

**PART III**

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**The Boom and Bust**



# 6

## CREDIT EXPANSION

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By the end of 2000, the economy had grown 39 straight quarters. Federal Reserve Chairman Alan Greenspan argued the financial system had achieved unprecedented resilience. Large financial companies were—or at least to many observers at the time, appeared to be—profitable, diversified, and, executives and regulators agreed, protected from catastrophe by sophisticated new techniques of managing risk.

The housing market was also strong. Between 1995 and 2000, prices rose at an annual rate of 5.2%; over the next five years, the rate would hit 11.5%.<sup>1</sup> Lower interest rates for mortgage borrowers were partly the reason, as was greater access to mortgage credit for households who had traditionally been left out—including subprime borrowers. Lower interest rates and broader access to credit were available for other types of borrowing, too, such as credit cards and auto loans.

Increased access to credit meant a more stable, secure life for those who managed their finances prudently. It meant families could borrow during temporary income drops, pay for unexpected expenses, or buy major appliances and cars. It allowed other families to borrow and spend beyond their means. Most of all, it meant a shot at homeownership, with all its benefits; and for some, an opportunity to speculate in the real estate market.

As home prices rose, homeowners with greater equity felt more financially secure and, partly as a result, saved less and less. Many others went one step further, borrowing against the equity. The effect was unprecedented debt: between 2001 and 2007, mortgage debt nationally nearly doubled. Household debt rose from 80% of disposable personal income in 1993 to almost 130% by mid-2006. More than three-quarters

of this increase was mortgage debt. Part of the increase was from new home purchases, part from new debt on older homes.

Mortgage credit became more available when subprime lending started to grow again after many of the major subprime lenders failed or were purchased in 1998 and 1999. Afterward, the biggest banks moved in. In 2000, Citigroup, with \$800 billion in assets, paid \$31 billion for Associates First Capital, the second-biggest subprime lender. Still, subprime lending remained only a niche, just 9.5% of new mortgages in 2000.<sup>2</sup>

Subprime lending risks and questionable practices remained a concern. Yet the Federal Reserve did not aggressively employ the unique authority granted it by the Home Ownership and Equity Protection Act (HOEPA). Although in 2004 the Fed fined Citigroup \$70 million for lending violations, it only minimally revised the rules for a narrow set of high-cost mortgages.<sup>3</sup> Following losses by several banks in subprime securitization, the Fed and other regulators revised capital standards.

#### HOUSING: "A POWERFUL STABILIZING FORCE"

By the beginning of 2001, the economy was slowing, even though unemployment remained at a 30-year low of 4%. To stimulate borrowing and spending, the Federal Reserve's Federal Open Market Committee lowered short-term interest rates aggressively. On January 3, 2001, in a rare conference call between scheduled meetings, it cut the benchmark federal funds rate—at which banks lend to each other overnight—by a half percentage point, rather than the more typical quarter point. Later that month, the committee cut the rate another half point, and it continued cutting throughout the year—11 times in all—to 1.75%, the lowest in 40 years.

In the end, the recession of 2001 was relatively mild, lasting only eight months, from March to November, and gross domestic product, or GDP—the most common gauge of the economy—dropped by only 0.3%. Some policy makers concluded that perhaps, with effective monetary policy, the economy had reached the so-called end of the business cycle, which some economists had been predicting since before the tech crash. "Recessions have become less frequent and less severe," said Ben Bernanke, then a Fed governor, in a speech early in 2004. "Whether the dominant cause of the Great Moderation is structural change, improved monetary policy, or simply good luck is an important question about which no consensus has yet formed."<sup>4</sup>

With the recession over and mortgage rates at 40-year lows, housing kicked into high gear—again. The nation would lose more than 340,000 nonfarm jobs in 2002 but make small gains in construction. In states where bubbles soon appeared, construction picked up quickly. California ended 2002 with a total of only 2,300 more jobs, but with 21,100 new construction jobs. In Florida, 14% of net job growth was in construction. In 2003, builders started more than 1.8 million single-family dwellings, a rate unseen since the late 1970s. From 2002 to 2005, residential construction contributed three times more to the economy than it had contributed on average since 1990.

But elsewhere the economy remained sluggish, and employment gains were frustratingly small. Experts began talking about a “jobless recovery”—more production without a corresponding increase in employment. For those with jobs, wages stagnated. Between 2002 and 2005, weekly private nonfarm, nonsupervisory wages actually fell by 1% after adjusting for inflation. Faced with these challenges, the Fed shifted perspective, now considering the possibility that consumer prices could *fall*, an event that had worsened the Great Depression seven decades earlier. While concerned, the Fed believed deflation would be avoided. In a widely quoted 2002 speech, Bernanke said the chances of deflation were “extremely small” for two reasons. First, the economy’s natural resilience: “Despite the adverse shocks of the past year, our banking system remains healthy and well-regulated, and firm and household balance sheets are for the most part in good shape.” Second, the Fed would not allow it. “I am confident that the Fed would take whatever means necessary to prevent significant deflation in the United States. . . . [T]he U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost.”<sup>5</sup>

The Fed’s monetary policy kept short-term interest rates low. During 2003, the strongest U.S. companies could borrow for 90 days in the commercial paper market at an average 1.1%, compared with 6.3% just three years earlier; rates on three-month Treasury bills dropped below 1% in mid-2003 from 6% in 2000.<sup>6</sup>

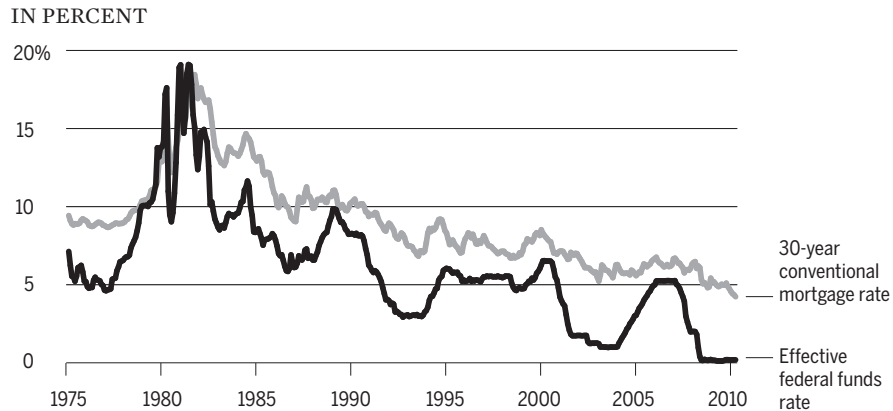
Low rates cut the cost of homeownership: interest rates for the typical 30-year fixed-rate mortgage traditionally moved with the overnight fed funds rate, and from 2000 to 2003, this relationship held (see figure 6.1). By 2003, creditworthy home buyers could get fixed-rate mortgages for 5.2%, 3 percentage points lower than three years earlier. The savings were immediate and large. For a home bought at the median price of \$180,000, with a 20% down payment, the monthly mortgage payment would be \$286 less than in 2000. Or to turn the perspective around—as many people did—for the same monthly payment of \$1,077, a homeowner could move up from a \$180,000 home to a \$245,000 one.<sup>7</sup>

An adjustable-rate mortgage (ARM) gave buyers even lower initial payments or made a larger house affordable—unless interest rates rose. In 2001, just 4% of prime borrowers with new mortgages chose ARMs; in 2003, 10% did. In 2004, the proportion rose to 21%.<sup>8</sup> Among subprime borrowers, already heavy users of ARMs, it rose from around 60% to 76%.<sup>9</sup>

As people jumped into the housing market, prices rose, and in hot markets they really took off (see figure 6.2). In Florida, average home prices gained 4.1% annually from 1995 to 2000 and then 11.1% annually from 2000 to 2003. In California, those numbers were even higher: 6.1% and 13.6%. In California, a house bought for \$200,000 in 1995 was worth \$454,428 nine years later. However, soaring prices were not necessarily the norm. In Washington State, prices continued to appreciate, but more slowly: 5.9% annually from 1995 to 2000, 5.5% annually from 2000 to 2003. In Ohio, the numbers were 4.3% and 3.6%.<sup>10</sup> Nationwide, home prices rose 9.8% annually from 2000 to 2003—historically high, but well under the fastest-growing markets.

## Bank Borrowing and Mortgage Interest Rates

*Rates for both banks and homeowners have been low in recent years.*



SOURCE: Federal Reserve Bank of St. Louis, Federal Reserve Economic Database

*Figure 6.1*

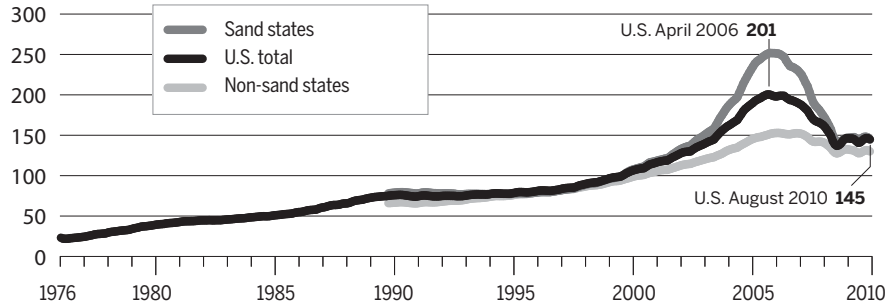
Homeownership increased steadily, peaking at 69.2% of households in 2004.<sup>11</sup> Because so many families were benefiting from higher home values, household wealth rose to nearly six times income, up from five times a few years earlier. The top 10% of households by net worth, of whom 96% owned their homes, saw the value of their primary residences rise between 2001 and 2004 from \$372,800 to \$450,000 (adjusted for inflation), an increase of more than \$77,000. Median net worth for all households in the top 10%, after accounting for other housing value and assets, as well as all liabilities, was \$1.4 million in 2004. Homeownership rates for the bottom 25% of households ticked up from 14% to 15% between 2001 and 2004; the median value of their primary residences rose from \$52,700 to \$65,000, an increase of more than \$12,000. Median net worth for households in the bottom 25% was \$1,700 in 2004.<sup>12</sup>

Historically, every \$1,000 increase in housing wealth boosted consumer spending by an estimated \$50 a year.<sup>13</sup> But economists debated whether the wealth increases would affect spending more than in past years, because so many homeowners at so many levels of wealth saw increases and because it was easier and cheaper to tap home equity.

Higher home prices and low mortgage rates brought a wave of refinancing to the prime mortgage market. In 2003 alone, lenders refinanced over 15 million mortgages, more than one in four—an unprecedented level.<sup>14</sup> Many homeowners took out cash while cutting their interest rates. From 2001 through 2003, cash-out refinanc-

## U.S. Home Prices

INDEX VALUE: JANUARY 2000 = 100



NOTE: Sand states are Arizona, California, Florida, and Nevada.

SOURCE: CoreLogic and U.S. Census Bureau: 2007 American Community Survey, FCIC calculations

Figure 6.2

ings netted these households an estimated \$427 billion; homeowners accessed another \$430 billion via home equity loans.<sup>15</sup> Some were typical second liens; others were a newer invention, the home equity line of credit. These operated much like a credit card, letting the borrower borrow and repay as needed, often with the convenience of an actual plastic card.

According to the Fed's 2004 Survey of Consumer Finances, 45.0% of homeowners who tapped their equity used that money for expenses such as medical bills, taxes, electronics, and vacations, or to consolidate debt; another 31.0% used it for home improvements; and the rest purchased more real estate, cars, investments, clothing, or jewelry.

A Congressional Budget Office paper from 2007 reported on the recent history: "As housing prices surged in the late 1990s and early 2000s, consumers boosted their spending faster than their income rose. That was reflected in a sharp drop in the personal savings rate."<sup>16</sup> Between 1998 and 2005, increased consumer spending accounted for between 67% and 168% of GDP growth in any year—rising above 100% in years when spending growth offset declines elsewhere in the economy. Meanwhile, the personal saving rate dropped from 5.2% to 1.4%. Some components of spending grew remarkably fast: home furnishings and other household durables, recreational goods and vehicles, spending at restaurants, and health care. Overall consumer spending grew faster than the economy, and in some years it grew faster than real disposable income.

Nonetheless, the economy looked stable. By 2003, it had weathered the brief recession of 2001 and the dot-com bust, which had caused the largest loss of wealth in

decades. With new financial products like the home equity line of credit, households could borrow against their homes to compensate for investment losses or unemployment. Deflation, against which the Fed had struck preemptively, did not materialize.

At a congressional hearing in November 2002, Greenspan acknowledged—at least implicitly—that after the dot-com bubble burst, the Fed cut interest rates in part to promote housing. Greenspan argued that the Fed’s low-interest-rate policy had stimulated the economy by encouraging home sales and housing starts with “mortgage interest rates that are at lows not seen in decades.” As Greenspan explained, “Mortgage markets have also been a powerful stabilizing force over the past two years of economic distress by facilitating the extraction of some of the equity that homeowners had built up.”<sup>17</sup> In February 2004, he reiterated his point, referring to “a large extraction of cash from home equity.”<sup>18</sup>

#### SUBPRIME LOANS: “BUYERS WILL PAY A HIGH PREMIUM”

The subprime market roared back from its shakeout in the late 1990s. The value of subprime loans originated almost doubled from 2001 through 2003, to \$310 billion. In 2000, 52% of these were securitized; in 2003, 63%.<sup>19</sup> Low interest rates spurred this boom, which would have long-term repercussions, but so did increasingly widespread computerized credit scores, the growing statistical history on subprime borrowers, and the scale of the firms entering the market.

Subprime was dominated by a narrowing field of ever-larger firms; the marginal players from the past decade had merged or vanished. By 2003, the top 25 subprime lenders made 93% of all subprime loans, up from 47% in 1996.<sup>20</sup>

There were now three main kinds of companies in the subprime origination and securitization business: commercial banks and thrifts, Wall Street investment banks, and independent mortgage lenders. Some of the biggest banks and thrifts—Citigroup, National City Bank, HSBC, and Washington Mutual—spent billions on boosting subprime lending by creating new units, acquiring firms, or offering financing to other mortgage originators. Almost always, these operations were sequestered in nonbank subsidiaries, leaving them in a regulatory no-man’s-land.

When it came to subprime lending, now it was Wall Street investment banks that worried about competition posed by the largest commercial banks and thrifts. Former Lehman president Bart McDade told the FCIC that the banks had gained their own securitization skills and didn’t need the investment banks to structure and distribute.<sup>21</sup> So the investment banks moved into mortgage origination to guarantee a supply of loans they could securitize and sell to the growing legions of investors. For example, Lehman Brothers, the fourth-largest investment bank, purchased six different domestic lenders between 1998 and 2004, including BNC and Aurora.<sup>22</sup> Bear Stearns, the fifth-largest, ramped up its subprime lending arm and eventually acquired three subprime originators in the United States, including Encore. In 2006, Merrill Lynch acquired First Franklin, and Morgan Stanley bought Saxon Capital; in 2007, Goldman Sachs upped its stake in Senderra Funding, a small subprime lender.

Meanwhile, several independent mortgage companies took steps to boost growth.



New Century and Ameriquest were especially aggressive. New Century's "Focus 2000" plan concentrated on "originating loans with characteristics for which whole loan buyers will pay a high premium."<sup>23</sup> Those "whole loan buyers" were the firms on Wall Street that purchased loans and, most often, bundled them into mortgage-backed securities. They were eager customers. In 2003, New Century sold \$20.8 billion in whole loans, up from \$3.1 billion three years before,<sup>24</sup> launching the firm from tenth to second place among subprime originators. Three-quarters went to two securitizing firms—Morgan Stanley and Credit Suisse—but New Century reassured its investors that there were "many more prospective buyers."<sup>25</sup>

Ameriquest, in particular, pursued volume. According to the company's public statements, it paid its account executives less per mortgage than the competition, but it encouraged them to make up the difference by underwriting more loans. "Our people make more volume per employee than the rest of the industry," Aseem Mital, CEO of Ameriquest, said in 2005. The company cut costs elsewhere in the origination process, too. The back office for the firm's retail division operated in assembly-line fashion, Mital told a reporter for *American Banker*; the work was divided into specialized tasks, including data entry, underwriting, customer service, account management, and funding. Ameriquest used its savings to undercut by as much as 0.55% what competing originators charged securitizing firms, according to an industry analyst's estimate. Between 2000 and 2003, Ameriquest loan origination rose from an estimated \$4 billion to \$39 billion annually. That vaulted the firm from eleventh to first place among subprime originators. "They are clearly the aggressor," Countrywide CEO Angelo Mozilo told his investors in 2005.<sup>26</sup> By 2005, Countrywide was third on the list.

The subprime players followed diverse strategies. Lehman and Countrywide pursued a "vertically integrated" model, involving them in every link of the mortgage chain: originating and funding the loans, packaging them into securities, and finally selling the securities to investors. Others concentrated on niches: New Century, for example, mainly originated mortgages for immediate sale to other firms in the chain.

When originators made loans to hold through maturity—an approach known as *originate-to-hold*—they had a clear incentive to underwrite carefully and consider the risks. However, when they originated mortgages to sell, for securitization or otherwise—known as *originate-to-distribute*—they no longer risked losses if the loan defaulted. As long as they made accurate representations and warranties, the only risk was to their reputations if a lot of their loans went bad—but during the boom, loans were not going bad. In total, this originate-to-distribute pipeline carried more than half of all mortgages before the crisis, and a much larger piece of subprime mortgages.

For decades, a version of the originate-to-distribute model produced safe mortgages. Fannie and Freddie had been buying prime, conforming mortgages since the 1970s, protected by strict underwriting standards. But some saw that the model now had problems. "If you look at how many people are playing, from the real estate agent all the way through to the guy who is issuing the security and the underwriter and the underwriting group and blah, blah, blah, then nobody in this entire chain is responsible to anybody," Lewis Ranieri, an early leader in securitization, told the FCIC,

not the outcome he and other investment bankers had expected. “None of us wrote and said, ‘Oh, by the way, you have to be responsible for your actions,’” Ranieri said. “It was pretty self-evident.”<sup>27</sup>

The starting point for many mortgages was a mortgage broker. These independent brokers, with access to a variety of lenders, worked with borrowers to complete the application process. Using brokers allowed more rapid expansion, with no need to build branches; lowered costs, with no need for full-time salespeople; and extended geographic reach.

For brokers, compensation generally came as up-front fees—from the borrower, from the lender, or both—so the loan’s performance mattered little. These fees were often paid without the borrower’s knowledge. Indeed, many borrowers mistakenly believed the mortgage brokers acted in borrowers’ best interest.<sup>28</sup> One common fee paid by the lender to the broker was the “yield spread premium”: on higher-interest loans, the lending bank would pay the broker a higher premium, giving the incentive to sign the borrower to the highest possible rate. “If the broker decides he’s going to try and make more money on the loan, then he’s going to raise the rate,” said Jay Jeffries, a former sales manager for Fremont Investment & Loan, to the Commission. “We’ve got a higher rate loan, we’re paying the broker for that yield spread premium.”<sup>29</sup>

In theory, borrowers are the first defense against abusive lending. By shopping around, they should realize, for example, if a broker is trying to sell them a higher-priced loan or to place them in a subprime loan when they would qualify for a less-expensive prime loan. But many borrowers do not understand the most basic aspects of their mortgage. A study by two Federal Reserve economists estimated at least 38% of borrowers with adjustable-rate mortgages did not understand how much their interest rates could reset at one time, and more than half underestimated how high their rates could reach over the years.<sup>30</sup> The same lack of awareness extended to other terms of the loan—for example, the level of documentation provided to the lender. “Most borrowers didn’t even realize that they were getting a no-doc loan,” said Michael Calhoun, president of the Center for Responsible Lending. “They’d come in with their W-2 and end up with a no-doc loan simply because the broker was getting paid more and the lender was getting paid more and there was extra yield left over for Wall Street because the loan carried a higher interest rate.”<sup>31</sup>

And borrowers with less access to credit are particularly ill equipped to challenge the more experienced person across the desk. “While many [consumers] believe they are pretty good at dealing with day-to-day financial matters, in actuality they engage in financial behaviors that generate expenses and fees: overdrawing checking accounts, making late credit card payments, or exceeding limits on credit card charges,” Annamaria Lusardi, a professor of economics at Dartmouth College, told the FCIC. “Comparing terms of financial contracts and shopping around before making financial decisions are not at all common among the population.”<sup>32</sup>

Recall our case study securitization deal discussed earlier—in which New Century sold 4,499 mortgages to Citigroup, which then sold them to the securitization trust, which then bundled them into 19 tranches for sale to investors. Out of those 4,499 mortgages, brokers originated 3,466 on behalf of New Century. For each, the

brokers received an average fee from the borrowers of \$3,756, or 1.81% of the loan amount. On top of that, the brokers also received yield spread premiums from New Century for 1,744 of these loans, averaging \$2,585 each. In total, the brokers received more than \$17.5 million in fees for the 3,466 loans.<sup>33</sup>

Critics argued that with this much money at stake, mortgage brokers had every incentive to seek “the highest combination of fees and mortgage interest rates the market will bear.”<sup>34</sup> Herb Sandler, the founder and CEO of the thrift Golden West Financial Corporation, told the FCIC that brokers were the “whores of the world.”<sup>35</sup> As the housing and mortgage market boomed, so did the brokers. Wholesale Access, which tracks the mortgage industry, reported that from 2000 to 2003, the number of brokerage firms rose from about 30,000 to 50,000. In 2000, brokers originated 55% of loans; in 2003, they peaked at 68%.<sup>36</sup> JP Morgan CEO Jamie Dimon testified to the FCIC that his firm eventually ended its broker-originated business in 2009 after discovering the loans had more than twice the losses of the loans that JP Morgan itself originated.<sup>37</sup>

As the housing market expanded, another problem emerged, in subprime and prime mortgages alike: inflated appraisals. For the lender, inflated appraisals meant greater losses if a borrower defaulted. But for the borrower or for the broker or loan officer who hired the appraiser, an inflated value could make the difference between closing and losing the deal. Imagine a home selling for \$200,000 that an appraiser says is actually worth only \$175,000. In this case, a bank won't lend a borrower, say, \$180,000 to buy the home. The deal dies. Sure enough, appraisers began feeling pressure. One 2003 survey found that 55% of the appraisers had felt pressured to inflate the value of homes; by 2006, this had climbed to 90%. The pressure came most frequently from the mortgage brokers, but appraisers reported it from real estate agents, lenders, and in many cases borrowers themselves. Most often, refusal to raise the appraisal meant losing the client.<sup>38</sup> Dennis J. Black, president of the Florida appraisal and brokerage services firm D. J. Black & Co. and an appraiser with 24 years' experience, held continuing education sessions all over the country for the National Association of Independent Fee Appraisers. He heard complaints from the appraisers that they had been pressured to ignore missing kitchens, damaged walls, and inoperable mechanical systems. Black told the FCIC, “The story I have heard most often is the client saying he could not use the appraisal because the value was [not] what they needed.”<sup>39</sup> The client would hire somebody else.

Changes in regulations reinforced the trend toward laxer appraisal standards, as Karen Mann, a Sacramento appraiser with 30 years' experience, explained in testimony to the FCIC. In 1994, the Federal Reserve, Office of the Comptroller of the Currency, Office of Thrift Supervision, and Federal Deposit Insurance Corporation loosened the appraisal requirements for the lenders they regulated by raising from \$100,000 to \$250,000 the minimum home value at which an appraisal from a licensed professional was required. In addition, Mann cited the lack of oversight of appraisers, noting, “We had a vast increase of licensed appraisers in [California] in spite of the lack of qualified/experienced trainers.”<sup>40</sup> The Bakersfield appraiser Gary Crabtree told the FCIC that California's Office of Real Estate Appraisers had eight investigators to supervise 21,000 appraisers.<sup>41</sup>

In 2005, the four bank regulators issued new guidance to strengthen appraisals. They recommended that an originator's loan production staff not select appraisers. That led Washington Mutual to use an "appraisal management company," First American Corporation, to choose appraisers. Nevertheless, in 2007 the New York State attorney general sued First American: relying on internal company documents, the complaint alleged the corporation improperly let Washington Mutual's loan production staff "hand-pick appraisers who bring in appraisal values high enough to permit WaMu's loans to close, and improperly permit[ted] WaMu to pressure . . . appraisers to change appraisal values that are too low to permit loans to close."<sup>42</sup>

#### CITIGROUP: "INVITED REGULATORY SCRUTINY"

As subprime originations grew, Citigroup decided to expand, with troubling consequences. Barely a year after the Gramm-Leach-Bliley Act validated its 1998 merger with Travelers, Citigroup made its next big move. In September 2000, it paid \$31 billion for Associates First, then the second-largest subprime lender in the country (after Household Finance.). Such a merger would usually have required approval from the Federal Reserve and the other bank regulators, because Associates First owned three small banks (in Utah, Delaware, and South Dakota). But because these banks were specialized, a provision tucked away in Gramm-Leach-Bliley kept the Fed out of the mix. The OCC, FDIC, and New York State banking regulators reviewed the deal. Consumer groups fought it, citing a long record of alleged lending abuses by Associates First, including high prepayment penalties, excessive fees, and other opaque charges in loan documents—all targeting unsophisticated borrowers who typically could not evaluate the forms. "It's simply unacceptable to have the largest bank in America take over the icon of predatory lending," said Martin Eakes, founder of a nonprofit community lender in North Carolina.<sup>43</sup>

Advocates for the merger argued that a large bank under a rigorous regulator could reform the company, and Citigroup promised to take strong actions. Regulators approved the merger in November 2000, and by the next summer Citigroup had started suspending mortgage purchases from close to two-thirds of the brokers and half the banks that had sold loans to Associates First. "We were aware that brokers were at the heart of that public discussion and were at the heart of a lot of the [controversial] cases," said Pam Flaherty, a Citigroup senior vice president for community relations and outreach.<sup>44</sup>

The merger exposed Citigroup to enhanced regulatory scrutiny. In 2001, the Federal Trade Commission, which regulates independent mortgage companies' compliance with consumer protection laws, launched an investigation into Associates First's premerger business and found that the company had pressured borrowers to refinance into expensive mortgages and to buy expensive mortgage insurance. In 2002, Citigroup reached a record \$215 million civil settlement with the FTC over Associates' "systematic and widespread deceptive and abusive lending practices."<sup>45</sup>

In 2001, the New York Fed used the occasion of Citigroup's next proposed acquisition—European American Bank on Long Island, New York—to launch its own in-

investigation of CitiFinancial, which now contained Associates First. “The manner in which [Citigroup] approached that transaction invited regulatory scrutiny,” former Fed Governor Mark Olson told the FCIC. “They bought a passel of problems for themselves and it was at least a two-year [issue].”<sup>46</sup> The Fed eventually accused CitiFinancial of converting unsecured personal loans (usually for borrowers in financial trouble) into home equity loans without properly assessing the borrower’s ability to repay. Reviewing lending practices from 2000 and 2001, the Fed also accused the unit of selling credit insurance to borrowers without checking if they would qualify for a mortgage without it. For these violations and for impeding its investigation, the Fed in 2004 assessed \$70 million in penalties. The company said it expected to pay another \$30 million in restitution to borrowers.<sup>47</sup>

**FEDERAL RULES:  
“INTENDED TO CURB UNFAIR OR ABUSIVE LENDING”**

As Citigroup was buying Associates First in 2000, the Federal Reserve revisited the rules protecting borrowers from predatory conduct. It conducted its second round of hearings on the Home Ownership and Equity Protection Act (HOEPA), and subsequently the staff offered two reform proposals. The first would have effectively barred lenders from granting any mortgage—not just the limited set of high-cost loans defined by HOEPA—solely on the value of the collateral and without regard to the borrower’s ability to repay. For high-cost loans, the lender would have to verify and document the borrower’s income and debt; for other loans, the documentation standard was weaker, as the lender could rely on the borrower’s payment history and the like. The staff memo explained this would mainly “affect lenders who make no-documentation loans.” The second proposal addressed practices such as deceptive advertisements, misrepresenting loan terms, and having consumers sign blank documents—acts that involve fraud, deception, or misrepresentations.<sup>48</sup>

Despite evidence of predatory tactics from their own hearings and from the recently released HUD-Treasury report, Fed officials remained divided on how aggressively to strengthen borrower protections. They grappled with the same trade-off that the HUD-Treasury report had recently noted. “We want to encourage the growth in the subprime lending market,” Fed Governor Edward Gramlich remarked at the Financial Services Roundtable in early 2004. “But we also don’t want to encourage the abuses; indeed, we want to do what we can to stop these abuses.”<sup>49</sup> Fed General Counsel Scott Alvarez told the FCIC, “There was concern that if you put out a broad rule, you would stop things that were not unfair and deceptive because you were trying to get at the bad practices and you just couldn’t think of all of the details you would need. And if you did think of all of the details, you’d end up writing a rule that people could get around very easily.”<sup>50</sup>

Greenspan, too, later said that to prohibit certain products might be harmful. “These and other kinds of loan products, when made to borrowers meeting appropriate underwriting standards, should not necessarily be regarded as improper,” he said, “and on the contrary facilitated the national policy of making homeownership

more broadly available.”<sup>51</sup> Instead, at least for certain violations of consumer protection laws, he suggested another approach: “If there is egregious fraud, if there is egregious practice, one doesn’t need supervision and regulation, what one needs is law enforcement.”<sup>52</sup> But the Federal Reserve would not use the legal system to rein in predatory lenders. From 2000 to the end of Greenspan’s tenure in 2006, the Fed referred to the Justice Department only three institutions for fair lending violations related to mortgages: First American Bank, in Carpentersville, Illinois; Desert Community Bank, in Victorville, California; and the New York branch of Société Générale, a large French bank.

Fed officials rejected the staff proposals. After some wrangling, in December 2001 the Fed did modify HOEPA, but only at the margins. Explaining its actions, the board highlighted compromise: “The final rule is intended to curb unfair or abusive lending practices without unduly interfering with the flow of credit, creating unnecessary creditor burden, or narrowing consumers’ options in legitimate transactions.” The status quo would change little. Fed economists had estimated the percentage of subprime loans covered by HOEPA would increase from 9% to as much as 38% under the new regulations.<sup>53</sup> But lenders changed the terms of mortgages to avoid the new rules’ revised interest rate and fee triggers. By late 2005, it was clear that the new regulations would end up covering only about 1% of subprime loans.<sup>54</sup> Nevertheless, reflecting on the Federal Reserve’s efforts, Greenspan contended in an FCIC interview that the Fed had developed a set of rules that have held up to this day.<sup>55</sup>

This was a missed opportunity, says FDIC Chairman Sheila Bair, who described the “one bullet” that might have prevented the financial crisis: “I absolutely would have been over at the Fed writing rules, prescribing mortgage lending standards across the board for everybody, bank and nonbank, that you cannot make a mortgage unless you have documented income that the borrower can repay the loan.”<sup>56</sup>

The Fed held back on enforcement and supervision, too. While discussing HOEPA rule changes in 2000, the staff of the Fed’s Division of Consumer and Community Affairs also proposed a pilot program to examine lending practices at bank holding companies’ nonbank subsidiaries,<sup>57</sup> such as CitiFinancial and HSBC Finance, whose influence in the subprime market was growing. The nonbank subsidiaries were subject to enforcement actions by the Federal Trade Commission, while the banks and thrifts were overseen by their primary regulators. As the holding company regulator, the Fed had the authority to examine nonbank subsidiaries for “compliance with the [Bank Holding Company Act] or any other Federal law that the Board has specific jurisdiction to enforce”; however, the consumer protection laws did not explicitly give the Fed enforcement authority in this area.<sup>58</sup>

The Fed resisted routine examinations of these companies, and despite the support of Fed Governor Gramlich, the initiative stalled. Sandra Braunstein, then a staff member in the Fed’s Consumer and Community Affairs Division and now its director, told the FCIC that Greenspan and other officials were concerned that routinely examining the nonbank subsidiaries could create an uneven playing field because the subsidiaries had to compete with the independent mortgage companies, over which

the Fed had no supervisory authority (although the Fed's HOEPA rules applied to all lenders).<sup>59</sup> In an interview with the FCIC, Greenspan went further, arguing that with or without a mandate, the Fed lacked sufficient resources to examine the nonbank subsidiaries. Worse, the former chairman said, inadequate regulation sends a misleading message to the firms and the market; if you examine an organization incompletely, it tends to put a sign in their window that it was examined by the Fed, and partial supervision is dangerous because it creates a Good Housekeeping stamp.<sup>60</sup>

But if resources were the issue, the Fed chairman could have argued for more. The Fed draws income from interest on the Treasury bonds it owns, so it did not have to ask Congress for appropriations. It was always mindful, however, that it could be subject to a government audit of its finances.

In the same FCIC interview, Greenspan recalled that he sat in countless meetings on consumer protection, but that he couldn't pretend to have the kind of expertise on this subject that the staff had.<sup>61</sup>

Gramlich, who chaired the Fed's consumer subcommittee, favored tighter supervision of all subprime lenders—including units of banks, thrifts, bank holding companies, and state-chartered mortgage companies. He acknowledged that because such oversight would extend Fed authority to firms (such as independent mortgage companies) whose lending practices were not subject to routine supervision, the change would require congressional legislation “and might antagonize the states.” But without such oversight, the mortgage business was “like a city with a murder law, but no cops on the beat.”<sup>62</sup> In an interview in 2007, Gramlich told the *Wall Street Journal* that he privately urged Greenspan to clamp down on predatory lending. Greenspan demurred and, lacking support on the board, Gramlich backed away. Gramlich told the *Journal*, “He was opposed to it, so I did not really pursue it.”<sup>63</sup> (Gramlich died in 2008 of leukemia, at age 68.)

The Fed's failure to stop predatory practices infuriated consumer advocates and some members of Congress. Critics charged that accounts of abuses were brushed off as anecdotal. Patricia McCoy, a law professor at the University of Connecticut who served on the Fed's Consumer Advisory Council between 2002 and 2004, was familiar with the Fed's reaction to stories of individual consumers. “That is classic Fed mindset,” said McCoy. “If you cannot prove that it is a broad-based problem that threatens systemic consequences, then you will be dismissed.” It frustrated Margot Saunders of the National Consumer Law Center: “I stood up at a Fed meeting in 2005 and said, ‘How many anecdotes makes it real? . . . How many tens [of] thousands of anecdotes will it take to convince you that this is a trend?’”<sup>64</sup>

The Fed's reluctance to take action trumped the 2000 HUD-Treasury report and reports issued by the General Accounting Office in 1999 and 2004.<sup>65</sup> The Fed did not begin routinely examining subprime subsidiaries until a pilot program in July 2007, under new chairman Ben Bernanke.<sup>66</sup> The Fed did not issue new rules under HOEPA until July 2008, a year after the subprime market had shut down. These rules banned deceptive practices in a much broader category of “higher-priced mortgage loans”; moreover, they prohibited making those loans without regard to the borrower's ability

to pay, and required companies to verify income and assets.<sup>67</sup> The rules would not take effect until October 1, 2009, which was too little, too late.

Looking back, Fed General Counsel Alvarez said his institution succumbed to the climate of the times. He told the FCIC, “The mind-set was that there should be no regulation; the market should take care of policing, unless there already is an identified problem. . . . We were in the reactive mode because that’s what the mind-set was of the ‘90s and the early 2000s.” The strong housing market also reassured people. Alvarez noted the long history of low mortgage default rates and the desire to help people who traditionally had few dealings with banks become homeowners.<sup>68</sup>

#### STATES: “LONG-STANDING POSITION”

As the Fed balked, many states proceeded on their own, enacting “mini-HOEPA” laws and undertaking vigorous enforcement. They would face opposition from two federal regulators, the OCC and the OTS.

In 1999, North Carolina led the way, establishing a fee trigger of 5%: that is, for the most part any mortgage with points and fees at origination of more than 5% of the loan qualified as “high-cost mortgage” subject to state regulations. This was considerably lower than the 8% set by the Fed’s 2001 HOEPA regulations. Other provisions addressed an even broader class of loans, banning prepayment penalties for mortgage loans under \$150,000 and prohibiting repeated refinancing, known as loan “flipping.”<sup>69</sup>

These rules did not apply to federally chartered thrifts. In 1996, the Office of Thrift Supervision reasserted its “long-standing position” that its regulations “occupy the entire field of lending regulation for federal savings associations, leaving no room for state regulation.” Exempting states from “a hodgepodge of conflicting and overlapping state lending requirements,” the OTS said, would let thrifts deliver “low-cost credit to the public free from undue regulatory duplication and burden.” Meanwhile, “the elaborate network of federal borrower-protection statutes” would protect consumers.<sup>70</sup>

Nevertheless, other states copied North Carolina’s tactic. State attorneys general launched thousands of enforcement actions, including more than 3,000 in 2006 alone.<sup>71</sup> By 2007, 29 states and the District of Columbia would pass some form of anti-predatory lending legislation. In some cases, two or more states teamed up to produce large settlements: in 2002, for example, a suit by Illinois, Massachusetts, and Minnesota recovered more than \$50 million from First Alliance Mortgage Company, even though the firm had filed for bankruptcy. Also that year, Household Finance—later acquired by HSBC—was ordered to pay \$484 million in penalties and restitution to consumers. In 2006, a coalition of 49 states and the District of Columbia settled with Ameriquest for \$325 million and required the company to follow restrictions on its lending practices.

As we will see, however, these efforts would be severely hindered with respect to national banks when the OCC in 2004 officially joined the OTS in constraining states



from taking such actions. “The federal regulators’ refusal to reform [predatory] practices and products served as an implicit endorsement of their legality,” Illinois Attorney General Lisa Madigan testified to the Commission.<sup>72</sup>

**COMMUNITY-LENDING PLEDGES:  
“WHAT WE DO IS REAFFIRM OUR INTENTION”**

While consumer groups unsuccessfully lobbied the Fed for more protection against predatory lenders, they also lobbied the banks to invest in and loan to low- and moderate-income communities. The resulting promises were sometimes called “CRA commitments” or “community development” commitments. These pledges were not required under law, including the Community Reinvestment Act of 1977; in fact, they were often outside the scope of the CRA. For example, they frequently involved lending to individuals whose incomes exceeded those covered by the CRA, lending in geographic areas not covered by the CRA, or lending to minorities, on which the CRA is silent. The banks would either sign agreements with community groups or else unilaterally pledge to lend to and invest in specific communities or populations.

Banks often made these commitments when courting public opinion during the merger mania at the turn of the 21st century. One of the most notable promises was made by Citigroup soon after its merger with Travelers in 1998: a \$115 billion lending and investment commitment, some of which would include mortgages. Later, Citigroup made a \$120 billion commitment when it acquired California Federal Bank in 2002. When merging with FleetBoston Financial Corporation in 2004, Bank of America announced its largest commitment to date: \$750 billion over 10 years. Chase announced commitments of \$18.1 billion and \$800 billion, respectively, in its mergers with Chemical Bank and Bank One. The National Community Reinvestment Coalition, an advocacy group, eventually tallied more than \$4.5 trillion in commitments from 1977 to 2007; mortgage lending made up a significant portion of them.<sup>73</sup>

Although banks touted these commitments in press releases, the NCRC says it and other community groups could not verify this lending happened.<sup>74</sup> The FCIC sent a series of requests to Bank of America, JP Morgan, Citigroup, and Wells Fargo, the nation’s four largest banks, regarding their “CRA and community lending commitments.” In response, the banks indicated they had fulfilled most promises. According to the documents provided, the value of commitments to community groups was much smaller than the larger unilateral pledges by the banks. Further, the pledges generally covered broader categories than did the CRA, including mortgages to minority borrowers and to borrowers with up-to-median income. For example, only 22% of the mortgages made under JP Morgan’s \$800 billion “community development initiative” would have fallen under the CRA.<sup>75</sup> Bank of America, which would count all low- and moderate-income and minority lending as satisfying its pledges, stated that just over half were likely to meet CRA requirements.

Many of these loans were not very risky. This is not surprising, because such broad definitions necessarily included loans to borrowers with strong credit histories—low

income and weak or subprime credit are not the same. In fact, Citigroup's 2002 pledge of \$80 billion in mortgage lending "consisted of entirely prime loans" to low- and moderate-income households, low- and moderate-income neighborhoods, and minority borrowers. These loans performed well.<sup>76</sup> JP Morgan's largest commitment to a community group was to the Chicago CRA Coalition: \$12 billion in loans over 11 years. Of loans issued between 2004 and 2006, fewer than 5% have been 90-or-more-days delinquent, even as of late 2010.<sup>77</sup> Wachovia made \$12 billion in mortgage loans between 2004 and 2006 under its \$100 billion in unilateral pledges: only about 7.3% were ever more than 90 days delinquent over the life of the loan, compared with an estimated national average of 14%.<sup>78</sup> The better performance was partly the result of Wachovia's lending concentration in the relatively stable Southeast, and partly a reflection of the credit profile of many of these borrowers.

During the early years of the CRA, the Federal Reserve Board, when considering whether to approve mergers, gave some weight to commitments made to regulators. This changed in February 1989, when the board denied Continental Bank's application to merge with Grand Canyon State Bank, saying the bank's commitment to improve community service could not offset its poor lending record.<sup>79</sup> In April 1989, the FDIC, OCC, and Federal Home Loan Bank Board (the precursor of the OTS) joined the Fed in announcing that commitments to regulators about lending would be considered only when addressing "specific problems in an otherwise satisfactory record."<sup>80</sup>

Internal documents, and its public statements, show the Fed never considered pledges to community groups in evaluating mergers and acquisitions, nor did it enforce them. As Glenn Loney, a former Fed official, told Commission staff, "At the very beginning, [we] said we're not going to be in a posture where the Fed's going to be sort of coercing banks into making deals with . . . community groups so that they can get their applications through."<sup>81</sup>

In fact, the rules implementing the 1995 changes to the CRA made it clear that the Federal Reserve would not consider promises to third parties or enforce prior agreements with those parties. The rules state "an institution's record of fulfilling these types of agreements [with third parties] is not an appropriate CRA performance criterion."<sup>82</sup> Still, the banks highlighted past acts and assurances for the future. In 1998, for example, when NationsBank said it was merging with BankAmerica, it also announced a 10-year, \$350 billion initiative that included pledges of \$115 billion for affordable housing, \$30 billion for consumer lending, \$180 billion for small businesses, and \$25 and \$10 billion for economic and community development, respectively.

This merger was perhaps the most controversial of its time because of the size of the two banks. The Fed held four public hearings and received more than 1,600 comments. Supporters touted the community investment commitment, while opponents decried its lack of specificity. The Fed's internal staff memorandum recommending approval repeated the Fed's insistence on not considering these promises: "The Board considers CRA agreements to be agreements between private parties and has not facilitated, monitored, judged, required, or enforced agreements or specific portions of agreements. . . . NationsBank remains obligated to meet the credit needs of its entire

community, including [low- and moderate-income] areas, with or without private agreements.”<sup>83</sup>

In its public order approving the merger, the Federal Reserve mentioned the commitment but then went on to state that “an applicant must demonstrate a satisfactory record of performance under the CRA without reliance on plans or commitments for future action. . . . The Board believes that the CRA plan—whether made as a plan or as an enforceable commitment—has no relevance in this case without the demonstrated record of performance of the companies involved.”<sup>84</sup>

So were these commitments a meaningful step, or only a gesture? Lloyd Brown, a managing director at Citigroup, told the FCIC that most of the commitments would have been fulfilled in the normal course of business.<sup>85</sup> Speaking of the 2007 merger with Countrywide, Andrew Plepler, head of Global Corporate Social Responsibility at Bank of America, told the FCIC: “At a time of mergers, there is a lot of concern, sometimes, that one plus one will not equal two in the eyes of communities where the acquired bank has been investing. . . . So, what we do is reaffirm our intention to continue to lend and invest so that the communities where we live and work will continue to economically thrive.” He explained further that the pledge amount was arrived at by working “closely with our business partners” who project current levels of business activity that qualifies toward community lending goals into the future to assure the community that past lending and investing practices will continue.<sup>86</sup>

In essence, banks promised to keep doing what they had been doing, and community groups had the assurance that they would.

#### BANK CAPITAL STANDARDS: “ARBITRAGE”

Although the Federal Reserve had decided against stronger protections for consumers, it internalized the lessons of 1998 and 1999, when the first generation of subprime lenders put themselves at serious risk; some, such as Keystone Bank and Superior Bank, collapsed when the values of the subprime securitized assets they held proved to be inflated. In response, the Federal Reserve and other regulators reworked the capital requirements on securitization by banks and thrifts.

In October 2001, they introduced the “Recourse Rule” governing how much capital a bank needed to hold against securitized assets. If a bank retained an interest in a residual tranche of a mortgage security, as Keystone, Superior, and others had done, it would have to keep a dollar in capital for every dollar of residual interest. That seemed to make sense, since the bank, in this instance, would be the first to take losses on the loans in the pool. Under the old rules, banks held only 8% in capital to protect against losses on residual interests and any other exposures they retained in securitizations; Keystone and others had been allowed to seriously understate their risks and to not hold sufficient capital. Ironically, because the new rule made the capital charge on residual interests 100%, it increased banks’ incentive to sell the residual interests in securitizations—so that they were no longer the first to lose when the loans went bad.

The Recourse Rule also imposed a new framework for asset-backed securities. The capital requirement would be directly linked to the rating agencies' assessment of the tranches. Holding securities rated AAA or AA required far less capital than holding lower-rated investments. For example, \$100 invested in AAA or AA mortgage-backed securities required holding only \$1.60 in capital (the same as for securities backed by government-sponsored enterprises). But the same amount invested in anything with a BB rating required \$16 in capital, or 10 times more.

Banks could reduce the capital they were required to hold for a pool of mortgages simply by securitizing them, rather than holding them on their books as whole loans. If a bank kept \$100 in mortgages on its books, it might have to set aside about \$5, including \$4 in capital against unexpected losses and \$1 in reserves against expected losses. But if the bank created a \$100 mortgage-backed security, sold that security in tranches, and then bought all the tranches, the capital requirement would be about \$4.10.<sup>87</sup> "Regulatory capital arbitrage does play a role in bank decision making," said David Jones, a Fed economist who wrote an article about the subject in 2000, in an FCIC interview. But "it is not the only thing that matters."<sup>88</sup>

And a final comparison: under bank regulatory capital standards, a \$100 triple-A corporate bond required \$8 in capital—five times as much as the triple-A mortgage-backed security. Unlike the corporate bond, it was ultimately backed by real estate.

The new requirements put the rating agencies in the driver's seat. How much capital a bank held depended in part on the ratings of the securities it held. Tying capital standards to the views of rating agencies would come in for criticism after the crisis began. It was "a dangerous crutch," former Treasury Secretary Henry Paulson testified to the Commission.<sup>89</sup> However, the Fed's Jones noted it was better than the alternative—"to let the banks rate their own exposures." That alternative "would be terrible," he said, noting that banks had been coming to the Fed and arguing for lower capital requirements on the grounds that the rating agencies were too conservative.<sup>90</sup>

Meanwhile, banks and regulators were not prepared for significant losses on triple-A mortgage-backed securities, which were, after all, supposed to be among the safest investments. Nor were they prepared for ratings downgrades due to expected losses, which would require banks to post more capital. And were downgrades to occur at the moment the banks wanted to sell their securities to raise capital, there would be no buyers. All these things would occur within a few years.

**COMMISSION CONCLUSIONS ON CHAPTER 6**

The Commission concludes that there was untrammelled growth in risky mortgages. Unsustainable, toxic loans polluted the financial system and fueled the housing bubble.

Subprime lending was supported in significant ways by major financial institutions. Some firms, such as Citigroup, Lehman Brothers, and Morgan Stanley, acquired subprime lenders. In addition, major financial institutions facilitated the growth in subprime mortgage-lending companies with lines of credit, securitization, purchase guarantees and other mechanisms.

Regulators failed to rein in risky home mortgage lending. In particular, the Federal Reserve failed to meet its statutory obligation to establish and maintain prudent mortgage lending standards and to protect against predatory lending.