is about to use any method, act or practice declared by the Act to be unlawful, and that proceedings would be in the public interest, he may bring an action in the name of the State against such person to restrain by preliminary or permanent injunction the use of such method, act or practice. The Court, in its discretion, may exercise all powers necessary, including but not limited to: injunction, revocation, forfeiture or suspension of any license, charter, franchise, certificate or other evidence of authority of any person to do business in this State; appointment of a receiver; dissolution of domestic corporations or association suspension or termination of the right of foreign corporations or associations to do business in this State; and restitution.
>
> b. In addition to the remedies provided herein, the Attorney General may request and this Court may impose a civil penalty in a sum not to exceed $50,000 against any person found by the Court to have engaged in any method, act or practice declared unlawful under this Act. In the event the court finds the method, act or practice to have been entered into with intent to defraud, the court has the authority to impose a civil penalty in a sum not to exceed $50,000 per violation.
>
> c. In addition to any other civil penalty provided in this Section, if a person is found by the court to have engaged in any method, act, or practice declared unlawful under this Act, and the violation was committed against a person 65 years of age or older, the court may impose an additional civil penalty not to exceed $10,000 for each violation.

84. Section 10 of the Consumer Fraud Act,815 ILCS 505/10, provides that "[i]n any action brought under the provisions of this Act, the Attorney General is entitled to recover costs for the use of this State."

85. The federal Truth in Lending Act, 15 U.S.C. §1664, requires the following for advertisements of closed end credit:

> ...(c) Rate of finance charge expressed as annual percentage rate

If any advertisement to which this section applies states the rate of a finance charge, the advertisement shall state the rate of that charge expressed as an annual percentage rate.

(d) Requisite disclosures in advertisement
If any advertisement to which this section applies states the amount of the downpayment, if any, the amount of any installment payment, the dollar amount of any finance charge, or the number of installments or the period of repayment, then the advertisement shall state all of the following items:

(1) The downpayment, if any.

(2) The terms of repayment.

(3) The rate of the finance charge expressed as an annual percentage rate.

86. Regulation Z, 12 C.F.R. §226.24, which interprets the federal Truth in Lending Act, 15 U.S.C. §1601 *et seq.*, provides the following regulations for the advertisement of closed end credit:

(a) Actually available terms. If an advertisement for credit states specific credit terms, it shall state only those terms that actually are or will be arranged or offered by the creditor.

(b) Advertisement of rate of finance charge. If an advertisement states a rate of finance charge, it shall state the rate as an "annual percentage rate," using that term. If the annual percentage rate may be increased after consummation, the advertisement shall state that fact. The advertisement shall not state any other rate, except that a simple annual rate or periodic rate that is applied to an unpaid balance may be stated in conjunction with, but not more conspicuously than, the annual percentage rate.

(c) Advertisement of terms that require additional disclosures.

(1) If any of the following terms is set forth in an advertisement, the advertisement shall meet the requirements of paragraph (c)(2) of this section:

(i) The amount or percentage of any downpayment.

(ii) The number of payments or period of repayment.

(iii) The amount of any payment.

(iv) The amount of any finance charge.

(2) An advertisement stating any of the terms in paragraph (c)(1) of this section shall state the following terms, as applicable:

(i) The amount or percentage of the downpayment.

(ii) The terms of repayment.

(iii) The annual percentage rate, using that term, and, if the rate may be increased after consummation, that fact.

Count I

Violation of Section 2 of the Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/2

87. Defendants engaged in unfair and/or deceptive acts or practices in the following:

Advertising Violations

88. Using advertising solicitations that:

a. Failed to clearly and conspicuously disclose the correct annual percentage rate (APR) applicable to the advertised offer;

b. Failed to disclose the amount or percentage of the down payment required for the advertised offer by stating two conflicting down payment amounts on the solicitation;

c. Failed to disclose the terms of the repayment of the advertised offer;

d. Failed to disclose that the interest rate on the advertised offer is only the interest rate for the first month of the mortgage loan;

e. Failed to disclose that the interest rate on the loan could adjust every month;

f. Failed to disclose that, if the consumer makes only the advertised payment, the consumer will not be paying any of the principal of the mortgage loan and will

also not be covering all of the interest that accrues on the mortgage loan each month;

g. Failed to disclose that the loan has the potential for negative amortization;

h. Failed to disclose the annual percentage rate (APR) applicable to the advertised offer, instead disclosing only the simply interest rate;

i. Failed to disclose at all the amount or percentage of the down payment required for the advertised offer,

j. Failed to disclose, clearly and conspicuously in a readily understandable manner, the terms of the repayment for this advertised offer.

k. Omitted some of the material terms of the advertised offer from the front side of the solicitation and placed those terms on the reverse;

l. Used a typeface and point size for material terms that was unreasonably small; and

m. Failed to disclose the terms of a mortgage loan in accordance with the requirements of the federal Truth in Lending Act, 15 U.S.C. §1601 *et seq.*, and 12 C.F.R. §226.24, which provide the minimum standards for uniform disclosure of mortgage terms, thus establishing a per se violation of Section 2 of the Consumer Fraud Act.

Loan Origination Violations

89. Engaging in the following misrepresentations and omissions in the origination of mortgage loans:

a. Misrepresented to consumers that they will offer the consumer the "best rate" One Source Mortgage, Inc. has to offer that consumer when, in truth and in fact, such is not the case;

b. Misrepresented to consumers that they could save money with lower payments with a One Source Mortgage, Inc. mortgage loan, when in fact the promised lower payment did not cover any of the principal and only portion of the interest that accrued each month on the mortgage loan;

c. Engaged in "up-selling," also known as placing a credit-worthy borrower in a mortgage loan when the borrower's credit history and profile would qualify the borrower for a better rate or lower costs;

d. Misrepresented the initial interest rate on the mortgage loan lasted longer than one month, when that rate in fact increased after the first month and at regular intervals thereafter;

e. Misrepresented that the negotiated minimum payment was the only payment the consumers had to make on the mortgage loan, although making that payment would not pay off any of the principal of the loan and would not cover the interest that accrued on the loan each month;

f. Failed to disclose that, if the consumers made the minimum payment on the mortgage loan, the principal of the mortgage loan would increase due to negative amortization;

g. Failed to disclose that the consumers would have different payment options aside from the minimum payment and what those different payment options would cover;

h. Failed to disclose, after being asked by consumers, the nature of the consumers' mortgage loans after the consumers received billing statements from their mortgage lenders that did not comport with what Defendants told the consumers about their mortgage loans;

i. Misrepresented to consumers who were concerned about the paying off their mortgage loans early that they would be able to refinance their mortgage loans, when in fact their loans had prepayment penalties;

j. Failed to disclose the yield spread premium that Defendants received for placing consumers in certain mortgage loans until closing;

k. Failed to disclose that the yield spread premium was a rebate that Defendants received from lenders for placing a consumer in a mortgage loan with an interest rate above the par rate for which the consumer qualified;

l. Failed to disclose that the consumer indirectly paid the yield spread premium to Defendants in the form of a higher interest rate;

m. Failed to disclose that the consumers paid Defendants twice for the origination of their mortgage loans, directly through origination fees and indirectly through the yield spread premium;

n. Misrepresented that consumers would benefit from refinancing their mortgage loans multiple times with Defendants when Defendants did not adequately disclose the details about these consumers' new mortgage loans to them and that these terms were less favorable than the terms of their previous mortgage loans.

o. Failed to disclose that consumers receive no benefit from refinancing their mortgage loans multiple times with Defendants;

p. Falsified income in consumers' Form 1003 loan applications; and

q. Engaged in the deceptive practice of rushing consumers through their closings, resulting in the consumers having no time to read and/or understand the mortgage loan documents that they were signing.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff respectfully prays for the following relief:

A. A finding that Defendants have engaged in and are engaging in trade or commerce within the meaning of Section 2 of the Illinois Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/2;

B. A finding that Defendants have engaged in and are engaging in acts or practices that constitute violations of Section 2 of the Illinois Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/2;

C. An order preliminarily and permanently enjoining Defendants from the use of acts or practices that violate the Consumer Fraud and Deceptive Business Practices Act including, but not limited to, the unlawful acts and practices specified above;

D. An order permanently enjoining Defendants from engaging in the trade or commerce of advertising, offering for sale, or the sale of residential mortgage loan brokering, loan originating, loan sales or servicing within the State of Illinois;

E. An order suspending and revoking Defendants' licenses, charters, franchises, certificates and all evidence of authority to do business in the State of Illinois, including but not limited to, its license issued pursuant to the Residential Mortgage Licensing Act;

F. An order requiring Defendants to make restitution to all consumers affected by the use of the above-mentioned unlawful acts and practices;

G. An order rescinding, reforming or revoking all contracts, loan agreements, notes or other evidences of indebtedness between Defendants and all Illinois consumers who were affected by the use of the above-mentioned unlawful acts and practices;

H. An order requiring Defendants to pay a civil penalty up to $50,000 for violating the Illinois Consumer Fraud and Deceptive Business Practices Act;

I. An order requiring Defendants to pay a civil penalty up to $50,000 for each violation of the Illinois Consumer Fraud and Deceptive Business Practices Act committed with the intent to defraud;

J. An order requiring Defendants to pay an additional civil penalty up to $10,000 per violation of the Illinois Consumer Fraud and Deceptive Business Practices Act found by the Court to have been committed against a person 65 years of age and older as provided in Section 7(c) of the Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/7(c);

K. An order requiring Defendants to pay the costs of this action; and

L. An order granting such further relief as this Court deems just, necessary, and equitable in the premises.

Count II

Violation of Section 2X of the Illinois Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/2X

1-89. Plaintiff realleges and incorporates Paragraphs 1-89 as if fully set forth herein.

90. Defendants violated Section 2X of the Consumer Fraud Act by using a simulated check in its direct mail solicitations that does not comply with the Consumer Fraud Act.

91. For example, Defendants disseminated a direct mailing on or about November 15, 2006 advertising a closed end line of credit of $681,182.00 for a monthly payment amount of $1,898.54.

92. At the top of this direct mailing, separated by dashed lines and resembling for all intent and purposes a real check, was a simulated check in the amount of $681,182.00.

93. Section 2X of the Illinois Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/2X, prohibits any person from promoting or advertising any business, product or interest in property by means of distributing documents designed to simulate checks or other negotiable instruments unless such instrument has printed upon both its front and back, the following statement: "This is not a Check."

94. The simulated check attached to the November 15, 2006 direct mailing had no disclosure on the front and back of the document stating that "[t]his is not a check."

95. The direct mail solicitation therefore violated 815 ILCS 505/2X.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff respectfully prays for the following relief:

A. A finding that Defendants have engaged in and are engaging in trade or commerce within the meaning of Section 2 of the Illinois Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/2;

B. A finding that Defendants have engaged in and are engaging in acts or practices that constitute violations of Section 2 of the Illinois Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/2;

C. An order preliminarily and permanently enjoining Defendants from the use of acts or practices that violate the Consumer Fraud and Deceptive Business Practices Act including, but not limited to, the unlawful acts and practices specified above;

D. An order permanently enjoining Defendants from engaging in the trade or commerce of advertising, offering for sale, or the sale of residential mortgage loan brokering, loan originating, loan sales or servicing within the State of Illinois;

E. An order suspending and revoking Defendants' licenses, charters, franchises, certificates and all evidence of authority to do business in the State of Illinois, including but not limited to, its license issued pursuant to the Residential Mortgage Licensing Act;

F. An order requiring Defendants to make restitution to all consumers affected by the use of the above-mentioned unlawful acts and practices;

G. An order rescinding, reforming or revoking all contracts, loan agreements, notes or other evidences of indebtedness between Defendants and all Illinois consumers who were affected by the use of the above-mentioned unlawful acts and practices;

H. An order requiring Defendants to pay a civil penalty up to $50,000 for violating the Illinois Consumer Fraud and Deceptive Business Practices Act;

I. An order requiring Defendants to pay a civil penalty up to $50,000 for each violation of the Illinois Consumer Fraud and Deceptive Business Practices Act committed with the intent to defraud;

J. An order requiring Defendants to pay an additional civil penalty up to $10,000 per violation of the Illinois Consumer Fraud and Deceptive Business Practices Act found by the Court to have been committed against a person 65 years of age and older as provided in Section 7(c) of the Consumer Fraud and Deceptive Business Practices Act, 815 ILCS 505/7(c);

K. An order requiring Defendants to pay the costs of this action; and

L. An order granting such further relief as this Court deems just, necessary, and equitable in the premises.

Respectfully submitted,

LISA MADIGAN, IN HER OFFICIAL CAPACITY AS ATTORNEY GENERAL OF ILLINOIS,

CHARLES G. FERGUS
Bureau Chief, Consumer Fraud

VERONICA L. SPICER
Assistant Attorney General

SHANTANU SINGH
Assistant Attorney General

LISA MADIGAN
Attorney General of Illinois

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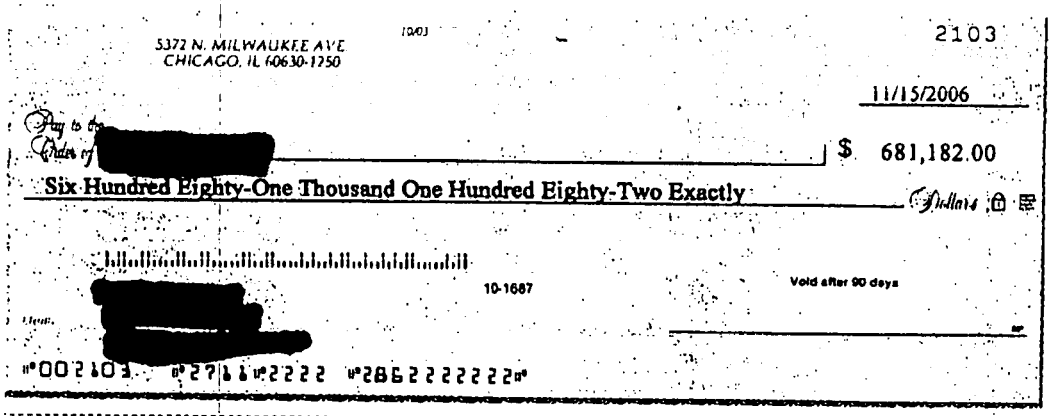


5372 N. MILWAUKEE AVE
CHICAGO, IL 60630-1250

2103

11/15/2006

Pay to the Order of [redacted] $ 681,182.00

Six Hundred Eighty-One Thousand One Hundred Eighty-Two Exactly Dollars

10-1687

Void after 90 days

[redacted]

Mr./Mrs. [redacted]

CONGRATULATIONS

You are preapproved for a new payment of

$ $1,898.54

Based on the loan amount shown above on the check

No Gimmicks!!! No Games!!!

Just 1 phone call

877-585-2005

My name is Chuck Mangold and I am the President of One Source Mortgage. Unlike other mortgage brokers who are only interested in refinancing your mortgage now, my main goal is to give my client's choices, examine their whole financial picture and offer sound financial solutions for now and into the future.

My ultimate goal is to make all my clients MILLIONAIRES! This may sound like an unrealistic goal, but I can show you how I've turned many of my current clients into millionaires last year alone. I do so by showing them how to make financially savvy decisions in these economically changing times. By just taking one hour a week, you can use real estate to *dramatically* improve your net worth!

If you are not looking to become an investor, but just want to save hundreds of dollars every month I can help you with that almost immediately.

I take much pride in my work and excel in what I do! If you are already seeking mortgage solutions, call me! Let me show you how a few minutes of your time could very well translate into a lifetime of savings! I look forward to speaking with you. Make it a priority to call me today; you will be glad you did!!!

Talk to you soon,

Chuck Mangold

One Source Mortgage

Equal Housing Opportunity

One Source Mortgage EQUAL HOUSING OPPORTUNITY MB.6759222
An Illinois Residential Mortgage Licensee....Equal Housing Lender
5372 N. Milwaukee Ave. Chicago, IL 60630
PHONE: 877-585-2005 FAX: 773-594-6970
www.1sourcemortgage.net

PLAINTIFF'S EXHIBIT 2

[redacted]

[redacted]

[redacted]

You can choose to stop receiving "prescreened" offers of credit from this and other companies by calling toll-free 1-888-5OPT OUT. See PRESCREEN & OPT-OUT NOTICE below for more information about prescreened offers.

PRESCREEN & OPT-OUT NOTICE

This "prescreened" offer of credit is based on information in your credit report indicating that you meet certain criteria. This offer is not guaranteed if you do not meet our criteria. If you do not want to receive prescreened offers of credit from this and other companies, call Equifax toll-free at 1-888-5OPT OUT; or write: **Equifax Options, P.O. Box 740123 Atlanta, GA 30374-0123**

** Based on 1 mth MTA Pay Option Arm, 1.45% start rate, 40 yr amortization, adj. rate based on mthly MTA index + margin- (no taxe, no ins.)

CENTER FOR RESPONSIBLE LENDING

INDYMAC: WHAT WENT WRONG?

How an "Alt-A" Leader Fueled its Growth with Unsound and Abusive Mortgage Lending

CRL Report
June 30, 2008

Mike Hudson

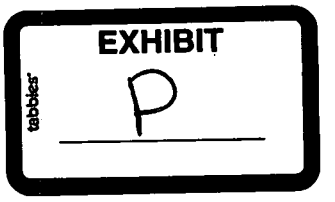
In Brief: IndyMac's story offers a body of evidence that discredits the notion that the mortgage crisis was caused by rogue brokers or by borrowers who lied to bankroll the purchase of bigger homes or investment properties. CRL's investigation indicates many of the problems at IndyMac were spawned by top-down pressures that valued short-term growth over protecting borrowers and shareholders' interests over the long haul.

> *"...I would reject a loan and the insanity would begin. It would go to upper management and the next thing you know it's going to closing."*
> —Audrey Streater, former Indymac underwriting team leader in an interview with CRL.

About the Center for Responsible Lending

The Center for Responsible Lending (CRL) is a national nonprofit, nonpartisan research and policy organization dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, the nation's largest community development financial institution.

For additional information, please visit our website at **www.responsiblelending.org**.



Ben Butler, an 80-year-old retiree in Savannah, Georgia got an IndyMac loan in 2005 to build a modular house. IndyMac okayed the mortgage based on an application that said Mr. Butler made $3,825 a month in Social Security income.

One problem: The maximum Social Security benefit at the time was barely half that. Mr. Butler had no idea his income had been inflated by IndyMac or the mortgage broker who arranged the deal, his attorney maintains. Even if IndyMac wasn't the one that puffed up the dollar figure, the attorney says, it should have easily caught such an obvious lie.[1]

Simeon Ferguson, an 86-year-old retired chef, ran into similar problems with an IndyMac loan in Brooklyn, New York.

His attorneys claim a mortgage broker steered Mr. Ferguson, who was suffering from dementia, into an IndyMac "stated income" loan program for retirees. IndyMac made no effort to verify retirees' income, attempting to duck accountability "by deliberately remaining ignorant of the borrower's ability to pay the mortgage," his lawsuit says. IndyMac's instructions for preparing the mortgage application required that "the file must not contain any documents that reference income or assets."[2]

In the case of **Elouise Manuel**, a 68-year-old Decatur, Georgia retiree, IndyMac instructed the mortgage broker to send copies of her Social Security award letters with the dollar amounts expunged: "Need copy of SSI letter blacked out for the last 2 yrs w/no ref to income."[3]

Each time, the result was the same: borrowers trapped in loans they couldn't afford.

They are not alone. An investigation by the Center for Responsible Lending has uncovered substantial evidence that IndyMac Bank and its parent, IndyMac Bancorp, engaged in unsound and abusive lending during the mortgage boom, routinely making loans without regard to borrowers' ability to repay. These practices left many deep in debt and struggling to avoid foreclosure.

CRL interviews with former employees and lawsuits in 10 states indicate that IndyMac

- pushed through loans based on bogus appraisals and income data that exaggerated borrowers' finances;
- worked hand-in-hand with mortgage brokers who misled borrowers about their rates and other loan terms and stuck them with unwarranted fees; and
- treated many elderly and minority consumers unfairly.

In interviews and court documents, 19 former employees describe an atmosphere where the hunger to close loans ruled. They say IndyMac pushed through loans with fudged or falsified information or simply lowered standards so dramatically that shaky loans were easy to approve.

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[1] Letter, Scott Vaughan, attorney at law, to Clarice Paschel, IndyMac, October 8, 2007.
[2] Ferguson v. IndyMac Bank, U.S. District Court for the Eastern District of New York, filed February 14, 2008.
[3] Manuel v. American Residential Financing, Inc., et al, Superior Court of Gwinnett County, State of Georgia, April 3, 2008.

Most of these ex-employees were mortgage underwriters who were responsible for reviewing loan applications to make sure information was accurate and that borrowers could afford the deals. Many say their efforts to do their jobs were hamstrung by higher-ups.

"I would reject a loan and the insanity would begin," Audrey Streater, a former underwriter and underwriting team leader for IndyMac in New Jersey, said in an interview with CRL. "It would go to upper management and the next thing you know it's going to closing. . . . I'm like, 'What the Sam Hill? There's nothing in there to support this loan.' "[4]

Disneyland loans

Like many other lenders during the housing and mortgage boom of 2003-2006, IndyMac moved away from documenting borrowers' incomes and assets – basic information that's crucial to determining whether consumers can afford a loan.

Take, for example, a $354 million pool of mortgages that IndyMac packaged into a mortgage-backed securities deal in June 2006. Less than 10% of the dollar volume involved "full-documentation" loans. The rest involved low or no-documentation loans -- mostly "stated income" loans in which borrowers' income was simply affirmed without supporting evidence such as tax documents or pay stubs.[5]

As recently as the first quarter of 2007, just 21% of IndyMac total loan production involved "full-doc" mortgages.[6]

As IndyMac lowered standards and pushed for more volume during the mortgage boom of 2003-2006, the quality of loans became a running joke among its employees, according to a former IndyMac fraud investigator who is cited as a "confidential witness" in a lawsuit in California.[7] The investigator says shoddily documented loans were known inside the company as "Disneyland loans" – in honor of a mortgage issued to a Disneyland cashier whose loan application claimed an income of $90,000 a year.

Another witness cited in the case, a former IndyMac vice president, claims chief executive Michael Perry and other top managers focused on increasing loan volume "at all costs," putting pressure on subordinates to disregard company policies and simply "push loans through."

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[4] Audrey Streater, telephone interview, Center for Responsible Lending.

[5] IndyMac INDX Mortgage Loan Trust 2006-FLX1, Prospectus dated June 14, 2006. A check of two other IndyMac loan pools put together around the same time show a higher percent of "full-doc" loan volume – 16% to 26%.

[6] IndyMac Bancorp Inc., 8K filing with Securities and Exchange Commission, May 12, 2008. IndyMac has now moved decidedly back in the direction of fully documenting borrowers income and other particulars, with 69% of its loan volume in March 2008 involving "full-doc" mortgages.

[7] Tripp et al v. IndyMac et al, U.S. District Court for the Central District of California, filed March 12, 2007. Unless otherwise indicated, all references to Tripp v. IndyMac refer to the "Third Amended Class Action Complaint" that was filed with the court on June 6, 2008.

Another former employee quoted in the suit claims Perry told him "business guys rule" and "[expletive deleted] you to compliance guys." As a result, this ex-employee claims, IndyMac was about "production and nothing else."

The company says the ex-employees' statements in the lawsuit are a mishmash of hearsay and speculation, and says the suit is "long on words but short of substance" and full of "meaningless filler."[8] The company says the simple truth is that it suffered rising borrower defaults and plunging profits not because management pushed through bad loans, but because the company "got caught in the same financial hurricane that affected every other participant in the mortgage and housing industries."[9]

IndyMac also denies wrongdoing in other lawsuits that it's battling around the nation. At this point, these cases are still wending their way through the legal process and haven't been proven in court, so the allegations remain just that – allegations.

"A much more responsible way"

The company says it supports "responsible lending that is free of unfair or deceptive acts or practices." It says it was a leader in providing clear disclosures to borrowers about the potential for "payment shock" as adjustable rate loans reset. And it says its pricing disclosures are designed to make sure borrowers understand what they're getting.[10]

And while it acknowledges it "loosened its lending standards along with everyone else" in an effort to "compete and grow," it says it did so "in a much more responsible way" than other lenders.[11]

"IndyMac and most home lenders were not 'greedy and stupid,' " IndyMac CEO Perry told shareholders in February. "Most of us believe that innovative home lending served a legitimate economic and social purpose, allowing many US consumers to be able to achieve the American dream of homeownership . . . and we still do."[12]

Perry said a good part of the blame for the company's problems lies with forces outside its control, including the fall in prices of mortgage-backed investments packaged by Wall Street and the huge decline in home prices and home sales.[13]

He's also lashed out at "house flippers" who took advantage of lenders' easy-credit policies. When IndyMac announced more than $200 million in losses for the third quarter of 2007, Perry

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[8] Tripp v. IndyMac.
[9] Tripp v. IndyMac.
[10] Letter from Richard Wohl, president, IndyMac Bank, to U.S. Office of Thrift Supervision, November 5, 2007. http://www.ots.treas.gov/docs/9/962970.pdf.
[11] Matt Padilla, "Lenders and their creative accounting; Part I, IndyMac answers questions about loan losses," Orange County Register, May 12, 2007. http://mortgage.freedomblogging.com/2007/05/12/lenders-and-their-creative-accounting-part-i-indymac-answers-questions-about-loan-losses/
[12] Business Wire, "IndyMac Issues 2007 Annual Shareholder Letter," February 12, 2008.
[13] "2007 Annual Shareholder Letter."

blamed these fast-buck artists for his company's financial stumbles. "A lot of speculators crept into the market – people who lied about their intent to live in the homes," he told the *Los Angeles Times*. Many used second mortgages – known as "piggyback" loans – to snap up houses without having to put any money down, Perry said. As home values swooned, he added, these speculators had little incentive to keep paying their mortgages.[14]

Some insiders paint a different picture. They describe IndyMac as less a victim than a facilitator of bad practices. The former vice president quoted in California court documents claims Perry and other top executives were aware that fraud and lying were rampant in the company's loan-approval process.[15] Another ex-employee – the former fraud investigator – claims that the vice president in charge of the company's fraud investigation department was pressured by upper management not to report fraud, and in one case was pressured to "sanitize" a report on the company's loan pipeline.[16]

THE COMPANY: Why IndyMac is important

IndyMac is a case study in the rise and fall of America's mortgage market. Its story offers a body of evidence that discredits the notion that the mortgage crisis was caused by rogue brokers or by borrowers who lied to bankroll the purchase of bigger homes or investment properties. CRL's investigation indicates many of IndyMac's problems were spawned by top-down pressures that placed short-term growth ahead of borrowers' and shareholders' interests over the long haul.

In this sense, the Pasadena, California-based company has much in common with its rival and one-time parent, Countrywide Financial Corp.,[17] and other lenders that grew wildly before falling on hard times.

IndyMac by the numbers

	Total loan production by year in billions	Mortgage industry market share	Return on average equity
2003	$29	0.8%	17%
2004	$38	1.4%	17.4%
2005	$61	2.0%	21.2%
2006	$90	3.3%	19.1%
2007	$77	3.3%	-31.1%

SOURCES: IndyMac filings with Securities and Exchange Commission

[14] E. Scott Reckard, "IndyMac's loss much wider than expected," *Los Angeles Times*, November 7, 2007.
[15] Tripp v. IndyMac.
[16] Tripp v. IndyMac.
[17] Center for Responsible Lending, "Unfair and Unsafe: How Countrywide's irresponsible practices have harmed borrowers and shareholders," February 7, 2008. http://www.responsiblelending.org/pdfs/unfair-and-unsafe-countrywide-white-paper.pdf.

IndyMac's lending volume and profits soared during the mortgage boom. Loan volume tripled in three years, approaching $90 billion in 2006. It grew far faster than most of its competitors; its share of the national mortgage market increased from 0.77% to 3.30% over that span. Profits more than doubled over those three years, hitting $343 million in 2006.

In 2007 and 2008, however, it suffered a dramatic reversal of fortune. IndyMac's "non-performing assets"– bankspeak for loans that have gone bad – have been growing at a steep rate. The firm's dollar volume of non-performing assets exploded 11-fold in 15 months – going from $184 million (0.63% of assets) at the close of 2006 to $2.1 billion (6.51% of assets) at the end of the first quarter of 2008.[18] IndyMac generally defines "non-performing assets" as loans that are at least 90 days overdue or in foreclosure.

As a result of the growing numbers of bad loans and a drop in mortgage originations, IndyMac posted a $615 million loss in 2007, and a $184 million loss in the first three months of 2008. That combined loss of nearly $800 million over 15 months means that it has more than given back all of the $636 million in profits it posted in 2005-2006, at the height of the mortgage boom.

Meanwhile, IndyMac's stock price, which hit its highest level ever at the end of 2006, topping $45, has plummeted, falling below one dollar as of June 26, 2008. Long-time shareholders have lost some 95% of their value in just over two years.

The company has eliminated riskier products such as low documentation Alt-A loans and "piggy back" loans[19], and Michael Perry continues to express optimism that the company will turn things around once the housing market improves.

Alt-A empire

IndyMac's record is also worth scrutinizing because of the ways it differs from many lenders involved in the mortgage mess.

For one thing, IndyMac's specialty was not subprime loans, but so-called Alt-A loans. While subprime loans were supposed to go to borrowers with the weakest credit profiles, Alt-A loans were generally supposed to be aimed at borrowers who had better credit but couldn't document all their income or assets. These borrowers paid higher rates than traditional prime borrowers, but lower rates than subprime borrowers.

No lender was more steeped in the Alt-A market than IndyMac. In 2006, IndyMac ranked number one in the nation among Alt-A lenders, producing $70 billion in volume, or 17.5% of the Alt-A market.[20] Nearly four-fifths of IndyMac's mortgage volume during that span involved Alt-A loans.[21]

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[18] IndyMac Bancorp, Form 8K report to Securities and Exchange Commission, May 12, 2008.
[19] IndyMac Bancorp, Inc., 10K Report to Securities and Exchange Commission 2007, Feb. 29, 2008.
[20] 2007 Mortgage Market Statistical Annual – Volume I," Inside Mortgage Finance.
[21] According to Inside Mortgage Finance, Countrywide was close behind in Alt-A volume, at $68 billion, but that figure represented a much smaller slice -- 15% -- of Countrywide's mortgage production.

Over the past year, much attention has been focused on subprime loans, with references to catch phrases such as "subprime meltdown." Alt-A lenders struggled to distance themselves from subprime. In early 2007, Perry argued that Alt-A lenders were being unfairly lumped in with subprime.[22]

But many of the practices prevalent in the subprime market – including bait-and-switch salesmanship and slapdash underwriting – also appear to have been common in the Alt-A sector. Rising defaults have shown that the Alt-A business wasn't as immune from problems as its proponents argued. As of February 2008, roughly one in seven Alt-A loans nationwide on owner-occupied homes were at least 30 days late, in foreclosure, or already in repossession, according to the Federal Reserve Bank of New York.[23]

Taxpayers at risk?

IndyMac is also worthy of note because it didn't rely as heavily on Wall Street financing as many of the lenders that got into trouble. IndyMac did sell the vast majority of its loans to Wall Street so they could be packaged into mortgage-backed securities investment deals. However, it depended less than many lenders on up-front lines of credit from Wall Street to bankroll its loans before they were sold to investors.

Instead, IndyMac has increasingly relied on federally-insured customer deposits and borrowings from the Federal Home Loan Bank (FHLB) system:

- Its deposits jumped from $4.4 billion at the end of 2003 to $18.9 billion as of March 31, 2008.
- Its FHLB borrowings grew from $4.9 billion at the end of 2003 to $10.4 billion as of March 31, 2008.
- Together, those two sources of funding represented roughly 94% of its total liabilities on March 31, 2008, up from 79% in March 2007.[24]

Initially, IndyMac's use of federally-guaranteed sources of funds made the company less vulnerable to the credit crunch than many other lenders, which went under when Wall Street firms cut-off their lines of credit. However, IndyMac's reliance on capital from the Federal Home Loan Bank system, and on deposits that are backed by the FDIC, puts the federal government in the position of bankrolling loans that may be abusive. It also puts the system at risk of significant losses as loans go bad.

U.S. Senator Charles Schumer has told federal regulators that he's "concerned that IndyMac's financial deterioration poses significant risks to both taxpayers and borrowers and that the

[22] Herb Greenberg, "IndyMac's Optimism Will Be Put to Test," Wall Street Journal, August 18, 2007.
[23] Federal Reserve Bank of New York, "Nonprime Mortgage Conditions in the United States," January 2008.
[24] IndyMac Bancorp, Inc., Form 10Q Report to Securities and Exchange Commission, May 12, 2008.

regulatory community may not be prepared to take measures that would help prevent the collapse of IndyMac or minimize the damage should such a failure occur."[25]

EMPLOYEES: Working for IndyMac

Audrey Streater worked in the mortgage business for three decades. She can remember a time – perhaps a decade ago – when mortgage underwriters "reigned in fear." When an underwriter gave thumbs up or thumbs down to a loan, it meant something.[26]

"Underwriter was spelled G-O-D, and our expertise and our knowledge was taken seriously," Streater recalls wistfully.

Things changed. In recent years, she says, underwriting became window dressing -- a procedural annoyance that was tolerated because loans needed an underwriter's stamp of approval if they were going to be sold to investors.

That was prevailing attitude at IndyMac during the mortgage boom, but also at other lenders too, she and several other former IndyMac underwriters say. A big problem, they say, were "stated income" loans that required no documentation of the borrowers' wages. They say these loans allowed outside mortgage brokers and in-house sales staffers to inflate applicants' incomes and make them look like better credit risks.

Even loans that IndyMac billed as "full-documentation" deals may not have been all that IndyMac presented them to be, according to one lawsuit.[27] The suit says some of IndyMac's "full doc" loans were supported not by W-2s or pay stubs but by a verification of employment form -- paperwork that confirms a borrower has a job but doesn't authenticate his or her income. The suit quotes a February 2006 IndyMac document that says, in bold letters, "**IndyMac NonPrime will accept a Verification of Employment for a full documentation loan with no pay stubs or W2s needed!**"

When underwriters tried to block questionable loans, several ex-employees say, brokers and salespeople went over their heads to management to overturn loan denials. Upper management at the company's Pasadena headquarters "probably got more involved than they should be," Streater says.

"It was the nature of the beast that Pasadena created," she adds. "The broker was always right. If the broker decided to fight it, chances were more than not that he would win."

"A wonderful company"

In all, CRL interviewed 14 former IndyMac employees.

Three said they didn't notice undue pressure to close loans during their time at the company. "It was a wonderful company to work for. There was never any pressure to push loans through," says

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[25] James R. Hagerty, "Schumer Asks Regulators For Greater IndyMac Scrutiny," Wall Street Journal, June 26, 2008.
[26] Audrey Streater, telephone interview with Center for Responsible Lending.
[27] Tripp v. IndyMac.

Maisha Smith, a loan conditions specialist for IndyMac in California in 2004 and 2005. She says the company had strong fraud controls designed to catch bad loans.

Eleven others told CRL that the company funded loans without enough regard for borrowers' ability to repay. In addition, eight more ex-employees are quoted in the California lawsuit describing internal pressures to approve dicey loans.[28] All of them are identified as unnamed "confidential informants." Included among them are two former vice presidents and a former senior auditor, the suit says.

In court papers, IndyMac dismisses the eight former workers as mostly lower-level, short-term employees who had no knowledge of top managers' thinking.[29] Rather than identifying fraud, the company says, these former employees simply "disagree with the policies they believe IndyMac undertook" to pursue a share of the rising mortgage market.

Almost all of the ex-employees interviewed by CRL were underwriters who worked at the company amid the nationwide mortgage surge. Streater came to IndyMac's Marlton, N.J., location as an underwriter in 2005, then worked as a team lead underwriter from 2006 until she left in mid-2007, supervising eight other underwriters.

IndyMac's underwriters were loyal and proud, Streater says, but many got worn down by the pressure to book loans. Many were stymied, afraid to make decisions because "somebody is going to yell at you," she says. Some "were making decisions based on: 'I might as well do this because it's going to get approved anyway.' "

Tamara Archuletta, who was an underwriter for IndyMac in Arizona in 2006 and 2007, recalls one inexperienced underwriter who declared: "It's not my money. I don't care."[30]

"Slap in the face"

Wesley E. Miller, who worked as an underwriter for IndyMac in California from 2005 to 2007, says that when he rejected a loan, sales managers screamed at him and then went up the line to a senior vice president and got it okayed.[31] "There's a lot of pressure when you're doing a deal and you know it's wrong from the get-go – that the guy can't afford it," Miller told CRL. "And then they pressure you to approve it."

The refrain from managers, Miller recalls, was simple: "Find a way to make this work."

Scott Montilla, who worked as an underwriter for IndyMac in Arizona around the same time as Achuletta, says that when salespeople went over his head to complain about loan denials, higher-ups overruled his decisions roughly half the time.[32]

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[28] Tripp v. IndyMac.
[29] Tripp v. IndyMac.
[30] Tamara Archuletta, telephone interview with Center for Responsible Lending.
[31] Wesley E. Miller, telephone interview with the Center for Responsible Lending.
[32] Scott Montilla, telephone interview with Center for Responsible Lending.

"I would tell them: 'If you want to approve this, let another underwriter do it, I won't touch it – I'm not putting my name on it,' " Montilla says. "There were some loans that were just blatantly overstated. . . . Some of these loans are very questionable. They're not going to perform."

In some instances, he adds, he was forced to approve loans that later went into default – and as a result he had points subtracted from his performance score for bad deals he'd tried to block.

"There were very good underwriters in that company," Streater, the New Jersey underwriter, says. "They just ran roughshod over them. . . . To turn around and hold them responsible for those delinquencies is the ultimate slap in the face."

BORROWERS: In IndyMac's debt

Willie Lee Howard grew up as one of 14 children in a sharecropping family near the rural crossroads of Snow Hill, N.C. He attended school sporadically until the end of seventh grade, when his father pulled him out so he could work in the fields. As a young man in the 1960s, he migrated north to Washington, D.C., where he picked up work as a construction laborer. He's put off retirement and, at age 65, continues to work construction, making $15.89 an hour. He tries to put in as much overtime as he can.

In the spring of 2000, he used a government-subsidized loan to buy a small two-bedroom, one-bath house in Northeast Washington. Eight years later, he's battling to save his home in court. He was the victim of a series of predatory mortgage refinances made by four name-brand lenders that "took advantage of his illiteracy and lack of sophistication in financial matters," according to a lawsuit filed for him by the AARP Foundation, CRL, and private attorneys.[33]

IndyMac is one of the lenders.

Howard agreed to the IndyMac loan after getting a telephone solicitation from a mortgage broker working on IndyMac's behalf. Mr. Howard made it clear to the mortgage broker that he could not read or write, but his loan application erroneously claimed he had had 16 years of education.

As part of the deal, IndyMac paid the mortgage broker a $3,895 "yield spread premium" – industry jargon for an incentive payment that rewards the broker for putting borrowers into loans with a higher rates or fees than they qualify for. The December 2005 loan had an initial teaser rate of 1.25% that evaporated after less than two months and rose to 6.58%, and could climb as high as 9.95% over the life of the loan.

Because it was a so-called Payment Option ARM, he was given a choice of four different payments. The lowest was the $621.03 he was quoted at closing. That was barely half of the amount need to cover the monthly interest on the loan, meaning that the rest of the interest was tacked onto the loan and the amount he owed would keep going up rather than going down. The loan included a prepayment penalty, which forced Mr. Howard to pay thousands of dollars to get out of his IndyMac loan when he refinanced with another lender a few months later.

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[33] Personal details and allegations are from Howard v. Countrywide Home Loans Inc. et al, U.S. District Court for the District of Columbia, March 25, 2008. Along with IndyMac and Countrywide, other lenders named as defendants include Washington Mutual Bank and WMC Mortgage Corporation.

The lawsuit alleges IndyMac violated federal and D.C. law by failing to properly disclose the loan's terms and putting him into a loan he was unable to repay. In court papers, IndyMac denies Mr. Howard's claims and suggests he has "unclean hands" in the matter.

Bait and switch

Mr. Howard's allegations echo those in other legal claims against IndyMac. Lawsuits accuse IndyMac of working with independent mortgage brokers to land borrowers into predatory loans. Several of the lawsuits claim that borrowers were bamboozled by brokers who promised low, low rates that would last a year or even five years. Instead, the lawsuits say, the teaser rate evaporated within one or two months.

A lawsuit in federal court in New York says the complexity of IndyMac's Payment Option ARM – along with its low teaser rates and low initial payments -- make it "an ideal product to mislead borrowers" with promises of "low interest rates" and "low payments."[34]

Another lawsuit claims Perry and other IndyMac executives "knew or should have known" that numerous mortgage brokers were duping borrowers and pushing them into IndyMac Option ARMs that weren't suitable for them.[35] In its "zeal to close loans at all costs," the lawsuit says, management created procedures that "placed speed, efficiency and profitability above making reasonably sure that their borrowers were not being defrauded into taking out these Option ARM loans."

In federal court in Pennsylvania, William and Emma Hartman claim a mortgage broker manipulated them into taking out an IndyMac loan by falsely promising their interest rate and monthly payments would *decrease* in a year or less.[36] Other complaints alleging bait-and-switch tactics by IndyMac and its brokers have been filed in Virginia[37], Colorado[38], Maine[39], Missouri[40] and California.[41]

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[34] Ferguson v. IndyMac Bank, U.S. District Court for the Eastern District of New York, filed February 14, 2008.

[35] Zurawski v. Mortgage Funding Corp. et al, U.S. District Court for the District of New Jersey February 13, 2008.

[36] Hartman v. Deutsche Bank National Trust Co. et al, U.S. District Court for the Eastern District of Pennsylvania, December 24, 2007.

[37] Mitchell v. IndyMac Bank, U.S. District Court for the Eastern District of Virginia, February 19, 2008. Andre and Christine Mitchell claim they were misled about the costs of the loan and weren't given the legally required disclosures laying out the loan terms.

[38] Brannan v. IndyMac Bank, U.S. District Court for the District of Colorado, June 15, 2006. Donna and Donald Brannan claim they specified they didn't want a loan with "negative amortization," in which the loan balance keeps growing because the payments don't fully cover the interest. Instead, the suit says, the broker stuck them in "the exact loan they were trying to avoid." In court papers, IndyMac said any losses the Brannans may have suffered "were the result of the conduct of third parties over whom IndyMac had no control." The case was settled on undisclosed terms in 2007.

[39] Darling v. IndyMac Bancorp, U.S. District Court for the District of Maine, October 3, 2006. Joseph and Roxanne Darling allege a mortgage broker dangled the lure of a 1% IndyMac loan and, in the face of their doubts, "continued to assure them that the loan was truly a one-percent loan and was not 'too good to be true.' " The Darlings claim they were given confusing and contradictory loan disclosures and that their monthly payment wasn't what they'd been promised. IndyMac said in court papers that any mistakes in the

IndyMac denies the allegations in these lawsuits. It maintains that it goes to great lengths to make sure borrowers know what they're getting. IndyMac Bancorp president Richard Wohl told financial analysts in 2006: "We have really good disclosures for our consumers, very plain English disclosures."[42]

One of the biggest legal attacks on the company has come in federal court in New Jersey, where more than 20 lawsuits are targeting IndyMac and the independent brokers that sniffed out loans for the company. According to one lawsuit, this group of brokers included one, Morgan Funding Corp., that employed a salesman who had been convicted in 2002 in a $500,000 insurance fraud involving staged auto accidents.[43] Another Morgan salesman had been barred from trading securities by the National Association of Securities Dealers, the suit says.

The suit claims IndyMac knew brokers were using slippery sales pitches to sell IndyMac loans, because the company had received repeated complaints about the brokers' tactics.[44] In the case of Morgan Funding, IndyMac not only had received complaints that the broker had lied to borrowers; it also had two employees working inside the broker's offices from 2004 to 2007, the suit says.[45] These IndyMac employees provided training to the mortgage brokers that "aided and abetted" Morgan Funding in deceiving borrowers, the suit claims.

Teaneck, N.J. residents Collin and Dorothy Thomas say their broker, DCI Mortgage Bankers LLC, promised them an IndyMac loan with a 1% rate for the first five years. What they got was "vastly different" – the 1% rate expired a month and a day later.[46] The paperwork, which said their rate "may" change at that time, was disingenuous – because IndyMac and the broker *knew* the rate was going to increase after a month, the Thomases claim.

Another New Jersey borrower, Arnette Garnes, says a broker promised her a 2.85% rate on an IndyMac loan for five years, but the real rate turned out to be 7.71%. When she complained she hadn't gotten what she'd been promised, she says, a salesman at the broker told her: "Well, Arnette, you should have read the fine print."[47]

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disclosures were good-faith errors that didn't violate the law. IndyMac paid $20,000 in late 2007 to settle its dispute with the Darlings.

[40] Harris v. Vinson Mortgage Services, U.S. District Court for the Eastern District of Missouri – Eastern Division, March 6, 2008. Pat Harris, a disabled Navy veteran, alleges a broker misled him about the size of his monthly payments. IndyMac denies the allegations and says Mr. Harris or "third parties" are to blame for any problems with the loan. SEE Appendix 2.

[41] George v. IndyMac Bank, U.S. District Court for the Central District of California, filed April 25, 2008. Attorneys for Methalee George, an 82-year-old widow, claim she was a victim of elder abuse and fraud at the hands of IndyMac. The suit alleges that the Option ARM sold to Ms. George was a "deceptively devised product."

[42] Voxant FD (Fair Disclosure) Wire, "Q3 2006 IndyMac Bancorp, Inc. Conference Call," November 2, 2006.

[43] Zurawski v. Morgan Funding.

[44] Zurawski v. Morgan Funding.

[45] Zurawski v. Morgan Funding.

[46] Thomas v. DCI Mortgage Bankers, U.S. District Court for the District of New Jersey, September 28, 2007.

[47] Glover v. Equity Source.

In court papers, IndyMac and the brokers deny wrongdoing. In response to one of the lawsuits, for example, IndyMac asserts the loan terms were properly disclosed and that borrowers may have "failed to read the documents provided to them."[48]

Racial discrimination

Some borrowers claim IndyMac has made a habit of targeting minority customers for overpriced loans. A lawsuit seeking class action status in federal court in Illinois[49] alleges IndyMac targets black and Latino borrowers for higher rates than whites. It notes that IndyMac's own data shows that in 2004 to 2006, minorities borrowing from the company were more than 50% more likely to receive a high interest rate loan than whites.

The lawsuit claims IndyMac has channeled minority borrowers "into mortgage loans with less favorable conditions than those given to similarly situated non-minority borrowers." According to the suit, Earlene Calvin, an Apple Valley, California homeowner, was stuck with a long list of excessive fees on a $416,000 IndyMac loan arranged by a mortgage broker. The fees included: a $8,320 loan origination fee to the broker, a $630 "broker processing fee," a $495 "administration fee" to the broker and a $725 "funding fee" to IndyMac.

Inflated appraisals

A lawsuit in federal court in New York[50] claims IndyMac used inflated appraisals to grease the loan process. It alleges IndyMac told outside appraisers the "target value" that they needed to hit to make a loan go through. The company rewarded appraisers who played ball and hit the values with more assignments, but punished those who didn't by cutting their assignments, the lawsuit claims.

One confidential witness in this lawsuit says IndyMac's chief appraiser and other executives were aware of these practices and allowed them to go on. In fact, the witness says, in-house employees who were supposed to make sure property values were accurate were intimidated by higher-ups and told they would be fired if they tried to block fraudulent appraisals.

Falsified paperwork

Another thread that runs through borrowers' legal complaints against IndyMac is the allegation that their loans were pushed through with falsified paperwork.

In California, Methalee George, an 82-year-old widow, claims an IndyMac employee falsified her loan application by listing her income as $3,900 a month. Her real income was $2,103 a month.[51] In Chicago, Thelma and Carter Ware claim they gave a broker accurate documentation of their

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[48] Glover v. Equity Source.

[49] Mables v. IndyMac Bank, U.S. District Court for the Northern District of Illinois – Eastern Division, filed April 17, 2008.

[50] Cedeno v. IndyMac, U.S. District Court for the Southern District of New York, August 25. 2006. IndyMac is seeking to have the lawsuit dismissed, arguing that its federal regulator, the Office of Thrift Supervision, has sole authority to address violations by the lender.

[51] George v. IndyMac Bank, U.S. District Court for the Central District of California, filed April 25, 2008.

income and assets, but the broker inflated the appraised value of their home and falsified their income on an application for two loans from IndyMac.[52] The Wares claim they were rushed through the loan closing and weren't told they were being given two loans – including one that carried a prepayment penalty and another that carried a "balloon payment" that would require them to come up with a large lump sum after 15 years. The broker took "exorbitant" fees totaling $12,760 in exchange for sticking the Wares into two "unnecessarily expensive" IndyMac loans totaling $329,000, their suit says.

Lenders frequently point the finger at borrowers and brokers when information on loan applications turns out to be fictitious. But borrowers aren't the ones who are in control of the process and handling the paperwork. Lenders have a responsibility – to their borrowers and to their shareholders – to thoroughly review loan applications and make sure the information is accurate. Otherwise, borrowers are likely to get in over their heads, stuck with loans they can't afford.

Montilla, the former IndyMac underwriter in Arizona, believes many borrowers had no idea their stated incomes were being inflated as part of the application process: "A lot of times you talked to the customer and the customer said: 'I never told them I made that much.' "

Archuletta, another former Indymac underwriter, agrees that most borrowers were unaware their incomes had been inflated. "Some of the borrowers were savvy and knew they were committing fraud," she says. "But a lot of them really didn't understand the programs. You sit down and there's 100 pages of stuff – nobody reads through all of that. It's our responsibility to let them know what they're getting into."

Scott Vaughan, the attorney for Ben Butler, the Savannah, Ga., retiree who claims his Social Security income was inflated, wrote IndyMac that the income listed in Mr. Butler's application paperwork "was not provided by Mr. Butler and was a complete fabrication by someone 'in the loop' so to speak. The mortgage broker and IndyMac are two of the persons/entities in that loop. . . . There is no amount of income filled in on the original application. Mr. Butler was never asked to state his income. Any prudent underwriter should have questioned the income considering the amount/source and required proof. It can only be surmised that this was the income needed to qualify for the loan."

Vaughan says his client was targeted for fraud and false promises because of his age, race, and limited education.[53] Mr. Butler was told the loan would eventually turn into a reverse mortgage, and was quoted a monthly payment that was less than a third of what it turned out to be, Vaughan says.[54]

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[52] Ware v. IndyMac Bank, U.S. District Court for the Northern District of Illinois – Eastern Division, April 10, 2007.

[53] Vaughan letter, and Butler v. John Flucas, Superior Court of Chatham County, State of Georgia, October 24, 2007.

[54] Scott Vaughan, telephone interview with Center for Responsible Lending.

Blacked out

Another Georgia case provides an example of a loan application full of obvious red flags that were missed or ignored by IndyMac's loan-underwriting system, according to an analysis by Atlanta Legal Aid Society's Home Defense Program, a non-profit legal clinic.[55]

Elouise Manuel, 68, has lived in her home in Decatur, Ga., for half her life.[56] She retired from a career in food service, making salads and working as a line server. She "is not sophisticated in the complex financial matters." In 2004, her only income was $527 a month in Social Security.

She owned her home free and clear when she began looking for a loan to pay off home repairs and other bills. She went to a mortgage broker where a cousin's daughter worked. Ms. Manuel told the broker she could afford a mortgage payment of no more than $120 a month. The broker told her she wouldn't have to pay any more than that, and that it would get her the lowest fixed rate possible.

The loan turned out to be something much different – an adjustable rate mortgage with an initial teaser rate of 3.875% that lasted one month. The rate quickly jumped to 6% and eventually rose to 10.25%.

As her monthly payment climbed to around $200 a month, Manuel called IndyMac and learned she had an adjustable rate loan. She had to get help from her family and apply for food stamps to keep up with her growing expenses.

How did she get in over her head?

Her lawsuit claims IndyMac purposely structured the deal so it was ignorant of her financial means and ignored clear evidence that something was amiss with the information submitted for her application. IndyMac specifically instructed the broker to send copies of her Social Security award letters with the dollar amounts blacked out. In other words, the lender wanted proof that she was receiving Social Security but didn't want to know how much.

Her IndyMac loan file is full of inaccurate and contradictory information. One document indicated she was getting $1,100 a month in retirement income. Another said she was employed and earning $2,100 a month. Another pegged her income at $3,200 a month. Similarly, IndyMac paperwork and computer files show her assets growing from zero to $2,100 to more than $20,000 – all in the matter of 10 days.

Ms. Manuel's lawsuit says she never misstated her income and that given the inconsistencies in the loan file, IndyMac should have known it needed real verification of her income and assets. It also knew from the paperwork, the suit says, that she wanted a fixed rate loan, not an adjustable rate one.

IndyMac told *BusinessWeek* last year that it followed standard procedure on Ms. Manuel's loan and that it relies on the broker and the borrower to provide accurate information.[57] It said the loan

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[55] Letter, from Karen E. Brown, staff attorney, Atlanta Legal Aid Society, to Susan E. McGovney, senior vice president and corporate compliance officer, IndyMac Bank, August 8, 2007.

[56] Personal details and legal claims from Brown letter, and Manuel v. American Residential Financing, Inc., et al, Superior Court of Gwinnett County, State of Georgia, April 3, 2008.

left Ms. Manuel better off, not worse off -- because the monthly payments were less than what she'd been paying on the bills it paid off.

A company spokesman said giving instructions to black out Ms. Manuel's income on her Social Security documents was "an error of judgment." It was the action of an individual employee, the spokesman said, and not company policy.

In its discussions with the Atlanta Legal Aid Society, company officials questioned Ms. Manuel's credibility, in part because a relative worked at the mortgage broker. In reply, the legal clinic said Ms. Manuel never asked anyone to falsify her information, and that records indicate her relative wasn't involved in preparing the file for submission to IndyMac.[58] It said IndyMac's "statements implying Ms. Manuel has engaged in criminal activities" were "preposterous."

MANAGERS: Ignoring red flags

In February, IndyMac CEO Michael Perry put out his annual letter to shareholders.[59] "2007 was a terrible year for our industry, for IndyMac and for you, our owners," he began.

Assessing blame for the nation's mortgage mess, Perry said all home lenders, including IndyMac, "were part of the problem, and, as IndyMac's CEO, I take full responsibility for the mistakes that we made."

Like other innovations – "e.g., the Internet, railroads, etc." – creative home lending "went too far," Perry said, partly because lenders were "too close to it, but mostly because objective evidence of this credit risk did not show up in our delinquencies and financial performance until it was too late."

Even if IndyMac had been "blessed with perfect foresight" and pulled back in 2005 and 2006, Perry said, the company would have still lost money in 2007 because its mortgage operations would still have cratered thanks to "the broader and unforeseeable collapse" of the Wall Street apparatus that pooled mortgages into investment deals.

Early warnings

Not everyone is convinced, though, that IndyMac's bad loans were simply the result of misjudgments made by company leaders as larger market forces swept them toward hidden shoals. In fact, IndyMac dealt with a number of episodes in recent years that should have prompted it to be more careful about the loans it was funding and the brokers it was doing business with.

For example:

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[57] Mara Der Hovanesian and Brian Grow, "Mortgage Mayhem," *BusinessWeek*, August 20, 2007.
[58] Brown letter.
[59] Business Wire, "IndyMac Issues 2007 Annual Shareholder Letter," February 12, 2008.

-- In early 2004, Washington Mutual Mortgage Securities Corp. sued IndyMac for more than $50 million, claiming IndyMac had peddled hundreds of problem loans from 1997 to 2000 to a Washington Mutual subsidiary. The pool of mortgages, the suit said, included loans with underwriting issues and inflated appraisals, and others on which borrowers had quickly defaulted, an indication fraud was involved or borrowers couldn't afford the loan from the start.[60]

IndyMac said it was not at fault. The two companies settled the dispute on undisclosed terms.

-- IndyMac became ensnarled in litigation over its relationship with a real-estate development firm whose owners were convicted of forging documents as part of a scheme to sell overpriced properties in Pennsylvania's Pocono Mountains in the late 1990s and early 2000s.

A lawsuit[61] in federal court alleges IndyMac funded loans arranged by the development firm even though it had been warned the Poconos were a hotbed of mortgage fraud. The suit claims IndyMac failed to do due diligence and "became pivotal to the conspiracy" by bankrolling the deals.

--IndyMac recorded a $9.7 million loss in first half of 2006 due to a fraud scheme that was the result of what Perry described as "massive collusion" between a mortgage broker and a developer in Michigan and Florida. [62]

CEO Perry admitted his company had "gotten a little bit laxed." "We didn't have the focus on fraud that we should have in this area," he said.

--IndyMac waited years in some cases before clamping down on mortgage brokers that had fed the company bad loans.

In 2007, for instance, IndyMac sued a Nevada-based broker, Silver State Mortgage, after 35 out of 36 borrowers in one pool of loans failed to make their first payment.[63] Many of the loans were made as early as 2005 and IndyMac waited at least a year to demand the broker repurchase the earliest ones – and continued taking on loans from Silver State even after dicey nature of Silver State-sponsored mortgages became apparent, attorneys in a California lawsuit have alleged.[64]

In another example, IndyMac asserts that 16 out 18 borrowers in a pool of loans brokered by Geneva Mortgage Corp. failed to make early payments.[65] Two of the bad loans dated back to 2003 and most of the rest were made in 2005.[66] However, IndyMac continued funding loans brought in by Geneva in 2006 and didn't file suit over the issue until 2007.[67]

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[60] Washington Mutual Mortgage Securities Corp. v. IndyMac Bancorp, Los Angeles Superior Court, February 3, 2004.
[61] Gaines v. Parisi, U.S. District Court for the Middle District of Pennsylvania, January 11, 2006.
[62] Voxant FD (Fair Disclosure) Wire, "Q2 2006 IndyMac Bancopr. Inc. Earnings Conference Call," July 27, 2006.
[63] IndyMac Bank v. Silver State Mortgage, U.S. District Court for the District of Nevada, March 29, 2007. IndyMac's suit against Silver State was dismissed April 1, 2008, at IndyMac's request.
[64] Tripp v. IndyMac.
[65] IndyMac Bank v. Geneva Mortgage Corp., U.S. District Court for the Central District of California, March 22, 2007.
[66] Tripp v. IndyMac.
[67] Tripp v. IndyMac.

Full speed ahead

Even as IndyMac was taking a less-than-aggressive approach to policing its brokers, the company was coming under growing pressure from Wall Street investors who were pushing back bad loans that IndyMac had sold into investment deals. These "kickbacks" swelled from $108 million in 2005 to $194 million in 2006 and $613 million in 2007 alone.[68] IndyMac tried to hide these loans by launching a special project on weekends in 2006, directing underwriters to aggressively "rework" loan files on kicked-back mortgages so they could be resold again to other investors, according to two witnesses in the California lawsuit.[68]

Amid these problems – and rising concerns industry-wide about the cooling housing market – IndyMac forged ahead. Instead of pulling back, IndyMac made it clear that its plan was to take advantage of other lenders' problems to take a bigger slice of mortgage market.

In June 2006, IndyMac predicted the housing slump was halfway over and was touting plans to open regional centers in Philadelphia, Chicago and other cities and reach for growth in Pay Option and interest-only adjustable rate mortgages.[69] "If you want to grow in a shrinking market, by definition you have to take market share," IndyMac president Richard Wohl said.

Three months later, Perry said that "certainly there are negative signs in our industry," but IndyMac's model made it "more optimistic than the industry overall."[70]

IndyMac's determination to keep growing as others fell to the wayside or pulled back showed in its 2006 mortgage production. The lender boosted its lending volume by some 50% in 2006, during a year when overall industry volume was slightly down.

In March 2007, as the severity of the U.S. mortgage crisis was becoming more clear, Perry issued a statement designed to calm fears about his company's vulnerability: "Based on an objective analysis of the facts, talk of the 'subprime contagion' spreading to the Alt-A sector of the mortgage market is, in our view, overblown."[71]

He said "IndyMac's credit quality shines in relation to the industry, validating our lending standards and practices."

In August 2007, with world financial markets flailing, IndyMac announced it was planning to hire as many as 850 former employees from its bankrupt rival, American Home Mortgage Investment Corp.[72]

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[68] IndyMac Bancorp, Inc., 10K Report to Securities and Exchange Commission 2007, Feb. 29, 2008.
[68] Tripp v. IndyMac.
[69] Reuters, "Housing slowdown halfway through, IndyMac says," June 19, 2006.
[70] Voxant FD (Fair Disclosure) Wire, "IndyMac Bancorp., Inc. at Lehman Brothers 4th Annual Conference,' September 13, 2006.
[71] Business Wire, "IndyMac Provides Additional Credit Loss Analysis on Alt-A and Subprime Lending," March 29, 2007.
[72] Jonathan Stempel, "IndyMac to hire up to 850 ex-American Home workers," Reuters, August 28, 2007.

By 2008, though, it had become apparent IndyMac had overreached, making large numbers of bad loans and failing to pull back quickly enough as the mortgage industry crashed.

In January, the company announced plans to slash its workforce by 24%, laying off 2,400 employees.

On May 12, the company announced a $184 million loss for the first quarter of the year. It called the results hopeful, because they were an improvement over the heavy losses it suffered in 2007.

"I am confident IndyMac will be a survivor," Perry said. ". . . IndyMac is the last remaining major independent home lender, and we will be a better company and stronger competitor for having survived the current crisis period, which should position us well to take advantage of the opportunities that will surely return."[73]

CONCLUSION

Federal regulators have pointed out that many of the lenders accused of bad practices, such as Ameriquest, were under state rather than federal supervision. However, IndyMac's record, as well as Countrywide's, raises questions about whether federal regulators turned a blind eye to improper practices among the lenders they licensed.

Amid the overheated atmosphere of the mortgage boom, IndyMac and lenders of many different stripes appear to have abandoned sound decision-making and sustainable growth strategies. Instead, they chose to take unreasonable risks and reach for spectacular levels of growth that produced short-term profits but ended in pain for borrowers, shareholders, and communities.

It didn't have to happen this way. Federal authorities – including the Office of Thrift Supervision – should have kept a closer eye on IndyMac's business model and practices. They had leverage over IndyMac, given that the company operated as a federally-chartered thrift supported by deposit insurance and borrowings from the FHLB system.

IndyMac's story suggests that, in the absence of rigorous oversight, there's little to stop lenders from getting swept up by market frenzies and embracing reckless practices. This should be uppermost in policymakers' and citizens' minds as federal and state governments work to clean up the mortgage mess – and to design rules that will prevent such disasters from happening again.

[73] Business Wire, "IndyMac Bancorp Reports First Quarter Loss of $184.2 million," May 12, 2008.

APPENDIX 1

"Patently unsuitable"

Simeon Ferguson was born in Jamaica in 1921. He moved to the United States in the mid-1960s. A few years ago, his behavior began to change. He began asking the same question over and over. He visited a dying daughter in Jamaica, but then forgot he'd visited her. He was suffering from dementia.[74]

By 2006, Mr. Ferguson had been living in his house in Brooklyn for more than three decades. He was 85 years old, living on a fixed income of $1,126 a month, and had a $360,000 mortgage with a fixed interest rate of 5.95%.

According to a lawsuit filed in federal court in New York, a telemarketer solicited Mr. Ferguson to refinance his mortgage. He told a neighbor that he was getting a 1% interest rate.

The loan had an initial teaser rate of 1.25%, but jumped to 7.138% after six weeks. His initial minimum payment was $1,482 a month, already more than his monthly retirement income. In early 2007, the gap grew even larger, with his minimum monthly payment jumping to $1,903.

It was a loan that was "patently unsuitable" for Mr. Ferguson and "virtually certain to result in foreclosure," the suit alleges.

According to the lawsuit, the loan was made under an IndyMac "stated income" loan program for retirees, which makes no effort to document borrowers income or determine whether they can afford the deal. A hallmark of the program, the suit says, was that IndyMac refused to take loan applications that made any mention of the borrowers' income, "thereby encouraging mortgage brokers to extend unaffordable loans while attempting to duck accountability by deliberately remaining ignorant of the borrower's ability to pay the mortgage." In fact, the lawsuit notes, IndyMac specifies that "the file must not contain any documents that reference income or assets."

In the end, the suit claims, the loan was a scheme targeted at retirees on fixed income, designed to make loans that strip equity from the borrowers homes and fatten IndyMac's bottom line.

It wasn't until Mr. Ferguson went into the hospital with a bone infection in May 2006 that one of his daughters took over his financial affairs and discovered the loan. When she asked him why he'd taken out an adjustable rate loan, he insisted he'd gotten a low-interest fixed rate one.

"It's not that my father went out to buy a home he couldn't afford, that's not what happened here," the daughter, Karlene Grant, said. "Somebody solicited him and made him think he was getting a better deal. Then they made some money and ran."[75]

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[74] Personal details and allegations are from Ferguson v. IndyMac Bank, U.S. District Court for the Eastern District of New York, filed Feb. 14, 2008.

[75] "Joseph Huff-Hannon, "Facing Foreclosure: Brooklyn Retiree On Verge Of Losing Home As Subprime Lenders Target Cash-Poor Seniors," The Indypendent, April 25-May 15, 2008.

The broker that arranged the deal initially maintained that Mr. Ferguson had had a lawyer with him at closing. In response to a complaint to New York banking authorities, the broker said Mr. Ferguson had been "involved, consulted, and took part through the whole loan process in an intelligent fashion."[76] Mr. Ferguson's lawsuit says no lawyer was present and "given that Mr. Ferguson was suffering from acute dementia at the time of the transaction, it's unlikely he was engaged and involved in the process."

IndyMac directed more than $21,000 in fees to the broker for arranging the transaction – apparently including, the lawsuit says, a large sum that rewarded the broker for "inducing Mr. Ferguson to take out a loan on terms much less favorable than were otherwise available to him."

[76] Ferguson v. IndyMac.

Appendix 2

A veteran's story

In late 2006 Pat Harris, a disabled Navy veteran in St. Louis, wanted to catch up on back taxes and other debts.

A mortgage broker promised Mr. Harris he could refinance his mortgage and pay off his credit card and tax bills with a loan that would carry a $526-a-month payment.[77]

Mr. Harris claims the mortgage professionals involved in the deal exaggerated his income, falsely listing it as $2,500 a month, or nearly three times his VA pension of $910 a month.

Instead of $526 a month, Mr. Harris' payment turned out to be $631 a month, nearly 70% of his income.

In addition to rolling over his original mortgage, the new loan provided $3,261 in new money to cover his credit card and tax debts. The settlement charges on the loan, meanwhile, totaled $5,962 – nearly twice the amount of new money provided by the loan.

Now Mr. Harris is suing, claiming IndyMac and the broker took advantage, overcharging him and flipping from his old mortgage, which had an interest rate of 5.99%, into a new one with an adjustable rate, which started at 10.5% and could go as high as 16.5%.

"The loan from IndyMac has not benefited the plaintiff," the suit says. "Instead, it has left him deeper in debt and with a mortgage payment that he cannot afford."

In court papers, IndyMac denies the allegations and suggests that any problems with the loan were caused by Mr. Harris or by "third parties."

[77] All details and allegations from Harris v. Vinson Mortgage Services, U.S. District Court for the Eastern District of Missouri – Eastern Division, March 6, 2008.

2005 LIST OF COUNTRYWIDE DEALS

CWMBS Inc.

Deal	Month	Hyperlink to PSA or Equivalent Documents	File No. to Access Prospectus Supplement
7	January	http://www.sec.gov/Archives/edgar/data/906410/000090514805002444/efc5-0996_exhibit991.txt	333-109248-50
4	January	http://www.sec.gov/Archives/edgar/data/906410/000090514805001361/0000905148-05-001361.txt	333-109248-48
5	January	http://www.sec.gov/Archives/edgar/data/906410/000090514805001087/0000905148-05-001087.txt	333-109248-47
HYB1	January	http://www.sec.gov/Archives/edgar/data/906410/000090514805001419/efc5-0526_5650371exhibit991.txt	333-109248-45
1	January	http://www.sec.gov/Archives/edgar/data/906410/000090514805002510/0000905148-05-002510.txt	333-109248-51
2	January	http://www.sec.gov/Archives/edgar/data/906410/000090514805002472/efc5-0711_5651207ex991.txt	333-109248-49
6	February	http://www.sec.gov/Archives/edgar/data/906410/000090514805002513/0000905148-05-002513.txt	333-121249-01
3	February	http://www.sec.gov/Archives/edgar/data/906410/000090514805001616/efc5-0704_exhibit41.txt	333-121249-02
11	February	http://www.sec.gov/Archives/edgar/data/906410/000090514805002512/0000905148-05-002512.txt	333-121249-03
9	March	http://www.sec.gov/Archives/edgar/data/906410/000090514805002905/0000905148-05-002905.txt	333-121249-07
10	March	http://www.sec.gov/Archives/edgar/data/906410/000090514805002500/efc5-1025_5690402exh991.txt	333-121249-05
12	March	http://www.sec.gov/Archives/edgar/data/906410/000090514805003025/0000905148-05-003025.txt	333-121249-06
HYB2	March	http://www.sec.gov/Archives/edgar/data/906410/000090514805002380/0000905148-05-002380.txt	333-121249-04
13	April	http://www.sec.gov/Archives/edgar/data/906410/000090514805003301/efc5-1365_exhibit991.txt	333-121249-09
HYB3	April	http://www.sec.gov/Archives/edgar/data/906410/000090514805003178/efc5-1312_ex991.txt	333-121249-08
14	May	http://www.sec.gov/Archives/edgar/data/1326470/000090514805004112/efc5-1691_5705298exh991.txt	333-121249-10
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15	June	http://www.sec.gov/Archives/edgar/data/1331156/000090514805004170/efc5-1739_5724690exh991.txt	333-121249-12
J2	June	http://www.sec.gov/Archives/edgar/data/1332055/000088237705001900/d346253_ex4-1.htm	333-121249-13
16	July	http://www.sec.gov/Archives/edgar/data/1334581/000090514805004742/efc5-1965_5739621exh991.txt	333-125963-01
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19	July	http://www.sec.gov/Archives/edgar/data/1334896/000090514805004528/efc5-1870_exhibit41.txt	333-125963-05
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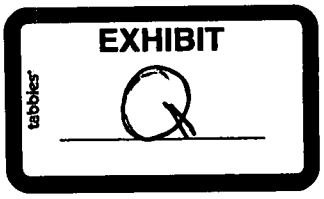
HYB5	July	http://www.sec.gov/Archives/edgar/data/906410/000090514805004103/0000905148-05-004103.txt	333-125963-03
18	August	http://www.sec.gov/Archives/edgar/data/1337574/000090514805004720/efc5-1967_5752418ex991.txt	333-125963-08
20	August	http://www.sec.gov/Archives/edgar/data/1337571/000090514805004616/efc5-1922_5752253psa.txt	333-125963-07
21	August	http://www.sec.gov/Archives/edgar/data/1337560/000090514805004635/efc5-1924_5750251exh991.txt	333-125963-06
HYB6	August	http://www.sec.gov/Archives/edgar/data/1337577/000090514805004657/efc5-1921_5747690exhibit991.txt	333-125963-09
22	September	http://www.sec.gov/Archives/edgar/data/1340401/000090514805005547/efc5-2349_ex991.txt	333-125963-13
23	September	http://www.sec.gov/Archives/edgar/data/1340389/000090514805006117/efc5-2605_exhibit991.txt	333-125963-11
24	September	http://www.sec.gov/Archives/edgar/data/1340392/000090514805005585/efc5-2360_ex991.txt	333-125963-12
25	September	http://www.sec.gov/Archives/edgar/data/1340496/000090514805005586/efc5-2361_exhibit991.txt	333-125963-14
26	September	http://www.sec.gov/Archives/edgar/data/1340547/000090514805005452/efc5-2309_exhibit991.txt	333-125963-15
HYB7	September	http://www.sec.gov/Archives/edgar/data/1340192/000090514805005054/efc5-2137_5760346exh991.txt	333-125963-10



2005 LIST OF COUNTRYWIDE DEALS

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29	November	http://www.sec.gov/Archives/edgar/data/1345530/000090514806000271/efc6-0204_ex991.txt	333-125963-21
30	November	http://www.sec.gov/Archives/edgar/data/1345515/000090514806000279/efc6-0203_exhibit991.txt	333-125963-20
31	December	http://www.sec.gov/Archives/edgar/data/1347331/000090514806000356/efc6-0214_5806033ex991.txt	333-125963-23
HYB10	December	http://www.sec.gov/Archives/edgar/data/1347162/000090514806000695/efc6-0265_5806259ex991.txt	333-100418-21

CWALT Inc.

Deal	Month		
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2	January	http://www.sec.gov/Archives/edgar/data/1269518/000090514805002511/0000905148-05-002511.txt	333-117949-22
6CB	February	http://www.sec.gov/Archives/edgar/data/1269518/000090514805001766/0000905148-05-001766.txt	333-117949-23
7CB	February	http://www.sec.gov/Archives/edgar/data/1269518/000090514805001775/efc5-0816_ex991.txt	333-117949-24
4	February	http://www.sec.gov/Archives/edgar/data/1269518/000090514805002474/efc5-0700_5664127ex991.txt	333-117949-25
J2	February	http://www.sec.gov/Archives/edgar/data/1269518/000090514805002446/0000905148-05-002446.txt	333-117949-26
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9CB	March	http://www.sec.gov/Archives/edgar/data/1269518/000090514805003648/efc5-1253_5677784exh991.txt	333-117949-33
10CB	March	http://www.sec.gov/Archives/edgar/data/1269518/000090514805002906/efc5-1191_ex991.txt	333-117949-29
14	March	http://www.sec.gov/Archives/edgar/data/1269518/000090514805003303/efc5-1367_5681742ex991.txt	333-117949-30
18CB	March	http://www.sec.gov/Archives/edgar/data/1269518/000090514805003747/efc5-1557_5679612exh991.txt	333-117949-32
J3	March	http://www.sec.gov/Archives/edgar/data/1269518/000090514805003671/efc5-1531_psa.txt	333-117949-31
J5	April	http://www.sec.gov/Archives/edgar/data/1324875/000090514805003755/efc5-1378_exhibit991.txt	333-123167-01
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23CB	April	http://www.sec.gov/Archives/edgar/data/1325781/000090514805003778/efc5-1569_ex991.txt	333-123167-05
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24	May	http://www.sec.gov/Archives/edgar/data/1269518/000090514805003694/0000905148-05-003694.txt	333-123167-09
25T1	May	http://www.sec.gov/Archives/edgar/data/1328468/000090514805004381/efc5-1798_5705305exh991.txt	333-123167-08
26CB	May	http://www.sec.gov/Archives/edgar/data/1328712/000090514805003740/efc5-1550_5705239ex991.txt	333-123167-11
29CB	May	http://www.sec.gov/Archives/edgar/data/1328727/000090514805003741/efc5-1551_5706767ex991.txt	333-123167-12

2005 LIST OF COUNTRYWIDE DEALS

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30CB	June		http://www.sec.gov/Archives/edgar/data/1331812/000090514805004133/efc5-1718_exh991.txt	333-123167-18
31	June		http://www.sec.gov/Archives/edgar/data/1332094/000090514805004609/efc5-1918_5724058exh991.txt	333-123167-23
32T1	June		http://www.sec.gov/Archives/edgar/data/1332077/000090514805004111/efc5-1693_5724567ex991.txt	333-123167-21
33CB	June		http://www.sec.gov/Archives/edgar/data/1331500/000090514805004110/efc5-1692_5725731ex991.txt	333-123167-17
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J7	June		http://www.sec.gov/Archives/edgar/data/1332018/000088237705001842/d347436_ex4.htm	333-123167-19
J8	June		http://www.sec.gov/Archives/edgar/data/1332065/000088237705001799/d346421_ex4.htm	333-123167-20
34CB	July		http://www.sec.gov/Archives/edgar/data/1334584/000090514805005099/efc5-2156_5738345ex991bl.txt	333-125902-02
35CB	July		http://www.sec.gov/Archives/edgar/data/1334744/000090514805004294/efc5-1780_5738503ex991.txt	333-125902-04
37T1	July		http://www.sec.gov/Archives/edgar/data/1334582/000090514805005453/efc5-2311_5739601exhibit991.txt	333-125902-01
38	July		http://www.sec.gov/Archives/edgar/data/1334881/000090514805005553/efc5-2357_5738535ex991.txt	333-125902-05
41	July		http://www.sec.gov/Archives/edgar/data/1269518/000090514805004106/0000905148-05-004106.txt	333-125902-03
J9	July		http://www.sec.gov/Archives/edgar/data/1334849/000090514805005552/efc5-2356_ex991.txt	333-123167-25
43	August		http://www.sec.gov/Archives/edgar/data/1337461/000090514805004686/efc5-1946_5752520exh991.txt	333-125902-07
40CB	August		http://www.sec.gov/Archives/edgar/data/1337432/000090514805004603/efc5-1907_5748773exh991.txt	333-125902-06
42CB	August		http://www.sec.gov/Archives/edgar/data/1337691/000090514805004765/efc5-1985_5763519ex991.txt	333-125902-10
44	August		http://www.sec.gov/Archives/edgar/data/1337723/000090514805004692/efc5-1945_5748411ex991.txt	333-125902-13
45	August		http://www.sec.gov/Archives/edgar/data/1337707/000090514805004690/efc5-1938_ex991.txt	333-125902-12
46CB	August		http://www.sec.gov/Archives/edgar/data/1337692/000090514805004721/efc5-1966_5750852ex991.txt	333-125902-11
47CB	August		http://www.sec.gov/Archives/edgar/data/1337510/000090514806000025/efc5-2590_5753306ex991.txt	333-125902-08
J10	August		http://www.sec.gov/Archives/edgar/data/1337689/000088237705002557/d370273.htm	333-125902-09
48T1	September		http://www.sec.gov/Archives/edgar/data/1340400/000090514805005002/efc5-2093_5763308ex991.txt	333-125902-15
49CB	September		http://www.sec.gov/Archives/edgar/data/1340399/000090514805005233/efc5-2211_ex991.txt	333-125902-14
50CB	September		http://www.sec.gov/Archives/edgar/data/1340423/000090514805006053/efc5-2350_exhibit991.txt	333-125902-16
51	September		http://www.sec.gov/Archives/edgar/data/1340517/000090514805006208/efc5-2347_5763241ex991.txt	333-125902-21
52CB	September		http://www.sec.gov/Archives/edgar/data/1340491/000090514805006045/efc5-2351_ex991.txt	333-125902-18
53T2	September		http://www.sec.gov/Archives/edgar/data/1340494/000090514805006050/efc5-2589_ex991.txt	333-125902-20
54CB	September		http://www.sec.gov/Archives/edgar/data/1340530/000090514805005554/efc5-2358_5767041ex991.txt	333-125902-23
55CB	September		http://www.sec.gov/Archives/edgar/data/1340492/000090514805005587/efc5-2359_5765399ex991.txt	333-125902-19
56	September		http://www.sec.gov/Archives/edgar/data/1340628/000090514806000165/efc6-0054_5766972ex991.txt	333-125902-24
59	September		http://www.sec.gov/Archives/edgar/data/1340519/000090514805006207/efc5-2367_5763622exh991.txt	333-125902-22
J11	September		http://www.sec.gov/Archives/edgar/data/1340489/000088237706000236/d382515_ex4.htm	333-125902-17
57CB	October		http://www.sec.gov/Archives/edgar/data/1343314/000090514806000437/efc6-0275_5781714exh991.txt	333-125902-33
58	October		http://www.sec.gov/Archives/edgar/data/1343003/000090514805006209/efc5-2348_5783128ex991.txt	333-125902-27

2005 LIST OF COUNTRYWIDE DEALS

60T1	October	http://www.sec.gov/Archives/edgar/data/1342961/000090514806000272/efc6-0206_5780000ex991.txt	333-125902-25
61	October	http://www.sec.gov/Archives/edgar/data/1342999/000090514806000618/efc6-0294_5781553ex991.txt	333-125902-26
62	October	http://www.sec.gov/Archives/edgar/data/1343106/000090514806000160/efc6-0055_5782151ex991.txt	333-125902-30
63	October	http://www.sec.gov/Archives/edgar/data/1343008/000090514806000155/efc6-0056_5780872ex991.txt	333-125902-28
64CB	October	http://www.sec.gov/Archives/edgar/data/1343108/000090514806000357/efc6-0213_579937ex991.txt	333-125902-32
J12	October	http://www.sec.gov/Archives/edgar/data/1343062/000090514806000817/efc6-0346_exhibit991.txt	333-125902-29
J13	October	http://www.sec.gov/Archives/edgar/data/1343107/000090514805006046/efc5-2591_ex991.txt	333-125902-31
75CB	November	http://www.sec.gov/Archives/edgar/data/1345518/000090514806000434/efc6-0273_exhibit99.txt	333-125902-35
65CB	November	http://www.sec.gov/Archives/edgar/data/1345747/000090514806000697/efc6-0309_exhibit991.txt	333-125902-39
67CB	November	http://www.sec.gov/Archives/edgar/data/1345740/000090514806000297/efc6-0207_5794293ex991.txt	333-125902-37
69	November	http://www.sec.gov/Archives/edgar/data/1345823/000090514806000736/efc6-0310_5796346exhibit991.txt	333-125902-42
70CB	November	http://www.sec.gov/Archives/edgar/data/1345743/000090514806000152/efc6-0057_5791812ex991.txt	333-125902-38
71	November	http://www.sec.gov/Archives/edgar/data/1345455/000090514806000619/efc6-0293_ex991.txt	333-125902-34
72	November	http://www.sec.gov/Archives/edgar/data/1345834/000090514806000683/efc6-0311_5795478ex991.txt	333-125902-43
73CB	November	http://www.sec.gov/Archives/edgar/data/1345783/000090514806000295/efc6-0205_5794076ex991.txt	333-125902-41
74T1	November	http://www.sec.gov/Archives/edgar/data/1345554/000090514806000301/efc6-0209_5794075exhibit991.txt	333-125902-36
79CB	December	http://www.sec.gov/Archives/edgar/data/1347610/000090514806000735/efc6-0330_5805301ex991.txt	333-125902-49
76	December	http://www.sec.gov/Archives/edgar/data/1348093/000090514806000822/efc6-0347_5806951ex991.txt	333-125902-58
77T1	December	http://www.sec.gov/Archives/edgar/data/1346365/000090514806000677/efc6-0314_5809057exhibit991.txt	333-125902-52
80CB	December	http://www.sec.gov/Archives/edgar/data/1348094/000090514806000410/efc6-0260_5810258ex991.txt	333-125902-57
81	December	http://www.sec.gov/Archives/edgar/data/1347411/000090514806000737/efc6-0328_5810278exh991.txt	333-125902-55
82	December	http://www.sec.gov/Archives/edgar/data/1347173/000090514806000607/efc6-0264_5806053ex991.txt	333-125902-50
83CB	December	http://www.sec.gov/Archives/edgar/data/1348096/000090514806000413/efc6-0258_ex991.txt	333-125902-56
84	December	http://www.sec.gov/Archives/edgar/data/1348097/000090514806000412/efc6-0261_ex991.txt	333-125902-51
85CB	December	http://www.sec.gov/Archives/edgar/data/1348098/000090514806000640/efc6-0292_5807802exhibit991.txt	333-125902-53
86CB	December	http://www.sec.gov/Archives/edgar/data/1346972/000090514806000629/efc6-0271_5810190ex991.txt	333-125902-54

CWABS Inc.

BC1	March	http://www.sec.gov/Archives/edgar/data/1321977/000088237705000807/d2005bc-1_psa.txt	333-118926-19
1	March	http://www.sec.gov/Archives/edgar/data/1322005/000090514805002453/0000905148-05-002453.txt	333-118926-20
2	March	http://www.sec.gov/Archives/edgar/data/1321973/000090514805002477/efc5-1007_5679051exhibit41.txt	333-118926-18
3	March	http://www.sec.gov/Archives/edgar/data/1322237/000090514805002538/efc5-1036_5679170ex41.txt	333-118926-22
AB1	March	http://www.sec.gov/Archives/edgar/data/1322017/000090514805002455/0000905148-05-002455.txt	333-118926-21
BC2	April	http://www.sec.gov/Archives/edgar/data/1325049/000088237705001217/d326839-ex4_1.htm	333-118926-23
4	June	http://www.sec.gov/Archives/edgar/data/1330582/000090514805003863/efc5-1579_5712687ex41.txt	333-125164-01
5	June	http://www.sec.gov/Archives/edgar/data/1331105/000090514805003864/0000905148-05-003864.txt	333-125164-02
6	June	http://www.sec.gov/Archives/edgar/data/1331529/000090514805003865/0000905148-05-003865.txt	333-125164-04

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7	June	http://www.sec.gov/Archives/edgar/data/1331961/000090514805003742/efc5-1555_5728552exh41.txt	333-125164-05
AB2	June	http://www.sec.gov/Archives/edgar/data/1331228/000090514805003684/0000905148-05-003684.txt	333-125164-03
BC3	June	http://www.sec.gov/Archives/edgar/data/1332066/000088237705001835/d350858_ex4.htm	333-118926-26
8	August	http://www.sec.gov/Archives/edgar/data/1338051/000090514805005433/efc5-2293_5748573exh41.txt	333-125164-07
9	September	http://www.sec.gov/Archives/edgar/data/1339864/000090514805005432/efc5-2294_5760374ex41.txt	333-125164-09
10	September	http://www.sec.gov/Archives/edgar/data/1339239/000090514805005470/efc5-2303_5760434ex41.txt	333-125164-08
11	September	http://www.sec.gov/Archives/edgar/data/1340246/000090514805005111/efc5-2142_5763355exh41.txt	333-125164-11
12	September	http://www.sec.gov/Archives/edgar/data/1340669/000090514805005431/efc5-2291_5768030ex41.txt	333-125164-13
AB3	September	http://www.sec.gov/Archives/edgar/data/1340422/000090514805005094/efc5-2143_5773345ex41.txt	333-125164-12
BC4	September	http://www.sec.gov/Archives/edgar/data/1340113/000088237705002934/d378244_ex4.htm	333-125164-10
13	November	http://www.sec.gov/Archives/edgar/data/1344978/000090514805005920/efc5-2452_exhibit41.txt	333-125164-15
AB4	November	http://www.sec.gov/Archives/edgar/data/1345654/000090514806000819/efc6-0301_5794090ex4.txt	333-125164-16
HYB9	November	http://www.sec.gov/Archives/edgar/data/1345775/000088237706000102/d392726.htm	333-125164-17
14	December	http://www.sec.gov/Archives/edgar/data/1347929/000090514806000900/efc6-0367_ex41.txt	333-125164-19
BC5	December	http://www.sec.gov/Archives/edgar/data/1346521/000088237706000136/d413762_ex4-1.htm	333-125164-20
15	December	http://www.sec.gov/Archives/edgar/data/1348453/000090514806000888/efc6-0368_1424780ex41.txt	333-125164-22
16	December	http://www.sec.gov/Archives/edgar/data/1348343/000090514806000814/efc6-0316_5810059ex41.txt	333-125164-21
AB5	December	http://www.sec.gov/Archives/edgar/data/1348454/000090514806000816/efc6-0315_ex41.txt	333-125164-23
17	December	http://www.sec.gov/Archives/edgar/data/1348455/000090514806000821/efc6-0317_5809806ex41.txt	333-125164-24

CWHEQ Inc.

Deal	Month		
A	February	http://www.sec.gov/Archives/edgar/data/1318665/000090514805001514/0000905148-05-001514.txt	333-121378-01
B	March	http://www.sec.gov/Archives/edgar/data/1322013/000090514805002447/0000905148-05-002447.txt	333-121378-02
C	June	http://www.sec.gov/Archives/edgar/data/1332029/000090514805003786/0000905148-05-003786.txt	333-121378-03
D	August	http://www.sec.gov/Archives/edgar/data/1337535/000090514805004726/0000905148-05-004726.txt	333-126790-01
E	August	http://www.sec.gov/Archives/edgar/data/1337536/000090514805004725/0000905148-05-004725.txt	333-126790-02
F	September	http://www.sec.gov/Archives/edgar/data/1340194/000090514805005101/0000905148-05-005101.txt	333-126790-03
G	September	http://www.sec.gov/Archives/edgar/data/1340398/000090514805005116/0000905148-05-005116.txt	333-126790-04
H	September	http://www.sec.gov/Archives/edgar/data/1340432/000090514805005130/0000905148-05-005130.txt	333-126790-05
I	December	http://www.sec.gov/Archives/edgar/data/1347169/000090514806000882/0000905148-06-000882.txt	333-126790-06
J	December	http://www.sec.gov/Archives/edgar/data/1347356/000090514806000913/0000905148-06-000913.txt	333-126790-08
K	December	http://www.sec.gov/Archives/edgar/data/1347170/000090514806000879/0000905148-06-000879.txt	333-126790-10
L	December	http://www.sec.gov/Archives/edgar/data/1347171/000090514806000884/0000905148-06-000884.txt	333-126790-07
M	December	http://www.sec.gov/Archives/edgar/data/1347172/000090514806000886/0000905148-06-000886.txt	333-126790-09

2006 Deals

CWALT Inc.

Deal	Month	CIK	CCC	File Number
2CB	January	1349806	gnkdr@d2	333-125902-60
OC1	January	1350624	xiio$o5z	333-125902-61
HY3	February	1354229	y7r@zacs	333-125902-63
4CB	February	1354230	@g6omivt	333-125902-65
5T2	February	1354231	yngky@r9	333-125902-62
12CB	March	1356320	@t8uiksf	333-131630-07
6CB	March	1356314	6vuyk@na	333-131630-10
7CB	March	1356315	wv*a6tof	333-131630-09
9T1	March	1356316	er$5cuho	333-131630-08
HY10	March	1356317	mxt@eon2	333-131630-05
11CB	March	1356318	5u#zgdsx	333-131630-03
13T1	March	1356319	gt7cot#w	333-131630-06
OC2	March	1354992	J$aa2duw	333-131630-01
OA3	March	1356321	gcmg8nx#	333-131630-11
OA2	March	1356766	6yyumy$g	333-131630-02
OA7	April	1359957	xg9icej@	333-131630-20
OC3	April	1359963	oae7q@co	333-131630-18
16CB	April	1359960	v9crf@va	333-131630-16
17T1	April	1359961	dkt8@zsy	333-131630-13
15CB	April	1359959	ryq2zx#s	333-131630-14
14CB	April	1359958	j#db7pzw	333-131630-15
HY11	April	1359962	iwgg2#ff	333-131630-19
J3	April	1359964	vwt$tcf9	333-131630-17
OA6	May	1359929	o*yiq6yv	333-131630-21
OA9	May	1363451	qq$bxx6t	333-131630-23
20CB	May	1363791	4$exmchx	333-131630-24
21CB	May	1363792	*phehf9e	333-131630-25
OC4	May	1363794	am*7ngsd	333-131630-26
18CB	May	1363790	anmdn#h9	333-131630-27
OA8	May	1363793	rdrk5m#e	333-131630-29
23CB	June	1366953	xdmajc#2	333-131630-33
19CB	June	1366952	my#y7tbd	333-131630-32
24CB	June	1366954	#hmghe3a	333-131630-34
OC5	June	1367258	#mgn3jya	333-131630-35
OA10	June	1366956	umdm6#so	333-131630-38
HY12	June	1366955	ex4#zoia	333-131630-31
OA11	June	1365928	oi5u$qco	333-131630-37
25CB	July	1368786	prk6x$xg	333-131630-42
26CB	July	1368787	z4knkzy*	333-131630-43
OC6	July	1369463	sfn#j8rj	333-131630-40
J5	July	1368788	mduw@vi5	333-131630-41
OA12	July	1368949	3sag*vho	333-131630-39
29T1	August	1371114	gsdj$g8g	333-131630-50
27CB	August	1371110	sopbe3h$	333-131630-48
28CB	August	1371111	@9suvsuu	333-131630-49
OC7	August	1374253	9zb*xoux	333-131630-47
OA16	August	1372623	2rkkkvc$	333-131630-46
31CB	September	1375034	qy9@brwc	333-131630-53

30T1	September	1375033	6ifukx#e	333-131630-54
32CB	September	1375035	9@ntmdnf	333-131630-55
34	September	1375544	g*vfznt2	333-131630-57
OC8	September	1375037	adf#9zkv	333-131630-56
33CB	September	1375543	zp@w5zsq	333-131630-58
OA14	September	1371112	koi7*ngk	333-131630-60
OA17	September	1375789	yvvf@o9y	333-131630-59
35CB	October	1377862	uzba$mr7	333-131630-61
36T2	October	1377863	6*uotrkk	333-131630-63
J7	October	1377865	@qvuqyv9	333-131630-62
OA18	November	1378487	6r$qjrij	333-131630-65
OC9	November	1375038	y6ngvyy#	333-131630-66
42	November	1380951	eax*ws2r	333-131630-69
40T1	November	1380949	w*vnv9qk	333-131630-70
41CB	November	1380950	cuivsb@8	333-131630-71
OA19	November	1381326	eqq3r$df	333-131630-68
39CB	November	1380948	evamk$8s	333-131630-72
OC10	November	1380952	6g@opxii	333-131630-67
OA22	December	1382612	xhq9j@hg	333-131630-73
J8	December	1382639	urkg3@hv	333-131630-76
43CB	December	1382635	p8zdvo#j	333-110343-29
45T1	December	1382636	e*dgevn3	333-131630-77
46	December	1382637	tmo2fie$	333-131630-75
OC11	December	1383727	hqurv#2e	333-131630-79
OA21	December	1384062	nfwzr9@r	333-131630-74
HY13	December	1382638	bja3tyg$	333-131630-78

CWMBS Inc.

Deal	Month	CIK	CCC	File Number
1	January	1349804	zerwf4*h	333-125963-25
1/Luminent	January	1350996	@xn8hncv	333-125963-24
J1	January	1349805	bpp#uvi7	333-125963-27
3	January	1351038	r3a*gkwr	333-125963-28
HYB1	January	1347203	e8zfpbc@	333-125963-26
6	February	1354058	#b9wgmxh	333-125963-29
7/ALT 8T1	February	1354295	hqsy3ky*	333-125963-31
OA4	February	1354059	up4pzo@u	333-125963-34
OA5	February	1354060	juj$r4mv	333-125963-35
J2	February	1354057	qd3vsrs#	333-125963-33
HYB2	February	1353976	c2ou$jbs	333-125963-30
OA1/ALT OA1	February	1354007	d9b#vmpc	333-125963-32
8	March	1356307	u#bmmx3e	333-131662-02
9	March	1356308	2jhbqki*	333-131662-04
10	March	1356309	rjcv4r*t	333-131662-03
TM1	March	1356306	r#3nqvwf	333-131662-01
11	April	1359956	*sibyho8	333-131662-05
HYB3	April	1359930	i@ev5qgt	333-131662-06
HYB4	May	1362460	8o#jycrs	333-131662-07
12	May	1363795	ery@s5sy	333-131662-08
J3	May	1363796	vg#6xcss	333-131662-09

13	July	1368855	p3ouhv#p	333-131662-12
14	July	1371097	vsui#kk5	333-131662-14
J4	July	1369462	bvzzh$2h	333-131662-11
HYB5	July	1368950	@bqa8kgz	333-131662-10
15	August	1371127	qoc7q#pq	333-131662-15
16	September	1375096	tngb*a8u	333-131662-16
17	October	1377804	ta*9hwmg	333-131662-17
18	October	1377805	oh*s5hdx	333-131662-18
19	November	1380946	dt#ffv4v	333-131662-19
20	December	1382633	ipoh3nt$	333-131662-21
21	December	1382634	up#r8tga	333-131662-20

CWABS Inc.

1	February	1351993	tm*yir8j	333-125164-26
3	February	1354296	ig3zzc#w	333-131591-02
2	February	1351994	x*aifj5p	333-131591-01
4	March	1354829	rzsq#f3f	333-131591-05
5	March	1354827	jftsk5r*	333-131591-06
6	March	1354828	2e#bjryt	333-131591-07
BC1	March	1354960	@f2hwbdd	333-131591-03
GSCC 2006-1	March	1355713	qgmf@2pf	333-131591-04
BC2	May	1362699	z6yn@nbo	333-131591-08
SPS1	June	1365926	psbqc8$g	333-131591-16
ABC1	June	1365988	qe*kbks6	333-131591-11
7	June	1355117	p5dsqg*t	333-131591-09
8	June	1365985	pvr$7xut	333-131591-15
9	June	1365986	idnra*r9	333-131591-12
10	June	1365987	gid9amw*	333-131591-13
11	June	1366937	*uuia7wk	333-131591-10
12	June	1366938	d7duz*rq	333-131591-14
13	July	1369736	4ir$cuqb	333-131591-17
SPS2	August	1372621	kfh2qyg@	333-135846-01
BC3	August	1371670	wt9kc@gs	333-131591-18
14	September	1374036	q7r@urpg	333-135846-02
15	September	1374481	va2g@arx	333-135846-08
16	September	1374482	p6umug@q	333-135846-03
17	September	1375559	c#zvy7vg	333-135846-05
18	September	1375560	tkb*2dar	333-135846-04
19	September	1376303	r2*hcpfz	333-135846-06
BC4	September	1375281	zfjq3#bn	333-135846-07
20	November	1379489	ykcp$p4m	333-135846-09
21	November	1380953	zroo@fe3	333-135846-11
22	November	1380954	5aunz@kj	333-135846-10
23	December	1381999	vae8tg*d	333-135846-12
24	December	1383361	cb6k*sea	333-135846-16
25	December	1383362	ip*c4gqu	333-135846-14
26	December	1383363	kc3v*ags	333-135846-15
BC5	December	1380210	x@ejtf4m	333-135846-13

CWHEQ Inc.

Deal	Month	CIK	CCC	File Number
A	February	1353881	3zvxexy#	333-126790-11
S1	March	1356767	gvv7sf*c	333-126790-12
S2	March	1357382	z*mgzw6g	333-126790-13
B	March	1356229	8zrhcq#a	333-126790-14
C	March	1356854	qq@a3oyf	333-126790-15
D	March	1357190	by8j@hvk	333-126790-16
S3	June	1366128	vjf#2ymb	333-132375-05
E	June	1365927	qmowy2@c	333-132375-04
F	June	1366929	*xtr9fea	333-132375-06
G	August	1372861	dojnw4q@	333-132375-07
S4	September	1366992	rzut7vSe	333-132375-08
S5	September	1375786	6st$ukjm	333-132375-09
H	September	1376063	amhxc7@p	333-132375-10
S6	September	1375787	ih7ucec*	333-132375-11
S7	November	1381327	ot6$hgon	333-132375-12
I	December	1383341	c7*itcqb	333-132375-13
S8	December	1383944	*zv2ekve	333-132375-14
S9	December	1383945	p6wqx$ms	333-132375-15
S10	December	1383946	z9ok*tke	333-132375-16

2007 Deals

CWALT Inc.

Deal	Month	CIK	CCC	File Number
2CB	January	1386750	yy6xa*xi	333-131630-80
1T1	January	1386749	*o1b5zhj	333-131630-81
HY2	January	1386752	uo@6osmk	333-131630-82
OA2	February	1386753	$ca9hkqr	333-131630-84
J1	February	1389097	zcf@7mqb	333-131630-86
3T1	Fenruary	1389090	6mzhgcc@	333-131630-87
7T2	February	1389094	dtjkhv#8	333-131630-83
6	February	1389093	$rgd4adm	333-131630-88
4CB	February	1389091	qr$uptv4	333-131630-89
5CB	February	1389092	8qy@nron	333-131630-85
OA3	February	1389098	kxuq*3mx	333-131630-91
HY3	February	1389095	5ztaj*zf	333-131630-90
OA4	March	1392406	@ntspx5c	333-131630-92
8CB	March	1392657	8u*ypthp	333-131630-93
10CB	March	1392659	s6ymx@tr	333-131630-94
9T1	March	1392658	yyij5t@r	333-131630-97
11T1	March	1392660	*5omfjfv	333-131630-98
OA7	March	1393623	yn2dc#fj	333-131630-96
13	April	1397169	vpudg5v$	333-140962-01
12T1	April	1397168	9@utycgg	333-140962-03
OA6	April	1397167	ti#bv3xr	333-140962-02
14T2	May	1399509	aeg*k6yy	333-140962-04
OH1	May	1393625	ysm8f$ey	333-140962-05
J2	May	1401295	d4*swqwa	333-140962-06
HY4	May	1389096	*nzzau2c	333-140962-07
15CB	May	1399510	mmht@z7h	333-140962-08
20	June	1402754	bvd9zdw$	333-140962-10
19	June	1402753	hga5e#ft	333-140962-13
OA8	June	1399511	p7gjr@xh	333-140962-11
17CB	June	1402751	kgw*qae9	333-140962-12
16CB	June	1402750	6yswp$nu	333-140962-14
18CB	June	1402752	hhtg3#xx	333-140962-15
HY6	June	1402755	zh2en@ao	333-140962-17
HY7C	June	1402756	*h6kzmci	333-140962-18
OH2	June	1404500	8@xgbfnj	333-140962-16

CWMBS Inc.

Deal	Month	CIK	CCC	File Number
HYB1	January	1387427	wxaeq*4b	333-131662-24
J1	January	1386748	q6nk*gkq	333-131662-23
1	January	1386746	cdxd9c*s	333-131662-22
2	January	1386747	3mhi*yhf	333-131662-25
3	February	1389089	tx9s@mrr	333-131662-27
HY1	February	1390838	sv#ov9oz	333-131662-28
4	March	1392644	pw3mpeq*	333-131662-31
5	March	1392645	$mub6mvj	333-131662-29
HYB2	March	1393621	b7h$dkwg	333-131662-30
7	April	1397165	kvm4suq*	333-140958-01
6	April	1397164	quwrw*6w	333-140958-02
HY3	April	1397166	y@votyw3	333-140958-03
10	May	1399503	jc*xca2y	333-140958-04
8	May	1399501	fp#nir2c	333-140958-05

9	May	1399502	uaj$yhs6	333-140958-06
J2	May	1392646	c4*mqbbk	333-140958-07
I1	June	1402758	ypt3$bjs	333-140958-08
I2	June	1402759	cu#8tpkn	333-140958-09
I3	June	1402760	yfm7kg@f	333-140958-10
J3	June	1402761	rfwu*fx6	333-140958-11

CWABS Inc.

1	February	1387906	nwk5@tpx	333-135846-17
BC1	February	1389052	cqzniy*9	333-135846-19
2	February	1390060	xj5s#hdq	333-135846-18
3	March	1393417	@h7qbpbv	333-135846-20
4	March	1393418	@6bavkrk	333-135846-21
5	March	1394390	rdh5i#va	333-135846-22
6	March	1394391	vbe$up4o	333-135846-23
BC2	April	1397033	fpq9fpv$	333-140960-01
7	May	1397241	t7@tromp	333-140960-02
8	May	1400722	f6xopyz*	333-140960-03
9	June	1401795	hwfs8*vs	333-140960-04
BC3	June	1403495	i2mhwkz#	333-140960-06
10	June	1403652	6bpm@mbw	333-140960-05
11	June	1404066	9b@fqsdg	333-140960-07

CWHEQ Inc.

Deal	Month	CIK	CCC	File Number
A	January	1387320	o3xt$njx	333-132375-17
S1	February	1391179	u8fnm#fs	333-132375-18
B	March	1393885	*xg2rxsr	333-132375-19
C	March	1393886	sx5mr#ug	333-132375-20
S2	March	1393626	2oh*jaiv	333-132375-22
S3	March	1393627	3bss#wzy	333-132375-21
D	May	1400716	d#fzxzp3	333-139891-01
E	May	1400725	b5j$dzeb	333-139891-02

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PREEMPTION AND REGULATORY REFORM:

RESTORE THE STATES' TRADITIONAL ROLE AS "FIRST RESPONDER"

A National Consumer Law Center
White Paper

September 2009

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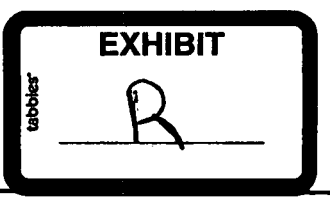

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EXECUTIVE SUMMARY

Consumer protection in the financial world has been dramatically weakened in the last several years by preemption of state consumer protection laws. Broad preemption of state law is a recent phenomenon; for most of the 150 years since national banks were created, they have complied with state law. Preemption has harmed states' ability to respond to financial abuses in both the banking and the nonbank world. Restoring the states' role as "first responders" is an essential element of regulatory reform.

For most of this nation's history, consumers have depended on states, not the federal government, to protect them. Even in the banking world, national banks were expected to comply with state law. Only in the last decade or so have federally-chartered depositories been able to ignore state laws with impunity.

- From 1864 to 1978, state laws were preempted *only* if they prevented or significantly interfered with national banks' exercise of their powers, or the law favored state banks over national banks.

- From 1978 to 1995, preemption of state laws governing interest rates began and laws covering certain mortgage terms were preempted for any lender, including nonbanks.

- From 1996 to the present, national banks have been able to ignore wide swaths of consumer protection laws.

The preemption of state consumer protection laws has harmed consumers. In area after area, abuses have followed preemption.

- *Mortgages.* The preemption of state laws in the mortgage area is a significant cause of the current crisis. In 2006, the peak year of irresponsible lending, national banks, federal thrifts, and their subsidiaries made 32% of subprime loans, 40% of Alt A loans, and 51% of interest-only and option ARM loans. A total of over $700 billion in risky loans were made by entities that states could not touch. States were also preempted from regulating *any* mortgage lender on the very terms that made many mortgages dangerous: balloon payments, negative amortization, variable rates, and other nontraditional terms.

- *Credit cards.* The abuses that eventually led to a federal crackdown – bait and switch rate increases, abusive fees, payment manipulations – were allowed to take off and grow due to preemption.

- *Overdraft fees.* Federal regulators preempted state laws while watching programs designed to induce overdraft fees grow into a $27 billion tax on the very consumers who need those funds the most.

- *Exploding debt, a climate of deception and high rate predatory lending.* The explosion of unaffordable debt that has destroyed many families and the growth of destructive forms of predatory lending have their seeds in preemption and the race to the bottom that preemption triggered.

States are our nation's first responders when new threats target consumers. Restoring their vital role in protecting consumers is a critical piece of regulatory reform.

- Only states provide comprehensive consumer protection. Flexible state laws are critical when gaps in protection or new abuses emerge.

- States see abuses sooner, react more quickly, and can address local problems before they become national ones. States have the tools and the incentives to enforce their laws and can augment federal resources.

- State laws provide the models for federal law. They are an essential element of our constitutional system of federalism.

- Exempting some entities from state laws leads to an uneven playing field and inconsistencies that are easily exploited.

- Preemption allows banks to cherry-pick those parts of state laws they need and ignore consumer protections in other parts of those same laws.

- Preemption undermines our dual banking system.

Contrary to the claims of bank lobbyists, restoring the role of states to protect individuals from banking and mortgage abuses will not impede nationwide commerce.

- When new problems arise, states approaches tend to converge. The uniform law movement and other national organizations promote uniform and model state laws. The uniform mortgage broker licensing laws that 49 states adopted in the past year are a case in point.

- Other nationwide corporations comply with state laws, and banks do in many areas. Banks tailor their products to many niche markets and can adapt to state variations. Minor differences do not prevent banks from marketing a standard product.

- Congress can adopt uniform national rules in particular areas, but state consumer protections should not be cleaved off with a meat-ax wholesale.

The uniformity achieved by preemption comes at a heavy price. States act when there is a problem. We have a choice: we can have uniformly weak protection, or vibrant consumer protection that uses the strengths of our system of federalism.

I. NATIONAL BANKS HAVE HISTORICALLY BEEN SUBJECT TO STATE CONSUMER PROTECTION LAWS[1]

For most of their 150 year history, national banks have been expected to comply with state consumer protection laws. Only in the last decade or so have national banks, as well as federal thrifts and federal credit unions, been able to ignore state law.

A. The Banking System

Federal law creates three different types of federally chartered depository institutions. National banks are chartered under the National Bank Act (NBA) and are supervised by the Office of the Comptroller of the Currency (OCC). Federal savings associations, or "thrifts," are chartered under the Home Owners Loan Act (HOLA) and are supervised by the Office of Thrift Supervision (OTS). Federal credit unions are chartered under the Federal Credit Union Act (FCUA) and are supervised by the National Credit Union Administration (NCUA).

Preemption of state laws applicable to national banks and federal thrifts and credit unions stems from these three federal banking statutes–the NBA, HOLA, and FCUA–and the regulations under them promulgated by the OCC, OTS, and NCUA, respectively. In addition, other federal statutes preempt state laws on some specific issues and give state chartered institutions parity with nationally chartered depositories in some areas.

B. Preemption, States and the Constitution

The preemption doctrine arises from the Supremacy Clause of the United States Constitution. If the provisions of a state law are "inconsistent with an act of Congress, they are void, as far as that inconsistency extends."[2] Federal regulations have the same preemptive force as federal statutes,[3] as long as the regulation is within the scope of the agency's authority to promulgate.

There are three general categories of preemption: (1) *express preemption* (a federal statute explicitly overrides state law); (2) *conflict preemption* (the state legislation is inconsistent or conflicts with federal law); and (3) *field preemption* (a federal law "occupies the field" and ousts all state laws in that area, even those that are consistent with federal law).[4] Express preemption occurs when Congress states directly that state law is preempted. Conflict preemption is implicit and arises from court interpretations of federal law. Field preemption is usually implicit but can be express.

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[1] The term "banks" in this paper will at times be used to refer to banks, thrifts, and credit unions. For a comprehensive discussion of the preemption of state consumer protection laws, see National Consumer Law Center, The Cost of Credit: Regulation, Preemption, and Industry Abuses Ch. 3 (4th ed. 2009).
[2] Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 31 (1824).
[3] Capital Cities Cable v. Crisp, 467 U.S. 691, 699 (1984); Fidelity Fed. Sav. & Loan Ass'n v. De la Cuesta, 458 U.S. 141, 153–154 (1982).
[4] *See* Lorillard Tobacco Company v. Reilly, 533 U.S. 525, 541 (2001).

Under the Constitution, the federal government is a government of limited powers, restricted to those set out in the Constitution. The states, however, are governments of general powers and the Constitution carefully preserves to the states all powers that have not been specifically taken away.[5]

The system of federalism created by our Constitution has led the Supreme Court to employ a presumption against preemption of state laws:

> [B]ecause the States are independent sovereigns in our federal system, we have long presumed that Congress does not cavalierly pre-empt state-law causes of action. In all pre-emption cases, and particularly in those in which Congress has "legislated ... in a field which the States have traditionally occupied," we "start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress."[6]

As discussed below, consumer protection is an aspect of the states' police power–the power to protect individuals—a traditional area of state activity.

C. 1864 to 1978: Limited Preemption of Laws That Significantly Interfere with National Banks

The National Bank Act (NBA) was passed in 1864 to create a system of national banks, in large part to fund the Civil War. At a time when state and federal authorities were engaged in bloody combat, the NBA protected national banks from state efforts to destroy them or to give state banks a competitive advantage. Consequently, the NBA gave national banks the right to charge interest at the higher of two rates: the rate charged by state banks or an alternative federal rate.[7]

In 1864, all states had usury laws and there was no interstate banking. The alternative usury caps in the NBA—the state cap or the federal one–provide alternative *limits* on national banks, not a means to preempt state usury laws. The NBA prohibits usurious interest and imposes double damages on banks that charge more than the higher of the two permitted rates.[8]

For over 100 years, until the recent wave of preemptive activity in the latter part of the twentieth century, state laws governing contracts, property rights and transfers, consumer protection, and other laws applied to the activities of national banks.[9] The

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[5] U.S. Const. amend. X.

[6] Medtronic, Inc. v. Lohr, 518 U.S. 470, 485 (1996) (citations omitted); *accord* Reid v. Colorado, 187 U. S. 137 (1902).

[7] 12 U.S.C. § 85.

[8] 12 U.S.C. § 86. As of August 2009, the alternative federal rate is less than 2%.

[9] *See generally* Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System*, 23 ANN. REV. BANKING & FIN. L. 225 (2004) ("OCC Threat").

NBA has no preemption provision other than the alternative usury cap. Like every federal law, the NBA implicitly preempts state laws that conflict with it. But any such conflict preemption is a narrow exception to the general rule that national banks were expected to follow state laws. As one of the earliest Supreme Court decisions explained:

> [National banks] are subject to the laws of the State, and are governed in their daily course of business far more by the laws of the State than of the nation. All their contracts are governed and construed by State laws. Their acquisition and transfer of property, their right to collect their debts, and their liability to be sued for debts, are all based on State law. *It is only when the State law incapacitates the banks from discharging their duties to the government that it becomes unconstitutional.*[10]

For most of our nation's history, national banks have rarely been permitted to ignore state law. State laws were preempted only if they prevented or significantly interfered with national banks' exercise of their powers, or the law favored state banks over national banks. For example, in 1954 the Supreme Court held that national banks did not have to comply with a New York law that prohibited any banks other than New York's own chartered savings banks and savings and loan associations from using the word "savings" in their name.[11] In other cases, the Supreme Court repeatedly affirmed that "national banks are subject to state laws, unless those laws infringe the national banking laws or impose an undue burden on the performance of the banks' functions."[12]

The Home Owners Loan Act of 1933 and the Federal Credit Union Act of 1934 were interpreted similarly to the NBA in the early decades, preempting only state laws that conflicted with a specific federal law or significantly interfered with federal thrift or credit union operations.[13]

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[10] National Bank v. Commonwealth, 76 U.S. (9 Wall.) 353, 362 (1869) (holding that state taxes on bank stock are not preempted) (emphasis added).

[11] Franklin Nat'l Bank of Franklin Square v. People, 347 U.S. 373 (1954).

[12] Anderson Nat'l Bank v. Luckett, 321 U.S. 233, 248 (1944); *accord* Lewis v. Fid. & Deposit Co., 292 U.S. 559, 564–66 (1934); First Nat'l Bank in St. Louis v. Missouri, 263 U.S. 640, 656–59 (1924); McClellan v. Chipman, 164 U.S. 347, 356–59 (1896); Davis v. Elmira Sav. Bank, 161 U.S. 275, 287 (1896) (affirming that "so far as not repugnant to acts of Congress, the contracts and dealings of national banks are left subject to the state law"); First Nat'l Bank of San Jose v. California, 262 U.S. 366, 368–69 (1923) (recognizing that "[the] contracts and dealings [of national banks] are subject to the operation of general and undiscriminating state laws which do not conflict with the letter or the general object and purposes of congressional legislation"); *see generally*. Wilmarth, OCC Threat, Jr., *supra*, 23 ANN. REV. BANKING & FIN. L. 225 (2004).

[13] *See generally* National Consumer Law Center, The Cost of Credit: Regulation, Preemption, and Industry Abuses §§ 3.5, 3.6 (4th ed. 2009).

D. 1978 to 1996: Preemption of State Laws on Interest Rates and Certain Mortgage Terms

Preemption of state consumer protection laws began with interest rate preemption in 1978 in the context of credit cards. In *Marquette National Bank v. First of Omaha Service Corp.*,[14] the Supreme Court interpreted the National Bank Act to hold that the applicable state interest rate cap governing lending by national banks was the interest rate law of the bank's home state, even for loans made to consumers in other states. This decision meant that a national bank could "export" its own home state laws governing interest rates, even when the state where the consumer lived and the loan was made was different.

The decision had the effect of wiping out the usury laws applicable to credit cards[15] that protected consumers of the other forty nine states. Not surprisingly, the decision provided national banks a powerful tool to convince states to either mimic the unlimited interest rates allowed by their sister states or risk losing the jobs and revenue sustained by a bank's headquarters. Banks had the upper hand: if they convinced the legislators of just one state to allow sky high interest rates on credit cards, they now had the power—by threatening to move their operations out of state—to force most other states to similarly deregulate. That is in fact what happened: national banks with credit card operations either moved to states with no interest rate caps, or convinced their home state to deregulate.

Meanwhile, the double-digit inflation of the late 1970s was making it difficult for mortgage lenders to make loans while complying with state caps on mortgage interest. In 1980 Congress attempted to calm the inflation fires in the mortgage market by passing the Depository Institution Deregulation and Monetary Control Act (DIDA).[16] DIDA completely removed state interest rate caps for most lenders, not just national banks, issuing loans secured by first mortgages on homes.[17] DIDA also preempted state limitations on a lender's ability to assess "points," finance charges, or "other charges."[18]

DIDA also gave all federally chartered or federally insured depository lenders—not just national banks—the right to export their home-state interest rates when lending to consumers in other states.

Congress went even further in 1982, in a law that opened up mortgage lending to abuses beyond high interest rates. The Alternative Mortgage Transaction Parity Act

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[14] 439 U.S. 299 (1978).

[15] Though the immediate impact of the *Marquette* decision was in the credit card world, as national banks began offering other products across state lines, it eventually had the impact of eliminating state interest rate caps in those areas.

[16] Pub. L. No. 96-221, 94 Stat. 161 (1980), codified throughout Title 12 of the U.S. Code.

[17] States were allowed to opt out for a limited time but only 15 states did so and some only opted out of some aspects of DIDA's preemption.

[18] States had the ability to "opt out" of the preemption so long as it was accomplished within three years of enactment. Only 13 states acted in time.

(AMTPA)[19] removed states' abilities to limit terms on "alternative" mortgages. Specifically, AMPTA preempted state laws governing:

- Variable rate loans (even those that only go up, and never go down and exploding adjustable rates);[20]
- Balloon payments;[21]
- Negative amortization and other types of "rate, method of determining return, term, repayment, or other variation not common to traditional fixed-rate, fixed-term transactions."[22]

In 1996, the OTS issued a regulation interpreting AMPTA to preempt prepayment penalties, but when the resulting abuses became clear, it rescinded the regulation effective in 2003.[23]

AMPTA also included a section that preempted state restrictions on due-on-sale clauses in mortgages.[24]

Aside from the specific issues of interest rate preemption and certain mortgage terms, the general rule in effect from 1978 to 1996 continued to be that national banks were covered by state laws except in those rare instances of conflict with federal law. For example, in 1996, the Supreme Court held in *Barnett Bank v. Nelson* that a state law prohibiting national banks from acting as insurance agents conflicted with a federal law specifically granting them that power.[25]

However, the Court made clear that state laws generally apply to national banks unless they significantly interfere with the bank's powers:

> In defining the pre-emptive scope of statutes and regulations granting a power to national banks, these cases take the view that normally Congress would not want States to forbid, or to impair significantly, the exercise of a power that Congress explicitly granted. *To say this is not to deprive States of the power to regulate national banks, where (unlike here) doing so does not prevent or significantly interfere with the national bank's exercise of its powers.*[26]

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[19] 12 U.S.C. § 3801.
[20] 12 U.S.C. § 3802(1)(a).
[21] 12 U.S.C. § 3802(1)(b).
[22] 12 U.S.C. § 3802(1)(c).
[23] 12 C.F.R. § 560.34, *rescinded by* 67 Fed. Reg. 60,542 (Sept. 26, 2002). *See also* National Home Equity Mortgage Association v. Office of Thrift Supervision, 271 F. Supp. 2d 264 (D.D.C. 2003).
[24] 12 U.S.C. § 1701j-3. That section of AMTPA is known as the Garn-St. Germain Depository Institutions Act.
[25] 517 U.S. 25 (1996).
[26] *Id.* at 31 (emphasis added).

Congress expressly approved the *Barnett* standard in 1999 when it enacted the Gramm-Leach-Bliley Act.[27]

Similarly, in 1994, when Congress authorized interstate banking in the Riegle-Neal Act, it added this provision to the National Bank Act:

> *The laws of the host State regarding community reinvestment, consumer protection, fair lending, and establishment of intrastate branches shall apply to any branch in the host State of an out-of-State national bank to the same extent as such State laws apply to a branch of a bank chartered by that State*, except—
>
> (i) when Federal law preempts the application of such State laws to a national bank; or
>
> (ii) when the Comptroller of the Currency determines that the application of such State laws would have a discriminatory effect on the branch in comparison with the effect the application of such State laws would have with respect to branches of a bank chartered by the host State.[28]

Thus, the status of preemption for national banks (as well as federal thrifts and credit unions) in early 1996 was:

- Interest rate caps for credit cards and first mortgages were preempted, and the combination of exportation and deregulation was eroding rate caps in other areas;
- States were preempted from regulating certain mortgage terms regardless who the lender was;
- Otherwise, state laws were not preempted unless they significantly interfered with the bank's exercise of its powers.

E. 1996 to Present: National Banks and Thrifts Enjoy Increasing Preemption of Consumer Protection Laws

In 1996, the OCC issued a regulation expanding interest-rate exportation to include preemption of state laws covering a long list of fees.[29] The regulation was passed in response to a suit by a California consumer challenging the credit card late fees charged by Citibank (a South Dakota bank). OTS took the same position.[30]

In 1996, in *Smiley v. Citibank (South Dakota)*, the Supreme Court upheld the OCC regulation. Without deciding whether the fees violated California law, the Court

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[27] 15 U.S.C. § 6701(d)(2)(A).
[28] 12 U.S.C. § 36(f) (emphasis added).
[29] 12 C.F.R. § 7.4001.
[30] 12 C.F.R. § 560.110(a).

held that state law challenges to the fees of national banks are preempted as long as the fees are legal in the bank's home state.[31] Not surprisingly, states like South Dakota and Delaware, where many national banks are located, allow any fees specified in the agreement with the consumer, regardless whether they are unconscionable or unfair.

In the fall of 1996, after the *Smiley* decision came out, the OTS finalized a sweeping preemption regulation. The rule asserts that "with certain narrow exceptions, *any* state laws that purport to affect the lending operations of federal savings associations are preempted."[32]

To avoid losing their regulated banks to other, more permissive oversight, the other banking agencies embarked on similar efforts. From 2000 to 2004, the OCC worked with increasing aggressiveness to prevent the states from enforcing state consumer protection standards against national banks. For example, the OCC openly instructed banks that they "should contact the OCC in situations where a State official seeks to assert supervisory authority or enforcement jurisdiction over the bank,"[33] and warned states that national banks need not comply with state laws.[34]

The OCC's efforts culminated in 2004, when the agency adopted a regulation preempting all state laws unless their effect on national bank powers was "only incidental."[35] The regulation allows national banks to ignore state laws regarding licensing, terms of credit, disclosure and advertising, solicitations, billing, and other topics.

Both the OCC and OTS also asserted that the subsidiaries of national banks and federal thrifts—though they are creatures of state law, are not banks, and do not have a federal charter—can ignore state law to the same extent that their parents can.[36]

Though somewhat less aggressive than the OTS and OCC, the National Credit Union Administration has also enacted regulations preempting state laws as applied to federal credit unions.[37] However, the NCUA regulation does not extend preemption to subsidiaries.

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[31] Smiley v. Citibank (South Dakota), 517 U.S. 735 (1996), and state-chartered credit unions, 46 Fed. Reg. 24,153 (Apr. 30, 1981). Federal credit unions have a federal usury cap of 18%, but state laws regulating interest rates and fees are otherwise preempted. *See* 12 U.S.C. § 1785(g).

[32] 61 Fed. Reg. 50,951 (Sept. 30, 1996) (enacting 12 C.F.R. § 560.2(a)); *see also* 12 C.F.R. § 557.11 (preempting state laws regulating deposits).

[33] Office of the Comptroller of the Currency, Interpretive Letter No. 957 n.2 (Jan. 27, 2003) (citing OCC Advisory Letter 2002-9 (Nov. 25, 2002)) (viewed June 19, 2009, at http://www.occ.treas.gov/interp/mar03/int957.doc , and available at 2003 OCC Ltr. LEXIS 11).

[34] *See, e.g.*, Office of the Comptroller of the Currency, Preemption Determination and Order, 68 Fed. Reg. 46,264, 46,264 (Aug. 5, 2003).

[35] 12 C.F.R. §§ 7.4007(c), 7.4008(e), 7.4009(c)(2).

[36] 12 C.F.R. § 7.4006 (OCC); *id.* § 559.3(h), (n) (OTS).

[37] The Federal Credit Union Act (FCUA) and NCUA regulations and opinion letters preempt state consumer protections in a wide number of areas, including state anti-predatory lending laws, and laws related to closing costs, balloon payments, prepayment limits, conditions on the type or amount of security for a loan, changes of terms in open-end credit, grace periods, and minimum payment disclosure

In 2007, the Supreme Court upheld the OCC regulation, including the rule preventing the states from imposing their inspection and registration requirements on non-bank subsidiaries doing business in their states.[38]

The effect of these regulations is that federal banks, thrifts, and credit unions can simply ignore wide swaths of state law—even much of the state law of their home state.

F. State-Chartered Banks Receive Less Preemption

The preemption rights of state-chartered institutions are more complex. Like their federal cousins, they enjoy preemption of state laws governing interest rates, fees, and certain mortgage terms. But beyond those specific terms, the scope of preemption is not as broad, though it varies state to state and issue to issue, and is more a creature of state parity laws than federal preemption.[39]

Another aspect of preemption that exacerbates the discrepancy between the playing fields for federally and state chartered institutions is that of enforcement. The ability of the states to enforce *any* laws—including non-preempted state laws and federal laws—against national banks, thrifts, or credit unions, or their subsidiaries, is severely restricted. States can file judicial actions to enforce non-preempted state laws, but they cannot seek information from the bank to investigate the issue first.[40] Though federal agencies in theory can enforce state law, they virtually never do. In contrast, state enforcement of state laws is generally vigorous against state-chartered institutions—which might be one reason these state institutions do not cause as much trouble.

II. THE PREEMPTION OF STATE CONSUMER PROTECTION LAWS HAS HARMED CONSUMERS

For consumers, the upshot of all these efforts to preempt state law has been the predictable failure of consumer protection. Consumer protections eliminated on the state level were never replaced with federal protections.[41] Though stronger consumer protection laws are definitely needed at the federal level, restoring states' ability to protect consumers is a critical part of regulatory reform. Preemption has played a role in every major consumer protection failure in recent years.

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requirements relating to credit card plans. *See generally* National Consumer Law Center, The Cost of Credit: Regulation, Preemption, and Industry Abuses § 3.6 (4th ed. 2009).

[38] Watters v. Wachovia Bank, N.A., 127 S. Ct. 1559 (2007).

[39] *See generally* National Consumer Law Center, The Cost of Credit: Regulation, Preemption, and Industry Abuses §§ 3.7.3, 3.7.4 (4th ed. 2009).

[40] *See* Cuomo v. Clearing House Association, 129 S. Ct. 2710 (2009).

[41] *See, e.g.*, Adam J. Levitin, *Hydraulic Regulation: Regulating Credit Markets Upstream*, 26 YALE J. ON REG. 143 (2009).

Mortgages. The preemption of state laws in the mortgage area is a significant cause of the current crisis. Many of the irresponsible loans that led to the foreclosure crisis were made by entities that could ignore state law.

Mortgage lending by national banks, federal thrifts, and their operating subsidiaries made up 31.5% – nearly a third – of the most dangerous, subprime loans during the peak year of 2006. Subprime loans typically were made with no documentation of income, without regard to ability to repay, and with a host of other problems such as exploding rates, failure to include escrow in affordability analysis, and inflated appraisals. Not surprisingly, they have failed in large numbers.

Table 1: Subprime Loans By National Banks and Federal Thrifts 2006
(includes operating subsidiaries)

LENDER	RANK	$ (BILLIONS)	*MARKET SHARE*
CitiMortgage, NY*	4	$38	6.3%
WMC Mortgage (GE), CA	5	33	5.5%
Wells Fargo Home Mort., IA	9	28	4.6%
First Franklin (National City Bank), CA	10	28	4.6%
Washington Mutual, WA	11	27	4.4%
BNC Mortgage, CA (Lehman Bros. Bank)	16	15	2.4%
Chase Home Finance, NJ	17	12	1.9%
Equifirst, NC (Regions Bank)	18	11	1.8%
TOTAL		$190	31.5%

Source: Inside Mortgage Finance
*CitiMortgage became an operating subsidiary of CitiBank in October 2006. Its volume of subprime originations rose in the 4th quarter, and its market share increased to 10%.

In the Alt A market, the percentage of loans made by banks or their operating subsidiaries was higher: 40.1% in 2006, as reflected in Chart 2. Alt A loans were made to borrowers who did not qualify for a prime loan though they may have had very good credit. Like subprime loans, Alt A loans were often obtained with little documentation, weak underwriting and risky features and have turned out to have high foreclosure rates.

Table 2: Alt A Loans By National Banks and Federal Thrifts 2006

(includes operating subsidiaries)

LENDER	RANK	$ (BILLIONS)	*MARKET SHARE*
IndyMac, CA	1	$70	17.5%
Washington Mutual, WA	5	25	6.1%
WMC Mortgage Corp. (GE), CA	8	18	4.4%
SunTrust Mortgage, VA	11	10	2.5%
Chase Home Finance, NJ	12	9	2.4%
National City Mortgage Co., OH	13	9	2.2%
CitiMortgage, MO*	14	8	2.1%
ABN AMRO Mortgage Group, MI (LaSalle Bank)	22	4	1.1%
Wells Fargo Home Mortgage, IA	24	4	1.0%
Flagstar Bank, MI	25	3	0.8%
TOTAL		$161	40.1%

Source: Inside Mortgage Finance

*CitiMortgage became an operating subsidiary of CitiBank in October 2006. Its volume of Alt A originations doubled in 2007 and its market share increased to 6%.

Bank domination was heaviest in the nontraditional interest-only and payment-option adjustable rate mortgage (ARM) markets: they held 51% of the total market in 2006, as shown in Chart 3. Typically made to prime borrowers, these loans also had features that put homeownership at risk. Interest-only loans had initial payments that did not include principal, making them appear affordable. Payments later increased once principal repayment began. Payment option ARMs had a fixed initial minimum payment but not a fixed rate. As rates rose, lenders who made the minimum payment experienced negative amortization and quickly owed more than their house was worth. Though the borrowers were prime, the loans were toxic.[42]

[42] *See, e.g.*, Allen J. Fishbein & Patrick Woodall, Consumer Federation of America, Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders (May 2006), *available at* http://www.consumerfed.org/pdfs/Exotic_Toxic_Mortgage_Report0506.pdf; Testimony of Margot Saunders, Counsel, National Consumer Law Center, on Mortgage Lending Reform: A Comprehensive Review of the Current Mortgage System, Subcommittee on Financial Institutions and Consumer Credit, House Financial Services Committee, at 7-10 (Mar. 11, 2009), *available at* http://www.consumerlaw.org/issues/predatory_mortgage/content/MortgageLendingReform0309.pdf (describing dangers of payment-option adjustable rate mortgages).

Table 3: National Bank and Federal Thrift Payment Option & Option ARM Lenders 2006
(includes operating subsidiaries)

LENDER	RANK	$ (BILLIONS)	*MARKET SHARE*
Wells Fargo Home Mortgage, IA	2	$94	17.7%
Washington Mutual, WA	3	68	8.8%
IndyMac, CA	4	54	7.0%
Golden West Financial, CA (World Savings/Wachovia)	7	31	4.0%
CitiMortgage, MO*	10	28	3.6%
Bank of America Mtg. & Aff., NC	11	24	3.1%
SunTrust Mortgage, VA	12	21	2.7%
Chase Home Finance, NJ	14	14	1.7%
National City Mortgage, OH	16	11	1.4%
First Franklin Financial, CA (National City Bank)	20	8	1.0%
TOTAL		$352	51.0%

Source: Inside Mortgage Finance
*CitiMortgage became an operating subsidiary of CitiBank in Oct. 2006. Its volume of PO/option ARM lending increased 20% in 2007 and its market share increased to 5.4%.

Overall, in 2006, national banks, federal thrifts, and their operating subsidiaries were responsible for over $700 billion of the riskiest loans. States could do little to touch these loans because of federal preemption.

Even for mortgage lenders who were technically still within the states' regulatory purview, states' ability to regulate many terms was also limited by preemption. Thus the stage was set for the wild, wild west of mortgages. Each element of a mortgage transaction that has been immune from state law has led directly to abuses:

- *Interest rates.* Preemption of interest rate caps led to a fringe market of high-cost predatory mortgages.

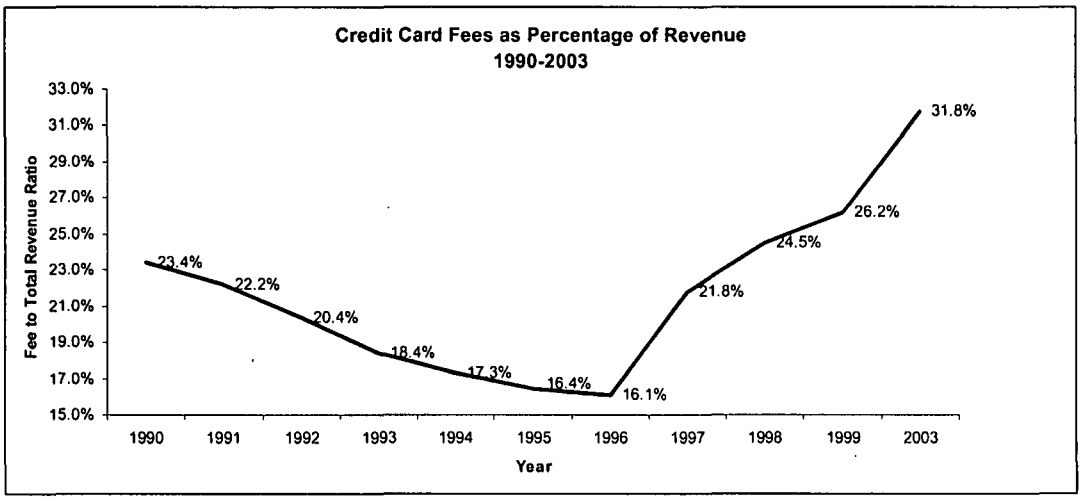
- *Point and fees.* The ability of lenders to charge high up-front fees and recoup them immediately by simply adding to the homeowner's loan fed the flames of equity stripping abuses.[43]

- *Balloon payments.* The use of balloon payments also forced homeowners into repeated home-equity stripping refinancings, as a new loan is generally the only way to pay off a large balloon payment due at the end of the loan term.

[43] *See* National Consumer Law Center *et al.*, Comments Regarding the Advance Notice of Proposed Rulemaking, OTS Docket Number RIN 2550-AB37, 12 C.F.R. Part 560, No. 2000-34 (July 5, 2000), *available at* http://www.consumerlaw.org/issues/predatory_mortgage/NCLC_CFA_comments.shtml.

- *Negative amortization and variable rates.* Equity that shrinks rather than grows, and low teaser rates that explode to unaffordable levels, are prime elements of the toxic mortgages that took down the financial system.

Credit cards. The preemption of state laws governing bank fees in 1996 also had pernicious effects. Credit card companies immediately began using tactics to increase their fee revenue:[44]



The broader preemption of state consumer protection laws allowed a variety of other unfair and deceptive credit card practices to take off unchecked. States had no power to address bait-and-switch rate increases, tricks to induce late payments and over-limit purchases, or payment allocation manipulations.[45] These abuses went on for years until the Federal Reserve, under the gun of losing its regulatory authority, and Congress, under a storm of public outrage, finally reined them in.

Overdraft fees. Overdraft fee abuses began shortly after the OCC and the OTS began expanding preemption. In the late 1990s, bank consultants started promoting services to banks and credit unions that would *encourage* consumers to overdraw their accounts. For example, one website promised that banks could increase non-sufficient

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[44] Source: Mark Furletti, Payment Cards Center, The Federal Reserve Bank of Philadelphia, Credit Card Pricing Developments and Their Disclosure, at 32 (Jan. 2003) (citing October 1999 and July 2000 issues of CardTrack, CardWeb.com as the source), *available at* http://www.philadelphiafed.org/payment-cards-center/publications/discussion-papers/2003/CreditCardPricing_012003.pdf. Mr. Furletti updated the information through 2003 at the request of the Center for Responsible Lending. (E-mail from Mark Furletti, March 5, 2003, on file with CRL.)

[45] *See* Plunkett Reg. Restructuring Testimony, *supra,* at 11-12; Testimony of Arthur E. Wilmarth, Jr., Professor of Law, George Washington University Law School, *Before The Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, U.S. House of Representatives Hearing on "Credit Card Practices: Current Consumer And Regulatory Issues*, at 7-13 (Apr. 26, 2007) ("Wilmarth Credit Card Testimony"), *available at* http://financialservices.house.gov/hearing110/htwilmarth042607.pdf.

funds fee income by "100%, 200%, 300% or more!"[46] Federal bank regulators did little to stop abuses[47] – even intervening in consumer protection lawsuits to argue, successfully, that state laws protecting consumers against overdraft abuses were preempted.[48]

The deep recession caused by the foreclosure crisis has helped banks in one respect. Consumers now lose $27 billion to overdraft fees annually.[49] These fees come from consumers who most need every penny. Indeed, much overdraft income comes from Social Security and other exempt income needed for basic sustenance.[50]

Exploding debt and increasing high rate predatory lending. The preemption of state usury laws through exportation led to a deregulatory race to the bottom as banks competed to retain their banking industries. The result was an explosion of credit card debt,[51] the consequences of which are now apparent.

A culture of deception. The limited ability of states to address rate and fee abuses also fed the ever-present culture of deception in the credit marketplace. Substantive state consumer protections have been eliminated in favor of weak federal disclosures, and the true cost of various forms of credit—credit cards,[52] overdraft loans,[53] mortgages[54]—is frequently obscured, made up of hidden fees and interest rate hikes.[55]

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[46] *See* NCLC & CFA, Bounce Protection: How Banks Turn Rubber Into Gold By Enticing Consumers To Write Bad Checks: An Examination of Bounce Protection Plans at 6 n. 33(January 2003), available at http://www.nclc.org/issues/bounce_loans/appendix.shtml.

[47] *See* Testimony of Lauren Saunders, National Consumer Law Center, Before the Subcommittee on Monetary Policy, Committee on Financial Services, U.S. House of Representatives, Hearing on Regulatory Restructuring: Safeguarding Consumer Protection and the Role of the Federal Reserve at 16-19 (July 16, 2009) ("Saunders Reg. Restructuring Testimony"), available at http://www.nclc.org/issues/legislative/content/Testimony7-16-09.pdf; Testimony of Travis Plunkett, Consumer Federation of America, and Edmund Mierzwinski, U.S. PIRG, Before the Committee on Financial Services, U.S. House of Representatives, Hearing on Regulatory Restructuring: Enhancing Consumer Financial Products Regulation at 12-14 (June 24, 2009) ("Plunkett Reg. Restructuring Testimony"), available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/mierzwinski_-_submitted_with_plunkett.pdf.

[48] *See Lopez v. Washington Mut. Bank, FA*, 302 F.3d 900 (9th Cir. 2002) (finding California's laws imposing restrictions on overdraft fees to protect Social Security and Supplemental Security Income benefits preempted).

[49] Ron Lieber And Andrew Martin, "Overspending on Debit Cards Is a Boon for Banks," New York Times (Sept. 8, 2009).

[50] Center for Responsible Lending, Quick Facts on Overdraft Loans, *available at* http://www.responsiblelending.org/overdraft-loans/research-analysis/quick-facts-on-overdraft-loans.html.

[51] *See* Mercatante, *The Deregulation of Usury Ceilings, Rise of Easy Credit, and Increasing Consumer Debt*, 53 S.D. L. Rev. 37 (2008). The amount of revolving debt, most of which is credit card debt, is approaching $1 trillion. *See* Federal Reserve, Statistical Release G-19, Consumer Credit, *available at* http://www.federalreserve.gov/releases/g19.

[52] Comments of the National Consumer Law Center et al. Regarding Advance Notice of Proposed Rulemaking Review of the Open-End (Revolving) Credit Rules of Regulation Z (Oct. 12, 2007), *available at* http://www.consumerlaw.org/issues/credit_cards/content/open_end_final.pdf (describing in detail the way fees have been used to undermine the usefulness of the APR disclosure).

[53] *See, e.g.*, Testimony of Eric Halperin, Center for Responsible Lending, *Before the U.S. House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit on Overdraft Protection: Fair Practices for Consumers* (July 11, 2007) *available at*

III. STATES ARE OUR NATION'S FIRST RESPONDERS AND PLAY A VITAL ROLE IN A FULL CONSUMER PROTECTION REGIME

A. Only States Provide Flexible, Comprehensive Consumer Protection That Can Attack New Abuses

States, not the federal government, have historically been the source of consumer protection. Consumer protection is an aspect of the states' broad "police power"—the power of the states, preserved under the Constitution, to regulate behaviors and enforce order in order to protect public welfare, security, health, and safety.[56] The federal government, by contrast, is a government of limited, enumerated powers under the Constitution. Though the power of the federal government has grown in the last century, the protection of individuals remains, in the first instance, a state responsibility.

States have a comprehensive network of laws to protect their citizens. This web of protection in the states is comprised of several levels: first, the traditional Anglo-Saxon common law, including the rules governing contracts, property rights, and commercial transactions, and those prohibiting fraud and unconscionability; second, universally applicable statutory laws such as those against unfair and deceptive acts and practices; and third, specific laws enacted in response to particular problems, such as those governing mortgage lending.

On occasion, Congress has passed limited and specific protections. However, there is no comprehensive network of federal law that protects consumers. There is no federal common law providing a broad set of rules governing contracts, property transfers, or commercial transactions.[57]

Also, federal law provides consumers with neither the broad nor the specific protections in state law governing contractual relations, requiring good faith and fair dealing, or prohibiting unjust enrichment, fraud and deceit, negligent misrepresentation, or unfair or deceptive acts and practices. Though the federal banking agencies have authority to stop banks from engaging in unfair or deceptive conduct, they have rarely done so,[58] and individuals have no direct recourse under federal law against unfair or deceptive practices.[59]

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http://www.responsiblelending.org/overdraft-loans/policy-legislation/congress/testimony-of-eric-halperin-7-11-07.pdf.

[54] HUD Final RESPA Rule, National Consumer Law Center's Summary Analysis (Dec. 5, 2008), *available at* http://www.consumerlaw.org/issues/predatory_mortgage/content/RESPAruleanalysis120508.pdf.

[55] *See* Elizabeth Renuart and Diane E. Thompson, *The Truth, The Whole Truth, and Nothing but the Truth: Fulfilling the Promise of Truth in Lending*, 25 Yale J. on Reg. 181 (Summer 2008).

[56] *See* "Police Power," Wikipedia, http://en.wikipedia.org/wiki/Police_power; Encyclopedia Britannica, http://www.britannica.com/eb/article-9060615/police-power.

[57] Erie Railroad Co. v. Tompkins, 304 U.S. 64 (1938).

[58] *See* Julie L. Williams & Michael L. Bylsma, *On the Same Page: Federal Banking Agency Enforcement of the FTC Act to Address Unfair and Deceptive Practices by Banks*, 58 Bus. Law. 1243, 1244, 1246, n.25,

Federal law has always been an overlay rather than a replacement for state law. The federal government has never set out to enact a comprehensive scheme to take over from the states the frontline role in protecting consumers. The federal Truth in Lending Act (TILA), while providing important standardized disclosures about the cost of credit, was not intended to replace the substantive protections provided by state law. The Supreme Court "has long recognized that federal law has a 'generally interstitial character,' in the sense that Congress generally enacts legislation against the background of existing state law."[60]

President Obama recognized the importance of state law in our federal system in one of his first executive orders:

> From our Nation's founding, the American constitutional order has been a Federal system, ensuring a strong role for both the national Government and the States. The Federal Government's role in promoting the general welfare and guarding individual liberties is critical, but State law and national law often operate concurrently to provide independent safeguards for the public. Throughout our history, State and local governments have frequently protected health, safety, and the environment more aggressively than has the national Government.[61]

After the recent mortgage debacle, it should be clear that the state laws protecting consumers are the last bastion of redress when federal protections fail. State laws on fraud, unfair trade practices, unconscionability, foreclosure defenses, good faith and fair dealing, conspiracy, joint venture, as well as other torts and contract defenses, have been the primary way many individual homes have been saved from foreclosure.[62] The rich and textured common law in the states has been particularly useful to the courts as they

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1253 (2003); Julie L. Williams & Michael L. Bylsma, *On the Same Page: Federal Banking Agency Enforcement of the FTC Act to Address Unfair and Deceptive Practices by Banks*, 58 Bus. Law. 1243, 1244, 1246, n.25, 1253 (May 2003) ("An obvious question is why it took the federal banking agencies more than twenty-five years to reach consensus on their authority to enforce the [ban on unfair and deceptive practices under the] FTC Act").

[59] The Federal Trade Commission Act bans unfair and deceptive practices, but it is not enforceable by individuals. 15 U..S.C. § 45.

[60] Watters v. Wachovia Bank, N.A., 550 U.S. 1, 23–24 (2007) (Stevens, J., dissenting); Three Affiliated Tribes of Fort Berthold Reservation v. Wold Engineering, 476 U.S. 877, 895 (1986) (The Supreme Court "has long recognized that federal law has a 'generally interstitial character,' in the sense that Congress generally enacts legislation against the background of existing state law." (quoting *Richards v. United States*, 369 U.S. 1, 7 (1962)); Shell Oil Co. v. Iowa Dep't of Revenue, 488 U.S. 19, 27 (1988) ("Congress recognized, however, that because of its interstitial nature, federal law would not provide a sufficiently detailed legal framework to govern life on [oil drilling platforms].").

[61] Memorandum for the Heads of Executive Departments and Agencies; Subject: Preemption (May 20, 2009).

[62] *See* Testimony of Margot Saunders, Counsel, National Consumer Law Center, *"HR 1728: Mortgage Reform and Anti-Predatory Lending Act," Before House Financial Services Committee* (Apr. 23, 2009), *available at* http://www.consumerlaw.org/issues/predatory_mortgage/content/Testimony-HR-1728-042309.pdf.

craft appropriate responses to the new and complex set of problems that have arisen in recent years.

B. States See Abuses Sooner, React More Quickly, and Provide the Experiments for Federal Law

States governments, with fewer residents commanding their attention, are closer to consumers. Individuals are much more likely to complain to state and local government agencies than they are to federal ones. States see credit market abuses when they first arise, before they become an essential part of an industry's profit model.

When specific problems have arisen that are not adequately addressed by more general laws, whether in the consumer area or any other area, states have traditionally been the ones to respond. States generally act much more quickly than do federal lawmakers. Understandably, Congress and federal agencies are more deliberate before adopting rules that will apply to the entire nation. But even when national attention is clearly needed, Washington is often slow to act.

Several years into the subprime mortgage crisis, Congress has yet to adopt laws to address toxic mortgages. The rules adopted belatedly in 2008 by the Federal Reserve—years after given the authority in 1994—were too little and too late. Neither Congress nor the banking agencies have adopted any rules addressing abuses in the prime market. In the meantime, though states have been severely hampered by preemption in their ability to adopt mortgage protections, they have made efforts to use what authority they have. Several states, including Illinois, New Jersey, New Mexico, New York, North Carolina, and Ohio, have passed predatory mortgage lending laws.

Similarly, California was the first state to address foreclosure rescue scams in 1979 as a result of a unique problem facing that state with its exceptionally robust and rising real estate prices. Other states found no need to respond until 2004 when the scams began spreading.[63] From 2004 to 2009, over half of the states adopted laws to address foreclosure rescue scams. In 2009, Congress gave the Federal Trade Commission authority to address the scams. The FTC is now considering such a rule, following the models and experience under the state laws. But in the meantime, it is the states that are providing protection to consumers.

States also act more quickly to enforce laws when a financial institution violates them. In the past decade there have been major multistate enforcement actions taken against Household, Ameriquest, and Countrywide. State regulators took more than 7,000 mortgage enforcement actions in 2008 alone.[64] Federal bank regulators, by contrast, have

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[63] While the housing market was still strong, many of the scams were aimed at equity stripping. After the foreclosure crisis hit, foreclosure consultant scams (extracting a fee in exchange for a false promise of help) came to predominate.

[64] *See* Mark Pearce, *Viewpoint: Far From Blame, States Deserve Vital Reg Role*, American Banker (Aug. 26, 2009). (The author, Mark Pearce, is North Carolina's deputy commissioner of banks and the president of the American Association of Residential Mortgage Regulators.)

been more reluctant to take aggressive action against predatory mortgage lending abuses.[65]

Thus, preserving the role of states is essential to protecting consumers from local abuses that have not commanded national attention and may not receive a federal response. Allowing states to act as new problems first develop also has the potential to stop them before they become a widespread, national problem.

On many other occasions, states have been prescient in addressing problems first, developing models eventually copied in federal legislation.[66] Even in the financial area, in which states' efforts have been heavily preempted, states have led the way on multiple issues:

- Congress adopted protections against identity theft only after several states did so. Congress omitted the right to a security freeze but most states gave consumers that right, and eventually the credit bureaus adopted the freeze nationwide.

- The "Schumer" box now required for all credit card applications followed California's rule that consumers be provided a chart showing the interest rate, grace period, and annual fee.

- States led the way in stopping long holds on deposited checks, which Congress followed with the Expedited Funds Availability Act.[67]

In these and many other areas, Congress benefitted from having solutions tried out on the state level first.

C. Exempting Some Entities Results in Unequal Treatment, Gaps in Protections and Manipulations to Exploit Those Gaps

A clear lesson of the financial crisis is that protections should apply consistently across the board, based on the product or service that is being offered, not on who is offering it. Disparities in the treatment of different institutions lead to a race to the bottom and anomalies that get exploited.

Preemption of laws for one segment of the market creates a disincentive for states to regulate other actors. One reason states were reluctant to use their limited authority to regulate nonbank lenders was the sense that it would be fruitless. As state law could not affect a significant segment of creditors, states may have perceived that the effect of

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[65] *See* Brief of *Amici Curiae* Center for Responsible Lending *et al.*, Clearing House Association, L.L.C. v. OCC, No. 08-453 (Mar. 4, 2009); Saunders Reg. Restructuring Testimony, *supra*, at 5–12.

[66] *See* Plunkett Reg. Restructuring Testimony, *supra,* at 36–39 (discussing Clean Air Act, national organic labeling laws, national "motor voter" laws, and Do-Not-Call Registry), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/mierzwinski_-_submitted_with_plunkett.pdf.

[67] *See id.*

partial regulation would be to place state lenders at a disadvantage without clear benefits for consumers.

Preemption allows different rules to be applied to the same product. This in turn leads to creditor gyrations just to avoid consumer protections. One example of disparate treatment is in the payday loan area. Payday loans are very high-rate (typically 300% to 400% APR) short term (2- to 4- week) loans that lead to a cycle of exploding debt. In the 1990s, as states started recognizing the evils of payday loans and began re-imposing their usury rates, payday lenders attempted to gain preemption rights by partnering with state and national banks.[68] The rent-a-bank partnerships were not completely shut down by the federal banking regulators until 2006.

Preemption leads to unequal levels of consumer protection that can undermine protections that do exist. For example, banks are now starting to get directly involved with payday lending. Bank payday loans take the form of direct deposit "account advance" loans on bank accounts and prepaid cards, with the same short-term repayment and similar triple-digit interest rates as traditional payday loans.[69] Though the destructive effect on consumers is the same, the bank products can ignore state laws. For example, payday lenders in Ohio must comply with Ohio's 28% payday loan cap but Fifth Third Bank's account advance product does not. Bank payday loans may be the new wave of abuse, as banks begin marketing them aggressively and see them as a substitute for the overdraft loans that are receiving increasing scrutiny.[70] Payday lenders hope that the banks' entry into the payday market will legitimize their own predatory product and weaken protections for everyone.[71]

D. Banks Often Take Advantage of State Laws and Should Not Be Able to Cherry Pick What to Use and What to Ignore

To transact commercial business it is necessary for banks to operate under the laws of the states in which they do business. The basic rules governing offer and acceptance of a contract, recordation of security interests, and foreclosure are routinely used and followed by banks in all of their commercial transactions with consumers. However, while the banks use one part of these laws to exercise their own rights, they have too often claimed preemption as to those parts of these same rules and laws that protect consumers.

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[68] *See* Plunkett Reg. Restructuring Testimony, *supra,* Appendix 3; Saunders Reg. Restructuring Hearing, *supra*, at 21–23.

[69] *See* NCLC, Bank Payday Loan ..... They're Baaaaaaaack (June 2009), *available at* http://www.consumerlaw.org/issues/payday_loans/content/Bank_Prepaid_Payday_Loans.pdf. There are two main differences between a traditional payday loan and a direct deposit account advance. First, the advances are made by the same institution that receives the direct deposit of the paycheck or public benefit check. Second, the term may be much shorter for an account advance, because the loan is repaid as soon as the direct deposit comes in, which is likely sooner than the full two weeks of a traditional payday loan.

[70] *See* Heather Landy, *Turning Fee Revenue into Customer Opportunities*, American Banker (June 24, 2009); Chris Serres, *Biggest Banks Stepping into Payday Arena*, Minneapolis Star Tribune (Sept. 9, 2009).

[71] Serres, *Biggest Banks Stepping into Payday Arena, supra.*

For example, banks use state foreclosure laws to collect on mortgages. Yet the OCC, the OTS and NCUA have all permitted their regulated institutions to ignore consumer protections in some state foreclosure laws.[72]

This cherry-picking approach is similar to the OCC's approach to preemption: it preempts state laws that protect consumers from banks, but leaves untouched state laws that are helpful to banks.[73]

E. Preemption Undermines the Dual Banking System

Preemption disrupts the balance between state and federal banks by favoring federal charters over state charters. State-chartered institutions do not enjoy the same broad preemption rights as federally chartered ones do, and can even led to a charter change to avoid state laws.[74] "The resulting imbalance threatened to harm a system that has been a proven laboratory of innovation."[75] As former FDIC Chairman Don Powell described in 2005:

> The facts of life today with regard to preemption are fairly simple. A state-chartered bank that wants to do business across state lines is at a substantial competitive disadvantage relative to a national bank or federal thrift. . . . In my view, there is little doubt what the current competitive imbalance, if not addressed, means for the future. . . . In the end, Congress may choose to level the playing field and preserve the dual banking system or it may, through inaction or otherwise, choose not to, and let the dual banking system fade into history. In my opinion, that would be a mistake.[76]

Current FDIC Chairman Sheila Bair agrees that applying the same rules to everyone will "eliminate the potential for regulatory arbitrage that exists because of federal preemption of certain State laws."[77]

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[72] *See, e.g.* 68 Fed. Reg. 8,959 (Feb. 26, 2003) (OCC preemption determination of the Georgia Fair Lending Act); National Consumer Law Center, The Cost of Credit: Regulation, Preemption, and Industry Abuses § 3.4.6.3 (4th ed. 2009).

[73] *See* Wilmarth Credit Card Testimony, *supra*, at 9–10.

[74] *See* Paul Wiseman, *Industry Lines Up to Fight Consumer Protection Agency*, USA Today (Sept. 9, 2009) (describing Capital One's charter change following West Virginia enforcement efforts). Charter changes to avoid regulation can happen in both directions, and both from state to federal and within different types of federal charters. *See* Plunkett Reg. Reform Testimony, *supra*, at 7–9.

[75] Stefan L. Jouret, Jouret & Samito, *Ruling in Cuomo Can Be Pro-Industry,* American Banker (July 10, 2009).

[76] Arthur E. Wilmarth, Jr., Fed. Res. Bank of Chi., "The OCC's Preemption Rules Threaten to Undermine the Dual Banking System, Consumer Protection, and the Federal Reserve Board's role in Bank Supervision," *Proceedings of the 42nd Annual Conference on Bank Structure and Competition*, at 106 (2006) (quoting Sept. 26, 2005 speech by Mr. Powell to the American Bankers Ass'n).

[77] Statement Of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, *On Regulatory Perspectives On Financial Regulatory Reform Proposals Before The Financial Services Committee, U.S. House Of Representatives*, (July 24, 2009), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/sheila_bair.pdf.

The OCC's preemption rules have had a very significant impact in encouraging large, multistate banks to convert from state to federal charters. Between 2004 and 2005 alone JP Morgan Chase, HSBC, and Bank of Montreal (Harris Trust) converted from state to national charters, moving over $1 trillion of banking assets from the state banking system. The share of all banking assets held by national banks and thrifts rose from 56% to 67%, while the share held by state banks declined from 44% to 33%.[78]

These trends have continued. State banks now make up only 29% of banking assets.[79] At this pace, state banks are a dying breed.

IV. RESTORING THE ROLE OF STATES WILL NOT IMPEDE NATIONAL COMMERCE

The banking system did quite well before state laws were widely preempted in the last decade or so. Of course, both national uniformity and state flexibility have their costs and benefits. But overall, the burdens of permitting different state standards are minimal and are far outweighed by the dangers of eliminating state protections in favor of a uniformly weak consumer protection.

A. States Laws Tend to Converge; Minimal Differences in Detail Do Not Impede National Products

Allowing states to act does not lead typically lead to widely divergent schemes. States generally look at other state models. After the first states experiment with a couple of approaches, the states that follow tend to converge on one approach.

For example, California passed the first specific foreclosure rescue scam law in 1979. In 2004, as the scams spread, Minnesota copied the California law with some improvements. Two dozen other states copied the Minnesota law from 2005 to 2009. These laws generally only have minor variations.[80]

In the privacy area, the 2003 Fair and Accurate Credit Transactions Act allowed states to take additional actions to prevent identity theft. Since its passage, fully 47 states and the District of Columbia have granted consumers the right to prevent access to their credit reports by identity thieves through a security freeze, and the credit bureaus then adopted the freeze nationwide.[81]

The Uniform Laws movement, spearheaded by the National Conference of Commissioners on Uniform State Laws, has created many uniform or model state laws—most notably the Uniform Commercial Code—that have been widely adopted by the

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[78] Wilmarth Credit Card Testimony, *supra*, at 11–12.
[79] Data from Conference of State Bank Supervisors (using FDIC data).
[80] *See* National Consumer Law Center, Foreclosures § 15.4.5 (2d ed. 2007 and Supp. 2009).
[81] *See* Plunkett Reg. Reform Testimony, *supra*, at 37.

states. Often these uniform laws carve out specific areas for individual state variations, always with a mind to minimizing compliance burdens.

Other national organizations also work to encourage uniform laws. For example, the Conference of State Bank Supervisors drafted a model mortgage broker licensing law, which many states have adopted:

> The Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (S.A.F.E. Act) is one very recent example of a how this "floor not ceiling" approach has led to strong and *uniform* standards. The S.A.F.E. Act, passed on July 31, 2008, gave the states one year—until July 31, 2009—to pass legislation to meet minimum licensing and registration requirements for loan originators. The states have risen to the challenge and have unified under a Model State Law. I am pleased to inform the Committee that, as of today, 49 states and the District of Columbia have enacted or introduced legislation implementing the S.A.F.E. Act.[82]

The National Conference of State Legislatures, the American Legislative Exchange Council, and other organizations also promote model state laws. Federal agencies can also work with the states to promote uniform standards.

Differences in state laws tend to be minor ones in areas such as disclosures, coverage, and remedies that do not prevent the same product from being offered in multiple states. The minor inconvenience of adding a few words to the fine print in a contract to comply with individual state disclosures laws is not a significant hindrance to national commerce.

In areas where Congress has acted, states do not deviate significantly even when given the chance. Virtually none of the federal consumer protection laws in the financial area preempt stronger state laws, yet there are few significant state variances. The Truth in Lending Act, the Electronic Funds Transfer Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Equal Credit Opportunity Act, the Truth in Savings Act, and a number of others all preempt only state laws that conflict with federal law and otherwise allow states to go farther. The few state laws in those areas that have added additional consumer protections have not proven problematic.

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[82] Testimony of Joseph A. Smith, Jr. North Carolina Commissioner of Banks on behalf of the Conference of State Bank Supervisors on *"Financial Regulation And Restructuring" Before The Financial Services Committee United States House of Representatives*, at 6 (July 24, 2009), *available at* https://www.csbs.org/AM/Template.cfm?Section=Search&section=Regulatory_Restructuring&template=/CM/ContentDisplay.cfm&ContentFileID=7171.

B. Other Nationwide Corporations Comply with State Laws; Banks Do in Many Areas and Often Tailor Their Products to Niche Markets

National employers, department stores, auto makers, national credit reporting agencies, nationwide debt collection agencies, and makers of other goods and services can and do follow local laws. Those industries have not needed preemption and the banking industry does not either.

Banks with multi-state operations have to comply with state laws in some areas, and routinely adapt to local rules without problems. For example, banks must comply with state laws regarding contracts, torts, criminal law, the right to collect debts, acquisition and transfer of property, taxation, and zoning as long as they only incidentally affect the exercise of national banks' powers.[83] Banks must still be cognizant of the specific—and different—state requirements for a host of state specific issues, such as:

- Contract law rules (parole evidence rules, what is considered an acceptance of an offer, what actions are considered anticipatory breach) vary considerably from state to state.
- Rules relating to preserving priority to title of secured property vary widely.
- Some states have judicial foreclosures, some have non-judicial foreclosures. Many states have rights to cure defaults, some do not. The terms of these rights to cure vary between states. Some states have rights of redemption after the sale, others do not.
- Rules relating to establishing a presence and running a business—the taxing authorities, the zoning rules, the employment compensation requirements—are all different from state to state.

Banks operating in multiple states are sophisticated entities with state-by-state legal compliance operations and are fully able to deal with regional differences where they exist. Indeed, many national banks have international operations that require them to comply with the laws of different countries—many of which are smaller than some American states. State-chartered banks also operate across state lines even though they do not enjoy the same full preemption rights that national banks do.

If banks wish to offer a uniform product, they can choose to apply a more protective law nationwide. Or, if it is more advantageous for the bank to apply that law only for consumers in a particular state, it can do so.

Banks have shown no difficulty offering a wide array of mortgages, credit cards, and other products aimed at different sets of consumers based on their income, credit, and other features. They also differentiate their treatment of different groups of consumers.

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[83] 12 C.F.R. §§ 7.4007(c), 7.4008(e), 7.4009(c)(2), 34.4.

A consumer who calls to complain about a credit card fee will get a different response depending on the volume of spending on the card.

Banks can tailor their products to state markets as well. Sophisticated computers and automated systems make it easier than ever to adapt products to particular markets. Those same tools can be used to accommodate differences in state markets.

C. Congress Can Act to Impose Uniformity in Particular Areas, As It Already Has Done

Congress can always preempt state law and impose a uniform standard, as it often has done in the past. For example, Congress passed the Electronic Signature Act in 2001 to standardize the rules for electronic authorizations, preempting state laws in that area.[84]

A state law that conflicts with a specific federal law will always be preempted even if banks no longer enjoy the automatic preemption of most consumer protection laws. For example, state restrictions on due-on-sale clauses are preempted if they conflict with the Garn-St. Germain Depository Institutions Act, which permits such clauses.

But preemption should happen issue by issue, after a debate in Congress. State consumer protections should not have been eliminated across the board through regulations by the banking agencies.

Even if the National Bank Act, Home Owners Loan Act, and Federal Credit Union Act are amended to roll back the broad preemption of the last several years, state laws that significantly interfere with the operation of national depositories will always be preempted, just as they were in the early days of those statutes. But laws that do not significantly burden those institutions will not be automatically wiped out.

D. The Costs of Uniformly Weak Consumer Protection Outweigh the Minimal Costs of Complying with State Laws

States have no need or desire to legislate if a problem has been fixed. A flurry of state activity only occurs when states are hearing an outcry of complaints on the ground and no response is coming from Washington.

The specter of "51 state laws" has been used for years to fight against consumer protection, but most recognize today that the financial industry would be better off if it had been subjected to more serious consumer protection laws. For example, in 2005, mortgage lenders pushed for preemption of the "uneven patchwork" of state laws that "drives up costs," and yet the estimated cost of complying with state predatory lending laws in states that had them was only $1 per mortgage.[85]

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[84] 15 U.S.C. § 7001 *et seq.*

[85] *See* Center for Responsible Lending, Complying with Laws against Predatory Lending Costs Lenders About One Dollar per Mortgage (July 26, 2005), *available at* http://www.responsiblelending.org/media-

The widespread preemption of state laws in the financial area has eliminated protection for consumers, wreaked havoc on communities, allowed abuses to take hold and spread into national problems, deprived Congress of the benefit of the experience of state approaches, and undermined our constitutional system of federalism. Our national banking system did quite well before state consumer protection laws were wiped out, and the minor inconveniences of some state variations are well worth the added safety value of allowing states to protect their citizens. As Nobel Laureate Joseph Stiglitz has pointed out, the cost of regulatory duplication is miniscule compared to the cost of the regulatory failure.[86]

V. CONCLUSION

The federal government cannot do everything. That much has become quite apparent with the spectacular failure of consumer protection in the financial world. There is plenty of fault to go around, and states could have done better too. But they were operating with two hands tied behind their backs, able only to bite and kick to stop abusive practices aimed at consumers.

The current crisis should be a wake-up call that everyone—consumers, the financial industry, and the economy as a whole—is better off with serious consumer protection. Effective regulatory reform demands a comprehensive system that does not leave significant gaps in protection, allow new destructive practices to spring up unhindered by reforms aimed at yesterday's problems, or ignore local problems until they reach the point where they command national attention.

Restoring the role of the states as first responders is vital to protecting consumers. States, with their ears closer to the ground, the ability to react more quickly, flexible laws that can adapt to new situations, and a set of resources to supplement federal enforcement efforts, are essential parts of a truly revitalized system of consumer protection.

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center/press-releases/archives/complying-with-predatory-lending-laws-costs-about-one-dollar-per-mortgage.html.

[86] "Some worry about the cost of duplication. But when we compare the cost of duplication to the cost of damage from inadequate regulation—not just the cost to the taxpayer of the bail-outs but also the costs to the economy from the fact that we will be performing well below our potential—it is clear that there is not comparison," Testimony of Dr. Joseph E. Stiglitz, Professor, Columbia University, *Before the House Financial Services Committee*, at 16 (Oct. 21, 2008).

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The 2007 HMDA Data

Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, of the Division of Research and Statistics, prepared this article. Cheryl R. Cooper, Christa N. Gibbs, Rebecca Tsang, and Sean Wallace provided research assistance.

The Home Mortgage Disclosure Act of 1975 (HMDA) requires most mortgage lending institutions with offices in metropolitan areas to publicly disclose information about their home-lending activity. The information includes characteristics of the home mortgages that lenders originate or purchase during a calendar year, the geographic location of the properties related to these loans, and demographic and other information about the borrowers.[1] The disclosures are intended not only to help the public determine whether institutions are adequately serving their communities' housing finance needs but also to facilitate enforcement of the nation's fair lending laws and to inform investment in both the public and private sectors.

Under the 1975 act, the Federal Reserve Board implements the provisions of HMDA through regulation.[2] In addition, the Federal Financial Institutions Examination Council (FFIEC) is responsible for collecting the HMDA data and facilitating public access to the information.[3] Each September, the FFIEC releases summary tables pertaining to lending activity from the previous calendar year for each reporting lender and an aggregation of home-lending activity by metropolitan statistical area (MSA).[4] The FFIEC also makes available a consolidated data file containing virtually all the reported information for each lending institution.[5]

The HMDA data consist of information reported by about 8,600 home lenders, including all of the nation's largest mortgage originators. The loans reported are estimated to represent about 80 percent of all home lending nationwide; thus, they likely provide a broadly representative picture of home lending in the United States.

This article presents key findings from the 2007 HMDA data. In doing so, it highlights the notable changes in relationships that are revealed when the 2007 data are compared with data from earlier years.[6] Because of the importance of the loan-pricing information included in the HMDA data and because of the recent turmoil in the residential mortgage market, particularly the higher-priced segment of the market, much of the focus here is on the data pertaining to that market segment.[7]

1. A description of the items reported under HMDA is provided in appendix A.

2. HMDA is implemented by Regulation C (12 C.F.R. pt. 203) of the Federal Reserve Board. More information about the regulation is available at www.federalreserve.gov.

3. The FFIEC (www.ffiec.gov) was established by federal law in 1979 as an interagency body to prescribe uniform examination procedures, and to promote uniform supervision, among the federal agencies responsible for the examination and supervision of financial institutions. The member agencies are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

4. For the 2007 data, the FFIEC prepared more than 63,000 MSA-specific reports on behalf of reporting institutions. These and other reports are made available to the public by the FFIEC.

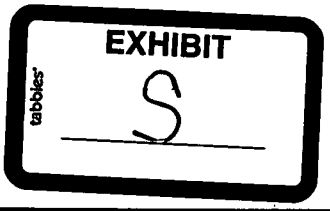
5. The only reported items not included in the data made available to the public are the date of application and the date on which action was taken on the application. These items are withheld to help ensure that the individuals involved in the application cannot be identified.

6. Previously published assessments include Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner (2007), "The 2006 HMDA Data," *Federal Reserve Bulletin*, vol. 93 (December 21), pp. A73–A109; Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner (2006), "Higher-Priced Home Lending and the 2005 HMDA Data," *Federal Reserve Bulletin*, vol. 92 (September 8), pp. A123–66; and Robert B. Avery, Glenn B. Canner, and Robert E. Cook (2005), "New Information Reported under HMDA and Its Application in Fair Lending Enforcement," *Federal Reserve Bulletin*, vol. 91 (Summer), pp. 344–94.

7. Borrowers in the higher-priced market segment generally fall into one of two market categories—"subprime" or "near prime" (sometimes referred to as "alt-A"). Individuals in the subprime category generally pay the highest prices because they tend to pose the greatest credit or prepayment risk. Statistics prepared by the lending industry do not characterize lending as higher priced but rather use the terms *subprime* or *alt-A*. Thus, when presenting data from industry sources on loan performance or other aspects of the mortgage market, this article will often refer to data on the subprime, alt-A, or prime lending market.

Mortgages with annual percentage rates (APRs, which encompass interest rates and fees) above designated thresholds are referred to here as "higher-priced loans"; all other loans are referred to as "lower priced." For loans with spreads above designated thresholds, revised Regulation C requires the reporting of the spread between the APR on a loan and the rate on Treasury securities of comparable maturity. The thresholds for reporting differ by lien status: 3 percentage points for first liens and 5 percentage points for junior, or subordinate, liens.

Further details are in note 12, p. A126, of Avery, Brevoort, and Canner, "Higher-Priced Home Lending and the 2005 HMDA Data."



TURMOIL IN THE MORTGAGE MARKET

Both primary and secondary mortgage markets experienced considerable stress in 2007, a condition that has continued into 2008.[8] Delinquency rates on higher-priced home loans, particularly those with adjustable-rate features, first began to increase notably in 2006; those rates then rose sharply during 2007 and far outpaced the performance problems that also emerged in the lower-priced segment of the market.[9]

One consequence of deteriorating loan performance and widespread declines in home values was a sharp contraction in 2007 in the willingness of lenders and investors to offer loans to higher-risk borrowers or, in some cases, to offer certain loan products that entailed features associated with elevated credit risk.[10] Moreover, to the extent that credit was still available, loan prices rose sharply, largely because of concerns about repayment prospects. In addition, many lenders whose business models relied on a robust secondary market to purchase the loans they originated were forced to cease or curtail operations, as they could no longer obtain funds to operate or find investors willing to purchase their loan originations.

Difficulties in the higher-priced portion of the mortgage market spilled over to other market segments, including the market for loans for large amounts (the so-called jumbo market), in which credit spreads widened substantially. The widening of spreads led to higher interest rates on such loans, which effectively reduced credit availability.[11]

The 2007 HMDA data reflect the difficulties in the housing and mortgage markets. Many reporting institutions experienced a sharp reduction in loan applications and originations, particularly in the higher-priced segments of the mortgage market. Also, some lenders that had previously reported HMDA data ceased operations during 2007 and did not file a HMDA report even though they extended loans during part of that year.[12] Although nonreporting by lenders that ceased operations affects the comprehensiveness of the HMDA data each year to some extent, nonreporting in 2007 had a much larger effect than in previous years. For 2007, many more lenders than in earlier years ceased operations because of a bankruptcy or other adverse business event, and the nonreporting institutions accounted for a significant minority of the loans originated in 2006 and an even larger share of the higher-priced loans made that year. Most important, the effects of nonreporting in the 2007 HMDA data amplified the measured decline in higher-priced lending from 2006. The amplification occurred because some of the lenders that ceased operations originated loans in 2007, and according to these institutions' lending profiles in 2006, a disproportionate share of those originations consisted of higher-priced loans. For this reason, some caution should be exercised in using the 2007 data to document the full extent of the disruptions in the higher-priced lending market in that year. The effects of nonreporting are difficult to quantify. This issue, among others, is addressed later in the article.

GENERAL FINDINGS FROM THE 2007 HMDA DATA

For 2007, lenders covered by HMDA reported information on 21.4 million applications for home loans. Almost all of the applications were for loans to be secured by one- to four-family (referred to here as "single family") houses (table 1). These applications resulted in more than 10.4 million loan extensions (data not shown in table). Lenders also reported information on 4.8 million loans that they had purchased from other institutions and on 433,000 requests for pre-approvals of home-purchase loans that had not resulted in a loan origination (data not shown in table); the pre-approval requests were turned down by the lender or were granted but not acted on by the applicant.

The total number of reported applications fell about 6.0 million, and the number of reported loans fell 3.5 million—or 22 percent and 25 percent,

8. See, for example, Randall S. Kroszner (2007), "The Challenges Facing Subprime Mortgage Borrowers," speech delivered at the Consumer Bankers Association 2007 Fair Lending Conference, Washington, November 5, www.federalreserve.gov/newsevents/speech/kroszner20071105a.htm.

9. Data from LoanPerformance, a subsidiary of First American CoreLogic, Inc., show that 20.4 percent of the subprime loans with adjustable-rate features were seriously delinquent at the end of 2007. By comparison, 8.2 percent of fixed-rate subprime loans, 1.0 percent of fixed-rate prime loans, and 4.2 percent of adjustable-rate prime loans were seriously delinquent at the end of that year.

10. Industry sources indicate that the dollar amount of originations of subprime loans fell 68 percent from 2006 to 2007, to a level of only $191 billion. Subprime loan originations in 2007 were the smallest since 2001. See Inside Mortgage Finance (2008), *The 2008 Mortgage Market Statistical Annual*, vol. 1: *The Primary Market* (Bethesda, Md.: Inside Mortgage Finance Publications).

11. Jumbo loans are loans that exceed the size limits set for loans that Fannie Mae and Freddie Mac are permitted to purchase (conforming loans). Fannie Mae and Freddie Mac are government-sponsored enterprises that focus on conventional loans that meet certain size limits and other underwriting criteria. Available data indicate that the dollar amount of originations of jumbo loans fell nearly 30 percent from 2006 to 2007. See Inside Mortgage Finance, *The 2008 Mortgage Market Statistical Annual*.

12. As in earlier years, some institutions ceased operations because of a merger or acquisition. Lending by these institutions is reported, in most cases, by the acquiring institution on a consolidated basis or as two distinct filings.

1. Home loan and reporting activity of lending institutions covered under the Home Mortgage Disclosure Act, 1990–2007

Number

Year	Applications received for home loans on 1–4 family properties, and home loans purchased from another institution (millions)						Reporters	Disclosure reports[2]
	Applications				Loans purchased	Total[1]		
	Home purchase	Refinance	Home improvement	Total[1]				
1990	3.3	1.1	1.2	5.5	1.2	6.7	9,332	24,041
1991	3.3	2.1	1.2	6.6	1.4	7.9	9,358	25,934
1992	3.5	5.2	1.2	10.0	2.0	12.0	9,073	28,782
1993	4.5	7.7	1.4	13.6	1.8	15.4	9,650	35,976
1994	5.2	3.8	1.7	10.7	1.5	12.2	9,858	38,750
1995	5.5	2.7	1.8	10.0	1.3	11.2	9,539	36,611
1996	6.3	4.5	2.1	13.0	1.8	14.8	9,328	42,946
1997	6.8	5.4	2.2	14.3	2.1	16.4	7,925	47,416
1998	8.0	11.4	2.0	21.4	3.2	24.7	7,836	57,294
1999	8.4	9.4	2.1	19.9	3.0	22.9	7,832	56,966
2000	8.3	6.5	2.0	16.8	2.4	19.2	7,713	52,776
2001	7.7	14.3	1.9	23.8	3.8	27.6	7,631	53,066
2002	7.4	17.5	1.5	26.4	4.8	31.2	7,771	56,506
2003	8.2	24.6	1.5	34.3	7.2	41.5	8,121	65,808
2004	9.8	16.1	2.2	28.1	5.1	33.3	8,853	72,246
2005	11.7	15.9	2.5	30.2	5.9	36.0	8,848	78,193
2006	10.9	14.0	2.5	27.5	6.2	33.7	8,886	78,638
2007	7.6	11.5	2.2	21.4	4.8	26.2	8,610	63,055

NOTE: Here and in all subsequent tables, components may not sum to totals because of rounding, and, except as noted, applications exclude requests for pre-approval that were denied by the lender or were accepted by the lender but not acted upon by the borrower. In this article, applications are defined as being for a loan on a specific property; they are thus distinct from requests for pre-approval, which are not related to a specific property.

1. Applications for multifamily homes are included only in the total columns; for 2007, these applications numbered 54,232.

2. A report covers the mortgage lending activity of a lender in a single metropolitan statistical area in which it had an office during the year.

SOURCE: Here and in the subsequent tables and figure except as noted, Federal Financial Institutions Examination Council, data reported under the Home Mortgage Disclosure Act (www.ffiec.gov/hmda).

respectively—from 2006 (2006 data not shown in tables). Lending for both home purchase and refinancing fell as slower house price appreciation and, in some areas, outright declines in property values diminished the attractiveness of buying and selling properties or limited opportunities to refinance outstanding loans. The imposition of tighter underwriting standards, an increase in mortgage interest rates, and the elimination of some loan products used to stretch affordability also contributed to the reduction in lending. Finally, a portion of the decline in lending activity was due to the nonreporting of loans made by institutions that reported data for 2006 but discontinued operations during 2007.

Reporting Institutions

For 2007, 8,610 institutions reported under HMDA: 3,910 commercial banks, 929 savings institutions (savings and loans and savings banks), 2,019 credit unions, and 1,752 mortgage companies (table 2). In total, the number of reporting institutions fell about 3 percent from 2006, primarily because of a relatively large decline in the number of independent mortgage companies—that is, mortgage companies that were neither subsidiaries of depository institutions nor affiliates of bank or savings association holding companies that reported data.

In total, 169 institutions that reported 2006 data did not report data pertaining to 2007 lending activity (these institutions ceased operations and were not merged into, or acquired by, another reporting entity). Some of the institutions that did not report were high-volume originators. In the aggregate, these nonreporting institutions accounted for about 2.4 million loans or applications that did not result in a credit extension, or about 7 percent of all the loan and

2. Distribution of reporters covered by the Home Mortgage Disclosure Act, by type of institution, 2006–07

Type	2006		2007	
	Number	Percent	Number	Percent
Depository institution				
Commercial bank	3,900	43.9	3,910	45.4
Savings institution	946	10.6	929	10.8
Credit union	2,036	22.9	2,019	23.4
All	6,882	77.4	6,858	79.7
Mortgage company				
Independent	1,328	14.9	1,124	13.1
Affiliated[1]	676	7.6	628	7.3
All	2,004	22.6	1,752	20.3
All institutions	**8,886**	**100**	**8,610**	**100**

1. Subsidiary of a depository institution or an affiliate of a bank holding company.

application records included in the 2006 HMDA data. (The effects of such nonreporting on the 2007 data are discussed in more detail later in the article.)

Disposition of Applications, Loan Types, and Activities Related to the Home Ownership and Equity Protection Act

For purposes of analysis, loan applications and loans reported under HMDA can be grouped in many ways; here the analysis focuses on 25 distinct product categories characterized by loan and property type, purpose of the loan, and lien and owner-occupancy status. Each product category contains information on the number of total and pre-approval applications, application denials, originated loans, loans with prices above the reporting thresholds established by Regulation C for identifying higher-priced loans, loans covered by the Home Ownership and Equity Protection Act (HOEPA), and the mean and median annual percentage rate (APR) spreads for loans priced above the reporting thresholds specified in Regulation C (tables 3 and 4).[13] The following sections highlight some notable aspects of the HMDA data for 2007 and, where relevant, earlier years.

Conventional and Government-Backed Loans

As in earlier years, most reported home loan activity in 2007 involved conventional loans—that is, non-government-backed loans (table 3). Such loans accounted for about 94 percent of all loan extensions in 2007.

The share of all HMDA-reported loans backed by the Federal Housing Administration (FHA) had fallen over the past several years, from about 16 percent in 2000 to less than 3 percent in 2005 and 2006. More-limited product availability and the imposition of tighter underwriting standards in the higher-priced segment of the conventional mortgage market in 2007 encouraged borrowers to take out FHA loans. Also, toward the latter part of 2007, the FHA created a new lending program, FHASecure, to help qualified individuals with higher-priced conventional loans refinance into an FHA loan.[14] The number of FHA-backed first-lien loans used to purchase homes or refinance a home loan increased nearly 20 percent from 2006, and the FHA's share of all home lending increased to 4.6 percent in 2007 (data not shown in tables).[15] The sharp curtailment of credit availability in the subprime portion of the market, recent steps to increase the maximum loan values that are eligible for FHA loan insurance, and a newly enacted foreclosure prevention law are likely to result in a higher incidence of FHA-insured lending in 2008.[16]

Loan Size and Borrower Incomes

For each loan made, the HMDA data include the amount borrowed and the incomes of the borrowers that were relied on in the loan underwriting decision. The analysis in this section considers four loan categories: (1) conventional loans that met the threshold for reporting as higher-priced loans under HMDA, (2) all other conventional loans, (3) FHA-insured loans, and (4) loans guaranteed by the Department of Veterans Affairs. The analysis is limited to site-built, owner-occupied, one- to four-family units, and the four categories are applied separately to home-purchase loans and to refinancings.

For 2007, about 91 percent of conventional loans for home purchase and about the same proportion of such loans for refinancing, whether higher priced or not, were within the conforming loan-size limits established for Fannie Mae and Freddie Mac (table 5).[17] Higher-priced loans tended to be somewhat smaller than others; for example, among conventional home-purchase loans, the mean size of higher-priced mortgages was $208,000, compared with $248,000 for others (table 5, memo item).

FHA-insured loans tend to be considerably smaller than conventional loans; the difference reflects the relatively low insurance limits of the FHA and the focus of the program on lower- and middle-income borrowers who tend to buy more modestly priced

13. HOEPA is implemented by Federal Reserve Board Regulation Z (12 C.F.R. pt. 226). Transition rules governing the reporting of the expanded HMDA data create problems for assessing the data on loan pricing, manufactured-home lending, and pre-approvals. The transition rules had a large influence on the data reported for 2004 and much smaller effects on the 2005 and 2006 data. In the 2007 data, transition rules affected only about 2,100 applications and 192 loans, the analyses here exclude those applications and loans when considering data on loan pricing, manufactured-home lending, and pre-approvals.

14. See U.S. Department of Housing and Urban Development, Federal Housing Administration (2007), "Bush Administration to Help Nearly One-Quarter of a Million Homeowners Refinance, Keep Their Homes," press release, August 31, www.hud.gov/news/release.cfm?content=pr07-123.cfm.

15. In contrast, the number of reported first-lien home-purchase loans or refinancings that involved loans guaranteed by the Department of Veterans Affairs fell about 2 percent from 2006.

16. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289 (2008).

17. For 2007, the conforming loan-size limit was $417,000 for a single-unit property, with limits 50 percent higher for properties in Alaska and Hawaii. Higher limits are also established for two-, three-, and four-unit properties; however, because the HMDA data do not distinguish among properties with fewer than five units, the analysis here uses the $417,000 limit.

homes. For 2007, the mean size of FHA-insured home-purchase loans was $142,000.

Borrower incomes differ substantially by loan product and loan pricing (table 6). Most notably, the mean income of borrowers with conventional loans, regardless of loan pricing, was about 72 percent higher than that of borrowers with FHA-insured loans (data derived from memo items in table). Among those obtaining conventional home-purchase mortgages, the mean income of individuals meeting the conforming loan-size limit established for Fannie Mae and Freddie Mac was $83,600, versus a mean income of $293,100 for those exceeding the conforming loan-size limit. Again, among borrowers with conventional loans, those using higher-priced loans to purchase a home or to refinance had a mean income about 20 percent lower than that of borrowers not paying higher prices.

Non-Owner-Occupant Lending

Part of the strong performance of housing markets over the first half of this decade was due to the growth in sales of homes to investors or individuals purchasing second or vacation homes, units collectively described as "non-owner occupied." HMDA data help document the role of investors and second-home buyers in the housing market because the data indicate whether the subject property is intended as the borrower's principal dwelling—that is, as an owner-occupied unit.[18]

The share of non-owner-occupant lending among first-lien loans to purchase one- to four-family site-built homes rose in every year between 1996, when it was 6.4 percent, and 2005, when it reached a high of 17.3 percent (table 7). For 2006, the share fell somewhat, to 16.5 percent, and in 2007 it declined further, to 14.9 percent. Falling non-owner-occupant lending likely reflected the reduced incentives for such borrowing as house prices weakened or fell in many parts of the country and as the imposition of tighter lending standards for borrowers in this market segment reduced access to credit.

Piggyback Lending

In recent years, so-called piggyback loans emerged as an important segment of the conventional mortgage market, particularly regarding loans to purchase homes. In piggyback lending, borrowers simultaneously receive a first-lien mortgage and a junior-lien (piggyback) loan. The piggyback loan finances the portion of the purchase price not being financed by the first mortgage and sometimes any cash payment that might have been made; the junior-lien loan may amount to as much as 20 percent of the purchase price.

Piggyback loans are generally used to reduce the cost of financing a home purchase. Often, they are designed to have a first-lien loan that can be financed at a lower price than a single loan for the total amount borrowed, such that the gains from the reduced finance costs on the first-lien loan outweigh the higher finance costs on the junior-lien loan portion of the total borrowing. A prime example is the practice of structuring the first-lien loan to avoid paying for private mortgage insurance (PMI) (for more information about PMI, see appendix B). Many of these loan transactions are structured so that the first-lien loan is eligible for sale to Fannie Mae or Freddie Mac, both of which require PMI on first-lien loans for amounts that exceed 80 percent of the value of the property backing the loan. Another example is the structuring of the loan transaction so that the first-lien loan can be more readily securitized in the secondary market. This practice has been common in the secondary market for subprime loans. Yet another example arises when the total amount requested exceeds the loan-size limits for Fannie Mae and Freddie Mac, thereby requiring the borrower to pay the higher interest rate usually charged on jumbo loans. Keeping the size of the first-lien loan within the amount that conforms to the loan-size limits of Fannie Mae and Freddie Mac can possibly result in lower overall financing costs.

The HMDA data can be used to help document the extent of piggyback lending over time. However, because not all lenders submit HMDA data, some of the junior-lien loans that are reported may not have the corresponding first-lien loan reported, and some of the first-lien loans that are reported may not have the associated junior-lien loan reported. Also, some piggyback loans may be home equity lines of credit (HELOCs) rather than closed-end loans. Under the provisions of Regulation C, lenders need not report HELOCs. Nonetheless, a loan-matching process can be undertaken to determine which reported junior-lien loans appear to be associated with a reported first-lien loan. A junior-lien loan was identified as a piggyback to a reported first-lien loan if both loans (1) were conventional

18. An investment property is a non-owner-occupied dwelling that is intended to be continuously rented. Some non-owner-occupied units—vacation homes and second homes—are for the primary use of the owner and thus would not be considered investment properties. The HMDA data do not, however, distinguish between these two types of non-owner-occupied dwellings.

3. Disposition of applications for home loans, and origination and pricing of loans, by type of home and type of loan, 2007

Type of home and loan	Applications				Loans originated							
	Number submitted	Acted upon by lender			Number	Loans with APR spread above the threshold[1]						
								Distribution, by percentage points of APR spread				
		Number	Number denied	Percent denied		Number	Percent	3–3.99	4–4.99	5–6.99	7–8.99	9 or more
1–4 FAMILY												
NONBUSINESS RELATED[3]												
Owner occupied												
Site-built												
Home purchase												
Conventional												
First lien	4,654,084	4,120,941	783,972	19.0	2,928,820	411,263	14.0	49.4	17.1	26.8	6.5	.3
Junior lien	927,255	828,053	170,231	20.6	548,567	118,673	21.6	. . .	. . .	65.8	30.0	4.3
Government backed												
First lien	550,551	493,260	79,818	16.2	392,157	11,504	2.9	91.1	3.5	1.7	3.6	.1
Junior lien	1,348	1,138	85	7.5	1,008	65	6.4	. . .	. . .	76.9	18.5	4.6
Refinance												
Conventional												
First lien	8,550,904	6,920,906	2,758,715	39.9	3,391,604	735,150	21.7	39.1	19.6	33.8	7.4	.1
Junior lien	1,408,232	1,228,245	450,348	36.7	636,443	120,854	19.0	. . .	. . .	58.0	32.4	9.5
Government backed												
First lien	342,768	288,814	91,106	31.5	179,330	11,893	6.6	92.1	4.3	2.7	.9	.0
Junior lien	710	527	151	28.7	316	63	19.9	. .	. .	65.1	31.7	3.2
Home improvement												
Conventional												
First lien	721,417	627,577	277,983	44.3	291,043	87,774	30.2	38.8	21.7	30.3	8.8	.5
Junior lien	949,861	863,800	341,244	39.5	429,624	72,114	16.8	. . .	. . .	45.3	32.5	22.2
Government backed												
First lien	10,962	9,614	2,347	24.4	6,666	410	6.2	59.5	7.6	22.7	8.0	2.2
Junior lien	3,407	2,789	866	31.1	1,577	1,044	66.2	. .	. .	39.8	31.6	28.5
Unsecured (conventional or government backed)	347,359	340,661	167,456	49.2	146,395	. . .	. . .	. .	. .	. .	. .	. . .
Manufactured												
Conventional, first lien												
Home purchase	359,351	347,819	175,312	50.4	94,247	57,954	61.5	25.8	23.9	31.0	13.5	5.8
Refinance	146,597	132,750	64,384	48.5	55,069	30,880	56.1	29.1	26.2	32.9	9.8	2.0
Other	141,807	127,179	48,899	38.4	69,077	16,142	23.4	36.0	12.2	24.8	16.5	10.4
Non-owner occupied[4]												
Conventional, first lien												
Home purchase	908,416	813,364	167,875	20.6	564,719	112,711	20.0	59.4	20.0	15.6	4.5	.5
Refinance	927,485	799,914	269,634	33.7	447,071	79,204	17.7	52.8	18.5	21.8	6.5	.4
Other	275,273	244,145	87,984	36.0	129,959	31,731	24.4	15.5	7.3	45.0	21.6	10.6
BUSINESS RELATED[3]												
Conventional, first lien												
Home purchase	19,798	17,626	1,983	11.3	14,863	881	5.9	60.5	14.5	23.7	1.0	.2
Refinance	27,267	24,630	2,977	12.1	20,707	1,112	5.4	60.0	16.5	20.2	2.7	.5
Other	7,156	6,867	1,074	15.6	5,463	149	2.7	28.9	11.4	45.0	12.1	2.7
MULTIFAMILY[5]												
Conventional, first lien												
Home purchase	48,635	46,057	1,991	4.3	43,063	2,904	6.7	44.7	23.0	11.6	15.1	5.6
Refinance	43,127	37,951	4,333	11.4	32,401	2,808	8.7	51.1	27.9	13.2	7.5	.3
Other	15,488	13,356	1,728	12.9	11,164	491	4.4	34.6	13.4	31.6	13.8	6.5
Total	**21,389,258**	**18,337,983**	**5,952,496**	**32.5**	**10,441,353**	**1,907,774**	**18.3**	**36.4**	**15.7**	**34.1**	**11.5**	**2.4**

NOTE: Excludes transition-period applications (those submitted before 2004) and transition-period loans (those for which the application was submitted before 2004).

1. Annual percentage rate (APR) spread is the difference between the APR on the loan and the yield on a comparable-maturity Treasury security. The threshold for first-lien loans is a spread of 3 percentage points, for junior-lien loans, it is a spread of 5 percentage points.

2. Loans covered by the Home Ownership and Equity Protection Act of 1994 (HOEPA), which does not apply to home-purchase loans.

3. Business-related applications and loans are those for which the lender reported that the race, ethnicity, and sex of the applicant or co-applicant are "not applicable", all other applications and loans are nonbusiness related.

4. Includes applications and loans for which occupancy status was missing.

5. Includes business-related and nonbusiness-related applications and loans for owner-occupied and non-owner-occupied properties.

. . . Not applicable.

loans involving property in the same census tract, (2) were originated by the same lender with approximately the same dates of loan application and closing, and (3) had the same owner-occupancy status and identical borrower income, race or ethnicity, and sex.

3. Disposition of applications for home loans, and origination and pricing of loans, by type of home and type of loan, 2007—*Continued*

Loans originated			MEMO					
Loans with APR spread above the threshold[1]			Transition-period applications (those submitted before 2004)					
APR spread (percentage points)		Number of HOEPA-covered loans[2]	Number submitted	Number denied	Percent denied	Loans originated		Number of HOEPA-covered loans[2]
Mean	Median					Number	Percent with APR spread above threshold	
4.5	4.0	. . .	305	10	5.9	67	6.0	. . .
6.6	6.3	. . .	19	1	9.1	6	0	. . .
3.5	3.2	. . .	26	0	0	12	50.0	. . .
6.7	6.4	. . .	0	0	0	0	0	. . .
4.8	4.5	3,145	1,488	17	1.6	30	20.0	0
6.9	6.6	1,951	36	1	4.2	4	25.0	0
3.4	3.2	120	16	2	22.2	4	25.0	0
6.7	6.4	0	1	0	0	0	0	0
4.8	4.5	1,214	3	0	0	2	0	0
7.5	7.3	2,827	1	0	0	0	0	0
4.5	3.6	6	0	0	0	0	0	0
7.5	7.4	6	0	0	0	0	0	0
. . .	. . .	. . .	0	0	0	0	0	. . .
5.5	5.0	. . .	4	0	0	1	0	. . .
5.1	4.8	1,184	9	0	0	1	0	0
5.6	5.1	810	4	0	0	1	0	0
4.2	3.8	. . .	50	0	0	11	0	. . .
4.4	3.9	156	94	3	5.0	9	33.3	0
6.2	5.9	73	6	0	0	4	50.0	0
4.2	3.7	. . .	5	0	0	5	0	. . .
4.3	3.8	3	5	0	0	5	0	0
5.3	5.2	1	1	0	0	1	0	0
5.0	4.2	. . .	32	0	0	25	16.0	. . .
4.4	4.0	6	1	0	0	1	0	0
5.5	5.1	2	9	0	0	3	0	0
5.1	**4.8**	**11,504**	**2,115**	**34**	**2.3**	**192**	**14.1**	**0**

Extent of piggyback lending. The HMDA data show that lenders extended a substantial number of junior-lien loans to help individuals purchase homes (for both owner-occupied and non-owner-occupied purposes) in 2005 and 2006 but that such lending contracted sharply in 2007.[19] For 2005, lenders reported on about 1.37 million junior-lien loans used to purchase homes; for 2006, they reported on about 1.43 million (data not shown in tables). In 2007, lenders covered by HMDA reported information on only about 600,000 junior-lien loans to purchase homes, a decline of nearly 60 percent from the 2006 level.

Regarding piggyback lending, our matching algorithm indicates that about 12 percent of the 2.9 million 2007 first-lien home-purchase loans on owner-occupied site-built homes for one to four families

19. A similar matching process was used to identify piggyback loans used for refinancing. HMDA reporting requirements, however, are less comprehensive for refinance loans, and therefore junior-lien loans used for refinancing are less likely to be reported. As a result, we do not report data on piggyback loan transactions used for refinancing.

4. Home-purchase lending that began with a request for pre-approval: Disposition and pricing, by type of home, 2007

Type of home	Requests for pre-approval			Applications preceded by requests for pre-approval[1]		
	Number acted upon by lender	Number denied	Percent denied	Number submitted	Acted upon by lender	
					Number	Number denied
1–4 FAMILY						
NONBUSINESS RELATED[3]						
Owner occupied						
Site-built						
Conventional						
First lien	754,318	209,478	27.8	420,435	371,847	37,300
Junior lien	95,782	28,538	29.8	54,088	48,760	5,585
Government backed						
First lien	85,606	31,821	37.2	55,236	48,944	5,524
Junior lien	95	13	13.7	84	72	4
Manufactured						
Conventional, first lien	45,358	22,802	50.3	42,728	37,831	20,624
Other	6,418	2,361	36.8	4,918	3,632	1,094
Non-owner occupied[4]						
Conventional, first lien	69,916	16,237	23.2	48,688	42,576	6,639
Other	6,040	1,850	30.6	4,637	4,020	1,032
BUSINESS RELATED[3]						
Conventional, first lien	1,169	131	11.2	1,126	943	102
Other	209	19	9.1	202	161	12
MULTIFAMILY[5]						
Conventional, first lien	321	109	34.0	220	164	23
Other	35	1	2.9	34	22	1
Total	**1,065,267**	**313,360**	**29.4**	**632,396**	**558,972**	**77,940**

NOTE: Excludes transition-period requests for pre-approval (those submitted before 2004). See general note to table 1.

1. These applications are included in the total of 21,389,258 reported in table 3.

2. See note 1, table 3.

3. Business-related applications and loans are those for which the lender reported that the race, ethnicity, and sex of the applicant or co-applicant are "not applicable"; all other applications and loans are nonbusiness related.

4. Includes applications and loans for which occupancy status was missing.

5. Includes business-related and nonbusiness-related applications and loans for owner-occupied and non-owner-occupied properties.

. . . Not applicable.

involved a piggyback loan reported by the *same* lender, a proportion that was down 45 percent from 2006 (data not shown in tables).

Changing nature of piggyback lending. A comparison of the 2007 HMDA data with the HMDA data for earlier years suggests that the nature of piggyback lending has changed. The HMDA data for 2005, 2006, and 2007 can be used to distinguish three types of piggyback loan arrangements: (1) those likely to be used as substitutes for PMI, (2) those intended primarily to keep the size of the first-lien loan within the limits set for loans that Fannie Mae and Freddie Mac are allowed to purchase in a given year, and (3) those used for other purposes, most likely to facilitate sale of the loan to the secondary market.

For purposes of this analysis, piggyback loans were assumed to be in the first category if two conditions were satisfied: (1) The first-lien loan in a piggyback loan transaction was not higher priced, and (2) the combined loan amount of the first- and junior-lien loans was less than the conforming loan-size limit. Piggyback loans were assumed to be in the second category if three conditions were satisfied: (1) The first-lien loan in a piggyback loan transaction was not higher priced, (2) the amount of the first-lien loan was under the conforming loan-size limit, and (3) the combined loan amount of the first- and junior-lien loans exceeded the conforming loan-size limit. For the first two categories of piggyback loans, the presumption is that the piggyback loan was used to facilitate sales to Fannie Mae or Freddie Mac. Consequently, in the analysis, we distinguish between loans that have been sold to Fannie Mae and Freddie Mac and those that might be sold. The third category of piggyback loans consists of those that do not appear eligible to be sold to these two entities because the first-lien loan is higher-priced or the loan amount exceeds the conforming loan-size limit.[20]

The analysis indicates that the share of piggyback loans used to keep the first-lien loan within the

20. Higher-priced loans are generally not eligible for purchase by Fannie Mae or Freddie Mac. Such loans typically involve elevated credit risk or have other features that tend to make them ineligible for purchase by these institutions.

4. Home-purchase lending that began with a request for pre-approval. Disposition and pricing, by type of home, 2007—*Continued*

Loan originations whose applications were preceded by requests for pre-approval										MEMO Applications with transition-period requests for pre-approval (request submitted before 2004)				
	Loans with APR spread above the threshold[2]													
Number	Number	Percent	Distribution, by percentage points of APR spread					APR spread (percentage points)		Number submitted	Number denied	Percent denied	Loans originated	
			3–3.99	4–4.99	5–6.99	7–8.99	9 or more	Mean spread	Median spread				Number	Percent with APR spread above threshold
302,513	19,003	6.3	65.5	18.6	12.9	2.5	.4	4.0	3.6	7	0	0	2	0
35,759	3,609	10.1	.	. .	71.9	21.9	6.2	6.4	5.9	3	0	0	2	0
41,437	1,357	3.3	74.3	9.7	3.5	12.5	0	4.0	3.4	8	0	0	7	85.7
64	1	1.6	.	. .	100	0	0	5.3	5.3	0	0	0	0	0
9,754	6,999	71.8	14.3	23.2	45.2	15.1	2.1	5.6	5.5	0	0	0	0	0
2,425	331	13.6	73.7	.3	6.0	19.9	0	4.3	3.3	0	0	0	0	0
31,846	3,856	12.1	60.6	20.4	14.7	3.7	.5	4.2	3.7	1	0	0	1	0
2,209	405	18.3	.2	0	52.6	32.3	14.8	7.1	6.8	0	0	0	0	0
803	53	6.6	58.5	17.0	15.1	9.4	0	4.4	3.8	1	0	0	0	0
140	12	8.6	33.3	0	33.3	25.0	8.3	5.9	5.8	0	0	0	0	0
125	13	10.4	76.9	7.7	7.7	7.7	0	3.9	3.2	0	0	0	0	0
20	2	10.0	0	0	100	0	0	6.0	6.0	0	0	0	0	0
427,095	**35,641**	**8.3**	**48.0**	**17.1**	**25.4**	**8.0**	**1.5**	**4.6**	**4.1**	**20**	**0**	**0**	**12**	**50.0**

5. Cumulative distribution of home loans, by loan amount and by purpose, type, and pricing of loan, 2007

Percent

Upper bound of loan amount (thousands of dollars)[1]	Home purchase					Refinance				
	Conventional			FHA	VA	Conventional			FHA	VA
	Lower priced	Higher priced	Total			Lower priced	Higher priced	Total		
24	2	1.0	.3	1	.0	.7	2.3	1.1	.1	.1
49	1.8	5.5	2.3	2.2	.4	3.3	7.1	4.1	1.0	.9
74	6.3	15.5	7.6	11.3	2.5	8.9	16.1	10.5	6.0	4.7
99	13.3	26.4	15.1	26.6	8.8	16.4	26.2	18.5	17.3	13.5
124	23.2	37.0	25.2	42.6	18.5	25.7	37.2	28.2	32.7	25.2
149	33.5	47.3	35.5	60.6	32.9	34.5	47.0	37.2	50.2	40.1
174	43.2	55.6	45.0	75.0	47.8	43.5	55.8	46.2	65.1	53.0
199	51.4	62.3	53.0	85.1	60.6	51.1	62.8	53.7	76.5	64.5
224	59.1	68.2	60.4	90.9	70.4	58.5	69.0	60.8	84.8	74.3
249	65.0	73.1	66.1	94.2	78.9	64.2	73.9	66.3	89.8	81.7
274	70.2	77.2	71.2	96.3	85.0	69.6	77.9	71.4	93.4	87.5
299	74.3	80.5	75.2	97.7	89.3	73.7	81.2	75.3	95.7	91.0
324	78.3	83.4	79.0	98.5	92.5	77.9	84.1	79.2	97.3	93.9
349	81.3	85.7	81.9	99.1	94.9	80.9	86.4	82.1	98.4	95.8
374	84.0	87.9	84.5	99.7	96.7	83.8	88.5	84.8	99.6	97.5
399	86.2	89.8	86.7	99.7	98.0	86.1	90.1	87.0	99.7	98.6
417	90.5	91.4	90.6	99.8	99.5	90.3	91.5	90.5	99.7	99.6
449	91.2	92.7	91.4	99.9	99.6	91.2	92.9	91.6	99.8	99.8
499	92.7	94.6	93.0	99.9	99.8	92.9	94.9	93.3	99.9	99.9
549	94.2	96.1	94.5	100	99.9	94.5	96.3	94.9	100	99.9
599	95.2	97.0	95.5	100	99.9	95.5	97.2	95.9	100	100
649	96.2	97.8	96.4	100	100	96.5	97.9	96.8	100	100
699	96.8	98.3	97.0	100	100	97.2	98.4	97.4	100	100
749	97.3	98.6	97.5	100	100	97.6	98.7	97.8	100	100
799	97.7	98.8	97.9	100	100	98.0	98.9	98.2	100	100
More than 799	100	100	100	100	100	100	100	100	100	100
MEMO *Loan amount (thousands of dollars)*										
Mean	247.9	207.9	242.3	142.3	193.1	243.9	203.2	235.0	160.3	181.7
Median[1]	194	157	189	134	179	195	157	186	149	168

NOTE: For definitions of lower- and higher-priced lending, see text note 7.

1. Loan amounts are reported under the Home Mortgage Disclosure Act to the nearest $1,000.

FHA Federal Housing Administration.
VA Department of Veterans Affairs.

6. Cumulative distribution of home loans, by borrower income and by purpose, type, and pricing of loan, 2007

Percent

Upper bound of borrower income (thousands of dollars)[1]	Home purchase					Refinance				
	Conventional			FHA	VA	Conventional			FHA	VA
	Lower priced	Higher priced	Total			Lower priced	Higher priced	Total		
24	2.4	5.3	2.8	4.6	.7	2.7	5.1	3.2	2.9	3.6
49	24.2	35.1	25.7	43.5	28.2	22.6	33.6	25.0	34.2	29.4
74	48.2	61.0	49.9	78.1	66.3	48.2	61.9	51.2	72.2	65.8
99	65.9	76.6	67.4	92.4	87.5	67.4	78.9	69.9	91.1	86.4
124	77.4	85.3	78.5	96.9	95.7	79.4	87.7	81.2	97.4	95.5
149	84.1	90.0	84.9	98.4	98.5	85.9	92.0	87.3	99.0	98.5
199	91.5	94.9	91.9	99.3	99.8	92.7	96.1	93.5	99.7	99.6
249	94.7	96.9	95.0	99.6	99.9	95.6	97.6	96.0	99.8	99.9
299	96.3	97.8	96.5	99.7	100	96.9	98.4	97.2	99.8	99.9
More than 299	100	100	100	100	100	100	100	100	100	100
MEMO Borrower income, by selected loan type (thousands of dollars)[2]										
All										
Mean	105.5	85.5	102.8	59.8	68.3	101.3	80.6	96.8	64.2	67.7
Median[1]	77	62	75	53	62	76	63	73	59	63
Below the conforming loan size[3]										
Mean	85.7	70.5	83.6	. .	. .	84.5	68.2	80.9	. .	. .
Median[1]	71	59	70	. .	. .	72	60	69	. . .	. . .
Above the conforming loan size[4]										
Mean	298.1	256.3	293.1	. .	. .	259.1	218.2	251.2	. .	. .
Median[1]	210	181	205	. .	. .	184	163	180	. .	. .

NOTE: For loans with two or more applicants, HMDA-covered lenders report data on only two. Income for two applicants is reported jointly. For definitions of lower- and higher-priced lending, see text note 7.

1. Income amounts are reported under HMDA to the nearest $1,000.
2. By size, all loans backed by the FHA or VA are conforming.
3. The conforming loan-size limit established for most loan purchases by Fannie Mae and Freddie Mac is $417,000. For more information, see text note 17.
4. Loans above $417,000, the conforming loan-size limit established for most loan purchases by Fannie Mae and Freddie Mac, are sometimes referred to as jumbo loans. For more information, see text notes 11 and 17.

. . Not applicable
FHA Federal Housing Administration.
VA Department of Veterans Affairs.

7. Non-owner-occupied lending as a share of all first liens to purchase one- to four-family site-built homes, by number and dollar amount of loans, 1990–2007

Percent

Year	Number	Dollar amount
1990	6.6	5.9
1991	5.6	4.5
1992	5.2	4.0
1993	5.1	3.8
1994	5.7	4.3
1995	6.4	5.0
1996	6.4	5.1
1997	7.0	5.8
1998	7.1	6.0
1999	7.4	6.4
2000	8.0	7.2
2001	8.6	7.6
2002	10.5	9.2
2003	11.9	10.6
2004	14.9	13.1
2005	17.3	15.7
2006	16.5	14.8
2007	14.9	13.8

conforming loan-size limit increased in 2007 from 2006 and 2005. For example, the share of lower-priced piggyback loans used to keep the first-lien loan within the conforming loan-size limits increased from 8.8 percent in 2006 to 12.3 percent in 2007 (data derived from table 8). The number of piggyback loans sold to Fannie Mae or Freddie Mac that were used to keep the first-lien loan within the conforming loan-size limits also increased from 2006 to 2007—by some 63 percent—despite a sharp decline in the total number of piggyback loans over this period. These results suggest that in 2007 relatively more borrowers used their piggybacks to take advantage of the lower rates available on the first-lien portion of their piggyback arrangements than to obtain a needed source of down payment.

In contrast, the data suggest that the use of piggyback loans as a substitute for PMI declined in 2007 from 2006. This was true of the loans sold to Fannie Mae and Freddie Mac as well as those that potentially were eligible for sale. The use of piggyback loans for purposes that made the loans non-eligible for sale to Fannie Mae and Freddie Mac also declined significantly. The decrease was most precipitous for higher-

8. Distribution of piggyback loan transactions involving home purchases, by status of first-lien loan, 2004–07

Status of first-lien loan	2004		2005		2006		2007	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Higher priced	105,463	18.88	535,004	50.90	465,154	43.75	62,461	16.05
Lower priced								
Sold to Fannie Mae or Freddie Mac								
Combined with junior-lien loan								
Total is above the conforming loan size	4,503	.81	7,691	.73	10,154	.95	16,546	4.25
Total is less than or equal to the conforming loan size	55,233	9.89	76,804	7.31	121,821	11.46	103,831	26.68
Not sold to Fannie Mae or Freddie Mac								
Above the conforming loan size	62,104	11.12	60,666	5.77	57,138	5.37	32,301	8.30
Less than or equal to the conforming loan size								
Combined with junior-lien loan								
Total is above the conforming loan size	40,725	7.29	43,734	4.16	42,704	4.02	23,761	6.11
Total is less than or equal to the conforming loan size	290,602	52.02	327,270	31.13	366,306	34.45	150,254	38.61
Total lower priced	453,167	81.12	516,165	49.10	598,123	56.25	326,693	83.95
Total	**558,630**	**100**	**1,051,169**	**100**	**1,063,277**	**100**	**389,154**	**100**

NOTE: In piggyback lending, borrowers simultaneously receive a first-lien loan and a junior-lien (piggyback) loan to purchase a home from the same lender. For definitions of higher- and lower-priced lending, see text note 7; for explanation of the conforming loan size established for most loan purchases by Fannie Mae and Freddie Mac, see note 3, table 6; for definition of jumbo loans, see note 4, table 6.

priced first-lien loans, which fell 87 percent. This development was consistent with, and indeed part of, the more general mortgage market turmoil in 2007.

Piggyback lending and mortgage market difficulties. Piggyback loans have contributed to the current mortgage market difficulties. As noted, many home purchases financed with piggyback loans were used to minimize the cash contributions of borrowers toward the purchase of the property. Because loan arrangements involve little borrower equity at the time of purchase, if housing prices fall, as they have in many areas of the country for the past year or so, borrowers may find that they owe more on their combined first- and junior-lien loans than the value of the property. Borrowers in these circumstances are much more likely to default than those with an equity stake in the property.[21]

Piggyback loan arrangements also can make it much more difficult to work out loan difficulties should borrowers fall behind on their loan payments. If property values have fallen below the amount owed on the combined loans, the junior-lien holder often has little prospect of recovering any money if the property is sold—either through a short sale or as a consequence of foreclosure. If the holders of the first- and junior-lien loans are different parties, the interests of the two loan holders may conflict, and the junior-lien holder may have little interest in working with the borrower or the holder of the first lien on a short sale or loan modification unless the first-lien holder provides the junior-lien holder with some financial incentive.

Little information is available on the frequency with which holders of first liens and junior liens differ. The HMDA data provide an opportunity to examine the relationships among loan holders in piggyback loan arrangements, as the data include information on whether or not a reported loan was held in portfolio or sold; if the loan was sold, the data also indicate the type of purchaser.

The analysis here divides lenders into groups based on the type of originator. The analysis focuses on piggyback loan transactions in which the first- and junior-lien loans were used to buy a property and the dates of the loan originations occurred in the first 10 months of the calendar year. The date restriction addresses the concern that loan sales may not be immediate and that originations near the end of the year that are reported in the data as retained in portfolio may not be, as at least some of the loan sales do not occur until the next calendar year. Because the pattern of loan holding and sale may differ by the credit risk embedded in the loans, the analysis is conducted separately for home-purchase transactions in which the first-lien loan was higher priced (table 9).

For each group, the analysis indicates the proportion of loan originations in which the lender held both

21. See Ronel Elul (2006), "Residential Mortgage Default," Federal Reserve Bank of Philadelphia, *Business Review* (Third Quarter), pp. 21–30; and Kerry D. Vandell (1995), "How Ruthless Is Mortgage Default? A Review and Synthesis of the Evidence," *Journal of Housing Research*, vol. 6 (2), pp. 245–64.

9. Distribution of lower- and higher-priced first-lien loans in piggyback loan transactions involving home purchases, by type of lender and lien status of loan that lender held at year-end, 2004–07

Percent

Lien status of loan that lender held at year-end	Type of lender			
	Depository	Mortgage company affiliate of depository	Independent mortgage company	Total
	Lower-priced first-lien loans involved in piggyback loan transactions			
2004				
First lien and junior lien	31.3	13.5	10.4	17.2
First lien only	29.8	21.0	5.4	15.4
Junior lien only	11.5	2.8	3.5	5.8
Neither[1]				
Different purchaser type	6.9	32.3	12.7	14.4
Same purchaser type	20.5	30.4	67.9	47.3
Total	100	100	100	100
MEMO				
Percentage of piggyback loan originations	29.7	17.2	53.0	100
2005				
First lien and junior lien	38.4	20.0	10.7	21.6
First lien only	33.8	25.1	2.8	17.2
Junior lien only	3.2	3.5	5.2	4.2
Neither[1]				
Different purchaser type	6.6	23.2	12.4	12.5
Same purchaser type	18.0	28.2	68.9	44.5
Total	100	100	100	100
MEMO				
Percentage of piggyback loan originations	32.9	18.7	48.4	100
2006				
First lien and junior lien	35.7	11.1	20.7	23.6
First lien only	38.3	21.5	5.2	19.5
Junior lien only	1.8	6.1	1.9	2.8
Neither[1]				
Different purchaser type	8.9	35.8	11.8	16.0
Same purchaser type	15.3	25.5	60.4	38.1
Total	100	100	100	100
MEMO				
Percentage of piggyback loan originations	32.9	21.3	45.8	100
2007				
First lien and junior lien	40.9	7.2	19.3	28.3
First lien only	43.0	67.2	11.0	38.1
Junior lien only	.5	.4	1.3	.7
Neither[1]				
Different purchaser type	7.3	12.8	11.7	9.6
Same purchaser type	8.3	12.4	56.7	23.3
Total	100	100	100	100
MEMO				
Percentage of piggyback loan originations	51.9	18.7	29.4	100
	Higher-priced first-lien loans involved in piggyback loan transactions			
2004				
First lien and junior lien	6.4	7.2	11.7	9.5
First lien only	3.4	2.9	7.5	5.7
Junior lien only	2.2	1.7	1.5	1.7
Neither[1]				
Different purchaser type	8.4	42.6	6.3	12.3
Same purchaser type	79.5	45.7	73.0	70.8
Total	100	100	100	100
MEMO				
Percentage of piggyback loan originations	28.7	14.9	56.3	100
2005				
First lien and junior lien	20.7	14.7	16.5	17.1
First lien only	25.1	16.7	4.4	10.7
Junior lien only	1.5	1.7	4.5	3.5
Neither[1]				
Different purchaser type	2.4	22.7	14.1	13.1
Same purchaser type	50.3	44.3	60.5	55.7
Total	100	100	100	100
MEMO				
Percentage of piggyback loan originations	20.5	16.2	63.3	100

9. Distribution of lower- and higher-priced first-lien loans in piggyback loan transactions involving home purchases, by type of lender and lien status of loan that lender held at year-end, 2004–07—*Continued*

Percent

Lien status of loan that lender held at year-end	Type of lender			
	Depository	Mortgage company affiliate of depository	Independent mortgage company	Total
2006				
First lien and junior lien	15.1	9.8	13.9	13.3
First lien only	10.5	21.5	6.4	10.6
Junior lien only	.9	2.6	1.7	1.7
Neither[1]				
Different purchaser type	6.2	10.0	12.5	10.5
Same purchaser type	67.2	56.1	65.5	63.9
Total	100	100	100	100
MEMO				
Percentage of piggyback loan originations	23.2	21.6	55.2	100
2007				
First lien and junior lien	60.2	64.2	28.0	52.6
First lien only	12.5	8.0	2.7	8.0
Junior lien only	1.8	1.7	4.5	2.5
Neither[1]				
Different purchaser type	7.0	.7	5.4	4.1
Same purchaser type	18.5	25.4	59.5	32.7
Total	100	100	100	100
MEMO				
Percentage of piggyback loan originations	33.3	38.5	28.2	100
	Total			
2004				
First lien and junior lien	27.7	12.7	10.6	16.0
First lien only	26.0	18.6	5.7	13.9
Junior lien only	10.2	2.7	3.2	5.2
Neither[1]				
Different purchaser type	7.2	33.6	11.7	14.1
Same purchaser type	29.0	32.4	68.7	50.8
Total	100	100	100	100
MEMO				
Percentage of piggyback loan originations	29.6	16.9	53.5	100
2005				
First lien and junior lien	31.4	17.5	14.1	19.3
First lien only	30.4	21.1	3.8	13.8
Junior lien only	2.6	2.6	4.8	3.8
Neither[1]	93.9	58.1	76.2	36.9
Different purchaser type				
Same purchaser type	5.0	23.0	13.4	12.8
Total	30.7	35.9	64.0	50.3
MEMO				
Percentage of piggyback loan originations	26.6	17.4	56.0	100
2006				
First lien and junior lien	28.3	10.5	17.4	19.0
First lien only	28.3	21.5	5.8	15.6
Junior lien only	1.5	4.5	1.8	2.3
Neither[1]				
Different purchaser type	7.9	24.3	12.1	13.5
Same purchaser type	33.9	39.2	62.9	49.5
Total	100	100	100	100
MEMO				
Percentage of piggyback loan originations	28.6	21.5	49.9	100
2007				
First lien and junior lien	43.2	24.0	20.7	32.4
First lien only	39.4	49.7	9.6	33.0
Junior lien only	.6	.8	1.8	1.0
Neither[1]				
Different purchaser type	7.3	9.2	10.7	8.7
Same purchaser type	9.5	16.3	57.2	24.9
Total	100	100	100	100
MEMO				
Percentage of piggyback loan originations	48.8	22.0	29.2	100

NOTE: For definition of piggyback lending, see note to table 8; for definitions of lower- and higher-priced lending, see text note 7.

1. For purchaser types, see appendix A in the text.

the first-lien loan and the piggyback loan at the end of the year or the incidence in which the loan holders differed. The following three lender categories are considered: (1) depository institutions, (2) mortgage company affiliates of depositories, and (3) independent mortgage companies. The analysis examines loan originations from 2004 through 2007 (excluding originations from the final two months of each year). The analysis focuses on these four years because data on lien status were not included in the HMDA data for the years before 2004.

As mentioned earlier, the mortgage market turmoil that deepened greatly during 2007 affected many aspects of the market, including the market for piggyback loans. The HMDA data reflect these events. Regarding piggyback lending patterns, relationships found in 2004, 2005, and 2006 are in some respects similar to, but in others notably different from, relationships found in 2007. For example, independent mortgage companies were a significant source of piggyback credit until 2007. Before 2007, independent mortgage companies extended between 46 percent and 53 percent of the lower-priced piggyback loans and, depending on the year, between 55 percent and 63 percent of the higher-priced piggyback loans. From 2004 to 2006, depository institutions accounted for about 30 percent of the lower-priced piggyback loans and about 20 percent to more than 28 percent of the higher-priced piggyback loans. In 2007, the depositories accounted for a much larger share of the piggyback loans that were reported—about 52 percent of such loans that were lower priced and about 33 percent of those that were higher priced.

The HMDA data indicate that in most piggyback loan transactions one or both loans were sold by the lender. Overall, for loans originated in 2004, 2005, or 2006, both loans in higher-priced piggyback transactions were held in portfolio less than 20 percent of the time. For lower-priced piggyback transactions, both loans were held in portfolio somewhat more often. The experience in 2007 was different, particularly regarding piggyback transactions in which the first-lien loan was higher priced: Here, in more than one-half of the transactions, both loans were held in the originating institutions' portfolios. The relatively low incidence of piggyback loan holding for loans originated before 2007 means that for those loan transactions in which defaults occur, loss mitigation problems are likely to be more difficult.

Patterns of loan holding or sale differ some by originator. For each of the years considered, depository institutions were more likely than independent mortgage companies to hold in portfolio both loans in a piggyback loan transaction. For example, in 2006, depositories held both loans in lower-priced piggyback transactions about 36 percent of the time; independent mortgage companies held both loans about 21 percent of the time. Also, in 2006, depositories were more likely than other originators to hold in portfolio both loans in a piggyback transaction when the first-lien loan was higher priced. In 2007, the likelihood of a depository's holding both loans in portfolio when the first-lien loan was higher priced increased substantially, from about 15 percent of the transactions in 2006 to about 60 percent. Mortgage company affiliates of depositories also experienced a similar substantial increase in the incidence of holding both loans in a piggyback transaction involving higher-priced first-lien loans: The incidence rose from 10 percent in 2006 to 64 percent in 2007.

Loans Covered by HOEPA

Under HOEPA, certain types of mortgage loans that have rates or fees above specified levels require additional disclosures to consumers and are subject to various restrictions on loan terms. Under the 2002 revisions to Regulation C, the expanded HMDA data include a code to identify whether a loan is subject to the protections of HOEPA.[22]

Before the release of the 2004 data, little information was publicly available about the extent of HOEPA-related lending or the number or types of institutions involved in that activity.[23] For 2007, roughly 1,050 lenders reported extending about 11,500 loans covered by HOEPA (data not shown in tables). Only 11 lenders made 100 or more HOEPA loans, and most lenders did not report any such loans (data not shown in tables). In the aggregate, HOEPA-related lending accounts for a very small proportion of the mortgage market: HOEPA loans made up less than 0.2 percent of all the originations of home-secured refinancings and home-improvement loans reported for 2007 (data derived from table 3).[24]

22. This reporting requirement relates to whether the loan is subject to the original protections of HOEPA, as determined by the coverage test in the Federal Reserve Board's Regulation Z, 12 C.F.R. pt. 226.32(a). The required reporting is not triggered by the more recently adopted protections for "higher-priced mortgage loans" under Regulation Z, notwithstanding that those protections were adopted under authority given to the Board by HOEPA. See 73 *Federal Register* 44522 (July 30, 2008).

23. Although the expanded HMDA data provide important new information, the data do not capture all HOEPA-related lending. Some HOEPA loans are extended by institutions not covered by HMDA, and some HOEPA loans made by HMDA-covered institutions are not reported under Regulation C, which implements HMDA. The extent of HOEPA-related lending not reported under HMDA is unknown.

24. HOEPA does not apply to home-purchase loans.

The 2007 HMDA Data on Loan Pricing

The following sections assess the loan-pricing information in the 2007 HMDA data. The analysis considers changes in the incidence of higher-priced lending, APR spreads paid on loans above the price-reporting thresholds, and a description of the institutions involved in higher-priced lending.

Factors That Influence Higher-Priced Lending

The reported incidence of higher-priced lending under HMDA can be affected by three broad factors (to be explained shortly) that are related to mortgage market conditions and the general economic environment prevailing in a given year. In addition, the extent of nonreporting by lenders that cease operations during, or shortly after the end of, a calendar year can influence the incidence of higher-priced lending.

The three broad, market-environment-related factors that influence the incidence of higher-priced lending are (1) changes in the interest rate environment, particularly changes in short-term rates relative to longer-term rates; (2) changes in the business practices of mortgage lenders and investors, particularly in the array of products offered and the willingness or ability of the parties to bear credit risk (for example, the willingness to offer loans with high loan-to-value ratios or adjustable-rate loans with initial discounted interest rates); and (3) changes in the borrowing practices and perceptions of consumers (such as changes in preferences for investment properties or in perceptions of future house price movements) or in consumers' credit-risk profiles (for example, changes in the distribution of credit risks for those seeking and obtaining loans).

Aside from the effects that these broad economic factors may have on the incidence of higher-priced lending, changes in the number, size, and product offerings of reporters can matter. Of particular import for users of the HMDA data are the effects on the incidence of higher-priced lending of lenders that extended loans during a portion of 2007 but ceased operations during that year or in early 2008 and, consequently, did not report any data to the FFIEC. In most years, nonreporting has little effect on the HMDA data overall or on any particular aspect of the data. But, as discussed later, it has a significant influence on the 2007 data because the institutions that ceased operations were generally focused on higher-priced loans, and some of these lenders extended large numbers of such loans in previous years.

Incidence of Higher-Priced Lending

As in earlier years, most loans reported in 2007 were not higher priced as defined under Regulation C. Among all the HMDA-reported loans, 18.3 percent were higher priced in 2007, down significantly from 28.7 percent in 2006 (data for 2007 shown in table 3; data for 2006 not shown). The incidence of higher-priced lending fell or was little changed across all loan product categories.

A number of factors account for the decline in the incidence of higher-priced lending as measured in the HMDA data. After increasing mildly in the first part of 2007, interest rates generally fell during the remainder of 2007 and ended the year well below the initial levels; the decrease likely contributed to the observed decline from 2006 in the incidence of higher-priced loans reported in 2007. Previous analyses of changing patterns in the reported incidence of higher-priced lending from 2004 through 2005 found that increases in short-term interest rates relative to longer-term rates help explain a portion of the increase over the period in the incidence of higher-priced lending, as more higher-risk adjustable-rate loans moved above the HMDA price-reporting thresholds.[25] From 2006 to 2007, the pattern reversed as short-term rates fell more than longer-term rates, which suggests that some higher-risk adjustable-rate loans likely fell below the HMDA price-reporting thresholds. However, given the magnitude of the difficulties in the mortgage and housing markets, it seems very likely that changes in lender and investor circumstances and risk tolerances, changes in borrower conditions and preferences, and nonreporting by certain lenders explain most of the reported decline in the incidence of higher-priced lending.[26]

Rate Spreads for Higher-Priced Lending

Most higher-priced loans have APR spreads within 1 or 2 percentage points of the HMDA reporting thresholds. For example, for higher-priced conventional first-lien loans for owner-occupied site-built

25. See Avery, Brevoort, and Canner, "Higher-Priced Home Lending and the 2005 HMDA Data."

26. Some of the change in lender behavior may stem from regulatory guidance provided by the bank regulatory agencies to banking institutions regarding their subprime and nontraditional lending activities. See Board of Governors of the Federal Reserve System (2007), "Federal Financial Regulatory Agencies Issue Final Statement on Subprime Mortgage Lending," press release, June 29, www.federalreserve.gov/newsevents/press/bcreg/20070629a.htm; and Board of Governors of the Federal Reserve System (2006), "Federal Financial Regulatory Agencies Issue Final Guidance on Nontraditional Mortgage Product Risks," press release, September 29, www.federalreserve.gov/newsevents/press/bcreg/20060929a.htm.

homes, two-thirds of the loans have spreads within 2 percentage points of the reporting threshold (table 3).

As in earlier years, only a relatively small proportion of first-lien loans have very large spreads—7 percentage points or more. Similarly, only a relatively small proportion of junior-lien loans have spreads of 9 percentage points or more.

Lenders and Higher-Priced Lending

Most institutions covered by HMDA do little or no higher-priced lending. For 2007, 56 percent of the 8,610 reporting institutions extended fewer than 10 higher-priced loans, and 33 percent of them originated no higher-priced loans (table 10). At the other end of the spectrum, nearly 1,000 lenders reported making at least 100 higher-priced loans, and these institutions accounted for 94 percent of all such loans. The share of higher-priced lending attributable to the 10 lenders with the largest volume of higher-priced loans dropped from 59 percent in 2005 to 35 percent in 2006 and then to 31 percent in 2007 (data not shown in table).

Higher-Priced Lending Specialists

Another way to assess the higher-priced lending market is to examine the extent to which institutions that originate higher-priced loans may be considered "specialists" in that activity—that is, institutions that have a large proportion of their lending in the higher-priced category. Such specialized institutions can have a business orientation that is quite different from that of other lenders. For example, many of these institutions hold relatively few loans in portfolio and rely greatly on their ability to sell loans to the secondary market.

Taking 60 percent of loan originations as a benchmark for defining higher-priced specialists, the analysis finds that 243 of the 987 lenders reporting at least 100 higher-priced loans, or about 3 percent of *all* reporting institutions, might be classified as specialists (data not shown in tables). These specialized lenders accounted for nearly 40 percent of all the higher-priced lending reported in the 2007 HMDA data.

10. Higher-priced lending: Distribution by number of higher-priced loans extended and by the number and percent of HMDA reporters and higher-priced loans, 2007

Number of higher-priced loans extended	HMDA reporters		Higher-priced loans	
	Number	Percent	Number	Percent
0	2,804	32.6	0	.0
1–4	1,282	14.9	2,788	.1
5–9	726	8.4	4,925	.3
10–24	1,212	14.1	19,425	1.0
25–49	881	10.2	31,127	1.6
50–99	718	8.3	50,742	2.7
100 or more	987	11.5	1,798,767	94.3
Total	**8,610**	**100**	**1,907,774**	**100**

NOTE. For definition of higher-priced lending, see text note 7.
HMDA Home Mortgage Disclosure Act of 1975.

Turmoil In Mortgage Markets and Coverage of the 2007 HMDA Data

Excluding government-backed lending, the HMDA data for 2007 show a substantial decline in mortgage lending activity from 2006 in all segments of the market. These declines are apparent whether the metric used to measure lending activity is loan applications, loan originations, loan purpose or type, or lending categorized by loan pricing. The HMDA data can be used to gauge the changes in lending activity by type of lender, population group, and geographies sorted along a number of dimensions, including demographic characteristics or measures of housing and mortgage market conditions.

The Effects of Lenders That Ceased Operations

As noted earlier, an issue when using the 2007 HMDA data is that some lenders ceased operations partway through 2007, yet none of their lending activity is included in the 2007 data because they did not report. As part of the HMDA data collection effort, staff members of the Federal Reserve Board track each financial institution that is expected to report (including all lenders that reported data for the previous calendar year) and contact, or attempt to contact, those that did not submit a report.[27] In some cases, nonreporting is due to a cessation of business; in others, it is the result of a merger, acquisition, or consolidation. When a merger, acquisition, or consolidation occurs, all lending by the institutions covered by HMDA in that year is reported by the surviving entity; only when an institution goes out of business is the volume of reported loans possibly affected. In some cases, a business closure does not compromise the completeness of the HMDA data because some of the closed institutions report lending activity for the portion of the year in which they extended loans.

27. Sometimes contacting a nonreporting lender is impossible because the firm has ceased operations.

Measuring the Activity of Nonreporters

The Federal Reserve's respondent tracking report records what happened to each institution that failed to report. For institutions that ceased operations, the tracking report also records, to the extent possible, the month that operations were discontinued. The tracking report indicates that 169 institutions that reported HMDA data for 2006 ceased operations during 2007 (or the very end of 2006) and did not report lending activity for 2007 (for a list of the institutions that ceased operations and did not report, see appendix table A.1, which has been posted separately as an Excel file).[28] Of these institutions, two were subsidiaries of banking institutions, and the remainder were independent mortgage companies. (All other lenders that ceased operations in 2007 either reported data for 2007 or were merged or acquired, and their 2007 lending activity was reported by the surviving entity.)

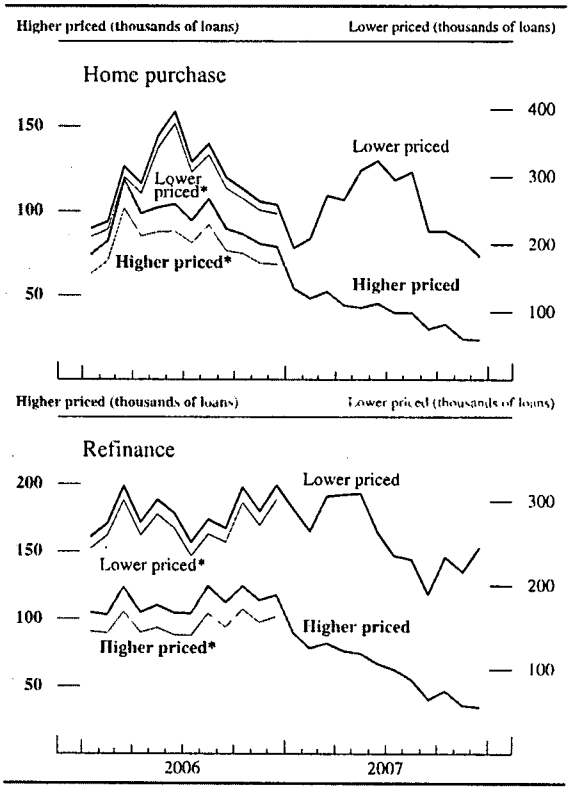
It appears impossible to know how many loans these 169 institutions originated in 2007 before discontinuing operations. To help gauge their potential importance, an analysis of the lending activity of these institutions as recorded in the 2006 HMDA data was undertaken. Specifically, the 2006 HMDA data were reaggregated to exclude the lenders that ceased operations and did not report in 2007. Although many of these lenders extended relatively few loans (30 percent of the lenders extended fewer than 250 conventional first-lien loans for site-built properties in 2006), a few were among the nation's leading lenders in 2006. Moreover, some of these institutions were particularly active in the higher-priced segment of the home-purchase or refinance market. In the aggregate, these companies accounted for nearly 15 percent of the higher-priced conventional first-lien loans for site-built properties reported in 2006, and they accounted for about 8 percent of all conventional first-lien loans for such properties (data not shown in tables).[29]

Time Pattern of Lending Activity

The dates of loan origination reported in the HMDA data can be used to review the pattern of monthly loan extensions over the course of 2006 and 2007 to help distinguish the effects of the mortgage market turmoil on reported loan activity from the effects of closed lenders not reporting 2007 activity. For this analysis, we focus on home-purchase and refinance lending for site-built properties. The volume of home-purchase originations peaked in June 2006 and declined over the rest of the year (figure 1). The pattern for refinancings was less consistent, as monthly originations varied over the course of the year, with high points reached in both March and October 2006.

Data for 2007 show a substantial falloff in activity from December 2006. The abrupt decline from December 2006 to January 2007 is likely a result of a combination of nonreporting by the 169 institutions that ceased operations and the mortgage and housing market turmoil in 2007 that caused most lenders to reduce origination activity. Among home-purchase loans, the greatest falloff in reported activity was in the higher-priced segment, in which originations dropped some 32 percent from December 2006 to January 2007. Overall, home-purchase lending fell

1. Volume of home-purchase and refinance loans originated, higher- and lower-priced loans, and such loans excluding those originated by closed lenders, by month of origination, 2006-07



NOTE: The data are monthly. Loans are conventional first-lien mortgages for site-built properties and exclude business loans. Closed lenders are lenders that reported data for 2006 under the Home Mortgage Disclosure Act (HMDA) but that subsequently ceased operations and did not report HMDA data for 2007. For definitions of higher- and lower-priced loans, see text note 7.

* Excluding loans originated by closed lenders.

28. The list of lenders that ceased operations and did not report is as comprehensive as possible at this time. If additional information becomes available, the list will be updated.

29. Calculations exclude home-improvement loans and business-related loans.

27 percent over this period. A similar pattern was found for refinancings.

To better evaluate the effects of nonreporting on loan volumes in the early part of 2007, the loans of the 169 lenders that ceased operations and did not report were removed from the total loan volumes reflected in the 2006 HMDA data. Excluding these lenders reduces by about 25 percent the differences in the level of home-purchase (and refinance) lending reported between the end of 2006 and January 2007. The reduction is larger for the higher-priced loan segment (about 42 percent), a finding that reflects the greater focus of these institutions on that segment of the market. The fact that a large drop in lending activity is still observed after removing from the 2006 data the institutions that ceased operations indicates that most of the decline in reported lending from 2006 to 2007 was due to the effects of the market turmoil and not nonreporting.

Higher-Priced Lending by Lender Type

Lending activity can be described by type of lender. Four groups of lenders are considered here: depository institutions and three types of mortgage companies—namely, independents, direct subsidiaries of depository institutions, and affiliates of depository institutions. In 2004 and 2005, independent mortgage companies originated about one-half of the higher-priced conventional first-lien loans related to site-built homes and about 30 percent of all conventional first-lien loans (table 11). Depository institutions extended about one-fourth of the higher-priced

11. Distribution of higher-priced lending, by type of lender, and incidence at each type of lender, 2004–07

Percent except as noted

Type of lender	Higher-priced loans			Memo: All loans	
	Number	Distribution	Incidence	Number	Distribution
			2004		
Independent mortgage company	789,337	50.6	25.5	3,093,777	27.8
Depository	403,661	25.9	8.0	5,017,334	45.2
Subsidiary of depository	179,375	11.5	9.0	1,993,212	17.9
Affiliate of depository	187,296	12.0	18.6	1,006,481	9.1
Total	1,559,669	100	14.0	11,110,804	100
			2005		
Independent mortgage company	1,525,424	52.0	41.4	3,684,489	31.0
Depository	670,024	22.8	12.8	5,217,810	43.8
Subsidiary of depository	381,228	13.0	20.7	1,842,652	15.5
Affiliate of depository	357,689	12.2	30.9	1,157,421	9.7
Total	2,934,365	100	24.7	11,902,372	100
			2006		
Independent mortgage company	1,280,987	45.7	41.5	3,083,947	31.2
Depository	800,421	28.5	18.7	4,285,896	43.4
Subsidiary of depository	346,882	12.4	22.9	1,517,564	15.4
Affiliate of depository	377,286	13.4	37.9	996,614	10.1
Total	2,805,576	100	28.4	9,884,021	100
			2006 (excluding loans by closed lenders)[1]		
Independent mortgage company	880,927	36.7	37.6	2,341,193	25.6
Depository	800,421	33.4	18.7	4,285,896	46.9
Subsidiary of depository	338,758	14.1	22.5	1,508,231	16.5
Affiliate of depository	377,286	15.7	37.9	996,614	10.9
Total	2,397,392	100	26.3	9,131,934	100
			2007		
Independent mortgage company	292,571	20.5	20.1	1,453,385	19.0
Depository	654,176	45.8	14.8	4,408,656	57.7
Subsidiary of depository	229,340	16.1	19.8	1,158,064	15.2
Affiliate of depository	252,739	17.7	40.6	622,571	8.1
Total	1,428,826	100	18.7	7,642,676	100

Note: Conventional first-lien mortgages for site-built properties; excludes business loans. For definition of higher-priced lending, see text note 7.

1. Closed lenders are lenders that reported data for 2006 under the Home Mortgage Disclosure Act (HMDA) but that subsequently ceased operations and did not report HMDA data for 2007.

loans and about 45 percent of all loans. The HMDA data for 2006 show that independent mortgage companies accounted for a somewhat smaller share of the higher-priced loan market (but a nearly equivalent share of the entire market): In that year, these companies extended 46 percent of the higher-priced loans and 31 percent of all loans.

As noted earlier, in 2007, turmoil in the subprime mortgage sector caused a number of lenders to cease operations, curtail their activities, or transfer their business to others; all but two of the institutions that ceased operations were independent mortgage companies. The HMDA data portray the diminished role of independent mortgage companies in the home-lending market: In 2007, these companies originated 21 percent of the reported higher-priced loans and 19 percent of all loans.

The reduced role of the independent mortgage companies in the 2007 HMDA data is due partly to some of these lenders ceasing operations and partly to a curtailment of activity among surviving institutions of this type. Because the independent mortgage companies that ceased operations in 2007 did not report any activity, it is impossible to determine the magnitude of their lending in 2007. To help gauge their potential importance, the 2006 HMDA data were re-aggregated to exclude the independent mortgage companies that ceased operations during 2007 and did not report. Excluding these closed institutions reduces by some 31 percent the number of higher-priced loans originated by lenders in the independent mortgage company category in 2006 and raises by between about 14 percent and 17 percent the share of higher-priced lending accounted for by the other types of lenders in that year (data derived from table 11).

In the 2007 HMDA data, depository institutions are the leading providers of higher-priced loans. In part, this finding is a reflection of the sharp reduction in lending by independent mortgage companies (both those that continued to operate throughout 2007 and those that closed and did not report). The increased role of depository institutions in the higher-priced segment of the market is not an indication of expanded lending; the number of higher-priced loans that depository institutions extended in 2007 was some 18 percent below the corresponding total for 2006. Rather, the increased role of such institutions reflects the large contraction in activity of other institutions in this part of the market.

2006 Lending Profile of the 169 Closed Institutions That Did Not Report

One way to learn about the activities of the institutions that ceased operations in 2007 and did not report data is to examine the nature of their lending activities in 2006 and to compare it with the lending of the other reporting institutions for that year. For the analysis, lending activities are described by a wide range of borrower, location, and loan characteristics and by local housing or mortgage market conditions (table 12).

The analysis identifies many differences between the lending activities of the 169 institutions in 2006 and those of the other HMDA reporters. Most striking is the much higher incidence of higher-priced lending for the 169 institutions than for the other reporters. This difference is revealed in the profile of lending arrayed by either borrower income or by race or ethnicity of the borrower. For all income categories, the incidence of higher-priced lending for the 169 institutions is about double the rate for the other HMDA reporters. Also striking is the very high incidence of higher-priced lending for blacks (74 percent) and Hispanic whites (63 percent) among the 169 lenders. Regarding their overall lending, the 169 lenders extended a higher share of their loans to blacks and Hispanic whites than the other HMDA reporters, and they also extended a higher share of loans to borrowers in census tracts with larger fractions of minority populations or lower incomes.

In 2006, the 169 institutions tended to extend somewhat larger loans and nearly double the share of piggyback loans. The loans they originated also were more likely to be for properties in the western region of the country and in metropolitan areas that experienced greater recent declines in home values and greater increases in mortgage delinquencies.

Changes in Lending Activity by Borrower and Geography

The HMDA data can be used to track changes in mortgage market activity between 2006 and 2007. Over this period, the mortgage market transitioned from one characterized by a relatively high incidence of higher-priced lending and of mortgage loan sales to one with a substantially lower share of both higher-priced lending and loans sold to the secondary mar-

12. Distribution of all loans and of lower- and higher-priced loans, and incidence of lower- and higher-priced lending, for the 169 closed lenders and for all other lenders, by characteristic of borrower and of loan and by location of property, 2006

Percent

Characteristic and status	Closed lenders					All other lenders				
	All loans	Lower-priced loans		Higher-priced loans		All loans	Lower-priced loans		Higher-priced loans	
	Distribution	Distribution	Incidence[1]	Distribution	Incidence[1]	Distribution	Distribution	Incidence[1]	Distribution	Incidence[1]
BORROWER										
Income ratio (percent of area median)[2]										
Lower	12.1	11.2	45.2	12.9	54.8	14.5	14.4	72.7	14.9	27.3
Middle	9.0	7.5	40.7	10.4	59.3	10.6	10.4	71.8	11.2	28.2
High	70.5	70.3	48.6	70.8	51.4	69.0	69.3	73.6	68.3	26.4
Missing[3]	8.4	11.1	64.2	5.9	35.8	5.9	6.0	74.7	5.6	25.3
Total	100	100	48.8	100	51.2	100	100	73.3	100	26.7
Minority status[4]										
Black or African American	16.7	9.5	26.1	22.7	73.9	9.7	6.5	49.3	18.9	50.7
Hispanic white	22.1	17.8	36.6	25.8	63.4	14.6	12.5	63.0	20.7	37.0
Asian	4.3	5.2	55.1	3.5	44.9	4.5	5.1	83.4	2.9	16.6
Non-Hispanic white	56.9	67.5	54.1	48.0	45.9	71.2	76.0	78.9	57.5	21.1
Total[5]	100	100	45.6	100	54.4	100	100	73.9	100	26.1
Sex										
Single female	31.1	27.7	40.4	34.0	59.6	24.8	23.2	68.9	29.1	31.1
Single male	40.0	36.7	41.7	42.9	58.3	33.0	30.7	68.4	39.4	31.6
Joint female and male[6]	28.8	35.7	56.3	23.1	43.7	42.2	46.0	80.2	31.5	19.8
Total[5]	100	100	45.5	100	54.5	100	100	73.5	100	26.5
LOAN										
Amount of loan (thousands of dollars)										
Less than 100	15.3	8.7	26.3	20.8	73.7	20.5	17.8	63.6	28.0	36.4
100–249	49.0	50.4	47.3	47.9	52.7	48.0	48.5	74.2	46.4	25.8
250 or more	35.7	40.9	52.7	31.3	47.3	31.5	33.7	78.3	25.6	21.7
Total[5]	100	100	46.0	100	54.0	100	100	73.3	100	26.7
Owner-occupancy status										
Owner	85.1	85.1	46.0	85.0	54.0	86.2	86.3	73.4	86.2	26.6
Non-owner[7]	14.9	14.9	45.9	15.0	54.1	13.8	13.7	73.2	13.8	26.8
Total[5]	100	100	46.0	100	54.0	100	100	73.3	100	26.7
Type of property										
1–4 family site-built	99.6	99.3	45.9	99.8	54.1	98.0	98.6	73.8	96.2	26.2
Manufactured home	.4	.7	73.8	.2	26.2	2.0	1.4	49.9	3.8	50.1
Total[5]	100	100	46.0	100	54.0	100	100	73.3	100	26.7
Piggyback status										
Piggyback[8]	23.2	19.8	39.3	26.1	60.7	12.7	10.3	59.3	19.5	40.7
Not piggyback	76.8	80.2	48.0	73.9	52.0	87.3	89.7	75.4	80.5	24.6
Total[5]	100	100	46.0	100	54.0	100	100	73.3	100	26.7
LOCATION OF PROPERTY, BY FREDDIE MAC REGION[9]										
Northeast	18.9	19.5	46.9	18.3	53.1	22.1	22.6	74.9	20.8	25.1
Southeast	20.8	18.3	39.8	22.9	60.2	22.1	21.2	70.6	24.4	29.4
North Central	13.1	10.3	35.5	15.5	64.5	16.7	16.4	72.0	17.5	28.0
Southwest	12.7	12.1	43.2	13.1	56.8	13.7	13.2	70.6	15.1	29.4
West	34.5	39.8	52.2	30.2	47.8	25.5	26.6	76.7	22.3	23.3
Total[5]	100	100	45.3	100	54.7	100	100	73.3	100	26.7
CENSUS TRACT OF PROPERTY										
Income ratio (percent of area median)[10]										
Lower	24.2	18.0	33.7	29.3	66.3	17.9	14.7	60.4	26.5	39.6
Middle	49.2	48.4	44.4	49.9	55.6	50.9	50.2	72.2	53.1	27.8
High	26.6	33.6	57.0	20.9	43.0	31.2	35.1	82.6	20.4	17.4
Total[5]	100	100	45.2	100	54.8	100	100	73.3	100	26.7

ket. As noted, a comparison of lending activity in these two years is complicated by an underreporting of loans in 2007 because some lenders went out of business during the year and did not report HMDA data. Most of the lenders that did not report data for 2007 exited the market by the middle of that year, and therefore underreporting of data is much less likely to be a problem for the last half of the year. Consequently, to reduce the uncertain effects of underreporting, we compare mortgage market activity in the first six months of 2006 with that in the last six months of 2007.

The comparison focuses primarily on the changes in the number of originated loans, although changes in the number of applications and of denials are also examined. Comparisons of loan originations are made

12. Distribution of all loans and of lower- and higher-priced loans, and incidence of lower- and higher-priced lending, for the 169 closed lenders and for all other lenders, by characteristic of borrower and of loan and by location of property, 2006—*Continued*

Percent

Characteristic and status	Closed lenders					All other lenders				
	All loans	Lower-priced loans		Higher-priced loans		All loans	Lower-priced loans		Higher-priced loans	
	Distribution	Distribution	Incidence[1]	Distribution	Incidence[1]	Distribution	Distribution	Incidence[1]	Distribution	Incidence[1]
Racial or ethnic composition (minorities as a percent of population)										
Less than 10	22.0	23.9	49.0	20.5	51.0	32.4	34.5	78.0	26.7	22.0
10–50	48.5	53.5	49.9	44.3	50.1	47.9	49.2	75.3	44.3	24.7
50 or more	29.5	22.6	34.7	35.1	65.3	19.7	16.3	60.8	28.9	39.2
Total[5]	100	100	45.2	100	100	100	100	73.3	100	26.7
Credit score of borrowers (percent of mortgage borrowers with scores below 600)[11]										
20 or more	17.3	9.8	26.0	23.7	74.0	13.9	10.2	53.7	24.1	46.3
10–20	32.8	30.0	42.1	35.2	57.9	30.6	28.5	68.4	36.3	31.6
Less than 10	49.9	60.1	55.5	41.1	44.5	55.5	61.3	81.0	39.6	19.0
Total[5]	100	100	46.0	100	54.0	100	100	73.3	100	26.7
MSA OF PROPERTY										
Real price appreciation of real estate (percent)[12]										
–8 or less	54.6	55.9	46.4	53.6	53.6	44.3	44.4	73.6	44.3	26.4
–8–0	33.8	32.4	43.6	34.9	56.4	41.9	41.8	73.5	42.1	26.5
0 or more	11.6	11.7	45.7	11.6	54.3	13.8	13.8	74.0	13.6	26.0
Total[5]	100	100	45.4	100	54.6	100	100	73.6	100	26.4
Change in delinquincy rate (percent)[13]										
0.5 or less	27.9	27.3	44.2	28.5	55.8	37.0	36.7	72.7	37.8	27.3
0.5–2	44.9	43.0	43.3	46.5	56.7	42.9	42.4	72.3	44.5	27.7
2 or more	27.2	29.7	49.5	25.1	50.5	20.1	20.9	76.4	17.8	23.6
Total[5]	100	100	45.2	100	54.8	100	100	73.3	100	26.7

NOTE: Conventional first-lien mortgages for home purchase or refinance for single-family houses, excludes business loans. For definition of closed lenders, see note 1, table 11; for definitions of lower- and higher-priced lending, see text note 7.

1. Distribution sums horizontally.

2. Borrower income is the total income relied upon by the lender in the loan underwriting. Income is expressed relative to the median family income of the metropolitan statistical area (MSA) or statewide non-MSA in which the property being purchased is located. "Lower" is less than 80 percent of the median; "middle" is 80 percent to 119 percent; and "high" is 120 percent or more.

3. Information for income or property location was missing on the application.

4. Categories for race and ethnicity reflect the revised standards established in 1997 by the Office of Management and Budget. Applicants are placed under only one category for race and ethnicity, generally according to the race and ethnicity of the person listed first on the application. However, under race, the application is designated as *joint* if one applicant reported the single designation of white and the other reported one or more minority races. If the application is not joint but more than one race is reported, the following designations are made: If at least two minority races are reported, the application is designated as *two or more minority races;* if the first person listed on an application reports two races, and one is white, the application is categorized under the minority race. For loans with two or more applicants, lenders covered under the Home Mortgage Disclosure Act report data on only two.

5. Excludes loans for which the information for the characteristic was missing on the application and loans deemed business related or multifamily.

6. On the applications for these loans, one applicant reported "male," and the other reported "female." For female and for male, only sole applicants were considered. Excludes loans for which sex was missing on the application and loans involving two females or two males.

7. Includes loans for which occupancy status was missing.

8. For definition of piggyback lending, see note to table 8.

9. Freddie Mac defines its regions as follows: *Northeast:* N.Y., N.J., Pa., Del., Md., D.C., Va., W.V., P.R. *Maine,* N.H., Vt., Mass., R.I., Conn., V.I., *Southeast:* N.C., S.C., Tenn., Ky., Ga., Ala., Fla., Miss., *North Central:* Ohio, Ind., Ill., Mich., Wis., Minn., Iowa, N.D., S.D., *Southwest:* Texas, La., N.M., Okla., Ark., Mo., Kan., Colo., Neb., Wyo.; *West:* Calif., Ariz., Nev., Ore., Wash., Utah, Idaho, Mont., Hawaii, Alaska, Guam.

10. The income category of a census tract is the median family income of the tract relative to that of the metropolitan statistical area (MSA) or statewide non-MSA in which the tract is located. "Lower" is less than 80 percent of the median; "middle" is 80 percent to 119 percent; and "high" is 120 percent or more.

11. Data from Equifax drawn from credit records of individuals as of December 31, 2006. A score below 600 generally conforms with borrowers in the subprime portion of the mortgage market. Includes all borrowers with an outstanding mortgage regardless of the year in which the loan was taken out.

12. Housing price index from the Office of Federal Housing Enterprise Oversight. House price changes calculated using the percent change in the index from the fourth quarter of 2006 through the first quarter of 2008. Based on the change in median home values for a constant 2000-defined geography.

13. Delinquency rates from Trend Data, a product of TransUnion LLC. The change in the mortgage delinquency rate is calculated using delinquency rates from the fourth quarter of 2003 to the fourth quarter of 2007.

for both lower-priced and higher-priced loans. Within the category of higher-priced loans, differentiation is made by the size of the reported APR spread. Loans for home purchase and for refinancing are examined separately, and the analysis is restricted to first-lien loans secured by a site-built property. Unlike some of the earlier analyses, we do not differentiate between government-backed and conventional loans. Changes in the number of loan originations are examined by borrower race or ethnicity, borrower income, census-tract income, and owner-occupancy status of the property securing the loan.

13. Change in the number of loan applications, denials, and originations, and change in the number of lower- and higher-priced originations, for all loans and for jumbo loans, by characteristic of borrower and of census tract, 2006:H1 through 2007:H2

A. Home purchase

Percent

Characteristic of borrower and of census tract, by owner-occupancy status of property	Applications		Loans originated										
					Higher priced				Jumbo				
						Distribution, by percentage points of APR spread[1]			Applications				
	Number acted upon by lender	Number denied	All	Lower priced	All	3–3.99	4–4.99	5 or more	Number acted upon by lender	Number denied	All	Lower priced	Higher priced
OWNER OCCUPIED													
BORROWER													
Minority status[2]													
Black or African American	–31.9	–25.7	–35.2	–2.3	–69.4	11.2	–46.7	–89.0	–37.3	–10.7	–57.2	–39.7	–74.5
Hispanic white	–42.1	–30.7	–48.8	–26.8	–75.7	–25.0	–66.4	–94.0	–57.3	–32.5	–72.8	–65.1	–83.1
Other minority[3]	–23.1	–20.7	–26.2	–15.3	–73.4	–24.7	–71.2	–93.1	–35.9	–26.9	–43.4	–36.2	–75.6
Non-Hispanic white	–20.1	–18.0	–21.8	–14.3	–60.0	–11.4	–47.6	–88.5	–31.7	–12.1	–40.2	–37.1	–62.3
Missing[4]	–27.5	–29.2	–26.3	–9.8	–71.1	–11.2	–56.0	–91.1	–31.5	–19.0	–38.8	–31.2	–71.4
Minority status, by income category[5]													
Lower													
Black or African American	–30.8	–30.3	–30.0	5.2	–65.7	43.7	–32.8	–88.0	–15.0	–7.4	–25.9	.0	–87.5
Hispanic white	–24.6	–21.7	–27.3	–4.7	–60.5	–1.2	–44.6	–90.6	–30.9	–12.2	–70.2	–65.0	–82.4
Other minority[3]	–14.0	–12.0	–16.4	–6.0	–61.6	6.1	–54.6	–90.6	–36.5	–30.5	–53.7	–53.9	–50.0
Non-Hispanic white	–19.8	–20.3	–20.3	–11.7	–54.6	13.7	–35.8	–88.8	–20.7	1.9	–38.6	–34.9	–63.3
Total	–22.9	–24.1	–22.6	–9.2	–59.2	15.4	–38.0	–88.9	–26.9	–13.3	–42.6	–37.8	–70.0
Middle													
Black or African American	–29.5	–24.7	–31.8	7.7	–64.4	28.9	–47.0	–90.0	–14.1	2.8	–29.2	–14.6	–55.6
Hispanic white	–36.9	–28.8	–42.1	–13.1	–70.3	–6.4	–64.0	–94.7	–44.4	–29.6	–58.3	–46.8	–80.5
Other minority[3]	–17.5	–14.7	–20.2	–8.8	–75.1	–3.1	–68.9	–93.4	–27.8	–11.7	–35.6	–31.4	–80.3
Non-Hispanic white	–20.0	–19.7	–21.1	–12.2	–71.0	6	–49.7	–90.1	–33.8	–12.9	–42.0	–40.6	–56.9
Total	–23.6	–23.2	–24.7	–10.1	–67.9	3.0	–54.0	–91.3	–31.7	–15.5	–40.9	–36.1	–68.2
High													
Black or African American	–31.8	–20.3	–38.7	–6.9	–72.9	–.3	–57.5	–89.6	–38.1	–13.4	–57.2	–36.6	–76.4
Hispanic white	–48.8	–35.4	–57.3	–35.8	–81.5	–29.7	–75.1	–94.7	–57.7	–34.3	–72.9	–64.3	–83.9
Other minority[3]	–23.6	–23.9	–27.0	–15.8	–77.1	–23.9	–75.9	–93.6	–34.6	–27.9	–42.0	–34.4	–75.7
Non-Hispanic white	–16.9	–12.9	–19.6	–13.3	–61.2	–15.7	–51.1	–87.0	–30.7	–12.5	–39.1	–36.1	–62.3
Total	–23.9	–21.7	–26.6	–14.6	–71.3	–17.6	–61.9	–90.9	–35.9	–20.6	–44.9	–37.7	–73.6
Missing[4]	–61.6	–36.4	–68.4	–67.7	–70.3	–70.2	–64.8	–80.7	–51.2	–2.9	–64.3	–64.6	–63.6
CENSUS TRACT OF PROPERTY													
Income category[6]													
Lower	–32.9	–29.5	–26.2	–13.2	–70.0	–8.1	–53.9	–90.8	–36.8	–19.3	–46.5	–38.8	–73.0
Middle	–24.8	–22.6	–27.2	–13.2	–65.8	–10.3	–52.7	–90.3	–37.2	–19.3	–47.0	–40.0	–72.9
High	–24.8	–18.5	–27.1	–16.3	–66.7	–20.4	–57.7	–90.0	–36.4	–19.8	–45.5	–38.8	–72.8
Total owner occupied	–25.2	–23.4	–26.9	–14.4	–67.1	–12.4	–54.1	–90.4	–36.6	–19.5	–45.9	–39.0	–72.9
NON-OWNER OCCUPIED[7]													
Total	–38.2	–29.2	–41.5	–32.6	–64.5	–52.0	–57.1	–86.1	–37.5	–25.3	–44.5	–40.2	–64.7
Total	**–27.4**	**–24.4**	**–29.3**	**–17.3**	**–66.6**	**–25.7**	**–54.7**	**–89.9**	**–36.7**	**–20.2**	**–45.7**	**–39.2**	**–71.9**

NOTE: Conventional first-lien mortgages for site-built properties; excludes business loans and applications, applications in U.S. territories, and applications missing census-tract information. For definitions of lower- and higher-priced lending, see text note 7; for definition of jumbo loans, see note 4, table 6.

1. See note 1, table 3.
2. See note 4, table 12.
3. Other minority consists of American Indian or Alaska Native, Asian, and Native Hawaiian or other Pacific Islander.
4. Information for the characteristic was missing on the application.
5. See note 2, table 12.
6. See note 10, table 12.
7. Includes applications and loans for which occupancy status was missing.

Changes in Lending Activity by Characteristic of Borrower and Census Tract

All borrower and census-tract groups, whether characterized by race or ethnicity, income, or owner-occupancy status, experienced a decline in the number of loan originations for home purchase and for refinancing (tables 13.A and 13.B, column 3). The percentage decline in loan originations was largest for Hispanic whites and for blacks. For example, home-purchase loans to Hispanic white and black borrowers fell 49 percent and 35 percent respectively, while such loans to non-Hispanic white borrowers fell 22 percent over the same period. Even when changes for borrowers of similar income levels are compared, differences across racial or ethnic groups are found. However, the overall differences across income classes, whether

13. Change in the number of loan applications, denials, and originations, and change in the number of lower- and higher-priced originations, for all loans and for jumbo loans, by characteristic of borrower and of census tract, 2006:H1 through 2007:H2—*Continued*

B. Refinance

Percent

Characteristic of borrower and of census tract, by owner-occupancy status of property	Applications		Loans originated										
					Higher priced				Jumbo				
						Distribution, by percentage points of APR spread[1]			Applications				
	Number acted upon by lender	Number denied	All	Lower priced	All	3–3.99	4–4.99	5 or more	Number acted upon by lender	Number denied	All	Lower priced	Higher priced
OWNER OCCUPIED													
BORROWER													
Minority status[2]													
Black or African American	–18.3	–.1	–37.4	–16.0	–59.0	–23.8	–51.6	–71.8	–25.3	15.0	–61.8	–57.2	–68.6
Hispanic white	–15.7	19.1	–40.6	–28.4	–63.4	–17.9	–55.2	–81.9	–22.1	26.5	–58.9	–55.2	–67.4
Other minority[3]	–12.2	14.6	–30.9	–22.3	–60.8	–25.6	–51.2	–79.5	–23.2	16.2	–49.1	–45.2	–66.6
Non-Hispanic white	–15.6	–3.8	–24.4	–15.5	–51.9	–20.3	–42.9	–71.2	–28.2	11.1	–49.6	–48.4	–55.7
Missing[4]	–29.4	–28.8	–33.1	–16.8	–62.5	–19.5	–57.4	–79.5	–27.0	–9.8	–47.3	–44.4	–57.0
Minority status, by income category[5]													
Lower													
Black or African American	–23.6	–11.4	–39.3	–9.8	–61.1	–25.9	–55.3	–72.6	6.2	19.1	–60.8	–32.0	–88.5
Hispanic white	–16.2	4.0	–35.5	–14.3	–66.0	–22.6	–58.0	–82.6	20.3	42.4	–54.2	–39.2	–90.5
Other minority[3]	–13.4	–1.6	–27.2	–13.8	–60.6	–34.2	–53.5	–75.0	23.7	36.8	–50.0	–49.0	–55.6
Non-Hispanic white	–24.6	–19.4	–29.9	–18.7	–54.8	–22.8	–47.5	–72.3	–4.6	4.5	–27.0	–17.6	–63.9
Total	–26.6	–21.6	–32.7	–16.9	–58.9	–24.0	–52.2	–74.7	–4.9	5.1	–38.2	–28.0	–71.6
Middle													
Black or African American	–14.5	9.1	–36.5	–11.7	–59.6	–21.0	–51.8	–72.3	–9.3	37.9	–69.8	–58.7	–80.9
Hispanic white	–14.0	24.5	–39.5	–23.8	–65.8	–16.9	–59.1	–82.4	–12.8	40.8	–63.7	–55.7	–84.2
Other minority[3]	–10.5	16.7	–30.1	–19.8	–61.2	–25.4	–49.1	–78.5	–11.3	35.0	–54.8	–49.4	–81.5
Non-Hispanic white	–16.0	–3.3	–25.3	–14.4	–54.3	–21.9	–46.3	–71.7	–33.5	3.7	–67.3	–62.2	–83.7
Total	–17.8	–4.1	–29.5	–15.5	–58.5	–21.5	–50.7	–74.9	–26.0	7.3	–64.9	–58.3	–82.3
High													
Black or African American	–10.5	19.1	–36.3	–21.9	–55.3	–16.4	–44.7	–70.5	–27.6	13.0	–62.0	–57.9	–67.9
Hispanic white	–13.5	29.1	–41.9	–32.9	–60.9	–7.7	–50.1	–81.4	–24.0	23.2	–58.8	–55.1	–67.3
Other minority[3]	–9.9	25.0	–30.6	–23.0	–61.1	–17.9	–51.5	–81.8	–24.1	13.8	–48.5	–44.4	–66.0
Non-Hispanic white	–6.1	15.0	–18.4	–11.3	–47.0	–10.1	–35.2	–70.0	–27.7	12.1	–49.0	–47.7	–55.2
Total	–9.6	11.0	–24.1	–15.1	–52.7	–10.3	–41.6	–74.2	–26.3	9.7	–50.4	–47.9	–60.0
Missing[4]	–40.8	–32.8	–44.5	–42.7	–54.2	–54.4	–50.3	–57.3	–35.1	.8	–52.3	–53.9	–44.2
CENSUS TRACT OF PROPERTY													
Income category[6]													
Lower	–23.2	–10.6	–29.0	–21.0	–59.3	–22.0	–51.4	–74.8	–25.7	10.1	–51.5	–49.9	–59.1
Middle	–17.9	–7.5	–28.9	–15.9	–55.1	–21.2	–46.7	–73.0	–26.4	8.9	–51.7	–49.3	–60.9
High	–15.4	–1.1	–28.8	–17.8	–56.8	–17.6	–48.3	–77.8	–26.3	8.7	–50.7	–48.0	–61.0
Total owner occupied	–18.3	–6.8	–28.8	–17.3	–56.5	–20.6	–48.2	–74.4	–26.4	9.0	–51.1	–48.5	–60.6
NON-OWNER OCCUPIED[7]													
Total	–7.8	23.9	–23.0	–8.3	–60.5	–37.4	–49.9	–81.3	–19.1	16.2	–40.0	–32.8	–66.2
Total	**–17.4**	**–4.8**	**–28.2**	**–16.4**	**–56.9**	**–22.9**	**–48.3**	**–75.0**	**–25.8**	**9.5**	**–50.1**	**–47.2**	**–61.1**

NOTE: See notes to table 13.A.

measured by the borrower's income or the median income for the census tract, are much smaller than the differences across racial or ethnic groups. There are two notable exceptions: (1) The number of refinance loans to high-income borrowers declined less than the number to middle- or lower-income borrowers, and (2) lending to borrowers with missing income declined much more than that to borrowers whose income was reported. Loans to borrowers with nonreported income may include a disproportionate share of stated-income or no-documentation loans, two products that experienced a sharp decline in 2007.

Most of the reduction in loan volume appears to be driven by declines in the number of applications. A portion of the decline in loan originations is also accounted for by a modest increase in denial rates. The increase in the denial rate is due to a smaller reduction in the number of denials (tables 13.A and 13.B, column 2) than in the number of applications (column 1).

The falloff in loan volumes differed substantially across loan-pricing categories. For example, the number of home-purchase loans with APR spreads of 5 percentage points or above declined almost 90 percent, whereas the number of lower-priced home-purchase loans declined only 17 percent. Differences in declines across pricing categories appear to explain at least a portion of the racial differences described earlier. For example, when comparisons are made for borrowers within each of the 12 combinations of borrower income and loan-pricing categories, the decline in home-purchase lending to blacks was lower than the decline in such lending to non-Hispanic whites in 10 of the 12 cases. Thus, the much larger overall decline in lending to blacks must be driven by the fact that blacks in 2006 were disproportionately in loan-pricing categories that experienced very large rates of decline. This pattern was less evident for refinance loans: Black borrowers tended to have greater declines than non-Hispanic whites, even when the comparison was made for borrowers of the same borrower income and loan-pricing category. However, these within-category differences were much smaller than the overall racial differences between black and non-Hispanic white borrowers. Generally, the large differences in the rates of decline in lending to Hispanic whites and non-Hispanic whites persisted across the loan-pricing categories. These differences appear to have been driven primarily by geography. For example, the rate of decline in higher-priced home-purchase lending to Hispanic whites was 15 percentage points greater than the decrease in such lending to non-Hispanic whites. More than two-thirds of this difference can be attributed to differences in the distribution of Hispanic whites and non-Hispanic whites across MSAs (data not shown in tables). This finding suggests that the higher rates of decline in lending to Hispanic whites can be attributed primarily to a higher proportion of Hispanic white borrowers in MSAs where lending has declined the most.

The recent mortgage market turmoil has raised concerns about the condition of the market for loans above the conforming loan-size limit established by Fannie Mae and Freddie Mac (jumbo loans). The 2006 and 2007 HMDA data provide an opportunity to profile changes in this market segment. The number of jumbo loan originations declined from the first half of 2006 to the last half of 2007 by a larger percentage than overall lending (46 percent compared with 29 percent), and it did so for every demographic category. Further, for both lower-priced and higher-priced loan categories, declines in loan originations were greater for jumbo loans than for overall lending. The difference was particularly large for lower-priced loans. For example, jumbo lower-priced refinance loans fell by almost one-half, while overall lower-priced refinance loans declined 16 percent.

Changes in Lending by Type of Lender

Changes in the number of loan originations differ substantially across types of lenders (tables 14.A and 14.B). For example, the number of higher-priced refinance loans originated by independent mortgage companies declined 85 percent between the first half of 2006 and the last half of 2007. In contrast, the number of such loans originated by depository institutions within their assessment areas actually rose 8 percent over the same period.[30] These differences are indicative of depository institutions' larger market shares (in total lending and higher-priced lending) in their assessment areas. However, the data in these tables show that the shift in market share from independent mortgage companies to depositories in their assessment areas has had very different patterns across racial or ethnic groups. For example, depository institutions experienced an increase in their volume of lower-priced home-purchase lending to black borrowers in their assessment areas by about one-fifth for each income category. In contrast, lower-priced home-purchase lending by depositories to non-Hispanic white borrowers in their assessment areas fell for each income class. Similar differences are shown for higher-priced loans. Overall, higher-priced home-purchase lending by depository institutions in their assessment areas fell 17 percent, whereas higher-priced lending to black borrowers fell only 3 percent.

Another way of looking at differences in loan originations across types of lenders is to examine how the changes differed across geographies that were predominantly served by specific lender types in 2006 (tables 15.A and 15.B). Here we identify those census tracts where 50 percent or more of the loans in 2006 were originated by (1) independent mortgage companies, (2) depository institutions in their assessment areas, or (3) lenders that went out of business during 2007 (this group includes the 169 lenders that did not

30. Larger commercial banks and savings associations covered by the Community Reinvestment Act of 1977 (CRA)—generally those with assets of $1 billion or more—are required to identify the census tracts in their CRA assessment areas as of the end of each calendar year. That information was used to determine which loans in the HMDA data were for properties within the lenders' CRA assessment areas. When lenders were part of a bank or thrift holding company, the combined assessment areas of all banks in the holding company were used for the analysis.

report HMDA data for 2007 as well as those lenders that went out of business and either reported 2007 HMDA data or were merged or acquired).

Higher-priced home-purchase or refinance lending declined more than the overall market in census tracts that in 2006 were primarily served by lenders that went out of business by 2007. This was also true for census tracts that had been heavily served by independent mortgage companies. In contrast, the decline in higher-priced lending in census tracts that were primarily served by depository institutions in their assessment areas was smaller than the declines in other census tracts. Patterns for lower-priced loans are less consistent. For example, the number of lower-priced home-purchase loans in census tracts that in 2006 were primarily served by lenders that went out of business in 2007 declined less than the number of such loans extended to borrowers in other census tracts. In contrast, the number of lower-priced refinance loans in census tracts that were primarily served by lenders that went out of business in 2007 declined at a higher rate than the number of these loans in other census tracts.

Differences in the rates of decline across racial or ethnic groups for these census tracts characterized by concentrated lending are sometimes quite large. For example, higher-priced home-purchase loans to black borrowers in census tracts primarily served by lenders that went out of business declined 70 percent between the first half of 2006 and the last half of 2007. In contrast, higher-priced home-purchase loans to non-Hispanic whites declined 53 percent over the same period. Interestingly, the number of lower-priced home-purchase loans to black borrowers in these census tracts increased 7 percent, while the number extended to non-Hispanic whites in the tracts decreased 3 percent.

We also look at census tracts concentrated by factors other than lender type. Specifically, we examine census tracts of two types: (1) those where 50 percent or more of the originated loans in 2006 were higher priced and (2) those where 50 percent or more of the loans were sold in the secondary market. The data indicate that the decline in the number of higher-priced loan originations in the second half of 2007 was greater in census tracts with a high concentration of sold loans in 2006 (72 percent) than in census tracts with a high concentration of higher-priced lending (57 percent). For both home-purchase and refinance loans, and for both higher-priced and lower-priced loans, census tracts with high concentrations of sold loans showed higher-than-average declines.

Changes in Lending by House Price Movements

To investigate the potential relationship between changes in housing market conditions and changes in lending activity from 2006 to 2007, metropolitan statistical areas were grouped into two categories corresponding to the percentage changes in the House Price Index of the Office of Federal Housing Enterprise Oversight (OFHEO) from the first quarter of 2003 through the fourth quarter of 2006.[31] Each of the two groups was split again according to the percentage changes in the index from the fourth quarter of 2006 through the first quarter of 2008. This process grouped census tracts in MSAs into those that, in the initial period, had either relatively weak growth or strong growth in home values and, in the more recent period, had small decreases, large decreases, or increases in home values.

As noted, the HMDA data show a marked decline in lending from 2006 to 2007. The falloff in lending activity is related to the pattern of house price changes over the previous few years. MSAs that experienced larger declines in house prices from the fourth quarter of 2006 through the first quarter of 2008 generally experienced larger declines in loan activity than MSAs in which house prices did not fall (tables 16.A and 16.B). Furthermore, in MSAs where house prices declined, the fall in home mortgage activity was relatively greater in those MSAs that had experienced larger house price appreciation from the first quarter of 2003 through the fourth quarter of 2006. Thus, the MSAs that experienced both the sharpest declines in recent house prices and the largest increases in house prices in the preceding four years experienced the largest declines in mortgage activity. For example, the volume of lower-priced home-purchase lending for owner-occupied properties fell 53 percent in MSAs that experienced large recent declines in home values after experiencing significant run-ups in such values in the preceding four years. By comparison, areas that also had large recent declines in house prices but smaller house price appreciation before 2006 experienced a decline of lower-priced home-purchase lending for owner-occupied properties of about 5.3 percent. The severity of declines in home lending was larger for higher-priced loans than for lower-priced loans regardless of the changes in house price patterns in recent years.

31. OFHEO's House Price Index has been renamed the Federal Housing Finance Agency House Price Index. More information about the index is available at www.ofheo.gov/hpi.aspx.

14. Change in the number of lower- and higher-priced loan originations, by type of lender and by characteristic of borrower and of census tract, 2006:H1 through 2007:H2

A. Home purchase

Percent

Characteristic of borrower and of census tract, by owner-occupancy status of property	Lower-priced loans				Higher-priced loans			
	All	Type of lender			All	Type of lender		
		Depository, by property location		Independent mortgage company		Depository, by property location		Independent mortgage company
		Within assessment area[1]	Outside of assessment area			Within assessment area[1]	Outside of assessment area	
OWNER OCCUPIED								
BORROWER								
Minority status[2]								
Black or African American	−2.3	17.8	4.8	−27.0	−69.4	−2.7	−63.0	−87.0
Hispanic white	−26.8	−.9	−30.2	−47.6	−75.7	−24.0	−69.9	−91.5
Other minority[3]	−15.3	1.5	−17.4	−35.5	−73.4	−16.7	−68.0	−90.4
Non-Hispanic white	−14.3	−4.2	−14.1	−29.5	−60.0	−17.4	−52.1	−82.7
Missing[4]	−9.8	7.0	−3.9	−33.7	−71.1	−23.0	−53.7	−89.2
Minority status, by income category[5]								
Lower								
Black or African American	5.2	20.6	12.3	−18.6	−65.7	−1.6	−60.0	−84.3
Hispanic white	−4.7	8.2	−11.8	−17.5	−60.5	−17.2	−55.0	−83.6
Other minority[3]	−6.0	1.3	−7.5	−16.5	−61.6	−16.1	−57.2	−83.3
Non-Hispanic white	−11.7	−5.1	−11.2	−22.9	−54.6	−20.5	−47.7	−77.9
Total	−9.2	−.4	−8.0	−23.7	−59.2	−17.4	−52.1	−81.2
Middle								
Black or African American	7.7	22.5	11.9	−9.4	−64.4	1.7	−64.6	−87.0
Hispanic white	−13.1	9.1	−19.1	−27.7	−70.3	−13.8	−69.9	−90.5
Other minority[3]	−8.8	5.9	−12.4	−22.6	−75.1	−16.2	−66.2	−87.3
Non-Hispanic white	−12.2	−2.2	−13.0	−24.3	−71.0	−20.9	−54.8	−82.6
Total	−10.1	1.5	−10.8	−23.2	−67.9	−16.7	−60.3	−86.1
High								
Black or African American	−6.9	17.1	−.7	−33.3	−72.9	−3.5	−66.7	−89.2
Hispanic white	−35.8	−7.1	−37.5	−58.2	−81.5	−29.5	−77.0	−94.0
Other minority[3]	−15.8	1.5	−19.0	−36.6	−77.1	−15.5	−73.1	−92.5
Non-Hispanic white	−13.3	−2.7	−13.2	−29.9	−61.2	−5.7	−53.9	−85.0
Total	−14.6	−1.0	−14.8	−33.5	−71.3	−12.5	−63.8	−89.8
Missing[4]	−67.7	−40.8	−64.9	−86.4	−70.3	−48.7	−48.8	−91.1
CENSUS TRACT OF PROPERTY								
Income category[6]								
Lower	−13.2	6.5	−14.3	−35.9	−70.0	−14.5	−62.3	−88.9
Middle	−13.2	−1.0	−11.9	−30.7	−65.8	−19.2	−57.5	−85.8
High	−16.3	−4.7	−16.4	−32.4	−66.7	−15.5	−58.1	−86.8
Total owner occupied	−14.4	−1.5	−13.9	−32.1	−67.1	−17.2	−58.8	−86.9
NON-OWNER OCCUPIED[7]								
Total	−32.6	−15.3	−33.6	−56.9	−64.5	−16.0	−57.4	−91.8
Total	**−17.3**	**−3.6**	**−17.4**	**−35.5**	**−66.6**	**−16.9**	**−58.6**	**−87.7**

NOTE. Conventional first-lien mortgages for site-built properties, excludes business loans. For definitions of lower- and higher-priced lending, see text note 7.

1. Includes lending by nonbank affiliates in the assessment areas of depository institutions covered by the Community Reinvestment Act of 1977. For more information, see text note 30.
2. See note 4, table 12.
3. Other minority consists of American Indian or Alaska Native, Asian, and Native Hawaiian or other Pacific Islander.
4. Information for the characteristic was missing on the application.
5. See note 2, table 12.
6. See note 10, table 12.
7. Includes loans for which occupancy status was missing.

House price changes in the initial period affected the magnitude of changes in refinance and home-purchase markets differently. Markets that experienced strong gains in home values from 2003 to 2006 experienced smaller declines in refinance lending relative to the declines in home-purchase lending than did markets that witnessed the same recent changes in home values but weaker initial house price increases. This may be because those refinancing benefited from the earlier increase in home values and had more equity to extract or to offer as a down payment on the new loan.

Changes in Lending by the Severity of Changes in Mortgage Delinquency Rates

To investigate the potential relationship between changes in mortgage market conditions and changes

14. Change in the number of lower- and higher-priced loan originations, by type of lender and by characteristic of borrower and of census tract, 2006:H1 through 2007:H2—*Continued*

B. Refinance

Percent

Characteristic of borrower and of census tract, by owner-occupancy status of property	Lower-priced loans				Higher-priced loans			
	All	Type of lender			All	Type of lender		
		Depository, by property location		Independent mortgage company		Depository, by property location		Independent mortgage company
		Within assessment area[1]	Outside of assessment area			Within assessment area[1]	Outside of assessment area	
OWNER OCCUPIED								
BORROWER								
Minority status[2]								
Black or African American	−16.0	−12.5	−5.7	−33.6	−59.0	−1.5	−46.3	−84.1
Hispanic white	−28.4	−15.6	−17.6	−56.7	−63.4	18.6	−52.5	−89.0
Other minority[3]	−22.3	−13.6	−16.2	−45.0	−60.8	3.5	−51.2	−87.6
Non-Hispanic white	−15.5	−13.2	−8.3	−30.3	−51.9	7.2	−38.9	−83.4
Missing[4]	−16.8	−10.6	2.0	−48.6	−62.5	6.7	−44.6	−81.2
Minority status, by income category[5]								
Lower								
Black or African American	−9.8	−9.6	−2.1	−20.6	−61.1	−16.4	−49.4	−84.5
Hispanic white	−14.3	−8.2	−1.4	−38.5	−66.0	−10.8	−53.1	−89.9
Other minority[3]	−13.8	−8.7	−10.4	−27.9	−60.6	−26.7	−48.7	−85.8
Non-Hispanic white	−18.7	−21.0	−11.5	−25.7	−54.8	−10.5	−42.8	−84.2
Total	−16.9	−17.9	−7.4	−28.9	−58.9	−13.5	−45.5	−84.2
Middle								
Black or African American	−11.7	−10.9	1.7	−28.9	−59.6	1.6	−46.3	−84.2
Hispanic white	−23.8	−16.6	−8.8	−49.2	−65.8	9.5	−55.5	−89.1
Other minority[3]	−19.8	−18.3	−11.8	−32.8	−61.2	−8.4	−51.9	−86.1
Non-Hispanic white	−14.4	−14.9	−6.9	−25.0	−54.3	.8	−41.2	−83.4
Total	−15.5	−15.2	−4.9	−30.7	−58.5	.7	−44.7	−83.9
High								
Black or African American	−21.9	−15.3	−12.1	−43.0	−55.3	23.9	−41.0	−84.3
Hispanic white	−32.9	−16.3	−24.2	−63.7	−60.9	52.6	−53.0	−88.9
Other minority[3]	−23.0	−12.5	−16.3	−49.8	−61.1	26.4	−53.2	−89.1
Non-Hispanic white	−11.3	−7.0	−2.7	−31.2	−47.0	34.6	−33.0	−82.9
Total	−15.1	−8.5	−5.3	−39.3	−52.7	37.6	−39.0	−84.1
Missing[4]	−42.7	−24.1	−38.8	−68.3	−54.2	−20.0	−35.3	−80.4
CENSUS TRACT OF PROPERTY								
Income category[6]								
Lower	−21.0	−14.7	−10.8	−42.2	−59.3	4.7	−45.9	−85.2
Middle	−15.9	−13.5	−6.2	−33.8	−55.1	5.7	−40.9	−83.5
High	−17.8	−12.0	−9.7	−38.8	−56.8	14.7	−44.4	−83.7
Total owner occupied	−17.3	−13.2	−8.0	−36.8	−56.5	7.2	−42.8	−84.0
NON-OWNER OCCUPIED[7]								
Total	−8.3	7.8	−2.2	−46.9	−60.5	17.3	−47.0	−92.8
Total	**−16.4**	**−11.0**	**−7.4**	**−37.7**	**−56.9**	**8.3**	**−43.2**	**−84.9**

NOTE: See notes to table 14.A.

in lending activity from 2006 to 2007, census tracts in MSAs were grouped into three categories according to the percentage change in their MSA-wide rate of serious mortgage delinquency from the fourth quarter of 2003 through the fourth quarter of 2007.[32] This process grouped census tracts in MSAs into those that had relatively healthy, moderate, or weak-performing mortgage markets over the past few years.

The 2006 and 2007 HMDA data show that changes in lending activity across MSAs were related not only to the magnitude and timing of changes in home prices but also to changes in mortgage performance. In particular, the falloff in loan activity was larger in MSAs that experienced the largest percentage increases in their rates of serious mortgage delinquency from the fourth quarter of 2003 through the fourth quarter of 2007 (table 17). This pattern held for both lower- and higher-priced lending and for virtually all demographic groups. For example, for lower-priced

32. Mortgage market delinquency rates by MSA were obtained from the Trend Data database; Trend Data is a registered trademark of TransUnion LLC (products.trendatatu.com/faqs.asp). Trend Data are based on the credit records of a geographically stratified random sample of about 30 million anonymous individuals drawn each quarter since 1992. The rate of serious mortgage delinquency is the percentage of outstanding mortgages that are 90 or more days delinquent or in foreclosure at the time the sample is pulled.

15. Change in the number of lower- and higher-priced loan originations, by type of loan concentration and by characteristic of borrower and of census tract, 2006:H1 through 2007:H2

A. Home purchase

Percent

Characteristic of borrower and of census tract, by owner-occupancy status of property	Lower-priced loan originations						Higher-priced loan originations					
	All lower-priced	Higher-priced loan concentration	Sold loan concentration[1]	Lender out-of-business loan concentration[2]	Independent mortgage company loan concentration	Depository within assessment area loan concentration[3]	All higher-priced	Higher-priced loan concentration	Sold loan concentration[1]	Lender out-of-business loan concentration[2]	Independent mortgage company loan concentration	Depository within assessment area loan concentration[3]
OWNER OCCUPIED												
BORROWER												
Minority status[4]												
Black or African American	−2.3	−10.9	−1.9	6.8	−2.6	5.1	−69.4	−62.2	−72.2	−70.1	−71.9	−39.0
Hispanic white	−26.8	−34.4	−29.0	−27.1	−30.3	−10.8	−75.7	−75.4	−78.3	−82.7	−79.1	−45.6
Other minority[5]	−15.3	−9.7	−17.3	4.0	−21.2	10.7	−73.4	−70.3	−76.7	−76.0	−78.7	−37.1
Non-Hispanic white	−14.3	−15.2	−14.1	−2.8	−16.4	−9.1	−60.0	−49.9	−66.1	−52.9	−66.1	−30.6
Missing[6]	−9.8	−7.2	−10.5	−7.1	−17.3	−2.4	−71.1	−62.8	−75.2	−82.0	−78.3	−35.7
Minority status, by income category[7]												
Lower												
Black or African American	5.2	6.8	6.5	11.5	8.0	9.5	−65.7	−44.8	−68.5	−67.0	−67.3	−37.3
Hispanic white	−4.7	−.2	−5.7	−8.0	2.2	−8.1	−60.5	−42.1	−63.8	−66.7	−62.2	−41.7
Other minority[5]	−6.0	4.3	−5.3	24.8	2.2	−10.1	−61.6	−54.8	−66.8	−56.7	−67.5	−34.4
Non-Hispanic white	−11.7	−9.9	−10.8	−9.4	−8.1	−9.5	−54.6	−34.7	−60.6	−44.6	−57.4	−33.5
Total	−9.2	−7.3	−7.7	−5.7	−4.4	−9.2	−59.2	−38.4	−64.4	−61.6	−62.9	−35.2
Middle												
Black or African American	7.7	5.3	7.6	7.9	12.1	15.2	−64.4	−48.8	−73.8	−69.4	−71.4	−24.2
Hispanic white	−13.1	−2.2	−19.3	−6.3	−8.9	−10.2	−70.3	−65.7	−78.6	−83.7	−76.7	−43.5
Other minority[5]	−8.8	−.8	−11.7	31.7	−3.2	12.6	−75.1	−58.3	−74.5	−69.4	−75.3	−38.8
Non-Hispanic white	−12.2	−11.8	−12.7	−.2	−11.4	−9.0	−71.0	−47.8	−68.7	−51.5	−66.6	−32.6
Total	−10.1	−8.9	−10.7	2.8	−8.0	−6.4	−67.9	−51.9	−73.4	−72.9	−72.4	−34.5
High												
Black or African American	−6.9	−17.8	−6.8	9.7	−10.9	.4	−72.9	−70.7	−75.4	−75.2	−76.4	−50.6
Hispanic white	−35.8	−42.3	−38.2	−36.0	−42.1	−10.7	−81.5	−80.3	−83.5	−86.6	−84.5	−51.1
Other minority[5]	−15.8	−10.4	−19.3	−4.0	−25.4	15.0	−77.1	−72.9	−81.0	−79.6	−81.5	−35.6
Non-Hispanic white	−13.3	−15.1	−12.8	1.4	−17.6	−7.6	−61.2	−54.5	−68.1	−59.1	−69.4	−24.9
Total	−14.6	−15.2	−16.0	−6.7	−22.1	−3.6	−71.3	−65.2	−76.9	−79.9	−78.8	−29.8
Missing[6]	−67.7	−59.3	−73.4	−62.0	−75.8	−41.5	−70.3	−59.8	−72.6	−60.6	−73.3	−51.7
CENSUS TRACT OF PROPERTY												
Income category[8]												
Lower	−13.2	−9.3	−14.8	−2.5	−17.6	−3.4	−70.0	−60.0	−73.8	−77.0	−76.2	−38.3
Middle	−13.2	−12.7	−14.7	−6.3	−17.0	−3.1	−65.8	−56.5	−71.6	−68.5	−73.0	−31.2
High	−16.3	−16.3	−14.8	−11.2	−20.0	−9.3	−66.7	−61.0	−71.3	−73.2	−71.6	−34.7
Total owner occupied	−14.4	−14.7	−14.8	−6.4	−18.2	−6.2	−67.1	−59.1	−72.3	−73.8	−73.8	−33.6
NON-OWNER OCCUPIED[9]												
Total	−32.6	−23.8	−39.5	−16.6	−40.4	−13.8	−64.5	−45.9	−69.6	−66.7	−69.9	−40.6
Total	**−17.3**	**−16.0**	**−18.8**	**−7.9**	**−21.7**	**−7.3**	**−66.6**	**−57.0**	**−71.7**	**−72.6**	**−73.1**	**−35.1**

NOTE: See general note to table 14.A. Loan concentration is by census tract. Lending in a census tract is defined as concentrated if 50 percent or more of the loans originated in the tract in 2006 had a particular characteristic or if 50 percent or more of the loans originated in the tract in that year were originated by a particular type of lender.

1. Sold loans are loans sold by the originator within the calendar year of origination.

2. Lenders that went out of business consist of lenders that ceased operations during 2007 (this group includes the 169 lenders that did not report data for 2007 under the Home Mortgage Disclosure Act as well as those lenders that went out of business and either reported 2007 HMDA data or were merged or acquired).

3. For explanation of lending within assessment area, see note 1, table 14.A.

4. See note 4, table 12.

5. Other minority consists of American Indian or Alaska Native, Asian, and Native Hawaiian or other Pacific Islander.

6. Information for the characteristic was missing on the application.

7. See note 2, table 12.

8. See note 10, table 12.

9. See note 7, table 12.

home-purchase loans, the decline in lending in MSAs experiencing smaller increases in delinquency rates was about one-half of that in MSAs experiencing very significant changes in delinquency rates. The decline in lending was particularly severe for higher-priced loans in MSAs with very significant increases in delinquency rates: Lending of such loans fell more than 81 percent from 2006 to 2007. The relationship between the decline in lending activity and the severity of changes in mortgage delinquency was similar for refinancings, although the falloff in activity was more muted.

15. Change in the number of lower- and higher-priced loan originations, by type of loan concentration and by characteristic of borrower and of census tract, 2006:H1 through 2007:H2—*Continued*

B. Refinance

Percent

Characteristic of borrower and of census tract, by owner-occupancy status of property	Lower-priced loan originations						Higher-priced loan originations					
	All lower-priced	Higher-priced loan concentration	Sold loan concentration[1]	Lender out-of-business loan concentration[2]	Independent mortgage company loan concentration	Depository within assessment area loan concentration[3]	All higher-priced	Higher-priced loan concentration	Sold loan concentration[1]	Lender out-of-business loan concentration[2]	Independent mortgage company loan concentration	Depository within assessment area loan concentration[3]
OWNER OCCUPIED												
BORROWER												
Minority status[4]												
Black or African American	−16.0	−32.0	−15.7	−30.6	−27.5	−3.5	−59.0	−43.7	−63.4	−61.0	−65.1	−12.7
Hispanic white	−28.4	−40.2	−27.0	−35.9	−34.5	−20.2	−63.4	−55.3	−66.2	−64.2	−66.4	−32.6
Other minority[5]	−22.3	−20.1	−25.9	−27.3	−34.9	7.2	−60.8	−51.2	−65.8	−60.4	−68.4	−31.2
Non-Hispanic white	−15.5	−21.8	−17.7	−19.8	−26.3	−9.0	−51.9	−39.9	−59.9	−50.8	−62.3	−15.8
Missing[6]	−16.8	−20.1	−19.0	−29.7	−28.7	−10.3	−62.5	−48.0	−66.9	−64.0	−66.8	−30.2
Minority status, by income category[7]												
Lower												
Black or African American	−9.8	−18.9	−10.1	−22.5	−4.9	−6.5	−61.1	−31.4	−65.8	−60.9	−67.3	−19.1
Hispanic white	−14.3	−20.8	−16.3	−23.0	−8.1	−12.9	−66.0	−45.2	−69.0	−68.7	−69.5	−41.0
Other minority[5]	−13.8	3.5	−20.5	−26.2	−11.4	59.9	−60.6	−46.0	−65.3	−50.9	−67.1	−50.5
Non-Hispanic white	−18.7	−21.5	−20.5	−18.4	−8.6	−13.9	−54.8	−37.0	−62.0	−51.9	−63.5	−22.0
Total	−16.9	−19.7	−18.1	−22.2	−23.1	−11.4	−58.9	−39.6	−64.9	−61.3	−66.8	−25.4
Middle												
Black or African American	−11.7	−24.9	−12.7	−32.1	4.9	3.0	−59.6	−45.2	−64.0	−64.8	−65.9	−2.4
Hispanic white	−23.8	−31.7	−24.9	−34.2	7.7	−21.8	−65.8	−57.6	−69.2	−63.4	−68.5	−26.2
Other minority[5]	−19.8	−21.8	−21.5	−22.5	−3.9	−6.3	−61.2	−56.1	−65.8	−60.5	−67.9	−39.7
Non-Hispanic white	−14.4	−20.1	−17.0	−19.6	.4	−6.9	−54.3	−44.5	−61.0	−54.6	−64.6	−22.3
Total	−15.5	−21.2	−17.8	−26.7	−26.0	−7.4	−58.5	−48.1	−64.4	−62.5	−66.6	−21.8
High												
Black or African American	−21.9	−37.3	−21.4	−34.6	19.5	1.8	−55.3	−50.7	−59.5	−58.1	−62.6	−8.5
Hispanic white	−32.9	−43.8	−29.0	−38.3	38.2	−16.4	−60.9	−56.8	−63.2	−62.5	−64.4	−29.1
Other minority[5]	−23.0	−20.4	−27.0	−25.8	31.5	6.7	−61.1	−51.2	−66.5	−63.7	−69.3	−20.0
Non-Hispanic white	−11.3	−20.2	−12.1	−17.2	18.8	−5.3	−47.0	−39.2	−56.3	−48.4	−60.0	−6.4
Total	−15.1	−22.0	−16.8	−25.8	−29.8	−4.7	−52.7	−43.5	−60.0	−57.4	−62.5	−11.1
Missing[6]	−42.7	−46.7	−45.3	−51.2	−50.8	−39.5	−54.2	−36.7	−56.7	−39.0	−54.6	−13.6
CENSUS TRACT OF PROPERTY												
Income category[8]												
Lower	−21.0	−28.8	−22.1	−31.4	−30.7	−11.4	−59.3	−37.7	−63.8	−62.7	−66.0	−19.8
Middle	−15.9	−23.6	−18.5	−24.9	−28.0	−2.3	−55.1	−40.9	−62.5	−54.9	−64.2	−17.2
High	−17.8	−21.7	−18.3	−21.5	−28.7	−12.2	−56.8	−47.6	−63.2	−57.9	−63.8	−22.4
Total owner occupied	−17.3	−22.9	−19.3	−26.9	−28.8	−8.3	−56.5	−43.6	−63.0	−59.6	−64.7	−18.8
NON-OWNER OCCUPIED[9]												
Total	−8.3	−11.7	−10.2	−12.2	19.8	3.5	−60.5	−48.7	−65.8	−67.3	−68.7	−29.4
Total	**−16.4**	**−21.8**	**−18.3**	**−25.2**	**−27.4**	**−6.9**	**−56.9**	**−44.1**	**−63.3**	**−60.7**	**−65.2**	**−19.9**

NOTE: See notes to table 15.A.

DIFFERENCES IN LENDING OUTCOMES BY RACE, ETHNICITY, OR SEX OF THE BORROWER

The HMDA data allow comparisons of the outcomes of the lending process across borrowers grouped by their race, ethnicity, or sex. Three outcomes are considered here: (1) the incidence of higher-priced lending, (2) the mean APR spreads paid by borrowers with higher-priced loans, and (3) denial rates. Analyses of HMDA data from earlier years revealed substantial differences in the incidence of higher-priced lending and in denial rates across racial and ethnic lines; analyses further showed that such differences could not be fully explained by factors included in the HMDA data.[33] Studies also found that differences across groups in mean APR spreads paid by those with higher-priced loans were generally small.

The analysis here uses the 2007 HMDA data to examine these three lending outcomes across racial, ethnic, and gender groups. The analysis focuses on conventional first-lien home-purchase and refinance

33. See Avery, Brevoort, and Canner, "The 2006 HMDA Data" and "Higher-Priced Home Lending and the 2005 HMDA Data"; see also Avery, Canner, and Cook, "New Information Reported under HMDA."

16. Change in the number of lower- and higher-priced loan originations, by recent change in house price index in metropolitan statistical area and by characteristic of borrower and of census tract, 2006:H1 through 2007:H2

A. Home purchase

Percent

Characteristic of borrower and of census tract, by owner-occupancy status of property	Lower priced							Higher priced						
	Loans to all MSAs	Change in house price index in MSA, 2006:Q4 to 2008:Q1 (percent)						Loans to all MSAs	Change in house price index in MSA, 2006:Q4 to 2008:Q1 (percent)					
		Large decrease (–8 or less)		Small decrease (–8-0)		Increase (0 or more)			Large decrease (–8 or less)		Small decrease (–8-0)		Increase (0 or more)	
		Change in house price index in MSA, 2003:Q1 to 2006:Q4 (percent)							Change in house price index in MSA, 2003:Q1 to 2006:Q4 (percent)					
		Small increase (less than 30)	Large increase (30 or more)	Small increase (less than 30)	Large increase (30 or more)	Small increase (less than 30)	Large increase (30 or more)		Small increase (less than 30)	Large increase (30 or more)	Small increase (less than 30)	Large increase (30 or more)	Small increase (less than 30)	Large increase (30 or more)
OWNER OCCUPIED														
BORROWER														
Minority status[1]														
Black or African American	–2.9	–8.5	–21.7	1.6	–3.6	.8	2.8	–69.9	–57.9	–81.2	–68.8	–71.9	–67.5	–61.2
Hispanic white	–27.7	–20.7	–45.4	–5.8	–30.6	–4.5	–1.2	–76.3	–60.2	–85.6	–60.8	–77.3	–56.8	–58.8
Other minority[2]	–15.9	–12.1	–31.3	–4.8	–12.9	–8.0	–8.1	–74.5	–57.4	–83.5	–66.5	–74.4	–60.1	–58.9
Non-Hispanic white	–15.6	–15.4	–29.1	–11.7	–18.8	–11.0	–10.1	–62.7	–46.7	–76.9	–57.4	–68.2	–55.3	–57.0
Missing[3]	–10.2	–14.0	–31.7	–5.4	–11.3	1.5	6.5	–72.6	–76.5	–83.6	–70.1	–73.5	–62.6	–60.1
Minority status, by income category[4]														
Lower														
Black or African American	5.1	–15.3	20.9	–1.2	13.7	2.5	–.2	–66.0	–58.8	–69.7	–65.8	–67.0	–68.2	–60.3
Hispanic white	–4.5	–27.4	21.5	–9.9	–5.7	–7.3	–3.9	–61.1	–57.6	–65.6	–60.8	–67.0	–56.6	–54.0
Other minority[2]	–6.1	–18.4	43.3	–2.8	–3.0	–19.1	–10.4	–62.8	–60.7	–65.8	–65.4	–64.9	–60.6	–58.9
Non-Hispanic white	–12.5	–14.1	6.9	–13.6	–13.2	–14.1	–10.6	–56.8	–42.5	–65.8	–54.5	–64.4	–54.5	–57.2
Total	–9.6	–15.9	12.1	–12.5	–8.7	–11.6	–8.7	–60.9	–52.4	–66.2	–59.4	–66.4	–59.6	–57.8
Middle														
Black or African American	7.2	6.4	18.6	5.5	2.9	10.2	7.5	–71.0	–57.7	–79.9	–72.1	–72.6	–69.9	–63.9
Hispanic white	–14.0	–12.1	–3.6	–7.1	–26.0	–2.1	.5	–75.7	–70.5	–79.7	–71.3	–80.0	–57.7	–63.0
Other minority[2]	–9.6	–13.0	11.7	–7.8	–13.3	–14.4	–8.2	–72.5	–49.1	–77.9	–74.6	–75.0	–67.1	–58.3
Non-Hispanic white	–13.4	–17.1	–7.9	–13.0	–17.2	–12.1	–9.5	–65.1	–49.7	–73.8	–61.7	–71.0	–60.2	–61.6
Total	–11.0	–14.8	–4.0	–11.3	–15.7	–8.8	–6.5	–69.9	–56.7	–77.9	–66.3	–74.8	–63.3	–62.4
High														
Black or African American	–7.9	–6.4	–33.9	7.6	–10.7	6.0	7.9	–73.4	–53.3	–83.6	–72.2	–74.8	–62.4	–58.9
Hispanic white	–36.9	–11.5	–54.6	8.1	–34.1	12.1	7.1	–81.9	–48.3	–87.9	–50.3	–79.2	–51.8	–58.1
Other minority[2]	–16.4	–3.8	–36.5	.4	–10.2	6.4	–2.9	–78.0	–60.8	–84.5	–62.8	–75.7	–51.2	–59.0
Non-Hispanic white	–14.8	–13.2	–33.5	–5.9	–18.0	–5.1	–7.2	–64.4	–49.5	–78.4	–56.6	–67.4	–49.8	–50.7
Total	–16.0	–10.4	–38.0	–3.4	–17.2	–1.8	–3.9	–73.5	–58.1	–84.5	–59.8	–73.4	–54.1	–53.6
Missing[3]	–68.5	–50.6	–79.7	–58.3	–70.6	–61.6	–56.9	–70.6	–66.7	–77.5	–60.8	–72.2	–65.3	–65.2
CENSUS TRACT OF PROPERTY														
Income category[5]														
Lower	–14.0	–30.2	–32.4	–11.7	–14.8	–2.8	–3.2	–70.9	–62.2	–84.9	–64.6	–73.5	–58.5	–58.3
Middle	–14.8	–15.4	–33.1	–9.6	–19.1	–6.5	–5.5	–68.7	–53.3	–82.5	–60.6	–72.7	–58.9	–58.5
High	–16.8	–7.9	–32.1	–10.0	–17.5	–12.1	–11.7	–67.7	–45.4	–79.0	–59.4	–70.1	–61.8	–58.0
Total owner occupied	–36.1	–5.3	–52.9	–15.4	–41.0	–19.0	–28.8	–66.3	–61.1	–80.2	–58.6	–69.6	–56.3	–59.5
NON-OWNER OCCUPIED[6]														
Total	–15.5	–14.6	–32.6	–10.0	–17.8	–8.6	–7.4	–69.1	–55.1	–82.4	–61.5	–72.4	–59.6	–58.4
Total	**–18.5**	**–14.0**	**–37.1**	**–10.5**	**–21.5**	**–9.8**	**–10.8**	**–68.5**	**–56.6**	**–82.0**	**–60.9**	**–71.9**	**–59.0**	**–58.6**

NOTE: See general note to table 14.A.

1. See note 4, table 12.

2. Other minority consists of American Indian or Alaska Native, Asian, and Native Hawaiian or other Pacific Islander.

3. Information for the characteristic was missing on the application.

4. See note 2, table 12.

5. See note 10, table 12.

6. Includes loans for which occupancy status was missing.

MSA Metropolitan statistical area

SOURCE: For house price index, Office of Federal Housing Enterprise Oversight (www.ofheo.gov/hpi.aspx).

loans for owner-occupied, one- to four-family, site-built homes, as these are the loan product categories included in the HMDA data with the largest number of reported loans.

Although the HMDA data include a variety of detailed information about mortgage transactions, many key factors that are considered by lenders in credit underwriting and pricing are not included. However, analysis using the HMDA data can account for some factors likely related to the lending process. Specifically, the HMDA data allow an accounting for property location (for example, the same metropolitan area), income relied on in underwriting, loan amount, time of year when the loan was made, and the presence of a co-applicant. To the extent that some of these HMDA factors are not used directly in

16. Change in the number of lower- and higher-priced loan originations, by recent change in house price index in metropolitan statistical area and by characteristic of borrower and of census tract, 2006 H1 through 2007:H2—*Continued*

B. Refinance

Percent

Characteristic of borrower and of census tract, by owner-occupancy status of property	Lower priced							Higher priced						
	Loans to all MSAs	Change in house price index in MSA, 2006:Q4 to 2008:Q1 (percent)						Loans to all MSAs	Change in house price index in MSA, 2006:Q4 to 2008:Q1 (percent)					
		Large decrease (–8 or less)		Small decrease (–8-0)		Increase (0 or more)			Large decrease (–8 or less)		Small decrease (–8-0)		Increase (0 or more)	
		Change in house price index in MSA, 2003:Q1 to 2006:Q4 (percent)							Change in house price index in MSA, 2003:Q1 to 2006:Q4 (percent)					
		Small increase (less than 30)	Large increase (30 or more)	Small increase (less than 30)	Large increase (30 or more)	Small increase (less than 30)	Large increase (30 or more)		Small increase (less than 30)	Large increase (30 or more)	Small increase (less than 30)	Large increase (30 or more)	Small increase (less than 30)	Large increase (30 or more)
OWNER OCCUPIED														
BORROWER														
Minority status[1]														
Black or African American	–16.8	–37.9	–49.4	–6.3	–16.4	14.2	13.7	–60.7	–72.0	–73.1	–57.2	–64.2	–52.8	–39.8
Hispanic white	–29.2	–18.6	–44.4	–2.0	–20.1	5.0	28.4	–64.1	–73.8	–70.8	–53.1	–63.5	–55.6	–35.2
Other minority[2]	–23.2	14.3	–42.4	.6	–14.7	10.2	10.1	–62.5	–43.9	–73.2	–55.2	–60.8	–46.9	–40.6
Non-Hispanic white	–17.1	–24.6	–42.7	–11.1	–17.3	.6	6	–55.4	–68.5	–68.9	–54.7	–59.7	–46.2	–39.3
Missing[3]	–18.5	–32.4	–37.7	–5.7	–15.7	10.1	8.8	–63.3	–81.0	–67.0	–65.5	–64.7	–56.4	–53.8
Minority status, by income category[4]														
Lower														
Black or African American	–10.2	–38.5	–38.7	–11.0	–12.5	7.8	13.2	–62.8	–73.9	–76.4	–61.0	–66.6	–58.9	–46.3
Hispanic white	–14.4	–18.8	–28.3	–3.6	–12.6	–5.7	23.6	–66.7	–70.4	–72.8	–63.6	–68.5	–62.8	–48.1
Other minority[2]	–14.4	–19.8	–28.5	–12.0	–12.0	–4.5	–1.1	–62.7	–57.7	–74.3	–60.7	–65.1	–53.7	–52.7
Non-Hispanic white	–19.3	–32.5	–37.2	–19.4	–20.4	–11.8	–7.5	–58.2	–69.4	–74.1	–58.4	–64.8	–50.1	–45.4
Total	–17.3	–33.3	–34.4	–17.5	–17.6	–8.5	–3.0	–61.4	–72.0	–73.9	–60.3	–66.4	–54.4	–47.7
Middle														
Black or African American	–12.3	–40.5	–46.6	–2.0	–13.0	27.8	15.0	–61.0	–70.5	–75.2	–54.9	–65.2	–50.2	–38.0
Hispanic white	–24.8	–30.5	–38.4	–7.9	–18.3	10.2	27.1	–66.6	–82.1	–74.0	–59.5	–66.3	–51.8	–35.9
Other minority[2]	–20.6	–6.0	–38.5	–3.5	–18.4	11.8	10.6	–63.0	–67.2	–74.8	–57.0	–63.4	–48.6	–40.9
Non-Hispanic white	–15.5	–28.8	–39.9	–11.9	–17.4	.7	.8	–57.4	–68.6	–73.4	–55.8	–62.3	–47.3	–41.1
Total	–16.7	–29.8	–39.5	–10.6	–16.9	4.2	3.8	–60.8	–71.5	–73.8	–57.5	–64.4	–49.1	–42.9
High														
Black or African American	–23.6	–36.6	–52.8	–1.1	–20.2	20.6	23.7	–57.4	–65.5	–71.8	–49.4	–60.6	–39.0	–19.9
Hispanic white	–33.8	–4.6	–48.3	15.0	–18.9	31.1	47.1	–61.7	–65.9	–69.5	–34.4	–58.5	–39.8	–15.7
Other minority[2]	–23.9	39.6	–43.4	16.8	–10.1	24.6	22.3	–62.5	–4.8	–73.1	–47.9	–58.0	–37.4	–26.2
Non-Hispanic white	–13.8	–15.4	–42.8	.1	–11.8	12.7	10.3	–51.2	–65.9	–66.1	–47.6	–53.8	–38.5	–29.3
Total	–17.6	–14.3	–43.6	1.6	–12.6	15.2	13.4	–55.7	–66.4	–67.7	–48.9	–56.7	–40.4	–30.2
Missing[3]	–43.2	–12.0	–61.0	–31.7	–46.4	–20.9	–33.8	–54.5	–79.7	–55.4	–57.5	–50.4	–58.5	–55.0
CENSUS TRACT OF PROPERTY														
Income category[5]														
Lower	–21.9	–36.4	–43.3	–15.2	–15.0	–4.0	5.1	–60.6	–72.3	–70.8	–60.1	–62.4	–50.5	–42.8
Middle	–18.0	–27.7	–43.6	–11.1	–16.7	2.4	4.6	–58.6	–71.3	–71.0	–55.3	–62.2	–48.0	–41.0
High	–18.7	–16.2	–41.1	–4.7	–18.8	6.2	1.4	–58.3	–67.1	–66.4	–54.6	–61.2	–51.4	–41.9
Total owner occupied	–10.1	–15.3	–24.8	–7.1	–7.1	–.5	8.3	–62.6	–65.5	–74.0	–60.4	–63.0	–54.4	–53.2
NON-OWNER OCCUPIED[6]														
Total	–18.8	–24.8	–42.6	–9.7	–17.1	2.9	3.6	–59.1	–70.8	–69.9	–56.4	–62.0	–49.4	–41.7
Total	**–18.0**	**–24.2**	**–40.7**	**–9.5**	**–16.2**	**2.6**	**4.1**	**–59.4**	**–70.1**	**–70.3**	**–56.9**	**–62.1**	**–50.0**	**–42.8**

NOTE: See notes to table 16.A.

loan underwriting or pricing, they are included in the analysis as proxies for at least some of the factors that are considered. Because of the focus here on specific loan product categories, the analysis already accounts in broad terms for loan type and purpose, type of property securing the loan, lien status, and owner-occupancy status. Given that lenders offer a wide variety of conventional loan products for which basic terms can differ substantially, the analysis can only be viewed as suggestive.

The pricing analysis focuses on both the incidence of higher-priced lending and the mean APR spreads paid by borrowers with higher-priced loans. Comparisons of average outcomes for each racial, ethnic, or gender group are made both before and after accounting for differences in the borrower-related factors cited earlier (income; loan amount; location of the property, or MSA; presence of a co-applicant; and, in the comparisons by race and ethnicity, sex) and for differences in borrower-related factors *plus* the spe-

17. Change in the number of lower- and higher-priced loan originations for home purchase and for refinancing, by change in mortgage delinquency rate in metropolitan statistical area and by characteristic of borrower and of census tract, 2006:H1 through 2007:H2

Percent

Characteristic of borrower and of census tract, by owner-occupancy status of property	Home purchase						Refinance					
	Lower priced			Higher priced			Lower priced			Higher priced		
	Change in mortgage delinquency rate in MSA (percent)[1]											
	Small change (less than 50)	Large increase (50–200)	Very large increase (200 or more)	Small change (less than 50)	Large increase (50–200)	Very large increase (200 or more)	Small change (less than 50)	Large increase (50–200)	Very large increase (200 or more)	Small change (less than 50)	Large increase (50–200)	Very large increase (200 or more)
OWNER OCCUPIED												
BORROWER												
Minority status[2]												
Black or African American	2.7	−4.4	−18.5	−63.7	−70.7	−81.5	10.9	−17.7	−49.0	−46.9	−66.2	−73.3
Hispanic white	−4.4	−27.4	−46.9	−58.6	−74.8	−86.3	19.0	−21.2	−45.1	−41.5	−66.0	−70.7
Other minority[3]	−14.1	−12.7	−22.4	−62.5	−73.5	−82.0	4.9	−17.6	−35.0	−43.1	−64.6	−70.5
Non-Hispanic white	−12.3	−16.8	−22.1	−57.3	−63.6	−74.7	−1.6	−17.3	−37.7	−43.4	−61.3	−66.7
Missing[4]	3.4	−12.6	−25.9	−62.2	−72.7	−83.6	8.8	−18.5	−35.5	−55.7	−67.5	−65.7
Minority status, by income category[5]												
Lower												
Black or African American	2.6	5.9	24.6	−62.3	−69.0	−69.0	8.7	−15.4	−38.5	−51.5	−69.7	−77.7
Hispanic white	−4.8	−7.9	22.0	−54.9	−63.6	−66.0	14.8	−15.6	−28.3	−49.5	−71.0	−73.4
Other minority[3]	−12.7	−8.9	27.3	−57.5	−65.6	−67.9	−2.7	−20.5	−13.5	−52.3	−65.4	−74.1
Non-Hispanic white	−13.1	−13.5	−3.1	−56.1	−56.6	−64.8	−10.1	−22.5	−30.9	−49.2	−63.8	−70.2
Total	−10.5	−10.8	3.1	−58.1	−62.7	−66.8	−5.5	−20.8	−29.8	−51.3	−67.2	−72.2
Middle												
Black or African American	8.7	4.3	19.4	−65.6	−72.0	−81.6	15.5	−13.3	−45.0	−45.3	−66.4	−75.5
Hispanic white	−2.1	−23.2	−3.1	−63.7	−77.6	−80.8	18.9	−19.0	−39.8	−41.9	−68.8	−74.2
Other minority[3]	−14.9	−12.5	11.1	−65.5	−74.5	−77.3	3.0	−16.2	−35.4	−46.0	−66.0	−73.2
Non-Hispanic white	−11.6	−16.3	−8.1	−61.7	−66.5	−72.8	−1.8	−18.0	−33.8	−45.0	−63.3	−71.0
Total	−8.8	−14.6	−4.4	−63.2	−71.9	−78.1	1.5	−17.6	−36.1	−46.8	−65.7	−72.6
High												
Black or African American	3.9	−7.1	−34.1	−63.8	−71.6	−84.1	15.4	−20.2	−52.9	−36.3	−60.5	−71.7
Hispanic white	3.1	−30.9	−56.3	−55.2	−78.8	−88.4	33.9	−19.7	−48.8	−30.1	−60.1	−69.4
Other minority[3]	−10.6	−8.0	−28.3	−64.4	−75.1	−83.3	14.4	−13.2	−35.9	−31.8	−64.3	−69.8
Non-Hispanic white	−9.2	−14.8	−26.9	−52.9	−65.5	−77.4	7.8	−10.6	−39.0	−34.4	−57.0	−64.2
Total	−6.4	−14.5	−32.6	−56.2	−71.9	−84.5	10.3	−12.3	−40.3	−36.7	−59.4	−66.3
Missing[4]	−59.8	−71.3	−74.0	−66.7	−71.9	−72.9	−28.9	−41.9	−58.6	−53.5	−56.3	−52.1
CENSUS TRACT OF PROPERTY												
Income category[6]												
Lower	−4.8	−15.0	−26.8	−58.4	−70.6	−84.3	4.8	−18.5	−42.0	−45.5	−64.5	−71.1
Middle	−8.6	−16.6	−26.3	−59.9	−69.0	−81.9	1.9	−18.3	−39.5	−45.5	−64.0	−69.2
High	−13.0	−16.4	−26.3	−59.5	−68.6	−77.8	−1.0	−17.0	−36.6	−47.8	−63.2	−63.2
Total owner occupied	−28.3	−39.5	−43.6	−58.8	−68.4	−76.8	5.8	−11.3	−24.5	−51.9	−65.1	−73.7
NON-OWNER OCCUPIED[7]												
Total	−9.8	−16.3	−26.4	−59.4	−69.4	−81.8	1.3	−17.9	−39.0	−46.0	−64.0	−68.5
Total	**−12.5**	**−19.7**	**−29.2**	**−59.3**	**−69.2**	**−81.1**	**1.8**	**−17.2**	**−37.5**	**−46.6**	**−64.1**	**−69.0**

NOTE: See general note to table 14.A.

1. Mortgage delinquency rate is the percentage of mortgage borrowers 90 days or more delinquent; calculated using delinquency rates for each metropolitan statistical area (MSA) from 2003.Q4 to 2007.Q4.
2. See note 4, table 12.
3. Other minority consists of American Indian or Alaska Native, Asian, and Native Hawaiian or other Pacific Islander.
4. Information for the characteristic was missing on the application.
5. See note 2, table 12.
6. See note 10, table 12.
7. Includes loans for which occupancy status was missing.

SOURCE: For delinquency rate statistics, Trend Data, a product of TransUnion LLC.

cific lending institution used by the borrower.[34] The method of controlling for these factors is to group borrowers into cells in which the individuals in each cell are similar along each dimension considered.

Comparisons for lending outcomes across groups are of three types: gross (or "unmodified"), modified to account for borrower-related factors (or "borrower modified"), and modified to account for borrower-related factors plus lender (or "lender modified"). For purposes of presentation, the borrower- and lender-modified outcomes shown in the tables are normalized so that, *for the base comparison group* (non-

34. Excluded from the pricing analysis are applicants residing outside the 50 states and the District of Columbia as well as applications deemed to be business related.

Hispanic whites in the case of comparison by race and ethnicity and males in the case of comparison by sex), the mean at each modification level is the same as the gross mean. Consequently, the borrower- and lender-modified outcomes for any other group represent the expected average outcome under the assumption that the members of that group had the same distribution of control factors (income, loan amount, and the like) as the base comparison group.

As noted earlier, mortgage market conditions changed significantly over the course of 2007. To help account for the possible effects of these changing conditions on the patterns of lending outcomes across population groups, the tables presented in this section show loan activity by half-year for both 2006 and 2007. Our analysis of the lenders that did not report in 2007 but that did so in 2006 indicates that by the second half of 2007 virtually all of these lenders had gone out of business. As noted, these lenders tended to be relatively more focused on the higher-priced segment of the market and on lending to minority borrowers. Consequently, the lending data for the second half of 2007 likely reflect a "truer" picture of the entire market for that period than the data for the first half of 2007, which do not include loans extended during this period by lenders that ultimately ceased operations and did not report.

Although the focus of the discussion that follows is on differences in lending outcomes across groups, it is important to keep in mind that, as shown earlier, the overall, or gross, incidence of higher-priced lending in 2007 fell sharply from 2006. This drop was experienced by all groups of borrowers regardless of race, ethnicity, or sex. The decline is apparent when comparing the unmodified incidences in higher-priced lending in 2007 for different groups with the unmodified incidences experienced by these groups in 2006.

Incidence of Higher-Priced Lending by Race and Ethnicity

The 2007 HMDA data, like those from earlier years, indicate that black and Hispanic white borrowers are more likely, and Asian borrowers less likely, to obtain loans with prices above the HMDA price-reporting thresholds than are non-Hispanic white borrowers. These relationships are found for both home-purchase loans and refinancings regardless of the specific period considered (tables 18.A and 18.B). Gross differences in the incidence of higher-priced lending between non-Hispanic whites, on the one hand, and blacks or Hispanic whites, on the other, are large, but these differences are substantially reduced after controlling for borrower-related factors plus lender. Differences in the incidences of higher-priced lending between Asians and non-Hispanic whites are generally relatively small.

In the second half of 2007, for conventional home-purchase loans, the gross mean incidence of higher-priced lending was 29.5 percent for blacks and 9.2 percent for non-Hispanic whites, a difference of 20.3 percentage points (table 18.A). Borrower-related factors included in the HMDA data accounted for 4.3 percentage points of the difference. Controlling further for the lender reduces the remaining gap to 11.1 percentage points. The results for Hispanic whites are similar to those for blacks. The difference between the gross mean incidence of higher-priced lending for Hispanic whites (24.3 percent) and the corresponding incidence for non-Hispanic whites (9.2 percent) is 15.1 percentage points. Borrower-related factors included in the HMDA data accounted for 5.7 percentage points of the difference. Controlling further for the lender reduces the remaining gap to 6.2 percentage points. The situation for Asians differs greatly from that for blacks or Hispanic whites: Compared with non-Hispanic whites, Asians had a lower mean incidence of higher-priced lending for home-purchase loans on both a gross and a modified basis.

Comparing the differences in the incidences of higher-priced lending between the various minority groups and non-Hispanic whites in the second half of 2006 with the differences between these groups in the second half of 2007 reveals relatively little change in the gaps modified for borrower-related factors plus lender. For example, the fully modified gap between blacks and non-Hispanic whites was 13.4 percentage points in the second half of 2006 and 11.1 percentage points in the second half of 2007. Similarly, the fully modified gap between Hispanic whites and non-Hispanic whites was 6.6 percentage points in the second half of 2006 and 6.2 percentage points in the second half of 2007.

Rate Spreads by Race and Ethnicity

The 2007 data indicate that among borrowers with higher-priced loans, the gross mean prices paid by black borrowers are moderately higher than—and those paid by Hispanic white borrowers are nearly the same as—those paid by non-Hispanic white borrowers (tables 19.A and 19.B). Asian borrowers with higher-priced loans also paid about the same mean prices, on average, as non-Hispanic whites with such loans. These relationships are little influenced by an accounting for borrower-related factors or the specific lender used by the borrowers.

18. Incidence of higher-priced lending, unmodified and modified for borrower- and lender-related factors, for conventional first liens on owner-occupied, one- to four-family, site-built homes, by half-year in which loan was originated and by race, ethnicity, and sex of borrower, 2006–07

A. Home purchase

Percent except as noted

Race, ethnicity, and sex[1]	Number of loans	Unmodified incidence	Modified incidence, by modification factor		Number of loans	Unmodified incidence	Modified incidence, by modification factor	
			Borrower-related	Borrower-related plus lender			Borrower-related	Borrower-related plus lender
	2006							
	H1				H2			
Race other than white only								
American Indian or Alaska Native	11,059	35.4	30.9	25.4	10,557	32.9	30.8	23.4
Asian	96,781	16.8	15.8	17.3	90,424	16.7	14.7	16.5
Black or African American	156,337	56.5	50.1	30.8	162,369	51.1	45.9	30.7
Native Hawaiian or other Pacific Islander	9,427	34.4	30.4	23.4	9,348	33.5	28.1	21.9
Two or more minority races	1,038	29.6	30.5	19.8	1,074	25.7	26.7	20.6
Joint	22,638	17.7	24.4	20.0	22,033	17.3	23.0	19.6
Missing	187,627	28.5	31.2	23.6	190,450	29.9	32.3	23.2
White, by ethnicity								
Hispanic white	235,283	48.1	36.9	24.5	229,008	45.1	34.0	23.9
Non-Hispanic white	1,219,990	18.1	18.1	18.1	1,186,928	17.3	17.3	17.3
Sex								
One male	635,262	33.2	33.2	33.2	620,402	31.4	31.4	31.4
One female	461,907	31.8	30.9	32.0	463,186	30.0	29.3	30.2
Two males	18,871	24.6	24.6	24.6	17,541	23.3	23.3	23.3
Two females	15,819	26.9	23.8	24.4	15,248	25.5	21.5	22.6
	2007							
	H1				H2			
Race other than white only								
American Indian or Alaska Native	7,437	22.0	21.1	17.2	6,241	17.5	14.7	15.1
Asian	75,610	9.6	9.9	11.0	70,801	5.6	6.9	7.8
Black or African American	110,747	37.8	34.1	24.5	86,220	29.5	25.2	20.3
Native Hawaiian or other Pacific Islander	6,410	20.8	19.5	15.4	5,347	14.1	14.4	12.8
Two or more minority races	902	15.5	13.6	15.7	974	10.6	11.8	12.7
Joint	18,781	10.4	15.2	13.0	17,769	7.3	11.3	10.5
Missing	146,171	16.7	21.3	16.2	131,177	11.4	15.4	12.3
White, by ethnicity								
Hispanic white	152,901	31.8	23.9	17.6	109,034	24.3	18.6	15.4
Non-Hispanic white	1,031,059	11.8	11.8	11.8	919,507	9.2	9.2	9.2
Sex								
One male	500,468	20.8	20.8	20.8	405,659	15.9	15.9	15.9
One female	362,266	19.3	18.7	19.5	301,836	14.4	13.6	14.3
Two males	14,504	16.4	16.4	16.4	14,145	12.8	12.8	12.8
Two females	12,553	17.7	15.0	16.5	11,886	12.8	11.4	12.6

NOTE: Excludes transition-period loans (those for which the application was submitted before 2004). For definition of higher-priced lending, see text note 7; for explanation of modification factors, see text.

1. See note 4, table 12. Loans taken out jointly by a male and female are not tabulated here because they would not be directly comparable with loans taken out by one borrower or by two borrowers of the same sex.

Pricing Differences by Sex

The 2007 HMDA data, like those in previous years, reveal relatively little difference in pricing outcomes when borrowers are distinguished by sex, although single males experienced a somewhat higher modified incidence of higher-priced lending than single females (tables 18.A and 18.B). The mean APR spreads paid by females are virtually the same as those paid by males after accounting for the presence or absence of a co-borrower (tables 19.A and 19.B).

Denial Rates by Race, Ethnicity, and Sex

Analyses of the HMDA data from earlier years have consistently found that denial rates vary across applicants grouped by race or ethnicity. For each broad loan product category in 2007 (first or second half), American Indians, blacks, and Hispanic whites had higher gross denial rates than non-Hispanic whites; blacks generally had the highest rates, and Hispanic whites had rates between those for blacks and those for non-Hispanic whites (tables 20.A and 20.B). The pattern for Asians was somewhat different, as the gross denial rate for them was either lower than, or very similar to, the rate for non-Hispanic whites, depending on the period and the loan purpose.

Controlling for borrower-related factors in the HMDA data reduces the differences among racial and ethnic groups. Accounting for the specific lender used by the applicant almost always reduces differences

18. Incidence of higher-priced lending, unmodified and modified for borrower- and lender-related factors, for conventional first liens on owner-occupied, one- to four-family, site-built homes, by half-year in which loan was originated and by race, ethnicity, and sex of borrower, 2006–07—*Continued*

B. Refinance

Percent except as noted

Race, ethnicity, and sex[1]	Number of loans	Unmodified incidence	Modified incidence, by modification factor		Number of loans	Unmodified incidence	Modified incidence, by modification factor	
			Borrower-related	Borrower-related plus lender			Borrower-related	Borrower-related plus lender
	2006							
	H1				H2			
Race other than white only								
American Indian or Alaska Native	14,030	31.2	34.9	28.6	13,718	34.4	37.6	29.9
Asian	61,485	17.6	22.2	24.7	66,388	21.5	25.2	25.8
Black or African American	195,050	52.0	49.4	31.9	202,412	53.6	50.8	34.4
Native Hawaiian or other Pacific Islander	12,282	31.1	36.5	28.3	11,796	36.3	38.9	31.4
Two or more minority races	1,474	27.1	29.5	28.6	1,439	28.8	29.3	33.4
Joint	21,091	25.4	32.5	26.4	20,784	27.0	34.1	27.8
Missing	281,183	36.3	42.3	29.6	289,263	40.1	45.1	32.0
White, by ethnicity								
Hispanic white	213,338	35.4	36.4	28.4	223,825	39.9	37.7	31.0
Non-Hispanic white	1,296,597	25.0	25.0	25.0	1,300,339	26.5	26.5	26.5
Sex								
One male	591,436	33.4	33.4	33.4	605,743	35.8	35.8	35.8
One female	506,018	34.1	32.8	33.1	527,701	36.6	35.6	35.8
Two males	13,457	26.3	26.3	26.3	13,879	27.0	27.0	27.0
Two females	15,620	33.2	28.9	27.2	15,559	35.1	30.6	26.0
	2007							
	H1				H2			
Race other than white only								
American Indian or Alaska Native	11,480	28.1	31.0	22.1	8,028	23.9	26.2	18.2
Asian	63,999	15.4	17.5	18.8	44,318	8.4	13.5	14.9
Black or African American	158,416	44.6	41.6	27.1	108,245	36.8	35.4	22.6
Native Hawaiian or other Pacific Islander	9,518	25.7	29.1	24.3	6,283	18.9	24.3	19.0
Two or more minority races	1,434	20.2	23.2	22.2	1,122	14.1	16.1	18.7
Joint	19,892	19.6	24.8	20.4	14,413	17.2	21.6	17.0
Missing	258,895	29.5	35.3	25.2	179,528	20.6	25.7	20.1
White, by ethnicity								
Hispanic white	180,394	30.2	28.3	23.4	121,618	22.3	21.9	19.1
Non-Hispanic white	1,238,650	19.8	19.8	19.8	935,658	16.2	16.2	16.2
Sex								
One male	546,140	26.6	26.6	26.6	381,204	19.9	19.9	19.9
One female	451,279	27.6	26.7	26.5	327,198	21.1	19.8	19.4
Two males	12,931	21.0	21.0	21.0	10,216	17.4	17.4	17.4
Two females	13,992	28.5	24.0	22.7	11,371	24.2	20.2	18.8

NOTE: See notes to table 18.A.

further, although unexplained differences remain between non-Hispanic whites and other racial and ethnic groups.

With regard to the sex of applicants, sole male applicants have marginally higher gross and modified denial rates than single females. Also, dual male borrowers and dual female borrowers generally have very similar denial rates, which are somewhat lower than those for single applicants.

Some Limitations of the Data in Assessing Fair Lending Compliance

Information in the HMDA data, including borrower income, loan amount, location of the property, date of loan origination, and the specific lender used, is insufficient to account fully for racial or ethnic differences in the incidence of higher-priced lending; significant differences remain unexplained. Similar patterns are shown in racial or ethnic differences in denial rates. In contrast, only small differences across groups were found in the mean APR spreads paid by those receiving higher-priced loans. Regarding the sex of borrowers, some very small differences were found in lending outcomes.

Both previous research and experience gained in the fair lending enforcement process show that unexplained differences in the incidence of higher-priced lending and in denial rates among racial or ethnic groups stem in part from credit-related factors not available in the HMDA data, such as measures of

19. Mean APR spreads, unmodified and modified for borrower- and lender-related factors, for higher-priced conventional first liens on owner-occupied, one- to four-family, site-built homes, by half-year in which loan was originated and by race, ethnicity, and sex of borrower, 2006–07

A. Home purchase

Percentage points except as noted

Race, ethnicity, and sex[1]	Number of higher-priced loans	Unmodified mean spread	Modified mean spread, by modification factor		Number of higher-priced loans	Unmodified mean spread	Modified mean spread, by modification factor	
			Borrower-related	Borrower-related plus lender			Borrower-related	Borrower-related plus lender
	2006							
	H1				H2			
Race other than white only								
American Indian or Alaska Native	3,911	5.25	5.23	5.17	3,478	5.12	5.13	5.11
Asian	16,307	5.11	5.13	5.15	15,089	4.97	5.07	5.11
Black or African American	88,335	5.69	5.64	5.34	82,903	5.66	5.59	5.31
Native Hawaiian or other Pacific Islander	3,247	5.25	5.22	5.14	3,130	5.17	5.15	5.17
Two or more minority races	307	5.42	5.38	5.16	276	5.43	5.45	5.37
Joint	3,999	5.30	5.34	5.19	3,803	5.30	5.29	5.12
Missing	53,557	5.41	5.43	5.28	56,977	5.51	5.55	5.26
White, by ethnicity								
Hispanic white	113,136	5.28	5.20	5.18	103,286	5.24	5.16	5.14
Non-Hispanic white	221,352	5.16	5.16	5.16	204,795	5.13	5.13	5.13
Sex								
One male	210,792	5.33	5.33	5.33	194,624	5.30	5.30	5.30
One female	147,065	5.35	5.34	5.31	138,876	5.31	5.31	5.29
Two males	4,634	5.15	5.15	5.15	4,084	5.23	5.23	5.23
Two females	4,254	5.41	5.33	5.24	3,889	5.45	5.35	5.32
	2007							
	H1				H2			
Race other than white only								
American Indian or Alaska Native	1,634	4.71	4.68	4.73	1,093	4.07	4.17	4.08
Asian	7,295	4.50	4.59	4.67	3,968	3.90	3.94	4.01
Black or African American	41,836	5.24	5.19	4.92	25,395	4.44	4.47	4.32
Native Hawaiian or other Pacific Islander	1,332	4.80	4.81	4.77	754	4.02	4.17	4.10
Two or more minority races	140	5.05	5.17	4.91	103	4.40	4.35	4.34
Joint	1,958	4.96	4.92	4.80	1,306	4.19	4.19	4.08
Missing	24,339	4.96	5.09	4.86	14,928	4.21	4.33	4.23
White, by ethnicity								
Hispanic white	48,619	4.77	4.70	4.71	26,484	4.06	4.13	4.07
Non-Hispanic white	121,526	4.66	4.66	4.66	84,943	4.06	4.06	4.06
Sex								
One male	104,020	4.80	4.80	4.80	64,664	4.14	4.14	4.14
One female	69,928	4.80	4.82	4.81	43,499	4.11	4.10	4.12
Two males	2,377	4.85	4.85	4.85	1,812	4.14	4.14	4.14
Two females	2,219	5.18	4.99	4.88	1,524	4.26	4.10	4.40

NOTE: Spread is the difference between the annual percentage rate (APR) on the loan and the yield on a comparable-maturity Treasury security. Excludes transition-period loans (those for which the application was submitted before 2004). For definition of higher-priced lending, see text note 7; for explanation of modification factors, see text. See also note 1, table 18.A.

credit history (including credit scores), loan-to-value and debt-to-income ratios, and differences in choice of loan products. Differential costs of loan origination and the competitive environment also may bear on the differences in pricing, as may differences across populations in credit-shopping activities.

Differences in pricing and underwriting outcomes may also reflect discriminatory treatment of minorities or other actions by lenders, including marketing practices. The HMDA data are regularly used to facilitate the fair lending examination and enforcement processes. When examiners for the federal banking agencies evaluate an institution's fair lending risk, they analyze HMDA price data in conjunction with other information and risk factors, as directed by the Interagency Fair Lending Examination Procedures.[35] Risk factors for pricing discrimination include, but are not limited to, the relationship between loan pricing and compensation of loan officers or brokers, the presence of broad pricing discretion, and consumer complaints.

It is difficult to draw conclusions from the HMDA data about changes in the fair lending environment from 2006 to 2007. For example, denial rate differences between non-Hispanic whites and minorities

35. The Interagency Fair Lending Examination Procedures are available at www.ffiec.gov/PDF/fairlend.pdf.

19. Mean APR spreads, unmodified and modified for borrower- and lender-related factors, for higher-priced conventional first liens on owner-occupied, one- to four-family, site-built homes, by half-year in which loan was originated and by race, ethnicity, and sex of borrower, 2006–07—*Continued*

B. Refinance

Percentage points except as noted

Race, ethnicity, and sex[1]	Number of higher-priced loans	Unmodified mean spread	Modified mean spread, by modification factor		Number of higher-priced loans	Unmodified mean spread	Modified mean spread, by modification factor	
			Borrower-related	Borrower-related plus lender			Borrower-related	Borrower-related plus lender
	2006							
	H1				H2			
Race other than white only								
American Indian or Alaska Native	4,376	5.14	5.09	5.14	4,720	4.98	5.05	5.09
Asian	10,815	5.11	5.09	5.14	14,281	4.68	4.91	5.00
Black or African American	101,506	5.42	5.37	5.23	108,406	5.30	5.24	5.08
Native Hawaiian or other Pacific Islander	3,819	5.29	5.21	5.21	4,283	5.01	5.07	5.03
Two or more minority races	400	5.27	5.18	5.20	415	5.20	5.31	5.11
Joint	5,354	5.08	5.14	5.16	5,604	4.96	5.07	5.03
Missing	101,960	5.35	5.36	5.16	115,955	5.20	5.25	5.02
White, by ethnicity								
Hispanic white	75,512	5.27	5.22	5.17	89,236	5.00	5.04	5.04
Non-Hispanic white	324,384	5.13	5.13	5.13	343,955	4.98	4.98	4.98
Sex								
One male	197,567	5.29	5.29	5.29	216,821	5.09	5.09	5.09
One female	172,442	5.30	5.28	5.29	192,926	5.12	5.09	5.09
Two males	3,533	5.08	5.08	5.08	3,743	5.02	5.02	5.02
Two females	5,185	5.17	5.11	4.99	5,461	5.11	5.00	5.09
	2007							
	H1				H2			
Race other than white only								
American Indian or Alaska Native	3,227	4.79	4.77	4.88	1,918	4.73	4.79	4.67
Asian	9,848	4.37	4.72	4.80	3,733	4.11	4.44	4.51
Black or African American	70,628	5.12	5.07	4.92	39,836	4.96	5.00	4.75
Native Hawaiian or other Pacific Islander	2,450	4.70	4.79	4.88	1,189	4.49	4.81	4.67
Two or more minority races	289	4.85	4.86	4.89	158	4.82	4.94	4.63
Joint	3,891	4.85	4.92	4.91	2,474	4.69	4.82	4.64
Missing	76,469	5.02	5.09	4.82	37,003	4.60	4.72	4.59
White, by ethnicity								
Hispanic white	54,477	4.79	4.87	4.89	27,151	4.46	4.60	4.62
Non-Hispanic white	245,074	4.79	4.79	4.79	151,120	4.58	4.58	4.58
Sex								
One male	145,314	4.88	4.88	4.88	75,729	4.56	4.56	4.56
One female	124,764	4.88	4.85	4.87	68,930	4.60	4.56	4.54
Two males	2,721	4.90	4.90	4.90	1,781	4.57	4.57	4.57
Two females	3,994	5.04	4.91	4.91	2,756	4.72	4.59	4.61

NOTE: See note to table 19 A

widened from 2006 to 2007, although this development may have reflected differences in the credit characteristics or other circumstances of the pools of borrowers in the two years and not unfair treatment by lenders. Similarly, differences between non-Hispanic whites and minorities in the incidence of higher-priced lending generally declined, although the fully modified differences narrowed proportionately less than the gross differences. Given the substantial decrease in overall higher-priced lending, it is difficult to know if this narrowing of the differences in the incidence of higher-priced lending was due to any change in the relative treatment of minorities or to changes in the credit profiles of marginal borrowers resulting from declines in applications and increased denial rates.

APPENDIX A: REQUIREMENTS OF REGULATION C

The Federal Reserve Board's Regulation C requires lenders to report the following information on home-purchase and home-improvement loans and on refinancings:

For each application or loan

- application date and the date an action was taken on the application
- action taken on the application
  - — approved and originated
  - — approved but not accepted by the applicant
  - — denied (with the reasons for denial—voluntary for some lenders)

20. Denial rates on applications, unmodified and modified for borrower- and lender-related factors, for conventional first liens on owner-occupied, one- to four-family, site-built homes, by half-year in which application was acted upon by lender and by race, ethnicity, and sex of applicant, 2006–07

A. Home purchase

Percent except as noted

Race, ethnicity, and sex[1]	Number of applications acted upon by lender	Unmodified denial rate	Modified denial rate, by modification factor		Number of applications acted upon by lender	Unmodified denial rate	Modified denial rate, by modification factor	
			Borrower-related	Borrower-related plus lender			Borrower-related	Borrower-related plus lender
	2006							
	H1				H2			
Race other than white only								
American Indian or Alaska Native	17,523	26.7	22.6	19.3	17,123	25.0	21.7	17.1
Asian	135,942	17.3	14.8	14.9	128,455	16.8	14.0	14.8
Black or African American	265,677	30.9	27.2	21.5	287,491	32.3	28.2	21.5
Native Hawaiian or other Pacific Islander	14,401	23.1	21.0	18.3	14,703	23.8	19.3	16.6
Two or more minority races	1,470	20.5	18.8	16.3	1,669	19.9	18.0	16.8
Joint	29,107	13.8	17.0	14.9	28,674	13.4	16.8	14.6
Missing	300,767	24.3	23.4	17.9	310,302	24.1	23.8	17.8
White, by ethnicity								
Hispanic white	357,209	24.7	20.0	17.5	361,957	26.2	20.7	17.6
Non-Hispanic white	1,543,650	13.2	13.2	13.2	1,519,786	13.1	13.1	13.1
Sex								
One male	915,120	21.3	21.3	21.3	918,501	22.1	22.1	22.1
One female	658,209	20.7	20.1	20.6	676,289	21.3	20.8	21.2
Two males	26,074	19.8	19.8	19.8	24,431	18.6	18.6	18.6
Two females	21,860	19.5	18.0	18.6	21,462	19.4	16.9	16.9
	2007							
	H1				H2			
Race other than white only								
American Indian or Alaska Native	12,326	28.6	25.1	21.4	10,301	27.0	23.8	20.0
Asian	106,595	17.1	14.6	15.0	104,233	17.7	15.2	15.1
Black or African American	206,186	36.0	31.6	23.9	158,701	34.2	29.3	22.9
Native Hawaiian or other Pacific Islander	10,540	28.2	23.0	21.1	8,896	26.7	21.4	19.5
Two or more minority races	1,384	25.9	24.7	21.9	1,440	21.3	19.3	19.3
Joint	24,610	14.7	18.5	15.4	23,715	14.4	17.6	15.3
Missing	233,947	25.4	24.4	18.1	207,299	23.6	21.5	16.7
White, by ethnicity								
Hispanic white	257,135	29.9	22.4	19.7	191,838	30.0	22.0	19.7
Non-Hispanic white	1,307,913	13.3	13.3	13.3	1,187,866	13.2	13.2	13.2
Sex								
One male	739,062	22.9	22.9	22.9	610,149	22.4	22.4	22.4
One female	527,172	22.2	21.7	22.1	440,646	20.9	20.6	21.2
Two males	20,708	21.4	21.4	21.4	20,420	20.6	20.6	20.6
Two females	18,053	22.1	20.6	20.2	17,131	20.0	18.1	18.7

NOTE: Includes transition-period applications (those submitted before 2004)
For explanation of modification factors, see text. See also note 1, table 18.A.

  - — withdrawn by the applicant
  - — file closed for incompleteness
- pre-approval program status (for home-purchase loans only)
  - — pre-approval request denied by financial institution
  - — pre-approval request approved but not accepted by individual
- loan amount
- loan type
  - — conventional
  - — insured by the Federal Housing Administration
  - — guaranteed by the Veterans Administration
  - — backed by the Farm Service Agency or Rural Housing Service
- lien status
  - — first lien
  - — junior lien
  - — unsecured
- loan purpose
  - — home purchase
  - — refinance
  - — home improvement
- type of purchaser (if the lender subsequently sold the loan during the year)
  - — Fannie Mae
  - — Ginnie Mac
  - — Freddie Mac
  - — Farmer Mac
  - — Private securitization
  - — Commercial bank, savings bank, or savings association

20. Denial rates on applications, unmodified and modified for borrower- and lender-related factors, for conventional first liens on owner-occupied, one- to four-family, site-built homes, by half-year in which application was acted upon by lender and by race, ethnicity, and sex of applicant, 2006–07—*Continued*

B. Refinance

Percent except as noted

Race, ethnicity, and sex[1]	Number of applications acted upon by lender	Unmodified denial rate	Modified denial rate, by modification factor		Number of applications acted upon by lender	Unmodified denial rate	Modified denial rate, by modification factor	
			Borrower-related	Borrower-related plus lender			Borrower-related	Borrower-related plus lender
	2006							
	H1				H2			
Race other than white only								
American Indian or Alaska Native	31,582	44.3	44.8	38.7	32,175	45.0	44.2	35.7
Asian	104,007	28.3	33.6	35.3	111,165	27.1	33.0	33.8
Black or African American	431,030	44.8	46.1	39.0	452,812	44.9	46.0	38.1
Native Hawaiian or other Pacific Islander	23,560	35.8	41.7	37.8	23,877	37.0	41.9	37.0
Two or more minority races	2,804	40.0	43.0	36.1	3,074	40.9	43.4	36.8
Joint	37,091	34.0	40.5	35.0	36,939	34.1	39.9	33.7
Missing	736,949	50.2	51.3	39.1	711,665	45.7	47.6	37.2
White, by ethnicity								
Hispanic white	387,469	33.3	36.4	36.7	414,344	33.7	37.1	35.2
Non-Hispanic white	2,180,168	31.3	31.3	31.3	2,163,111	30.0	30.0	30.0
Sex								
One male	1,151,237	38.3	38.3	38.3	1,172,849	36.9	36.9	22.1
One female	950,223	37.0	35.8	36.6	975,866	35.2	34.2	21.2
Two males	25,064	36.5	36.5	36.5	25,806	36.5	36.5	36.5
Two females	29,707	38.8	36.3	36.3	30,478	40.2	37.7	35.7
	2007							
	H1				H2			
Race other than white only								
American Indian or Alaska Native	32,148	54.2	51.0	41.4	27,626	60.2	56.1	43.6
Asian	111,681	30.1	35.5	36.4	90,733	35.6	38.8	39.5
Black or African American	408,342	51.3	51.4	42.2	329,444	55.9	56.4	44.9
Native Hawaiian or other Pacific Islander	21,457	43.6	46.5	41.3	17,394	49.7	51.5	44.6
Two or more minority races	3,276	49.2	50.4	41.8	2,928	53.0	53.9	47.0
Joint	38,339	38.9	44.5	37.1	32,643	44.5	48.8	40.3
Missing	646,545	48.5	49.8	39.4	500,917	50.7	49.7	41.2
White, by ethnicity								
Hispanic white	377,168	40.1	42.0	39.8	318,369	47.3	46.6	43.4
Non-Hispanic white	2,149,801	32.7	32.7	32.7	1,767,691	35.7	35.7	35.7
Sex								
One male	1,125,730	40.6	40.6	40.6	891,020	44.2	44.2	44.2
One female	888,877	39.1	38.1	39.1	717,686	42.3	41.4	42.6
Two males	25,663	40.1	40.1	40.1	22,436	43.1	43.1	43.1
Two females	29,119	43.4	40.8	40.5	26,193	46.2	43.8	41.7

NOTE: See note to table 20.A.

— Life insurance company, credit union, mortgage bank, or finance company
— Affiliate institution
— Other type of purchaser

For each applicant or co-applicant

- race
- ethnicity
- sex
- income relied on in credit decision

For each property

- location, by state, county, metropolitan statistical area, and census tract
- type of structure
  — one- to four-family dwelling
  — manufactured home
  — multifamily property (dwelling with five or more units)
- occupancy status (owner occupied, non-owner occupied, or not applicable)

For loans subject to price reporting

- spread above comparable Treasury security

For loans subject to the Home Ownership and Equity Protection Act

- indicator of whether loan is subject to the Home Ownership and Equity Protection Act

APPENDIX B: PRIVATE MORTGAGE INSURANCE DATA

Historically, mortgage lenders have required prospective borrowers to make a down payment of at least 20 percent of a home's value before they will extend a loan to buy a home or refinance an existing loan. Such down payments are required because experience has shown that homeowners with little equity are substantially more likely to default on their mortgages. Private mortgage insurance (PMI) emerged as a response to creditors' concerns about the elevated credit risk of lending backed by little equity in a home as well as to the difficulties that some consumers encounter in accumulating sufficient savings to meet the required down payment and closing costs.

PMI protects a lender if a borrower defaults on a loan; it reduces a lender's credit risk by insuring against losses associated with default up to a contractually established percentage of the claim amount. The costs of the insurance are typically paid by the borrower through a somewhat higher interest rate on the loan.

In 1993, the Mortgage Insurance Companies of America (MICA) asked the Federal Financial Institutions Examination Council (FFIEC) to process data from PMI companies on applications for mortgage insurance and to produce disclosure statements for the public based on the data.[36] The PMI data largely mirror the types of information submitted by lenders covered by HMDA. However, because the PMI companies do not receive all the information about a prospective loan from the lenders seeking insurance coverage, some HMDA items are not included in the PMI data. In particular, loan-pricing information, requests for pre-approval, and an indicator of whether a loan is subject to the Home Ownership and Equity Protection Act are unavailable in the PMI data.

The seven PMI companies that issued PMI during 2007 submitted data to the FFIEC through MICA. In total, these companies acted on nearly 2 million applications for insurance: 1.4 million applications to insure mortgages for purchasing homes and about 540,000 applications to insure mortgages for refinancing existing mortgages. PMI companies approved 92 percent of the applications they received. Approval rates for PMI companies are notably higher than they are for mortgage lenders because lenders applying for PMI are familiar with the underwriting standards used by the PMI companies and generally submit applications for insurance coverage only if the applications are likely to be approved. □

36. Founded in 1973. MICA is the trade association for the PMI industry. The FFIEC prepares disclosure statements for each of the PMI companies. The statements are available at the corporate headquarters of each company and at a central depository in each metropolitan statistical area (MSA) in which HMDA data are held. The central depository also holds aggregate data for all the PMI companies active in that MSA. In addition, the PMI data are available from the FFIEC at www.ffiec.gov/reports.htm.

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

August 15, 2001

VIA FIRST CLASS MAIL

Susan Henrichsen
Assistant Attorney General
Office of Attorney General
State of California
110 W. A Street, #1100
San Diego, California 92101

Dear Ms. Henrichsen:

Enclosed please find a memorandum issued by the Office of the Comptroller of the Currency ("OCC") on the processing of referrals received from state Attorneys General and other state officials ("State Officials") of potential violations of consumer laws by national banks. The OCC developed these internal procedures in response to matters raised at a meeting with you and other Assistant Attorneys General on May 9, 2001. The policy set forth in the memorandum will facilitate effective communication between State Officials and the OCC concerning national bank compliance with consumer laws. We appreciate you bringing these matters to our attention and encourage you to bring any other concerns regarding national banks to our attention.

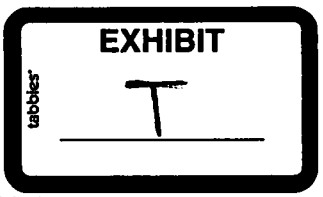
Please feel free to share this memorandum with your colleagues and other State Attorneys General. Should you have questions, please do not hesitate to call me at (202) 874-5200.

Sincerely,

Daniel P. Stipano
Deputy Chief Counsel

cc: Assistant Attorneys General:
Julie Brill, Vermont
Linda Conti, Maine
Prentiss Cox, Minnesota
Deborah Hagan, Illinois
Shirley Stark, New York

Attachment



MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Distribution

From: Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel

Date: August 13, 2001

Subject: Referrals from State Attorneys General and Other State Officials

PURPOSE

This memorandum establishes a policy for the OCC's processing of referrals received from state Attorneys General and other state officials (hereinafter collectively referred to as "State Officials") of potential violations of consumer laws by national banks. For purposes of this memorandum, a "referral" means any written or telephonic communication regarding a complaint or series of complaints against a national bank alleging a violation of state and/or federal consumer laws, where: (1) a State Official has expressed an intention to bring an action, or (2) a State Official has requested information or assistance from the OCC in resolving the alleged violation. Contacts with, or correspondence received from State Officials that do not meet this definition, such as the transmittal of individual or isolated consumer complaints, should be forwarded to the Customer Assistance Group in Houston, Texas ("CAG").

The policy set forth in this memorandum is intended to recognize the necessity for greater communication between State Officials and the OCC in situations of mutual concern regarding national bank compliance with consumer laws. The policy also recognizes the importance of notification of the initiation of an action. Clarifying the procedures to be followed regarding these referrals will ensure effective communication between the State Officials and the OCC. All information provided to the OCC by the State Officials should be accorded confidential treatment.

PROCEDURES

District Office Responsibilities

The District Counsel serve as a primary contact for State Officials making referrals to the OCC. Set forth below are the procedures that District Counsel should follow upon receiving referrals from State Officials.

Delegated Banks

District Counsel are responsible for receiving referrals from State Officials, conducting a review of the referrals to determine whether additional information is needed to process the referral, contacting the referring State Official to obtain such information, and in accordance with the procedures listed below, notifying and providing information to the appropriate District and Washington offices.

Within ten (10) calendar days of receipt of a State Official referral in a District office, the District Counsel shall notify the Deputy Comptroller responsible for the oversight or supervision of the bank (hereinafter, the "appropriate Deputy Comptroller"), the appropriate Compliance Assistant Deputy Comptroller, the Deputy Comptroller for Community and Consumer Policy ("DCCCP") and the Deputy Comptroller for Compliance Operations ("DCCO") (hereinafter collectively referred to as "appropriate OCC personnel") of the referral. In addition, the District Counsel shall notify the CAG of the referral within ten (10) calendar days of receipt of a State Official referral in a District office and provide all relevant documentation.

For written referrals, within ten (10) calendar days of receipt of the referral, the District Counsel shall provide a copy of the State Official's letter and all relevant documentation to the Director of the Enforcement and Compliance Division ("E&C Director") and Director of the Community and Consumer Law Division ("CCL Director").

For telephonic referrals, within ten (10) calendar days of receipt of the referral, the District Counsel shall provide the following information to the appropriate OCC personnel and the E&C and CCL Directors:

- name, charter number, address, telephone and fax number of institution;
- name and position of a contact person at the State Official's office; and
- concise, specific description of the matter being referred, or information or assistance being requested.

In consultation with the offices listed below, District Counsel are responsible for recommending the type of enforcement action, if any, the OCC should take to resolve or respond to the referral. In accordance with District office and agency-wide policies and procedures, District Counsel are also responsible for making a written recommendation to the District Supervision Review Committee or Credit Card Supervisory Review Committee, as appropriate. District Counsel and the E&C Director will coordinate on the review and staffing of State Official referrals and in the case of recommended enforcement actions, the presentation of these matters to the Washington Supervision Review Committee ("WSRC").

Non-Delegated and Large Banks

Within ten (10) calendar days of receipt of a referral from a State Official concerning a non-delegated or large bank, District Counsel shall notify the E&C and CCL Directors of the referral and provide any relevant documentation received to the E&C Director.

Washington Office Responsibilities

Delegated Banks

For delegated banks, the E&C Director is responsible for coordinating with the District Counsel and CCL Director on the review of State Official referrals. Within ten (10) calendar days of receipt from a District Counsel of any relevant documentation relating to a State Official's referral, the E&C Director will forward copies to the DCCCP and the DCCO. Within ten (10) calendar days of receipt of a written referral *directly* from a State Official concerning a delegated bank, the E&C Director shall notify the appropriate District Counsel of the referral and forward copies of any information or materials received to the District Counsel, the DCCCP, the DCCO, the CAG and the CCL Director.

Non-Delegated and Large Banks

For non-delegated and Large Banks, the E&C Director is responsible for receiving State Official referrals, reviewing such referrals to determine whether additional information is needed, contacting the referring State Official to obtain such information, and notifying and providing the information listed below to appropriate District and Washington offices.

For written and telephonic referrals, within ten (10) calendar days of receipt of the referral from a State Official, the E&C Director shall notify the appropriate Deputy Comptroller (and the Examiner in Charge in the case of a Large Bank), the DCCCP, the DCCO, the CAG, and the CCL Director of the referral. In addition, the E&C Director shall forward copies of any information or materials received from a State Official or District Counsel in connection with a referral or request to each of the above-referenced offices.

For telephonic referrals, the E&C Director or the CCL Director shall provide the following information to the appropriate Deputy Comptroller (and the Examiner in Charge in the case of a Large Bank), the DCCCP, and the DCCO:

- name, charter number, address, telephone and fax number of institution;
- name and position of a contact person at the State Official's office; and
- concise, specific description of the matter being referred, or information or assistance being requested.

In consultation with appropriate OCC personnel, the E&C and CCL Directors shall recommend the type of action, if any, the OCC should take to resolve or respond to the referral. In the case of a resolution involving a proposed enforcement action, the E&C and CCL Directors, in consultation with appropriate OCC personnel, shall make a written recommendation to the WSRC. On matters raising privacy issues, consultation in both of the foregoing instances shall include the appropriate Assistant Chief Counsel. Thereafter, recommended actions will be presented to, as appropriate, the Senior Deputy Comptroller for Mid-Size and Community Banks or the Senior Deputy Comptroller for Large Banks for approval.

The E&C Director is also responsible for notifying the appropriate State Official upon the initiation of an enforcement action pertaining to a national bank for which a referral was made. The procedures outlined in this memorandum do not supersede and are intended to be consistent with the procedures for bringing enforcement actions set forth in the Policies and Procedures Manual 5310-3 (Rev), Enforcement Action Policy, and other relevant policy issuances.

Distribution:

District Deputy Comptrollers
District Counsel
Compliance Assistant Deputy Comptrollers
Britton
Roeder
Rushton
Jee
Long
Jaedicke
Schneck
Hammaker
McCormally
Bylsma
Sharpe
Stipano
Natter
Friend
Stone
Golden

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| Customer Assistance Brochure |
| Customer Assistance Group |

Who is the OCC?

The Office of the Comptroller of the Currency (OCC) is an agency of the United States Department of the Treasury. The OCC charters, regulates, and supervises over 2,500 national banks to ensure a safe, sound and competitive national banking system that supports the citizens, communities and economy of the United States. The Comptroller's Office also supervises federally licensed branches and agencies of foreign banks. The national banks fund the agency through assessments paid by the banks based on their assets and fees they pay for special services.

What Is a National Bank?

A national bank is a financial institution chartered by the Office of the Comptroller of the Currency. National banks can usually be identified because they have the words "national" or "national association" in their titles or the letters N.A. or NT&SA following their titles. National banks represent about 28 percent of all insured commercial banks in the United States, holding 57 percent of the total assets of the banking system.

If You Have a Problem With a National Bank

It is best to try to resolve a complaint directly with your bank before involving an outside agency. If you are unable to do so or are uncertain about whether your complaint falls under our jurisdiction, the OCC Customer Assistance Group can help you.

General inquiries about banking laws or practices often can be answered on the phone by a customer assistance specialist. The specialist may also be able to suggest other ways for you to try to resolve your problem directly with the bank.

When resolution seems impossible, you may file a formal complaint with the OCC.

The OCC Customer Assistance Group

The OCC Customer Assistance Group was created to answer questions, offer guidance, and assist consumers in resolving complaints about national banks.

Contacting a Customer Assistance Specialist

You can reach one of the Office of the Comptroller of the Currency's customer assistance specialists by:

- Telephoning 1-800-613-6743, toll-free (business days 9:00 a.m. to 3:30 p.m. CST);
- E-mailing - E-mail to Customer.Assistance@occ.treas.gov;
- Fax - Faxing to - 1-713-336-4301 or;
- Sending mail to -

Customer Assistance Group
1301 McKinney Street
Suite 3710
Houston, TX 77010

Filing a Formal Complaint

You may file a formal complaint about a national bank with the OCC by writing and sending (or faxing) a letter -- no special forms are required -- to the Customer Assistance Group at the above address.

Your fax or letter should identify the national bank about which you have the complaint by providing the bank's full name and address. Explain the nature of your problem and tell us what resolution you are seeking. ***Do not forget to give us YOUR name, address, and a telephone number where you can be reached during the day, as well.***

When You Contact the OCC

When we receive your call about a complaint, a customer assistance specialist will request certain information from you about your complaint. He or she will evaluate your information and attempt to resolve your problem while on the phone. Should the specialist not be able to resolve your complaint immediately, he or she may request that you send additional information to assist in their research. The specialist will assign you a case number and tell you exactly what they require you to provide, so that your case research can continue.

When we receive your written complaint or additional documentation that was requested by one of our customer assistance specialists, we will send you an acknowledgment and assign your case to a customer assistance specialist. They will research your complaint and contact the bank for an explanation of

what happened. The specialist may request that you provide additional documentation and will identify exactly what it is that they might require. The OCC will notify you after the bank responds. Complaints caused by bank error or misunderstanding are often resolved voluntarily by the bank.

When You Need Other Help

Many complaints stem from factual or contract disputes between the bank and the customer. Only a court of law can resolve those disputes and award damages. If we find that your case involves such a dispute, we will suggest that you consult an attorney for assistance.

The OCC regulates only NATIONAL BANKS, not all types of financial institutions. If your complaint involves a bank or other institution not regulated by the OCC, we may refer it to another agency. We will notify you if we do so. You should not have to resubmit your complaint or accompanying documentation. However, you may be contacted if the other agency needs additional information.

Consumer Help Is Available From These Agencies:

Office of the Comptroller of the Currency

(Regulates national banks)

Customer Assistance Group
1301 McKinney Street
Suite 3710
Houston, TX 77010
1-800-613-6743
E-mail: Customer.Assistance@occ.treas.gov
Internet: http://www.occ.treas.gov

The Office of Thrift Supervision

(Regulates federal savings and loans (S&Ls) and federally chartered savings banks (F.S.B.s))

Office of Consumer Programs
1700 G Street, NW
Washington, DC 20552
(202) 906-6237
1-800-842-6929
E-mail: consumer.complaint@ots.treas.gov
Internet: http://www.ots.treas.gov

The Federal Reserve Board

(Regulates state banks that are members of the Federal Reserve System)

Division of Consumer and Community Affairs
Federal Reserve Board
Washington, DC 20551
(202) 452-3946
Internet: http://www.bog.frb.fed.us

The Federal Deposit Insurance Corporation

(Regulates Federally insured state banks that are not members of the Federal Reserve System)

Division of Compliance and Consumer Affairs
550 17th Street, NW
Washington, DC 20429
(202) 942-3100
1-800-934-FDIC
Email: consumer@fdic.gov
Internet: http://www.fdic.gov

The National Credit Union Administration

(Regulates federal credit unions)

1775 Duke Street
Alexandria, VA 22314-3428
(703) 518-6300
Internet: http://www.ncua.gov

Federal Trade Commission

(Regulates other lenders)

Consumer Response Center
6th and Pennsylvania Avenue, N.W.
Washington, DC 20580
(202) 326-2222
Email: consumerline@ftc.gov
Internet: http://www.ftc.gov

Department of Housing and Urban Development (HUD)

(Enforces Fair Housing Act)

Office of Fair Housing and Equal Opportunity
451 Seventh Street, S.W., Room 5100
Washington, DC 20410
(202) 708-4252
1-800-669-9777
Internet: http://www.hud.gov

AL 2002 - 9

OCC ADVISORY LETTER

Comptroller of the Currency
Administrator of National Banks

Subject: Questions Concerning Applicability and Enforcement of State Laws: Contacts From State Officials

TO: Chief Executive Officers of all National Banks, Department and Division Heads, and All Examining Personnel

PURPOSE

This advisory letter describes the general principles that apply in determining whether a state law is applicable to a national bank. It also describes the statutory authority of the OCC to regulate national banks, to examine national banks for compliance with federal and applicable state laws, and to enforce these laws. Finally, it advises national banks to consult with the OCC if state officials contact them concerning the potential application of a state law, or if these officials seek information concerning a national bank's operations.

BACKGROUND

Recently, we have been asked for guidance on the role of state officials in the enforcement of state laws that may affect national bank operations. The applicability of state laws to national banks and their operating subsidiaries -- and the authority to enforce those laws -- raise complex issues of both federal preemption and the statutory authority of the OCC as the supervisor and regulator of national banks.[1] Due to the often complex nature of the determinations regarding the application and enforcement of state law in a particular instance, this advisory letter notifies national banks to consult with the OCC on such matters. In addition, it encourages state officials to contact the OCC when they have information that would be relevant to the OCC in its supervision of national banks and their compliance with applicable laws, or if they seek information from national banks. We appreciate the interest of state officials in these issues, and this advisory is designed to summarize the standards that are applicable in this area.

[1] In most instances, the OCC is responsible for enforcing federal laws that apply to national banks or to their operating subsidiaries. However, some federal statutes also specifically give enforcement authority to state attorneys general. See, *e.g.*, 15 USC 1681s(c) (Fair Credit Reporting Act). Even in these instances, issues may arise as to the appropriate role of a state official with respect to a national bank's activities. Thus, the procedures discussed in this advisory letter should also be followed by national banks in instances involving any state attorney general enforcement action under federal law.

EXHIBIT

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Applicability of State Laws to National Banks

The National Bank Act was enacted in 1864 to create a new system of nationally chartered banks that would operate independently of state regulation.[2] Since that time, courts have recognized the essentially federal character of national banks,[3] and the Supreme Court has repeatedly held that subjecting national banks' federally authorized activities to state regulation and supervision would conflict with their federally derived powers and with the purposes for which the national banking system was established.[4] In one such decision, the Court noted that national banks are "instrumentalities" of the federal government and stated that "any attempt by a State to define [the] duties [of a national bank] or control the conduct of [the] affairs [of the national bank] is void whenever it conflicts with the laws of the United States or frustrates the purposes of the national legislation or impairs the efficiency of the bank to discharge the duties for which it was created."[5]

Essential to the character of national banks and the national banking system is the uniform and consistent regulation of national banks by *federal* standards.[6] To that end, Congress vested in the OCC broad authority to regulate the conduct of national banks except where the authority to issue such regulations has been "expressly and exclusively" given to another federal regulatory agency. 12 USC 93a. State law could be applicable to national banks, however, in limited circumstances when it does not conflict or interfere with the national bank's exercise of its powers. Thus, for instance, one federal court recently noted that states retain some power to regulate national banks in areas such as "contracts, debt collection, acquisition and transfer of property, and taxation, zoning, criminal, and tort law."[7]

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[2] *Bank of Am. v. City and County of San Francisco*, 309 F.3d 551, 561 (9th Cir. 2002) (citing Cong. Globe, 38th Cong., 1st Sess., 1451 (1864)).

[3] *See, e.g., Davis v. Elmira Savings Bank*, 161 U.S. 275, 283 (1896) ("[n]ational banks are instrumentalities of the Federal government").

[4] *See Easton v. Iowa*, 188 U.S. 220, 229, 231-32 (1903), in which the Supreme Court explained:

> [Federal legislation concerning national banks] has in view the erection of a system extending throughout the country, and independent, so far as powers conferred are concerned, of state legislation which, if permitted to be applicable, might impose limitations and restrictions as various and numerous as the states. ... [W]e are unable to perceive that Congress intended to leave the field open for the states to attempt to promote the welfare and stability of national banks by direct legislation. If they had such power it would have to be exercised and limited by their own discretion, and confusion would necessarily result from control possessed and exercised by two independent authorities.

See also Barnett Bank of Marion County, N.A. v. Nelson, 517 U.S. 25, 32 (1996) (the powers of national banks are "grants of authority not normally limited by, but rather ordinarily pre-empting contrary state law").

[5] *First Nat'l Bank of San Jose v. California*, 262 U.S. 366, 368, 369 (1923). *See also Bank of Am.*, 309 F.3d at 561 (state attempts "to control the conduct of national banks are void if they conflict with federal law, frustrate the purposes of the National Bank Act, or impair the efficiency of national banks to discharge their duties").

[6] Such standards may be embodied explicitly in OCC regulations, or in other federal law, including various federal consumer protection laws, such as the Truth in Lending Act, the Truth in Savings Act, the Electronic Fund Transfer Act, the Real Estate Settlement Procedures Act, the Equal Credit Opportunity Act, and the Federal Trade Commission Act. *See* 15 USC 1601 *et seq.*; 12 USC 4301 *et seq.*; 15 USC 1693 *et seq.*; 12 USC 2601 *et seq.*; 15 USC 1691 *et seq.*; 15 USC 45. However, whether or not the OCC has specifically addressed a national bank activity in a regulation, all national bank operations must be conducted in a safe and sound manner, in accordance with the OCC's supervisory standards.

[7] *Bank of Am.*, 309 F.3d at 559.

Supervision of National Banks and Enforcement of Applicable Laws

In addition to uniform federal standards for regulation of national banks, Congress provided for a complementary system of uniform federal oversight of the activities of national banks as an integral component of the national banking system. Exclusive federal oversight, uniform federal regulation, and state law preemption constitute three essential and distinctive elements of the national bank charter.[8]

Congress provided that the uniform federal standards that would govern national banks – and state laws, where federal law makes them applicable – would be enforced by a single, federal supervisor, the OCC. By statute, national banks generally are not subject to any visitorial powers except as authorized by federal law:

> No national bank shall be subject to any visitorial powers except as authorized by Federal law, vested in the courts of justice or such as shall be, or have been exercised or directed by Congress or by either House thereof or by any committee of Congress or of either House duly authorized.[9]

12 USC 484(a). The OCC is specifically authorized under the National Bank Act to "examine every national bank as often as the Comptroller of the Currency shall deem necessary," and OCC examiners have the power to "make a thorough examination of all the affairs of the bank." 12 USC 481. Thus, except in specialized instances where federal law makes provision for another regulator to have a role, the OCC's visitorial powers are exclusive with respect to activities that are authorized or permitted for national banks under federal law or regulation, or by OCC issuance or interpretation.

Congress reaffirmed the OCC's exclusive visitorial powers in the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Pub. L. 103-328, 108 Stat. 2338 (1994). Congress provided in that legislation that specified types of laws of the "host" state in which a national bank has an interstate branch are applicable, *unless* federal law preempts their application to national banks. However, Congress stated that "[t]he provisions of any State law to which a branch of a national bank is subject under this paragraph shall be enforced, with respect to such branch, by the Comptroller of the Currency." 12 USC 36(f)(1)(B).[10]

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[8] Moreover, OCC regulations provide for comparable treatment of national bank operating subsidiaries. The OCC's regulations state: "Unless otherwise provided by Federal law or OCC regulation, State laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank." 12 CFR 7.4006. In addition, 12 CFR 5.34(e)(3) provides that "[a]n operating subsidiary conducts activities authorized under this section pursuant to the same authorization, terms and conditions that apply to the conduct of such activities by its parent national bank."

[9] "Visitorial" powers generally refer to the power to "visit" a national bank to examine the conduct of its business and to enforce its observance of applicable laws. *See, e.g., Guthrie v. Harkness*, 199 U.S. 148, 158 (1905) (the word "visitation" means "inspection; superintendence; direction; regulation") (internal quotations omitted). Section 484 provides an exception to the OCC's exclusive visitorial authority for state examiners inspecting for compliance with state unclaimed property or escheat laws upon reasonable cause to believe the bank has failed to comply with those laws. 12 USC 484(b).

[10] *See also National State Bank v. Long*, 630 F.2d 981, 989 (3rd Cir. 1980) ("[E]nforcement of the state statute is the responsibility of the Comptroller of the Currency rather than the State Commissioner.")

The OCC's regulations also set forth the agency's exclusive visitorial authority, providing that, subject to limited exceptions, only the OCC may exercise visitorial powers with respect to national banks. 12 CFR 7.4000(a)(1). These exclusive visitorial powers include:

1. examination of a bank,
2. inspection of a bank's books and records,
3. regulation and supervision of activities authorized or permitted pursuant to federal banking law, and
4. enforcing compliance with any applicable federal or state laws concerning those activities.

12 CFR 7.4000(a)(2)(i - iv).

PROCEDURE

The OCC recognizes that state officials may from time to time possess information that would be valuable to the OCC in connection with its oversight of national banks, or may seek to obtain information from national banks concerning their operations. Given the complexity of issues that can arise with respect to whether a state law is applicable to national bank operations, the enforcement of any such laws, or the propriety of disclosure of information concerning a national bank's operations, the OCC has established the following procedure to address circumstances when state officials raise issues concerning potential violations of laws by national banks, including when state officials may seek information from a national bank about its compliance with any law or for other purposes:

- **State officials are urged to contact the OCC** if they have any information to indicate that a national bank may be violating federal or an applicable state law or if they seek information concerning a national bank's operations. The OCC will review any such information and, if appropriate, take supervisory action, which may include an enforcement action, if it concludes that a national bank has violated an applicable law.

- **National banks should contact the OCC** if they are contacted by a state official seeking information from the bank that may constitute an attempt to exercise visitation or enforcement power over the bank. National banks are encouraged to consult with the OCC as soon as possible following the initial contact by a state official on whether such request may conflict with the federal standards applicable to the regulation and supervision of national banks. Following such consultation, the OCC may want to contact the state official directly to discuss the state's inquiry and to obtain any information that the state might possess that may be relevant to the OCC's supervision of the bank.

OCC Contacts:

- Director, Enforcement and Compliance Division, at (202) 874-4800 (for inquiries by state officials and questions about this Advisory Letter)
- Director, Community and Consumer Law Division, at (202) 874-5750 (for inquiries by state officials and questions about this Advisory Letter)
- The OCC District Counsel for the district in which the bank is headquartered (for inquiries by state officials)
- Director, Legislative and Regulatory Activities Division, at (202) 874-5090 (for questions about preemption and visitorial powers generally)

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

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Mortgage system crumbled while regulators jousted

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P-I INVESTIGATIVE REPORTER

Federal bank regulators fought over turf with state agencies while America's mortgage lending system grew increasingly unstable and then fell apart.

When state investigators spotted questionable loan practices, the feds rejected their help and informed the state that it had no business looking into the affairs of federally chartered institutions. Scott Jarvis, director of the Washington state Department of Financial Institutions, said his files are full of letters from federal bank regulators, bankers and other lenders politely telling his office to take a hike.

In a typical case in late 2002, state bank examiners believed National City Mortgage was violating the state's Consumer Loan Act by charging extra fees on mortgages, said Kwadwo Boateng, the state's chief bank examiner. When asked to explain the costly "discount loan fees, underwriting fees, processing fees and marketing fees," National City Mortgage sought intervention from federal regulators, records show.

The investigation was stopped by federal decree.

At the company's request, Julie Williams, general counsel of the federal Office of the Comptroller of the Currency, wrote National City a letter in January 2003 saying the state had no right to examine or even visit its offices. Because National City's parent bank in Cleveland was chartered with the OCC, the federal agency pre-empted the state's authority. National City attached Williams' letter to a missive to the state in February 2003, asking state investigators to stay away.

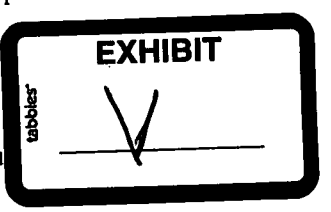
And here's the kicker. The federal agency didn't go after the mortgage fee complaint because it had no authority to enforce state consumer protection laws, Boateng said.

"We dropped the case," he said.

National City spokesman Todd Morgano said he wasn't aware of the case, but "in general we fully cooperate with all of our regulators."

"Pre-emption is about the application of uniform, national and ... rigorous standards," said Williams, who is also the first senior deputy comptroller at the OCC. "It is not about getting out of rules and being allowed to play in a more relaxed environment."

Williams increasingly pre-empted state regulatory actions starting in 2002, about the time subprime and nontraditional mortgage lending was beginning an astounding climb, from $267 billion in originations nationally to more than a trillion by 2005, according to Inside Mortgage Finance, a tracking newsletter. Mortgages sold as pools on Wall Street created a firestorm of irresponsible lending that peaked in 2006 and smoldered afterward with widespread foreclosures and today's financial instability.



The OCC's federal cousin -- the Office of Thrift Supervision -- wasn't far behind in the pre-emption effort. For example, Washington and other states have been waging a battle with the OTS and State Farm Bank over the state's right to license the bank's mortgage brokers and originators.

"We don't need dual supervision," said State Farm Bank general counsel Todd Haynes, who expressed a strong preference for the feds. "They've done a fine job."

That's not the opinion of others, nor is it reflected in statistics regarding enforcement actions that show almost nothing from the feds in the area of consumer protection.

"National banks and their operating subsidiaries function without meaningful law or enforcement," said Rep. Barney Frank, D-Mass., then ranking member of the House Financial Services Committee, in a toughly worded letter to federal Comptroller John Dugan three years ago. He said that's because the feds have shoved aside state regulators without filling the "regulatory void."

He pointed out that the comptroller's office lacked the ability to enforce state consumer protection laws, yet repeatedly shielded national banks from state investigations, as it did with National City. Both federal agencies have imposed "visitorial" bans, meaning state investigators can't even visit their chartered institutions for interviews.

"What value is an applicable state consumer protection law if there is no one to enforce it?" asked Frank, who is now chairman of the committee.

Nothing has significantly changed since Frank wrote the letter to Dugan, except for a U.S. Supreme Court decision last year that more firmly barred the door to state investigators.

Other laws encourage concurrent federal and state investigations of consumer violations regarding credit repair and telemarketing fraud, said Joseph Vincent, state DFI general counsel.

Most big depository and lending institutions -- like Wells Fargo and Washington Mutual -- are chartered by either the comptroller's office or the thrift supervisor. Washington's Department of Financial Institutions, as well as bank regulators in other states, charter or license community banks, financing firms, credit unions and mortgage brokers.Deciding who oversees you is mostly voluntary in the banking world.

Banks are governed by a patchwork of federal and state laws, which are notably weak at the federal level in the areas of predatory lending and consumer protection, according to law professors, attorneys and other experts. Some states, like North Carolina, New Jersey and New York, have passed tougher predatory lending laws with provisions holding Wall Street liable for financing bad loans. But the two federal agencies in recent years have increasingly shielded their chartered banks, and by extension Wall Street financiers, from states' laws.

Assistant state Attorney General David Huey, who has handled some of the state's biggest predatory lending cases, wants Congress to empower state regulators to investigate federally chartered banks. Federal and state regulators should work closely together, he said, just as state attorneys enforce the federal anti-trust Sherman Act.

Without that authority, Chuck Cross, former Washington state regulator and currently vice president of the Conference of State Bank Supervisors, and others said they watched federally chartered institutions such as Washington Mutual founder in their own backyards, while federal regulators did nothing to stop

the bleeding.

Cross said he had an inside source at WaMu who told him he wouldn't believe what was going on with its questionable underwriting activities. Bill Longbrake, recently retired WaMu vice chairman, said the bank reported to its stockholders problems with loans made by a subsidiary, Long Beach Mortgage, but those problems were solved over time to the satisfaction of the OTS.

Jarvis said the community banks under his office's supervision didn't wade into the risky subprime and nontraditional lending waters the way nationally chartered banks did. One of the largest, Sterling Savings Bank in Spokane, didn't engage insubprime or nontraditional loans, spokeswoman Jennifer Lutz said. Nor did Cascade Bank in Everett, bank President and Chief Executive Officer Carol Nelson said.

Two-thirds of bank deposits in the state are regulated by the federal regulators, Jarvis said.

Jarvis acknowledged that some mortgage brokers and other financial institutions under his agency's watch participated in the risky lending behind the current crisis.

But the numbers support his contention that the state was a better guardian.

The federal OCC took about a dozen formal enforcement actions against banks for "unfair and deceptive practices" in the current decade, agency spokesman Robert Garsson said. The other federal agency, OTS, took about half as many, in "the five to six range," OCC Chief Operating Officer Scott Polakoff said. States, by contrast, took 3,694 enforcement actions against mortgage lenders and brokers in 2006 alone, according to congressional testimony.

The quality of local oversight varies from state to state, said Longbrake, who was WaMu's liaison to regulators. Yet state regulators are more innovative than the feds, he said. He encouraged them to work together.

Pre-emption is a good practice, said Peter Wallison, co-director of the American Enterprise Institute's market deregulation program. Complying with 50 different sets of rules is expensive to banks and consumers, he said.

But recent events show that predatory and reckless lending comes at a cost to taxpayers, leading to the $700 billion federal bailout.

Congressional testimony, court records, interviews, academic papers and news stories over the past decade reveal contrasting trends with state and federal bank regulators. The states work together. The federal agencies compete with each other, and with the states.

The feds were set up as rivals. Bank oversight is "the only place I know of where regulated entities get to pick their regulators," said Kathleen Keest, with the Center for Responsible Lending.

The two agencies exist on funds assessed from members, though the president appoints their directors.

"They are competing with each other for the business," said Keest, a charge officials at both agencies denied.

In what appears to be an enticement to state-chartered banks, the OTS on its Web site boldly advertises its ability to pre-empt state laws and regulators.

"Our examiners are very focused on predatory lending, and on inappropriate lending," the OCC's chief operating officer Polakoff said.

To its credit, the OCC participated in a settlement in 2000 with Providian National Bank forcing it to pay $300 million to consumers for deceptive credit card practices. But according to publicity afterward, the California state attorney general and the San Francisco district attorney forced the issue.

Williams and Polakoff said they work behind the scenes, privately counseling banks to change their lending practices without taking public action. Washington's Jarvis said that's part of the problem, "when it comes to protecting the public, we do a much better job."

Cross described feeling a chill reading what he called a "how to rip people off" manual he obtained by subpoena from state-chartered First Alliance Mortgage Company, a California company. It bluntly instructed employees how to trap vulnerable customers in a room, distract them with banter and stick them with outrageous fees and rates they couldn't afford, he said.

The Washington Department of Financial Institutions forced First Alliance to leave the state. Joining the effort were an Alameda County, Calif., deputy prosecutor, state attorneys general around the country, and the Federal Trade Commission, which operates separately from the federal bank agencies. The company owners -- who declined to talk with the Seattle P-I -- sought bankruptcy protection. They also paid $60 million to victims in a settlement.

As a result of the same investigation, Lehman Brothers also was found liable in a federal lawsuit in California for knowingly financing the First Alliance lending practices, a rare case where a Wall Street firm was held liable for financing abusive loans.

Lehman filed for bankruptcy protection in mid-September, leading to what has become the notorious sound bite from presidential candidate John McCain, long a supporter of market deregulation, that "the fundamentals of our economy are strong."

State investigators -- led by Washington -- produced other big settlements with Household Finance for $484 million in 2002 and Ameriquest for $325 million in 2006. Ameriquest was owned by now-deceased Roland Arnall, a multimillion-dollar contributor to President Bush's 2004 re-election campaign.

Earlier this week, Countrywide Financial Corp., recently acquired by Bank of America, agreed to reduce loan payments and halt foreclosures, at a cost of $8.7 billion nationwide. California, Illinois and Florida led that multistate effort.

Cross said certain state regulators, all members of the Conference of State Bank Supervisors, consult regularly to coordinate battles against predatory lending. He cited Gov. Chris Gregoire as a leading participant when she was attorney general, as well as her successor, Rob McKenna.

But the feds won the pre-emption war, unless Congress overturns the whole system next year. Frank has indicated he might try.

The U.S. Supreme Court ruled in a split decision last year that the OCC has absolute right to insist on exclusive oversight without states intervening. The case involved Wachovia, a Charlotte, N.C.-based lender that subsequently crumbled under an avalanche of subprime problems and is now up for sale.

But Joe Vincent, general counsel for Washington's bank regulator, said he doesn't care what the Supreme Court ruled. "It was wrong," he said.

SECOND OF A TWO-PART SERIES

NO LIABILITY: Wall Street was shielded from lawsuits that would have protected borrowers and halted a frenzy of buying and selling that ultimately led to the current financial meltdown.

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Comptroller of the Currency
Administrator of National Banks

Washington, DC 2021

OCC Working Paper

[This paper is a work in progress circulated to stimulate discussion and comment.]

Economic Issues in Predatory Lending

July 30, 2003

This paper contains a summary and analysis of key statistics and studies on the issue of predatory lending. The piece specifically addresses the major questions that have been raised on this topic:

- What is a predatory loan?
- How and to what extent are banks engaged in predatory lending?
- Do high interest rates and fees represent predatory practices?
- What is the relationship between interest rates charged on subprime loans and borrower risk?
- Is the structure of interest rates among subprime credit grades similar to that within the speculative grade corporate bond market?
- Are elevated risks in the subprime relative to the prime market simply a matter of degree, or is there also a difference in kind?
- To what extent do higher servicing and other costs account for the level of subprime interest rates?
- What is the evidence for lack of competition and pricing inefficiency in the subprime market?
- What is the evidence that subprime providers earn excess profits or economic rents?
- Do anti-predatory laws effectively restrain abusive lending?
- What is the evidence that anti-predatory laws restrain legitimate lending?
- Is the pattern of subprime lending activity in lower income and minority locales different than that in higher income areas?
- What is the quantitative evidence regarding the percentage of subprime borrowers who could have qualified for a prime loan?
- What is the role for CRA in curbing predatory lending abuses?

I. Summary

Concerns about predatory lending abuses have prompted financial service providers, banking regulators and legislators to seek ways to curb these practices while maintaining legitimate credit flows to subprime borrowers. Proponents of anti-predatory measures argue that there is substantial evidence that such legislation has inhibited predatory lending tactics without damaging the burgeoning subprime market.

It has also been argued that inexperienced borrowers are steered by predatory lenders into loans that are overpriced relative to the borrower's risk profile. This is viewed as justification for government intervention to protect the most vulnerable in society. Moreover, many suggest that predatory practices are often specifically aimed at minority and elderly borrowers, for whom traditional banking services are often less accessible. A series of HUD studies (2000)[1] has documented the concentration of subprime lenders in low-income and minority communities in five cities including Atlanta, Los Angeles, Baltimore, New York and Chicago. HUD found that subprime loans were three times more likely in low-income neighborhoods than in high-income neighborhoods and five times more likely in African American neighborhoods than in majority neighborhoods.

A study prepared by Calvin Bradford (2002)[2] on subprime lending patterns in all of the nation's 331 metropolitan areas reports similar findings and asserts that the magnitude of these disparities raises serious questions about the extent to which risk alone could account for such patterns. Bradford's analysis suggests that racial disparities actually increase as income increases suggesting that a portion of subprime lending is occurring with borrowers whose credit histories would qualify them for lower-cost, conventional prime loans. There are also those analysts who suggest that CRA be utilized to create disincentives to banks that engage in or provide indirect support for predatory lending.

By contrast, others who have analyzed the market for subprime credit have obtained results that suggest that regulatory and legislative initiatives to combat predatory practices are unnecessary and may be counterproductive. They believe that self-regulation and better enforcement of existing laws represent the best practical solution to predatory practices. Indeed, there is substantial empirical evidence that anti-predatory statutes can impede the flow of mortgage credit, especially to low income and higher-risk borrowers, and that any reduction in predatory abuses resulting from these measures is probably achieved at the expense of many legitimate loans.

North Carolina, which recently enacted legislation in this area, has been the subject of some analytical research. A recently released study by Roberto G. Quercia, Michael A. Stegman, and Walter R. Davis (2003)[3] examined changes in subprime lending activity before and after enactment of North Carolina's anti-predatory law. The authors conclude that there has been a large decline in subprime refinance originations with predatory terms. They also indicate their research suggests that lending to high-risk applicants, which they define as having FICO scores below 580, in North Carolina has followed patterns similar to those in states without anti-predatory statutes. This implies that there was no reduction in access to credit among these borrowers as a result of the law. However, the authors do not address the impact of the law on subprime borrowers with FICO scores in the 580-660 range, which is recognized as the heart of the industry, and they also acknowledge that their results could be impacted by changes in the structure of the data base used in the analysis. On the other hand, Gregory Elliehausen and Michael Staten (2002)[4], report lending to borrowers in North Carolina with FICO scores below 580 actually weakened more than for any other credit group after the law began to be implemented.[5] Their analysis suggests that the decrease in lending to low income and higher risk borrowers in North Carolina was due to increased underwriting costs, potential legal liability and other factors associated with the law. The study also shows that the interest rates on loans within all credit grades before and after enactment of the first part of the statute closely reflected the loans' risks.

In fact, the North Carolina statute is actually considered less onerous than those enacted in other states. One of the most important channels through which anti-predatory laws can impede credit flows is by reducing the willingness of agency and non-agency securitizers to buy loans originated in a covered jurisdiction. This can prompt lenders to cut back or eliminate their loan originations in these jurisdictions. By disrupting the secondary market, the impact of these laws can potentially go beyond simply reducing the number of loans with specifically forbidden features, such as prepayment penalties in the case of the North Carolina law. Whereas the government-sponsored enterprises (GSEs) have not announced restrictions on the purchase of mortgage loans in North Carolina, they have cut back or even eliminated entirely their purchase of high cost and other loans in Georgia and New York as a consequence of more severe anti-predatory laws enacted in those states.

In November 2002, Fannie Mae announced that it would not purchase mortgages that qualify as "high-cost home loans" under the Georgia Fair Lending Act. Fannie Mae reissued this "no-buy" policy in March 2003, following the amendments to the Georgia law. In March, Fannie Mae also announced that it would not purchase loans that qualify as "high cost home loans" under New York Banking Law § 6-l. Freddie Mac has similar "no-buy" policies concerning "high cost home loans" subject to the amended Georgia Fair Lending Act and the New York law. In addition, Fannie Mae will not purchase any mortgage originated in Georgia between October 1, 2002 and March 7, 2003, due to "continued uncertainty in the marketplace" regarding those loans originated following enactment of the original Georgia Fair Lending Act and the date of the amendments. Freddie Mac has adopted a similar policy.

Indeed, anti-predatory laws with vaguely defined compliance procedures or that involve unlimited potential liability make securitization of loans originated in that jurisdiction problematic, since lender violations may siphon off funds available to pay investors. When the magnitude of potential damages is exorbitant, it may be difficult to shield investors in these securities sufficiently to obtain an investment grade rating. When this occurs, loans subject to a particular statute may be effectively unsecuritizable.[6] Indeed, all of the major rating agencies have recently announced severe strictures for the rating of MBS pools connected with loan purchases in Georgia, New York and New Jersey. This could easily end up restricting subprime activity in those states even more severely than has been the case in North Carolina.

Opponents of expanded anti-predatory legislation typically assert that the concept of abusive lending has been defined too broadly and that the higher interest rates typically associated with subprime mortgages are for the most part justified by the elevated level of risk inherent in this form of lending. For example, economists point out that interest rates on lower-quality subprime loans are higher than those for better quality subprime mortgages. In late 2002, subprime loans classified with a "C" credit grade carried an average interest rate of 11.8%. Those graded in the "B" category carried a 10.6% average rate. Meanwhile, subprime loans within the "A" credit grade carried a still lower 9.4% rate. The relationship between delinquencies and interest rates paints a similar picture. Delinquency rates climb steadily for subprime loans with higher interest rates. This suggests that subprime lenders are charging higher interest rates to riskier borrowers.

In addition, empirical data suggest that subprime loans are different from prime loans in terms of the greater variety and complexity of risks and this also affects pricing. While FICO scores are good predictors of delinquency patterns in both the subprime and prime markets, the pricing discrepancies between the two markets cannot be expected to conform solely to differences in traditional risk measures. In the prime market, for example, as loan-to-value ratios decrease (i.e., as equity increases) the delinquency rate decreases, as would be expected. In the subprime market, by contrast, LTVs have little relationship with loan performance. Analysts who have studied the subprime market find that loans to borrowers with blemished credit histories are more costly to service than the relatively commoditized mortgage loans extended to prime borrowers. This also accounts for the higher interest rates on subprime loans.

In the view of some analysts, the subprime market suffers from pricing inefficiencies that enable financial service providers to extract excessive profits or above-normal returns. However, as a relatively new market, it would not be surprising to observe high returns prevailing in the short term. As the market matures, as seems to be happening quickly, pricing will become increasingly competitive. Indeed, interest rate spreads have narrowed in the subprime market relative to prime loans since the early 1990s when the market first started to take off. In the early 1990s, the spread between prime mortgage rates and A- rated subprime mortgages, was some 250 basis points. These have narrowed and at present are approximately 175-200 basis points. This has occurred despite the small number of subprime mortgage lenders. At present there are only 178 lenders engaged primarily in supplying subprime mortgage credit out of a total of over 7,000 bank and nonbank home mortgage lenders. Moreover, since 1999, the number of subprime lenders has actually declined by 74 due to a string of bankruptcies and consolidations in the industry.

The substantially higher risks and servicing costs associated with subprime lending, and perhaps the drop in the number of subprime lenders, appear to account for the lion's share of the pricing differential between subprime and prime mortgages. Therefore, the empirical data do not support the contention that subprime providers in the aggregate are earning excess profits. The low interest rate environment which has boosted demand and allowed lenders to spread their costs over more units of production is probably temporary. If rates should rise, or if the employment situation should deteriorate further, it is possible that housing prices could pull back. Consumer balance sheets, especially among lower income and riskier borrowers, could also deteriorate and subprime losses could jump, placing subprime lenders under financial pressure. There are tangible risks in making the blanket assertion that the subprime sector is earning abnormal returns, as even the current rate of profitability in the industry could easily dry up under less favorable economic circumstances.

The success enjoyed by many subprime providers in the mid-1990s reversed itself swiftly as the financial markets entered a period of turmoil. From late 1997 through the following year, subprime lenders that had underestimated prepayment rates and loan defaults were forced to restate the value of their servicing rights, resulting in a shrinkage of their capital base. Market participants drove down the value of the outstanding debt and asset-backed securities of subprime lenders.[7] Simultaneously, the financial turmoil of the late 1990s engendered severe capital market disruptions. This drove up funding costs for subprime providers and in some cases these firms were squeezed out of the capital markets entirely. In fact, during 1998, Wall Street cut back its purchases of mortgage-backed securities and in particular the subordinated portions of subprime securitizations, thus seriously truncating secondary market liquidity of these loans. As a result, several subprime lenders were forced to file for bankruptcy protection during 1998. In addition, according to the FDIC, subprime lending was involved, at least to some extent, in each of the three most costly depository institution failures of 1999.[8]

There is little data suggesting that banks themselves are engaged in predatory lending to any significant degree. Banks already face disincentives to originating subprime mortgages, especially loans that might be perceived as predatory. Banks are sometimes cautious about increasing lending to consumers with impaired credit since they could come under increased scrutiny for charging higher interest rates or for having to implement more foreclosures in a community. Subprime lending also has the potential to raise increased safety and soundness issues for banks.[9]

Although some banks engage in subprime lending, most banks are not subprime lenders. According to HUD, there were 178 lenders whose business focus was subprime mortgage lending in 2001. The majority, or 112 (63%), were independent mortgage companies. Of the remaining lenders, 30(17%) were non-bank affiliates and only 36 (20%) were depository institutions or their direct subsidiaries. These depository institutions represented only 0.6% of the 6,423 depository institutions that filed HMDA reports

in 2001.[10] Rather, an overwhelming proportion of subprime providers are non-bank mortgage lenders or finance companies.[11] Some of those lenders are independent companies others are non-bank affiliates or subsidiaries of insured banks.[12]

II. Background: Trends in the Subprime Market

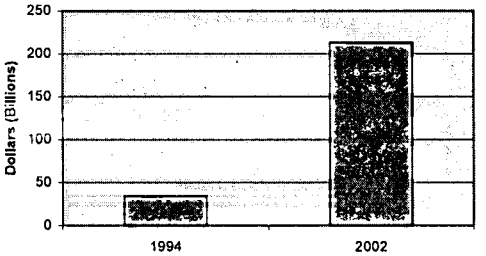
Nationally, subprime mortgage originations have skyrocketed since the early 1990s. Finance companies, non-bank mortgage companies and to a lesser extent commercial banks have become active players in this area. Several factors contributed to the rapid growth of the subprime mortgage market including: (i) the Tax Reform Act of 1986, which eliminated the deductibility of most consumer interest payments except for mortgage interest; (ii) increased securitization of subprime loans which facilitated expanded capital flows to the subprime market;[13] (iii) growing competition in the prime market which squeezed margins on loans to higher-quality borrowers, thus pushing lenders increasingly toward the subprime market; (iv) the rapid escalation in home prices during the 1990s which allowed borrowers more money with the same loan-to-value ratio. More recently, the low interest rate environment has led to an unusually robust housing sector. This has also powered expansion in subprime originations.

The subprime segment of the mortgage market is undergoing rapid transition. Prior to the early 1990s, most subprime mortgages were small-balance second liens. During the 1990s, by contrast, the subprime market has shifted to originating primarily first lien mortgages. By 1999, over 75 percent of loans in the subprime mortgage market were first liens. At the same time, the lion's share of these subprime first lien mortgages, or 82 percent, were used for refinancing rather than for purchasing a home.[14] Subprime refinance mortgages are typically smaller than prime refinance mortgages. According to 1998 HMDA data, the median loan amount for a subprime refinance mortgage was $63,000 compared to $98,000 for a prime refinance mortgage.[15]

In 1994, just $34 billion in subprime mortgages were originated, compared with over $213 billion in 2002 (Chart 1). The proportion of subprime loans compared with all home loans also rose dramatically. In 1994, subprime mortgages represented 5.0% of overall mortgage originations in the U.S. By 2002, the share had risen to 8.6%. Meanwhile, securitized subprime loans increased from $11 billion in 1994 to $83 billion in 1998 before retreating back to $60 billion in 1999. The fallback was likely related to turmoil in the industry during that period that resulted in increased failures and consolidation.[16]

Chart 1

Subprime Mortgage Originations



Source: U.S. Dept. of the Treasury, 2003 MMSA

III. Review of Major Economic Issues in Predatory Lending:

This section provides a summary of the major predatory lending issues. We examine the arguments of proponents of anti-predatory lending laws as well as the often more formal statistical analyses published by economists in this area. A good deal of the piece also represents our own analysis. While proponents of anti-predatory measures assert that there is substantial evidence that such legislation has inhibited predatory lending tactics, others who have analyzed the market for subprime credit have obtained results that suggest that any reductions in predatory lending achieved by such measures come at the expense of fewer legitimate loans as well.

Issue #1: What Is A Predatory Loan?

There is no single, generally accepted definition of a "predatory loan." Indeed, disagreements over the definition of predatory lending have often served to confuse the debate over this issue. The federal Home Ownership and Equity Protection Act (HOEPA) of 1994 has served as the basis for many of the definitions generally in use at present. The act classifies mortgage loans with relatively high interest rates and fees as potentially predatory and imposes upon them a range of additional consumer protections.* The term has been employed loosely by community groups, policymakers and regulators to refer to a wide range of practices.

Kathleen Engel and Patricia McCoy (2001) define predatory lending as exploitive loan practices involving one or more of the following five characteristics: (i) loans structured to result in seriously disproportionate net harm to borrowers; (ii) rent seeking that is harmful to borrowers; (iii.) loans involving fraud or deceptive practices; (iv) other instances of lack of transparency in loans that are not actionable as fraud; (v) loans that require borrowers to waive meaningful redress.[17] Other participants in the debate, such as the Association of Community Organizations for Reform Now (ACORN), assert that predatory lending occurs when loan terms or conditions become "abusive" or when borrowers who should qualify for credit on better terms are targeted instead for higher cost loans.[18]

Within the academic literature on predatory lending, economists typically suggest that judgments as to whether a loan's price is high or abusive in the absence of additional concrete economic analysis of underlying risks, costs and other fundamentals, such as the level of demand for credit, are not a valid basis for defining predatory lending. These analysts point out that without a precise definition, many of the published figures on predatory lending abuses become less convincing. There have been a variety of estimates on the societal costs of predatory lending released in the media. However, a closer examination of some of these studies suggests that with even slight definitional or methodological changes, a case could be made for significantly smaller estimates of abusive lending costs.

Predatory loans can occur in a variety of lending areas, including home mortgages, auto loans, credit cards and payday loans. Researchers have typically directed their efforts at analyzing predatory residential mortgage lending due to the more severe financial consequences to borrowers resulting from abusive tactics in this area.[19] Specific terms or measures that many associate with predatory lending include high interest rates and fees, balloon payments, high loan-to-value ratios, excessive prepayment penalties, loan flippings, loan steering and unnecessary credit insurance.

Issue #2: How and To What Extent Are Banks Engaged In Predatory Lending?

Banks and their direct subsidiaries are not major participants in the subprime market and there is scant evidence that they are engaged in predatory lending practices. Putting aside for the moment the issue of what actually defines a predatory loan, banks could potentially participate in predatory lending through a number of channels. The most important of these is simply through direct lending by originating predatory mortgages. There are also indirect and inadvertent ways in which banks could facilitate

* "HOEPA loans" are closed-end loans secured by a consumer's principal dwelling (other than a reverse mortgage or a loan to finance the acquisition or initial construction of the home) that are higher cost because they exceed specified statutory and regulatory interest rate or fee thresholds. Such loans are subject to specific disclosure requirements and substantive restrictions. Among other things, HOEPA prohibits negative amortization, increases in the interest rate upon default and balloon payments for covered loans with a term of less than five years. It also restricts the use of prepayment penalties and due on demand clauses in covered loans. HOEPA also prohibits the refinancing of a covered loan to another covered loan in the first year of the loan, unless the refinancing is in the borrowers interest.

predatory lending practices. There is the potential that banks could inadvertently buy securities that were issued on RMBS pools (i.e. pools of residential, mortgage-backed securities) containing predatory loans. Banks could also unintentionally facilitate predatory lending practices through the use of third party loan brokers. In order to prevent indirectly supporting abusive practices, banks are expected to establish appropriate due diligence and monitoring procedures to adequately address such risks.

There is little data suggesting that banks themselves are engaged in predatory lending to any significant degree. The majority of mortgage loans to LMI (low-to-moderate income) borrowers† and in LMI neighborhoods are originated by lenders covered under CRA. However, CRA-covered institutions are primarily prime lenders. Between 1993 and 1998, CRA-covered institutions accounted for eighty-three percent of the growth in prime loans to LMI borrowers. By contrast, CRA covered institutions were responsible for only fifteen percent of the increase in subprime loans during the same interval.[20] ‡

According to HUD, there were 178 lenders that concentrated primarily on subprime mortgage lending in 2001. The majority, or 112 (63%), were independent mortgage companies. Of the remaining lenders, 30(17%) were non-bank affiliates and only 36 (20%) were depository institutions or their direct subsidiaries. These depository institutions represented only 0.6% of the 6,423 depository institutions that filed HMDA reports in 2001.[21] Rather, an overwhelming proportion of subprime providers are non-bank mortgage lenders or finance companies.[22] Some of those lenders are independent companies others are non-bank affiliates or subsidiaries of insured banks.[23]

Issue #3: Do High Interest Rates and Fees Represent Predatory Practices?

High interest rates and fees could be the result of a variety of factors unrelated to predatory practices. However, some suggest that interest rates on subprime loans, if they reach a sufficiently high level, are in and of themselves evidence of predatory practices. A similar argument is made for high fees. Indeed, as mentioned earlier, since its passage in 1994, the federal Home Ownership and Equity Protection Act (HOEPA) has classified mortgage loans with relatively high interest rates and fees as potentially predatory. In recent years, many state and local governments have also enacted or proposed their own

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† As defined under CRA, LMI borrowers are those having household incomes that are less than eighty percent of the local median family income. [Engel and McCoy (citing Litan), p.1 footnote 3]

‡ The data as to bank involvement in predatory lending is therefore vague, although there is some anecdotal evidence on the issue. Numerous borrowers sued the failed subprime lender Superior Bank in alleging that the institution engaged in predatory lending (Federal regulators seized Superior Bank in July 2001.) The plaintiffs have alleged that Superior encouraged them to take on loans they did not need or could not afford, and engaged in various types of fraud. Separately, the U.S. Department of Justice brought fair lending actions against Fleet Mortgage Corp. (*U.S. v. Fleet Mortgage Corp.* is May 7, 1996 (E.D.N.Y.)) and Huntington Mortgage Corp. (*U.S. v. Huntington Mortgage Co.* is Oct. 18, 1995 (N.D.Ohio)) for allegedly charging higher rates or fees to minorities than similarly situated nonminorities. [From Engel and McCoy, p.7 and p.14, footnote 47]

At the same time, a more recent case found no evidence of abusive practices. This involved a revised regulation issued by OTS to implement the Alternative Mortgage Transaction Parity Act. In supporting the OTS's decision to distinguish between supervised depository institutions and unsupervised housing creditors and to retain preemption of state laws with respect to the former, but not for the latter, the State Attorneys General stated: "Based on consumer complaints received, as well as investigations and enforcement actions undertaken by the Attorneys General, predatory lending abuses are largely confined to the subprime mortgage lending market and to non-depository institutions. Almost all of the leading subprime lenders are mortgage companies and finance companies, not banks or direct bank subsidiaries." [Brief for Amicus Curiae State Attorneys General, National Home Equity Mortgage Association v. OTS, No. 1:02CV02506 (GK) (D.D.C. filed March 21, 2003) at 10-11.)]

regulations that impose even more restrictive regulations than does HOEPA. The first statute below the federal level for regulating high-cost mortgage loans was enacted in North Carolina in July 1999. That law covers more loans than the federal law and its restrictions are more severe. A recent law enacted in Chicago defined predatory loans as any mortgages with interest rates more than five percentage points above the yield on U.S. Treasury securities of comparable maturity.

Others who have analyzed the market for subprime credit, point out that loans with higher interest rates than those seen in the conventional prime market are not necessarily predatory. The higher interest rates on these loans may simply reflect the higher risks and servicing costs associated with subprime lending. To some extent, higher rates may also reflect robust demand for subprime credit (empirical examination these issues is taken up later on).[§]

Table 1

Subprime Mortgage Market Data[24]

	Alt-A or A-Minus						
	AA+	AA	A	B	C	CC or D	All Subprime
Share of All 2001 1-Family Mortgage Originations*	0.47	3.42	1.94	0.87	0.66	0.89	8.25
30-Year, Fixed APR Interest Rate**	7.2	9.1	9.4	10.6	11.8	12.75	9.83
Serious Delinquency Rate ***	1 36	5 88	10 19	15 83	21 00	23.56	10 44
Loss Rate (% of original UPB) ******	0 05	0 51	1 05	1 64	2 80	2 62	1 10

Source: Data collected and assembled by Cutts and Van Order (citing B&C Lending, Option One, Loan Performance, and Inside Mortgage Finance.) Notes following are edited version of Cutt's &Van Order's. * Share of all mortgages based on 2001-dollar volume of originations. Inside B&C Lending (2/11/02), Inside Mortgage Finance (1/25/02), and Option One Mortgage Corporation (June 2002)). ** Interest rates are from the week ended 9/6/2002. Rates are APRs calculated using average points and fees with simple interest rate using the standard APR formula; Prime rates are from Inside Mortgage Finance (9/6/02); Subprime rates are from Option One Mortgage Corporation (OOMC) for Legacy Plus Platinum (AA+) and Legacy (all others) program loans for Colorado and Utah. LTVs are assumed to be 80% in all cases except C and CC quality loans, which assume 75% and 65% LTVs, respectively. Option One's prices are wholesale; to get retail prices 50 bps were added for average broker compensation. *** Delinquency and loss data from Option One Mortgage Corporation (2002). ****Loss rates are total net cumulative losses.

Issue #4: What Is The Relationship Between Interest Rates Charged on Subprime Loans and Borrower Risk?

The concept that high interest rates in and of themselves represent an abusive practice is a popular argument in some quarters. However, others make the more economically sophisticated assertion that one of the key symptoms of predatory lending is *a lack of correlation between price and borrower risk.* They assert that vulnerable and inexperienced borrowers are sometimes steered by predatory lenders into loans that are overpriced relative to the borrower's risk profile and that as a result subprime lenders make excessive profits.

By contrast, economists generally view the subprime lending area as

Table 2

Prime Mortgage Market Data[25]

	All Prime Conventional	FHA
Share of All 2001 1-Family Mortgage Originations *	82.32	9.43
30-Year, Fixed APR Interest Rate**	6.14	6.11
Serious Delinquency Rate ***	0.55	4.45
Loss Rate (% of original UPB) ******	0.01	0.29

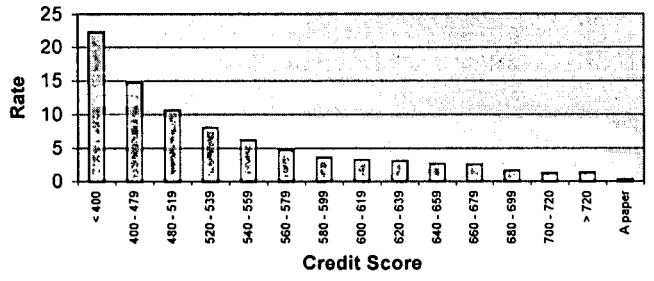
Source: Data collected and assembled by Cutts and Van Order (citing B&C Lending Loan Performance, and Inside Mortgage Finance.) Notes following are edited version of Cutt's &Van Order's. * Share of all mortgages based on 2001-dollar volume of originations. Inside B&C Lending (2/11/02), Inside Mortgage Finance (1/25/02).** Interest rates are from Inside Mortgage Finance for the week ended 9/6/2002. Rates are APRs calculated using average points and fees with simple interest rate using the standard APR formula. *** Delinquency rates from Loan Performance, San Francisco, CA as of June 30, 2002. ****Loss rates based on Freddie Mac experience for conventional conforming loans; FHA loss rates from are from Weicher (2002). Loss rates are total net cumulative losses.

[§] Banking regulators generally designate a "subprime" borrower as having one of the following characteristics: two or more 30-day delinquencies in the last 12 months; 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; a high default probability as measured by a credit score of 660 or below; or a debt service-to-income ratio of 50% or greater. (See OCC Bulletin 2001-6.) Generally, a credit score of 680 qualifies a borrower for consideration for a prime loan, whereas a score below 620 virtually eliminates the possibility.

highly competitive with a strong correlation between price and borrower risk.[26] The empirical evidence shows that as interest rates on subprime loans rise the probability of default and the probability of loss given default also increase.

For example, the data demonstrate that subprime mortgages have significantly higher delinquency rates than prime mortgages. As illustrated in Table 1, serious delinquency rates for subprime mortgages in the aggregate were 10.44% in late 2002 (seriously delinquent rates are the percentage of loans that are over 90 days past due or in foreclosure). This is far above the serious delinquency rate for all prime conventional mortgages of 0.55% (Table 2).

Chart 2
Serious Delinquency Rates for Prime and Subprime Mortgages by Credit Score



Source: OTS (citing MIC), LTVs < 80%

In addition, delinquencies increase steadily with paper grade in the subprime market. As illustrated in Table 1, for subprime loans issued in 2002, AA+ subprime credit** was associated with serious delinquency rates of 1.36%. AA, A, B, C and CC subprime credit were associated with steadily rising serious delinquency rates of 5.88%, 10.19% 15.83%, 21.00% and 23.56% respectively.

Moreover, as illustrated in Chart 2, based on data assembled by OTS from the Mortgage Information Corporation (MIC) database,[27] the relationship between credit score and serious delinquency rates is similar to that between paper grade and delinquency rates, with a steady rise in delinquencies as credit score decreases.††

Similar to delinquencies, losses on subprime loans are also higher than on prime loans. As illustrated in Tables 1 and 2, the average loss rate for subprime loans in 2002 was 1.10% versus 0.01% for all conventional prime loans. That these loss rates appear low can be deceptive. Loss rates on residential

** Mortgage underwriting guidelines differ among lenders. Within the subprime sector, borrowers are often graded from the least risky "A minus" borrower to the most risky "D" grade borrower. However, these grades are not well defined across the industry. Mortgage Information Corporation (MIC) defines "A minus" as the least risky of its subprime grades. By contrast, Option One Mortgage Corporation, the source for the subprime data used in Table 1, relies on its own unique subprime classification system. Option One's AA+, AA and A grades are similar to what are typically referred to as Alt-A and A-minus subprime grade loans, and their CC grade loans are similar to what are typically referred to as "D" grade subprime loans in the mortgage industry. [Information on Option One from "On the Economics of Subprime Lending," by Amy Crews Cutts and Robert Van Order, March 2003, p.4, footnote 6.]

†† Although there is a close overall relationship between paper grade and credit score, there is also considerable variability of credit scores among subprime mortgages in each grade level. In the MIC database, for example, the median "A-" subprime mortgage had a credit score of 630, although scores ranged from a high of 670 to a low of low of 590. The median B subprime mortgage had a credit score of 570, with scores ranging from a high of 610 to a low of 550. Under the Option One system, the A credit grade is associated with credit scores ranging from 660 to 560. The B grade with 640 to 540. [Information on Option One from Cutts and Van Order, appendix Table 4. Information on MIC from, "What About Subprime Mortgages," Mortgage Market Trends, Research and Analysis, Office of Thrift Supervision, Washington, DC. Volume 4, Issue 1, June 2000, p.10.]

portfolios are generally subdued compared with other lending areas since they are collateralized. A loss rate on a residential portfolio of 1.10% is considered high. Loss rates among B and C grade subprime loans in the Option One sample (Table 1) actually averaged around 2.2% in 2002.

Table 3

Percentage Distribution of Subprime and Prime Mortgage Originations By Year (By $ Volume)

	Subprime Mortgages	Prime Mortgages
1999	33.3%	19.2%
1998	36.2%	30.8%
1997	16.6%	10.0%
1996	7.1%	7.3%
1995	2.8%	5.2%
1994	1.6%	5.5%
1993	0.9%	11.9%
Pre-1993	1.6%	10.2%

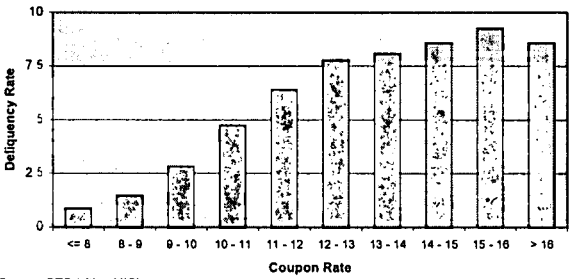
Source: OTS (citing MIC)

In addition, the loss rates reported in Table 1 tend to understate the severity of risks in the subprime area. High volume growth has repressed aggregate loss rates throughout the residential market in general (loss rates on recently originated loans are generally low relative to more mature loans). In addition, the average age of outstanding subprime loans is lower than in the prime area (Table 3). This tends to "cover up" the severity of losses in the subprime relative to the prime area when judged by the average cumulative loss rate figures presented in Tables 1 which encompass all vintages. Examination of cumulative loss rates for earlier vintages of subprime loans provides a more revealing picture. According to data from Moody's, while cumulative loss rates on the 2001 and 2002 vintages of subprime loans currently are just 0.84% and 0.1% respectively, cumulative losses on the 1996, 1997 and 1998 vintages are a far higher 4.78%, 4.49% and 4.77%.

The higher losses associated with subprime lending suggest that this is a much riskier undertaking than the prime area. This does not imply, however, that profits in the subprime sector should necessarily be below those in the prime sector. In order to offset the greater risk, as well as the higher servicing and other costs associated with subprime lending, providers charge higher interest rates. In fact, according to traditional investment theory, subprime lending should provide higher expected returns than prime lending specifically due to the higher risk.[28]

Chart 3

Interest Rates and Serious Delinquency Rates in the Subprime Sector



Source: OTS (citing MIC)

Table 1 contains 30-year fixed interest rates for subprime loans issued in 2002 by paper grade. As expected, interest rates on lower quality loans are higher than those for the better quality subprime mortgages. While the average 30-year fixed interest rate for all conventional prime loans in the aggregate was 6.14%, AA+, AA, A, B, C, and CC subprime loans carried rates of 7.2%, 9.1%, 9.4%, 10.6%, 11.8% and 12.75% respectively.[29]

The relationship between interest rates and delinquencies paints a similar picture. As illustrated in Chart 3, serious delinquency rates on subprime loans climb fairly steadily for loans with higher interest rates. These data support the view that subprime lenders are charging higher rates to riskier borrowers. (The decline in serious delinquency rates for the highest interest rate category is probably not meaningful. According to OTS, only one percent of loans in the MIC sample data carry a coupon of over 16 percent. This makes it difficult to draw any solid conclusions.)[30]

Issue # 5: Is The Structure of Interest Rates Among Subprime Credit Grades Similar To That Within the Speculative Grade Corporate Bond Market?

The corporate bond market is highly competitive. Yield spreads between bonds with varying credit ratings tend to accurately reflect differences in underlying risk. The data show that spreads between adjacent credit grades in the subprime market are generally analogous to those between ratings categories

in the speculative grade corporate market. This suggests that interest rates in the subprime market also accurately account for differences in risk between credit grades.

Table 4

Spreads in the Subprime Mortgage and Speculative Grade Corporate Bond Markets

	Corporate	Subprime	Corporate	Subprime
	BBB BB+	AA+ AA	BB+ BB/BB-	AA A
Spread (bps)	246	190	23	30

Source: S&P, Haver, Cutts (citing Option One), our calculations.

As illustrated in Table 4, the spread between AA+ and AA subprime mortgage loans in the Option One sample (from Table 1) was 190 basis points in September of 2002. Meanwhile, the spread between BBB and BB+ corporate bond yields was a similar 246 basis points at that time. Spreads on corporate bond yields are fairly volatile over the course of the business cycle relative to those in the subprime lending area, so a spread of 246 basis points could be considered generally in the same range as the 190 basis point spread observed in the subprime market. In the corporate bond area, BBB is the lowest rating within the investment grade category, while BB+ represents the first rung of the speculative category. These two bond rating categories can be considered as more or less analogous to the Option One AA+ and AA subprime categories. Meanwhile, the 23 basis point spread between BB+ and BB/BB- rated corporates is also within the same general range as the 30 basis point spread between AA and A subprime loans.

Admittedly, the subprime and corporate markets are very different structurally. In addition, as mentioned above, cyclical factors that have short-term impacts on corporate bond yields, especially macroeconomic shocks that can spark rapid flights to quality, add a great deal of volatility to corporate yield spreads that is often less pronounced in the subprime mortgage market (the period encompassing the financial market turmoil in the late 1990s was a notable exception). However, the general correspondence between spreads in the speculative corporate bond market and those in the subprime area provide some additional evidence that the subprime market is well functioning and competitive.

Issue #6: Are Elevated Risks In The Subprime Relative To The Prime Market Simply A Matter of Degree, Or Is There Also A Difference in Kind?

Empirical evidence suggests that subprime loans are different from prime loans in terms of the variety and complexity of risks, not simply in terms of the degree of risk, and this also probably impacts pricing. As discussed in the previous section, subprime loans default far more frequently than prime loans. In addition, however, subprime loans prepay both when interest rates decline and when credit worthiness improves. Prepayment risk is, therefore, greater for subprime loans. Cumulative monthly prepayment rates for subprime loans are typically 1.5 to 2 times higher than those for prime loans during periods of stable interest rates. (During periods when interest rates have fallen sharply, prime prepayment rates have risen above those in the subprime sector. However, these periods have tended to be brief.)[31] In addition, unlike prime mortgages, more mature subprime mortgages tend to be riskier. This is the case because, in the absence of other factors atypical in the prime market, such as prepayment penalties, they might have prepaid had the borrower's creditworthiness improved. In addition, prepayments of subprime mortgages are more difficult to predict than those of prime mortgages.

Moreover, in the prime market, as the loan-to-value ratio decreases (i.e., as equity increases) the rate of serious delinquency decreases. This is the expected relationship. In the subprime market, by contrast, LTVs have little relationship with loan performance. For example, as illustrated in Table 5, for *prime* borrowers in the highest-risk category, delinquency rates are 12.49% when LTVs are above 90%. With LTVs under 70%, (in other words, with increased equity), the delinquency rate for prime borrowers falls dramatically to 4.2%. By contrast, the highest-risk subprime borrowers show a 27.39% delinquency rate with LTVs above 90%. However, when LTVs fall below 70%, delinquency rates in the subprime market

remain high, in this case at 28.07%. This pattern is repeated for both prime and subprime borrowers in each risk category.[32]

Table 5

Prime and Subprime Loan Performance by FICO Score and LTV (Percent of Loans Ever 90+ Days Delinquent

LTV	Prime Market FICO Score				Subprime Market FICO Score			
	Low	Medium	High	Very High	Low	Medium	High	Very High
G.T. 90%	12.49	5.28	2.11	0.68	27.39	13.15	8.27	3.51
80%-90%	8.41	4 37	1 64	0 47	24 12	14 74	9 45	4 56
70%-80%	6.01	3.02	1.00	0.23	27.42	15.52	11.01	7.39
L.T. 70%	4.20	2.00	0.64	0.15	28.07	12.01	7.25	3.16

Source: Cutts and Van Order (citing Loan Performance, San Francisco, CA) Data is for areas of medium home price appreciation. FICO score category. Low (<620), Med (620-660), High (660-720); Very High (>720). Table format based on display by Cutts and Van Order.

By contrast, higher FICO scores remain excellent predictors of delinquency patterns in both the subprime and prime markets. As illustrated in Table 5, delinquencies decline as FICO scores increase (i.e. as credit worthiness increases) for every LTV category. This suggests a difference in the structure of risk between the two markets. In other words, differences in risk between prime and subprime borrowers cannot be accounted for simply with reference to the traditional stratification of credit scores and other underwriting criteria. Since greater equity does not appear to help subprime borrowers stave off financial difficulties, this further increases the disparity in risks between the two markets from the point of view of lenders. Therefore, pricing discrepancies between the two markets also cannot be expected to conform solely to differences in traditional risk measures.[33] As underscored by recent failures of subprime providers, success in subprime lending requires more effective internal controls and risk management expertise than in the prime area.

Issue #7: To What Extent Do Higher Servicing and Other Costs Account For The Level Of Subprime Interest Rates?

Some economists and lenders also argue that loans to borrowers with blemished credit records, lower income and cash flow concerns are more costly to service and originate than the relatively commoditized mortgage loans extended to prime borrowers due to lack of standardization in underwriting.[‡‡] They assert that this, in addition to higher risks, also accounts for the higher interest rates on subprime loans. Currently, servicers typically charge 50 basis points for servicing subprime portfolios. The going rate for servicing prime portfolios is generally around 25 basis points. This implies that it costs 25 basis points more to service a subprime portfolio than a prime portfolio.

However, this figure may be somewhat low. Because the subprime industry is still relatively young, firms continue to wrestle with the proper figure for servicing costs. Soon after mortgages are originated, 50 basis points may indeed cover all servicing costs of a subprime portfolio. However, as the portfolio matures and delinquencies rise, servicing costs inevitably increase. Subprime portfolios are of much more recent vintage than prime portfolios (Table 3) due to the more recent development of the industry. As discussed earlier, since loans closer to origination have lower loss rates (Table 6), the rapid growth of subprime loan volume has held down losses as a percentage of overall loans outstanding. This could be holding down actual servicing costs in the short term. Therefore, it is possible that 50 basis points may underestimate the true long-term cost of servicing these portfolios. Market participants generally agree that the industry continues to grapple with establishing an accurate estimate of long-term servicing costs.

[‡‡] The typical subprime median refinance loan amount of $63,000 is also smaller than the $98,000 for the median prime loan. This makes the associated fees higher as a percentage of the loan amount.

Separately, in a published interview on the topic of subprime lending, the CEO of Union Acceptance Corp. estimated that it costs 225 basis points to service a subprime portfolio of auto loans.[34] According to Union's CEO, this is three times greater than the 75 basis point cost of servicing Union's prime portfolios (i.e. an additional 150 basis points to service the subprime portfolio). Union is an auto lender that used to be engaged in subprime lending but recently exited the market. Although Union's assessment referred to subprime auto loans, it nevertheless is suggestive that a subprime portfolio may be more costly to service than current industry estimates.

Table 6

Cumulative Loss Rates

Subprime Sector

Months From Origination	Vintage						
	1996	1997	1998	1999	2000	2001	2002
11	0.04%	0 06%	0 07%	0 09%	0 07%	0 08%	0 10%
22	0.46%	0.65%	0.83%	0.79%	0.78%	0.84%	
34	1.58%	2.11%	2.27%	2.10%	2.06%		
46	2.83%	3.31%	3.61%	3.31%			
58	3.73%	4.22%	4.77%				
62	3.99%	4.49%					
78	4.78%						

Source: Moody's, OCC.

In September 2002, the interest rate on prime conventional mortgages with 80% LTVs was 6.14%. The interest rate on subprime mortgages for borrowers with 680 FICO scores and 80% LTVs was 8.1% (these rates include average points and fees). A subprime borrower with a 680 FICO score would be among the lowest risk applicants receiving a subprime mortgage. (Borrowers with FICO scores of 680 often qualify for prime mortgages.) Therefore, these 80% LTV mortgage products extended to conventional prime borrowers and 680 subprime borrowers can be considered as roughly similar.

The difference or spread between the mortgage rates on these prime and subprime loans is 196 basis points. In 1997, Freddie Mac estimated the difference between A- prime and A- subprime rates as 215 basis points, based on their own internal data and analysis.[35] Since interest rate spreads between the prime and subprime markets have narrowed a bit since that time, our estimate of a 196 basis point spread seems reasonable.

Given that the spread between prime and subprime rates is 196 basis points, and assuming that it costs 40 basis points more to service a subprime portfolio than a prime portfolio (this estimate of 40 basis points seems reasonable given the foregoing discussion), then this leaves an additional 156 basis points in spread (196 - 40 = 156) as being attributable to the greater risks inherent in subprime lending and other factors other than servicing costs.

Of this 156 basis points residual, we estimate that approximately 111 basis points is due specifically to differences in risk. As calculated from Table 1, the average jump in interest rates between various grades of subprime loans, which, as discussed earlier, is strongly related to increases in risk alone, is 111 basis points. This 111 basis points is also a reasonable estimate of the portion of the prime/subprime spread attributable just to differences in risk (interestingly, this estimate is similar to those published by Freddie Mac[36] using a more accounting-based approach).

Together, the 40 basis points attributable to the greater servicing costs of subprime credit plus the additional 111 basis points attributable to higher risk amounts to 151 basis points. This is just 45 basis points less than the 196 basis point interest rate spread between 80% LTV conventional prime mortgages and 80% LTV subprime mortgages to borrowers with 680 FICO scores. Although this is admittedly a very rough calculation, it nevertheless suggests that in the aggregate, the gap between prime and subprime rates is largely explained by differences in risk and servicing costs between the two markets and that subprime rates therefore do not appear to be particularly out of line with underlying risk and cost considerations.

In addition, there are other factors besides risk and cost that can impact mortgage pricing. These could also account for a substantial portion of the remaining 45 basis points in spread between subprime and prime interest rates that is not explained by differences in risk and servicing costs. For example, borrower demand for subprime credit has been strong and has probably been outstripping supply. This could also be supporting stronger pricing in the subprime market (this issue is taken up more fully under Issue #9).

Issue #8: What Is the Evidence For Lack of Competition and Pricing Inefficiency in the Subprime Market?

For most subprime borrowers and lenders, the subprime market is a legitimate channel to make credit available at a return commensurate with the risk undertaken. If subprime markets are competitive, the higher interest rates charged by lenders may be justified, given the additional risks and costs involved. At the same time, some view the subprime market as suffering from pricing inefficiency and less than full competition where lenders make excessive profits.

One widely cited study regarding the issue of inefficiency and abnormal returns in the subprime market was performed by Lax, Manti, Raca and Zorn at Freddie Mac (2000). For the study, Freddie Mac designed and commissioned a survey that was performed by the Gallup Organization from a sample of borrowers who obtained mortgages between January 1996 and June 1997. The borrower sample was obtained from DataQuick. The survey responses, which included the type of mortgage held by the borrower (prime or subprime) and borrower demographics, were supplemented with individual credit histories such as payment histories and FICO scores, which Freddie compiled separately from a credit depository. The Freddie Mac study examines three separate findings in concluding that there are inefficiencies in the subprime relative to the prime market:

- The first finding is that risk, while by far the single most important factor in determining if an individual ends up in the subprime market, is not the only factor. Other borrower characteristics such as age, level of education, being less familiar with mortgage types, searching little for the best rates and responding to an offer of "guaranteed" loan approval all also played some role in determining whether a borrower ended up in the subprime market. The study asserts that the market justification for the subprime sector is to fund higher-risk mortgages. Therefore, the study's finding that factors other than risk are significant in explaining why borrowers end up with subprime mortgages is an indicator of some market inefficiency.[37]

- Second, the study questions subprime borrowers as to their satisfaction with their mortgages and the service they receive from subprime lenders. The survey found that subprime borrowers were generally less satisfied customers than prime borrowers. This was also taken as an indicator of reduced efficiency relative to prime lending.[38]

- Third, the study attempts to determine to what extent increased risk and costs account for the difference between mortgage interest rates in the prime and subprime sectors. (This is similar to the analysis we performed in the previous section although our assumptions and methodology were slightly different). Using 1997 interest rate data, Freddie Mac researchers found that A- mortgage rates in the subprime sector averaged 215 basis points above A- rates in the prime sector. (The prime loans included in the analysis are mortgages purchased by Freddie Mac and scored as A- through an internal underwriting model. The subprime loans are mortgages included in subprime pools purchased by Freddie Mac that were scored A- by the subprime lenders originating the mortgages. All loans consisted of first-lien, 15-year, fixed rate financings.) The Freddie study asserts that roughly 90 basis points of the 215 b.p. spread can be accounted for by differences in risk. They base this 90 b.p. figure on their finding that among similarly graded

loans from prime and subprime lenders, loans from subprime lenders often default at rates three to four times those from prime lenders. This is similar to the 111 basis point figure we arrived at by observing the average jump in interest rates between various grades of subprime loans, which as we point out, is highly correlated to increases in delinquency rates and risk.

The authors then estimate that servicing costs for subprime loans are an additional 25 basis points more than those for prime loans. They base this on their conversations with industry experts, and as mentioned in the previous section, this figure represents a generally accepted rule of thumb within the industry. This is slightly lower than the 40 basis point figure for additional servicing costs that we used in our analysis. Freddie then sums the factors for risk and servicing costs which amounts to 115 basis points. Since the spread between prime and subprime rates calculated by Freddie earlier was 215 basis points, this means that risks and servicing costs do not explain 100 basis points of the prime-subprime spread. The authors of the Freddie study conclude that this100 basis points of unexplained spread represents a measure of subprime inefficiency.[39]

The authors of the Freddie Mac analysis concede that none of these three studies of efficiency are conclusive alone and each has its flaws. In combination, though, the evidence adds up, according to the analysis, to a strong case for inefficiency. However, it is useful to examine some of the potential issues with each of the findings. In the first study, for example, the measure of risk employed does not precisely capture the role that risk plays in allocating borrowers between the prime and subprime markets (this is pointed out by the authors themselves). The study places its emphasis on default risk. However, as discussed in a pervious section, prepayment rates are on average much higher in the subprime market.[§§] As pointed out by the Freddie analysis, this is an element of risk to lenders and investors not addressed in the study. In addition, underwriters typically examine a whole range of factors not considered by the Freddie study when assessing risk. Therefore, the risk factors used by Freddie may underestimate the risks inherent in subprime lending (a point also conceded by the authors of the analysis).[40]

Moreover, in its attempt to explain the gap between subprime and prime mortgage rates by estimating risk and servicing costs, the Freddie Mac study does not consider the impact of demand factors on these spreads. As analyzed in the following section, demand may be outstripping supply for subprime credit and this could be playing a considerable role in pricing in this area. In addition, the Freddie study's estimate of servicing costs may be a bit low in light of the data on cumulative loss rates that we examined earlier.

Issue # 9: What Is The Evidence That Subprime Providers Earn Excess Profits?

A common assertion in some quarters is that subprime providers earn abnormally high profits. However, the empirical evidence suggests that in the aggregate the earnings of these firms appear to be in line with underlying supply and demand fundamentals. Indeed, the evidence that subprime lenders earn abnormally high profits (also known as economic rents) tends to be anecdotal. In the Freddie Mac study discussed in the previous section, the authors assert that while some analysts suggest that the subprime sector is highly competitive, discussions with focus groups of market participants indicate that the competition is in reality more for customers than over rates and fees. According to the authors of the Freddie Mac study, these same focus groups noted that subprime lenders spend a great deal of money originating mortgages through sales calls, direct mail, advertising and brokers fees. The Freddie analysis concludes that combined with the history of market entry and consolidation around the time of the study,

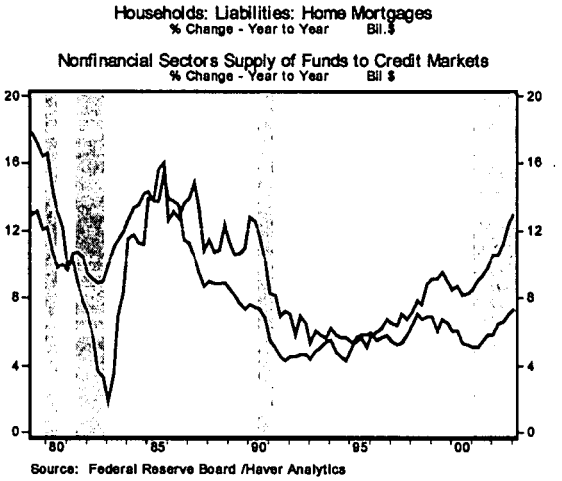
[§§] There are also prepayment penalties in much of the subprime market. However, subprime lenders don't collect their origination fees upfront but build them into the loan amount. So, if a borrower refinances shortly after origination, lenders absorb the cost. This is the reason for the prepayment penalties.

this provides additional circumstantial indications that, at least in 1997, the subprime sector generated excess profits or economic rents.[41]

However, the Freddie Mac study does not attempt to demonstrate directly that these rents actually exist. In fact, the authors concede that it is difficult, if not impossible, to accurately assess the competitive nature of an industry solely on the basis of focus groups and surveys, such as those employed in their study. In addition, as pointed out in the study, since the survey was taken, the subprime industry has been buffeted by financial turmoil, bankruptcies and consolidations and the profits of some of the remaining firms have come under pressure.

In any case, as a relatively new market, it would not be surprising that high returns might prevail in the short term. However, as the subprime business matures, as appears to be occurring rapidly, pricing would be expected to become increasingly competitive. Indeed, this seems to be the case. Interest rate spreads in the subprime market have been compressing since 1993. For example, the spread between prime mortgage rates and A- rated subprime mortgages, was some 250 basis points in the early 1990s. These have narrowed and at present are around 175-200 basis points.[42]

As discussed earlier, the risks and costs associated with subprime lending are significantly higher than those in the prime sector. These factors account for the lion's share of the pricing differential between subprime and prime mortgages. In addition, there are indications that demand for subprime credit is currently outstripping available supply. While perhaps a temporary phenomenon, this could also be propping up subprime margins and interest rates. Since mid-2000, the sharp decline in interest rates has propped up demand for overall home mortgage credit in both the prime and subprime areas. Since the second quarter of 2000, the 10-year Treasury yield has fallen from 6.44% to 3.57%, or 35.7%. Correspondingly, aggregate net household home mortgage borrowing has surged by a similar 32.2%.



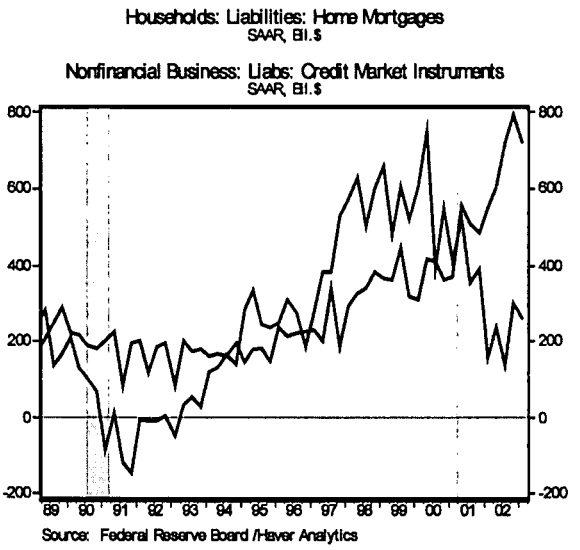
As illustrated in the inset to the right, the present cycle has been an unusual one in that growth in aggregate household home mortgage borrowing has far outstripped the increase in aggregate supply of funds to credit markets. In prior periods of economic weakness, the overall supply of funds to credit markets softened. However, demand for home mortgage credit contracted even more sharply.

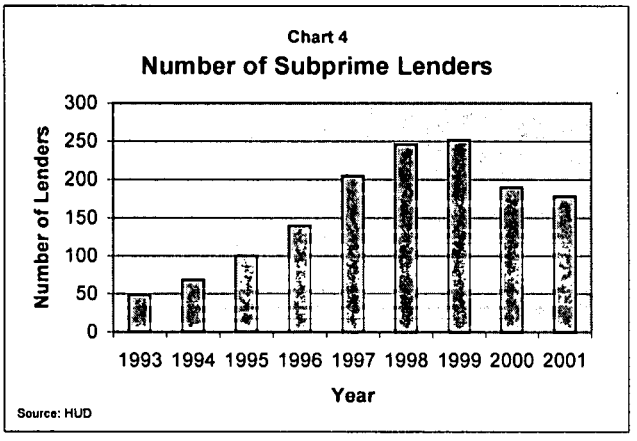
However, this cycle has also been unusual in that the recession has largely been the result of a collapse in business capital spending. This has resulted in an unusually large decline in the business demand for funds. As illustrated in the inset on the next page, which contains actual dollar flows, the collapse in the business demand for funds has freed up sufficient funds to accommodate the unusually large surge in household demand for mortgage credit. This is an important reason, in addition to Fed easing, why prime mortgage rates have come down so sharply despite the surge in household demand for mortgage credit.

However, while the overall supply of credit to U.S. mortgage markets has kept pace with surging demand, this has probably not been the case in the subprime sector. The sharp decline in U.S. interest rates has

propped up demand in the subprime and prime markets about equally. From 2001 to 2002, subprime originations grew 22.9%, slightly faster than prime originations which advanced 22.3%.

However, according to HUD, at present, there are only 178 lenders engaged primarily in supplying subprime mortgage credit out of a total of over 7,000 total bank and nonbank home mortgage lenders. Moreover, since 1999, the number of subprime lenders has actually declined by 74, due to a string of bankruptcies and consolidations in the industry (Chart 4). These disruptions to the marketplace raise the possibility that the supply of subprime credit may not be keeping pace with the unusual surge in demand and this may be keeping subprime rates slightly higher than otherwise would be the case. Recall, that by our calculations, differences in risk and cost explain all but 45 basis points of the spread between subprime and prime mortgage rates. This residual could easily be explained by even a slight imbalance between the supply and demand for subprime funds.





Therefore, the empirical data do not support the contention that subprime providers are earning economic rents. In fact, the general low rate environment which has boosted demand and allowed lenders to spread their costs over more units of production is probably temporary. As mentioned earlier, the present housing cycle is highly unusual. In the periods leading up to previous recessions, as well as during the earlier stages of those prior recessions, Fed tightening typically resulted in sharp contractions in housing starts and home mortgage demand (first inset on previous page). By contrast, the present cycle has been characterized by persistent Fed rate cuts which have bolstered housing demand throughout the past several years in an effort to counter the depressive effects of the collapse in capital spending (and other depressive influences such as the widening trade imbalance). This has also resulted in continued strong increases in home prices in comparison with past recessionary episodes when home prices decelerated sharply.

However, if rates should back up at some point up, or if the employment situation should deteriorate further, it is possible that housing prices could pull back. Consumer balance sheets, especially among lower income and riskier borrowers, could also deteriorate and subprime losses could jump placing subprime lenders under financial pressure. There are tangible risks in making the blanket assertion that the subprime sector is earning abnormal returns, as even the current rate of profitability in the industry could easily dry up under less favorable economic circumstances.

Issue #10: Do Anti-Predatory Laws Effectively Restrain Abusive Lending?

Proponents of anti-predatory measures stress that there is substantial evidence that such legislation inhibits predatory lending tactics and that these measures do not impede legitimate credit flows. A recent analysis by Quercia, Stegman and Davis (2003) on the impact of the North Carolina law examined changes in subprime lending activity before and after the statute was implemented.*** The study was based on an analysis of 3.3 million subprime loans covering 1998-2002 supplied by Loan Performance Inc. (LP). Overall, the study concludes that, after the law was fully implemented, the subprime market in North Carolina behaved "essentially as the law intended -- there was a reduction of loans with predatory terms without a restriction in access to or increase in the cost of loans to borrowers with blemished credit."[43]

In particular, the study found a reduction in subprime originations from 1999 to 2000 due to a decline in the number of refinance originations (these types of loans, according to the authors, are most often associated with predatory abuses), not loans for purchase, with most of the decline associated with loans having terms specifically defined as abusive or predatory by the new law. The analysis reports an overall reduction of about 5,300 subprime loans between the pre- and post-implementation periods. From this perspective, according to the study, the observed decline cannot be considered undesirable or unanticipated by policymakers.[44]

In addition, the study reports that loans to borrowers with credit scores below 580 in North Carolina have actually increased by almost one-third since the law was fully implemented. This growth is consistent with that in neighboring states (except Tennessee). This demonstrates, according to the authors, that changes in North Carolina's regulatory environment have had no detrimental impact on the supply of subprime credit to these high-risk borrowers.[45]

The findings in Quercia, Stegman and Davis appear to contradict some of the assertions of earlier analyses of the North Carolina Law performed by Keith Harvey and Peter Nigro (2002) and Elliehausen and Staten (these are analyzed in the following section). However, much of the disagreement with other analyses is largely definitional. Some of these issues include:

- The study defines a predatory loan simply as a loan having the presence of the terms listed in the law. Since the North Carolina law prohibits these terms, it would be expected that the number of loans containing these terms would be reduced. However, as discussed earlier, there is substantial debate over what a predatory loan actually is.

- The study notes that out of the reduction of 5,300 subprime loans from the pre- to post-implementation period, there were 2,800 fewer loans with prepayment penalty terms, 1,600 fewer loans with balloon payments and 650 fewer loans with combined LTVs over 110%. However, the study does not calculate the degree of overlap of these terms. A single loan could contain one, two, or all three terms. This means that the total reduction in loans with some kind of predatory term could range from 2,800 to 5,050. If there was a good deal of overlap, this could mean that

*** The North Carolina law was enacted in stages beginning in July 1999. The law's anti-predatory features included a HOEPA-like trigger mechanism for classifying closed-end mortgage loans as "high-cost" loans. The law was enacted in two phases. In October of 1999, three features of the law took effect. First, prepayment penalties were prohibited for loans up to $150,000. Second, permissible classes of fees were defined for loans secured by real property and for fees to be paid to third parties in association with the loan. Finally, consumer home loan refinancing transactions were prohibited where they failed to provide a borrower with a *reasonable, tangible net benefit* (the "no flipping" provision). The remaining requirements of the law took effect on July 1, 2000.

the law did restrain a substantial number of legitimate loans even by the study's criteria. If there was 100% overlap, this would mean that 47.2% of the decline in lending was non-predatory by the authors' definition of the term.

- The study's conclusion that there was no reduction in access to mortgages among borrowers with blemished credit in North Carolina following implementation of the state's anti-predatory law is based in large part on how it defines the issue. In defining *high-risk* or *blemished credit*, Quercia, Stegman and Davis consider only those borrowers with identified FICO scores below 580. These are indeed very high-risk applicants and originations to these borrowers did increase following enactment of the law according to the Loan Performance Inc. (LP) data used in the study. However, loans to borrowers identified as having such low FICO scores represented only 21.2% of all subprime originations in North Carolina at the time of the law's implementation according to the LP data.

  The study does not provide results for borrowers with FICO scores in the 580-660 range, which encompasses the largest category of subprime borrowers and represents the heart of the industry. Rather, it only considers the smaller below 580 and above 660 categories. Borrowers with FICO scores between 580 and 660 are also considered as having blemished credit. All of the major bank regulatory agencies define borrowers with FICO scores of 660 or below as having, "a relatively high default probability."[46] At the very least, the bottom half of the 580-660 range (i.e., 580-620), is generally acknowledged as denoting high risk by the standards of many market participants. Lenders often will not even consider a score below 600, some as high as 620. The study indicates that overall subprime loans in North Carolina dropped by 17.0% following implementation of that state's anti-predatory law, and suggests that much of that decline comes from the 580-660 range.

- Weaknesses in the data structure complicate interpretation of the Quercia, Stegman and Davis study. As pointed out by the authors,[†††] the Loan Performance database used in the analysis expanded its coverage from 41 percent to 50 percent of the total subprime market over the period encompassed by the study. In addition, LP improved its data reporting. Between 1998 and 2001, there was a reduction of over 50 percent in the number of records in the database with missing FICO scores. Therefore it is risky to draw conclusions about division of changes in lending by FICO scores because it is not known how reduction in missing FICO scores is distributed across the ranges. For example, the increase in originations among borrowers with identified credit scores below 580 noted by Quercia, Stegman and Davis may simply be due to changes to the coverage in the LP database during the study period. It is possible that credit scores in the under 580 category are over-represented among the missing data.[47] This would have made it appear that originations to these borrowers grew relatively more strongly than was actually the case.

  Indeed, Elliehausen and Staten (2002), relying on the American Financial Services Association (AFSA) database that included loan information from nine major finance companies encompassing a substantial component of the subprime lending business, report different findings than Quercia, Stegman and Davis. The AFSA database did not expand or alter its data reporting over the pre-and post enactment periods of the North Carolina law, but continued to encompass the same group of nine firms. In contrast to Quercia, Stegman and Davis's conclusions, Elliehausen and Staten suggest that lending to borrowers in North Carolina with FICO scores

[†††] Our comments on the database are adapted from those provided by Quercia, Stegman and Davis, footnote 8, p. 18.

below 580 actually weakened more than to any other credit group after the law began to be implemented.[48] Therefore, rather than having no impact on borrowers with blemished credit, the evidence suggests that lending to high-risk borrowers declined significantly following implementation of the North Carolina law.

Issue #11: What Is The Evidence That Anti-Predatory Laws Restrain Legitimate Lending?

There is a good deal of empirical evidence to suggest that anti-predatory statutes impede the flow of mortgage credit, especially to low income and higher-risk borrowers, and any reductions in predatory abuses resulting from these measures is probably achieved at the expense of many legitimate loans.

There are three primary means through which anti-predatory lending measures can potentially impede the flow of legitimate credit to homebuyers:

- First, lenders may simply be reluctant to extend credit in jurisdictions covered by these laws due to the increased legal risks they entail. For example, some of the documentation requirements of the new laws may impose unacceptable risks of legal liability for creditors (predatory and legitimate) active in the high-cost mortgage market. Thus, these measure risk restricting credit beyond those loans offered by predatory lenders. The Georgia predatory lending law which took effect on October 1, 2002 raises the potential for large punitive damages. The law also requires lenders to document that a refinancing of a loan less than five years old provides a "net tangible benefit" to the borrower. The *American Banker* reported that this provision convinced Ameriquest Mortgage Co. (Orange, CA), the nation's seventh-largest subprime originator, to stop making all subprime loans in Georgia.

- As mentioned in the previous section, another way that anti-predatory laws can impede credit flows is by hindering the ability of lenders to sell loans originated in that jurisdiction into the secondary market. This can prompt lenders to cut back their loan originations in that jurisdiction. As mentioned in the summary to this piece, the GSEs have taken a number of steps to reduce the possibility that they will purchase predatory loans. These actions further reduce the liquidity of these mortgages by restraining demand for such loans in the secondary market. Although the GSEs are much smaller participants in the subprime market than the non-agency aggregators, Fannie Mae and Freddie Mac have shown increasing interest in the subprime business in recent years either through direct purchases of subprime loans or through purchases of non-agency mortgage-backed securities. The GSEs are also involved in guaranteeing repayment of securities issued by the private aggregators.

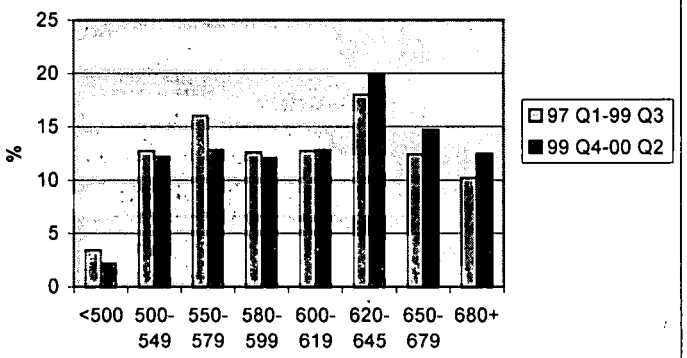
- Finally, anti-predatory lending measures can reduce lenders willingness to extend loans in a jurisdiction due to the increased costs of complying with the provisions of the law or decreased profit margins resulting from the law. In general, these laws increase underwriting costs since lenders must institute additional controls and procedures to ensure that they do not make loans that fall into the high cost category. Even apart from their higher rates, subprime loans are more likely to trigger the high-cost tripwires contained in anti-predatory measures. On average, loans in the subprime mortgage market are smaller than loans in the prime market. Partly as a result, subprime loans tend to have significantly higher fees and rates than for prime loans. However, even if the fees were the same for prime and subprime loans, since subprime loans generally are smaller than prime loans, the fees would be higher as a percentage of the loan amount.[49] (The North Carolina law also expanded the legal and reputational liability of lenders.)

Based on an analysis of data from nine major finance companies active in North Carolina and neighboring states, Elliehausen and Staten (2002)[50] concluded that there was a significant and large decline in the number of closed-end mortgages active in North Carolina as a result of the passage of the state's anti-predatory lending law. The study does not attempt to disentangle the reasons for the decline in lending. As mentioned above, these laws reduce the availability of credit through a number of channels (greater legal liability, the negative impact on the secondary market for these loans and the increased costs to lenders associated with complying with the laws.) In all probability, all of these factors played a role in the reduction of subprime lending in North Carolina.

The finance company data used in the Elliehausen and Staten study had the advantage that it contained information on borrower risk characteristics. Overall, according to the Elliehausen and Staten data, the number of subprime mortgage originations in North Carolina declined by about 14% as a result of the law. This confirms the decline observed in the broader HMDA data for North Carolina presented previously. In addition, the study also found that significant declines occurred only in North Carolina and only among the lower income borrowers. Neither the higher income borrowers in North Carolina nor borrowers in a comparison group of states not affected by the law experienced significant declines.[51]

Moreover, the Elliehausen and Staten analysis demonstrates that the declines in closed-end subprime mortgage lending in North Carolina counties were found only in the higher-risk segment of the market. Chart 5 contains the percentage of subprime loans within each risk-score category that were originated in North Carolina during the pre-enactment period. It also contains the percentage of loans within each risk category in the period following enactment of the initial prohibitions of the law on October 1, 1999 through just before the final implementation date on July 1, 2000.[52] In the period after the first phase of the law became effective, there was a clear decline in the percentage of loans originated in the higher-risk (lower FICO score) categories. The lower-risk (higher FICO score) categories, by contrast, experienced an increase in the percentage of originated loans.[53]

Chart 5
Perentage Distribution of First Mortgage Originations in North Carolina by FICO Score Before and After Law



Source: Elliehausen & Staten, (citing AFSA data).

In addition, the annual interest rates on loans before and after passage of the North Carolina anti-predatory law broadly reflected the loans' risks, according to the study. Table 7 presents the average risk premium on mortgage loans originated in North Carolina by the nine finance companies under review (risk premium is defined as the difference between the interest rate on mortgage loans and the interest rate of a Treasury security of comparable maturity) for a range of FICO score categories. The data suggest a strong relationship between credit risk and risk premiums both before and after the North Carolina law began to be implemented. Borrowers with higher incomes and higher FICO scores generally paid lower interest rates. If the law had indeed driven out predatory lending in the state, as suggested by proponents of the legislation, then subprime pricing after enactment should have shown a stronger relationship with borrower risk than before enactment of the law. However, these data do not suggest that the fundamental pricing structure of subprime loans in North Carolina was altered. According to the authors of the study, the data suggest that the North Carolina statute did impede

the flow of mortgage credit to higher-risk borrowers, and any reductions in predatory lending were probably achieved at the expense of fewer legitimate loans.[54]

Table 7

Average Risk Premiums in North Carolina by FICO Score

FICO Score	Risk Premium (%) Before Enactment	After Enactment
680+	6.1%	5.7%
650-679	6.4%	6.4%
620-645	6.7%	6.7%
600-619	6.9%	6.9%
580-599	7.2%	7.1%
550-579	7.3%	7.2%
500-549	7.5%	7.3%
500	7.9%	7.2%

Source: Elliehausen and Staten (citing AFSA); Risk premium is the difference between interest rate on loans and rate on comparable maturity Treasury security. Before enactment period is from Q197 to Q3 99. After enactment is from Q4 99 to Q2 2000.

The study does have a number of shortcomings, however. The authors maintain that the data used in the analysis are highly representative of the subprime mortgage market in general and that the volume of subprime lending activity captured by their data is a substantial component of all subprime lending. However, while these data do indeed contain information on borrower risk characteristics, they do not cover the entire market, as does the HMDA data. It is also a smaller sample than covered by the LP database. In addition, the nine finance companies used in the Elliehausen and Staten study are the largest in the marketplace and therefore probably receive the most scrutiny from the government. So, these firms may not be the worst offenders as far as predatory lending tactics are concerned.

In addition, the AFSA database used in the study only covered loan originations through June of 2000, one month prior to the final implementation date of the law. Some of the law's prohibitions were enacted in late 1999. So, the database did cover this period. Elliehausen and Staten assert that since lenders had full knowledge of all of the law's final provisions ahead of time, they would have adjusted their lending behavior in advance of the final implementation date. However, this remains an open question at this juncture.[55]

A study by economists Harvey and Nigro that used the broader HMDA data examined the effects of predatory lending laws enacted by the cities of Chicago and Philadelphia. The results tended to compliment those of the Elliehausen and Staten analysis. The Chicago law focuses on banks. Specifically, it bars the City of Chicago from placing any of its $1 billion in municipal funds at banks with predatory loans (defined as mortgages with interest rates five percentage points or more higher that the yield on U.S. Treasury securities of comparable maturity). The Philadelphia law, which was subsequently preempted by a state law, imposed an escalating series of limitations and sanctions on all mortgage lenders, based on the spread between the mortgage rate and comparable Treasury securities. The analysis concludes that although it is likely that the state and city predatory lending laws may have reduced or eliminated some predatory practices, the results suggest that policymakers need also be concerned about their impact on legitimate subprime lending. The reduction in subprime lending after the passage of the laws was significant and it is likely that a good portion of this was not predatory in nature.[56]

Issue #12: Is the Pattern of Subprime Lending Activity in Lower Income and Minority Locales Different Than That In Higher Income Areas?

Studies by HUD and other researchers have documented the high rates of subprime lending in low-income and minority communities. Each year HUD identifies a list of lenders that are engaged in predominantly subprime lending (50% or more). The lists are updated each year based on conversations with lenders and information obtained from HMDA data analysis, trade publications, and lenders websites. According to the HMDA data from 2001, minority borrowers represent 17.5% of all borrowers in the prime segment of the mortgage market. However they account for more than 36% of borrowers in the subprime segment. Low-and moderate-income borrowers also are disproportionately represented in the subprime market. Roughly 39% of prime borrowers have low to moderate incomes while 54.3% of subprime borrowers have low to moderate incomes.

In 2000, HUD issued a report entitled "Unequal Burden: Income and Racial Disparities in Subprime Lending in America" documenting the concentration of these lenders in low-income and minority communities in five cities including Atlanta, Los Angeles, Baltimore, New York and Chicago. They found that subprime loans were three times more likely in low-income neighborhoods than in high-income neighborhoods and five times more likely in black neighborhoods than in white neighborhoods.[57] More recently, a study prepared by Calvin Bradford (2002) on subprime lending patterns in all of the nation's 331 metropolitan areas, states that there are "widespread" racial disparities in subprime lending activity nationwide and that African Americans and Latinos have a disproportionately representation in the subprime lending market and that these patterns persist across all income levels and throughout the nation.[58]

Issue # 13: What Issues Are Raised By These Disparities?

These disparities raise the specter that lower income and minority groups are more often the victims of predatory lending or at the very least are being poorly served by the industry. According to the Bradford study, the racial disparities in levels of subprime lending do not, in and of themselves, constitute conclusive proof that there is widespread discrimination in the subprime lending markets. However, Bradford asserts that these disparities do raise serious questions about the extent to which risk alone could account for such patterns. He argues that the issue of whether there is racial exploitation in the subprime markets essentially rests on two issues. First, are the disparities in subprime lending related to race? Second, can these disparities be fully explained by legitimate risk factors?[59]

In the view of many community groups active in the predatory lending debate, as well as of some researchers, risk alone does not explain the racial disparities. They point to the absence of active mainstream prime lenders in minority markets which they assert has increased the chances that borrowers in these communities paying higher interest rates. For example, the assertion by Bradford that racial disparities actually increase as income increases suggests that a portion of subprime lending is occurring with borrowers whose credit histories would qualify them for lower-cost, conventional, prime loans. In addition, the level of disparity presented in studies which showed African American households had more credit problems than majority households was not equal to the level of disparities seen in subprime lending.[60]

Issue# 14: What Is The Quantitative Evidence Regarding The Percentage Of Subprime Borrowers Who Could Have Qualified For A Prime Loan?

In a 1996 release, Freddie Mac estimated that from 10% to 35% of borrowers who obtained mortgages from the subprime market could have qualified for a conventional loan through Loan Prospector (Freddie Mac's automated underwriting system).[61] These and other similar statistics have been viewed by some as evidence of steering or some other form of predatory practice.

As discussed earlier, risk plays a dominant role in determining whether or not a borrower ends up in the subprime market. Table 8, which was assembled by OTS, shows the percent of subprime mortgages in the MIC database within specific credit score categories. These data generally support the case that less creditworthy borrowers receive the great majority of subprime mortgage loans, as 81% of subprime loans have credit scores below 660.[62] As discussed earlier, all of the major regulatory agencies use 660 as the cutoff point to denote borrowers that are at high risk of default. In addition, many prime lenders generally regard 680 as the point at which a borrower comes into consideration for a prime loan. Over 88% of the MIC subprime mortgages are associated with credit scores below 680.

At the same time, 11.8% of borrowers with credit scores above 680 received subprime mortgage loans. This is at the very low end of the range estimated in the Freddie Mac release. It is probable, therefore, that the Freddie Mac figures represents a substantial overestimate. Indeed, the range estimated by Freddie was made in 1996 when the subprime market was in a significantly less competitive stage of its development. In addition, automated underwriting does not take into account many of the non-quantitative factors that can influence denial rates. The Freddie Mac researchers themselves pointed out that lack of financial sophistication played a large role in the behavior of these borrowers and do not necessarily view these figures as evidence of predatory practices.

Table 8

Percentage Distribution of Subprime Mortgages by Credit Score

Credit Score	Percent
Under 400	0.02%
400 to 479	1.1
480-519	6.2
520-539	7.5
540-559	9.9
560-579	11.2
580-599	11.8
600-619	12.1
620-639	11.5
640-659	9.7
660-679	7.2
680-699	4.8
700-719	3.2
Over 720	3.8

Source: OTS (citing MIC); Percent figures based on $ volumes.

Issue# 15: What Other Data Exist On The Issue of Racial Disparities in Subprime Lending?

Empirical studies suggest that the subprime market is highly competitive and that the disparities that do exist are for the most part due to differences in credit risk among groups of borrowers. The widely cited Freddie Mac study of the subprime market discussed under Issue #8 in this piece attempted to look separately at race and ethnicity, in addition to those of borrower risk, educational background, age and effort expended in searching for the best rate on a mortgage loan. As mentioned previously, the study found that borrower risk was by far the most important factor in explaining whether or not an applicant took out a subprime loan. The study also determined that education, age and search effort were significant, though less important factors than risk. However, Freddie Mac also determined that their data provided no evidence that race or ethnicity had any significant independent impact on whether or not a borrower ended up with a subprime loan when statistically controlling for risk, search effort, educational background, age or other demographic factors.[63]

Other empirical data appear to support this contention. As mentioned earlier, some researchers assert that one of the symptoms of predatory lending in a locale is the lack of a close connection between the interest rates charged on subprime mortgages and borrower risk. They argue that predatory lenders steer less sophisticated applicants into loans that are overpriced relative to the borrower's risk profile. If this were indeed the case, then a law that eliminates predatory lending should result in the re-establishment of a close relationship between price and borrower risk.[64]

Table 9

Subprime Market Loan Originations in the Pre- and Post- Legislation Periods Minority Borrowers

	Total Subprime Origination in North Carolina	Minority Subprime Originations In North Carolina	Percent of Total Subprime Originations In North Carolina	Minority Subprime Originations In Neighboring States	Percent of Total Subprime Originations In Neighboring States
Before Law	41,203	8,482	20.6%	23,653	22.48%
After Law	35,157	7,116	20.24%	27,388	25.38%
% Change	-14.67%	-16.1%		15.79%	

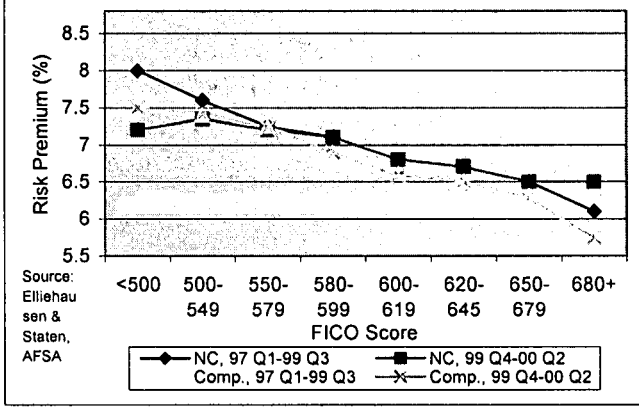
Source: Harvey and Nigro (citing HUD), OCC.

In North Carolina, according to HUD data, minorities represent over one fifth of all subprime borrowers (Table 9). Therefore, these borrowers should figure significantly in the risk/ pricing structure observable on subprime loans within the state. As mentioned above, if anti-predatory laws were successfully eradicating this form of lending, then

there should be a shift in the relationship between price and borrower risk on subprime loans following the imposition these statutes resulting in a stronger connection between price and underlying borrower risk.[65]

However, econometric studies do not support this contention. For example, according to Elliehausen and Staten, in North Carolina, the relationship between the average risk premium -- defined as the difference between the mortgage rate and the interest rate for a Treasury security with a comparable term -- and FICO scores of borrowers was very similar both before and after the state's anti-predatory law began to be implemented. Prior to enactment, higher borrower risk (i.e. lower FICO scores) was associated with higher risk premiums. After the law began to be implemented, the relationship between risk premiums and FICO scores of borrowers was very similar. Higher risk borrowers continued to pay virtually the same higher risk premiums. If the legislation actually reduced predatory lending in the state, then there should have been a significant change in the relationship between risk premiums and FICO scores after enactment. However, this was not the case (Chart 6).[66]

Chart 6
Mean Risk Premiums in North Carolina and Comparison Group States by FICO Score



Source: Elliehausen & Staten, AFSA

In addition, to the positive relationship between risk and risk premiums in both periods in North Carolina, there was also a similar relationship in a group of surrounding states where no such legislation was enacted. As illustrated in Chart 6, the level of average risk premiums in North Carolina and surrounding states, for loans with scores in the same FICO range, differed by no more than about 50 basis points during the pre- and initial post-enactment periods. Therefore, according to Elliehausen and Staten, the data do not suggest that the relationship between interest rates on subprime loans and borrower risk in North Carolina was altered, relative to the comparison states, as a result of the state's anti-predatory law. This casts further doubt on the view that the decline in lending in North Carolina following the passage of the anti-predatory statutes resulted entirely from eliminating predatory practices.[67]

Issue #16: What is the Role for CRA In Curbing Predatory Lending Abuses?

As it is currently implemented, CRA does not penalize banks that engage in predatory lending, directly or indirectly. Some policymakers and researchers have recommended that CRA be utilized to create disincentives to banks that engage in or provide indirect support for predatory lending. Engel and McCoy (2002) recommend that federal bank regulators use CRA to penalize behavior that could further predatory lending. They identify two justifications for the use of CRA in reining in predatory lending. The first justification stems from CRA's goal of encouraging banks to serve the credit needs of their communities. If CRA is creating incentives for banks to engage in predatory lending, then CRA is actually defeating one of its stated goals according to Engel and McCoy. The second justification, according to the two professors arises from the fact that banks are the recipients of special government privileges in the form of exclusive charters, federal deposit insurance and so forth. These subsidies are considered part of the rationale for imposing CRA obligations on banks. If banks use these privileges to harm the communities they serve, there is a role for CRA in scrutinizing bank activities.[68]

A potential issue with Engel's and McCoy's analysis is that its conclusions rest upon a number of assumptions, each of which is not entirely clear-cut. For example, the two professors state that "predatory lending has surged" and therefore, there is a role for CRA to rein in these abuses However, as analyzed earlier, while anecdotal evidence suggests that predatory lending is a problem, its magnitude remains unclear, particularly among banks. Moreover, despite the fact that many economists and other researchers have examined the issue, there remains much debate over whether the higher rates and fees charged on many subprime loans are predatory or simply reflect higher borrower risk, servicing costs or demand factors related to the macroeconomy. In addition, Engel's and McCoy's own report points out that predatory lending by banks is probably insignificant due partly to a whole host of disincentives.

Another assumption of Engel and McCoy, is that banks are subsidized by the taxpayer supported deposit insurance system and other factors. They assert that banks receive special government privileges in the form of exclusive charters, federal deposit insurance and so forth. According to Engel and McCoy, these subsidies are considered part of the rationale for imposing CRA obligations on banks.[69] However, there is actually a good deal of debate among economists as to whether or not banks are actually subsidized. For example, a rough measure of the fair value of deposit insurance is what banks pay customers for uninsured deposits, over and above what they pay customers for insured deposits. Surveys of institutional brokers on Wall Street typically demonstrate that well-capitalized banks typically pay little or no premium for uninsured money. At the same time, banks must pay for deposit insurance and in addition incur considerable expense to comply with a broad array of regulatory requirements.

Endnotes:

[1] U.S. Department of Housing and Urban Development (2000), "Unequal Burden in Atlanta: Income and Racial Disparities in Subprime Lending," Washington, D.C. Companion studies were also performed by HUD for Baltimore, Los Angeles, and New York and Chicago.

[2] "Risk or Race? Racial Disparities and the Subprime Refinance Market," A Report of the Center for Community Change, prepared by Calvin Bradford, Calvin Bradford & Associates, LTD. May 2002, Executive Summary.

[3] "The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment," Roberto G. Quercia, Michael A. Stegman, Walter R. Davis, Center for Community Capitalism, The Frank Hawkins Kenan Institute of Private Enterprise, University of North Carolina at Chapel Hill, Chapel Hill, NC 27599-3440, June 25, 2003.

[4] "Regulation of Subprime Mortgage Products: An analysis of North Carolina's Predatory Lending Law," by Gregory Elliehausen and Michael Staten, Credit Research Center Working Paper #66, November 2002.

[5] The before and after periods looked at by Elliehausen and Staten were different than those used in the Quercia, Stegman and Davis study. The pre-enactment period used by Elliehausen and Staten went from the first quarter of 1997 through the third quarter of 1999, immediately prior to the implementation date of the first set of new regulations under the North Carolina anti-predatory statute on October 1, 1999 (essentially the same as the period used in the Quercia, Stegman and Davis study). However, the AFSA database ends its coverage in June of 2000, one month before the final implementation date of the law. Therefore, the second period examined in the Elliehausen and Staten study only includes originations from the fourth quarter of 1999 through the second quarter of 2000. Elliehausen and Staten assert that because the statute was phased in over 12 months, the impact of the North Carolina measure would be seen on originations before the final implementation date (July 1, 2000). He concedes that the window for detecting alterations in lending patterns following passage of the North Carolina law is brief. However, he points out that parts of the statute (most notably the prohibition on prepayment penalties) became effective as early as October 1, 1999 and all of the new regulations were known to lenders as early as July 1999. So, Elliehausen and Staten (p. 10) assert that it is reasonable to expect that creditors would not wait for the law to be fully effective to adjust their lending behavior.

[6] "Impact of Predatory Lending Laws on RMBS Securitizations," by Christine Lachnicht, Moody's Investors Service, Structured Finance, Special Report, March 26, 2002, pp. 1,5.

[7] "Predatory Lending," HUD Treasury Special Report, U.S. Department of Housing and Urban Development 451 7th Street S.W., Washington, DC 20410. p. 44.

[8] HUD Treasury Special Report, p. 44.

[9] "The CRA Implications of Predatory Lending," Kathleen C. Engel and Patricia A. McCoy, 29 Fordham Urban Law Journal 1571 (2002) forthcoming, p.16.

[10] Engel and McCoy, p. 7, footnote (citing HUD).

[11] Engel and McCoy, p. 19 (citing Robert E. Litan et al., The Community Reinvestment Act After Financial Modernization: A Baseline Report 2 (2000).

[12] Engel and McCoy, p. 19 (citing HUD Treasury Report).

[13] HUD Treasury Special Report, p. 30.

[14] HUD Treasury Special Report, p. 31.

[15] HUD Treasury Special Report, pp. 31.

[16] HUD Treasury Special Report, p. 41.

[17] Engel and McCoy, pp. 2-3.

[18] "Separate and Unequal: Predatory lending In America," Association of Community Organizations for Reform Now, November 2002, p. 2.

[19] Engel and McCoy, p. 7.

[20] Engel and McCoy, pp.15-17 (citing Litan)

[21] Engel and McCoy, p. 7, footnote (citing HUD).

[22] Engel and McCoy, p. 19 (citing Litan).

[23] Engel and McCoy, p. 19 (citing HUD Treasury Report).

[24] These data appear in the first appendix table of: "On the Economics of Subprime Lending," by Amy Crews Cutts and Robert Van Order, March 2003 (obtained from the Freddie Mac Website, http://www.freddiemac.com/corporate/reports/).

[25] These data appear in the first appendix table of: "On the Economics of Subprime Lending," by Amy Crews Cutts and Robert Van Order, March 2003 (obtained from the Freddie Mac Website, http://www.freddiemac.com/corporate/reports/).

[26] "What About Subprime Mortgages," Mortgage Market Trends, Research and Analysis, Office of Thrift Supervision, Washington, DC. Volume 4, Issue 1, June 2000, p. 2.

[27] "What About Subprime Mortgages," Mortgage Market Trends, Research and Analysis, Office of Thrift Supervision, Washington, DC. Volume 4, Issue 1, June 2000, p. 2.

[28] Mortgage Market Trends, OTS, p. 11.

[29] Cutts and Van Order. p. 4-5.

[30] Mortgage Market Trends, OTS, p. 12.

[31] Based on data appearing in Figure 1in the appendix of: "On the Economics of Subprime Lending," by Amy Crews Cutts and Robert Van Order, March 2003. The study cites Loan Performance, and the Freddie Mac Primary Mortgage Market Survey as the original source for the data.

[32] Cutts and Van Order, p. 5.

[33] Cutts and Van Order, p. 5.

[34] Specialty Lender Weekly, September 11, 2000.

[35] "Subprime Lending: An Investigation of Economic Efficiency," Howard Lax, Michael Manti, Paul Raca, Peter Zorn, Corresponding author: Peter Zorn, Freddie Mac, December 21, 2000, p. 18.

[36] Lax, Manti, Raca, and Zorn, p. 18.

[37] Lax, Manti, Raca, and Zorn, p. 22.

[38] Lax, Manti, Raca, and Zorn, p. 17.

[39] Lax, Manti, Raca, and Zorn, pp. 17-19. The authors point out that their analysis does not take into account the higher average origination points and fees paid by subprime borrowers. So their figure of 100 basis points may underestimate the degree of inefficiency in the subprime market, according to the study. However, spreads have come down since the time of the study, so this would counter some of that effect.

[40] Lax, Manti, Raca, and Zorn, pp. 12-16.

[41] Lax, Manti, Raca, and Zorn, pp. 19.

[42] In Lax, Manti, Raca and Zorn, p. 20, it states: "... Nor is there the overall standardization of products, underwriting and delivery systems that is found among prime lenders. Increasing price competition in the subprime sector is likely changing this, enhanced by the recently more aggressive entry of prime market participants."

[43] Quercia, Stegman and Davis, pp. 21-22.

[44] Quercia, Stegman and Davis, pp. 21-22.

[45] Quercia, Stegman and Davis pp. 1-6.

[46] Interagency Guidance on Subprime Lending, originally issued on March 1,1999.

[47] These changes in the database are pointed out in the study, and our comments on the database are adapted from those provided in the study. [See Quercia, Stegman and Davis, footnote 8 on p. 18].

[48] See endnote 5.

[49] Elliehausen and Staten, pp. 13-15.

[50] "Regulation of Subprime Mortgage Products: An analysis of North Carolina's Predatory Lending Law," by Gregory Elliehausen and Michael Staten, Credit Research Center Working Paper #66, November 2002.

[51] "Regulation of Subprime Mortgage Products: An analysis of North Carolina's Predatory Lending Law," Credit Research Center Working Paper #66, November 2002, by Gregory Elliehausen and Michael Staten.

[52] See endnote 5.

[53] Elliehausen and Staten, p. 14 and appendix Chart 4.

[54] Elliehausen and Staten, pp. 14-15.

[55] See endnote 5.

[56] Comments from a memorandum by Peter J. Nigro to Jonathan Fiechter entitled: "Summary of Research of Predatory Lending Law. " The memo summarized an earlier piece entitled: "How do Predatory Lending Laws Influence Mortgage Lending in Urban Areas? A Tale of Two Cities," by Keith Harvey and Peter J. Nigro, Unpublished Abstract, March 2002.

[57] U.S. Department of Housing and Urban Development (2000), "Unequal Burden in Atlanta: Income and Racial Disparities in Subprime Lending," Washington, D.C. Companion studies were also performed by HUD for Baltimore, Los Angeles, and New York.

[58] "Risk or Race? Racial Disparities and the Subprime Refinance Market," A Report of the Center for Community Change, prepared by Calvin Bradford, Calvin Bradford and Associates, LTD. May 2002, Executive Summary.

[59] Bradford, Executive Summary.

[60] "Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)" 65 Fed. Reg. 65,044, 65,053 (Oct. 31, 2000).

[61] "Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America's Families," Freddie Mac, ch. 5 and pp 5-6 (Sept. 1996).

[62] Mortgage Market Trends, OTS, p. 8.

[63] Lax, Manti, Raca, and Zorn, pp. 15.

[64] Elliehausen and Staten, pp. 14-15.

[65] Elliehausen and Staten, pp. 14-15.

[66] Elliehausen and Staten, pp. 14-15.

[67] Elliehausen and Staten, pp. 14-15.

[68] "The CRA Implications of Predatory Lending," Kathleen C. Engel and Patricia A. McCoy, 29 Fordham Urban Law Journal 1571 (2002) forthcoming.

[69] Engel and McCoy, pp. 20-23.

The Impact of Federal Preemption of State Anti-Predatory Lending Laws on the Foreclosure Crisis

Research Report

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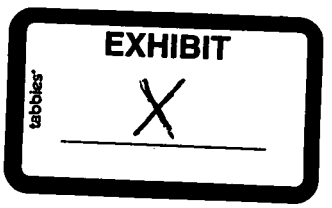

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Executive Summary

Federal preemption of state anti-predatory lending laws ("APLs") has received increased attention in recent debates over the subprime crisis. This is because lending by preempted lenders accounts for a significant share of the mortgage market and federal laws regarding mortgage lending had been substantially less restrictive than many state laws before the crisis. As policy makers try to deal with mounting foreclosures, it is important to understand the role that federal preemption had played in the foreclosure crisis. The overall goal of this study is to examine the impact of federal preemption, namely the 2004 preemption of state laws by the Office of the Comptroller of the Currency on the performance of loans preempted and those that remained subject to stronger APLs.

We examine whether OCC preemption had an effect on the behavior of lenders during the subprime boom and thus also had an effect on the foreclosure crisis that followed. Our *a priori* expectation was that after the OCC preemption, the quality of mortgages originated by preempted lenders would become worse in states with strong APLs because preempted institutions were no longer required to abide by more stringent state regulations, and that this deterioration in underwriting standards increased default risk in these states.

In this study, we test this contention by examining the performance of mortgages originated by lenders in states with and without APLs, before and after the 2004 OCC preemption. More narrowly, we test for a preemption effect in two ways: changes in the quality and performance of loans originated by OCC lenders and changes in the performance of loans originated by lenders subject to different regulators. By focusing on a large sample of privately securitized nonprime mortgages, we are able to identify the extent to which the 2004 ruling contributed to the foreclosure crisis that followed. The results suggest that preemption resulted both in deterioration in the quality of and in the increased default risk for mortgages originated by OCC-regulated lenders in states with anti-predatory lending laws. More narrowly, they show that OCC-preempted lenders increased their share of loans originated with risky subprime characteristics. Similarly, they show that loans originated by OCC-preempted lenders were more likely to default in APL states after the OCC preemption. Finally, the results show that in the refinance market the increase in default risk among OCC lenders often outpaced that of independent mortgage companies that remained subject to stronger APLs after 2004.

The study has important policy implications for the current regulatory reform debate. The larger increase in default risks of OCC-regulated lenders after the preemption suggests that even during the subprime boom, state APLs did protect consumers from risky mortgage products. It also suggests that the OCC preemption removed those protections for covered lenders who gained market share in the origination of risky subprime loans that led to the foreclosure crisis. We believe that these results provide compelling support for policy proposals that require the Federal law to provide a regulatory floor while allowing states to adopt stronger APLs based on local conditions. Re-examining federal preemption on the basis of these results is likely to better protect consumers and to help ensure against future excesses in the mortgage market.

The Impact of Federal Preemption of State Anti-Predatory Lending Laws on the Foreclosure Crisis

1. Introduction

Federal preemption of state anti-predatory lending laws (APLs) has received increased attention in recent debates over the subprime crisis. This is because federal laws regarding mortgage lending had been substantially less restrictive than many state laws in recent years and because lending by preempted lenders accounts for a significant share of the mortgage market. As policy makers try to deal with mounting foreclosures, it is important to understand the role that federal preemption may have had in the subprime boom and the resulting foreclosure crisis. The overall goal of this study is to examine the impact of federal preemption, namely the 2004 preemption of state laws by the Office of the Comptroller of the Currency (OCC) on the recent mortgage foreclosure crisis.

There is ample justification for this examination. As research has shown, many loans features and mortgage underwriting practices addressed by state anti-predatory lending laws have been associated with higher default risks (Calhoun and Deng 2002; Ambrose, LaCour-Little, and Huszar 2005; Quercia, Stegman, and Davis 2007; Immergluck 2008; Pennington-Cross and Ho 2010). These include features such as prepayment penalties, balloon payments, lack of verification of borrowers' repayment capacity, and very high interest rates and fees. There is also some preliminary research that demonstrates that an effective APL improves the quality of loans originated by giving lenders an incentive to tighten underwriting standards, thereby reducing default and foreclosure rates (Goodman and Smith 2009). In a descriptive analysis, Ding, Quercia, and White (2009) find a lower foreclosure rate in states with stronger mortgage market regulations.

Federal preemption of stronger state laws may lead to riskier underwriting standards and undermine the protections states have put into place. The Office of Thrift Supervision (OTS) exempted federally chartered thrifts and their operating subsidiaries from state anti-predatory lending laws (and broadly from many credit regulations) in 1996. In February 2004, the OCC officially preempted national banks and their operating subsidiaries from most state laws regulating mortgage credit, including state anti-predatory lending laws, arguing that they should only be subject to federal laws regulating mortgage credit. As a result, mortgage lenders regulated by the OCC were free to disregard state laws and therefore mortgage loans made by these lenders generally were not subject to restrictions on loan terms or requirements to verify a borrower's ability to repay. Considering the ever-growing share of subprime mortgages originated by national banks, thrifts, and their subsidiaries—all preempted by federal laws[1]—there is some debate whether such preemption is to blame, at least in part, for the current foreclosure crisis (Belsky and Essene 2008; Bostic, Engel, McCoy, Pennington-Cross, and

[1] In fact, mortgage lending by preempted lenders accounted for a significant share of the market. The share of high-cost loans that were preempted in APL states increased from 16 percent in 2004 to 46 percent in 2007. Although "high-cost" or "higher-priced" are not strictly analogous to "subprime," many researchers use these three terms interchangeably.

Wachter 2008b). It should be noted that the 1996 OTS preemption came early on in the development of the subprime market, while the OCC preemption seems to have coincided with the beginning of the explosive growth in that industry when underwriting standards overall were declining (Demyanyk and van Hemert 2008). In the present study, we focus on the impacts of the latter.

We contend that federal preemption did affect the behavior of lenders during the subprime boom and thereby had an impact on the foreclosure crisis. There is good evidence that some types of loan features tend to be used less in states with APLs and that restrictive laws can reduce the flow of subprime credit (Pennington-Cross, Chomsisengphet, Bostic, Engel, McCoy, and Wachter 2008). The less restrictive federal regulation would therefore result in more originations of risky loans and changes in the product mix of preempted lenders. In turn, this is likely to lead to changes in patterns in mortgage performance. Our *a priori* expectation was that after the OCC preemption, the quality of mortgages originated by preempted lenders would become worse in states with strong APLs because they were no longer required to abide by more stringent state regulations, and that this deterioration in underwriting standards would increase default risk in these states. We also expected this effect would be strongest in the refinance market where state APLs were more stringent.

In this paper, we test this contention by examining the performance of mortgages originated by lenders in states with and without APLs, before and after the 2004 OCC preemption. More narrowly, we test for a preemption effect by examining changes in the quality and performance of loans originated by OCC lenders and changes in the performance of loans originated by lenders subject to different regulators. By focusing on a large sample of privately securitized nonprime mortgages, we are able to identify the extent to which the 2004 ruling contributed to the foreclosure crisis that followed. We compare the product mix and the probability of default of mortgages originated by preempted lenders before and after the 2004 OCC preemption in states with and without APLs. The results support our *a priori* expectations and suggest that preemption resulted both in the deterioration in the quality of loans, and in the increased default risk for mortgages, originated by OCC lenders in states with strong anti-predatory lending laws.

Notably, the increase in default risk of OCC-regulated lenders in the refinance market outpaced that of independent mortgage companies, which also originated a large share of subprime loans but which remained subject to state laws. These effects are statistically significant for both fixed and adjustable rate refinance loans. We believe that these results provide strong support for policy proposals that would have the Federal law provide a regulatory floor while allowing the states to adopt stronger APLs based on local conditions. (We note that the findings are sensitive to the inclusion or exclusion of one outlier.)

The remainder of the study is divided into five sections. In Section 2, we review the recent studies on the impact of state anti-predatory lending laws and the impact of federal preemption. In Section 3, we describe the method used to identify the impact of federal preemption. In Section 4, we describe the dataset used for this study, including the unique dataset created by merging private securitizations and the Home Mortgage Disclosure Act data. Section 5 presents

our regression results. In the final section, we summarize the results and derive policy implications.

2. Literature Review

Since 1999, when North Carolina passed the first state anti-predatory lending law, researchers have tried to understand how APLs impact the mortgage market, including credit flows, cost of credit, and mortgage product substitution. Recent research has started to examine how APLs affected the use of more exotic loan types and how state laws impacted mortgage foreclosure rates across states and neighborhoods. One area that has received almost no empirical attention is the impact of federal preemption. This is an important omission since addressing the causes of the current crisis may require understanding the role played by federal preemption. To provide the background and context to the present study, in this section, we review the literature on the coding of APLs, the impact of APLs on mortgage foreclosure rates, and the impact of federal preemption.

2.1 Coding of State Anti-Predatory Lending Laws

During the period leading up to the subprime foreclosure crisis, from 2000 through 2007, many states adopted laws regulating subprime mortgage lending. The laws were intended to curb so-called predatory practices while permitting non-abusive subprime lending to develop (Li and Ernst 2007). Most of these state laws were modeled after the federal Homeownership Equity Protection Act (HOEPA) adopted in 1994,[2] although there are several states that took various different approaches. The federal HOEPA statute restricts loan terms for mortgages with high prices, based on either the APR or the total points and fees imposed. The mini-HOEPA laws, in turn, can be divided between those that replicated the federal coverage and restrictions, and those that extended HOEPA to either cover more loans, or restrict more contract terms, or both.

Because there is significant variation in the coverage and strength of APLs across different states, most researchers have developed a set of indices to quantify the substantial variation in the laws. Ho and Pennington-Cross (2006) created a two-component index of state laws. The first component, "coverage," reflects the extent to which a law extends market coverage beyond HOEPA; the second component, "restriction," reflects the extent to which a law restricts or requires specific practices on covered loans. Bostic et al. (2008a) further added the enforcement index, which includes measures of assignee liability and enforcement against originators.

However, it seems the different components of the composite index of state laws may have "slider effects" in which the strength of the coverage component offsets the effects of the restriction component. For example, stronger restrictions are likely to reduce subprime loan volumes while increasing the coverage of a state law may in fact mitigate this effect since

[2] Home Ownership and Equity Protection Act, Pub. L. No. 103-325, subtit. B of tit. I, §§151-158, 108 Stat. 2160 (1994).

because potential applicants may feel more comfortable applying for a subprime loan if a lending law covers their application (Bostic et al. 2008a).

In a few other studies, researchers have used a simple dummy to indicate whether a state had adopted the APL at a particular time (e.g. Pennington-Cross et al. 2008). But there is also a fundamental difference between the states that extended restrictions on subprime mortgages beyond federal requirements, and states that simply copied federal HOEPA restrictions into their state statutes. Some state laws did not extend coverage beyond mortgages covered by federal law. In several instances, the intent of these laws was to preempt local laws and ordinances that imposed greater restrictions than federal law. So it is important to distinguish between these two types of state laws when comparing results.

Another approach employed in Li and Ernst (2007) ranks state laws according to the type of loans covered, points-and-fees triggers, substantive legal protections, and remedies available to borrowers. The advantage of this approach is that it is easier to derive policy implications based on these measures. But because they finished their study in 2006, many APLs that were adopted in recent years were not considered in their study. In this study, we developed a state law coding system for high-cost or predatory mortgage laws and overcome some limitations in previous coding.

We reviewed the existing studies, including Pennington-Cross et al. (2008), Bostic et al. (2008a), and Li and Ernst (2007). We also reviewed the description of state laws in several treatises, including Renaurt, Keest, Carter, Wu, and Cohen (2009) and Nelson and Whitman (2007), reviewed various rate matrices that reflect mortgage originators' understanding of state laws, particularly for prepayment penalty restrictions, and then reviewed statutory language itself. A summary of states with strong APLs will be discussed in the Data section and more details about the coding system can be found in Ding, et al. (2009).

2.2 Impact of State Anti-Predatory Lending Laws on Foreclosure Rates

One line of research has started to investigate whether differences in regulatory environment, including state anti-predatory lending laws, contribute to differences in the quality of loans originated and subsequent rates of foreclosure. Many of the features covered under APLs, such as the use of prepayment penalties, balloon payments, lack of verification of borrowers' repayment capacity, and very high interest rates and fees, have been associated with higher default risk. Calhoun and Deng (2002) and Quercia, Stegman, and Davis (2007) found that subprime adjustable-rate mortgages (ARMs) have a higher risk of foreclosure because of the interest-rate risk, the underwriting using teaser rates, and other such practices. At the aggregate level, the share of ARMs appears to be positively associated with market risk, as measured by house price declines (Immergluck 2008). Subprime hybrid ARMs, which usually have prepayment penalties, bear particularly high risk of default at the time the interest rate is reset (Ambrose, LaCour-Little, and Huszar 2005; Pennington-Cross and Ho 2010).

As to prepayment penalties and balloons, Quercia et al. (2007) found that compared to loans without these features, refinance loans with prepayment penalties are 20 percent more likely to

experience a foreclosure, while loans with balloon payments are about 50 percent more likely. Prepayment penalties also tend to reduce prepayments and increase the likelihood of delinquency and default among subprime loans (Danis and Pennington-Cross 2005). Ding, Quercia, Li, and Ratcliffe (2008) identified that ARMs, prepayment penalties, and broker originations all contribute significantly to subprime loans' increased risk of default.

Although the literature does document a clear link between these product features and foreclosures, given the limited publicly available information on loan performance, very few studies have linked state APLs explicitly to local- or state-level foreclosure rates. After controlling for housing market conditions, we would expect to find lower foreclosure rates in states with stronger mortgage market regulations. In a working paper, Goodman and Smith (2009) suggest that the laws governing mortgage underwriting, mortgage foreclosures, and the potential costs to the lender differ substantially across states. Based on the foreclosure rate data constructed from Lender Processing Services Applied Analytics, Inc. (LPS) data and a hierarchical linear model, they found some evidence that mini-HOEPA laws reduce the level of foreclosure. The results suggest that higher lender costs for foreclosure and stringent controls on predatory lending are connected to lower foreclosure rates. However, since Goodman and Smith are only able to use a cross-sectional dataset for one particular month, their paper's applicability may be limited. The presence of seasoned loans in the dataset could introduce significant bias, since loans could have been originated before the enactment of state laws. It is also unclear whether the results can be generalized to other time periods. In addition, Goodman and Smith use the law index from Bostic et al. (2008b), which did not cover years after 2005. As regulations are being proposed and amended to address the current mortgage crisis, further research in the area of laws and regulations and the measurement of their effectiveness is needed (Richter 2008).

2.3 Impact of Federal Preemption

In the United States, residential mortgage lenders have been regulated by a complex web of national and local regulatory bodies. National banks and Federal thrifts (those chartered at the national level) are supervised by the OCC or the OTS, respectively. Before Federal preemption, they were also subject to many of the laws of the states in which they, and their subsidiaries, operate before federal preemption. In contrast, state banks and thrifts (those chartered at the state level) are supervised by either the Federal Reserve System (FRS) or the Federal Deposit Insurance Corporation (FDIC) and by their chartering state. The National Credit Union Administration (NCUA) supervises credit unions. Finally, non-depository independent mortgage companies are regulated by the Department of Housing and Urban Development (HUD) and the Federal Trade Commission and they are subject to state regulations too.

Federal preemption fundamentally changed the regulatory structure for many lenders. The OTS issued a regulation in 1996 that broadly exempted federally chartered savings and loan institutions and their operating subsidiaries from state laws regulating credit. OTS-regulated institutions were therefore free to disregard the state laws discussed above throughout the study period. On August 5, 2003, the OCC issued a Preemption Determination and Order stating that the Georgia mini-HOEPA statute would not apply to National City Bank, a national bank, or to its operating subsidiaries, including non-bank subprime mortgage lender First Franklin Financial

Company. The OCC then issued a broad preemption regulation, effective February 12, 2004, that exempted national banks and their operating subsidiaries from most state laws regulating mortgage credit.[3] The OCC maintained that its regulations override a number of state laws that conflict with a national bank's exercise of its banking powers. Consequently, prior to August 5, 2003, national banks and their subsidiaries were likely subject to state mortgage laws, while after February 12, 2004, they clearly were not.

Federal preemption has intensified the regulatory competition in this dual regulatory system. By allowing certain mortgage lenders to be exempted from complying with state mortgage laws, preemption makes national charters more attractive, relative to state charters, to many institutions.[4] There are several possible negative outcomes from preemption. First, it could result in banks abandoning one regulatory system in favor of the other that may seem more favorable. Now subject to a more relaxed regulation environment, these lenders may feel freer to originate riskier loans, previously covered by stronger state regulation, leading to relatively more foreclosures. Second, preemption could make the regulators unwilling to impose appropriate standards on the institutions they regulate, since banks or thrifts can let regulators compete against one another. Third, preemption might help push the market towards looser underwriting standards, particularly if the direct consequences of these riskier standards are not immediately obvious (e.g., during a housing boom). Thus, the preemption could upset the balance of the dual banking system and cause a systematic failure.

There has been almost no empirical research and only minimal discussion on the impact of federal OCC preemption. Harvey and Nigro (2004) suggest that the APL in North Carolina might have a unique impact on non-bank lenders, which are generally not subject to the same federal oversight as their bank competitors and therefore are perceived as being more likely to engage in predatory lending than banks. However, there is evidence that over this time period, many non-bank lenders were acquired by national banks, thereby avoiding anti-predatory lending laws. Burnett, Finkel, and Kaul (2004), for example, found a shift in subprime lending from non-banks to banks in North Carolina after the 1999 passage of the APL, as well as a change to a significantly higher share of originations by subprime bank lenders in North Carolina than in the control states. The authors suggest that the consolidation in the financial services industry —in particular, the acquisition of subprime lenders by bank holding companies—during the study period may help to explain this finding. They also surmise that another factor driving the results was that bank lenders expected the state anti-predatory lending law eventually to be preempted by federal laws for federally regulated institutions. Similarly, Harvey and Nigro (2004) found that, following adoption of the law, subprime lending by bank lenders held steady while subprime lending by non-bank lenders fell in North Carolina, in comparison with the control states.

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[3] 12 C.F.R. 34.4(a)(4), 69 Federal Register 1904 (Jan. 13, 2004).

[4] Federal bank regulators employed other regulatory techniques during the housing bubble to address concerns about lax loan underwriting, but these were less restrictive than strong state APLs. For example, federal regulators addressed the repayment ability issue through non-binding guidelines, bank examinations, supervisory orders, and sanctions. Thus, preemption did not entirely eliminate oversight of loan terms, but it displaced binding state laws with the less stringent and more opaque federal regulatory structure.

Because of the collapse of the subprime sector starting late 2006, it is important to understand how mortgage market regulations—and who was covered by what—influenced both the deterioration in lending standards and ultimately loan performance. Due to data availability and the timing of the action relative to the growth of the subprime market, we focus on the impacts of the OCC 2004 preemption in the empirical analysis presented below. Did the originations of prime, subprime, and loans with predatory characteristics shift from the non-preempted to preempted institutions? Did the OCC preemption affect the default rates of loans originated by national banks? Did the preemption lead to riskier underwriting standards and higher foreclosures? The existence of federal preemption and APLs creates a natural experiment for an evaluation of the effectiveness of different modes of regulation. The regression analysis in this study complements the descriptive analysis presented in our earlier descriptive examination (Ding et al. 2009).

3. Data

In this section, we describe the data sources used in the analysis. We first describe our coding system of state laws based on their coverage and strength regulating the subprime market. Then we describe the unique dataset created by merging HMDA with a large sample of private-label securitizations. We also used data from several other sources to control for house price dynamics and neighborhood characteristics.

3.1 State Anti-Predatory Lending Law Data

To develop a state law coding system for high-cost or predatory mortgage laws, we reviewed various rate matrices that reflect mortgage originators' understanding of state laws and then reviewed statutory language itself. We identified that mini-HOEPA laws were adopted in 25 states and the District of Columbia on or before December 31, 2007.[5] In addition, five states (Michigan, Minnesota, Nevada, Texas, and West Virginia) passed significant subprime mortgage regulation statutes that were not HOEPA extension statutes and not based on rate and fee triggers. A number of other states had laws adopted prior to 2000 that restricted prepayment penalties, balloon payments, or negative amortization for all mortgages.

Of the mini-HOEPA laws, eight (Utah, Pennsylvania, Nevada, Oklahoma, Ohio [prior to 2007], Maine [prior to 2007], Kentucky, and Florida) did not extend coverage beyond mortgages covered by federal law. In several instances, the intent of these laws was to preempt local laws and ordinances that imposed greater restrictions than federal law. There is thus a fundamental difference between the states that extended restrictions on subprime mortgages beyond federal requirements, and states that simply copied federal HOEPA restrictions into their state statutes.

We developed and coded a set of law variables to describe state laws that could affect the type of subprime mortgages made and the default and foreclosure rates of mortgages in a given state.

[5] Arkansas, California, Connecticut, District of Columbia, Florida, Georgia, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Nevada, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, and Wisconsin.

The binary variable *ineffect*, modeled on Pennington-Cross et al. (2008) and Bostic et al. (2008b), in combination with the effective date variable for the same state and law, is intended to identify states with mortgage statutes that could plausibly have an impact on high-cost or subprime mortgage lending (Figure 1 and Table 1). A value of 1 was assigned for the *ineffect* variable to the states with any restrictions on charging or financing points and fees, credit insurance, prepayment penalties, balloon payments, negative amortization, determination or documentation of income or repayment ability, and/or significant counseling requirements, so long as the state law covers any share of the subprime (or the entire) mortgage market below the HOEPA rate and/or fee triggers. A value of zero (0) was assigned to the *ineffect* variable for the eight states with HOEPA copycat statutes, which is a departure from some prior studies. During the study period, virtually no mortgages were made nationwide that would have been covered by HOEPA's high-cost thresholds (Avery, Brevoort, and Canner 2007). While some of the eight statutes imposed minor additional restrictions not found in federal law on high-cost loans above the HOEPA triggers, it is doubtful that a difference in regulation of a negligible slice of the mortgage market would affect the outcome variables.

So, based on our definition, states with strong APLs prior to 2007 include Arkansas, California, Connecticut, Georgia, Illinois, Indiana, Maryland, Massachusetts, Michigan, Minnesota, New Jersey, New Mexico, New York, North Carolina, Rhode Island, South Carolina, Tennessee, Texas, West Virginia, and Wisconsin, as well as the District of Columbia. A few states (Maine, Rhode Island, and Minnesota) made significant amendments after December 31 2006 but we are not aware of other post-2004 amendments that would change the coding for any state.[6]

3.2 Columbia Collateral File Data

To study the impact of federal preemption on loan performance, the data must include information about loan originations and the regulatory agency governing the lending institution, loan product characteristics, and mortgage performance. By merging the private-label securitization data from the Columbia Collateral file (CCF) with HMDA, we are able to make these variables available for individual mortgages since the CCF data provides rich information on loan features and mortgage performance, while HMDA provides important lender information and borrower income data.

Loan-level data, known as the Columbia Collateral file, provide detailed mortgage information for a national sample of nonprime loans (White 2009; Quercia and Ding 2009).[7] These cover mortgage pools for which Wells Fargo serves as trustee; the pools are serviced by many of the leading mortgage servicing companies. The data are available through remittance reports produced by the trustee and its servicing companies on many mortgage pools, altogether representing more than four million outstanding mortgages.

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[6] Maine made significant amendments in 2007, having enacted a copycat statute previously, so it is treated as *ineffect*=1 for originations after 2008. Minnesota made significant amendments in 2007 but they did not change the value of the *ineffect* variables. Rhode Island's statute was first effective December 31, 2006. We are not aware of other post-2004 amendments that would change the coding for any state.

[7] These investor report files are available at www.ctslink.com, administered by the Corporate Trust Services group of Wells Fargo Bank, N.A.

The CCF dataset consists of monthly loan-level data on nonprime home purchase and refinance mortgages that have been packaged into private-label mortgage-backed securities. It includes mortgages with different interest rate structures (fixed rate, adjustable rate, hybrid rate, interest only, balloon,), different purposes (refinance or purchase), different property types (one-to-four family or multifamily), and different lien statuses (first-lien, second-lien, and others). The data contains loan-level data including the loan interest rate, loan-to-value (LTV) ratio, borrower credit score at origination, origination date, loan amount, whether the loan was based on low- or no-documentation, whether there were prepayment penalties, and whether the loan required a balloon payment. The monthly performance reports provide loan-level details on loan characteristics, defaults, foreclosures, bankruptcy, and losses on foreclosed homes.

To study of the impact of federal preemption, all loans originated from January 1, 2002 through December 31, 2006 in the CCF dataset were initially included in the sample, allowing us to follow cohorts before and after the 2004 OCC preemption. We focus on the performance of these loans during the period from December 1, 2006 to December 31, 2008. So we can gauge their loan performance through the height of the subprime foreclosure crisis. After 2008, the combination of the recession, rapid rise in unemployment, and the changing policy environment make it difficult to isolate the impact of APLs and federal preemption on loan performance (Immergluck 2009).

HMDA data provide rich information on the lenders who originated the mortgages, demographic and other information on borrowers, the geographic location of the property securing the loan, and some characteristics of the home mortgages. HMDA's extensive coverage also provides a broadly representative picture of home lending.[8] To obtain the information on the regulatory structure of lenders, we merged the CCF data with HMDA data using variables that are common in both datasets. We matched data using a geographic crosswalk file that sorted CCF and HMDA loans into the census tracts of the purchased property and then matched loan originations on the following variables: origination date, loan amount, lien status (for loans originated in 2004 and later), and loan purpose.

By pooling all the monthly remittance reports together, we started with more than 3.5 million mortgages that were originated from 2002 to 2006 and were still active as of December 2006. After the match,[9] we had a sample of 2.5 million private securitizations originated from 2002 to 2006, representing about 30 percent of subprime and Alt-A mortgages, and about 5 percent of all U.S. mortgages. The number of national banks and subsidiaries with at least 1,000 originations was 25 in the matched dataset. The top five national banks include Bank of America, Wells Fargo Bank, National City Bank, JP Morgan Chase Bank, and Countrywide Bank. Included in the matched dataset are over 400,000 mortgages in foreclosure during the study period (December 2006 to December 2008). This compares with about two million foreclosures as of December 2008, so our sample includes almost 20 percent of all mortgages in foreclosure.

[8] The match rate is about 70 percent for different cohorts of mortgages in the CCF data, ranging from 57 percent for the 2002 originations to 82 percent for the 2003 originations (Table 2).

[9] Estimations are based on National Delinquency Survey data for the first quarter of 2007 (Mortgage Bankers Association 2008). The National Delinquency Survey data are estimated to cover 85 percent of the residential mortgage market.

The matched dataset includes all the static loan characteristics at origination as well as added information about the borrower's income and information about which regulator oversaw the lending institution that originated the loan. Specifically, the field for agency code in the HMDA data identifies the regulating agency – whether OCC, OTS, FRS, FDIC, NCUA or HUD -- that supervises the lender in question.

Of course, it needs to be noted that the matched sample does not represent a statistically random sample of all mortgage loans or all nonprime mortgage loans. A few caveats about the Columbia Collateral file data need to be mentioned. First, the coverage of the CCF data is limited to securitized subprime and alt-A mortgages, which obviously do not represent the entire mortgage market. The CCF data does not include the portion of nonprime loans that are held in portfolio. Therefore, any systematic difference between loans held in portfolio and those that are securitized may limit the applicability of our results to the portfolio loan market.

Second, only seasoned loans that were still active as of December 2006 are included in this study; thus, we missed the loans that were terminated before December 2006. For example, loans could be dropped out of the pools if they were foreclosed or prepaid, and there could be some inevitable systematic differences between the seasoned loans and those early terminations.

Third, the representativeness of the study sample may be limited for some old cohorts and for some lender types. In particular, the coverage of nonprime loans originated by state banks (regulated by either FRS or FDIC) and by credit unions (regulated by NUCA) was quite limited.[10]

Finally, although our sample is national in scope, loans tended to be geographically concentrated in high-growth states. For example, there is an over-representativeness of loans in California, which had nearly a quarter of all loans.[11]

In other respects, the mortgages in the study sample should be typical of nonprime mortgages originated between 2002 and 2006. Nevertheless, given that nonprime mortgages account for more than half of all foreclosures, and that the vast majority of nonprime loans that led to the crisis were securitized,[12] a study of a sample which covers one fifth of the foreclosures should provide important insights as to the impact of government regulation in the nonprime market.

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[10] We found a limited coverage of this matched sample for the FRS and FDIC loans: originations by FRS and FDIC lenders accounted for less than 15 percent of all subprime loans. Compared to the 30 percent to 40 percent coverage for originations by the OCC and OTS lenders, this dataset may not allow us to conduct a meaningful analysis of the FRS and FDIC lenders. Using the HMDA data, we constructed a sample of subprime originations (based on the subprime list approach for originations before 2004) and high-cost loans (for originations after 2004) that were not sold to government sponsored enterprises (GSEs) as a proxy of the population of private securitizations.

[11] The HMDA data show that California's market share in the conventional mortgage market was around 16 percent during the study period (2002-2006).

[12] According to the National Delinquency Survey, the number of subprime mortgages that were in foreclosure accounted for about 47 percent of the two million mortgages in foreclosure in the fourth quarter of 2008 (MBA 2008). About 59 percent of subprime loans were securitized in 2003, and this rate increased to over 80 percent in 2006 (Inside Mortgage Finance 2008). So the securitized subprime loans should account for a significant share of the total foreclosures during the study period.

For simplicity, we focus on conventional, 30-year, first-lien mortgages and mortgages with non-missing value of origination credit scores, occupancy type, property type, or loan amount. Because the focus of the study is the impact of the OCC preemption, loans originated by federal thrifts and their subsidiaries, originations by state banks (regulated by FRS or FDIC) and credit unions (regulated by NCUA) were also excluded. OTS lenders were not considered because their preemption came early on in the development of the subprime market. The FRS and FDIC lenders were not considered for two primary reasons: 1) the small and likely unrepresentative sample for the pre-preemption cohort (2002-2003 originations); 2) insufficient information about the changes in the regulatory environment for these lenders, especially an unknown portion of state bank loans had been preempted.[13] Loans originated by independent mortgage companies were kept to serve as a benchmark of the performance of OCC originations.

To better isolate the impact of preemption, we focus on the 47 states that either had adopted APLs before 2004 and or had not adopted APLs as of December 2007. Three states, Wisconsin, Indiana, and Rhode Island, adopted APLs between 2004 and 2007 and were dropped from the analysis. Loans originated before the adoption of APLs in APL states were dropped from the analysis.

The final sample size was reduced to about 1.1 million loans. The summary statistics were calculated at the loan level in Table 3. The average loan amount was $255,086. The combined LTV ratio at origination for all loans was around 80 percent and the average Fair Isaac or FICO credit score was a little over 668. A little more than half of all loans provided full documentation (54 percent). Almost half of the loans (49 percent) included prepayment penalties; the share for adjustable-rate mortgages and refinance mortgages was even higher. About 30 percent of loans were interest-only mortgages and almost 8 percent of loans had balloon payments.

During the period, the average serious delinquency rate was 23 percent. In other words, almost one quarter of mortgages had at least one 90-day delinquency between December 2006 and December 2008. Fixed-rate mortgages had lower delinquency rates (12.3 percent for purchase loans and 12.0 percent for refinance loans) while adjustable-rate mortgages had much higher delinquency rates (29.4 percent for purchase loans and 25.9 percent for refinance loans).

4. Research Approach

The primary objective of this section is to determine whether the introduction of federal preemption has led to a change in the quality of loans subprime borrowers use, and as a result, whether loans originated by the preempted lenders in APL states become more likely to default. Using a unique loan-level dataset that allows us to identify both regulatory agencies and mortgage performance during the mortgage crisis, we compared the relative performance of loans originated by preempted lenders in APL states before and after federal preemption.

[13] Some states made provisions in their anti-predatory mortgage laws that permitted state-regulated banks to avoid the laws to the same extent that OCC- and OTS-regulated federal banks could. Thus, loans made by such lenders may have been unaffected by state APLs.

To do so, we ran a set of regression models comparing the performance of mortgages originated by different lender types in APL states to those in non-APL states across time. By controlling for borrower risk factors and neighborhood characteristics, we are able to attribute the relative change in the default risk of different OCC originations to the federal preemption. Using a logit model, we estimated the probability of default for mortgages originated before and after the OCC preemption on February 12, 2004. By comparing the relative default risk (odds ratios) of mortgages originated by OCC and non-bank lenders (independent mortgage companies) in APL states and in non-APL states before and after preemption, we are able to isolate the impact of the OCC preemption on mortgage default, because independent mortgage companies remain subject to state APLs.

Before the OCC preemption, the regression structure can be more formally written as follows:

$$Log(Odds_i) = \alpha + \beta * X_i + \sum_j \eta_j * S_{ij} \quad (1)$$

where $Odds_i$ represents the odds of default for mortgage i. X_i represents the control variables mentioned above other than originator types. S_{ij} represents originator types, which is constructed as a set of interaction variables that combine the regulatory structure of the lender with the presence of a state APL. We consider loans originated by OCC lenders and independent mortgage companies only.

The dummy variables are:

- Loans originated by OCC lenders in non-APL states (OCC_nonAPL, reference group)
- Loans originated by OCC lenders in APL states (OCC_APL)
- Loans originated by independent mortgage companies in APL states (IND_APL)
- Loans originated by independent mortgage companies (IND) in non-APL states (IND_nonAPL)

Loans originated by OCC lenders in non-APL states serve as the reference group for the models, since these should not be affected by either federal preemption or state APLs and instead should reflect the baseline of loan performance for OCC lenders over this period in time. Loans originated by OCC in APL states would have been subject to federal regulation and state APLs before preemption. Loans originated by independent mortgage companies in APL states would not have been preempted, and should be subject to state APLs over the entire study period. Loans originated by independent mortgage companies in non-APL states would not have been affected by federal preemption or state APLs.

In addition to these lender variables, we also control for other factors that might influence default risk, including borrower credit risk, local economic conditions, and house price dynamics. Research has shown that these factors also influence subprime lending, loan features, and loan performance from one market to the next. To capture borrower risk, we control for borrower FICO score, estimated current LTV ratio as of December 2006, property type, and owner occupancy status (owner occupied or not). We also calculated a proxy of borrower debt-to-income ratio using borrower household income and loan amount information available in the

HMDA dataset. To control for local housing and economic conditions, we include data on house price appreciation after December 2006 (based on Federal Housing Finance Agency (FHFA) House Price Indices complimented by the Case-Shiller House Price Indices) as well as the 2007 unemployment rate. These data were obtained from economy.com, a division of Moody's Analytics that provides economic analysis, data, and forecasting and credit risk services. Borrower race information from HMDA is also considered. Loan features other than loan purpose (home purchase or refinance) and loan types (fixed-rate or adjustable-rate) are not included in the model since they are endogenous variables.[14] Definitions of all variables are provided in Table 4.

After the OCC preemption, we expect the effect of state laws on underwriting standards to become weaker for preempted lenders in APL states. As a result, it is expected that the loans originated by preempted lenders in APL states are more likely to default and the coefficients for individual lender types will change from η_j to η_j'. The regression can be rewritten as:

$$Log(Odds_i) = \alpha + \beta * X_i + \sum_j \eta_j' * S_{ij} \quad (2)$$

We assume the coefficient of the OCC_APL variable (origination by an OCC lender in an APL state) can be decomposed into two components: one component (γ_1) capturing the impact of APL alone and the other component (γ_2) representing unobserved difference (such as uncontrolled market conditions) in APL states. Accordingly, for the coefficient of the IND_APL variable, we assume it has three components: the systematic differences between two groups of lenders (γ_{IND}), the impact of APL (γ_1), and the uncaptured heterogeneity such as differences in market conditions in APL states (γ_2). After the OCC preemption, the coefficient for the OCC_APL variable will change from η_{OCC_APL} to η_{OCC_APL}' because of the federal preemption (reflected by the change in γ_1) and/or change in market conditions (reflected by the change in γ_2).

So, before the OCC preemption, the odds ratio of OCC_APL (relative to the reference group) captures the impact of state laws and differences in market conditions in APL states:

$$OR_{OCC\_APL} = \exp(\eta_{OCC\_APL}) = \exp(\gamma_1 + \gamma_2) \quad (3)$$

After the OCC preemption, the odds ratio of OCC_APL becomes:

$$OR_{OCC\_APL'} = \exp(\eta_{OCC\_APL}') = \exp(\gamma_1' + \gamma_2') \quad (4)$$

[14] Of course, the adjustable-rate feature may also be endogenous since most mini-HOEPA laws had interest rate triggers that could be gamed to some extent through use of an adjustable-rate loan. But the adjustable-rate feature alone is generally not as risky as other loan features addressed by state anti-predatory lending laws like prepayment penalties, balloon payments, lack of verification of borrowers' repayment capacity, and very high interest rates and fees.

A direct comparison of the two odds ratios (trend effect presented in Table 6 and discussed below) provides useful information about the change in default risk for OCC lenders after the preemption. But the result is likely biased since such a comparison implies that the overall conditions of the housing and mortgage markets, like differences in the prevalence of different origination channels or differences in underwriting standard, in APL states and non-APL states remained unchanged during the study period, which is unrealistic. To better capture the impact of OCC preemption, we need to make the following two assumptions:

1) The default risk of loans originated by one group of lenders relative to that of another lender group is assumed to be fixed across time, when the regulatory environment and the market conditions do not change. In other words, the ratio between the default hazards of mortgages originated by two groups of lenders is constant over time (the aggregate hazard functions are strictly parallel), if borrower underwriting criteria have been controlled and the regulatory environment and the market conditions are kept constant. This assumption allows us to compare the relative default risk of mortgages originated by two groups of lenders over time. This seems to be a strong assumption but it is quite similar to the key assumption of the Cox proportional hazard model that has been widely employed in mortgage performance studies (Allison 1995).

2) When the regulatory environment has been unchanged and the borrower underwriting criteria have been controlled, the change in mortgage performance over time reflects the change in unobserved market conditions that influence mortgage performance. Since independent mortgage companies had been subject to APLs but almost no other regulations during the study period, we should be able to assume the change in their mortgage performance, other things equal, reflects the changes in market conditions. In other words, the regulatory environment for independent mortgage companies remained the same during the study period and any change in their relative performance could be attributed to changes in housing and mortgage market conditions or in the macroeconomic environment.

Based on these two assumptions, we can use the relative change (trend effect) in the performance of loans originated by independent mortgage companies after the preemption to proxy the unobserved change in local market conditions, which helps us isolate the preemption effect for OCC lenders. Before the preemption, the odds ratio of loans originated by independent mortgage companies is:

$$OR_{IND\_APL} = \exp(\eta_{IND\_APL}) = \exp(\gamma_{IND} + \gamma_1 + \gamma_2) \quad (5)$$

If we assume the systematic difference between independent mortgage companies and OCC lenders is fixed over time,[15] after the OCC preemption the odds ratio of loans originated by independent mortgage companies will be:

$$OR_{IND\_APL'} = \exp(\eta'_{IND\_APL}) = \exp(\gamma_{IND} + \gamma_1 + \gamma'_2) \quad (6)$$

[15] If there was in fact a narrowed gap in terms of the loan quality between those originated by OCC lenders and those by independent mortgage companies (which is very likely), our results underestimates the effect of preemption on mortgage default.

So the impact of preemption on default rate can possibly be identified by calculating the difference between γ_1 and γ_1'. It can be derived by factoring out the changes in local market conditions and the impact of APL alone:

$$preempt\_effect = \frac{\frac{OR_{OCC\_APL'}}{OR_{OCC\_APL}}}{\frac{OR_{IND\_APL'}}{OR_{IND\_APL}}} = \frac{\exp((\gamma_1' - \gamma_1) + (\gamma_2' - \gamma_2))}{\exp((\gamma_{IND} - \gamma_{IND}) + (\gamma_1 - \gamma_1) + (\gamma_2' - \gamma_2))} = \exp(\gamma_1' - \gamma_1) \quad (7)$$

By controlling for borrower risk factors and neighborhood characteristics, we attribute the relative change in odds ratios to the federal preemption. A value greater than one for the effect of preemption indicates the preemption increases the default risk of mortgages originated in APL states. In contrast, a value of one or less suggests the preemption does not increase the default risk, all other things being equal. The significance of the trend effects for OCC lenders and when comparing OCC lenders to independent mortgage companies can be tested using a significant test of coefficients of one logit model among different groups, as introduced in Allison (1999).

We stratified our analysis for different loan categories (home purchase fixed-rate, home purchase adjustable-rate, refinance fixed-rate, and refinance adjustable-rate) and different cohorts (before the OCC preemption in 2004, after preemption and originated in 2004, and originations in 2005 and 2006). Worthy to mention is that we focus on conventional, 30-year, and first-lien mortgages only for this analysis.

Following the idea of this empirical approach, we generated a descriptive table based on the serious delinquency rates of different lender types (OCC or IND) and different law status (with and without APLs) for different cohorts and different markets (Table 5). We calculated the odds ratios based on the observed delinquency rates and compared the odds ratios before and after the 2004 preemption. The results suggest, without controlling other factors, the odds of default increased for both OCC lenders and independent mortgage companies after the preemption (the trend effects were greater than one for all loan types). But the increase in the relative default risk was higher for OCC lenders in the refinance market, while the increase was higher for independent mortgage companies in the purchase market. Of course, changes in borrower credit risk, house price dynamics, or local economic conditions of different groups of mortgages likely influence the mortgage performance. We will control for these factors and draw more concrete conclusions in the next section.

5. Empirical Results

Overall, we do find that the quality of mortgages originated by the preempted lenders after preemption deteriorated in states with APLs, as reflected by the increased risk of default after the OCC preemption. Table 6 provides a summary of the results, presenting the odds ratios and trend effects for mortgages originated by OCC regulated lenders in APL states. The trend effect compares the default risk of mortgages originated by one group of lenders after the preemption (the 2004 or 2005-2006 cohort) to that before the preemption (the 2002-2003 cohort).[16]

Several important trends stand out from the results in Table 6. First of all, loans originated by national banks and their subsidiaries performed relatively better in APL states than those in non-APL states, even after the preemption. The odds ratios of the OCC_APL variable are significant and less than one in most cases. It should be noted that before the 2004 preemption, refinance loans were significantly less likely to default in APL states, measured by the incidence of 90-day delinquency, compared to those made in non-APL states (an odds ratio of 0.653 for fixed-rate loans and 0.728 for adjustable-rate loans). Second, the absolute odds ratios for loans originated by OCC- regulated institutions had been better than for those originated by independent mortgage lenders for all products and cohorts. This is consistent with prior work indicating that originations by independent mortgage companies usually have higher default risk than depository institutions (Laderman and Reid 2009). The popularity of risky loan terms and broker originations among independent mortgage companies originations, which are not controlled in the model, help explain the significantly higher default risk of the lending by independent mortgage lenders.

However, while loans originated by OCC lenders continued to perform better in the APL states, the performance of OCC loans became relatively worse in APL states post-preemption, compared to those in non-APL states. In other words, though they were still generally less likely to default in APL states after the preemption, the default risk increased significantly. For example, a typical fixed-rate refinancing loan originated by an OCC lender in an APL state in 2004 was 35 percent less likely to default (an odds ratio of 0.653) before the preemption, but only 14 percent less likely to default after the preemption, compared to that in non-APL states. The trend effects are generally greater than one, suggesting the default risk of loans originated by national banks in general became higher after the preemption. The effects of preemption are statistically significant for both fixed and adjustable rate refinance loans.

Next, we compare the changes in mortgage performance of preempted lenders with those of independent mortgage companies that remained subject to state APLs. We find strong effects from preemption in the refinance market but these results are sensitive to the inclusion or exclusion of one lender. Preemption consistently increases the default risk of originations by OCC lenders in the refinance fixed rate market. Even after accounting for market trends, the odds ratios for the refinance fixed-rate mortgages by OCC lenders increased after preemption, by

[16] Trend effect was calculated by dividing the odds ratio of the 2004 or 2005-2006 cohort by that of the 2002-2003 cohort. It can be interpreted as the increase in default risk (90-day) during the study period for a mortgage originated by one group of lenders (OCC or IND) in APL states, relative to the one originated by a national bank in non-APL states.

20 percent for both the 2004 cohort and for the 2005-2006 cohort. In contrast, the effects of preemption in the refinance adjustable-rate mortgage market are sensitive to the inclusion or exclusion of one lender, First Franklin Financial Corp. (see below). When this lender is excluded, preemption led to significantly higher default risks in the refinance adjustable rate market in 2004 as well (Table 7). These effects in the refinance market are statistically significant.

It should be noted that in the home purchase market, the performance of OCC lenders was generally similar to or slightly better than the market trend, as proxied by the changes in the performance of mortgages originated by independent mortgage companies. While the effects of preemption in the purchase market are around one, they are statistically insignificant. It should be noted that the odds ratios for the purchase adjustable-rate mortgages by OCC lenders decreased significantly after 2004 (Table 7). However, the effect of preemption becomes insignificant once the First Franklin is excluded.

We conducted additional analysis to better understand the influence of the one outlier. First Franklin was the largest subprime lender regulated by OCC in 2003.[17] After 2004, First Franklin reported its loans through its parental company, National City Bank, Indiana (National City).[18] Since most major OCC lenders were traditional depository institutions like Bank of America, Wells Fargo Bank, and etc., we suspect the behavior of this big subprime lender, First Franklin and its parental company, National City, would behave differently from others. We created a new dummy to identify First Franklin and National City originations in the APL states and reran the regression models.

Table 8 provides the effects of preemption for these two different groups of OCC lenders: First Franklin and National City and other OCC lenders. For other non-subprime OCC lenders, the increase in the default risk is significant in the refinance fixed-rate market (23-25 percent more likely) after the preemption. The effects of preemption in the adjustable rate markets increase (increased to 1.02 and 1.13 for different refinance ARMs cohorts, though insignificant) and the effects become insignificant in the purchase adjustable rate market.

In contrast, the default risk of loans originated by National City and its subsidiary First Franklin generally decreased after 2004: the effects of preemption were all less than one though they were only significant in the purchase adjustable rate market. It may be possible that the quality of the loan they originated improved. But the truth seems to be that First Franklin and National Bank significantly expand its private securitization market by being more active in originating and securitizing mortgages to many near-subprime borrowers. In this study sample, over 5,578 loans were originated by First Franklin and only 539 loans were originated by National City during 2002-2003. The average credit score of First Franklin originations was as low as 639 and most loans were adjustable rate mortgages, which seemed to be a typical subprime portfolio. But there were over 30,000 loans originated by National City in this sample for the 2004 cohort alone,

[17] Based on HMDA data, it was estimated that the originations by the First Franklin Finance Corp. accounted for 68 percent of subprime loans originated all subprime lenders regulated by OCC in 2003. It was also the nation's fourth largest subprime lender.

[18] National City Bank sold its subsidiary, First Franklin Financial Corp., to Merrill Lynch in December 2006.

which should include all First Franklin originations and its own originations. The average credit score also increased to over 675. The HMDA data also indicate that the total number of originations by First Franklin was about 143,376. Though National Bank only reported several hundred of loans in 2003, it reported 452,239 originations in 2004 and 390,394 loans in 2005. All these facts suggest the lower default risk for First Franklin/National City originations should be attributed to the shift/expansion of its market from high-risk subprime population to subprime and near-subprime population.[19] Since securitized nonprime loans were regarded as the major products that induced the housing crisis, as mentioned early, we do not believe the increased securitizations by National Bank should be regarded as an improvement of its originations.[20]

So, overall the results suggest that, even after accounting for general market trends, the preemption often increases the default risk of refinance mortgages originated by non-subprime lenders regulated by the OCC. The OCC preemption does not have significant impact on the default risk of non-subprime OCC lenders in the purchase market. In the case of the outlier lender First Franklin and its parental company, the major subprime lender regulated by OCC, the lowered default rates in the purchase adjustable rate market when First Franklin is included in the analysis seem to be a result of the expanded market.

One possible explanation for this difference in the impact of the OCC preemption in refinance and purchase market is the fact that most state APLs have broader coverage and more restrictions in the refinance market.[21] For example, during the study period, the North Carolina state anti-predatory lending law only covers the refinance market (Quercia et al. 2007). Since APLs are less restrictive in the home purchase market, we surmise that the lack of a significant increase in the default risk of originations by OCC lenders is likely due to the fact that originations by other non-preempted lenders also worsened, since all lenders were subject to fewer restrictions in this market. In contrast, we find that mortgage originations by the OCC lenders had higher default rates in the refinance market, compared to those originated by independent mortgage companies, possibly because OCC lenders were exempt from, while independent mortgage companies were subject to, more restrictive state laws in the refinance market.

The study results for other control variables are generally consistent across different models so the discussion of other control variables is based primarily on the model focusing on refinance adjustable-rate mortgages, as summarized in Table 9. Generally, the results are consistent with our expectations that borrowers with lower credit score, higher LTVs, and higher debt ratios are more likely to default. Properties that are not occupied by owners are more likely to default. Mortgages originated in a market with a lower appreciation rate or with a higher unemployment rate are more likely to default too. Borrowers who are African American have been consistently more likely to default than others, while Hispanic borrowers exhibit mixed results.

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[19] While our regression models control for some important underwriting characteristics, broker origination channel and risky loan terms were not controlled explicitly. The 2002-2003 originations by First Franklin had extremely high default rates (over 34 percent experienced at least on serious delinquency during the study period) possibly because of some uncaptured characteristics of the portfolio.

[20] As demonstrated by Keys, Mukherjee, Seru, and Vig (2010), a portfolio that is more likely to be securitized Has a 20 percent higher default risk than a similar risk profile group with a lower probability of securitization.

[21] The HOEPA law adopted in 1994 and the 2002 revision did not cover home purchase loans (Federal Reserve System 2001). As a result, many mini-HOEPA laws, built upon HOEPA, have limited coverage and restriction in the home purchase market.

We examine the findings on the impact of federal preemption with additional analysis. First, when compared with strong state APLs, the less restrictive regulation for OCC lenders likely resulted in increased lending of risky products, which lead to an increase in default risks of OCC loans in the refinance market. Because of the likely selection bias for this study sample, we cannot compare the share of loans with exotic features directly. Instead, similar to our default analysis, we compare the odds of loans with exotic feature in APL states with that in the non-APL states and track the change of the odds ratios over time (Table 10).[22]

The descriptive table shows an obvious pattern in the refinance market: the relative increase in the odds of high-risky lending of OCC lenders in APL states was greater than that of independent mortgage companies. For example, before preemption, OCC lenders in the APL states were about 66 percent less likely to originate a loan with risky features in the fixed-rate refinance market than those in non-APL states (an odds ratio of 0.329). However, after the preemption, these OCC lenders in APL states were only 58 percent less likely to originate such loans in 2004 and 50 percent less likely in 2005 and 2006. In contrast, the relative increase in the odds of originating risky loans for independent mortgage companies is more modest during that period: the odds ratio increases from 1.585 before the preemption to 1.720 in 2004 and to 1.876 in 2005 and 2006). However, in the home purchase market, though the probability of originating loans with risky features increased significantly for OCC lenders, there was a similar, and sometimes even greater, increase for independent mortgage companies. In other words, after the OCC preemption, OCC lenders increased their share of loans with risky features in all the markets, aligning their lending practices to those of the independent mortgage companies. However, likely because state APLs had more restrictions in the refinance market and independent mortgage companies had to follow these rules, the increase in high-risky lending for OCC lenders outpaced that for independent mortgage companies in this market. This sharp increase in risky lending could explain the increased default risk of OCC loans.

Second, the overall composition of the mortgage industry may also explain these results. Lenders whose business model relied on greater volumes of subprime mortgages may have shifted to national charters to take advantage of the preemption. In fact, some banks like JP Mortgan Chase and HSBC switched to national charters after the preemption and the market share of out-of-state national banks increased much more in APL states than in non-APL states (Davis and Rice 2006). In addition, Avery, et al. (2007) documented that national banks expanded their share in the subprime market in part by acquiring existing independent mortgage companies. OCC preemption, then, would have granted these independent mortgage companies a way to become immune from the strong APLs that they were previously under, thereby also increasing the volume of risky lending.

Although our results are strongly suggestive of a link between federal preemption and risky lending, we should note that, due to data limitations, the focus of this study is on conventional, 30-year, first-lien, and private securitized mortgages only. Additional research is needed to

[22] Odds of a loan with an exotic feature is calculated here by dividing the share of loans with exotic features (p) by that of loans without such features ($1-p$). For example, the share of loans by OCC lenders with exotic features in the 2002-2003 cohort is 17.45 percent, then the odds is 0.211. Odds ratios can be calculated by dividing the odds of one particular lender type by the odds of the reference group (OCC_nonAPL).

examine the relationships between anti-predatory lending laws, federal preemption, and loan performance for the overall market; this will require additional data with broader market and geographic coverage and more efforts to make that data transparent and accessible to researchers.

It also needs to be noted that other possible impacts of the OCC preemption were not examined. These include effects on equity stripping, effects on the safety and soundness of the banking or mortgage lending industries, and others. Especially, the loss of equity can occur if borrowers are trapped in high-cost loans or forced into expensive refinancing, even if they do not experience foreclosure. Equity stripping can cause borrowers great financial harm, but reliable data on it is, to our knowledge, unavailable. These important impacts need to be incorporated in a future comprehensive analysis of the total impacts of federal preemption.

6. Conclusion

Prompted by concerns over the growing subprime market many states enacted state anti-predatory lending laws to expand legal protections for consumers in the mortgage market and deter the origination of loans with characteristics considered detrimental to consumers. By filling a regulatory gap in the residential mortgage lending market, state anti-predatory lending laws were expected to improve the quality and to reduce the risk of default of nonprime loans. However certain mortgage lenders were exempted by their federal regulators from complying with the state mortgage laws. In this way, due to the weaker federal law, federal preemption fundamentally changed the regulatory structure for national banks (and earlier federal thrifts), weakening consumer protections. Most unfortunately, the OCC preemption coincided with the beginning of the explosive growth in subprime lending. Traditional OCC lenders and lenders who migrated to national charters were now able to originate the riskier loans at the core of the current foreclosure crisis. In this study, we examined the relationship between APLs, federal preemption, and the foreclosure crisis. More narrowly, we compared the probability of default of mortgages originated by preempted lenders before and after the 2004 OCC preemption in markets with and without strong state APLs.

We captured the effects of preemption in two ways. First, preempted OCC lenders increased their share of loans originated with risky characteristics in states with strong APLs after the preemption. Similarly, we found the preemption consistently increases the default risk of privately securitized mortgages originated by the OCC lenders in APL states. Second, the increase in default risk among OCC lenders even outpaced that of independent mortgage companies in the refinance market that remained subject to APLs after preemption. Consistently, the effects are statistically significant for both OCC originated fixed and adjustable rate refinance loans and for OCC originated fixed rate mortgages when compared with similar mortgages originated by independent mortgage companies. The effect is also statistically significant for adjustable rate refinance mortgages in 2004 when the outlier lender is excluded. All these findings suggest that preemption resulted in deterioration in the quality of, and an increase in the default risk for, mortgages originated by OCC lenders in states with strong anti-predatory lending laws.

Though this study sample has some specific characteristics, the empirical results have important implications for the debate surrounding federal preemption and consumer protection. We demonstrated that the 2004 OCC preemption weakened lending restrictions for national banks and their subsidiaries by displacing binding state consumer protection laws with the less stringent federal regulatory structure. Preemption resulted in more risky mortgages being originated, thus playing a significant role in the ensuing foreclosure crisis. Without the OCC preemption, which sent out signals to all preempted lenders, the performance of loans originated by national banks would have been better. Finally, the findings are consistent with legislative initiatives that propose having the Federal government provide a regulatory floor while allowing states to enact stronger consumer protections based on local conditions.

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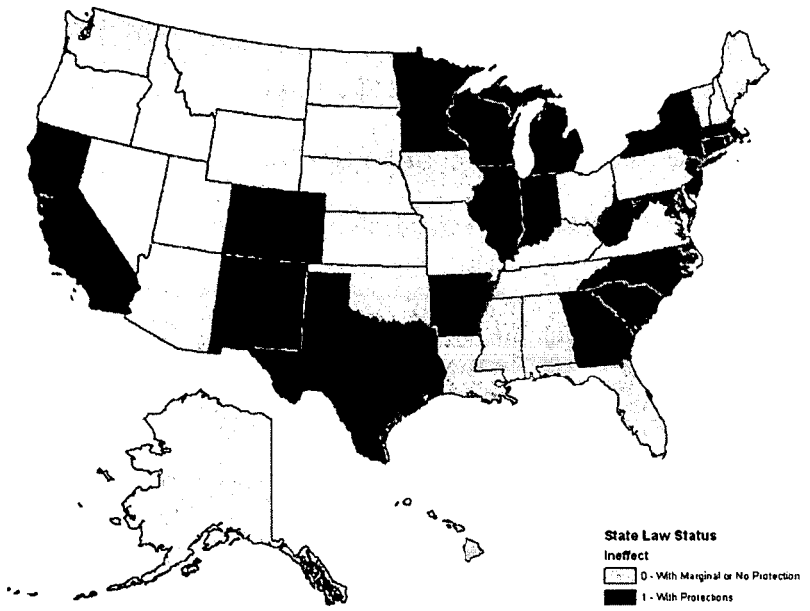

Figure 1 States with Effective Anti-Predatory Lending Laws before 2008

Table 1 Summary of the Coding of Anti-Predatory Lending Laws

State	Effective Date	*Ineffect*	Pennington-Cross et al. (2008)	Li and Ernst (2007)	Bostic et al. (2008b)
Alabama	.	0	0	NA	0
Alaska	.	0	0	8	0
Arizona	.	0	0	NA	0
Arkansas	7/16/2003	1	0	10	6.56
California	7/1/2002	1	1	NA	4.93
Colorado	7/1/2003	1	1	NA	4.18
Connecticut	1/1/2002	1	1	NA	4.88
Delaware	.	0	0	NA	0
D.C.	5/7/2002	1	1	11	7.75
Florida	.	0	1	8	3.75
Georgia	3/7/2003	1	1	12	6.83
Hawaii	.	0	0	NA	
Idaho	.	0	0	7	0
Illinois	1/1/2004	1	1	12	8.11
Indiana	1/1/2005	1	1	NA	6.76
Iowa	.	0	0	8	0
Kansas	.	0	0	7	0
Kentucky	.	0	1	7	5.86
Louisiana	.	0	0	NA	
Maine	.	0	1	8	3.01
Maryland	10/1/2002	1	1	8	3.39
Massachusetts*	11/7/2004	1	1	16	8.44
Michigan	12/23/2002	1	1	8	5.99
Minnesota	1/1/2003	1	1	10	7.01
Mississippi	.	0	0	NA	
Missouri	.	0	0	NA	
Montana	.	0	0	NA	
Nebraska	.	0	0	NA	0
Nevada	.	0	1	NA	2.81
New	.	0	0	NA	0
New Jersey	11/27/2003	1	1	15	7.34
New Mexico	1/1/2004	1	1	18	9.9
New York	4/1/2003	1	1	15	5.82
North Carolina	7/1/2000	1	1	17	6.4
North Dakota	.	0	0	NA	0
Ohio	.	0	1	7	3.47
Oklahoma	.	0	1	NA	4.29
Oregon	.	0	0	NA	0
Pennsylvania	.	0	1	NA	3.47
Rhode Island*	12/31/2006	1	0	NA	0
South Carolina	1/1/2004	1	1	13	4.8
South Dakota	.	0	0	NA	0
Tennessee	.	0	0	NA	0
Texas	9/1/2001	1	1	10	4.34
Utah	.	0	1	NA	3.91
Vermont	.	0	0	8	0
Virginia	6/26/2003	0	0	8	0
Washington	.	0	0	NA	0
West Virginia	6/8/2000	1	1	17	9
Wisconsin*	2/1/2005	1	0	7	0
Wyoming	.	0	0	NA	0

Note: * Three states, Wisconsin, Indiana, and Rhode Island, which adopted the anti-predatory lending laws after February 12, 2004 were excluded from the preemption analysis. Eight states (Utah, Pennsylvania, Nevada, Oklahoma, Ohio, Maine, Kentucky, and Florida) with nominal anti-predatory lending laws are regarded as without effective APLs in this study.

Table 2 Matching of Columbia Collateral file data and HMDA

Origination year	Original Sample	Matched	Match Rate
2002	78,150	44,930	57.49%
2003	287,211	236,357	82.29%
2004	638,180	466,461	73.09%
2005	1,200,929	899,590	74.91%
2006	1,447,951	889,903	61.46%
Total	3,652,421	2,537,241	69.47%

Note: Loans that were still active as of December 2006 or later in the Columbia Collateral file data (www.ctslink.com) are included. The following variables are used in the match: origination date, loan amount (in thousands), geography, lien status (for originations after 2004), and loan purpose.

Table 3 Descriptive Statistics of the Study Sample

Mortgage Information	All Loans	Purchase_FRM	Purchase_ARM	Refi_FRM	Refi_ARM	2002-2003 Origs	2004 origs	2005-2006 origs
Purchase (%)	51.37%	100.00%	100.00%	0.00%	0.00%	33.88%	48.50%	54.24%
ARM (%)	69.56%	0.00%	100.00%	0.00%	100.00%	45.52%	68.70%	72.65%
Loan Amount ($s)	$255,086	$219,903	$266,189	$229,222	$270,556	$213,627	$216,003	$270,874
Initial Interest Rate	6.74	6.90	6.64	6.99	6.66	6.81	6.43	6.82
FICO @ Origination	668	703	677	668	642	666	661	670
LTV @ Origination (%)	80.46%	85.17%	85.65%	72.37%	76.64%	76.25%	80.93%	80.83%
1-4 Family	86.16%	75.62%	87.13%	84.61%	90.23%	87.28%	85.58%	86.19%
Owner Occupied (%)	85.53%	74.06%	86.36%	83.81%	90.27%	86.11%	84.15%	85.85%
Full Documentation (%)	53.76%	45.62%	53.45%	57.19%	55.61%	67.18%	61.56%	49.99%
Prepay Penalty Flag (%)	49.37%	28.49%	53.53%	44.18%	55.86%	40.61%	50.53%	50.08%
Balloon (%)	7.72%	4.29%	9.20%	4.72%	9.01%	1.34%	2.41%	9.96%
IO (% of loans)	30.49%	12.14%	46.23%	7.13%	31.83%	9.85%	25.36%	34.36%
Negative Amortization (%)	4.34%	0.00%	4.39%	0.00%	8.50%	0.19%	0.65%	5.85%
Del90 (%)	23.06%	12.33%	29.41%	11.96%	25.94%	18.70%	21.35%	24.05%
APL States	59.45%	56.97%	58.45%	59.52%	61.67%	57.63%	61.08%	59.21%
OCC	40.15%	57.65%	38.29%	42.04%	34.08%	37.92%	33.17%	42.36%
IND	59.85%	42.35%	61.71%	57.96%	65.92%	62.08%	66.83%	57.64%
Number of Loans	1,067,471	139,128	409,230	185,793	333,320	90,649	212,575	764,247

Note: Conventional, 30-year, first-lien mortgages only; loans originated in states that adopted APLs after February 12, 2004 and before December 31 2007 were excluded.

Table 4 Variable Definition

Variable	Definition
cred580	credit score <580
cred620	credit score 580-619
cred660	credit score 620-659
cred720	credit score 660-719
cltv60*	current loan-to-value ratio 60-69.9%
cltv70*	current loan-to-value ratio 70-79.9%
cltv80*	current loan-to-value ratio 80-89.9%
cltv90*	current loan-to-value ratio 90-94.9%
cltv95*	current loan-to-value ratio 95-99.9%
debt_ratio	loan amount divided by household income
black	black borrower as identified in HMDA
hisp	Hispanic borrower as identified in HMDA
race_miss	race/ethnicity information missing in HMDA
prop_type1	1-4 family property
owner_occ	owner-occupied property
appre_af07	metropolitan area house price appreciation from the fourth quarter of 2006 to the fourth quarter of 2008, calculated based on FHFA HPI and Case-Shiller HPI
unemployment	average county unemployment rate during the period of Q12007 to Q42008
IND_nonAPL	originations by non-OCC lenders (IND) in non-APL states
OCC_APL	originations by the OCC lenders in APL states
IND_APL	originations by independent mortgage companies in APL states

Note: *The current loan-to-value (CLTV) ratio is calculated using the unpaid mortgage balance as of December 2006 and the estimated house price using the Case-Shiller house price index (HPI) and FHFA HPI. If the property is located in the 20 major MSAs, we used the Case-Shiller HPI. Otherwise we used the FHFA's MSA level HPI. If the property is located in an area outside an MSA, we used the state-level HPI. When the property has multiple liens, we estimated the CLTV by assuming the second or higher liens had been paid at the same speed as the first lien.

Table 5 Mortgage Default (90+day) by Lender Type and State Laws in Different Markets (Descriptive)

	Before preemption (2002-2003)			Post-preemption (2004)			Post-preemption (2005-2006)			Trend effect	
	non_APL	APL	Odds Ratio	non_APL	APL	Odds Ratio	non_APL	APL	Odds Ratio	2004/pre	2005-2006/pre
OCC lenders											
purchase_frm	9.51%	6.25%	0.634	6.85%	6.11%	0.886	10.44%	7.11%	0.657	1.397	1.036
purchase_arm	33.55%	25.23%	0.668	17.35%	17.01%	0.976	23.75%	20.86%	0.847	1.460	1.267
refi_frm	8.21%	2.79%	0.322	9.32%	6.44%	0.669	11.80%	8.70%	0.712	2.082	2.213
refi_arm	29.77%	15.56%	0.435	18.52%	15.34%	0.797	22.09%	17.92%	0.770	1.835	1.773
IND lenders											
purchase_frm	14.78%	12.60%	1.372	19.91%	15.92%	2.577	21.22%	17.53%	1.824	1.879	1.330
purchase_arm	37.04%	28.06%	0.773	28.09%	29.02%	1.948	34.85%	36.66%	1.858	2.521	2.405
refi_frm	13.64%	8.71%	1.068	17.14%	12.76%	1.423	17.27%	14.44%	1.261	1.333	1.181
refi_arm	37.37%	30.32%	1.027	30.63%	29.69%	1.858	28.80%	28.82%	1.428	1.810	1.391

Note: Serious delinquency rate (90+day) is measured by whether the loan had ever experienced any 90 or 90 plus days of delinquency from December 1 2006 to December 31 2008.

The odds ratios are calculated by dividing the serious delinquency rates in APL states (OCC or IND) by the delinquency rates of loans originated by OCC lenders in non-APL states (OCC_nonAPL); trend effect=odds ratios for the 2004 or 2005-2006 cohort divided by the odds ratios for the pre-preemption cohort (2002-2003). A value greater than one for the trend effect suggests, though not conclusive, the default risk increases.

Conventional, 30-year, first-lien mortgages only; loans originated in states that adopted APLs after February 12, 2004 and before December 31 2007 were excluded.

Table 6 Impact of the OCC Preemption on Mortgage Performance (based on logit regression results)

	Odds Ratio			Trend Effect	
	Before preemption (2002-2003)	Postpreemption 2004	Postpreemption 2005-2006	Postpreemption 2004	Postpreemption 2005-2006
OCC					
purchase_frm	0.753**	0.806**	0.716**	1.070	0.951
purchase_arm	0.797**	0.882**	0.789**	1.107	0.990
refi_frm	0.653**	0.864*	0.786**	1.323*	1.204*
refi_arm	0.728**	1.026	0.841**	1.409**	1.155*
IND					
purchase_frm	1.326**	1.388**	1.399**	1.047	1.055
purchase_arm	0.941	1.359**	1.348**	1.444**	1.433**
refi_frm	1.001	1.105	1.003	1.104	1.002
refi_arm	0.988	1.376**	1.144**	1.393**	1.158**

Note: * significant at 0.05 level; ** significant at 0.01 level.

Odds ratios and p-values are obtained from a set of logit regression models where serious delinquency (90+day) is the outcome variable and the reference lender group is OCC_nonAPL (see Table 10); trend effect=odds ratios for the 2004 or 2005-2006 cohort divided by the odds ratios for the pre-preemption cohort (2002-2003); OCC-IND comparison=trend effect of OCC lenders/trend effect of independent mortgage companies (IND_APL). Conventional, 30-year, first-lien mortgages only; loans originated in states that adopted APLs after February 12, 2004 and before December 31 2007 were excluded.

Table 7 Examination of the Influence of First Franklin on Effects of Preemption

	All Lenders		Excluding Outlier (First Franklin)	
	Postpreemption 2004	Postpreemption 2005-2006	Postpreemption 2004	Postpreemption 2005-2006
OCC Trend Effect				
purchase_frm	1.070	0.951	0.982	0.870
purchase_arm	1.107	0.990	1.164	1.025
refi_frm	1.323*	1.204*	1.332*	1.211*
refi_arm	1.409**	1.155*	1.650**	1.338**
OCC-IND Comparison				
purchase_frm	1.023	0.901	1.080	0.952
purchase_arm	0.766**	0.691**	1.030	0.921
refi_frm	1.199*	1.201**	1.224**	1.222*
refi_arm	1.012	0.998	1.158*	1.096

Note: * significant at 0.05 level; ** significant at 0.01 level.

trend effect=odds ratios for the 2004 or 2005-2006 cohort divided by the odds ratios for the pre-preemption cohort (2002-2003); OCC-IND comparison=trend effect of OCC lenders/trend effect of independent mortgage companies (IND_APL). Conventional, 30-year, first-lien mortgages only; loans originated in states that adopted APLs after February 12, 2004 and before December 31 2007 were excluded.

Table 8 Effect of Preemption on Different OCC Lenders (based on logit regression results)

	Before preemption (2002-2003)	Post-preemption (2004)	Post-preemption (2005-2006)	OCC Trend		OCC-IND Comparison	
	Odds Ratio	Odds Ratio	Odds Ratio	2004/Pre	2005-2006/pre	2004	2005-2006
Othere OCC Lender							
purchase_frm	0.702**	0.743**	0.708**	1.059	1.008	1.043	0.961
purchase_arm	0.553**	0.671**	0.753**	1.214*	1.362**	0.835	0.931
refi_frm	0.643**	0.876	0.790**	1.362*	1.229*	1.248*	1.229*
refi_arm	0.603**	0.869**	0.820**	1.441**	1.361**	1.016	1.126
FF/NCB							
purchase_frm	1.025	0.884	1.008	0.863	0.983	0.850	0.937
purchase_arm	1.087	1.022	1.138**	0.940	1.047	0.647**	0.716**
refi_frm	0.888	0.85	0.762**	0.957	0.858	0.878	0.859
refi_arm	0.981	1.256**	1.061	1.280*	1.081	0.903	0.894
IND							
purchase_frm	1.349**	1.369**	1.415**	1.015	1.049		
purchase_arm	0.932	1.355**	1.364**	1.454**	1.463**		
refi_frm	1.008	1.099	1.007**	1.091	0.999		
refi_arm	0.951	1.349**	1.150**	1.418**	1.209**		

Note: * significant at 0.05 level; ** significant at 0.01 level.

Odds ratios and p-values are obtained from a set of logit regression models where serious delinquency (90+day) is the outcome variable and the reference lender group is OCC_nonAPL; trend effect=odds ratios for the 2004 or 2005-2006 cohort divided by the odds ratios for the pre-preemption cohort (2002-2003); OCC-IND comparison=trend effect of OCC lenders/trend effect of independent mortgage companies (IND_APL). Conventional, 30-year, first-lien mortgages only; loans originated in states that adopted APLs after February 12, 2004 and before December 31 2007 were excluded.

Table 9 Sample Logit Regression Results (Refinance and ARM Loans)

	2002-2003 Origs			2004 Origs			2005-2006 Origs		
Parameter	Estimate	P_value	Odds Ratio	Estimate	P_value	Odds Ratio	Estimate	P_value	Odds Ratio
Intercept	-4.6356	<.0001		-4.5255	<.0001		-2.196	<.0001	
cred580	3.1436	<.0001	23.188	2.4504	<.0001	11.593	1.9131	<.0001	6.774
cred620	2.7202	<.0001	15.183	2.0667	<.0001	7.899	1.6623	<.0001	5.272
cred660	2.392	<.0001	10.935	1.7573	<.0001	5.797	1.4359	<.0001	4.203
cred720	1.5832	<.0001	4.87	1.1826	<.0001	3.263	0.9585	<.0001	2.608
cltv60	0.6434	<.0001	1.903	0.5048	<.0001	1.657	0.5137	<.0001	1.672
cltv70	0.9238	<.0001	2.519	0.8336	<.0001	2.302	1.0904	<.0001	2.976
cltv80	1.2152	<.0001	3.371	1.1045	<.0001	3.018	1.3745	<.0001	3.953
cltv90	1.0841	<.0001	2.957	1.2214	<.0001	3.392	1.4063	<.0001	4.081
cltv95	1.5628	<.0001	4.772	1.3947	<.0001	4.034	1.4665	<.0001	4.334
debt_ratio	0.0793	<.0001	1.082	0.0358	<.0001	1.036	0.00766	0.0212	1.008
black	0.1624	0.1049	1.176	0.1961	<.0001	1.217	0.0155	0.3087	1.016
hisp	-0.1595	0.0201	0.853	-0.0586	0.0607	0.943	0.24	<.0001	1.271
race_miss	-0.054	0.2035	0.947	0.0598	0.0097	1.062	0.0574	<.0001	1.059
prop_type1	0.0623	0.5258	1.064	-0.0917	0.0743	0.912	-0.0666	0.0061	0.936
owner_occ	-0.3278	0.0008	0.721	-0.2402	<.0001	0.786	-0.3725	<.0001	0.689
appre_af07	0.2853	0.0265	1.33	0.5242	<.0001	1.689	-1.5678	<.0001	0.208
unemployment	0.1154	<.0001	1.122	0.106	<.0001	1.112	0.0651	<.0001	1.067
IND_nonapl	0.1831	0.0005	1.201	0.3735	<.0001	1.453	0.1856	<.0001	1.204
OCC_APL	-0.3168	<.0001	0.728	0.0255	0.5874	1.026	-0.1734	<.0001	0.841
IND_APL	-0.0121	0.8235	0.988	0.3193	<.0001	1.376	0.1342	<.0001	1.144
Likelihood Ratio		5545.1 (21)			10826.0(20)			27139.1 (21)	
N		24436			69312			239570	

Note: time dummies for 2002 cohort and 2005 cohort were included in corresponding models but not listed here. Conventional, 30-year, first-lien mortgages only; loans originated in states that adopted APLs after February 12, 2004 and before December 31 2007 were excluded.

Table 10 Mortgages with at Least One Exotic Feature by Lender Type and State Laws in Different Markets (Descriptive)

	Before Preemption (2002-2003)			Post-preemption (2004)			Post-preemption (2005-2006)			Trend Effect	
	non_APL	APL	Odds Ratio	non_APL	APL	Odds Ratio	non_APL	APL	Odds Ratio	2004/pre	2005-2006/ pre
OCC lenders											
purchase_frm	24.68%	17.45%	0.645	27.31%	22.31%	0.764	27.71%	22.61%	0.762	1.185	1.182
purchase_arm	78.21%	65.36%	0.526	82.13%	76.11%	0.693	88.54%	81.23%	0.560	1.319	1.065
refi_frm	27.63%	11.17%	0.329	44.35%	24.98%	0.418	45.34%	29.15%	0.496	1.269	1.507
refi_arm	74.06%	50.25%	0.354	83.29%	67.20%	0.411	89.34%	80.34%	0.488	1.162	1.378
IND lenders											
purchase_frm	48.33%	39.12%	1.960	53.89%	47.84%	2.442	65.80%	61.87%	4.234	1.246	2.160
purchase_arm	77.79%	69.41%	0.632	87.77%	75.92%	0.686	92.89%	85.09%	0.739	1.086	1.169
refi_frm	58.80%	37.70%	1.585	74.91%	57.83%	1.720	79.21%	60.88%	1.876	1.085	1.183
refi_arm	74.66%	53.11%	0.397	85.77%	64.72%	0.368	91.26%	79.07%	0.451	0.928	1.136

Note: Exotic loan features include prepayment penalties, balloon payments, interest only, and negative amortization.

Odds ratios are calculated by dividing the odds of one particular lender type by the odds of the reference group (OCC_nonAPL), where odds of a loan with exotic feature is calculated here by dividing the share of loans with exotic features (p) by that of loans without such features (1-p). trend effect=odds ratios for the 2004 or 2005-2006 cohort divided by the odds ratios for the pre-preemption cohort (2002-2003). A value greater than one for the trend effect suggests, though not conclusive, the probability or originating of risky loans in APL states increases.

Conventional, 30-year, first-lien mortgages only; loans originated in states that adopted APLs after February 12, 2004 and before December 31 2007 were excluded.

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LYNNE M. ROSS
Executive Director

October 6, 2003

Via Facsimile: (202) 874-4448

Office of the Comptroller of the Currency
250 E Street, S.W., Public Information Room, Mailstop 1-5
Washington, DC 20219

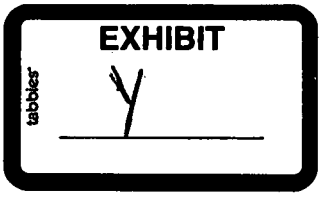
Re: Docket No. 03-16, 12 CFR Parts 7 and 34.

Dear Sir or Madam:

We, the undersigned Attorneys General of 50 States and the Virgin Islands and the District of Columbia Office of Corporation Counsel, submit the following Comments on the rules proposed by the Office of the Comptroller of the Currency in Docket No. 03-16. As the chief law enforcement officials of our respective jurisdictions, we strongly oppose these preemption rules and urge the OCC to defer further action on them.

The OCC's current proposal, coupled with other recent OCC pronouncements on preemption, represents a radical restructuring of federal-state relationships in the area of banking. In recent years, the OCC has embarked on an aggressive campaign to declare that state laws and enforcement efforts are preempted if they have any impact on a national bank's activities. The OCC has zealously pushed its preemption agenda into areas where the States have exercised enforcement and regulatory authority without controversy for years.

The OCC's preemption analysis is one-sided and self-serving. The OCC has paid little deference to well-established history and precedent that has allowed the States and the OCC to coexist in a dual regulatory role for over 130 years. That precedent has upheld this nation's policy that national banks are subject to state laws unless the state laws significantly impair the national bank's powers created under federal law. The OCC is destroying that careful balance by finding "significant interference" or "undue burden" whenever state law has any effect on a national bank.



The States acknowledge that the National Bank Act preempts some state laws, such as regulation of credit card interest rates charged by out-of-state national banks.[1] Particularly in the area of consumer protection, however, there are state laws that affect virtually all commercial entities doing business with the public, including banking institutions. These laws do not impose significant burdens on national bank activities and are applied evenhandedly throughout the marketplace. As a general rule, state consumer protection laws prohibit businesses from engaging in unfair or deceptive practices. These laws are consistent with Section 5 of the Federal Trade Commission Act, and the States traditionally have enforced them in a wide range of financial activities involving consumers. A national bank's compliance with these laws should be expected and welcomed by the OCC, not regarded as a "significant impairment" of the bank's federal rights. It would be unprecedented and unfair to grant national banks (including, in the OCC's view, affiliated nonbank institutions) total immunity from all state consumer protection regulation and enforcement.

In the area of predatory mortgage lending, the OCC's actions are particularly disappointing. The States have taken a leadership role in devising legislation to restrict abusive practices in home equity lending. These state laws were carefully crafted to avoid preemption issues, to create safe harbors for mortgage lenders, and to add consumer protections to high cost subprime loans. In the States' experience, these laws have worked. Instead of commending the States' efforts, the OCC has gone to great lengths to attack them and to declare that they are inapplicable to national banks and their operating subsidiaries. In their place, the OCC has recommended minimal protections that fail to address many of the worst predatory lending abuses.

The States would prefer to cooperate and partner with the OCC, especially when enforcement resources are limited. The States and the OCC share similar goals of protecting the public and providing for a fair credit marketplace. But instead of seeking cooperation and joint enforcement, the OCC is insisting on an exclusive regulatory regime that would eliminate the role of the States, particularly with respect to such important consumer protection issues as predatory mortgage lending and telemarketing abuses. There is much work to be done by all regulatory and enforcement agencies on real and pressing problems. The States submit that this is not the time to devote energies to turf battles and empire building.

A. National Banks Historically Have Been Subject to State Laws and a Dual System of Enforcement.

The OCC's recent campaign to obtain exclusive enforcement authority over its constituent national banks, and to shield the banks from virtually all state laws, ignores a longstanding tradition of federal and state enforcement. Under this dual system, federal authorities have overseen the business activities of national banks to ensure the "safety and soundness" of banking institutions. The States, for their part, have enforced state laws of general application against all persons and businesses within their borders, including national banks. This complementary system of state and federal enforcement has worked well, both to maintain safe and sound banking practices, and to protect the consuming public from deleterious business practices. The dual system has roots not only in actual enforcement experience, but also in U.S. Supreme Court and other judicial precedents as

[1] Marquette National Bank v. First of Omaha Service Corp., 439 U.S. 299 (1978).

well as Congressional pronouncements recognizing the vital role of the States in monitoring business activities within their borders.

1. Under Supreme Court Precedent, National Banks Are Subject to State Laws that Do Not Conflict With, or Substantially Impair, Bank Rights under Federal Law.

The National Bank Act ("NBA"), on which the OCC heavily relies to augment its powers, is a Civil War-era statute that was intended to finance the war and restore control of the monetary system to the federal government.[2] Contrary to the OCC's current assertions, the NBA was not intended to divest all state authority over national banks. Indeed, from its earliest decisions involving the NBA, the U.S. Supreme Court has recognized and upheld the applicability of state laws to national banks. In 1870, the Supreme Court rejected a preemption challenge to a state's collection of a bank shares tax, declaring that national banks "are subject to the laws of the State, and are governed in their daily course of business far more by the laws of the State than of the nation. It is only when the State law incapacitates the banks from discharging their duties to the government that it becomes unconstitutional."[3] In McClellan v. Chipman,[4] the Court rejected a bank's "assertion that national banks in virtue of the [NBA] are entirely removed, as to all their contracts, from any and every control by the state law," holding instead that state laws govern the business transactions of national banks except in areas where Congress expressly preempts state law or state law would impair the banks' efficiency in carrying out their duties imposed by federal law. Other Supreme Court decisions affirm the principle that national banks remain subject to many state laws.[5]

In general, the Supreme Court has upheld state laws that 1) did not expressly conflict with the statutory powers of national banks; 2) did not discriminate against national banks; or 3) did not impose undue burdens on the performance of bank functions mandated or permitted under national banking laws. Where the Court has found preemption, it usually has been in instances where the state law either prohibited or significantly impaired an express statutory power of a national bank.

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[2] Act June 3, 1864, ch. 106, 13 Stat. 99.

[3] National Bank v. Commonwealth, 76 U.S. (9 Wall.) 353, 361-62 (1870).

[4] 164 U.S. 347, 359 (1896).

[5] See, e.g., Davis v. Elmira Savings Bank, 161 U.S. 245, 290 (1896) ("Nothing, of course, in this opinion is intended to deny the operation of general and undiscriminating state laws on the contracts of national banks, so long as such laws do not conflict with the letter or the general objects and purpose of Congressional legislation."); First National Bank in St. Louis v. Missouri, 263 U.S. 640, 656 (1924) (National banks "are subject to the laws of a State in respect of their affairs unless such laws interfere with the purposes of their creation, tend to impair or destroy their efficiency as federal agencies or conflict with the paramount law of the United States."); Anderson National Bank v. Luckett, 321 U.S. 233, 244-52 (1944) ("National banks are subject to state laws, unless those laws infringe the national banking laws or impose an undue burden on the performance of the banks' functions," holding that a state statute administering abandoned deposit accounts did not "unlawful[ly] encroac[h] on the rights and privileges of national banks."); Franklin National Bank v. New York, 347 U.S. 373, 378 n.7 (1954) ("National banks may be subject to some state laws in the normal course of business if there is no conflict with federal law."). More recently, in the 1997 case, Atherton v. FDIC, 519 U.S. 213, 222-23, the Supreme Court reaffirmed the principle that "federally chartered banks are subject to state law," based on its earlier decisions.

The Supreme Court's 1996 decision in Barnett Bank of Marion County, N.A. v. Nelson[6] is consistent with these principles. In Barnett, the Court struck down a Florida law restricting the sale of insurance by national banks because a federal statute granted national banks the right to sell insurance in towns of 5,000 or fewer. The Court stated that preemption would be found if there was a direct conflict with express federal statutory authority because "normally Congress would not want States to forbid, or to impair significantly, the exercise of a power that Congress explicitly granted."[7] However, the Court went on to stress that the preemption test was not intended "to deprive States of the power to regulate national banks, where (unlike here) doing so does not prevent or significantly interfere with the national bank's exercise of its powers."[8]

Therefore, the test to determine whether a state law is preempted when applied to a national bank focuses on whether there is a "significant impairment" of a bank's express rights under federal law or a "significant interference" with the legitimate functions of a bank. This test reflects the traditional standard for conflict preemption in that only those state laws significantly interfering with a bank's exercise of its powers are preempted.

Lower court decisions also have recognized and affirmed the general applicability of state laws to national banks. For example, in Video Trax, Inc. v. NationsBank, N.A.,[9] the U.S. District Court for the Southern District Court of Florida observed: "Banking is not an area in which Congress has evidenced an intent to occupy the entire field to the exclusion of the states, and thus, state legislatures may legislate in all areas not expressly or impliedly preempted by federal legislation."

The OCC's current approach to conflict preemption flies in the face of these judicial precedents; it is so sweeping that, in reality, the OCC is establishing a regime of field preemption. The OCC presupposes that any state law that can arguably "impair the efficiency" of national bank lending operations compels a finding of preemption. Under this theory, most state consumer protection laws would be preempted, since such laws are unlikely to provide any protection without having some incidental impact on a bank's "efficiency." The OCC should not, by expansively interpreting the terms "impair significantly" and "significant interference," undertake to overturn over 130 years of precedent establishing that national banks are not entitled to immunity from all state laws and regulation.

2. Congressional Intent Supports the Applicability of State Law to National Banks and the Presumption against Preemption.

In 1994, Congress enacted the Riegle-Neal Interstate Banking and Branching Efficiency Act to permit national banks to operate interstate branches to better serve consumers. In enacting the legislation, Congress made a clear pronouncement of its intent that state law would continue to apply to the interstate operations of national banks, particularly in the area of consumer

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[6] 517 U.S. 25 (1996).
[7] Id. at 33.
[8] Id.
[9] 33 F. Supp. 2d 1041, 1048 (S.D. Fla. 1998), aff'd per curiam, 205 F.3d 1358 (11th Cir.), cert. denied, 531 U.S. 822 (2000).

protection. The report of the House-Senate conference committee on the Riegle-Neal Act noted that "[u]nder well established judicial principles, national banks are subject to state law in many significant respects."[10] The report emphasized:

> States have a strong interest in the activities and operations of depository institutions doing business within their jurisdictions, regardless of the type of charter an institution holds. In particular, States have a legitimate interest in protecting the rights of their consumers, businesses and communities. Congress does not intend that the Interstate Banking and Branching Efficiency Act of 1994 alter this balance and thereby weaken States' authority to protect the interests of their consumers, businesses, or communities.[11]

On the question of whether state laws may be preempted by federal banking law, the Conference Report noted that courts generally have applied "a rule of construction that avoids finding a conflict between Federal and State law where possible."

The OCC appears tone deaf to the Congressional message sent by Riegle-Neal. The OCC discounts Riegle-Neal's legislative history by noting that the Act excluded from its coverage those state laws that were preempted by federal law. While this statement is correct, the OCC ignores the fact that in 1994, when Riegle-Neal was enacted, it was generally accepted that most state consumer protection laws (outside of usury regulation) were not subject to preemption. Now that the OCC is taking the position that essentially all state consumer protection laws are preempted as to national banks, it contends that the Riegle-Neal mandate on the continued applicability of such state laws has no import. Surely, Congress did not anticipate that its stated intent could be displaced by the OCC pushing the boundaries of preemption off the map.

B. The OCC Has Established an Aggressive Pattern of Advocating Preemption of State Laws.

The OCC has, of late, undermined Congressional intent and the historic federal-state balance by promoting preemption and exclusive OCC control at every opportunity. In recent court appearances, policy statements, opinion letters and proposed rules, the OCC has articulated an intent to exempt its bank clientele from any duty to comply with state law or state consumer protection enforcement. The OCC's efforts have included reducing the traditional "significant interference" test to one of "impairing the efficiency" of a national bank; construing the "visitorial powers" of the OCC[12] to exclude any state enforcement of state laws; and using the "incidental powers" granted national banks under the NBA[13] as a catch-all preemption provision.

The OCC has been candid about its desire, for the benefit of its constituent national banks, to sweep aside the nuisance of state laws: "The ability of a national bank to conduct a multistate business subject to a single uniform set of federal laws, under the supervision of a

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[10] H.R. Rep. No. 103-651, reprinted in 1994 U.S. Code Cong. & Ad. News 2068, 2074 (emphasis added).
[11] Id.
[12] 12 U.S.C. § 484.
[13] 12 U.S.C. § 24 (Seventh)

single regulator, free from the visitorial powers of various state authorities, is a major advantage of the national charter...."[14] The Comptroller has stated that the power to override state law "is one of the advantages of a national charter and I'm not the least bit ashamed to promote it."[15]

The OCC has been an assertive advocate in persuading most federal courts to ratify its aggressively expansive preemption policy.[16] In all of the recent decisions cited by the OCC as background for the proposed rule, federal courts found in favor of the OCC's position on preemption. This is hardly surprising, given the OCC's aggressive advocacy role in the federal courts.

Under the Chevron doctrine,[17] federal courts give substantial deference to federal regulatory agencies when interpreting laws enforced by those agencies. Pursuant to the Supreme Court's directive in Chevron, federal courts must exercise restraint in substituting their own construction of a statute for a "reasonable" interpretation by the appropriate agency administrator. The OCC has taken full advantage in exploiting this judicial deference, as have its regulated entities. In banking regulatory cases raising preemption issues, the OCC has repeatedly filed amicus briefs that uniformly promote the interests of the major national banks and oppose state consumer protection interests. Although some courts have questioned the OCC's motives,[18] most courts have felt bound to follow the OCC's preemption interpretations under the Chevron doctrine.

For example, in Bank One, Utah v. Guttau,[19] the OCC sided with a national bank and against the State of Iowa in opposing a state statute requiring that ATM owners maintain an Iowa office and that ATMs display the name, address and phone number of the owner. This latter requirement, intended to give consumers access to information that could help them resolve ATM operational problems, was characterized by the dissent as "a straightforward consumer protection measure."[20] Although the District Court found that the OCC's interpretation of the NBA was "unreasonable,"[21] the Eighth Circuit adopted the OCC's preemption position. In Metrobank v. Foster,[22] the OCC supported another national bank in opposing Iowa's prohibition against charging ATM fees that exceed the "interchange fees" paid to financial institutions by non-account holders.

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[14] OCC News Release 2002-10.

[15] "Dependent on Lender's Fees, the OCC takes Banks' Side Against Local Laws," Wall Street Journal, 1/28/02.

[16] One exception is the case of Bowler v. Hawke, 320 F.3d 59, 62-63 (1st Cir. 2003). The First Circuit found that an opinion issued by the OCC, which purported to declare certain Massachusetts insurance laws as preempted by the Gramm-Leach-Blilely Act, was "no more than informal agency guidance to banks and other interested parties," and did not "create a 'regulatory conflict' giving rise to a case or controversy . . ."

[17] Chevron, U.S.A., Inc., v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984)

[18] Wells Fargo Bank of Texas, N.A. v. James, 321 F.3d 488, 494 (5th Cir. 2003)

[19] 190 F.3d 844 (8th Cir. 1999), cert. denied sub nom. Foster v. Bank One, Utah, 529 U.S. 1087 (2000).

[20] Id. at 851

[21] Bank One, Utah v. Guttau, 1998 U.S. Dist. Lexis 14830 (S.D. Iowa, 1998).

[22] 193 F. Supp. 2d 1156 (S.D. Iowa 2002).

This year, in the case of Wells Fargo v. James,[23] the OCC again argued in support of a group of national banks opposed to a Texas consumer protection law. At issue in that case was a "par value" statute that prohibited any Texas bank from charging fees to cash checks drawn on that bank (known as "on us" checks). Texas contended that such check cashing charges fell disproportionately on the working poor, who often did not have their own bank at which to cash paychecks. Although the Fifth Circuit found in favor of the OCC's preemption position, it expressed concerns about the OCC's role:

> Here, the constituency positively affected by the OCC's position is concentrated, organized and well-funded, and also happens to be the regulated industry. In contrast, the constituency which is adversely affected by the decision, though vast, is diffuse, unorganized, and definitionally ill-funded. It may be that these competing interests could better be balanced, as Appellant suggests, by a national Congress whose commitments are diverse and universal, or even by the people as they are represented in the state legislatures, than by a solitary institution whose focus is a single industry.[24]

The breadth of the OCC's preemption position is revealed in recent interpretative letters issued by the Comptroller. In May 2001, the OCC issued opinions overriding Ohio and Michigan motor vehicle regulatory laws. In the Ohio opinion, the OCC authorized national banks to conduct sales of returned lease vehicles without complying with Ohio sales licensing laws.[25] Ohio law was preempted, according to the OCC, because the bank was authorized to sell the vehicles "in the manner most economically beneficial." In the Michigan opinion, the OCC found that a car dealer is not subject to the State's motor vehicle sales financing laws if a national bank is financing the sale.[26]

C. The OCC's Preemption Actions Interfere with State Consumer Protection Enforcement.

In addition to claiming that most state laws are inapplicable to national banks, the OCC essentially contends that the States do not have any consumer protection enforcement jurisdiction over national banks. The OCC does have explicit "visitorial powers" over national banks pursuant to the NBA.[27] The States therefore may not conduct bank examinations or engage in the direct supervision of a national bank. The OCC, however, is seeking to stretch the meaning of visitorial jurisdiction to block all investigations and enforcement actions directed at national banks.

The OCC has recently advised national banks to notify it if any bank is contacted by a state official, even if the state official is simply seeking information.[28] And although the visitorial powers provision in the NBA contains an express exemption for litigation ("except as ... vested in the courts of justice"), the OCC, in a recent proposed rule on visitorial powers,[29] dismisses the States' right to

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[23] 321 F.3d 488 (5th Cir. 2003).
[24] Id. at 494.
[25] 66 Fed. Reg. 23977 (5/10/01).
[26] 66 Fed. Reg. 28593 (5/23/01).
[27] 12 U.S.C. § 484.
[28] OCC Advisory Letter 2002-9, 11/25/02.
[29] 68 Fed. Reg. 6366 (2/17/03).

seek legal remedies against national banks. The OCC would limit state enforcement actions to the filing of declaratory judgment actions aimed at determining whether or not the state law in question is preempted. If, then, the court finds against preemption, the OCC maintains that enforcement of a bank's compliance with the state law "is within the OCC's exclusive purview."[30]

In the past, state Attorneys General have brought consumer law enforcement actions against national banks with little controversy, just as attorneys representing private individuals have filed suit to obtain legal redress against national banks.[31] The States have routinely investigated consumer complaints against national banks and have reached formal and informal settlements with national banks. Until recently, most national banks cooperated in the resolution of these actions, and the OCC voiced no disapproval of state enforcement efforts.

In some of these actions, the States were targeting fraudulent or deceptive practices by a local retail seller. To obtain adequate relief for victimized consumers, the States have included as defendants the banking institutions that provided the financing for the questionable transactions. As the West Virginia Supreme Court noted in allowing the state Attorney General to maintain an action against a national bank that financed the allegedly unlawful sale of motor vehicle extended warranties:

> Logic and experience dictate that if the types of lawsuits which the Attorney General could bring under the CCPA did not include lawsuits against financial institutions such as defendants, these institutions could, if unsavory, run in effect a "laundry" for "fly-by-night" retailers that seek to excessively charge their consumers. Consequently, the real meaning of consumer protection would be stripped of its efficacy.[32]

The OCC has increasingly hardened its position against state enforcement rights in the past three years. In 2001, the Minnesota Attorney General brought a federal court case against Fleet Mortgage Corporation under the FTC's Telemarketing Sales Rule[33] and the Minnesota Consumer Fraud Act. Minnesota alleged that Fleet Mortgage had engaged in a deceptive marketing scheme by providing customers' private account information to third party telemarketers selling memberships in buying clubs. Fleet also added the charges for the buying club sales to customers' mortgage loan accounts.[34]

Fleet Mortgage argued that only the OCC could enforce state consumer protection laws against it. The District Court rejected Fleet's motion to dismiss, holding that "[f]ederal law does not require that the OCC have exclusive enforcement over such actions. The OCC has no direct responsibility for enforcing non-banking state laws such as the [Minnesota consumer protection

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[30] Id. at 6370.

[31] See, e.g., State of Alaska v. First National Bank of Anchorage, 660 P.2d 406 (Alaska 1982); State of Arizona v. Sgrillo, 176 Ariz. 148, 859 P.2d 771 (1993); State of Wisconsin v. Ameritech Corp., 185 Wis. 2d 686, 517 N.W.2d 705 (1994); State of West Virginia v. Scott Runyan Pontiac-Buick, Inc., 194 W.Va. 770, 461 S.E.2d 516 (1995).

[32] State v. Scott Runyan Pontiac-Buick, Inc., supra, 461 S.E.2d at 526.

[33] 16 C.F.R. § 310 (promulgated pursuant to the federal Telemarketing and Consumer Fraud and Abuse Prevention Act, 15 U.S.C. § 6101).

[34] State of Minnesota v. Fleet Mortgage Corp., 158 F. Supp. 2d 962 (D. Minn. 2001).

laws]." [35] Fleet, with the support of the OCC, brought a second motion to dismiss. The OCC, in its amicus brief, contended that neither Minnesota nor the FTC had any authority to enforce the Telemarketing Sales Rule against Fleet Mortgage because national banks are exempt from the Rule and the exempt status extended to non-bank subsidiaries like Fleet Mortgage. The District Court rejected the OCC's position: "The OCC's contention that it must have exclusive jurisdiction over subsidiaries in order to avoid having its authority 'restricted' is unpersuasive."[36]

There are other recent examples of States' consumer protection enforcement efforts against national banks, all of which the OCC would eliminate under its current preemption and visitorial powers stance. In some of these cases, the OCC has actively attempted to interfere with the state actions by advising banks that the States had no jurisdiction over them.

Beginning in 2001, a group of states, including California, Illinois, New York, and Florida, conducted an investigation into telemarketing operations by several major national banks. The banks had contracted with third-party telemarketers to share, for a fee, personal information about the banks' credit card customers and to provide access to bank customer billing information. The bank's name was then used in the telemarketer's sales pitch. The products sold were unrelated to the bank or to any banking services. The investigating states reached settlement agreements with Citibank and First USA despite the OCC's efforts to dissuade the banks from concluding such agreements. The OCC's view was that state Attorneys General had no enforcement authority over national banks.

In other recent examples, the Kentucky and Indiana Attorneys General have settled alleged violations of state "Do Not Call" telemarketing law violations with a national bank. The State of Arizona brought a case against an air conditioning company and Household Bank for alleged deceptive sales and financing practices targeting Spanish-speaking customers. In 2002, the States of Illinois, Maryland, and Missouri investigated an unlicensed trade school for deceptive advertising. The States questioned a national bank's role in financing tuition payments but were advised by the bank that they were preempted. The OCC confirmed the bank's view, and informed the States that the OCC alone would determine if there had been any violation of state consumer protection laws by the bank.

The proposed rule, when coupled with the OCC's pending proposed rule on visitorial powers and other OCC pronouncements, demonstrates that the OCC intends to divest the States of their traditional consumer protection enforcement jurisdiction over national banks.

D. The OCC's Proposed Rule and Other Recent Actions Undermine State Efforts to Attack Predatory Lending Abuses.

The OCC's recent preemption activity, including its order preempting Georgia's Fair Lending Law, is an unfortunate and unnecessary response to efforts by the States to control the problem of predatory mortgage lending. The States have taken a leadership role in addressing predatory lending, both in regulation and enforcement, and these state actions have been effective. The OCC should

[35] Id. at 966 (D. Minn. 2001).

[36] State of Minnesota v. Fleet Mortgage Corp., 181 F. Supp. 2d 995, 1001 (D. Minn. 2001).

recognize and support these efforts and seek to cooperate in achieving a shared goal of a fair lending marketplace.

Instead, as demonstrated by its order on the Georgia law, the OCC has found conflicts with the National Bank Act in virtually every statutory anti-predatory lending consumer protection adopted by the States. The OCC has also gone beyond assessing the impact of these laws on national banks, and has attacked the usefulness of these laws even as they apply to non-depository institutions.[37] If national banks are not subject to state laws, and if national banks are not the problem, as the OCC repeatedly asserts, then the OCC should have no reason to undermine the States' predatory lending initiatives.

The OCC's efforts to deal with the very substantial problem of predatory lending, while a step in the right direction, fall short of the actions taken by many states. In the proposed rule, the OCC takes a token and minimalist approach. The OCC's proposal addresses only asset-based lending, which is just one of the many abusive practices present in predatory lending. If the OCC intends to supplant all state laws governing predatory lending as to national banks, it should substitute a regulatory regime that more comprehensively addresses the unfair practices that are well-documented in this area. The OCC did begin to adopt a more broad based approach in Advisory Letter 2003-2, in which it recommended that banks adopt guidelines to prevent predatory lending practices. However, the OCC's general guidelines were merely advisory, intended to "encourage" national banks to adopt appropriate policies and do not carry the force of formal rules. The OCC should continue to build on the standards identified in AL 2003-2 and promulgate meaningful and specific predatory lending controls.

In every recent pronouncement the OCC has made on predatory lending, it has pointed out that a group of state Attorneys General are on record saying that most predatory lending problems have come from non-depository subprime mortgage lenders, not national banks. These statements by a group of Attorneys General were made in comments supporting a rulemaking proceeding by the Office of Thrift Supervision under the Alternative Mortgage Transaction Parity Act (AMTPA) and in an amicus brief filed in related litigation.[38] The Attorneys General supported the rational basis for OTS' distinction, in its revised AMTPA preemption rules, between "state housing creditors" and federally supervised banking institutions. The Attorneys General encouraged the OTS to revisit a prior preemption determination, and to require state housing creditors to comply with state laws regulating prepayment penalties and late fees.

It is true that most complaints and state enforcement actions involving mortgage lending practices have not been directed at banks. However, most major subprime mortgage lenders are now subsidiaries of bank holding companies (although not direct bank operating subsidiaries). Recent major settlements by state Attorneys General and the FTC related to alleged unfair lending practices by Household Finance and the Associates, both of which have now been acquired by bank holding companies. A national bank was a defendant in the only court case alleging class-wide

[37] *See* OCC News Release 2003-57 (7/24/03); OCC Working Paper, "Economic Issues in Predatory Lending," 7/30/03, available at: http://www.occ.treas.gov/workingpaper.pdf.

[38] National Home Equity Mortgage Association v. OTS, No. 02-2506 (GK) (D.D.C. 2003).

violations of North Carolina's Predatory Lending Act.[39] Several national banks have partnered with payday lenders for the sole purpose of claiming preemption authority to make very high rate, short-term consumer loans in violation of state laws. (The OCC took effective action to curtail this latter practice, known as "charter renting.") Based on these actions and other state consumer protection enforcement actions detailed above, it is clear that a national charter does not prevent a bank from engaging in unfair or deceptive practices.

State predatory lending laws have clearly identified unfair and deceptive lending practices and have imposed specific, appropriate requirements to protect consumers. The States that have enacted legislation have been sensitive to federalism concerns and have been careful not to impose direct restrictions on the rates and fees that nationally chartered lenders (or any lender) may charge. The objective in all states has been to narrowly target abusive practices and to cover only the more problematic reaches of the subprime marketplace, where borrowers are unsophisticated and where most of the problems have occurred.

Responsible lenders do not engage in the practices targeted by state predatory lending laws. These laws impose minimal burdens on legitimate lending institutions and do not impair any reasonable lending activity on the part of banks. The laws, by controlling the most abusive actors, serve to clean up the mortgage lending marketplace and restore consumer confidence, which benefits consumers and lenders alike.

In fact, many state predatory lending controls have now been voluntarily adopted by national subprime lenders. The prohibition on financing single premium credit insurance, which was considered controversial when it was included in North Carolina's 1999 law, has been accepted and implemented nationally by all of the major finance company mortgage lenders. The prohibition against flipping and the related "net tangible benefit" test, which was questioned by some lenders when it was introduced in North Carolina, also has been voluntarily adopted as a useful standard. Leading subprime lenders also have imposed restrictions on exorbitant points and origination fees, which were among the primary abuses identified in state predatory lending laws. Far from restricting the flow of credit, the predatory lending controls initially adopted by several states have become useful as bright line industry standards on a nationwide basis.

Despite the success and acceptance of state predatory lending laws, the OCC has declared every significant component of such laws to be impermissible burdens on national banks. In its order preempting the Georgia law, the OCC finds even the most non-controversial and widely accepted provisions to interfere with banks' ability to lend and therefore to be in conflict with the National Bank Act. As an example, no reasonable person would contend that encouraging a borrower to default on an existing loan is an acceptable lending practice. But just such a practice has been used by unscrupulous lenders or brokers to lead borrowers into a desperate delinquency situation, so that the borrowers then fall prey to whatever terms the lender dictates. Widely recognized as an unfair trade practice, encouraging default is prohibited by state predatory lending laws. Yet the OCC found this prohibition in the Georgia law to be preempted because it imposed

[39] Baxter v. Guaranty National Bank of Tallahassee, 01 CV 9168 (Wake County, NC Superior Court). The bank contended that the North Carolina law was preempted as to a national bank but the case was settled before this issue was judicially resolved.

impermissible restrictions on, and interfered with, "the exercise of the Federal power of national banks to make real estate loans."[40] The OCC also declared restrictions on other practices, such as negative amortization and financing of prepaid credit insurance premiums, and the requirement for high cost loan borrowers to receive credit counseling, to be similarly preempted.

If national banks do not routinely engage in practices such as encouraging default or using negative loan amortization, it is difficult to see how these consumer protections impede any bank's ability to lend. Yet under the proposed rule, any state law provision is preempted if it, among other things, 1) restricts a lender's ability to require insurance; 2) regulates anything relating to the terms of credit, including loan amortization or loan acceleration; 3) requires any disclosures; or 4) regulates advertising.

The OCC recognizes that national banks are subject to Section 5 of the Federal Trade Commission Act, which prohibits unfair or deceptive trade practices.[41] Most states have similarly worded consumer protection statutes, many modeled on the FTC Act. If national banks are prohibited from engaging in unfair and deceptive practices under federal law, then it should be no impediment for them to comply with state laws proscribing the same unlawful practices. State predatory lending acts apply the States' unfair and deceptive practices regulatory authority to the field of mortgage lending. These statutes give further definition and more precise guidelines for lenders on fair conduct in making mortgage loans to consumers.

In the experience of the States, lenders welcome bright line tests more than general proscriptions against unfair conduct. However, in adopting its own very limited restrictions on predatory lending, the OCC falls back on compliance with the FTC Act as a standard for lenders to follow. The OCC would be better advised to fall back on the numerous state laws and regulations in this area and to develop more useful rules for the benefit of the banking industry and consumers alike. The OCC also should insist that national banks comply with state predatory lending laws unless there is compelling evidence that such compliance substantially interferes with a bank's ability to make real estate loans.

E. The OCC Has Exceeded its Authority in Extending Preemption Rights to the Operating Subsidiaries of National Banks.

The OCC's proposal to apply its overly broad preemption rules to operating subsidiaries of national banks clearly exceeds its authority under the National Bank Act. The proposal would do great damage to the state-federal dual banking system, and should be withdrawn.

Operating subsidiaries are not national banks subject to a national charter; they are state-created entities incorporated under state law and have been licensed and regulated by the States for years without controversy. Nothing in the NBA grants the OCC power to bar states from licensing, examining and otherwise regulating state-created non-bank entities that happen to be subsidiaries of national banks. Nevertheless, the OCC now proposes that operating subsidiaries of national banks should have the same legal and regulatory status as the national banks themselves, contending

[40] 68 Fed. Reg. 46278 (8/5/03).

[41] 15 U.S.C. § 45(a)(1).

that these subsidiaries are effectively departments, divisions or equivalent parts of the banks.

The OCC proposes to federalize state-chartered subsidiaries by placing them within the exclusive supervisory control of the OCC. Under the OCC's proposal, the States would be deprived of all authority to regulate these state-chartered corporations, which include mortgage companies that have long been licensed by States. The OCC proposal intrudes upon the States' sovereign powers and exceeds the boundaries of federal authority under the Tenth Amendment. It attempts to convert state-chartered corporations into creatures of federal law without permission of the chartering states.[42]

According to the OCC, a state law is exempted from preemption only if it is expressly incorporated into the federal banking laws or has no more than an "incidental" effect on banking activities. The OCC, however, considers mere inconvenience to a subsidiary of a national bank to be a conflict between federal and state law. As indicated by amicus curiae briefs filed by the OCC across the country, this overreaching standard would lead to the preemption of nearly all state licensing and regulatory laws. The preemption of state licensing laws, including the ability to license and examine mortgage lending entities, is not sound public policy. It would encourage financial institutions to give up their state charters, and to instead, seek either to obtain a federal charter or to merge with a national bank, effectively destroying the dual banking system that is valued by both Congress and the States.

Operating subsidiaries historically have been regulated by States under their respective laws and relevant regulatory regimes and are in no manner considered "national banks" by the NBA. Moreover, the NBA provides absolutely no basis for ignoring the corporate distinctions between a parent national bank and its subsidiary. In an area where, as here, state law traditionally has applied, Congressional intent to preempt state law must be clearly manifested.[43] There is no such intent expressed anywhere in the NBA, and the OCC's proposal is, in fact, contrary to Congressional intent, expressed most recently in the legislative history of the Riegle-Neal Interstate Banking Act.[44]

Additionally, the NBA provides stringent requirements for banks to qualify as national banks. None of these requirements apply to their state-chartered and state-regulated operating subsidiaries. Instead, as creatures of state law, operating subsidiaries should comply with applicable state law requirements.

Moreover, the States have long held an unquestioned primacy in regulating state-chartered corporations, particularly including companies that engage in consumer financial services. Courts have repeatedly upheld States' authority to exercise comprehensive supervision over the corporations they charter and to license and regulate corporations chartered by other states that transact business within their borders. As affirmed by the Supreme Court, "No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations."[45] The

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[42] Hopkins Federal Savings & Loan Ass'n v. Cleary, 296 U.S. 315 (1935).

[43] English v. General Electric Co., 496 U.S. 72, 74 (1990); California v. ARC American Corp., 490 U.S. 93, 101 (1989); Jones v. Rath Packing Co., 430 U.S. 519, 525 (1977).

[44] See discussion in Section II.B. at pp. 4-5 above.

[45] CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 89 (1987).

fact that a state-chartered corporation is an affiliate of a national bank does not alter the principles of federalism that grant States the right to regulate corporations chartered under their laws. Indeed, in a case where the OCC similarly engaged in an overly aggressive interpretation by the OCC of the NBA, a federal circuit court of appeals concluded that "to defer to the OCC in this case would flout Congressional intent – something we remain unwilling to do."[46]

The OCC's claim of exclusive supervisory powers over operating subsidiaries is contrary to both this nation's dual system of banking and the historic primacy of the States in matters of corporate governance. The OCC's broad assertion of field preemption has no basis in any of the federal legislation that provide that agency with its regulatory authority. Like the OCC's claims of complete preemption with respect to national banks, the OCC's proposal to extend its hegemony to banks' operating subsidiaries wholly exceeds any reasonable interpretation of the regulatory powers given to the OCC by national banking laws. The OCC's proposal to create such a sweeping standard of preemption and to bar the States from regulating subsidiaries of national banks created under state laws directly violates Congressional intent, federal law and the Tenth Amendment to the Constitution.

In conclusion, the OCC's proposed rules represent a significant expansion of preemption standards and a restructuring of the federal-state balance that has existed for many years, particularly in the area of consumer protection. For the reasons expressed above, we urge the OCC to withdraw the proposed rules.

We thank you for the opportunity to submit these Comments. If you have questions or comments, please do not hesitate to contact Sarah Reznek, NAAG's Consumer Protection Project Director, at (202) 326-6016 or Blair Tinkle, NAAG's Legislative Director, at (202) 326-6258.

Respectfully,

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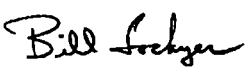
[46] American Land Title Association v. Clarke, 968 F.2d 150, 157 (2d Cir. 1992).



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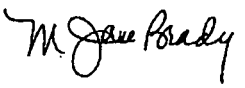

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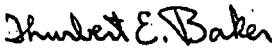

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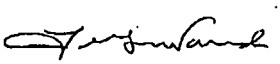

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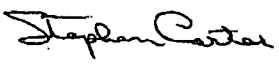

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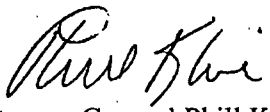

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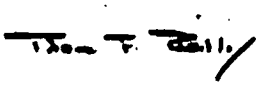

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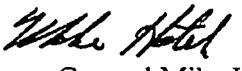

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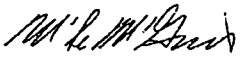

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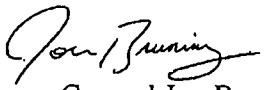

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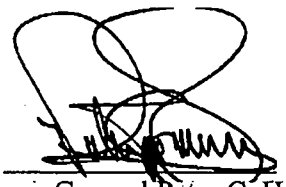

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Economic Crisis, The Audit — April 16, 2010 04:40 PM

Angelides, The Audit, and Unfair Lending

An ex-regulator's testimony to the commission needs examining

By Ryan Chittum

Comptroller of The Audit Dean Starkman spent three months last year poring over nearly a decade of financial-press archives to put together "Power Problem," a *CJR* cover story that examined coverage in the years leading up to the crisis.

A PDF download of the original CJR 'Power Problem" story can be purchased from CJR by clicking here. ADD TO CART

Phil Angelides, who heads the Financial Crisis Inquiry Commission, cited it last week in questions to John Dugan and John D. Hawke Jr., respectively the Comptroller and the ex-Comptroller of the Currency:

> So, but when you see I think 26 states actively trying to deal with this because they saw an on-the-ground problem —there's a fascinating article you may or may not have seen from the *Columbia Journalism Review* about whether the press saw the coming financial crisis.
>
> The only reason I mention it is there's a piece of the article that talks about how much press coverage there was from 2000 to 2003 as states were actively trying to fight deceptive, unfair lending across the country, the boiler rooms, the aggressive lending.
>
> I guess I would in a question probably pose to both of you, given the ground reality that you had state officials all over the country concerned about the level of unfair, deceptive lending, I'm going to ask you both to consider what might have been deficient, therefore, in national —in national enforcement that would have led them to believe it was such a matter of paramount concern.

Angelides was referring to the story's point that forthright press coverage and uncompromised regulation produced a virtuous cycle of reform that helped to police the worst lenders at a time when the mortgage frenzy could have been contained. (The converse was also true, unfortunately; when regulation folded its tent, so, too, did the press.)

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Here's what Hawke, who implemented the ought-to-be-infamous rule in 2003 that pre-empted state regulations of national banks in favor of (weaker, typically) federal rules, said in response (emphasis mine):

> Well, I should say, Mr. Chairman, that we asked state law enforcement officials on many occasions to refer to us any evidence that they had or any incidents they had of national banks involved in conduct of the sort that you described. And we got zero. And we asked consumer groups for the same thing.

That would be, how do you say... false. I went to the tape. The record shows states all but begged Hawke's OCC to take on abusive lenders or allow states to do it to themselves. The OCC first preempted the states, then sat on its hands, effectively running interference for its regulated institutions.

Take a gander at Dean's "Spitzer's Ghost" piece from October 2008:

> Then Eliot Spitzer publicly took on Hawke and brought national attention to the issue of lending-industry abuses, the abuses that led to our current moment global financial peril. This is 2003.

I recalled my November 2008 Audit Interview with John Ryan of the Conference of State Bank Supervisors, which spent a lot of time trying to get the press to cover the feds' pre-emption of state predatory-lending laws:

> Perhaps the greatest frustration is that some federal regulators were working side by side with the industry to push aside state laws or enforcement efforts to address the sorts of abusive or unsustainable lending we were experiencing at the local level. It seemed outrageous to us that a regulatory agency could preempt these laws without any clear authority.

I asked Ryan today about Hawke's comments. He says he "would strongly disagree" with them:

"That statement doesn't reflect what we experienced," Ryan says. "There were tons of consumer complaints referred to the OCC by the states. I was regularly hearing from state regulators that sending complaints to the OCC was equivalent to a black hole. This resulted in the GAO

conducting a study on the matter. The agreement they sent the states was not meant to be cooperative. It required the states to say 'we surrender, we have no authority'. Their focus was not on cracking down on lending practices but rather facilitating the subprime business model of the biggest banks. The actions of the OCC weren't meant to create a cooperative atmosphere."

He pointed to the case of National City, a bank federally chartered by Hawke's OCC. Here's the *Seattle Post-Intelligencer* in 2008 on that (emphasis mine):

> When state investigators spotted questionable loan practices, the feds rejected their help and informed the state that it had no business looking into the affairs of federally chartered institutions. Scott Jarvis, director of the Washington state Department of Financial Institutions, said his files are full of letters from federal bank regulators, bankers and other lenders politely telling his office to take a hike.
>
> **In a typical case in late 2002, state bank examiners believed National City Mortgage was violating the state's Consumer Loan Act by charging extra fees on mortgages, said Kwadwo Boateng, the state's chief bank examiner. When asked to explain the costly "discount loan fees, underwriting fees, processing fees and marketing fees," National City Mortgage sought intervention from federal regulators, records show.**
>
> **The investigation was stopped by federal decree.**
>
> At the company's request, Julie Williams, general counsel of the federal Office of the Comptroller of the Currency, wrote National City a letter in January 2003 saying the state had no right to examine or even visit its offices. Because National City's parent bank in Cleveland was chartered with the OCC, the federal agency pre-empted the state's authority. National City attached Williams' letter to a missive to the state in February 2003, asking state investigators to stay away.
>
> And here's the kicker. The federal agency didn't go after the mortgage fee complaint because it had no authority to enforce state consumer protection laws, Boateng said.

Hello, regulatory capture!

Here's *The Wall Street Journal* from 2007 (emphasis mine):

> Federal regulators, meanwhile, have tended to focus more on the solvency of the institutions they oversee and less on individual consumer complaints. The case of Dorothy Smith, a 67-year-old from East St. Louis, Ill., illustrates how hard it was for individuals to get regulators' help. In 2001, Ms. Smith, living on $540 a month in government benefits, was encouraged by a contractor to apply for a loan to finance home repairs. After two loan applications were rejected, a broker submitted a third showing that she had monthly income of $1,499 and was employed at a senior-citizens home though she had actually retired 10 years before, she said. The $36,000 mortgage that First Union National Bank (now part of Wachovia Corp.) approved for her required a monthly payment of $360.33 for 15 years followed by a "balloon" payment —when she would be over 80 —of $30, 981.48. Fees and closing costs came to $3,431.
>
> When the contractor left work unfinished, Ms. Smith sought help from Land of Lincoln Legal Assistance Foundation, which complained to Illinois bank regulators. The legal aid lawyers say the loan required unreasonably high payments given Ms. Smith's income and a balloon payment when she would be over 80 years old. **The state forwarded her complaint to the OCC, First Union's regulator, which responded in 2002**: "We cannot intercede in a private party situation regarding the interpretation or enforcement of her contract .... The OCC can provide no further assistance."

Here's something from a great 2002 *Wall Street Journal* leder by Jess Bravin and Paul Beckett headlined "Friendly Watchdog: Federal Regulator Often Helps Banks Fighting Consumers — Dependent on Lenders' Fees, OCC Takes Their Side Against Local, State Laws — Defending Uniform Rules." It shows how Hawke's OCC actively fought against holding banks to account for their deceptive lending practices, even after complaints by what I think you could fairly call a "consumer group":

> In the FleetBoston case, the OCC received hundreds of letters from customers in 2000, complaining that the federally chartered bank had increased interest rates on its credit cards after allegedly promising a "fixed" rate. In response, the OCC sent customers letters saying it couldn't help. Federal law "recognizes banks' ability to change the terms of credit card account agreements," as long as the

> change is disclosed, the OCC said in a typical letter sent to a complaining customer on March 23, 2000. "If you wish to pursue further remedy to your complaint, we can only suggest that you contact private legal counsel regarding any additional remedies," the OCC added.
>
> **In October 2000, several customers filed suit, seeking class-action status and accusing FleetBoston of deceptive practices under Rhode Island state law. A Rhode Island state judge in Providence ruled in April that the case could proceed. But the OCC stepped in to help FleetBoston.** The OCC argued in a friend-of-the-court brief that the state law on which the suit was based doesn't apply to FleetBoston because the OCC can take action against unfair and deceptive practices, as it did in the Providian case — although the agency hadn't done so regarding FleetBoston.

Here's the *American Banker* in 2004:

> A host of predatory practices —including equity stripping, loan-flipping, and insurance packing —have become part of the consumer finance lexicon. Industry advocates and the OCC have argued that these abuses are perpetrated by nondepository lenders, not banks. But some disagree.
>
> "That is absolutely, 100% incorrect," said Tom Methvin, the managing shareholder of the Montgomery, Ala. class action law firm Beasley, Allen, Crow, Methvin, Portis & Miles PC. "The depositories own the finance companies that are doing it all."
>
> Predatory lending has reached "epidemic proportions," Mr. Methvin said. "Many times banks make loans to people who do not demonstrate the ability to repay, knowing they can come take the collateral and just sell it to someone else."

This took me all of an hour and a half to find. It's worth noting that Hawke was under oath. I have a request for comment out to Hawke, now a partner at Arnold & Porter LLP, where he "provides US and international financial institution clients with comprehensive regulatory, litigation, and transactional services." Also: "The practice group is recognized for developing innovative structures and novel solutions to regulatory issues."

The rest of the press ought to ask him for comment, too.

CHASE

December 19, 2007

Mark Pearce
Deputy Commissioner
NC Office of the Commissioner of Banks
316 W. Edenton Street
Raleigh, NC 27603

Dear Mr. Pearce:

I am in receipt of your letter dated November 19, 2007 regarding the collection of monthly servicing data. We at Chase agree that there is a need to encourage financial institutions and others to be as proactive as consistent with prudent lending practices and the terms of their governing servicing agreements or other documents in accomplishing successful loss mitigation and preventing foreclosures. Chase continues to be engaged in homeownership preservation both for loans it owns and services through its Homeownership Preservation Office, its loss mitigation programs; its proactive ARM reset program and the HOPE Now Alliance. Foreclosure is an undesirable outcome for borrowers, lenders, servicers, investors and the community. Chase monitors its progress on foreclosure prevention so that we can modify our procedures and practices as appropriate or useful to enhance their effectiveness in addressing these problems. Chase also continues to work on new initiatives and cooperate with all involved in the process. As we have previously indicated, Chase is happy to discuss with you and other interested parties the steps we are taking that show promise in meeting the challenges we all face today in the mortgage market.

With respect to your request that we complete and submit monthly the detailed servicer call report you provided, I'm sure you appreciate that Chase is a national bank, chartered under authority of federal law, and is supervised and regulated exclusively by an agency of the federal government – the Office of the Comptroller of the Currency (OCC). The call report requests information about the bank, its loans and its servicing practices subject to this federal oversight, and as such, this kind of detailed information would ordinarily be available only to the OCC. We have consulted with the OCC and they have advised us that it would be inconsistent with the OCC's exclusive oversight and examination of a national bank for information of the kind required to complete the call report to be provided to officials other than the OCC. As a result, Chase must respectfully decline your request for the call report and supplements which would contain detailed information about loan performance, loss mitigation efforts, and foreclosures. The OCC has advised us that you should feel free to discuss with the OCC.

The foregoing notwithstanding, we have enclosed herewith information we have developed which will provide you with some insight into Chase's efforts at loss mitigation and our results to date. We hope you find this information useful. We continue to stand ready to discuss with you Chase efforts at your convenience.

Very truly yours,

Jim A. Miller
Executive Vice President

cc: Ned Pollock, Office of the Comptroller of the Currency
Daniel Cooney, General Counsel, Chase Retail Financial Services

Chase Home Finance • 8333 Ridgepoint Drive, Irving TX 75063
Telephone: 972-443-5747 • Facsimile: 972-443-5734

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CHASE STRIVES TO KEEP HOMEOWNERS IN THEIR HOMES

Chase understands that the current economy, the reduced availability of credit and the reality of flat and declining home prices are creating financial hardship for a growing number of homeowners.

More than 6 million borrowers – including 2 million subprime borrowers -- have faced or will face an additional challenge: the interest rate on their loans – and thus their mortgage payments – will reset and likely increase in 2007, 2008 and beyond. Those increases could be especially painful for subprime borrowers with blemished credit histories and little savings. The end result for many families could be financial difficulties or even foreclosure.

That's where Chase has stepped in and stepped up, supplementing its existing programs by reaching out to tens of thousands of homeowners. Chase's simple goal is shared by homeowners and community groups alike: Keep homeowners in their homes whenever possible.

Through the experience of servicing more than $700 billion of mortgages, Chase has created a toolkit to help homeowners – and Chase has expanded it for the special challenges of 2007 and 2008.

Tried-and-True Practices

Over the years, Chase has followed a tried-and-true approach to helping customers with their loans, whether the customer approaches Chase or Chase reaches out to the customers.

Knowing how important it is to make contact with borrowers and to address payment issues quickly, Chase has established quick-action programs:

- **Early and Often.** Chase starts calling customers as soon as 5 days after a payment is missed.
- **On the Doorstep.** Chase will go directly to the homes of customers when unable to reach them by telephone and mail. A representative will try to talk to the customer or leave a sealed notice on the door providing telephone numbers for Chase and consumer or community organizations.
- **The Video Approach.** Chase also will send out a DVD if a customer is nearing foreclosure and still has not contacted Chase.

One-On-One Attention

During the initial delinquency period, every customer in default is assigned an individual Chase representative who is trained to understand the customer's individual financial situation. The representative will help the customer try to bring the loan current. If the problem is long term, each customer will be assigned to a Homeowner's Assistance representative.

The specially trained Homeowner's Assistance representative gets to know the customer's individual circumstances, income and expenses. To consider a modification, Chase asks borrowers to provide up-to-date information, including the following: their two most-recent bank statements, their two most-recent pay stubs, their most recent federal income tax return and a hardship letter. The one-on-one relationship will help the trained specialist review options and determine what solutions might be affordable.

Working Hand-in-Hand with Community Groups

Chase knows that worried homeowners might be more comfortable seeking help from a trusted community group and might not respond to the company's outreach. So, Chase created its Homeownership Preservation Office in 2004 to make it easier for those non-profit community groups to talk directly to Chase about customers at risk of losing their home. Chase then works with the community group to provide in-depth counseling to the homeowner in distress.

In 2007, the Homeownership Preservation Office has been involved in a number of ways:

- Its toll-free hotline staffed by full-time case managers has received more than 5,000 calls from non-profits, resulting in 1,540 new cases. The call volume has increased and so did the complexity of consumer issues.

- Its 60 foreclosure prevention workshops have trained more than 2,000 non-profit counselors, housing advocates and public officials.

- It has worked with foreclosure prevention programs in Chicago, Cleveland, Colorado, Dallas, Detroit, Indiana and New York.

ARMed for the Tough Times of 2007 and 2008

The biggest challenge for many subprime borrowers in 2007 has been the interest-rate and payment resets of the 2-28 and 3-27 adjustable-rate mortgages. The interest rate and payment had been fixed for the first two or three years of the loans, but they can adjust annually or even twice a year for the next 27 or 28 years. The vast majority of these ARMs face their first reset in 2007 or 2008 because they were originated in 2004 and 2005.

So, Chase introduced its ARM Reset Notification Program in early 2007. Simply put, the program provides the homeowner advance personalized information about how their interest rate and monthly mortgage payment likely will change at the reset date.

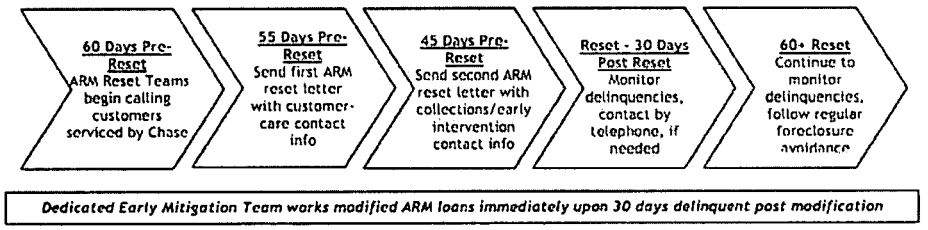
Many customers lose track of their ARM reset date or simply don't understand how dramatically the interest-rate reset could increase their monthly payment. Chase developed programs for both prime and non-prime customers, starting with those most at risk.

CHASE

Chase reaches out to customers multiple times by multiple means, including mail and telephone, two to five months before the scheduled interest-rate and payment reset date. Chase gives highest priority to those with the shortest time until reset. (Chase can't reach 100% of customers because some servicing agreements with investors won't allow it.)

Through the process, Chase seeks to focus the customer on the impending financial impact and to make its specialists available to discuss the homeowner's options if the increased payment would not be affordable.

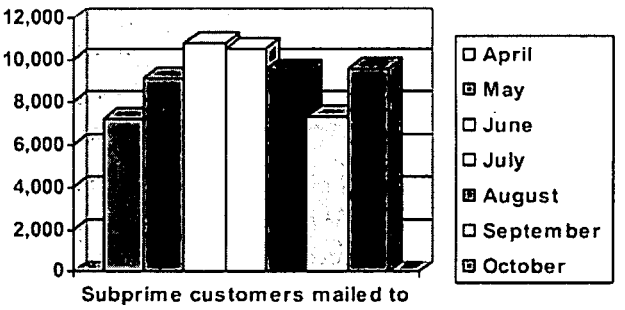
ARM Reset Lifecycle:



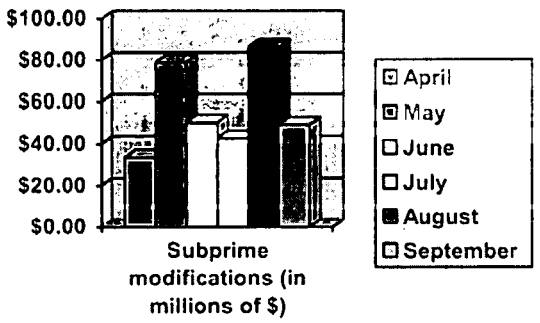
Measuring the Results to Get Even Better

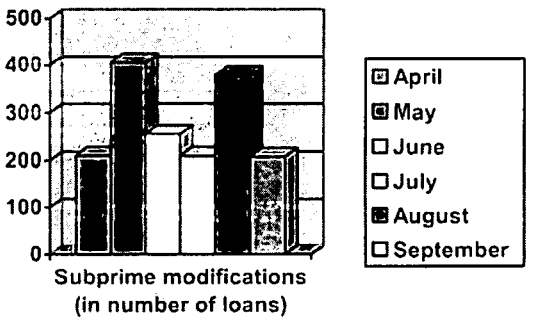
Chase has created a disciplined reporting system to track the notification program's results so it can continue to improve the program. The results since April are impressive:

- Chase has made more than 64,000 contact attempts and reached more than 24,000 subprime customers and modified more than $347 million of their ARMs. It has refinanced an additional $28 million of their loans.
- Chase has modified 17 percent of all subprime ARMs due to be reset by March, 2008.



- Chase charges no prepayment or modification fees when the Homeowner's Assistance Department modifies the loan to make it affordable.





- Chase has made more than 140,000 contact attempts to *prime* borrowers -- a larger group with larger mortgages -- generating more than 83,000 conversations and the funding and modification of more than $648.5 million of prime ARMs.

Always Seeking More Ways to Help Customers

Chase continues to explore additional ways to assist customers and keep them in their homes. Initiatives under development include:

- **The Enhanced Streamline Refinance Program** uses prequalification and streamlined documentation to convert more customers with Chase-owned ARMs to a fixed-rate mortgage with minimal processing.

- **The HELPP Program** seeks to help customers with Chase-owned mortgages who wish to stay in their homes even if their loan-to-value ratio exceeds 100% because of declining house values.

- **The Foreclosure Rescue Program** is designed to help any customer serviced by Chase at any point during the foreclosure process. Up until five days before a foreclosure, Chase will put it on hold and review the file to see if anything can be done to prevent foreclosure.

Taking a National Approach

In October, Chase helped found HOPE NOW, a national alliance of counselors, servicers, investors, and other mortgage market participants. Alliance members recognize that a consistent approach applied in every state and across the industry will be more effective than state-by-state initiatives.

Its action plan calls for:

- Conducting a new, national direct mail campaign to contact at-risk borrowers, encouraging them to either call their lender or a credit counselor.

- Adopting a standard process model that will strengthen and speed work flow, productivity, and communications between servicers and counselors.

- Working to expand the capacity of an existing national network to receive, assess, counsel, refer, and connect borrowers to servicers.

- Developing a common set of metrics to measure the initiative's progress.

Embracing a Common Framework for a Five-Year, Interest-Rate Freeze

In early December, 2007, Chase joined with government and industry leaders in supporting a new federal initiative designed to keep more homeowners in their homes. The five-year, interest-rate freeze for qualifying borrowers will help Chase further streamline its process to review and approve loan modifications for qualified homeowners.

Chase now has an even more streamlined framework to evaluate which borrowers qualify for the rate freeze. The qualifications include:

- The borrower must live in the home.

- The adjustable-rate loan will have its first reset between Jan. 1, 2008, and July 31, 2010.

- The borrower must be current on the loan.

- The borrower must have less than 3 percent equity in the home, either at origination or currently.

- The borrower's current FICO credit score is less than 660 and has not risen at least 10 percent since the loan was originated.

Chase also will continue its extensive efforts to assist other borrowers who face challenges with their mortgages.

Striving to Be Best in Class for Customers

Chase is proud of the programs it has developed over time, especially in the last year, to address the needs of customers who encounter financial difficulties. We continually re-examine our practices to remain responsive to changing market conditions and their impact on our customers. We believe our programs are among the best in class and will help our customers manage through this challenging environment.

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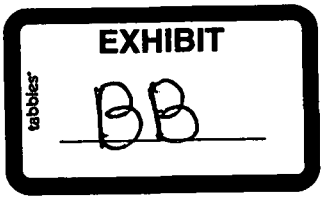


WELLS FARGO

Wells Fargo Home Mortgage
MAC X7801-03Y
3476 Stateview Blvd
Fort Mill, SC 29715

December 13, 2007

Mr. Mark Pearce
Deputy Commissioner of Banks
4309 Mail Service Center
Raleigh, NC 27699

Dear Mr. Pearce:

Wells Fargo Bank, N.A. would like to thank you, your staff, and the State Attorneys General for their participation in the meetings in Chicago in September. We appreciate your efforts with respect to the current challenges in subprime mortgage loan delinquencies and foreclosures. While this problem is complex and involves the balancing of multiple considerations, we remain committed to communicating and working with customers facing financial difficulties in order to minimize foreclosures.

Among the efforts we are taking to help homeowners is the HOPE NOW alliance. A number of servicers, including Wells Fargo Bank, are participating in this initiative with the U.S. Treasury Department and HUD. In the past, mortgage servicers and housing counselors working individually have undertaken a variety of efforts to encourage customers in financial distress to work with us on alternatives designed to help avoid foreclosure. HOPE NOW will harness the collective strengths of these individual efforts in a much more coordinated way with the federal government's backing to bring benefits to consumers across the country.

HOPE NOW lenders and servicers have:

- established special toll-free numbers for consumers,
- added more default specialists and increased the hours they are accessible to consumers,
- been calling and writing customers in advance of any ARM reset,
- created financial education web sites,
- increased advertising to emphasize the importance of contacting the lender early for help, and
- worked on a variety of national and local counseling efforts.

As I am sure you are aware, Wells Fargo is a also a supporter of the most recently announced initiatives by President Bush and Secretary Paulson that will help to streamline solutions for subprime borrowers facing ARM resets.

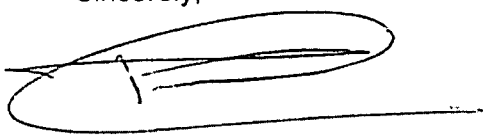
Regarding your request for information, as you might expect, we have received an unprecedented number of requests for data and other information from various organizations and state agencies. The Office of the Comptroller of the Currency, our regulator, has suggested that we need to balance providing bank books and records to various state enforcement agencies, with the

limitations placed on a national bank's ability to do so. Among the primary concerns are visitorial exclusivity, customer privacy issues, the public release of highly proprietary and confidential information, and securities laws which come into play in relation to the trading of any mortgage-backed securities based on this non-public information.

In the interest of assisting groups, such as yours, with exploring additional options for homeowners, the Mortgage Bankers Association (MBA) has volunteered to act as a clearinghouse for industry data as part of the HOPE NOW Alliance. Wells Fargo Bank will be participating in this clearinghouse and we are confident that the MBA will share this industry data with your office.

Wells Fargo Bank looks forward to working with you and the other participants in the Chicago meetings to continue find solutions to this situation. Should you have any questions or require any additional information please contact me.

Sincerely,



Patrick A. Carey
Executive Vice President

National City

National City Card Services
One National City Parkway
Kalamazoo, MI 49009-8002

December 8, 2003

OFFICE OF THE ATTORNEY GENERAL
ATN: CONSUMER PROTECTION DIVISION
500 SOUTH SECOND STREET
SPRINGFIELD, IL 62706

Re: [redacted] File No: 2003-CONSC-00089476

National City Card Services, a division of National City Corporation ("National City") is in receipt of your letter dated November 24, 2003 with respect to the above –referenced matter.

Please note that National City is a national bank, regulated by the Office of the Comptroller of the Currency ("OCC"). Consistent with the OCC's Advisory Letter AL2002-9, a copy of which is enclosed for your reference, National City requests that your office send any future inquiries that it receives from National City customers to the OCC's Customer Assistance Group, or advise such customers to contact the OCC directly. The address and phone number for the Customer Assistance Group are:

Office of the Comptroller of the Currency
Customer Assistance Group
1301 McKinney St, Suite 3450
Houston TX 77010 - 3031

(800 613 6743)

National City will be providing a response to our customer's inquiry directly to the OCC. In an effort, however, to avoid any duplication of effort or any unnecessary delay with respect to our customer's inquiry, a copy of the response provided to the OCC is enclosed.

Sincerely,

Tom Richardson

Tom Richardson
Compliance Administrator
National City Card Services

pc: Office of the Comptroller of the Currency

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73-0021-25 (Rev 09/03)

WALL STREET JOURNAL.

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t's News—

* * *

World-Wide

RUMSFELD TOURED Guantanamo Bay and insisted detainees there aren't POWs. The defense secretary's stance may be tested at a meeting of Bush's security team today after weekend reports of internal administration debate over the status of captives from Afghanistan and the application of the Geneva Conventions. Meanwhile, interim Afghan President Hamid Karzai arrived in Washington to seek a continued U.S. commitment to rebuilding his country, the first visit by an Afghan leader in 39 years. Afghan villagers claim civilians were killed in last week's raids by U.S. special-forces troops. U.S. soldiers have mounted an operation against al Qaeda fighters holed up at a Kandahar hospital for the past six weeks. (Articles in Column 4 and on Pages A12 and A16)

A group in Pakistan released photos and said it has captured Wall Street Journal reporter Daniel Pearl, who has been missing since Wednesday. It alleged Pearl worked for the CIA, which both the agency and the Journal denied.

* * *

A suicide bomber killed one Israeli on a busy Jerusalem street. In a shift in Palestinian tactics, the bomber was a woman. One person injured in the attack had escaped the World Trade Center unhurt on Sept. 11. On Friday, a suicide bomber wounded 24 in Tel Aviv. The U.S. relationship with Arafat is near a breaking point. (Article on Page A12)

* * *

Bush prepared for his State of the Union speech tomorrow, calling for vastly expanded spending on the military and homeland security in a budget projected to return the U.S. to deficit spending. Despite concern the nation can't afford tax cuts already in place, the president will seek more as part of his economic-stimulus plan. (Article on Page A16)

Bush may use the address to try to revive his plan to give Medicare recipients prescription-discount cards. The proposal, derided by Democrats as a gimmick to shift debate away from a Medicare drug benefit, has been stalled for months. (Article on Page A16)

* * *

Cheney vowed the administration will go to court to guard details of his meetings with companies, including Enron, while he was crafting Bush's energy plan. With the Enron debacle heating up as a potential election issue, the GAO is threatening to sue to force such disclosure. (Article on Page A6)

* * *

A Russian helicopter exploded in Chechnya and killed all 14 aboard, including two senior Interior Ministry officers. There were conflicting reports about whether the crash was accidental or the result of a rebel attack.

* * *

Iraq admitted a nuclear-inspection team for a brief tour as Baghdad seeks renewed U.N. sanctions talks. But the team said it won't be able to reach definitive conclusions on arms research. (Article on Page A10)

* * *

India tested a missile capable of carrying a nuclear warhead Friday and said it has no intention of pulling its troops back from the Pakistan border anytime soon. The test and its timing drew Pakistani criticism.

* * *

Computer attacks rose sharply in the second half of 2001 and a surprising number appeared aimed at specific companies, a computer-security firm found. Many seemed to originate in the Mideast. (Article on Page B6)

* * *

Australian protests mounted over treatment of refugees, many of whom are on hunger strikes in detention camps. The Howard government says conditions are meant to be harsh in order to curb illegal immigration.

* * *

Colombian rebels bought rockets from the Irish Republican Army and received training in making bombs, a rebel defector told a Bogota magazine. Three IRA guerrillas have been in custody in Colombia since 1999.

* * *

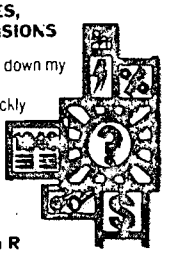
Inside Today's Journal

A REPORT ON

PERSONAL FINANCE

HARD TIMES, HARD DECISIONS

- Should I pay down my mortgage?
- How do I quickly raise cash?
- How do I invest more safely?
- And more.



See Section R

Pakistani Group Says It Seized Daniel Pearl, Journal Correspondent

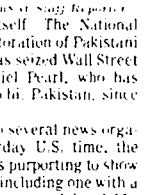
* * *

It Wants Pakistanis in Cuba And Afghan Envoy Returned; Paper Asks Reporter's Release

By a WALL STREET JOURNAL Staff Reporter

A group calling itself "The National Movement for the Restoration of Pakistani Sovereignty" said it has seized Wall Street Journal reporter Daniel Pearl, who has been missing in Karachi, Pakistan, since Wednesday.

In an e-mail sent to several news organizations early yesterday U.S. time, the group appended photos purporting to show Mr. Pearl in captivity, including one with a gun to his head. The group claimed Mr. Pearl was captured because he was a CIA officer posing as a journalist of the Wall Street Journal, an assertion the U.S. government and the newspaper said was wrong.



Daniel Pearl

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"The terrorists who have seized Daniel Pearl have made a mistake," said a statement released by Vice President Steven Goldstein of Dow Jones & Co., which publishes The Wall Street Journal. "Mr. Pearl, as are all Wall Street Journal reporters, is solely a journalist and has written regularly on a variety of subjects during his 12 years on our staff. He has no connection whatever with the government of the United States, including its Central Intelligence Agency.

"In the interest of humanity, the terrorists should release Mr. Pearl unconditionally."

The Outlook

Chinese Multinationals Aim to Be Just That

New York

By almost any measure, China is a great rising economic power in the world. But later this week, when 3,000 global business leaders and dignitaries convene at the annual meeting of the World Economic Forum, China's corporate presence will be almost negligible.

It isn't that mainland Chinese companies are excluded from "Davos in New York," as the meeting is dubbed. It's just that the conference, normally held in the Swiss resort town of Davos, but now here for the first time, will be filled with big, globe-girdling multinational companies. U.S., European, Canadian and Japanese multinationals dominate the membership list. Of the roughly 1,000 corporate members of the Forum, only six are Chinese, and most of these are bloated state-owned concerns.

In a way, China is the great missing member of the Davos set. Most developing countries have at least a few homegrown, world-class entities. Mexico has Cemex SA, a powerhouse in cement. Brazil boasts the successful airplane maker Embraer. India has the Tata group, a conglomerate that has interests in trucking, utilities, engineering and software.

"We're all trying to figure out why China hasn't developed a world-class multinational company," says Wei Qun E, chief executive of the Chinese Enterprise Association, a California-based group and an informal adviser to the Chinese government. Actually, decades of Communist rule have hobbled the Chinese terribly. Today, China has no famous global brands, except perhaps Tsingtao beer.

But China has tremendous ambition to break into the club. It could happen. A few genuine Chinese multinational corporations are beginning to emerge. A handful of winners in the domestic market have begun opening offices overseas and building plants around the globe, in hopes of taking on entrenched U.S., European, Japanese and South Korean competitors in global markets. One company, Hangzhou-based conglomerate Hulley Group, has even made two small acquisitions in America.

The best example of the emerging Chinese multinational is Haier Group, China's largest appliance company. Famous at home but unknown abroad, Haier is expanding globally. In the 1990s, it opened factories in 10 countries. Then in 2000, it opened a $40 million plant in Camden, S.C., to make compact refrigerators, sold through Wal-Mart, Home Depot and other retailers, quickly capturing more than 30% of this U.S. market niche.

Why would Chinese companies, blessed with a low-wage work force at home, open plants in high-wage America? Haier officials say shipping refrigerators across the ocean is costly and can take 40 days. Better to build close to the customer, and be able to place "Made in U.S.A." on the product. For Haier, the cost savings come from cheap research-and-design costs in China, and cheaper machinery, shipped from China to its factories in the U.S. and elsewhere.

Today, Haier is quickly rolling out more products, including freezers, air conditioners, flat-panel television screens, DVD players and microwave ovens, into the U.S. market. This year, says Michael Jemal, the American head of Haier's U.S. subsidiary, total U.S. sales, $5% of which are imports, will be almost $500 million. The U.S. unit is profitable, Mr. Jemal says.

None of this has Whirlpool, Nokia or Panasonic quaking in their boots quite yet. But they are sitting up and taking notice, and so is Japan.

It's clear that China will be more than a manufacturing platform, says Ian Okumura, head of the New York office of the Japan External Trade Organization. "We

Friendly Watchdog

Federal Regulator Often Helps Banks Fighting Consumers

Dependent on Lenders' Fees, OCC Takes Their Side Against Local, State Laws

Defending Uniform Rules

By Jess Bravin And Paul Beckett

Staff Reporters of The Wall Street Journal

When a federal appeals court in San Francisco took up the issue of automated-teller-machine fees earlier this month, it sparked the latest round in the battle between big banks and customers.

Sticking up for consumers were the cities of San Francisco and Santa Monica. They had banned certain ATM fees after customers complained about being gouged when they use ATMs belonging to banks other than their own. Defending the fees were California's two largest banks—Bank of America Corp. and Wells Fargo & Co.—which had won at trial.

Also in the courtroom, the Office of the Comptroller of the Currency, the federal banking regulator. But in this case—as in more than a dozen others in recent years—the OCC wasn't there to check the economic power of banking titans. Instead, the regulator was helping the nationally chartered banks defend their fees. The appeals court is expected to rule in coming months.

Many federal regulators have a clear mandate to put consumers first. The Securities and Exchange Commission, for example, refers to itself as "the investor's advocate."

It's less clearcut for the federal banking watchdog. Time and again, the U.S. agency that bank customers might assume is on their side has lined up with banks to fight state and local measures that purport to aid consumers.

In addition to the ATM fees case in California, the OCC recently has supported banks in their effort to kill a ban in Texas on certain check-cashing fees. In Pennsylvania and Rhode Island, the OCC has weighed in on the side of giant FleetBoston Financial Corp. against consumer allegations of improper increases in credit-card rates. And in Michigan, the federal agency has even supported a push by banks making auto loans to curb a state law aimed at unscrupulous car dealers.

The OCC's solicitousness toward the businesses it oversees stems in part from its need to compete for their loyalty. In an uncommon arrangement, banks can choose either a state or federal regulator, and the selection has financial consequences. The OCC and state banking departments subsist entirely on fees paid by the institutions they regulate.

The competition, though discreet, can get intense. As consolidation has swept the industry, the OCC's once-mighty position has slipped. Since 1990, as the number of U.S. banks dropped 31%, to 8,300, the number regulated by the OCC dropped 45%, to about 2,240. It still regulates the bulk of the banking industry as measured by assets, but consolidation has made the agency increasingly dependent on a few big players. Third-ranking Bank of America, based in Charlotte, N.C., now pays $40 million a year to the OCC in fees, or the equivalent of 10% of the agency's annual $400 million budget.

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Friday, a suicide bomber wounded 24 in Tel Aviv. The U.S. relationship with Arafat is near a breaking point. (Article on Page A12)

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Bush prepared for his State of the Union speech tomorrow, calling for vastly expanded spending on the military and homeland security in a budget projected to return the U.S. to deficit spending. Despite concern the nation can't afford tax cuts already in place, the president will seek more as part of his economic-stimulus plan. (Article on Page A16)

Bush may use the address to try to revive his plan to give Medicare recipients prescription-discount cards. The proposal, derided by Democrats as a gimmick to shift debate away from a Medicare drug benefit, has been stalled for months. (Article on Page A16)

* * *

Cheney vowed the administration will go to court to guard details of his meetings with companies, including Enron, while he was crafting Bush's energy plan. With the Enron debacle heating up as a potential election issue, the GAO is threatening to sue to force such disclosure. (Article on Page A6)

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A Russian helicopter exploded in Chechnya and killed all 14 aboard, including two senior Interior Ministry officers. There were conflicting reports about whether the crash was accidental or the result of a rebel attack.

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Iraq admitted a nuclear-inspection team for a brief tour as Baghdad seeks renewed U.N. sanctions talks. But the team said it won't be able to reach definitive conclusions on arms research. (Article on Page A10)

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India tested a missile capable of carrying a nuclear warhead Friday and said it has no intention of pulling its troops back from the Pakistan border anytime soon. The test and its timing, drew Pakistani criticism.

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Computer attacks rose sharply in the second half of 2001 and a surprising number appeared aimed at specific companies, a computer-security firm found. Many seemed to originate in the Mideast. (Article on Page B3)

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Australian protests mounted over treatment of refugees, many of whom are on hunger strikes in detention camps. The Howard government says conditions are meant to be harsh in order to curb illegal immigration.

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Colombian rebels bought rockets from the Irish Republican Army and received training in making bombs, a rebel defector told a Bogota magazine. Three IRA guerrillas have been in custody in Colombia since 1999.

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Munitions explosions rocked Nigeria's commercial capital, but there were no immediate reports of casualties. State TV sought to assure Lagos residents that the blasts at an army base in the city weren't a sign of a coup.

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Honduras restored diplomatic ties to Cuba, which were broken in 1961, dealing a fresh blow to U.S. efforts to isolate Castro. The order came just before a new president, Ricardo Maduro, took office in Tegucigalpa.

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Amtrak finances continue to worsen and the railroad needs much higher capital funding, the Transportation Department says. The issue of federal help will come to a head in Congress this year. (Article on Page B6)

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The Rams and the Patriots square off in football's Super Bowl next Sunday after each team won their respective conference. ... **Thomas Johansson won** the Australian Open men's tennis title, beating Marat Safin in four sets. Among women, Jennifer Capriati defeated Martina Hingis in three sets.

By a WALL STREET JOURNAL Staff Reporter

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"In the interest of humanity, the terrorists should release Mr. Pearl immediately," the statement said. "Mr. Pearl is a private citizen employed by an independent newspaper. Neither he nor we can change the policies of the United States or Pakistan."

U.S.-Held Prisoners Cited

The e-mail sent yesterday said that "if the Americans want the release of Mr. Pearl, all Pakistanis being illegally detained by the FBI inside America merely on suspicion must be given access to lawyers and allowed" to see their family members.

It said that Pakistani prisoners in Cuba "must be returned to Pakistan and they will be tried in a Pakistani Court. After all, Pakistan was a full member of the international coalition against terror and it deserves the right to try its citizens."

The e-mail also called for sending "Afghanistan's Embassador [sic] Mulla Zaeef back to Pakistan and if there is any accusi-

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China hasn't developed a world-class multinational company," says Wei Qun E, chief executive of the Chinese Enterprise Association, a California-based group and an informal advisor to the Chinese government. Actually, decades of Communist rule have hobbled the Chinese terribly. Today, China has no famous global brands, except perhaps Tsingtao beer.

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"It's clear that China will be more than a manufacturing platform," says Jun Okumura, head of the New York office of the Japan External Trade Organization. "We see the increasing capacity of Chinese companies to conduct R&D and come up with sophisticated products, not just knockoffs."

So far, the scale of Chinese outward investment is still small by most measures. The business investment flowing outward from China was only $2.32 billion in 2000, the latest data show, about half the level of Singapore or South Korea. This budding investment by Chinese multinationals is dwarfed by the capital flowing into China, which totaled $42 billion in 2000 and an estimated $50 billion last year.

It's precisely this inflow of foreign money and technology that will create a strong base of know-how inside China. China will also benefit from its accession to the World Trade Organization, which will reduce commercial barriers into China but also open markets to Chinese goods. And the Chinese government is offering encouragement and low-interest export loans.

Some newcomers stumble hard anyway. Konka Group, a big TV-set maker in the domestic Chinese market, has closed its contract-manufacturing operation in Tijuana, Mexico, which served the U.S. The company said that selling TV sets in the U.S. was a money loser. "If we can't sell at a profit, we won't sell at all," says Helen Huang, the chief executive of Konka U.S.A.

Optimists say Chinese multinationals are akin to Japanese companies in the 1960s and South Korean conglomerates in the 1980s. That may be. Yet international brand building is difficult. Even mighty Toyota Motor Corp. stumbled when the Toyopet subcompact failed to excite U.S. buyers in the late 1950s. Similarly, it will be hard for Konka to make a serious dent against the Sony or Panasonic brands. And for Haier to dislodge Maytag.

Whirlpool and Maytag have earned their stripes, says Haier's Mr. Jemal. "We're the new kid on the block."

—BERNARD WYSOCKI JR.

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John D. Hawke Jr.

The OCC promises federally chartered banks the predictability of a uniform set of rules, rather than the burden of complying with varying state standards. A further attraction is the likelihood that the agency will support its banks in court against aggressive state regulators. State banking authorities typically offer the competing enticement of lower examination fees.

The OCC, an arm of the Treasury Department with 2,900 employees, maintains that it safeguards customers by enforcing federal consumer-protection laws and by securing the overall health of the national banking system. But the agency's chief, John D. Hawke Jr., says that state efforts to stick up for bank customers often threaten to undermine the right of national banks under federal law to operate and charge fees as they see fit.

The OCC's siding with banks in court fights "may operate in some cases to the disadvantage of consumers," says Mr. Hawke, a 68-year-old lawyer who in private practice represented both state- and federally chartered banks. But his agency "can't pick and choose whether a [state] law or action is good or bad" for consumers. If it cramps banks' freedom to operate in the eyes of the OCC, it must go, he says.

History helps explain the OCC's stance. It was founded during the Civil War to oversee newly created national banks that were formed to circulate a national currency and finance the Union's military campaign. With strong backing from the federal courts, the OCC still interprets the National Bank Act of 1863 as authorizing it to oppose any state or municipal attempt to interfere with the ability of nationally chartered banks to engage in the business of banking. When the agency goes to court, it also invokes a provision in the U.S. Constitution stating that federal law prevails in conflicts with state law.

Frustrated consumers say the upshot is that the OCC favors the industry that pays its bills. "The individual bank customer is

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28 2002

Federal Regulator Often Sides With Banks

Continued From First Page

just no equal of the large banking institutions," says David Buda, an attorney in Fort Lee, N.J., who has complained unsuccessfully to the OCC about increases in the interest rate on his FleetBoston credit card. If "your only avenue is to complain to the comptroller of the currency, then all you're going to get is a form letter saying, 'We can't help you,' " Mr. Buda adds.

Other federal regulators operate differently. The SEC budget comes from fees from securities exchanges and publicly traded companies. But unlike banks, these companies don't have a choice of regulator, so the SEC isn't competing for their loyalty. About 12% of the Food and Drug Administration's budget comes from industry fees. The Federal Trade Commission is funded by taxpayers.

During tough economic times, the bank-regulatory setup comes under a brighter spotlight. Consumers find it harder to keep up financially. Banks, faced with rising loan losses, seek additional revenue with moves such as fee hikes on credit cards – making it that much more likely that consumers will seek help from the federal bank regulator.

Mr. Hawke, who was appointed by President Clinton in 1998 to a five-year term, says he spends time both looking out for consumers and seeking to defend his regulatory turf. In 1999, he introduced a 12-minute video the OCC distributes to banks called "The Value of the National Bank Charter." In it, he describes "how the OCC and a national charter can help banking organizations achieve their goals."

Personal Appeals

Sometimes, he makes personal appeals. In August 1999, when state chartered AmSouth Bancorp of Birmingham, Ala., was in the process of buying OCC-chartered First American Corp. of Nashville, Tenn., Mr. Hawke flew to visit C. Dowd Ritter, AmSouth's chief executive. After exchanging pleasantries, Mr. Hawke reached into his briefcase to show Mr. Ritter a copy of a federal bank charter issued in 1884 to one of AmSouth's predecessor banks.

"This is something I thought you would like to see," Mr. Hawke said, according to Stephen Yoder, AmSouth's general counsel, who attended the meeting. We have something in Washington that is part of your history."

Despite the imaginative appeal, AmSouth rebuffed Mr. Hawke, retaining its Alabama state charter after the merger. The bank says it already had a good relationship with its state regulator.

Mr. Hawke, who confirms the account, says that losing market share "is a matter of concern to us." But he stresses the OCC takes seriously its responsibility to protect consumers. He occasionally makes speeches chastising bankers for such practices as selling confidential customer information to telemarketing firms. And the agency enforces about a dozen federal consumer laws, including the Truth in Lending and Fair Credit Reporting Acts. Typically, the OCC enforces compliance with those laws during its routine bank examinations, agency spokesman Robert Garsson says.

Earlier this month, as the result of an examination, the OCC ordered Eagle National Bank, a small institution in Upper Darby, Pa., to get out of the business of funding so-called payday loans. These are high-interest loans repayable on the borrower's next payday and viewed by many regulators as exploitative. The OCC said it acted because Eagle's lack of oversight of the loans had placed its financial viability at risk.

In a separate case 18 months ago, the agency joined a civil probe initiated by the San Francisco district attorney into allegations that Providian Financial Corp., a San Francisco credit-card issuer, had misled customers about interest rates on credit cards. Providian allegedly promised card holders they wouldn't have to pay an annual fee when the company in fact imposed a mandatory $156 annual charge for "credit protection." Without admitting wrongdoing, Providian agreed to pay $300 million to purported victims, plus a $7.5 million penalty to San Francisco. Mr. Hawke calls the case a landmark exercise of the OCC's authority to ban deceptive practices.

Still, he doesn't apologize for using the OCC's power to override state and local laws designed to protect consumers. Enjoying this and provides an incentive for banks to sign up with the OCC, he says. "It is one of the advantages of a national charter, and I'm not the least bit ashamed to promote it." His counterparts at the SEC, FTC or FDA don't have a comparable turf-related incentive to advertise their ability to knock down state and local consumer-protection laws.

State banking regulators often engage in their own efforts to lure banks. The Kansas banking commissioner, for instance, promises on his official Web site that state chartered banks will have greater ability "to lobby [the] state legislature for changes in laws and regulations." Commissioner Franklin Nelson explains in an interview that his department is next door to the statehouse and can help bank officials and their lobbyists reach lawmakers. The OCC can't offer such access, he says.

State regulators also aren't shy about pointing out that national banks pay as much as 2.5 times the annual examination fees charged to state banks. The fees are determined by bank size. A small bank, with $500 million in assets, would typically have to pay $43,000 under a state charter, compared with $113,000 under a federal charter, according to OCC estimates.

OCC Impact

It is the OCC's ability to help override state laws that has the biggest impact on consumers. The OCC's involvement in the California ATM case began in 1999, when Bank of America and Wells Fargo, which together control more than 60% of the ATMs in the state, asked a federal judge in San Francisco to void that city's and Santa Monica's bans on some fees, which generate about $6 million annually for the two banks. The OCC, in separate legal papers, said "the public interest" favored allowing banks to charge noncustomers more for using their ATMs. Otherwise, the OCC argued, the banks would lack the incentive to operate large numbers of ATMs in areas where they don't have many customers.

That's flat-out wrong," Santa Monica Mayor Michael Feinstein responds in an interview. "We are closer to that consumer than the OCC is," he adds. And, on balance, he says, consumers want lower fees, even in the face of bank threats to deny noncustomers any access to their ATMs.

Mr. Hawke suggests that angry customers do as he says he does: walk a few extra blocks to find a no-fee ATM.

A federal judge in 2000 agreed with the OCC's argument and blocked the municipal ATM-fee restrictions, prompting this month's hearing before a three-judge panel of the Ninth U.S. Circuit Court of Appeals. Opposing the OCC in that case, officials from California, New York and seven other states filed papers siding with the cities.

The OCC came to the defense of the same pair of big banks, among others, last year in Texas. The legislature there had recently passed a law that effectively prevented a bank from charging noncustomers a fee for cashing certain kinds of checks. Four big banks that operate in the state, including Wells Fargo, levy the fees, which typically range from $3 to $5 per check. Bank of America is planning to do the same. The four that currently charge the fees account for 40% of bank deposits in the state and generate a total of $5.2 million a year from the fees, according to court papers.

Before the new law was scheduled to take effect Sept. 1, Wells Fargo, Bank of America and Bank One Corp. of Chicago, which also holds a federal charter, asked the OCC if they had to obey the law. The OCC said they didn't. The agency weighed in with a friend of the court brief in U.S. district court in Austin, arguing that the National Bank Act permits national banks to charge whatever fees they deem appropriate for their services. In December, Judge James R. Nowlin agreed.

The Texas Banking Department is appealing the decision. "Texas passed a consumer protection law that was duly enacted and should apply," says state Banking Commissioner Randall James.

The OCC even has backed its banks trying to knock down regulations that cover other companies they do business with outside of the banking industry.

In Michigan, the state Motor Vehicle Sales Finance Act, passed in 1950, requires that auto dealers fully disclose installment-payment terms. It also limits document-preparation fees to $30 and restricts the conditions under which a car can be repossessed. The statute applies only to dealers who sell cars through installment plans. It doesn't apply to banks.

But National City Bank, a unit of Cleveland's National City Corp., and Huntington National Bank, owned by Huntington Bancshares Inc. of Columbus, Ohio, sought in administrative proceedings to make the dealers who market their car loans exempt from the law. Michigan's commissioner of financial and insurance services, Frank Fitzgerald, ruled in January 2000 that car dealers who teamed with national banks were still covered.

'We Had to Do Something'

"We had to do something to get by that," says Daniel W. Morton, Huntington National's vice president and senior counsel. So the two banks asked the OCC for an opinion saying the state law was trumped by the National Bank Act. Commissioner Fitzgerald filed an objection, arguing that it would be "absurd" if the OCC could kill a state law aimed at nonbanking businesses.

In May the OCC found otherwise, concluding that Michigan's law "frustrates the [banks'] ability to exercise their lending authority" and therefore shouldn't be enforced against car dealers marketing loans made by OCC-chartered banks. Michigan isn't contesting the ruling. The state doesn't think it can beat the OCC in federal court, says Mr. Fitzgerald.

Mr. Garsson, the OCC spokesman, says that consumers obtaining car loans funded by national banks – such as those in the Michigan case – would be covered by federal consumer protections that the OCC enforces.

In the FleetBoston case, the OCC received hundreds of letters from customers in 2000, complaining that the federally chartered bank had increased interest rates on its credit cards after allegedly promising a "fixed" rate. In response, the OCC sent customers letters saying it couldn't help. Federal law "recognizes banks' ability to change the terms of credit card account agreements," as long as the change is disclosed, the OCC said in a typical letter sent to a complaining customer on March 23, 2000. "If you wish to pursue further remedy to your complaint, we can only suggest that you contact private legal counsel regarding any additional remedies," the OCC added.

In October 2000, several customers filed suit, seeking class-action status and accusing FleetBoston of deceptive practices under Rhode Island state law. A Rhode Island state judge in Providence ruled in April that the case could proceed. But the OCC stepped in to help FleetBoston. The OCC argued in a friend-of-the-court brief that the state law on which the suit was based doesn't apply to FleetBoston because the OCC can take action against unfair and deceptive practices, as it did in the Providian case – although the agency hadn't done so regarding FleetBoston.

Justice Judith Colenback Savage of Rhode Island Superior Court rejected the OCC's argument last April, a decision the state's Supreme Court declined to review. The case was then consolidated with a similar suit filed by a separate group of disgruntled FleetBoston customers before another Rhode Island judge.

In December, the new judge, Michael Silverstein, handed the OCC a victory. He ruled that FleetBoston couldn't be sued under the state's deceptive practices law. Such a suit would call into question the OCC's very foundational authority to regulate national banks," the judge ruled. At a hearing last week, FleetBoston sought to have the suit dismissed on those grounds. A decision is expected by the end of March.

UPS and Teamsters Open Talks This Week On a New Contract

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of the hard work they do that produces these profits."

Despite the firm rhetoric, UPS expects Mr. Hoffa to be easier to deal with than predecessor Ron Carey, who was battling Mr. Hoffa for control of the union in 1997 and was embroiled in an election scandal.

I'm looking for a collaborative set of negotiations," Mr. Mahoney of UPS says. The willingness is there to get an agreement. Indeed, the two sides fought together on a successful campaign to win new air routes to China in 2000, but Mr. Hoffa says the union did it because expansion is good for the union.

A drawn-out brawl could be tough on UPS even if it doesn't lead to another strike. After going public in 1999, UPS now faces pressure from a much larger shareholder base, and nervousness about the latest contract talks is expected by analysts to put a drag on the company's stock price until a deal is reached.

Meanwhile, customers blindsided by the unexpected strike last time also are making emergency plans earlier than they did five years ago, which soon could start hurting the company's delivery volume.

James Valentine, a Morgan Stanley analyst, says most of the biggest shippers in a recent survey conducted by him indicated they would divert shipments to other carriers if an agreement isn't reached, with some starting as soon as February. The biggest potential winner would be FedEx, of Memphis, Tenn., which has bolstered its much-smaller ground-delivery operation since the 1997 strike. Mr. Mahoney says UPS hasn't seen any diversion at this point.

Existing-Home Sales Slipped in December, Set Record During '01

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her to $151,400. The median is the midpoint; half of the homes sold for more, half sold for less. The average home price rose 6.5% to $190,100.

Ironically, the continued strength of home prices has renewed some old debates about whether home values are getting too high, possibly increasing the chances of a correction. Such worries flared up over the summer, then eased as the economy sank deeper into recession. But in a report released this month, HSBC Securities economist Ian Morris noted that home values are now at their highest levels relative to income since 1989, which he calls "an unsustainable situation."

However, many economists believe the housing market will remain healthy this year, especially if interest rates stay relatively low and the economy recovers as expected. The short-term outlook certainly is good. Applications to purchase homes rose 6.7% in the week ended Jan. 18 to nearly their highest level ever, the Mortgage Bankers Association of America said. Also, there is no sign of an overabundance of homes. NAR said there was a 4.2 months' supply of homes available in December given the current sales pace, down from 4.8 months in November.

Existing-home sales among regions in December were mixed. In the Northeast, sales were down 1.6% while in the Midwest, sales rose 0.9%. Home resales in the South slipped 2.4%, and the West saw sales grow 0.7%. The South and Midwest regions posted record sales for all of 2001, NAR said.

Separately, the Commerce Department said the nation's homeownership rate dropped marginally in the fourth quarter to 67%, from 68.1% in the third quarter. However, the homeownership rate for Hispanics continued to grow, to 48.8% from 48.1%, while the rate for African-Americans grew to 48.1% from 47.5%.

–Rebecca Christie contributed to this article.

Journal Link: Read the full text of the existing home sales report for December, in the Online Journal at **WSJ.com/JournalLinks**.

Pakistani Group Says It Holds Journal Correspondent

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tion [sic] Pakistani Government should handle it." Abdul Sattar Zaeef, the Taliban's former ambassador to Pakistan and most recognized spokesman, was deported from Pakistan to Afghanistan in early January.

Mr. Pearl was in Karachi seeking to interview leaders of Islamic groups for possible articles on the war's impact on the region. He was accompanied to Karachi by his wife, Mariane, who is a French citizen. She is expecting the couple's first child in March.

Shortly afterward, Mr. Pearl tackled the wrenching issue of the U.S. bombing of a Sudanese pharmaceutical plant in August 1998. Some U.S. allies and Washington officials still doubt the U.S. hit a legitimate target, and the full truth of El Shifa