1 FEDERAL TRADE COMMISSION
2
3 RESEARCH ROUNDTABLE
4 ECONOMIC PERSPECTIVES ON THE HOME
5 MORTGAGE MARKET
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21 professionally transcribed as described on page 213 of
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23 to improve punctuation, spelling and clarity. In
24 addition each speaker was given the opportunity to edit
25 their comments.

1 PANEL MEMBERS

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5 (Moderator)	
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10 Susan Wachter	The Wharton School of the
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1 P R O C E E D I N G S
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3 MS. IPPOLITO: Welcome to the FTC. This is the
4 Mortgage Research Roundtable. We really appreciate you
5 all coming out in the middle of noreaster here. Of
6 course, to a New Englander, this isn't what a noreaster
7 really looks like. But in October, I guess it does.
8 We have a full day planned, so I'd like to get
9 going quickly. As most of you know, this is not a
10 workshop to discuss a particular policy issue. When Tim
11 Muris approached us about putting this together, it was
12 driven in part by the fact that so many things are
13 changing in this market. We have a shifting role of
14 brokers and lenders; we have deceptive lending practices
15 that we have been involved with, others have been
16 involved with from an enforcement perspective. We have
17 several states experimenting in various ways with
18 particular constraints on the market. HUD has proposed
19 revisions of its federal disclosure remedies. There are
20 developments in e-commerce that will change this market.
21 We had a series of three workshops last week
22 including a panel on e-commerce and financial markets
23 that raised a number of issues that are of interest to
24 us.
25 So, the Chairman asked us to put together not a

1 public hearing with interested parties so much as a
2 research roundtable to bring the policy people and the
3 research people together to think more deeply about
4 what's really going on in this market, where is there
5 room for productive improvement, what are the issues we
6 should be addressing, how do we measure things, how do we
7 move forward.
8 So, to begin, I'd like to introduce Howard
9 Beales, who is currently the Director of the Bureau of
10 Consumer Protection -- that's the Bureau here at the FTC
11 that does all the enforcement in the credit area. So,
12 Howard?
13 MR. BEALES: Thanks, Pauline, and thank you all
14 for taking the time from your busy schedules to come
15 spend a lovely day with us. The one thing I can promise
16 you is you probably won't regret being indoors all day.
17 The mortgage market is one that's obviously
18 extraordinarily important for consumers and for the
19 economy as a whole. For many consumers, buying a house
20 is the most important purchase they will ever make. Over
21 the last decade, in particular, there's been tremendous
22 change in the mortgage market and in the way mortgage
23 loans are originated and funded. Today, most loans are
24 sold by brokers, funded by the secondary market and
25 securitized and marketed to individual investors. This

1 revolution has created unprecedented access to credit for
2 Americans and enabled continued growth in home ownership.
3 But we understand that issues and problems in credit
4 markets remain.
5 As you probably know, the FTC is charged with
6 enforcing the various credit laws against finance
7 companies, mortgage companies and other non-bank lenders.
8 The FTC has long been a leader in the fight against
9 deceptive and abusive mortgage lending, and we continue
10 to conduct a vigorous enforcement program to root out
11 deception by lenders and to lower the cost of home
12 ownership for all consumers.
13 In the last six months, the FTC has obtained over
14 $300 million in consumer redress for deceptive lending
15 practices. Not only have we announced a $240 million
16 settlement with Citigroup concerning alleged deception by
17 the Associates in the sale of credit insurance, we've
18 also announced settlements with First Alliance Mortgage
19 for imposing deceptive loan terms and origination fees,
20 and with Mercantile Mortgage for deceiving consumers
21 about loan terms. Moreover, Mercantile represents the
22 first case where the FTC has held a lender responsible
23 for a mortgage broker's misconduct.
24 We've also taken an active role in educating
25 consumers to spot abusive lending practices, to avoid

1 unscrupulous lenders and to complain if they're
2 victimized by lenders. Over the last several years, the
3 FTC has developed a series of publications. We've
4 launched dedicated web pages. We've made this the focus
5 of National Consumer Protection Week in 2001, and we've
6 worked with numerous Federal agencies to develop and
7 disseminate consumer friendly materials in English, and
8 more recently, in Spanish.
9 Now, Chairman Muris and I are both trained as
10 economists, and so, it's perfectly natural for us to
11 believe that sound economic and financial research are
12 the keys to formulating sensible enforcement and
13 regulatory policy in any area, and particularly in one as
14 complex as mortgage lending.
15 The purpose of today's program is to hear from
16 economic and financial researchers about the important
17 issues that they see in today's mortgage market, how we
18 can better understand those issues, and how we should be
19 evaluating the various regulatory schemes that are being
20 proposed to address some of these issues.
21 We want to explore what economic and financial
22 research tells us about how well the mortgage market is
23 working, the extent and nature of possible market
24 failures, and the kind of empirical financial and
25 economic research that we should be conducting and need

1 to be conducting in order to better understand mortgage
2 markets.
3 Our first panel will be directed at the
4 critical questions of consumer behavior. How do
5 consumers shop for mortgages? What information is
6 available to them? How do consumers actually use the
7 information that's put in front of them? What other
8 information might be helpful or would less information be
9 helpful?
10 Our second panel will address the structure of
11 the mortgage market. What is the extent of competition
12 in the mortgage market? How are loans priced? What
13 factors get reflected in price? And ultimately, how
14 efficient is this market in achieving efficient prices?
15 Our final panel will focus on various
16 regulations addressing perceived market failures that
17 have been enacted or that are being considered on the
18 local, state and federal level. What are the costs and
19 benefits of some of these regulations? What is their
20 likely effect on the cost and availability of credit?
21 Are the regulations that are in place accomplishing their
22 stated goals? Are there ways that they can be improved?
23 These are the sort of the crucial policy questions that
24 we want the research to illuminate.
25 Each of these panels will also discuss what

1 questions we should have asked but that weren't on my
2 list. That's actually an important part of the purpose
3 today is to identify the questions we should be
4 addressing as we try to move forward in this area and to
5 address what research needs to be done to answer those
6 questions.
7 I'm very pleased that the Bureau of Economics
8 has assembled such an expert group of panelists and such
9 a distinguished audience. We've built time into the
10 program for the audience to participate and we actively
11 encourage give and take with panel members. There's so
12 much that we do not know about today's complex mortgage
13 markets and the most effective means of ensuring
14 consumers continued access to low cost credit.
15 I look forward to a lively discussion of these
16 topics today and, again, I want to thank you all for
17 coming.
18 MS. IPPOLITO: Okay. Let me just lay out the
19 rules of the road. I think the way we're going to do
20 this is to go through each of the speakers without
21 questions through the panels, and then we'll open up the
22 forum for discussion. We will have microphones and would
23 appreciate very much if you would speak into those
24 microphones. We are being transcribed today. I just
25 want to flag that for everybody.

1 Also, this session is being sent through our
2 internal network to people in their offices, but it's not
3 being taped, just so you feel a little freer to express
4 yourself.
5 We would appreciate when we go through
6 questions that you identify yourself and where you're
7 from, what group you're associated with or what
8 institution, just for clarity.
9 So, with those rules in mind, let me introduce
10 the first panel. This is certainly an esteemed panel,
11 people who have been working on housing and credit for a
12 number of years, most of whom I suppose are well known to
13 you, but let me introduce them nonetheless.
14 First will be Tom Durkin who is a Senior
15 Economist at the Federal Reserve Board. Tom has worked
16 on TILA and consumer credit issues for many, many years,
17 probably more than he would care to admit to. He will
18 speak first.
19 Then Tony Yezer. I remember reading Tony Yezer
20 when I first came to the FTC, which is more years than I
21 would care to admit to, when we were doing the Credit
22 Practices Rule here at the FTC. He is from George
23 Washington.
24 And then Susan Wachter from Wharton, who many
25 of you may know in her more recent incorporation as

1 Assistant Secretary for Policy and Development at HUD
2 from 1998 to 2001.
3 So, with that, let me begin with Tom.
4 FIRST PANEL -- INFORMATION, SEARCH AND CONSUMER BEHAVIOR
5 MR. DURKIN: Thank you, Pauline. It is certainly my
6 pleasure to be here today. Pauline has already told me
7 that I'm not allowed to tell stories, but, nonetheless,
8 those of you who know me know that I frequently like to
9 illustrate things with examples from the antiques market.
10 What market is more appropriate for illustrating any
11 aspect of the economics of information than the antiques
12 market? After all, with antiques you have a market with
13 auctions and agents and you often have often asymmetric
14 information. You have lemons and signals. You have
15 spreads, goofy pricing, and even predators. An
16 interesting thing about the antiques market is the
17 predators seem to operate on both sides of the market.
18 In any case, I recently heard a story about a
19 traveler who went to a city and who, like me, likes to
20 visit antique shops when he travels. This traveler saw
21 an antique shop, walked in, looked at some things, and
22 eventually noticed on a shelf a bronze rat. It wasn’t
23 your typical rat; it was sort of like Mickey Mouse in the
24 sense it was standing up and it sort of had an intriguing
25 attitude. It really had an attractiveness to it.

1 So, he asked the dealer about it and the dealer
2 said, “Yeah, that's really a good piece. Bronze.
3 Ancient Egyptian, 4th Century, B.C., time of Alexander
4 the Great, a really good piece. But remember, if you buy
5 it, you can't bring it back.” So, the traveler looked at
6 it some more and finally decided, “Well, I think that is
7 a good price, and I'm going to buy it.” At which point
8 the dealer said again, “Just remember you can’t bring it
9 back.” The traveler said, “I don't want to bring it
10 back, I like the thing.”
11 Anyway, he took it and, as he was walking down the
12 street with it under his arm, he noticed as he went by an
13 alley that the rats in the alley started looking at him.
14 As he went further down the street he noticed that the
15 rats had come out of the alley and were actually
16 following him. As he went past the next alley he saw
17 some more rats and, unfortunately, they noticed him also
18 and they started following too. Pretty soon he had a
19 real entourage going down the street.
20 He quickly saw that they were getting closer and he
21 started moving faster and they went faster too. So, he
22 moved faster and faster, but they were getting closer and
23 closer. Just as he approached a bridge, he noticed that
24 they weren't really looking at him, that they were
25 actually looking at the rat that he was carrying under

1 his arm, the ancient Egyptian bronze sculpture.
2 At this point the traveler said to himself, “I have
3 a problem here but maybe I know a solution.” So, as he
4 went onto the bridge and they were getting very close, he
5 threw the statue into the river. The rats all went off
6 the side and down into the river too. And he said,
7 “Well, that was really close, but I think I’ve solved the
8 problem.... Hey, I've got to go back and see that
9 antique dealer.”
10 So, he went back to the antique dealer and the
11 antique dealer said, “I told you that you can't bring
12 that thing back.” And the traveler answered, “I know I
13 can't bring it back, I just want to know whether you have
14 a bronze economist.”
15 Now, the point of this story here today is that if
16 you change the viewpoint in that story, the perceived
17 outcome changes as well. For instance, the next talk
18 that I'm going to give is to the Society of Actuaries.
19 When I go to the Society of Actuaries, if I tell that
20 same story, nobody's going to laugh at all. They would
21 ask themselves why in the world did that guy tell that
22 story?
23 On the other hand, if I change the world “economist”
24 there to “actuary,” then they are not only not going to
25 laugh, they are going to be annoyed. In contrast, I have

1 found in talking to business groups that you can always
2 get a big laugh if you change the word to “lawyer.” In
3 fact, with almost any group, you get a big laugh if you
4 say “lawyer,” except among lawyers. Don't tell that
5 story to lawyers unless you are a lawyer yourself. Then
6 you can get away with it.
7 Again, the point is that a very small difference in
8 viewpoint and stance that can make a big difference in
9 the interpretation, not only of a story like this, but
10 also in the evaluation of an economic phenomenon.
11 So, what does this mean for credit disclosures? I
12 think that it can illustrate how different individuals,
13 say an economist, a behavioral specialist, and a lawyer,
14 each with a slightly different view of a market might
15 arrive at a different conclusion concerning the
16 functioning of disclosures in that market.
17 Quickly, let's talk for a moment about some things
18 we know from economics. It is embarrassing for me to
19 stand up here in front of this room and talk about
20 information economics in the building where others have
21 done so much of the work in this area in the past. In
22 fact, I'll note that a lot of it was done by Howard
23 Beales, who just spoke a moment ago, and by Pauline
24 Ippolito, as well. So I'm not going to say very much.
25 Actually, I'm going to ask you to take a lot of what I'm

1 going to say about economics on faith, but remember that
2 economists have an important viewpoint here.
3 Economists, I would say, are concerned, above all,
4 first and foremost, with the efficiency of markets. They
5 use theory as a guide in studying markets, and theory
6 says to economists that information lowers search costs
7 and improves the quality of markets overall. Their
8 viewpoint is that information makes markets more
9 efficient, improving the ratio of output to input.
10 Information narrows the spread in the market and makes
11 consumers better off, if we're talking about a consumer-
12 oriented market. So, this ultimately is the reason why
13 economists basically approve of the concept of required
14 disclosures. In fact, in many ways, the idea of
15 disclosing information is an economic type idea.
16 Since market efficiency is the important outcome,
17 economists do not contend that all consumers must be
18 informed. Mostly, they are interested in the functioning
19 of the market itself, not individual consumers. Of
20 course, it's true that the more consumers who are
21 informed, the better; all economists would agree with
22 that. But no individual consumer is absolutely
23 important. Now, the proportion of consumers that must be
24 informed for a market to behave efficiently is an
25 interesting, important empirical question. Sometimes we

1 don't know the answer to that -- mostly we don't know the
2 answer -- and it may vary from market to market. Also,
3 the economists would argue that it's likely true that the
4 fewer the margins, the fewer the dimensions of the
5 market, the more likely it is to be efficient. So, the
6 more who are informed the better and the fewer the
7 dimensions the better off they are, but the condition of
8 the individual consumer is less important to the
9 economist than the functioning of the market itself.
10 I think that ultimately this is the reason why
11 economists sometimes seem non-responsive when they hear
12 about a particular individual who has a problem. In
13 other words an economist might well say, "That's
14 interesting to find out there's a particular consumer
15 who's uninformed, who doesn't know how this market
16 functions, but tell me about the market itself. I want
17 to know what the characteristics of this market are, and
18 in particular, I don't necessarily want to try to change
19 the whole market to make that one consumer informed.
20 There may be a more focused approach to improving the
21 situation of individual consumers." It seems this may
22 well be the genesis of why economists seem relatively
23 uninterested in anecdotal type stories. They're
24 interested in the big picture of the market itself, more,
25 I would say, than some other observers.

1 Of course, it is also true that if we find that one
2 market is efficient or inefficient, that doesn't tell us
3 anything about closely associated markets. Here we may
4 find a good example in the mortgage area. If we find,
5 through studies or theory or empirical work or whatever,
6 that the prime mortgage market, for instance, is
7 efficient or functioning pretty well, that doesn't tell
8 us anything necessarily about the subprime mortgage
9 market. That's something else, and we have to study that
10 separately.
11 In contrast to the economists, there are also other
12 behavioral specialists, including psychologists. I would
13 include in this group the business manifestation of
14 behavioral scientists: the marketers. They clearly are
15 very interested in individuals. These researchers tend
16 to be much less interested in the overall functioning of
17 the market itself. They're interested in whether or not,
18 for example, they can sell products to individuals. And
19 so, they tend to approach the information problem in a
20 different way. There is theory in the world of the
21 psychologists and other behavioral scientists, but it
22 seems like theory is less important overall to them than
23 it is to the economists. Behavioral researchers often
24 operate more with experiments and surveys as guides. We
25 can learn a lot from experiments and surveys,

1 particularly if we're trying to sell products to
2 individuals, but, like theory, they do not tell us
3 everything we might like to know either. Notably, they
4 do not often tell us much definitively about the
5 functioning of the market itself. So, these surveys and
6 experimental studies tend not to satisfy the economists.
7 As I mentioned, survey results can be interesting,
8 even if they do not provide definitive answers about
9 market conditions. In the handout I included some tables
10 of survey results. The reason for picking these survey
11 results is that they are the only questions concerning
12 credit disclosures I know about for which we have
13 comparative survey results over the years.
14 The first table concerns consumers' overall
15 perception of the ease of obtaining information on credit
16 terms. I am not going to make anything of small
17 differences from year to year because there could be some
18 differences over time in consumers' attitudes towards
19 questioning and other things. The interesting thing to
20 me, however, is that over a long period of time there
21 appears to be relative consistency of findings.
22 Let's look at the top two rows of the table in
23 particular; I am going to add them together. Going left
24 to right from 1977, 62 percent said that year it was very
25 easy or somewhat easy to obtain credit cost information.

1 That rose a little bit, to 76 percent in 1981, 71 percent
2 in the next column, then 72 percent and 65 percent in
3 2001. Again, my interest here is in the finding that
4 there's a relative consistency over a long period of time
5 in the response to that particular question. We don't
6 have a measurement from before Truth-In-Lending, but it's
7 difficult for me to believe that this proportion of
8 consumers would have said before Truth-In-Lending that
9 obtaining credit information was easy or very easy.
10 I am not going to say much about the far right-hand
11 column in the table, but, for your edification and
12 amusement, this column contains the results of a question
13 in the year 2001 differentiating views of how easy it is
14 for individuals to obtain information for themselves
15 versus their views how easy it is for others to obtain
16 information. It seems quite a few people think it is
17 easier for themselves than for others. This is what I
18 have characterized as the "other guy effect." Maybe
19 others are just not as smart as I am.
20 If we look down in the second panel of that table,
21 there are viewpoints on whether creditors provide enough
22 information: Leaving out 1977 but looking at the years
23 beginning with 1981, the "yes" answers are 65 percent, 62
24 percent, 61 percent, and 65 percent, indicating the
25 general belief that creditors provide enough information.

1 Again, it seems difficult that consumers would have felt
2 the same before Truth in Lending. Does this tell us
3 anything about the efficiency of credit markets? No, I
4 do not think so, but maybe it tells us that things are a
5 little bit better than we otherwise might think, at least
6 in terms of people's reaction to the condition of their
7 own situations in the marketplace. It is not possible to
8 tell of course, which respondents would be prime or
9 subprime credits.
10 Very quickly, let's look at the next table. This
11 one contains results of specific questions about
12 viewpoints concerning Truth-In-Lending type statements
13 themselves, focusing a little bit more closely on Truth-
14 In-Lending than on information generally. Again, the
15 interesting thing to me is the consistency over time of
16 these findings. Likewise for the next table which
17 involves specific actions to obtain information. The top
18 line refers to the attempt to obtain information and
19 lines 7 through 11 indicate the kinds of information
20 sought. I think the last line, line 22, is especially
21 interesting. It indicates the proportion of those who
22 looked for information or said they looked for
23 information who reported they were able to find the
24 information they wanted, a high percentage in each year.
25 Does that mean the market is efficient? Not necessarily.

1 I think it's interesting nonetheless, and it is an
2 indication that maybe things aren't quite as bad as we
3 might otherwise think. The next table simply is the same
4 kind of questioning, but for specific kinds of second
5 lien credit, second mortgages and home equity lines of
6 credit. We do not have as long a time series on these
7 questions.
8 The next page in your handout tables lists a variety
9 of research questions related to credit information. I
10 do not have the time to go through these here, but you
11 can look at them at your convenience. If you do, you may
12 say that we know some things about some of these
13 questions. I would agree with you, but we do not know a
14 lot, and in some cases we don't know very much at all. I
15 would add that they all are researchable questions; some
16 of them may take substantial amounts of research and
17 resources.
18 It is possible to divide the economic questions
19 into a number of subgroups. The first three questions
20 specifically concern the economics of information as we
21 understand it from a consumer viewpoint. The fourth and
22 fifth look at the issue whether or not various government
23 regulations have maybe made it more difficult for
24 consumers to provide signaling of their own in the
25 market. Specifically, have privacy and other

1 restrictions such as the Fair Credit Reporting Act in any
2 way made it more difficult for credit worthy individuals
3 to signal this fact? I do not have any conclusions on
4 this issue, but it is not impossible. The last issue in
5 the first section concerns the costs of disclosure
6 regimes themselves, and whether, in fact, the cost of
7 disclosures and changing disclosures means that we might
8 restrict or negate, in some way, the benefits that flow
9 from disclosures. In other words, if search costs are,
10 in fact, lowered by disclosures, do we run a risk of
11 losing a portion of the benefit by raising the costs of
12 disclosing the information that the people want? The
13 rest of the research questions in the table refer to a
14 variety of behavioral issues concerning individual
15 consumers or groups of consumers.
16 As I mentioned at the outset, I do not have a lot of
17 time, and so I will not offer much of a perspective on
18 lawyers and what their participation in this process
19 means for Truth-In-Lending. A few facts are worth
20 mentioning briefly. One of them is emphasizing again
21 that Truth in Lending is ultimately an economic
22 regulation, or that is how it was intended. Some of you
23 probably know, some of you may not, that Senator Paul
24 Douglas, who was a chief Congressional sponsor of Truth
25 in Lending in the 1960s, was President of the American

1 Economic Association the year that he was elected to
2 Congress in 1948, probably a unique accomplishment. The
3 point is that certainly he thought like an economist.
4 Congress as a whole did not necessarily think that
5 way, though. The Congress, as it should in a democratic
6 society, thought about a whole lot of things, including
7 whether or not every constituent was considered. This is
8 more like how a behavioralist or marketer might approach
9 a problem: the individual needs of every consumer should
10 be considered. The outcome was a structure of Truth in
11 Lending reflecting the concept I might refer to as “full
12 disclosure”: disclose everything that might be useful to
13 someone, somewhere, sometime, for some purpose. This
14 means that there is a lot more to Truth in Lending than
15 only what economists might argue could make the market
16 more efficient. The breadth of disclosed information
17 probably accounts for the survey findings that consumers
18 find their Truth-in-Lending disclosures complicated. In
19 effect, the Congress approached credit disclosure as a
20 behavioral regulation but, of course, one forged in the
21 give and take of daily politics of a generation ago. The
22 political aspect always complicates changes to regulatory
23 regimes, even in those cases when everyone agrees
24 something should be done.
25 I already have begun to run over my time, so I will

1 have to skip over for now any further discussion of a
2 number of matters, including the dynamics of Truth in
3 Lending reform. Maybe we'll have time to talk about some
4 of these things later in the day. I will take only a
5 moment to mention what I consider to be some key issues
6 in this area.
7 One is to make sure to pay attention to goals and
8 incentives. Concerning the former, there are many goals
9 of Truth in Lending; I have provided a list of some of
10 them in the handout. Concerning incentives, if everybody
11 is not on board, it just complicates the reform issue.
12 Even casual observation shows that Truth-In-Lending has
13 become so complicated that the people who hate it the
14 most are the businesses that are the most legitimate. In
15 other words, the ones that ought to want everybody to
16 have to disclose because they have a good story to tell
17 cannot comply with it easily enough and hate it the most.
18 Something is wrong with the incentives there, which
19 should be a warning when reform is contemplated.
20 With issues like this in mind, I have listed some
21 possible principles for reform on the last page of my
22 handout. I do not have the time to discuss them all in
23 detail here now. I know there are some other speakers
24 later in the day who are going to talk about the
25 usefulness of technology, and so maybe we can get back to

1 reform issues later. It seems worthwhile to look at how
2 technology might be able to move us beyond the paper-
3 based disclosure systems designed originally for 1968
4 technology. Likewise, we need to focus again on the
5 underlying goals of disclosure and the incentives of
6 interested parties. We also should carefully consider
7 how enforcement methodologies can affect outcomes.
8 Obviously, I've taken up all my time and I've tried
9 to talk about a lot of things in a fairly short period.
10 I would like to spend even more time on it. Pauline,
11 thank you for inviting me and I'm looking forward to
12 hearing Tony and the rest of the speakers.
13
14 MS. IPPOLITO: Thanks for coming. Next we will
15 hear from Anthony Yezer.
16 MR. YEZER: I was asked to talk about
17 information, research and consumer behavior. I'm going
18 to concentrate on the third. I think if we know
19 something about consumer behavior --
20 (Brief portion of presentation inaudible due to
21 Mr. Yezer's distance from the microphone.)
22 MR. YEZER: Quite honestly, I know a lot less
23 about information and research than I do about behavior.
24 I'm going to first begin to ask the question, and I'm
25 getting fairly, I guess, fundamental here, and that is,

1 are consumers making good decisions when we look at the
2 decisions they're making.
3 Secondly, I'm going to talk about something I
4 call the home equity trap. Perhaps a lot of people are
5 not aware of it.
6 Third, I'm going to talk a little bit about the
7 role of subprime mortgage lenders because they've been
8 getting a lot of attention, mention some needs for better
9 information, ask the classic question, is the government
10 part of the solution or part of the problem, and make
11 some suggestions for change.
12 Now, I'm going to have to be brief here, so I'm
13 not going to give you a lot of proof or evidence for many
14 of these statements. Those familiar with the literature
15 know where the proof is, and those who aren't maybe can
16 ask during the question and answer session or just
17 consult someone who is familiar with the literature.
18 First, are consumers making good decisions?
19 Are, I'll use the term households, making good decisions?
20 I want to begin with some insights from the Survey of
21 Consumer Finances, another fine survey. By the way, the
22 Consumer Expenditures Survey has a lot of these questions
23 on it, also, so you could get the same insights from
24 that.
25 First, and some of this may be stereotypical to

1 you, but it is in the data, young households buy housing
2 with high LTV mortgage. They concentrate on building
3 equity in the housing unit. If we look at the median
4 owner occupant, the median owner occupant under 50 years
5 of age has zero stocks. Burning the mortgage is a
6 priority. Burning the mortgage is, I guess if you have a
7 first and a second, is a priority with households. All
8 of a sudden, at the age of 50, the household discovers
9 stocks and starts investing in the stock market.
10 Now, what you'll observe there, of course, is
11 something that -- and I have to, after this session, give
12 a principle's lecture to about 250 eager GW freshmen and
13 sophomores, and what you'll discover there is something
14 that even in a freshman and sophomore Principles of
15 Economics class you'd say is a disaster in terms of risk
16 management. This is the economic equivalent of smoking a
17 pack of cigarettes and drinking a fifth of bourbon a day
18 without the fun, okay? I mean, this is bad, you
19 understand?
20 What households do has nothing to do with what
21 we teach in the classroom, nothing. It's a disaster. I
22 can't say that more strongly.
23 Households are badly diversified. In addition
24 to everything that's obvious about this portfolio,
25 housing equity is often closely related to the local

1 labor market conditions. Now, not so much in D.C.,
2 inside the Beltway because our local economy has a Beta
3 of zero or something like that.
4 But let me give you a little example. Tom said
5 we didn't do this, but this is my conversation with a
6 Lucent household. I was riding the train up to
7 Philadelphia on business and a young woman was sitting
8 next to me and she said, well, that she and her husband,
9 who was a techie type, lived in some town in
10 Massachusetts, north and west of Boston -- of course most
11 of Massachusetts is at least west of Boston. But in any
12 event, she recounted the fact that they had their two
13 boys and what have you and they had a large house in a
14 neighborhood and basically everybody in the neighborhood
15 worked for Lucent because Lucent pay for engineers and
16 managers was essentially the one source of employment
17 that could allow you to afford that housing. Of course,
18 they had a lot of Lucent stock and stock options.
19 Then she asked me what I thought. Okay, this
20 was about three years ago. And I said, sell your house
21 and rent, buy a put on Lucent stock or short Lucent every
22 way you can, you're in deep trouble, you're in deep
23 trouble. You are walking on a tightrope. Now, I hope
24 she paid some attention to me, I doubt if she did. I
25 think that household has probably had a very, very bad

1 experience. These households are all over the United
2 States, folks. This is bad.
3 Let me talk about something even worse, the
4 home equity trap. So, we've already got households not
5 even doing what we would teach a freshman in college. Of
6 course, then again, I see the exams and when I see the
7 final exam I can see that we didn't teach them anyway.
8 I'll get to that in a moment. I mean, I've actually
9 learned something from my inability to teach. Humility.
10 Okay, next, the home equity trap. So, we've
11 got the households overinvesting in housing equity. Your
12 wealth should provide a cushion to deal with fluctuations
13 in your income. We don't want your consumption to bounce
14 up and down with your income. One of the things that
15 wealth does is provide that cushion for what we in the
16 jargon call "income shocks."
17 Okay. Here's a common scenario. You lose your
18 job, you lose your health, you lose your spouse,
19 whatever. The first thing you do is you exhaust your
20 bank savings. By the way, the other thing households
21 hold other than home equity is government-guaranteed
22 assets. So, they've got this real high risk there and I
23 guess they've read sort of the skimmed version of Tobin's
24 Portfolio Separation Theorem in which they hold
25 government-guaranteed assets and housing equity, and also

1 their human capital, which is invested in something
2 highly correlated with their housing equity.
3 So, fine, you got into that situation, let's
4 apply for cash out refinancing to tap all that home
5 equity, right? Excellent. So, we'll go to a prime
6 mortgage lender and say, all right, well, I have no
7 income and I've maxed out my credit cards, so now I want
8 to do a cash out refinancing or a home equity line. And
9 what do they hear? You've got to be kidding me. Of
10 course not. They're rejected.
11 See, the trap is that you can't access your
12 home equity when you need it. So, we tell people, hold
13 all your wealth in home equity, home equity is a cushion
14 against fluctuations income and just when you need it,
15 you can't access it in the prime market. This is
16 wonderful. A Catch-24? I mean, it goes beyond Catch-22,
17 right?
18 It doesn't get much worse than this, folks.
19 Now, no one in this room has been in this situation, but
20 that doesn't mean that lots of people aren't.
21 Okay, so now we get to the role of subprime
22 lenders. What's going on there? Well, subprime lenders
23 for a lot of these folks are the major alternative to
24 selling their home. I mean, you can always do -- instead
25 of cash out refinancing, your other way to tap your home

1 equity is by selling the house, and many people have to
2 do that. They do that rather than engage in -- get in
3 the subprime market.
4 These folks serve a group with default rates
5 five to ten times of a prime borrower's. They also have
6 very high prepayment rates because anybody who cures
7 their credit problems will obviously refinance out, and
8 many people just decide to sell their house. They have
9 high underwriting costs because of the folks they're
10 dealing with and the lack of posted prices make it very,
11 very difficult for individuals to shop for credit and for
12 researchers to study them. I must say I've been trying
13 to study them. I won't even tell you some of the things
14 I've done. I mean, I've applied for -- I've got research
15 assistants applying for a lot of mortgages, and even then
16 they want to call you back, you can't get a price. So,
17 it is very, very difficult to figure out what's going on
18 in this market and to do either research or to be a well-
19 informed consumer.
20 So, that brings me to my next point, the need
21 for better information. Consumers need appropriate
22 indices of the cost of credit that be compared. I agree
23 entirely with Tom. They don't need 47 numbers to be
24 disclosed. We need to sit down and decide what
25 economical numbers they need. Is the APR enough? Do we

1 need something else?

2 Lots of information is, in fact, data, not

3 information. People need information. You've got to get

4 to a bottom line that they can understand. In fact,

5 researchers need information. We can't even identify

6 subprime loans because we don't know the interest rates.

7 So, very, very difficult.

8 Now, I'll give you an example of that that's

9 contaminating research, the problems with the widely used

10 HUD list of subprime lenders. Everybody says subprime

11 lending has grown explosively. Sure, it's grown

12 explosively because the list of HUD subprime lenders has

13 grown. I mean, this has nothing to do with the growth of

14 subprime lending. If you read the footnotes to the HUD

15 list, you'll understand that. They're very modest about

16 saying that they're identifying subprime loans. The

17 other thing is more lenders who do subprime lending are

18 reporting for other purposes.

19 So, this huge growth in subprime lending is a

20 statistical artifact due to the growth of the list of

21 subprime lenders and due to the fact that subprime

22 lenders increasingly are reporting more of their loans.

23 So, this is just all botched statistics because we lack

24 decent information. However, you know, the fact that

25 these are botched doesn't keep them from being believed

1 by the vast majority of people.
2 Finally, I think lenders would benefit from
3 better information on what other lenders are doing, and
4 researchers need to study the fundamental reason for
5 household overinvestment in home equity. What's the
6 information set that people are using that has gotten
7 them to make such bad investment decisions?
8 All right, finally, let me get to more policy
9 area. Is the government part of the solution or part of
10 the problem? I mean, I'd argue that the government
11 encourages overinvestment in home equity. In fact, the
12 Homeowners Equity Protection Act actually treats equity
13 stripping as a bad thing. I mean, equity stripping, when
14 you've had a shock to your income, allows you to maintain
15 your consumption. That's a good thing. We also have
16 lots of problems to encourage economically marginal
17 households to become homeowners. Good, so they can fall
18 into the old equity trap, right? People who can only
19 hold housing equity and a few government guaranteed
20 assets in their portfolio are just being encouraged to
21 fall into the home equity trap, right? So, we're telling
22 all these people to do the wrong thing.
23 By the way, I'd mention that while we're so
24 concerned about housing equity, there's absolutely no
25 impediments to households destroying their credit history

1 by using revolving credit, sales finance, pawn shops. If
2 I want to strip all the equity out of my account at a
3 broker dealer by buying on margin or by writing myself a
4 check and effectively buying on margin, nobody cares
5 about that, right? There's only one area where we care
6 about equity stripping. I mean, that's just so silly.
7 Finally, we even have banking legislation,
8 Gramm-Leach-Bliley, it doesn't let us use credit score
9 for any purpose other than to improve credit scoring.
10 So, we can't even do research in this field because we
11 can't match up credit scores with individuals, so we
12 can't do a proper supply of credit function, now that
13 we've decided that even depersonalized credit history
14 can't be used in our research.
15 Man, does it get worse than this? Well,
16 anyway, some suggestions for change. You know, they were
17 implicit there, but I want to surprise you by saying
18 lenders need to change. Almost one-third of households
19 that are owner occupants have no mortgage. That's a
20 disgrace, an absolutely disgrace. I tell the mortgage
21 bankers every time they let me talk to them. They sell a
22 product which most people want to get rid of. I don't
23 know any vendor that has -- and they agree with that,
24 right? They agree with that. This is ridiculous. We
25 want people mortgaged forever, mortgages for a lifetime.

1 Look, folks, the 30-year self-amortizing
2 mortgage is an artifact of the 1930s. It was invented
3 then. Do you know of any financial instrument that has
4 survived from the 1930s? In the 1930s, what did we know
5 about financial economics? Nothing. I mean, McCauley
6 just talked about measuring interest rate risk about
7 1938. This is ridiculous for this to be our primary
8 instrument or for our thinking to be based on this.
9 Mortgages should allow borrowers to miss
10 payments, to access their equity in a sort of automated
11 fashion. Look, we invented the index mutual fund to
12 allow people who are clueless to invest intelligently, to
13 hold a market portfolio. Why? Because Tobin's Portfolio
14 Separation Theorem told us that that's what they should
15 do. Fine, we did that for people. Some of them do it,
16 some of them day trade. Tough. I mean, at least a lot
17 of them are holding the index mutual fund.
18 We need to invent instruments that cause people
19 to make the right decisions without knowing economics,
20 because I give up on trying to teach households enough
21 financial economics so that they will make the right
22 decision. We need to design instruments, lenders need to
23 design instruments that are mortgages for a lifetime, to
24 have a lifetime relationship with the borrower so that
25 they will automatically make good decisions.

1 Government needs to change. Stop promoting
2 ownership of marginal owners, encourage households to
3 diversify their portfolio, get off the housing equity as
4 the prime investment that you should make trip and
5 promote information availability and research on what's
6 going on, both with consumers and in the industry.
7 So, that's enough of my rant. If you have
8 questions, we'll get to them later.
9 MS. IPPOLITO: Thank you. Okay, Susan?
10 MS. WACHTER: Good morning. It is a great
11 pleasure to be here.
12 In my comments today, I am going to briefly
13 address what we do and do not know about the workings of
14 the subprime mortgage market versus the prime market.
15 We have substantial research at hand, thanks in part to
16 the recent conference convened by Tony Yezer and Michael
17 Staten and the forthcoming, two volume Journal of Real
18 Estate Finance on this topic. I will also point out what
19 we need to know going forward and what kind of research
20 efforts will be necessary.
21 Now, I speak as someone who does research with
22 large data sets and I think that they are important and
23 have helped to inform the nation's policies, in
24 particular in the area of mortgage policy. For example,
25 the Home Mortgage Disclosure Act data sets have been

1 extraordinarily important in the development of anti-
2 redlining policy. We have had armies of researchers who
3 have been able to mobilize on all sides of the issue to
4 the benefit of research and informed public policy.
5 In the area of subprime versus prime lending
6 and the potential market failures in the subprime market,
7 I think we also will benefit by research utilizing large
8 data sets including the new data that we will have
9 available due to some of the very good efforts on the
10 part of Federal Reserve Board.
11 But I think that we are going to need to access
12 different kinds of data and do a different kind of
13 research going forward, as well.
14 I want to congratulate the FTC and the Consumer
15 Protection Division on their recent remarkable successes.
16 I think it's a timely point in their work to address what
17 should be the next steps, which should be a new
18 generation of research and a somewhat different kind of
19 research than economists traditionally undertake.
20 That said, I commend to the research
21 forthcoming in the Journal of Real Estate and Finance.
22 The conclusion of much of this research is that the
23 spatial distribution of subprime lending cannot be fully
24 explained by economic fundamentals. For example a paper
25 by myself, Paul Calem of the Federal Reserve Board and

1 Kevin Gillen a PhD student at Penn, indicates that even
2 with estimated credit scores, and other market data, we
3 cannot fully explain the percentage of subprime lending
4 in minority neighborhoods. There was one exception to
5 this finding in the research we did for two cities,
6 Philadelphia and Chicago. Now, in one estimation for
7 Philadelphia, a logistic regression which included
8 individual data, there did not appear to be undue
9 subprime concentration in African-American neighborhoods.
10 These were areas in Philadelphia which had been subject
11 to the outreach and affirmative programs of the Delaware
12 Valley Mortgage Plan, a group of prime lenders who made
13 special efforts to lend in minority and low to moderate
14 income areas. This prime market outreach appears to
15 account for this otherwise unexplained result.
16 Nonetheless, in general, we still find that the minority
17 status of the borrower is significant in explaining the
18 concentration of subprime lending.
19 So, what's going on? I think there is
20 potential market failure. There are three areas of
21 potential dysfunction and market failure that should be
22 explored. To do so we need a different kind of research,
23 in addition to the continuation of large scale research
24 efforts.
25 The first of these three areas is price

1 revelation. In the prime mortgage market, there is a
2 posted price. In the subprime market, the first
3 potential market failure derives from an asymmetric
4 information problem.
5 In a well-functioning competitive market
6 without asymmetric information, the consumer surplus
7 goes entirely to the consumer, because lenders compete to
8 offer the lowest price to borrowers. In this market,
9 there is the potential for this to be reversed so that
10 borrowers are charged a high price because of their lack
11 of knowledge of alternatives. They don't know their risk
12 status and therefore the terms lenders would be willing
13 to offer. Even if they go to several competitors, in each
14 case, they may very well receive the maximum offer for
15 their risk status. Moreover they may not be able to
16 compare offers (as discussed below). Also, consumers have
17 a strong incentive not to go to multiple competitors
18 since this might be detrimental to their credit rating.
19 So, how to solve this problem? I think we need
20 research on what it would take to create a price
21 revelation facility. The facility might even be, at some
22 point, profitable.
23 What would be necessary for that? It would be
24 necessary, of course, to know the FICO score, the credit
25 information of the borrower. That's not difficult. And,

1 obviously, there would have to be a charge for this. How
2 much? A FICO score can be produced at almost no cost.
3 Obviously, we still need to pay for something because of
4 the infrastructure cost that goes behind it.
5 Secondly, there, of course, needs to be
6 property information. But we are beginning to be at a
7 point where for a large part of the United States, we do
8 have, through automated valuation models, estimates of
9 market prices and identification of those markets where,
10 indeed, we cannot get prices. So, access to these two
11 pieces of information, as well as, of course, some range
12 of mortgages that the individual may wish to take down,
13 would be key to the establishment of a market price
14 posting facility. This, again, would require research
15 into how to structure such a facility and to address the
16 market microstructure issue of the failure of price
17 revelation posting.
18 The second area that needs research is how best
19 to accomplish disclosure of mortgage pricing. How best to
20 require disclosure of the rate and terms in ways that
21 borrowers can understand. The issue here is that we do
22 not understand what is necessary to communicate
23 efficiently to consumers on this extraordinarily complex
24 transaction. RESPA and Truth-in-Lending regulation could
25 be improved by marketing and behavioral research of two

1 kinds-focus groups and randomized large scale trials,
2 using the medical model, relating interventions to
3 outcomes, where we offer different kinds of disclosures
4 than we currently have.
5 The third area of research is on the myopic
6 behavior. Even if households understand the price of the
7 mortgage, even if they understand what alternatives they
8 have and they get the best offer, the question is do they
9 make the best decision and under what circumstances do
10 they make better decisions.
11 The area of research that this targets is
12 research going on now, behavioral economics, about
13 rationality and irrationality in decision-making and
14 particularly myopia in decision-making. There is
15 experimental research that is going on in this area that
16 I think we need to take advantage of, exploit, and use to
17 analyze the mortgage borrowing decision, because the
18 research in this area suggests that people do poorly in
19 making decisions that involve time dimensions.
20 We need to reach out in these three different
21 areas. The good news is that the methodologies for such
22 research already exist. There is no consumer decision
23 more important in terms of the size of transaction than
24 the home purchase and the mortgage purchase.
25 There is a lot of effort going on in the

1 private sector, and engaging the private sector, together
2 with the public sector to investigate some of these
3 issues will be critical in informing public policy going
4 forward. Thank you.
5 MS. IPPOLITO: Who would like to start?
6 Questions? Questions for our speakers? Broader
7 questions? Jack?
8 MR. GUTTENTAG: A comment directed to Mr.
9 Durkin's information on opinions of credit users with
10 regard to whether or not they get enough information to
11 make correct decisions. You find that a positive, maybe
12 it indicates that the market works a little bit better
13 than we usually assume. Sixty-five percent of people say
14 that it's easy or very easy or somewhat easy to get the
15 information they need.
16 But those numbers assume that people know what
17 they need, and my experience has been that usually they
18 don't. I'll just give you one illustration. I answer
19 letters from people who write me about mortgage problems.
20 Over the last four years, I've probably fielded 10 to
21 12,000 such letters. In recent months, a great many have
22 asked the question, "should I refinance my mortgage?"
23 Now, what percentage of those people do you
24 think provided me with all the information that I would
25 need to advise them? The answer is none, zero. If you

1 ask how many gave me enough information to make a pretty
2 good estimate, somewhere between 10 and 20 percent. They
3 just don't know what information they need to make this
4 decision.
5 MR. DURKIN: I do not disagree with you one bit.
6 I think that this is one of the failures of Truth in
7 Lending, if you want to call it a failure, that it has
8 not ever really figured out what it is that consumers
9 need. All I am illustrating with those numbers is that
10 consumers do seem to feel like they are better off than
11 we might have thought that they feel like. You did
12 mention you got thousands of letters, but there were many
13 more mortgages made during those years, too. Maybe there
14 were a lot of people who felt like they did have the
15 information they needed; I think you probably have to
16 grant that.
17 Are you Professor Guttentag?
18 MR. GUTTENTAG: Yes.
19 MR. DURKIN: Okay. I don't know you but you,
20 in particular, are a person I had in mind as one with a
21 lot of good ideas for disclosure improvements. My point
22 is that many people do not seem to feel like they are
23 absolutely utterly unable to get the information that
24 they feel like they need most of the time to make some of
25 their decisions. You and I and most of the people in

1 this room and an awful lot of other people who do not
2 know very much about mortgages still know that it is
3 possible to look in the Washington Post on Saturday and
4 find a rough mortgage rate there, with points and without
5 points. If they go to their mortgage lender and they get
6 some quote that is dramatically different, they know that
7 there is something wrong here.
8 Are they going to become experts in mortgage
9 process? Probably not; so it is still useful to try to
10 find ways to get them better information. You and I are
11 not on any different wavelength here. You, as I say,
12 have in the past suggested some innovative ways to get
13 better information to consumers. But there is still the
14 problem of the disclosure system that we have put in
15 place. Nobody can experiment along the ways you have
16 suggested because they can easily be illegal and you can
17 be in deep weeds if you try to innovate.
18 As a matter of fact, unfortunately, as mentioned,
19 the people with the good story to tell are the most
20 fearful because they often are the ones with the deep
21 pockets. If you are a good bank and decide to give
22 multiple disclosures along the lines that you and
23 Professor Hurst wrote about years ago, you would probably
24 have class-action attorneys on you in a minute. That is
25 a problem; it is written in stone somewhere else that

1 this is the way we do it. Innovation is very difficult.
2 MS. IPPOLITO: If they add a disclosure to the
3 TILA disclosures, that's a problem? I mean, if they do
4 it a different way in addition?
5 MR. DURKIN: Be careful of additions. Truth-In-
6 Lending requires on a mortgage loan, for example, that
7 you give a specific disclosure that makes certain
8 assumptions: that if it is a 30-year loan, for instance,
9 Truth in Lending requires disclosure of the yield of
10 maturity if you hold it for the whole 30 years. A
11 problem with this disclosure is that it is not correct
12 for any other period because of initial fees.
13 MS. IPPOLITO: Right.
14 MR. DURKIN: If you engaged in what I would
15 characterize the multiple disclosure approach, for
16 example disclosing the yield for five years, 10 years, 15
17 years, and so forth, you better darn well run that by
18 your legal division. I don't know whether you could do
19 that, but I would not want to be the bank out front
20 doing that if I were in management.
21 MR. GUTTENTAG: No, the answer is that you
22 can't.
23 MR. DURKIN: Yes. I think that's the answer.
24 MR. GUTTENTAG: None of the lenders will do it,
25 and that's why Truth-In-Lending has actually become a

1 terrible impediment to the development of better private
2 disclosure.
3 MR. DURKIN: Exactly, exactly. And maybe, as I
4 said, it's time to rethink some of this stuff, to use
5 technology, and in particular, maybe to differentiate
6 prime from subprime mortgage markets. Maybe we could at
7 least get better information into the prime marketplace
8 at less cost using technology.
9 MR. GUTTENTAG: Could I make a comment to Mr.
10 Yezer?
11 MS. IPPOLITO: Yes.
12 MR. GUTTENTAG: You say its a disgrace that
13 one-third of homeowners have no mortgage. I don’t agree.
14 I had a letter yesterday from a gentleman who was 60 and
15 he had just come into $80,000 and he wanted to know
16 whether to use it to repay the balance of his 7%
17 mortgage, or keep it in the bank where it was earning 2
18 percent. My suggestion to him was that although it was
19 an undiversified investment, 7 percent is a much higher
20 return than 2 percent. A lot of people are in that
21 situation today, where the highest yielding investment
22 that they have is the repayment of their mortgage and the
23 alternative investment returns that they can get on
24 anything else are very low.
25 MR. YEZER: If you want me to answer, again, I

1 would have to know the person's portfolio, which, since
2 people don't give you enough information, I know you
3 didn't know. But remember, I mean, if you live in a
4 state that will not allow deficiency judgments and you're
5 really badly diversified, you know, I really think that
6 you have to advise the person very, very carefully about
7 not carrying a mortgage balance. Again, there's an age
8 at which, given the investment horizon, you know, you
9 pull them out of equities, you pull them into fixed
10 income, et cetera, et cetera. But I think you need to
11 look at the person's overall portfolio before you advise
12 them, and that's what I teach my students.
13 MR. GUTTENTAG: Yeah. Well, people view their
14 investment in their home a little bit differently than
15 investment in financial assets because they feel, rightly
16 or wrongly, they have some control over that investment,
17 which, in fact, they do. They don't control the market,
18 but they do control their particular parcel. So, they
19 don't look at it as an investment.
20 MR. YEZER: I understand that's a problem, yes.
21 I mean, that's a difficulty. You know, they don't know
22 about the equity trap, yackity, yackity, yack, yes,
23 exactly. You know, they try to tap that equity when, if
24 he loses his job, if he's forced out of his job at 60 and
25 tries to tap the equity in his house, he may get a rude

1 awakening.

2 MR. GUTTENTAG: Yeah, the equity trap -- if his
3 credit is good and he doesn't have his mortgage he'll be
4 able to tap his equity.

5 MR. YEZER: I understand, but that's not how
6 people behave. The first thing they do rather than go
7 through all the transaction cost of the mortgage is they
8 max out their credit card and they -- I mean, I'm talking
9 about the typical behavior. I'm not talking about what
10 you and I would tell the guy to do. We'd tell him to
11 refinance immediately while he was still eligible for
12 prime credit. But, man, people don't even know about the
13 equity trap. Half this room didn't know about it until I
14 mentioned it. Obviously -- because we don't publicize
15 this, right, because we want to sell people on putting
16 all their money in home equity.

17 When I give this talk, by the way, a lot of
18 people come up to me and ask -- and say, oh, my god, I'm
19 doing this. You know, when I tell people, even adult
20 audiences of people who actually -- sometimes they're
21 even involved in the financial services industry, they'll
22 come up to me afterward and they'll give me their
23 portfolio, and I'll say, in the next week, you need to
24 make the following sorts of adjustments, and by the way,
25 probably see a financial planner.

1 But, you know, this is a real problem, that
2 people have this biased view towards home equity and they
3 don't know about the home equity trap and we don't even
4 tell them. It's sad.
5 MS. IPPOLITO: Jean?
6 MS. HOGARTH: Thank you. This is for Susan or
7 Anthony. Susan, you mentioned --.
8 MS. IPPOLITO: By the way, this is Jean HOGARTH
9 from the Fed.
10 JEAN HOGARTH: I'm sorry, Jean HOGARTH from the
11 Federal Reserve. You mentioned a Housing Research
12 Conference that you and Mike Staten and somebody else --
13 could you tell us a little bit more about that and are
14 the papers posted on the web anywhere or --
15 MS. WACHTER: Yes. That was a conference where
16 I presented a paper, but we have the two organizers in
17 the room, Mike Staten and Tony Yezer.
18 MR. YEZER: Everybody who was a participant got
19 a CD of the papers that were presented, and Pauline has
20 the CD and she's at the FTC. So, I think, Jean, that
21 probably answers your issue.
22 Mike, I don't know if you're going to put them
23 up on the website of the Credit Research Center or not.
24 We are, by the way, having a special now, double issue of
25 the Journal of Real Estate Finance and Economics, which

1 will have the edited and refereed versions of the papers
2 and that will probably be a superior vehicle for people
3 who can wait.
4 MR. STATEN: Yes, let me just add to that. The
5 only reason we haven't put them up so far is because we
6 had some authors come up to us afterwards and say, if
7 you're going to post these, since we're going to be
8 revising them anyway in the next four weeks, don't post
9 these yet, let us do the revised versions because we
10 received good comments.
11 So, we haven't posted them yet. They've been
12 released in the sense that the conference versions are
13 out there on the CDs. Tony and I really haven't figured
14 out how to actually distribute the revised versions.
15 MR. DURKIN: If you or any Fed people want it,
16 I have the CD.
17 MR. STATEN: Yes, there are plenty of CDs
18 around.
19 MR. DURKIN: They're floating around, yeah.
20 MS. IPPOLITO: Okay. Down here on the right?
21 MS. ENGEL: My name is Kathleen Engel. I'm
22 from Cleveland-Marshall College of Law. I challenge the
23 assumption that subprime underwriting is more expensive,
24 and the reason I challenge it is that there are estimates
25 that up to 50 percent of the people who currently have

1 subprime loans would actually qualify for prime loans
2 using either of the GSEs` underwriting standards.
3 Just because borrowers have subprime loan does
4 not mean that they are subprime borrowers in terms of
5 their credit risk. We should be careful about assuming
6 they are.
7 My second point is that this idea of a price
8 revelation facility is intriguing. It's a little bit
9 like what prime borrowers have with MonsterMoving.com.
10 The problem is that risk assessment methods for some
11 borrowers do not always lead to consistent results. Cary
12 Collins, Keith Harvey and Peter Nigro have done a study
13 where they compared different credit-scoring methods and
14 found rejection rates among low and moderate income
15 borrowers vary based, in part, on the underwriting
16 methods used. We have to go back to some more basic
17 questions, which are: are the methods lenders use to
18 assess risk fair to all borrowers, are their methods
19 accurate predictors of risk, and how can we compare
20 methodologies when underwriting standards are often
21 proprietary.
22 MS. WACHTER: May I respond to that? I think
23 that's exactly the kind of research that we need to
24 pursue and to expand, and I agree with you that my
25 predictions are that on the A/A minus area, we're going

1 to have a lot of uncertainty. But exactly how much -- we
2 can actually put confidence intervals around that
3 uncertainty and it would be useful to know that in a
4 public way and also to know the B, C and D. This is
5 privately held information, if even private folks know
6 it. So, I think this is the kind of research we need.
7 We need to get around the proprietary. I don't
8 know if it's going to be possible to get around it, but,
9 again, it would seem to me in terms of new areas of
10 research, this is and could be a very useful area of
11 research for informing public policy.
12 MR. YEZER: Can I?
13 MS. IPPOLITO: Yes.
14 MR. YEZER: Okay. Two points. Number one, the
15 first thing you've got to do is consider the rejection
16 rate. What's the rejection rate for subprime lenders?
17 Anybody know? Okay, well, according to HUD, 50 percent.
18 So, you know, remember, your underwriting cost
19 is your underwriting cost per loan you actually accept,
20 and they also have huge drop-out rates. So, they have to
21 underwrite two to get one, not even counting their huge
22 drop-out rate as compared to 12 percent. So, that really
23 jacks up the underwriting costs.
24 Let me just show you something here about
25 what's going on and why we have to be very careful about

1 making statements. This is the rate sheet from -- I
2 didn't do another one today for this lecture, but this is
3 9/16, so I had to give a seminar on September 16th.
4 These are wholesale prices from a firm that buys subprime
5 loans. Now, they're buying them from mortgage brokers,
6 right? So, a mortgage broker can shop their mortgage to
7 a prime lender or to a subprime lender. If they shop it
8 to a prime lender, their margin for adding points and
9 fees is much higher.
10 The only reason you would, as a mortgage
11 broker, shop your mortgage to a subprime buyer is that
12 you, in your judgment, know it won't fly at a prime
13 lender.
14 Now, let's look at this. Let's look at this
15 box. This is a full documentation loan, a full document
16 loan, 80 percent loan to value ratio, credit score of
17 680. Clearly, that's an A loan, right? Clearly, it's an
18 A loan. Notice it's wholesale price is 110 basis points
19 above the A market price on the same day. Why the heck
20 are mortgage brokers shopping this loan at 660 when they
21 could shop it at 110 basis points and put the difference
22 in their pocket, folks?
23 The reason is that they know it's got problems
24 and we can't observe them given credit score, loan to
25 value ratio and full documentation. That's what's going

1 on in the subprime market.
2 The brokers would easily shop this to the prime
3 market, they can add more fees, unless you think brokers
4 somehow want to give away money. Why are they able to
5 buy these loans at these prices with full documentation
6 and credit scores of 650 and 680 and 80 percent, 85
7 percent, 90 percent loan on value ratios?
8 The reason is that the broker knows that
9 there's real problems and they aren't easily observable,
10 so you just can't make the statements you're making about
11 people who would qualify for A or A minus, somehow being
12 in the subprime market. These are all A-qualified, and
13 the broker is deciding that they're not A-qualified and
14 taking money out of his own pocket. So, that's my
15 comment on being able to identify who qualifies for what.
16 MS. IPPOLITO: Tony, that raises a question I
17 had. I forget which speaker raised it. Is there any
18 consensus at this point or is there research really
19 telling us which characteristics of the borrower and the
20 loan determine the riskiness of the loan? I mean, do we
21 fully understand that question?
22 MS. WOODWARD: I'm Susan Woodward and I've been
23 around here for a long time. I live in California now,
24 but I was Chief Economist at HUD for a while and then at
25 the Securities and Exchange Commission.

1 The people who really understand where the risk
2 comes from in loan underwriting are the private mortgage
3 insurers, Fannie Mae and Freddie Mac, and a few large
4 lenders. They have the data to observe the loan
5 properties and outcomes, and those that are really on top
6 of their data, like GE Mortgage Insurance, I think,
7 understand it really fairly thoroughly. They can tell
8 you what the contribution is from credit score and from
9 loan-to-value ratio and from an implied variance in
10 property values geographically and from combinations of
11 these things. For example, a loan that has both a crummy
12 credit score and high loan to value ratio, the risk
13 impact will be greater than that you get just from one or
14 the other independently.
15 So, there's a lot that's known, but on the
16 other hand, the information is proprietary. But you can
17 sort of back it out from prices.
18 MS. IPPOLITO: If you had good price data.
19 MS. WOODWARD: Yeah, if you had good price
20 data.
21 MS. IPPOLITO: And had good credit information.
22 MS. WACHTER: Well, there is literature on this
23 and there are several articles and I will reference one
24 that I wrote with Paul Calem -- it's published in Real
25 Estate Economics -- where we did have access to

1 proprietary database. We had access to Bank X, which is
2 actually First Union, no longer in existence, so they
3 wouldn't mind, I don't think, our telling this data. We
4 had their severity costs, we had their default, we had
5 their foreclosure, and the multiple regression analysis
6 showed that, indeed, the individual credit risk and
7 credit score was highly predictive of both default and
8 foreclosure and that the loan to value ratio a was
9 separately orthogonal and explanatory variable, not as
10 much on the delinquency and default, but absolutely on
11 the foreclosure, so that these two dimensions are
12 critically important, as theory would say.
13 MR. YEZER: One other point I'd like to make
14 about this, having, again, tried to estimate credit
15 scoring models and working in this area for a while. One
16 of the difficulties is you have to work with what's in
17 the loan file and the problem is that one of the most
18 serious causes for loan rejection is that the loan
19 officer can't verify information, which is a euphemism to
20 say I'm being lied to, and the problem is that the loan
21 file may very well still contain the information that was
22 false because a loan officer gets so ticked when they
23 find that they've been lied to that -- and they have no
24 financial incentive because they've lost their
25 commission, whatever. They have no incentive at all to

1 correct the loan file.
2 And so, part of your problem in classifying the
3 really high risk market in trying to deal with it is
4 going through a loan file and trying to find out what
5 really was the initial and what was the final information
6 that you had on this individual. And in order to correct
7 credit score, your biggest problem is you have to correct
8 for the selectivity bias of the people that were
9 rejected. And when you do that, a lot of those people
10 that were rejected, the information in the file was
11 false.
12 So, even though I have done this, again, as
13 with my teaching being inadequate, I have a certain
14 amount of humility about our credit scoring at the bottom
15 end of the market, and of course the bottom end of the
16 market, that's what everybody is interested in. So,
17 that's an issue. I don't want to publicize this because
18 I have a vested interest in people believing in
19 statistical models.
20 MS. IPPOLITO: I saw a hand on the aisle. Yes?
21 MS. SAUNDERS: Thank you. I'm Margot Saunders
22 from the National Consumer Law Center. I had a couple of
23 comments. Professor Yezer, you said that equity
24 stripping is not a bad thing, it's a good thing and HOEPA
25 is a bad law because it discourages equity stripping or

1 something approximately like that. I wanted to
2 specifically address that.
3 What HOEPA addresses and tries to minimize is
4 when the equity is stripped out of the home to pay for
5 the loan. It does not, in any way, hurt a borrower or
6 impact a borrower who is accessing the equity in his
7 house to pay other debts or to meet other expenses. A
8 loan is considered triggered into a HOEPA loan by high
9 points and fees going to pay for the loan, not being used
10 to meet emergency or other expenses. So, I think that
11 there's a major misunderstanding there.
12 The other point is that you all seem to be
13 talking about different kinds of borrowers than the
14 borrowers that we see in legal services all over the
15 country, and those that are my clients all over the
16 country don't shop for loans. They are sold loans. You
17 assume that providing more and better information to them
18 will help enable them to be better buyers in the
19 marketplace, and I'm afraid that that is unlikely to be
20 the case in most situations. Most of our clients who
21 have bad loans are sitting in their home and someone
22 comes into the house and provides one set of documents
23 that say one thing on them in writing, but verbally
24 presents a totally different picture.
25 People are naive. People will always be --

1 unfortunately, all of us will want to believe what
2 someone sitting across from them, especially in your own
3 living room, tells them. And until we make it illegal
4 for the documents to say what they say rather than the
5 person to say what he said, we won't be able to address
6 these problems, because if we're entirely relying on
7 being able to prove that the documents say something
8 different than what the person says, that is enforcing
9 fraud laws, which is virtually impossible to do across
10 the country. It's just -- it's too high a burden. So,
11 the documents themselves have to be -- the loan
12 provisions themselves have to be changed.
13 The other thing is the laws today create an
14 incentive to have a home mortgage and to pay off our
15 credit card loans with our home mortgage, to pay off our
16 car loans with our home mortgage. And for those of us in
17 very high tax brackets, where we're paying 35, 40 percent
18 of our income in taxes and therefore can take advantage
19 of the deductions that we get by having all that money in
20 home loans, that might be a good idea to have home
21 mortgages. But for people who are paying 10 or 15
22 percent of their income at most in taxes, it's not
23 necessarily a good idea.
24 If you analyze the cost of taking a five-year
25 car loan at 12 percent and paying it off over 30 years at

1 even 8 percent, you are paying far more interest -- in
2 other words, you're wasting money on that car loan, even
3 if you -- over 30 years, even if you take into account
4 the added benefit of the tax savings that you get from
5 using your house as security.
6 So, we have to keep in mind that we're talking
7 about different people in different tax brackets and
8 different levels of sophistication.
9 MR. YEZER: Okay, my comment on equity
10 stripping was that we've made it a pejorative term, and
11 yet, as I say, for people who need to have cash, it is
12 important. By the way, I mean, the people who are going
13 into the subprime market, they have the lowest
14 application fees. The reason is that those are folks
15 that don't even have the money for the application fee,
16 and they pay a lot of points because the points are
17 paying the underwriting even. That's why they run afoul
18 with HOEPA.
19 As far as individuals who are the victims of
20 fraud, I'm all against fraud. The thing that we have to
21 do is realize that we have to be economical in the
22 burdens that we place on lenders, because we're going to
23 place those on everybody. And I would like to get as
24 many lenders interested in lending to people caught in a
25 housing equity trap as possible. What we tend to do with

1 regulation often is we push out the people who are
2 reputable and allow the people who are not reputable,
3 even a larger margin, to operate. So, that's what I
4 worry about.
5 Now, I don't have a research position on how
6 many of those people there are or who you push out. I
7 think you'd have to talk to people in the industry. But,
8 you know, I do know lenders are quite frightened by the
9 possibility that if they make high point fee loans to
10 these people who, again, can't even pay the application
11 fee, have to finance the application fee, that they're
12 really going to be nailed. And if they have deep
13 pockets, they get nailed very, very heavily.
14 By the way, again, this is not research at all
15 at this point, but my impression is that -- and there's a
16 lot of mortgages that are in the books when you go
17 through and you actually look at the property transfer
18 records, I mean, I don't even recognize who the heck
19 these people are. It's not seller finance. But you go
20 through property trends and you'll see a lot of
21 idiosyncratic mortgages, people -- they're only making a
22 few mortgages, and some of the worst predators, again,
23 are people who are simply in the business of defrauding
24 and to actually even call them lenders is wrong and put
25 them in the same category.

1 Can I say something bad about lawyers? I mean,
2 often the real estate lawyers have a comparative
3 advantage in bankruptcy proceedings, and the best way to
4 force those people out of the market is to get the honest
5 people in. If you put too much of a regulatory burden on
6 the honest people, then the dishonest people enter.
7 Now, I can't tell you what the margins of all
8 that are, but that's what worries me.
9 MS. IPPOLITO: Back of the room?
10 MR. ZYWICKI: Todd Zywicki from George Mason
11 Law School. That sort of leads into a question I was
12 going to ask, which is, why is there so much
13 heterogeneity in this market compared to say the regular
14 market? In particular, my impression is similar to that
15 that was just offered, which is that HOEPA is so punitive
16 that parties or lenders attempt to reprice any terms they
17 can in order to prevent falling into HOEPA. So, in order
18 to keep down points and those sorts of things, they play
19 around with foreclosure fees, they play around with
20 credit insurance, they do things like that. So, my first
21 question is whether or not the current regulatory system
22 has something to explain with respect to the
23 heterogeneity, and second, related to that, which is, why
24 is this a market -- I think it's related to that -- why
25 is this a market where marginal consumers don't seem to

1 be able to drive prices such that there seems to be some
2 sort of permanent price discrimination at work here?
3 And I guess as a follow-up to that, if
4 information in this market is valuable, why isn't there
5 somebody providing it such as a Lending Tree or somebody
6 like that who provides an easy way for people to shop for
7 loans?
8 MS. WACHTER: That's just, of course, the
9 question, and with huge costs of price revelation,
10 upfront costs as well as costs of setting up the
11 infrastructure, that's really the question, how best to
12 get the pricing information out there. And right now, we
13 don't know the answer to that. Individuals don't know
14 what the best price for themselves is. We certainly, as
15 researchers, have a very hard time with that as well.
16 How difficult would it be for a Green Tree, for
17 example, to go in and sell this information product, and
18 what would be the value of this information product?
19 Certainly from a public policy perspective, it would be
20 extraordinarily valuable.
21 I also just want to make a comment on the HOEPA
22 point. There are lenders out there that only do HOEPA
23 loans. So, it certainly isn't the case where it's
24 impossible to profitably do HOEPA lending. It can be
25 done and it is being done.

1 MS. IPPOLITO: All right. Maybe we should take
2 that as our last word. We'll take a short break and
3 we'll be back at 11:00.
4 (Whereupon, at 10:48 a.m., the first panel was
5 concluded.)
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15 SECOND PANEL -- MARKET STRUCTURE, COMPETITION AND PRICING
16 MS. IPPOLITO: For this second panel, we got a
17 very good panel, we think, and we asked these panelists
18 and selected them to talk more about the supply side of
19 the market. So, this is more how the industry is
20 functioning, efficiency, structure issues and so on.
21 So, let me introduce them and we'll follow the
22 same rules as before. We'll have each speaker in
23 succession and then we'll open up the floor to questions.
24 So, first will be Charles Kahn, who is currently Bailey
25 Memorial Chair Professor of Finance at the University of

1 Illinois, who's worked on real estate issues for many
2 years. Tony Sanders, who is Galbreath Chair in Real
3 Estate, also Professor of Finance at the Fisher College
4 at Ohio State. And then Amy Crews Cutts who is a
5 principal economist coming to us from the Household
6 Economics and Financial Research Division at Freddie Mac,
7 and as you know Freddie Mac has data we'd all love to
8 get.
9 So, with that as an introduction, let us begin.
10 MR. KAHN: Thank you very much. Thank you,
11 Pauline. In some respects, this is going to be the
12 outlier of all this set of talks because I'm going to
13 start not from lending but from brokerage in real estate.
14 On the other hand, it's also going to be the talk that
15 ties back to several of the discussions from the first
16 session because I'm going to be looking more carefully at
17 questions of search and information in this particular
18 market.
19 So, in fact, the market for homes, for single-
20 family homes, is a market where one of the predominant
21 characteristics is the ubiquity of middlemen. A vast
22 majority of sales of single-family homes go through a
23 real estate broker. What I want to talk about is the
24 structure of that market, how regulation has affected it.
25 Briefly, I'll be mentioning some results that Paul

1 Caldwell and I have found, and we've heard in a broad
2 brush way some results of other people.
3 The theoretical work on middlemen in real
4 estate and in other markets is voluminous. The empirical
5 work, at least on the topics and points I'll be talking
6 about, is pretty sparse. For more detailed citations or
7 a list of other articles that are related, since they're
8 not in detail in the presentation, just e-mail me at the
9 address there and I'll put together a set of random
10 papers that might be of interest.
11 Finally, at the end of this time, I'll end with
12 some speculative implications -- speculative notions of
13 implications of what I'm talking about in this brokerage
14 market for mortgage lending as well.
15 Basically, above everything, the real estate
16 market is a search market. The main task of the real
17 estate broker is to facilitate that search, to bring
18 buyers and sellers together in more efficient ways than
19 buyers and sellers could have managed on their own.
20 And there are many theoretical papers which
21 examine the effects of introducing brokers into search
22 markets. These papers take the form of, you've got these
23 buyers and sellers making random meetings, and then along
24 comes a broker and the broker speeds up the meetings.
25 That sounds like a good story, but if it's a story that

1 if it's the real story of what brokers do, seems like
2 there's not that great a value to having brokers'
3 activities in the real world.
4 After all, buyers and sellers in the real world
5 don't blindly grope in the fog to find each other.
6 Instead, they have the natural instincts for seeking each
7 other out. And in reality, it's not that difficult to do
8 so. That's what want ads are for. Everybody knows to go
9 put an ad in the paper and everybody knows to go and read
10 that paper. So, in fact, it's easy for buyers and
11 sellers to find each other. What's the big deal? What
12 is it that brokers do that want ads couldn't do?
13 The big deal comes once you recognize the
14 heterogeneity of housing for sale and the heterogeneity
15 of buyers' tastes. It takes time for buyers to determine
16 the suitability of one house versus another, and it takes
17 time for a seller to show the house to every potential
18 buyer. The broker speeds up that process by collecting
19 the information on the characteristics of houses and the
20 information on buyers' idiosyncracies of tastes, and
21 using that information to winnow the universe of
22 possibilities down to a manageable few potential matches.
23 The broker is a matchmaker.
24 Now, it might also be thought that brokers play
25 another role in speeding up this process. You might

1 think that they also serve to reduce the cost of
2 negotiations, that is that you get these guys with this
3 nice, calm person from the outside coming in and taking
4 the hysterical buyer and the hysterical seller and
5 calming them down. In reality, that may be true, but
6 such evidence as we have experimentally is that the
7 opposite is true. That when you try experimental
8 results, it takes longer for the negotiations to come
9 together when you put a guy in the middle than they do
10 without.
11 Now, these experiments are usually done on
12 undergraduates, so you never know whether real people
13 with negotiating skills might do it better. But at least
14 such evidence we have seems to knock that one out. I'm
15 going to go ahead and stick with this question of
16 matchmaking, of finding the best matches as the one that
17 I'm going to focus on.
18 These three papers are examples of this second
19 generation of the heterogeneity being the floor of the
20 model and that heterogeneity being what the broker,
21 through his efforts, invests in learning about and
22 thereby speeding up the matching.
23 So, in these models, brokers expend their
24 efforts to learn about house qualities and buyers' tastes
25 and put matches together as a result. Now, there are two

1 basic kinds of implications that come out of those
2 models, and I'm going to state those implications as
3 blandly as possible so you can say, well, who would have
4 doubted that.
5 The first implication is that incentives for
6 middlemen matter, okay? You've got to get these guys to
7 put the effort in to do this kind of matching and it's
8 hard to check whether they're doing a good job or a bad
9 job of it because they know more than you do about
10 whether they've gone through and found the right guy for
11 you.
12 Indeed, there is at least indirect empirical
13 evidence of the importance of this. These papers that
14 I've listed up there are papers in which you can measure
15 the changes in broker's incentives in one situation to
16 another. In the first paper listed there, what happens
17 is that the comparison is made between how well the
18 broker does when he's working for someone else and how
19 well the broker does when he happens to own the property
20 him or herself, and he does better for himself.
21 The second paper looks at what difference it
22 makes when the broker has a larger or smaller share of
23 the proportion of the gains. What does that do to the
24 incentive? And it changes the incentives as well. So,
25 these papers give you two results really. The first

1 result, incentives matter for brokers, they care about
2 the incentives. But the second result is, it also
3 matters for the market, okay? There brokers really are
4 doing something useful because you can see how much of a
5 gain in price or time to find the match comes from the
6 broker doing a good job versus doing a mediocre job.
7 The second feature that the theoretical models
8 have is that the middleman's search -- the middleman's
9 activities provide benefits both to the buyer and to the
10 seller. If the market is structured in such a way that
11 only one of those parties formally does the paying, then
12 to get it right, the compensation, the adjustment in the
13 compensation to the broker and the price of the house
14 that comes out of that, the net price of the house, have
15 to take into account not only the benefit to the guy
16 who's doing the paying, but the benefit to the other guy
17 as well, to the other side of the market.
18 In more complex environments, we have built
19 some with additional information problems in them, to get
20 things to work right, you actually have to have both
21 buyer and seller pay the broker for the work the broker
22 is doing. In other words, middlemen in these markets, as
23 in all markets, really serve two masters, and the detail
24 of the compensation arrangements with each will have
25 significant effects on how that market functions.

1 It's not just two masters, in fact. Because
2 it's not just the buyer and seller who benefit when a
3 broker brings them together. The transfer of a house
4 requires a host of ancillary services. I list some.
5 There are probably more. In all of these jobs, there's a
6 problem of having the buyer find these people in the
7 first place. So, one of the jobs of a broker is, in
8 fact, to match not only the buyer with the seller, but
9 the buyer with all of these kinds of experts that are
10 going to be needed to get the closing of the house done.
11 In all of these jobs, that's a problem. It's a
12 problem having the buyer find these services. Half of
13 these jobs, the buyer doesn't even know beforehand that
14 these services are going to be useful or necessary. So,
15 matching customers with appropriate qualities of service
16 from reputable providers is actually part of what a
17 broker sees him or herself as doing.
18 There are several ways that that happens.
19 Brokers reduce the costs of marketing these services,
20 brokers know about the services. It's a lot cheaper than
21 trying to advertise for every potential buyer to learn
22 about the services once more, instead the broker knows
23 about them already and you now know as a first-time house
24 buyer that, yeah, you're going to need an appraiser in
25 there and you're going to need a title search and all the

1 rest.

2 Brokers can screen customers to see which ones
3 are actually really going to be in the market for these
4 services. They can match with the appropriate level of
5 service and they can certify the quality of the services.
6 And to a certain extent, brokers do all of those things.
7 But I believe the extent to which they provide this kind
8 of matching is limited by regulatory restrictions.
9 RESPA, the Real Estate Settlement Procedures Act, and its
10 intended regulations, limit the amount of matching
11 provision that brokers do. The piece of RESPA that does
12 that is the piece which requires that payments between
13 different providers of services are going to be limited
14 to the actual services provider.

15 Now, in an economist's view, finding a good
16 match is a service. Finding a good match is a service
17 that requires expenditures. Learning about the services
18 available, learning about the qualities of the
19 individuals involved in being decent or lousy appraisers
20 and all the rest is a service for which compensation is
21 perfectly reasonable. But by the terms of RESPA, that's
22 not a real service and by the terms of RESPA, such
23 compensation is referred to as an illegal kickback.

24 Indeed, for most of these services, since
25 buyers don't really care about them, know very much about

1 them, would really simply regard them as an
2 undifferentiated cost of the transaction, you would have
3 predicted, if you didn't know the regulatory story, that
4 what would indeed happen is that the broker himself would
5 become the representative of all of these individuals,
6 taking responsibility for putting together a bunch of
7 settlement services, and even in typical instances
8 saying, look, here's the fixed fee for the settlement,
9 you pay this fixed fee, we'll handle the rest of it for
10 you, and then subcontract the specifics as necessary.
11 Technological advances would make that even
12 more lucrative as a possibility. While it would be
13 possible, although difficult, for large firms to do such
14 arrangements under current regulations, it's very tricky
15 and probably illegal for independent agents to try to
16 figure out contracts which would make that work.
17 It's not so hard to see why there's this fear
18 of these kinds of payments back and forth between
19 suppliers. It's coming from a consumer protection
20 argument. The notion is that the best protection of a
21 consumer is to have an agent have exclusive loyalty to
22 that consumer. If he's tied to that consumer, then we
23 don't have to worry about conflicts of this sort.
24 But divided loyalties are an aspect of many
25 service professions. In fact, the essence of

1 professionalism, in some cases, is mastering the rules
2 for trading off one loyalty against another. So, it
3 would be, in many other fields, not a particularly
4 surprising thing to learn that referral fees are being
5 paid. But in real estate brokerage, they are not.
6 Let me talk briefly about some of the
7 implications of these kinds of studies of search and of
8 design of mechanisms in response to regulation have for
9 mortgage lending. It seems to me that what shows up both
10 in the brokerage stories and when you think about
11 mortgages themselves is that there are two typical kinds
12 of consumer protection techniques. The first is
13 standardization. The way you protect a consumer is you
14 make sure that everybody, or virtually everybody, buys
15 the same product. The product is good for most people or
16 not too bad for most people. There can't be any
17 uncertainty about it being the wrong product. We'll go
18 out and find the way which will fit for the typical case
19 and there it will be.
20 A second source of protection is the use of the
21 middleman. The guy who is the middleman becomes the
22 agent in searching for the best kinds of deals of other
23 sorts. Both of those techniques probably are important
24 in real estate markets. In fact, they're probably among
25 the techniques that make it the case that there's less

1 trouble in the new lending market than there would be in
2 the refinancing market. Both of those techniques are
3 more readily available in the market for new loans than
4 for refinancings.
5 But such techniques are costly as well.
6 They're costly to the extent that consumers are diverse,
7 to the extent that one size doesn't fit everybody, then
8 the protection comes at a cost. And so, the fundamental
9 question for any kind of regulation of this sort is going
10 to be how high the hurdles are going to be to get out of
11 the standardized version. How high of a hurdle do you
12 set before a consumer is allowed to take a non-
13 standardized loan? Is the requirement simply of the form
14 that this is the norm, it's publicized as the norm,
15 everybody will know it's the norm, so you'll go out on
16 your own if you want to do something different? Or do
17 you make the standard more difficult? If you make the
18 standard more difficult to be something like the standard
19 on hedge funds, you have to meet certain requirements
20 before you're allowed to play in that kind of a game at
21 all.
22 Similarly, you might imagine the difficulties
23 of how high the hurdles should be to forego exclusive
24 loyalty. Perhaps, it might be good for some people. For
25 consumer protection purposes, it might be good to require

1 that every closing have a lawyer. It might be good to
2 require that every refinancing go through a third party
3 to certify that this is actually a refinancing which is
4 in the interest of the consumer. But that would be a
5 very expensive kind of an arrangement to make.
6 So, the question is how high of a hurdle would
7 you want to set for the ability to opt out of such
8 protection and to go off into the more dangerous waters
9 on your own? It seems to me that those two questions are
10 going to be the fundamental questions for any consumer
11 protection legislation or any consumer protection
12 regulation that goes on in the lending market. Thanks.
13 MS. IPPOLITO: Tony?
14 MR. SANDERS: Thank you very much for inviting
15 me here for this presentation. All the papers so far
16 have been very interesting and I've enjoyed them quite a
17 bit, learning quite a bit about this area.
18 What I want to talk about today is a product
19 that has seen better days, but is an example of a product
20 where we do have potential for problems, and this is a
21 product called a 125 LTV loan, that some of you may
22 remember was hawked by a variety of companies, First Plus
23 Financial out of Dallas, Empire Mortgage, there's been a
24 whole bunch of them. And most of them have gone
25 bankrupt.

1 I worked on this product on Wall Street and had
2 a plethora of experience talking to the different lenders
3 and people about who they are targeting because I was
4 very interested in hearing this. And as you probably
5 know, Dan Marino, the Dolphins quarterback, was a big
6 proponent of this. They even had a race car in NASCAR,
7 not something I actually watch myself, but I was aware of
8 it.
9 This is a very popular contract, but it brings
10 in a type of interesting issue that we're supposed to be
11 discussing today in that -- and I'll show you the
12 advantages of this type of mortgage and the
13 securitization of it, why it was so popular and why it
14 flamed out. But part of the problem with it was that who
15 the lenders were -- targeting has a negative connotation.
16 It sounds like they say, let's find the person that's
17 most ignorant or whatever. The answer is they target,
18 but they're targeting people who have a specific "need."
19 We'll discuss what that is and sort of the detriments to
20 the contract.
21 So, what we're going to try to do is we have
22 this loan database on all these loans that have been
23 originated by a multitude of these 125 LTV lenders and
24 we're trying to go through and see if they rationally
25 price loans, particularly to the high-risk borrowers.

1 Now, I'm not really concerned with the very low-risk
2 borrowers, but we're concerned more with the high-risk
3 borrowers. Bear in mind this is a market niche in which
4 we don't have Fannie and Freddie involved who have their
5 wonderful underwriting services and could give us great
6 information about credit, whether someone should get it,
7 shouldn't get it, et cetera.
8 This is much more of a one off lending
9 situation, more typical of what we used to see. But this
10 is a market where we still talk about habit. We're going
11 to go through and see if borrower protection laws help,
12 whether they actually lower rates, increase rates, and
13 we're going to go through and take a look whether
14 borrowers in states that limit lender ability to seek
15 default remedies pay a higher credit cost.
16 Now, let's take a look at what these things
17 are. These high LTVs were mortgages that allowed
18 borrowers to borrow up to 125 percent of their house
19 value. So, in other words, you have a household that may
20 have a 70 percent LTV on their first mortgage. This
21 allowed them to bump that up to 125 percent of house
22 value. And immediately, as soon as I heard that, I went
23 nuts. I went, oh, my god, this can't be a good thing,
24 and, of course, it isn't. But let's discuss who was
25 taking out these mortgage contracts and we'll get to that

1 in a second.

2 Let me explain to you what the demand for this
3 contract came from. The person who innovated this had a
4 very clever idea. The basic principle of it was is that
5 in Wall Street when we're selling mortgage-backed
6 securities such as the Freddie/Fannie type of MBS pass
7 through or whatever we're doing, is that what you want is
8 you want a fixed income security, which is a high yield
9 bump over a treasury, but also has low risk. Okay,
10 ideal. But, of course, there's trade-offs.

11 And so, what they did was they said, is it
12 possible that we can get a mortgage that will not prepay
13 as far as kind of the Ginnie/Freddie/Fannie type MBS
14 products and that still carries a higher yield, so that
15 would make investors very happy. And, of course, the
16 answer was the 125 LTV contract.

17 Take a look at this, this is just an example
18 from Bloomberg of prepayment rates on various types of
19 contracts. I didn't put any Freddie and Fannie product
20 up here because we all know what those are like, but here
21 is a residential funding, basically a GMAC whole loan,
22 prepayment speed, and you'll notice that during '98, over
23 50 percent CPR, which means conditional prepayment rate.
24 These things are paying off like greased lightning.
25 Rates drop, people prepay these things really quick.

1 Investors holding these products, of course, aren't
2 overly wild about that because rates have dropped,
3 inducing the prepayment. As these things pay off, the
4 investors then have to take their money and invest at
5 lower interest rates. So, not really a good thing.
6 Here's the Money Store, which has, of course,
7 seen better days as well. The Money Store has faster
8 prepayments than the 125 LTV but are clearly lower. So,
9 the advantage of the Money Store home equity loan product
10 was that it prepaid more slowly so it was outstanding a
11 longer time, and then down here we've got the First Plus
12 Financial 125, which prepaid very slowly relative to
13 everything else. So, slower prepayment was sold to
14 investors such as pension funds, insurance companies as a
15 good thing. You got to keep the contract longer.
16 Well, here's historical 90-day delinquency. If
17 you look at the Money Store -- this is kind of a fabled
18 legend with some home equity loans. The Money Store had
19 -- you know, this is from issuance. Rose, rose, rose,
20 finally kind of capped out at near 16 percent. Sixteen
21 percent, 90-day delinquency? That's a little bit more
22 than most of us would like to have. Here is the
23 residential funding on the whole loans and, of course, as
24 anyone that's in the industry knows, General Motors
25 Acceptance Corporation or Residential Funding had

1 excruciatingly strict rules on underwriting, and they
2 only really underwrite the people that have absolutely
3 prime credit quality.
4 Now, here is the First Plus. Now, what's
5 interesting about this is that the First Plus is the
6 slowest prepayment speed and also has very manageable 90-
7 day delinquencies. And you're saying, this is sort of a
8 conundrum. We'd expect that the 125 LTV would probably
9 be the blue line and the home equity loan would be this
10 line. But not so. Let's discuss why this is before we
11 read too much into this type of story.
12 Well, we have a whole bunch of hypotheses we're
13 going to go take a look at on what happens, but let me
14 give you some characteristics of the loan market here.
15 Who takes out a -- not just a home equity loan, but who
16 takes out a 125 LTV loan? From the sample, the average
17 household income was $40,000. The average credit cards
18 they had outstanding were about $20,000. How, first of
19 all, can a household with $40,000 in income have $20,000
20 outstanding in credit cards? That is -- and these are
21 credit cards rates of 18 to 21 percent.
22 So, most of the loans we see in here are
23 consolidation loans. So, here's the story -- I didn't
24 pitch this myself, but here's the story that the lenders
25 were pitching. They're saying, you're paying 18 percent,

1 20 percent on your credit cards, you've got enormous
2 amounts of them outstanding, here's what you need to do,
3 you need to consolidate them into this lower interest 125
4 LTV contract, and plus if you do this, it's tax-
5 deductible. Now, we have to ask ourselves how much taxes
6 are people with $40,000 of income paying. It's not a
7 heck of a lot in the first place. So, this was sold to
8 people who were basically lower income on average.
9 There's a few -- you know, we have the database and
10 there's a few higher income people. But mostly lower
11 income households that had a whopping amount of credit
12 cards outstanding.
13 Now, the question we have to ask ourselves at
14 this point is, information. We've been discussing this
15 at Charlie's, we've been talking about this, we've heard
16 it from a variety of people. How informed are these
17 people about competing market rates and credit? I would
18 contend that we have, again, Internet access so everyone
19 can get online. Everyone with a computer can get online.
20 Everyone reads the newspaper on the weekends where you
21 have the plethora of mortgage rates. Again, that's
22 assuming you understand -- and could get to the Internet
23 -- understand what these mortgages are.
24 A lot of the people that end up in these kind
25 of high LTV situations are households that do not

1 generally have computer access, are not functionally
2 literate in terms of finance. They don't understand the
3 difference between arms and they certainly don't know
4 what wax, wanes and all this type of stuff is that pops
5 up on the Internet if they had it. And so, these are
6 people that really shouldn't probably be in this contract
7 or maybe they should.
8 Would it help them to consolidate all their
9 mortgages? You see this ditech.com ad. Is it helpful
10 for them to consolidate at a lower rate? The answer, of
11 course, is yes, with a big asterisk. The asterisk says
12 as long as you don't re-ramp, meaning that, oh, my gosh,
13 the credit cards, they're clear. I do the same stupid
14 thing, I pay them off and all of a sudden I look at
15 something and I go, you know, I've always wanted a bike
16 that I'm never going to ride. So, I go out and buy it
17 and I'm going, what the hell am I doing.
18 Susan Wachter was talking about behavioral
19 economics. I'm sure there's a whole chapter we can write
20 on kind of the behavior of zero credit card balances and
21 sort of idiocy in terms of purchases. But what we have
22 to worry about here is how often do these people,
23 particularly the ones that are not financially savvy --
24 we're not talking about the really -- you know, the big-
25 time investors such as the Donald Trumps. Of course,

1 they're financially literate.
2 So, the question is, how do we protect these
3 people because a lot of them got into these contracts and
4 are kind of -- but why is the default rate so low? Well,
5 basically, we go through and take a look at it. A lot of
6 them have prepayment restrictions on them, I think most
7 125 LTVs do. We go through a variety of theories. Like
8 Charlie, I will post these on my website. My website is
9 at Ohio State University College of Business, and if you
10 just do a simple Google search on Anthony B. Sanders, I
11 always come up first -- actually second. There's a
12 Jamaican reggae person called Anthony B. It might be
13 more entertaining them my website. It's up to you.
14 But in any case, we go through and we go
15 through and take a look at a variety of issues such as
16 deficiency judgments to borrowers in states that require
17 judicial foreclosure of more debt than borrowers in
18 states, and all these things are on there. But let me
19 cut to the kind of -- and, again, you can read it and go
20 through these things in more detail. I'll post them when
21 I get back tonight and I'll post the paper from which
22 this stuff has originated. So, forget the modeling for
23 now.
24 What I want to do is really get to the back
25 end. The back end, once you read through all the

1 results, are the following: Is that pretty much the 125
2 lenders price the debt efficiently. Low FICO score
3 borrowers, which is the credit score, paid higher rates
4 and substantially higher rates, about 300 basis points
5 more than high FICO score borrowers. So, the credit-
6 impaired borrowers ended up having to pay 300 basis
7 points which is not trivial. It's still less than the 21
8 percent they're paying on their credit cards.
9 Pretty much, it's fairly priced. However, what
10 we found was that the pricing model, the fit we use was
11 excellent for high FICO score borrowers, but once again,
12 to the lower, the real low, like bottom 20 percent of
13 FICO scores, the rate is unusually high given the quality
14 of the FICO score and housing characteristics. Stated
15 differently, we can't explain the pricing. It's mis-
16 priced on the low FICO score.
17 Who do those people tend to be? The one
18 variable, of course, we wanted to do was have race or
19 gender. We didn't have those variables. So, I can't
20 definitely say that they're selected, that there is some
21 sort of predatory lending. But what is predatory lending
22 in this case? Well, it's very clear that people with
23 very low FICO scores had an unusually high error in terms
24 of measuring what the rate is going to be. And, again,
25 that could be -- you know, if I sat down with Charlie or

1 Amy and we discussed modeling, we could discuss maybe
2 it's non-linear, maybe there's some sort of utility
3 function that banks face on low FICO score borrowers. It
4 could be a variety of explanations, but it also doesn't
5 look very good either.
6 And so, the question is, why does this happen?
7 Well, on one part it's just that some of the lower income
8 households you see borrowing money from these kind of
9 home equity loan borrowers is that they don't really have
10 the proper counseling. How do you get them counseling?
11 Again, they're not Internet savvy, so this is a segment
12 of the market we're really missing.
13 I am not worried about it too much because Jack
14 Guttentag has Dr. Mortgage, whatever it's called, a great
15 website. If you're web savvy, you can find a site and
16 find out all about mortgages. The problem is, when we
17 get -- like, for example, the Hispanic community in rural
18 California, in Hollister, how do you get to those people?
19 Well, I ran into or was in contact with a group
20 called the Home Loan Counseling Center out of Sacramento,
21 California, who actually, I think, in conjunction with
22 Freddie Mac, runs a truck around to the rural areas, to
23 civic centers and tries to counsel people on lending to
24 help them out. So, I would advocate -- actually, I'm
25 less concerned about sort of the high FICO score

1 borrowers, although an education is always a good thing.
2 On the low FICO score borrower, I think we have to take a
3 more proactive measure in terms of getting the minority
4 communities who don't have access to the web. If they
5 read the newspaper and they're reading the difference
6 between 30-year fixed rate, 10-year fixed rate, arms with
7 different cap rate combinations, heck, MBA students
8 sometimes get completely confused by that. I don't know
9 how people unfamiliar with this can do this.
10 You know, I would like to see Freddie Mac and
11 Fannie Mae take a stronger position in these markets. In
12 other words, I'm not sure their charter allows them to,
13 but they should because they do some of the best work in
14 trying to get people of modest incomes the best mortgage
15 available. And, again, the banks may or may not like
16 that, but I think having them more involved in this
17 market will greatly decrease the probability of people
18 paying too high a rate for given credit constraints. I
19 think that would be a very big social good.
20 So, the answer is -- and Pauline asked me this
21 earlier. She said, do we really need any sort of
22 regulations or anything on this? And I'm a very free
23 market, laissez-faire economist, but in terms of the
24 lower income we have to figure out a way, such as the
25 Freddie Mac truck with this organization that goes to

1 civic centers, to inform these people, A, don't run up
2 your credit cards that much unless it's a medical
3 emergency, and B, if you do, here are the sane ways to
4 get out of it.
5 So, I think some work needs to be done. We
6 need some thought into these type of issues. And again,
7 I'll post these on my Internet site tonight when I get
8 back and if you have any questions, of course, feel free
9 to call me. I have my e-mail address on there and also
10 my phone. But, again, thank you very much and I greatly
11 appreciate the opportunity to talk to you.
12 MS. CREWS CUTTS: The nice thing about going
13 last in a section on sort of theoretical aspects or what
14 we know from research is that I get to sort of round out
15 what we don't know, and I think that's far larger than
16 what we do know about the subprime market.
17 The conference that Tony and Michael organized
18 through the Credit Research Center, for me, was one of
19 the best conferences I had been to in a long time because
20 the purpose of this was to collect together all that we
21 do know about the subprime market. And today's
22 discussion, I think, will extend that beyond the
23 equations and charts that we have to hopefully outline
24 even more of what we don't know and where we need to go
25 and get information.

1 The things I'd like to discuss today are really
2 three themes. What I'd like to do here is abstract from
3 the idea of predatory lending. Predatory lending is a
4 crazy part of the market where I'm not sure borrowers are
5 rational, and I certainly know that lenders are engaging
6 in fraudulent practices. I want to abstract away from
7 that and talk about good subprime lending, the kind of
8 lending that comes out of simply differences of risks and
9 information and options that borrowers and lenders might
10 have.
11 The three themes I want to discuss are: How
12 might borrower behavior, given embedded options in
13 mortgages, affect pricing and features of subprime loans?
14 There are very different options, or at least the
15 incentives to take options, between subprime and prime
16 borrowers.
17 The second theme is, why do separate subprime
18 and prime lenders exist? Why isn't there one stop
19 shopping where borrowers get priced according to risk and
20 everybody goes away happy?
21 The third is, why are there discrete price
22 jumps between subprime and prime loans of about equal
23 quality and how much does the primary and secondary
24 market relationship affect this?
25 In my discussion here, when I talk about banks,

1 I mean all kinds of lenders who originate loans, and when
2 I talk about the secondary market, I mean all kinds of
3 investors who don't originate mortgages but invest in
4 them after origination.
5 First, discuss the options that borrowers hold.
6 We know very well in the prime market two of the options
7 that borrowers hold, and one of those is the refinance
8 option, that when rates fall, the borrowers more or less
9 ruthlessly refinance. When house value falls, borrowers
10 more or less ruthlessly exercise their option to default.
11 And there's a lot of regulatory limits in various states
12 about whether those options are truly in the money or
13 whether it's too much hassle to default. But
14 nonetheless, there's a vast literature that's been around
15 for a long time, very well developed. But it focuses
16 only on the prime market.
17 Some of the reasons why it doesn't focus on the
18 subprime market is that there isn't very good data
19 available on subprime borrowers and how they might take
20 these options if they're offered to them. However, we do
21 know that without any conditional research on this, that
22 subprime borrowers default at higher rates, but we don't
23 have the conditions that got them to that default action.
24 The third one I'm going to call the FICO
25 option, which is when credit history improves, there is

1 an option to refinance. And what I mean by that is that
2 if your FICO score improves to a 600 to maybe a 650,
3 there's an incentive if you're a subprime borrower. If
4 that's the only sort of big thing that kept you from
5 being a prime borrower, there is an incentive, at that
6 point, to refinance into a prime quality loan.
7 If you're a 700 FICO score borrower and already
8 a prime borrower, improving your score to a 750 does very
9 little to the pricing that you would face and the option
10 is much less sensitive than the option you would face
11 because rates moved.
12 The fourth option is what I call the borrow
13 option, which is to borrow the mortgage payment at the
14 mortgage rate plus a penalty fee is perhaps lower for a
15 borrower than to go back into the unsecured debt market,
16 for one who's risky, or doesn’t have other avenues for
17 borrowing. So, in essence, you get a small balance loan
18 for a couple of months, which is your mortgage payment.
19 At the end of this presentation, there's an
20 address where you can reach me. This paper is in the
21 process of being revised and will be available next week
22 if you want the latest and greatest. I've already
23 revised this chart, but nonetheless, the answers are the
24 same here, the patterns.
25 What I'd first like to point out is that the

1 prime conventional market and the FHA market interest
2 rates are relatively close, and they are 90 percent of
3 the market taken together. Those rates, as of the first
4 week in September, were around six and an eighth for both
5 loan products.
6 However, contrast that to the average subprime
7 market loan here, and I use as average here loans that
8 were quoted rates by Option One Mortgage Corporation
9 because they're the only subprime lender I could find
10 that systematically posts rate sheets. But nonetheless,
11 I take them as average.
12 Well, their average rate was 9.3 percentage
13 points. There is a big, big difference between average
14 prime and average subprime. Between the highest quality
15 subprime loans that they originate, the double A plus and
16 double A loans, there still is a significant price jump
17 of about 50 to 60 basis points and higher, and that's
18 among the good loans relative to the prime quality loans.
19 I mentioned earlier that subprime borrowers
20 take the option to default at a much higher rate than
21 borrowers who are of prime quality. If you look at the
22 bottom two rows here, the serious delinquency rate and
23 the loss rates, prime conventional loans -- this is from
24 the Mortgage Bankers Association -- have a serious
25 delinquency rate of 1.25 percent and the FHA loans have a

1 serious delinquency rate of -- actually this rate I have
2 here is incorrect. It's more like 4.8 percent. Very
3 high -- or much higher delinquency rates among FHA loans,
4 but look at the subprime loans. Those have a serious
5 delinquency rate of 13 percent. So, more than double
6 even the worst among the prime loans, if you think of FHA
7 as the worst among the prime, and more than 10 times the
8 rate for regular prime conventional.
9 The loss rates are even more telling. Freddie
10 Mac's loss rate as a share of unpaid mortgage balance at
11 origination is one basis point. That's in our investor
12 analyst report. That's public information. The rate is
13 70 times higher for subprime loans on average, but even
14 among the best of the subprime loans originated by Option
15 One that rate is 10 times higher. So, these loans are
16 very, very different, even if you think that subprime
17 loans that are double A plus or double A quality -- as
18 Tony pointed out, there's something different about these
19 loans, even though, looking at the charts that Option One
20 gives you of how to rate these loans -- underwrite these
21 loans, they look very similar.
22 FEMALE PARTICIPANT: Since Freddie Mac's
23 highest LTV loans have to, by law, be insured, those are
24 not quite apples and apples comparisons. Can you give us
25 an idea of what the default losses would look like if you

1 added in the private mortgage insurance losses?
2 MS. CREWS CUTTS: Yeah, that would be a --
3 that's a very good question. I don't know it off the top
4 of my head. I've looked at loss rates within Freddie Mac
5 and I think from that that the MI coverage on average --
6 of those loans that suffered losses, MI coverage was
7 maybe half or a little bit better than that. So, it
8 might double the loss UPB component. But the loss UPB is
9 across all loans, so I'm not sure it would even double it
10 there. But that's something that would be worth looking
11 at, and hopefully, I can examine that.
12 Let me back up a step here. Sorry my slides
13 were out of order here of how I wanted to present them.
14 Let's talk about the option to prepay. The
15 option to prepay for prime borrowers is very much
16 triggered by interest rates. In this chart, the orange
17 line is the prepayment rate, the three-month CPR for
18 prime loans as reported by Loan Performance, and the 30-
19 year fixed mortgage interest rate as reported as Freddie
20 Mac's weekly survey. Here you see exactly what you would
21 expect, that when rates drop, the prepayment speeds jump
22 up, and when rates go up, the prepayment speeds slow way
23 down. It's very, very sensitive.
24 What you'll see here about the subprime is that
25 not only is it insensitive to rates, but it's higher on

1 average. So, the subprime prepayment rates -- over the
2 period 1998 to 2000, rates went up and rates went down,
3 but over that period, the subprime prepayment rates just
4 generally slowed. There wasn't this sensitivity to
5 interest rates that we would have expected. So, this is
6 more consistent not with an interest rate prepayment, but
7 with this FICO option that I presented.
8 This chart here is from Fair Isaac, from a
9 study that they did where they pulled 400,000 accounts
10 that had credit cards and looked at the transition rates
11 here between FICO scores over a 90-day period. What we
12 see from this is among borrowers who have very low FICO
13 scores, those below 600, there's about a 30 percent
14 likelihood that those borrowers will have FICO scores
15 that jump up by 20 points or more. Twenty points could
16 move them from a 600 to a 620, 620 is often used as a
17 cut-off to describe subprime, sometimes 600. It's kind
18 of hard to find a fixed definition. But that's a very
19 valuable jump and could be the difference here of a
20 percentage point or two in rate for these borrowers.
21 So, there's a big, big incentive for those borrowers to
22 refinance given that option.
23 It's also true that loans in the subprime
24 market have a much higher propensity to have prepayment
25 penalty clauses written into them. That's consistent

1 here with the mortgage industry that's looking at this
2 very high prepayment speed I showed you in the earlier
3 slide trying to mitigate that and keep them from
4 prepaying, as their credit improves. So, there is
5 benefits and costs to both parties when those borrowers
6 prepay.
7 What the lenders are stuck with is that all the
8 good borrowers, the ones who have the ability to cure,
9 leave and they're stuck with the borrowers who don't cure
10 and who go on to default. So, they don't get the cross
11 subsidization of flow of those -- that average interest
12 rate over that period. So, there is a problem for the
13 lenders of, in some sense, an adverse selection that
14 borrowers who can, get out.
15 Back to this chart. This chart has some more
16 good information in it beyond just the rates that I
17 discussed earlier. I talked about the option to borrow
18 the mortgage payment and remain delinquent for a while
19 without defaulting. The line here with foreclosure rates
20 is one that could fit this option to borrow the payment.
21 It could also be consistent with not borrowing, but it
22 takes a very long time to clear foreclosures. So, loans
23 that get into foreclosure may stay there until they
24 become full defaults, but it may take a couple of years
25 for that to happen. So, don't look at the foreclosure

1 line.

2 But look at the pattern between 30, 60 and 90
3 days. Let's stick with the yellow bar there. Thirty-day
4 delinquency rates among prime loans are very high, drop
5 off by the time you get to 60, and 90 days are even
6 smaller. So, for prime borrowers, this pattern is once
7 you start to become delinquent, you're on the path to
8 default. It's not something that you end up cycling in.

9 Look at the subprime, the far right, I guess
10 it's the blue bar up there, and what you'll see is that
11 for subprime borrowers, 30-day delinquencies are very
12 high, 60 days are smaller. That's what we would expect.
13 But when you get to 90 days, it's almost double the rate
14 of the 60 days. So, these borrowers get into trouble,
15 maybe have a financial emergency of a medical bill or
16 something like that and borrow the couple thousand
17 dollars worth of mortgage payments for a couple of months
18 and cycle there. They don't want to default.

19 If they did want to default -- and I don't have
20 this line up here, but if you go to Option One's mortgage
21 site and you look at their quarterly report, they give
22 you a table that has all these rates, the 30, 60, 90
23 foreclosure and so on in the REO rate. But when you get
24 to the REO rate, it's very, very small once again. So,
25 borrowers don't like to default. They don't want to give

1 up their homes, but they're willing to cycle in
2 delinquency for a while.
3 The hit to prime borrowers of doing that is
4 very high because then your FICO score and your other
5 credit profiles takes that hit and you have more access
6 to either more credit cards, apply for another credit
7 card, you get that short term loan, or just go to your
8 lender and get an unsecured loan or home equity line of
9 credit. There's many, many options for prime borrowers
10 besides delinquency.
11 Now, I want to turn quickly to a discussion
12 about why there are prime and subprime shops that are not
13 integrated. It would seem obvious that if we had really
14 good information, that there should be one-stop shopping.
15 Why is it even when a Bank of America or another lender
16 buys a subprime shop and has those underwriters, why they
17 don't give them a desk within the Bank of America office
18 and just say, one stop shopping, here we can help you,
19 this would work very well?
20 In the work that I've done with Bob Van Order
21 that's the basis for this talk, we posit that in a very
22 simple world where information is costly to elicit and
23 rejection is a costly event for a borrower, that it makes
24 sense for there to be separate lenders because there's a
25 signal there that in the prime market, we have very good

1 information. It's very easy to find what it takes to
2 qualify for a prime mortgage. Freddie Mac gives all
3 kinds of information out on that. You can go to FICO's
4 website and get your FICO score. There's a lot of good
5 information. People may not take advantage of it, but in
6 the prime market, relative to the subprime market,
7 there's very good information.

8 But if you go and you look at that information
9 you say, well, gee, you know, I was late one or two times
10 and I got really sick and was laid off from my job and I
11 have a lot of high credit card balances. I think I'm a
12 prime borrower but I don't want to get rejected because I
13 really, really want to buy that house or I really need
14 that refinance loan, it could be then that borrowers self
15 select, and it's efficient for them to do so, into the
16 subprime market. And for B grade borrowers who I'm going
17 to label as these subprime borrowers, those guys go to
18 the subprime lender because they already know that
19 they're not going to get the prime loan. So, it's
20 efficient for them to go directly to the place where they
21 can get that.

22 Underwriters in the subprime market don't do
23 the detailed underwriting that you see in the prime
24 market, in part, because they don't have to. They've
25 already got the borrowers who've arrived on their

1 doorstep with blemished credit. However, they often have
2 a higher equity requirement because they know those
3 borrowers are more likely to default and that's going to
4 limit their loss severity.
5 A final word now because I'm almost out of
6 time, but what I call the lemons or adverse selection
7 problem. In the mortgage market, you have secondary
8 market investors who bring very low cost financing, but
9 they're one step removed. They are not the originators.
10 In some cases they are. A portfolio lender like a Wells
11 Fargo has both the origination information, they met the
12 borrower and has access to big capital markets. But
13 that's a new revelation. We didn't have these large
14 national lenders until very, very recently.
15 Prior to that, what you had were a secondary
16 market that's very far removed and doesn't have very good
17 information. How they solve the information problem and
18 get loans that they can package and bring the debt
19 markets in, the capital markets in, is to use licensing
20 with lenders to say, deliver loans of investment quality,
21 and if they do that, they bring the very low cost capital
22 markets into the mortgage markets, and that brings with
23 it a heterogeneity of loans. They want loans that are of
24 similar quality so they can package them and sell them.
25 They also want to know that they can do ex post

1 underwriting on those loans or quality control sampling
2 and make sure that those loans are of good quality.
3 What that brings into the marketplace is
4 divergence between the loans that are backed by the
5 secondary market and -- or backable, that is sellable on
6 the secondary market, and loans that aren't, that is more
7 than the risk-based pricing wedge that you would see just
8 based on default costs, because there isn't a lot of
9 difference between the marginal borrower in the prime
10 market and the best borrower in the subprime market in
11 terms of the risk. But there is a very high premium
12 between, as I pointed out earlier, look at those Option
13 One rate sheets for the double A plus loans, assuming
14 that those are very close in quality, that there isn't
15 some missing information that makes them very, very
16 different.
17 Those loans pay a very high premium that I
18 would guess is not -- that others have posited, see for
19 example a study by Howard Lax, Peter Zorn, et al., at
20 Freddie Mac that used a subprime survey from three years
21 ago to look at that. They found that the default costs
22 were not consistent with the rates paid, but it would be
23 consistent with not taking into account access to capital
24 markets, that prime markets do enjoy.
25 So, there are lots of reasons why there are

1 very different rates and very different behaviors between
2 prime and subprime borrowers, prime and subprime lenders
3 that can be explained by simple economics. We don't even
4 understand those mechanisms very well. The model that I
5 present here is theoretical, it's very abstract, it
6 doesn't have data behind it. If we could get better
7 data, we would do that. What we posit here are theories
8 that are in support of a healthy subprime market relative
9 to a healthy prime market that lead to very big
10 differences. Beyond that, we still need to look at why
11 there's an unhealthy subprime market and borrowers that
12 get harmed by that.
13 MS. IPPOLITO: Okay. Any questions?
14 MR. SANDERS: Pauline, one comment I want to
15 make. One of the reasons why the 125 LTV contract
16 vanished from the face of the earth was not a demand side
17 issue from consumers. It was that in '98, during the
18 Russian credit crisis, when all credit sensitive
19 instruments got hammered, basically, as they were
20 bringing this product to market to sell in the secondary
21 market, which Amy discussed, is that people looked at it
22 and just basically came up with a total disbelief. How
23 can 125 LTV be riskless? They just basically ceased to
24 buy the securities and then the pipeline providing the
25 funding dried up and all these companies filed Chapter

1 11.

2 So, it's not that it was inherently a bad

3 product, it was just there was a lack of demand from

4 secondary market investors.

5 MS. IPPOLITO: But they were judging it to be a

6 bad product?

7 MR. SANDERS: Yes. Although the evidence was

8 actually pretty favorable --

9 MS. IPPOLITO: Yes.

10 MR. SANDERS: -- that it was a good product.

11 MS. IPPOLITO: Okay. Any other questions?

12 Back there?

13 FEMALE PARTICIPANT: A lot of people have

14 mentioned the different information asymmetries between

15 the originators and the secondary market brokers and

16 originators and the information asymmetries that exist

17 between the borrowers and the brokers or originators.

18 The response sort of uniformly has been that we need to

19 get more information to the borrowers. I would posit

20 that to the extent that brokers and originators are

21 exploiting those information asymmetries to the

22 disadvantage of borrowers, it's not right to put the onus

23 on the borrowers of obtaining more information, that the

24 onus should be put on the parties who are best able to

25 exploit the information asymmetries to the disadvantage

1 of the borrowers.
2 MS. CREWS CUTTS: What I find very hard about
3 this is that the consumers -- there's certainly much
4 information out there and consumers get bombarded by
5 information. There's almost too much information
6 available now, but it's information of the right kind.
7 There is a study that was done by Abdi Hirad
8 and Peter Zorn last year that has been submitted for
9 publication but I don't believe, as yet, has come out in
10 a published journal, but looks at the value of credit
11 counseling on subsequent loan performance.
12 The value of credit counseling of the intensive
13 type -- I'm not talking about telephone or a
14 correspondence course, but actual classroom or one-on-one
15 counseling, is very, very valuable, and the better
16 consumers are armed with information about the options
17 that they have and how to shop for things and how to
18 defend their financial rights, the better off they are
19 both in how they perform -- that is, I think they get
20 better matched with good products, but also can get out
21 of trouble better, faster, with more of their credit skin
22 intact, ex post.
23 But it's not so much placing the onus of the
24 information burden on them, but that borrowers who are
25 naive are most likely and easily taken advantage of.

1 MS. IPPOLITO: Jerry? This is Jerry Ellig of
2 the FTC.
3 MR. ELLIG: Hi. I also have a question for
4 Amy. I hope you don't feel like we're all picking on
5 you. I'm curious about this last problem that you're
6 talking about because, you know, when we think about
7 adverse selection in other markets, a lot of times the
8 way that the firms doing business in that market deal
9 with it is to gather information so they can more
10 accurately assess risks and group people into smaller,
11 you know, better defined groups so that they can charge
12 them accurate prices. If you think of auto insurance,
13 for example, or life insurance or other types of
14 insurance that -- health insurance probably isn't a good
15 example, but other types of insurance.
16 It seems like what we have right now is a
17 theory about adverse selection that seems to fit the
18 empirical regularity that you observe, but we don't know
19 for sure if it's true because we don't really know what
20 the cost of information is. So, I'm just curious. I'm
21 still left thinking, well, why -- this looks like a
22 theory that says, lenders are leaving money on the table
23 and the only reason -- the only thing that saves the
24 theory is the assumption that information costs are high.
25 So, I still feel pressed to ask, why are lenders leaving

1 money on the table? What data might tell us why they're
2 leaving money on the table?
3 MS. CREWS CUTTS: Right. So, the theoretical
4 model is almost more of a history of how the secondary
5 market has developed rather than a state of the secondary
6 market today. Certainly, what we have today relative to
7 the older days is a movement towards risk based pricing
8 with better matching of loan product characteristics with
9 the borrower's needs, and therefore, a better transaction
10 altogether.
11 But I also would posit that the cost of
12 information in the prime market where loans are very
13 homogeneous is not worth the benefit of having a very
14 liquid type of product where they all pretty much look
15 the same. Having that little, itty, bitty, teeny, tiny
16 bit of extra information to elicit how my credit
17 performance might be one tiny bit different from yours, I
18 think the paperwork and computer time that it would take
19 to process that is not worth it. That's where the
20 information cost comes from.
21 But the information costs have certainly gone
22 down over time and this is certainly true both by the
23 rise of credit repositories that keep more and better
24 data than they ever have before, our ability to use and
25 process that information quickly, and I think that's come

1 out.

2 One thing to look at, there is a slide that
3 Mark Zandy likes to use. It comes from the Federal
4 Housing Finance Board on transactions costs.
5 Transactions costs have come from 2 percent of the
6 mortgage costs down to 50 basis points of the mortgage
7 costs, and I think that's part of this information cost
8 being reduced over time. But that doesn't play out into
9 the rate necessarily, especially in the prime market
10 where those small differences would get just eaten up by
11 the management costs of that information.

12 MS. WOODWARD: I'll suggest that there's one
13 other factor -- who's leaving money on the table and why
14 and --

15 MS. IPPOLITO: This is Susan Woodward.

16 MS. WOODWARD: The larger, household name
17 lenders are much more afraid of being sued than the
18 smaller lenders who do the loans in the subprime market.
19 That's part of the story. And, it also makes sense that
20 mortgage brokers are more aggressive than big, in-house
21 lenders, again, because the lenders have more to lose if
22 they are sued.

23 MS. IPPOLITO: Jack?

24 MR. GUTTENTAG: The notion that subprime
25 borrowers self select and don't waste time going to a

1 prime lender puzzled me when I first heard it because I
2 just don't believe that subprime borrowers search out
3 subprime lenders. I think what happens is that subprime
4 lenders solicit and subprime borrowers respond where
5 prime borrowers don’t. This also explains why you have
6 separate prime and subprime lenders.
7 Loan officers who work the subprime market are
8 a different group than those who work the prime market.
9 They're trained differently, they have different ways of
10 operating with customers, and they are expert in
11 soliciting.
12 Self-selection arises, to a great extent,
13 through the solicitation process. A large market has
14 evolved in mortgage leads, and the subprime lenders all
15 use leads in soliciting customers. Although they don't
16 have perfect ways of selecting subprime customers, that's
17 where the self-selection comes in because the prime
18 customers don't respond to solicitations.
19 I advise borrowers not to respond to
20 solicitations because all the scamsters solicit and
21 they'd do better throwing a dart at the yellow pages. But
22 they don't listen.
23 MS. IPPOLITO: Jack, can I follow up on that
24 because it is an oddity in this market? In-home selling
25 has basically been driven out of every other market that

1 we know of, you know, the vacuum cleaner salesmen, the
2 encyclopedia salesmen, those guys are all gone. Why do
3 they survive here?
4 MR. GUTTENTAG: Well, the Internet has opened
5 up a new mechanism for generating mortgage leads, which
6 makes soliciting mortgages cost efficient.
7 MS. IPPOLITO: So, the cost of information to
8 identify these target consumers --
9 MR. GUTTENTAG: Well, they don't try to
10 identify subprime borrowers as such because usually the
11 data available on the leads does not allow that.
12 Sometimes it does. Some leads are worth much more than
13 others because they come with more information about the
14 particular borrower. Some leads are worth a dollar,
15 others $5, and some are worth $10 or more.
16 MS. IPPOLITO: But why don't legitimate
17 companies use that information to service this market?
18 Why are they disproportionately -- or why are the
19 problems that we see more in the subprime market and
20 normal competition doesn't drive them out?
21 MR. GUTTENTAG: Well, reliable firms do
22 solicit. So, just because you get a solicitation doesn't
23 mean you're getting it from a scamster. But all the
24 scamsters solicit, that's how they get their clients or
25 most of them. So, that's why I tell people, if you have

1 no other source of information, throw a dart at the
2 Yellow Pages.
3 MR. SANDERS: Pauline, I agree with Amy,
4 though, on the sorting, on that mechanism, because in
5 reality if there's somebody -- again, use the 125 LTV or
6 home equity loan. If you're a household with $60,000,
7 $20,000 in credit cards, you automatically in your own
8 mind say, my god, I'm credit impaired. Even if you have
9 a high FICO score you say, what lender is going to do
10 this and they read an ad in the paper and it says, credit
11 problems, come see us, and these are all the people that
12 are out there and they say, sure, no problem.
13 Automobile dealerships do exactly the same
14 thing. There's a big sorting mechanism that people that
15 know they're credit impaired go to some dealers, you see
16 the ads, there's self-sorting on that. But I think the
17 borrowers actually select into this. I don't think they
18 go to Citibank or Wells Fargo if they know their credit
19 stinks right off the bat. So, I think that kind of
20 sorting mechanism, I think, makes sense because that's
21 how these people come up with these clients. It's not
22 through phone calls.
23 MS. CREWS CUTTS: But I also want to caution
24 about what it means to think that my credit stinks. It
25 could be that I'm a prime borrower that's had a run of

1 bad luck, and even if I've gotten out of that bad luck,
2 the information -- I've been talking with some other
3 researchers who are particularly concerned about
4 borrowers in the minority community who are very good
5 borrowers, but for one reason or another, believe
6 themselves not to be of prime quality. Darryl Getter has
7 done research on this about people's perceptions of being
8 rejected even though they have very good credit.
9 Part of that is too much information. They've
10 heard that if you're 30 days late one time that you're a
11 bad borrower. They may self select on the basis of the
12 information they believe to be true, it may not, in fact,
13 be true when we do a credit evaluation.
14 The other part is that for many people, getting
15 to yes is important. It may be more important than the
16 rate that they pay and there's more credit research that
17 also shows that getting to yes is -- maybe this is the
18 irrational part of it, but getting to yes is more
19 important than getting a good rate.
20 MS. IPPOLITO: Kathy?
21 MS. ENGEL: I think it's important to
22 distinguish between the two different groups of subprime
23 borrowers. One group is subprime borrowers who are
24 actively seeking credit and those are the people who are
25 most likely to end up with legitimate subprime loans. The

1 other group consists of people who are passive, who need
2 credit for example for home repairs or for medical bills,
3 but are not actively seeking credit because they think
4 they are ineligible for credit. Those are the people who
5 are more likely to become victims of abusive lending
6 practices.
7 As to the question of how to reach these
8 people, the predatory lenders seek these folk out, for
9 example by identifying homeowners who have housing code
10 violations, learning when the city is going to mail out
11 the violations, and then showing up two days later. To
12 the homeowners, the lenders are a dream come true. They
13 think to themselves "Oh, my god, I can't believe this
14 coincidence", and don't realize that they have been
15 totally duped. Bank One is not going to send their loan
16 officers down to city hall to find the names of everyone
17 who has a housing code violation and is at risk of having
18 a lawsuit filed against them by the city.
19 Part of the problem of access simply has to do
20 with bank culture. The old style of making loans does not
21 reach the people who are most likely to be the victims,
22 and the new methods, such as the Internet, do not reach
23 these potential borrowers. A big question we need to ask
24 is: how can we create incentives for legitimate lenders
25 to make either subprime or prime loans to borrowers who

1 are disconnected from the market so they get in there and
2 create competition? If there is enough competition, the
3 problem is solved. We do not need to go about educating
4 consumers anymore.
5 MR. GUTTENTAG: Competition to sell a
6 tremendously complex instrument to someone who is unable
7 to evaluate different offers does not lead to good
8 decisions. The lenders who tell the truth are probably
9 not going to get the loan.
10 MS. IPPOLITO: Right, right. And the fact that
11 they're solicited, somehow they don't recognize that the
12 deal they're being presented isn't a good deal. I mean,
13 that's the second part of the problem. I mean, the fact
14 that they're solicited isn't necessarily bad if the
15 solicitation is valuable.
16 MR. GUTTENTAG: That's right. They may have
17 the mindset that nobody in their right mind would lend
18 them money, so they're delighted to find somebody that
19 would.
20 MS. WACHTER: Maybe the gains for the borrower
21 are still large.
22 MS. IPPOLITO: Susan?
23 MS. WACHTER: Maybe the gains are large and we
24 don't know. And it's, unfortunately, as simple as
25 saying, more competition solves the problem because they

1 can have five solicitors and each one of them taking them
2 to the maximum price that can be borne as opposed to the
3 minimum price which, because of the complexity of the
4 deals here, just simply may not be known.
5 MS. IPPOLITO: Your name and organization?
6 MR. GORIN: I'm Dan Gorin with the Federal
7 Reserve Board. What can we learn from the other
8 industries or other products that are out there that have
9 this kind of pricing mechanism?
10 I mean, it seems to me that the insurance
11 industry is where we need to go to find products in the
12 marketplace that have variable pricing based on risk and
13 it seems like maybe we haven't done enough research into
14 how health insurance is priced versus how life insurance
15 is priced versus how auto insurance is even priced. The
16 best example that comes to my mind, for auto insurance,
17 the assigned risk category. Because of the way state
18 regulation occurs, service providers, insurance companies
19 are required in some states to say, no, if you want to
20 provide auto insurance to the prime category people, then
21 you have to take a certain share of the marketplace at
22 subprime. I mean, that's one solution that states
23 themselves have said, this is how we're going to cause
24 the big players in the prime market to enter the subprime
25 market.

1 I mean, do we have that kind of information
2 about the insurance industry that would teach us lessons
3 about the housing mortgage market?
4 MS. CREWS CUTTS: Well, the only thing I can
5 say about that is that I think the insurance industry is
6 as much of a mess as the mortgage industry. The
7 dichotomy here about the shops that I talked about, the
8 prime shops being separate bricks and mortar operations
9 from the subprime shops exists also with the auto
10 insurers. There is AllState, who's very fussy about who
11 they take and how many accidents you've had and those
12 kinds of things, and there is a subsidiary of AllState
13 that's not called AllState, which is the have we got a
14 deal for you insurance company, no driver is too bad for
15 us.
16 And they keep them very separate in part
17 because, I'm guessing, that -- not the underwriting but
18 the ex post accident -- oh, I forget what that's called.
19 After you have an accident, you have the folks come in
20 and try to evaluate whether it's a legitimate claim and
21 how much to pay on that, and those folks are very
22 different in the way -- it's almost like the equivalent
23 between servicers in the prime and subprime market and
24 how they engage with their clients.
25 And I think there are lessons to be learned

1 from the insurance industry not because it's great and
2 there's nothing wrong with it, but because there are lots
3 of parallels of problems in the insurance industries
4 whether it's auto insurance or other types of insurance
5 that match the troubles we're having in the mortgage
6 markets.
7 MS. IPPOLITO: Susan Woodward.
8 MS. WOODWARD: To use an example where the
9 product is inherently somewhat simpler than either
10 insurances or mortgages, mutual funds. And here you
11 don't have any sorting of the customers according to how
12 risky the customers are. It's only how risky the funds
13 are. And you have just an enormous variance in how much
14 people pay for their mutual funds and whether they're
15 diversified or not. The highest quality product, in the
16 eyes of most financial economists, are the fully
17 diversified funds, index funds, and you can buy those for
18 13 basis points a year. But the average equity mutual
19 fund costs about 135 basis points a year and the more
20 actively managed ones that really hype their services and
21 say, you know, we've had great performance for X years,
22 and investors do chase performance, you can pay 250, 300
23 basis points.
24 Now, slowly but surely the good news is that
25 the money is moving to the cheap Vanguard index funds and

1 to TIAA-CREF. But it's really slow. It was only a
2 couple of years ago that Vanguard's index S&P 500 fund
3 was bigger than Magellan.
4 MR. SANDERS: One final point. I know everyone
5 wants to eat a sandwich or something, so I apologize
6 profusely. But does more competition make the
7 information problem go away? The answer is no because
8 the 125 LTV contract I talked about, home equity loans,
9 all these things are innovations to try to capture market
10 share. So, everyone that's constantly coming out with a
11 new product that nobody understands so they can be the
12 first one in there, get a lot of borrowers in there, and
13 then change it again.
14 So, simply more competition doesn't solve the
15 problem. Then we have another informational distortion.
16 And this happens -- look at the number of ARM
17 combinations that are even published in the newspaper.
18 Try and get consumers to understand it. And they change
19 all the time.
20 MS. WOODWARD: Right. There are more mutual
21 funds, more equity mutual funds than there are individual
22 companies traded on the New York Stock Exchange. And the
23 difference it makes which fund an investor chooses, it's
24 not a small difference, it's a huge difference. The
25 difference in your retirement income whether you sign up

1 for a 30 basis point fund or a 130 basis point fund is a
2 difference of 30 percent in the level of your retirement
3 income. Thirty percent in the level of your retirement
4 income.
5 MS. IPPOLITO: That's a whole other set of
6 problems that we're not going to get into.
7 MS. WOODWARD: Yeah, people just don't
8 realize.
9 FEMALE PARTICIPANT: The answer is hard.
10 MR. KAHN: Maybe the answer is actually the
11 opposite. Maybe finance, per se, is easy, but has to be
12 made hard to obscure it to make it possible to have
13 niches in the market.
14 MS. IPPOLITO: Okay. On that note, let's break
15 for lunch. We will all reconvene here at 1:45.
16 (Whereupon, at 12:27 p.m., the second panel was
17 concluded.)
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15 AFTERNOON SESSION
16 (1:45 p.m.)
17 MS. IPPOLITO: All right. I guess we'll get
18 going again. You're such a good group, back in time and
19 everything.
20 We will follow, basically, the same rules. So,
21 let me introduce this afternoon's panel. First, we have
22 Charles Calomiris, who is Paul Montrone Professor of
23 Finance and Economics, Graduate School of Business at
24 Columbia. He's also Co-Director of the American
25 Enterprise Institute Project on Financial Deregulation.

1 Then we have Jack Guttentag who probably
2 doesn't need an introduction in this audience. This is
3 the Mortgage Professor for everyone who doesn't know.
4 But in a current life, he is Professor Emeritus at
5 Wharton. He probably knows more about the mortgage
6 market than any of us could ever dream about knowing.
7 Then Michael Staten, who's Director of the
8 Credit Research Center at the McDonough School,
9 Georgetown. And then John Farris, who is a Research and
10 Policy Associate at the Center for Responsible Lending in
11 North Carolina.
12 So, with that introduction, we'll begin with
13 Charles Calomiris.
14 MR. CALOMIRIS: Thank you very much. I want to
15 begin by saying what I think the goal of public policy in
16 the subprime market should be. We really want to create
17 an atmosphere where good lenders can enter this market to
18 compete.
19 Now, some of the people when they say, good
20 lenders, what they have in mind are institutions that are
21 basically run by consumer advocacy groups. Well, maybe -
22 - you know, God bless them. But, gee, I hope we can
23 expand competition beyond the institutions that are run
24 as consumer advocacy groups and charitable organizations
25 and we can bring in other organizations that would love

1 to be involved if legal risks could be dealt with.
2 Some of you are aware that last year the
3 District of Columbia passed this -- the only word I can
4 use really is asinine -- law. What did this law say?
5 This law said that if I make a loan to a customer --
6 something that's called a subprime loan -- I'm legally
7 liable if that customer might be able to demonstrate
8 after the fact that that customer could have gotten a
9 better set of terms from some other institution.
10 Imagine that. I not only have to beat the
11 competition, but I have to, after the fact, be able to
12 demonstrate, the burden is on me, that the borrower
13 couldn't have possibly gotten a better set of terms.
14 Also, we had all sorts of new disclosure requirements
15 that required us to spend about a half an hour longer
16 with our customers even for prime lending in the
17 District.
18 So, immediately when the City Council passed
19 this statute, many institutions stopped making mortgages
20 in the District of Columbia.
21 So, before telling you what I think public
22 policy should be in this market, I want to point out the
23 risks of regulatory overreach. You can think of the
24 thousand disclosure rules that you want to impose and
25 every one of them takes times, especially if you're going

1 to be conscientious and actually make sure someone
2 understands what you're saying, and time costs money. I
3 think the intent of the district law, like the North
4 Carolina law was basically to kill the high-rate subprime
5 loan market -- it's a usury law. It's basically set up
6 to make it so legally poisonous to lend at those interest
7 rates that no sane person would make those loans.
8 When push comes to shove and you talk to the
9 advocates of that legislation, they basically agree, yes,
10 that's their intent, to actually prevent those loans from
11 being made.
12 So, I want to now talk about what I think the
13 goals should be in light of what I just said. I think
14 the goals should be to foster informed choices and
15 competition. Now, I want to emphasize to foster informed
16 choice, not to impose usury laws, not for someone to be
17 able to sit there as a well-meaning, somewhat
18 sanctimonious consumer advocate and say, no, that person
19 shouldn't be able to borrow at 20 percent interest. We
20 don't want that to happen. And the institutions that do
21 that should hightail it out of town and we're glad to see
22 them go, and if that's what we accomplished in Georgia or
23 the District or North Carolina, so be it, that's good.
24 Well, I'm sorry. There are victims. The
25 victims of that are the people who consciously, knowingly

1 would have wanted to sign that agreement. They're not
2 going to show up at Paul Sarbanes' office to complain or
3 at the Governor of Georgia's office or the office of the
4 Governor of North Carolina because they're not aware that
5 those actions by those people actually forestalled their
6 opportunities. But these victims do exist nonetheless.
7 Now, who might such a person be? Let me give
8 you an example. Suppose that you're somebody who's often
9 viewed as at risk of being manipulated. Suppose you own
10 an $80,000 house with a $20,000 existing mortgage. You
11 have no free cash flow to speak of after your current
12 expenses. You may have some possibility of some future
13 cash flow coming your way. But you have an immediate
14 need for $30,000. Now, you have a very high probability
15 of not being able to meet your subprime payments because
16 this is now going to be a $50,000 mortgage.
17 You also, though, because of this possibility
18 of future cash flow, also have a possibility of prepaying
19 your mortgage maybe after a year. So, you're somebody
20 who might cost the bank a lot of money to foreclose on.
21 Remember, foreclosure is expensive. There's only going
22 to be about $30,000 of equity left in this house.
23 Suppose there's a 40 percent chance that you're not going
24 to be able to pay and suppose the foreclosure costs are
25 $10,000. What do you think the interest rate, given the

1 prepayment risk and given the foreclosure costs and the
2 high foreclosure risk, what kind of interest rate would
3 make sense to charge on this loan? It isn't going to be
4 10 percent. It's going to be maybe 20 percent, maybe 25
5 percent.
6 So, now you have to ask yourself this question.
7 Should the law prevent this person from borrowing that
8 money? I say no. Why? She may need it for an
9 operation. She may need it because she had a grandchild
10 in need of some money and she's making the conscious
11 choice to make a sacrifice or to take a risk. So, I want
12 to emphasize, I don't like any regulation that tells that
13 woman that she may not borrow that money.
14 At the same time, it's, I think, our
15 responsibility ethically to make sure that when she makes
16 that decision she knows what she's doing. So, to me,
17 that's what our primary goal should be, making sure that
18 people make informed choices.
19 And then the other major goal is competition.
20 You should want lenders to get interested in subprime
21 lending. And with the legal risks that are out there
22 right now and multiplying daily, many are not going to.
23 Well, I don't want to belabor those goals,
24 because I think they're obvious and I don't think there's
25 going to be a lot of disagreement about them. I should

1 hope not. But now let's talk about what makes sense to
2 do and what doesn't make sense to do.
3 I think a lot of the regulatory reforms that
4 the Federal Reserve has been implementing basically make
5 sense. I don't agree with them in every respect, but I
6 think that the disclosure requirements, the reporting
7 requirements, the triggers that they've established do
8 not pose big problems, and I think that there are
9 arguments in favor of them.
10 I would add to the current system more on
11 disclosure and counseling opportunities, and an emphasis
12 on meaningful disclosure, not just more paper, which
13 actually can reduce the amount of information really
14 conveyed to the borrower.
15 It might be worthwhile to require lenders to
16 give the customer a phone number and say, there's a
17 special public counseling service provided that's going
18 to be, of course, at taxpayers' expense, which is
19 designed to help you figure out whether the prices I'm
20 quoting for you and the deal I'm quoting to you is
21 competitive. Here's the number and I strongly recommend
22 that you call them.
23 And, secondly, I would like to require lenders
24 to tell borrowers what their risk of default is on the
25 loan, using the Fair Isaac Model or some other model. If

1 a borrower were told that her chance of losing her home
2 was 30 percent, she might thereby realize that the risk
3 is too much for her. Or, if she were told that the
4 chance was only 0.5% she might realize that she might do
5 better in the prime market. Either way, this disclosure
6 is compact, meaningful, and helpful to borrowers, a lot
7 like the APR reporting requirement.
8 The combination of making clear that there's
9 counseling available and having to tell someone the
10 probability of default, I think, would be very powerful.
11 I'll skip over some of the other things that I
12 think are details. I'm worried a little bit about single
13 premium insurance, which I think has become kind of a
14 whipping boy and I think that people have missed the
15 point there, that certainly there was a lot of abuse in
16 single premium insurance. I think it could have been
17 handled by simply requiring that single premium payments
18 only last over the period of the coverage; that would
19 have been good enough.
20 I think that there are some problems with
21 limiting prepayment periods, although I understand the
22 motives for them and it's a difficult balancing act. But
23 I want to emphasize in some cases, people that have
24 substantial prepayment risk really benefit from being
25 able to commit not to take advantage of the prepayment.

1 So, we have to be very careful.
2 Similarly with balloon payments. It might be
3 very much what somebody would like. Suppose that I'm 85
4 or 90 years old, I might look at a balloon payment as
5 very good because the chances that I'll be alive in 10
6 years is very small and I might like to actually have
7 less debt service payments of principal during the
8 intervening years.
9 Mortgages are very complicated contracts. They
10 have multiple dimensions. Figuring out whether someone
11 is better off or worse off really is not something we
12 want Senator Sarbanes to do sitting there on Capitol
13 Hill, because people are different. You can't make one
14 rule that's going to fit everybody.
15 One thing that I think might be interesting to
16 consider on prepayment penalties would be to require
17 lenders to offer you contracts with and without
18 prepayment penalties so that you could actually see the
19 benefit to you of the prepayment penalty being applied,
20 or the costs of the prepayment limitations.
21 What definitely isn't sensible is to attach
22 poison, through the regulatory and legal risks lenders
23 face, to consumer lending whenever interest rates are
24 high, and thereby effectively discourage entry and limit
25 consumer choice. That's where we are in many states now.

1 And the consequences, I think, are very clear.
2 One thing I'd like to see Congress do is
3 actually reassert preemption through the 1982 Act and
4 basically declare that these things that masquerade as
5 consumer protection really are usury laws, and therefore,
6 are in violation of the 1982 Parody Act. I think I'll
7 leave it there.
8 MR. GUTTENTAG: This has been a very
9 interesting conference. I'm tempted to spend my minutes
10 commenting on Charles' comments and other people's
11 comments, some of which have been extremely interesting,
12 but I have to resist that temptation because I do want to
13 make my own comments.
14 One point that was raised that I think is quite
15 interesting and fits in with what I'm going to say is the
16 relationship between characterizing a market and
17 characterizing the plight of one individual operating in
18 that market. In the equity market, we would probably say
19 that if 30 percent of the participants are well-informed
20 and know what they're doing, the other 70 percent are
21 well-protected as a result and will get fair pricing.
22 You can't say that about the home loan market.
23 You can't even say that if 70 percent of the people in
24 this market know what they're doing, the other 30 percent
25 will be protected. Indeed, I'm not even sure that if 99

1 percent knew what they were doing, the other 1 percent
2 would be protected. Part of trying to understand what
3 makes this market tick has to do with understanding
4 exactly why there is this disconnect between the market
5 and the individual borrower in this market.
6 Although there has been a lot of emphasis on
7 predatory lending in the subprime market, my view is that
8 the abuses really are marketwide. Subprime borrowers may
9 have less capacity to absorb punishment, but the problems
10 apply across the board, and I think it would be extremely
11 useful if the solutions applied across the board. As we
12 heard from Charles, partial solutions directed towards
13 subprime lending can have horrendous side effects.
14 Now, a point that perhaps is not too obvious to
15 you is that many of the problems of the primary market
16 really have arisen from the development of the secondary
17 market. There are three characteristics of the primary
18 market that are unique to the US, which can be attributed
19 to the growth of the secondary market: nichification,
20 volatility and rebate pricing.
21 Nichification, my term, means that prices are
22 affected by multiple factors that impinge on the risk or
23 cost of a transaction. Volatility means that prices are
24 reset frequently. Rebate pricing means that lenders will
25 pay for rates above the zero-point rate.

1 The secondary market has been primarily
2 responsible for nichifying the primary market. Over time,
3 investors in the secondary market learn how to price all
4 the borrower, property, documentation and transaction
5 characteristics of the mortgages in a pool that affect
6 default risk and prepayment risk. As the secondary
7 market prices these characteristics, lenders in the
8 primary market have to adjust their own prices to
9 borrowers correspondingly. These price adjustments in the
10 primary market are extremely detailed and complex.
11 I'm associated with a mortgage technology firm,
12 GHR Systems, Inc. that specializes in creating systems
13 that lenders use in transmitting price information to
14 mortgage brokers and to their own loan officers. Our
15 pricing engine permits, at this time, 40 million price
16 combinations on any one loan program. A loan program is,
17 let's say, a 30-year fixed rate mortgage. A different
18 loan program, say a one-year ARM, could involve a
19 different 40 million price combinations.
20 A major consequence of nichification is that a
21 distinction arises between generic and transaction-
22 specific price quotes. A generic price quote is one
23 that's based on a long list of assumptions about a
24 particular deal, whereas a transaction-specific price
25 applies to a particular deal. The prices that you see in

1 the Washington Post or other media are all generic.
2 Probably they apply to 5 percent of transactions or less.
3 Nichification generates abuses. One abuse is
4 that customers are snared based on a generic quote,
5 because many shoppers don't understand the difference.
6 Transaction-specific quotes are almost always higher than
7 the generic quote. This kind of abuse is similar to the
8 proverbial bait and switch. You make the generic quote,
9 but then when you get more specific information about the
10 customer, you give them the bad news.
11 Another abuse is to penalize committed niche
12 switchers. A committed borrower is one who has already
13 decided he's going to go with a given lender or mortgage
14 broker. Somewhere along in the process he decides he
15 wants to change some characteristic of his loan. For
16 example, he might want to go from an ARM to an FMR, from
17 30 years to 15 years, pay fewer points to get a higher
18 rate, whatever. When he changes his niche, he is subject
19 to a new price, but since he is already committed, he may
20 be over-charged.
21 It is worth noting that nichification has
22 provided a major impetus to the growth of mortgage
23 brokers, who now handle about 70 percent of all the loans
24 that go through this market. A major stock in trade of
25 brokers is their knowledge of the lenders that offer

1 loans in unusual market niches. But mortgage brokers are,
2 themselves, the source of a number of abuses.
3 Let me turn to price volatility. The secondary
4 market has transmitted price volatility to the primary
5 market. Back in the fifties when I wrote a book on this
6 market, the lag between changes in the bond market and in
7 the mortgage market ranged from three to seven months.
8 Today, there's no lag. What happens in the secondary
9 market is transmitted to the primary market immediately.
10 Volatility has a lot of implications for the
11 way this market works. For example, price quotes in hard
12 copy media are out-of-date by the time they appear in
13 print. While some internet sites provide live prices,
14 most of them provide generic quotes. None of them
15 provide live transaction-specific pricing for every
16 niche.
17 The combination of volatility and nichification
18 makes shopping difficult. To get transaction specific
19 quotes on your deal generally requires that you have some
20 give and take with your lender, it usually can't be done
21 over the telephone. You have to make visits to see the
22 lender to get your information. If the visits are not
23 all done on the same day, then the quotations of
24 different loan providers are not comparable because by
25 tomorrow the terms may be different.

1 Volatility also leads to float abuse. Assume a
2 borrower does a thorough canvas of his alternatives, and
3 selects the lender L based on L having the best price.
4 However, the quoted price is not binding on L. The price
5 floats with the market until the lender locks it.
6 Part of that float is mandatory meaning that
7 the lender won't lock until the borrower goes through a
8 couple of hoops. Usually, the borrower has to submit a
9 loan application. Part of the float period may be
10 voluntary if the borrower wants to play the market before
11 he locks.
12 Whatever the reason for the float, when the
13 time comes to lock, the lender should give the borrower
14 the same price it would give to the borrower's twin
15 sibling if the twin sibling walked into the office that
16 day with exactly the same deal. However, it is very
17 common that the borrower will get a higher price than the
18 twin, simply because at that point, the borrower is
19 committed and her twin, if the twin walked in, would be
20 shopping and wouldn't be committed. Float abuse is one
21 of the most widespread abuses in this market.
22 The secondary market also leads to rebate
23 pricing. In the secondary market, prices deviate from
24 par in both directions. If a 6 percent mortgage-backed
25 security sells for 100 in the secondary market, a 5.75

1 percent might sell for 98.5 and a 6.25 might sell for
2 101.3. This practice has been carried over to the
3 primary market.
4 In the primary market, 100 means zero points;
5 98.5 means 1.5 points; and 101.3 means a 1.3-point
6 rebate. The United States is the only country in the
7 world that uses the point rebate system.
8 Rebate abuse means steering borrowers to high-
9 rate loans on which they should get a rebate but don't.
10 Mortgage brokers have been very much involved in rebate
11 abuse and they've gotten a bad rap for it. They argue,
12 however, and I suspect that they're right, that the abuse
13 is carried on as much by lenders as by them.
14 Here is an illustration of rebate abuse by
15 brokers. Assume the wholesale lender quotes a 6 percent
16 rate with one point rebate to the broker. The broker is
17 dealing with a borrower who is not privy to the wholesale
18 price. Brokers typically don't show their wholesale
19 prices to borrowers. So, the broker quotes 6 percent and
20 one point to the borrower. That makes the broker's mark-
21 up two points, one point paid by the borrower and one
22 point paid by the lender. The borrower may know nothing
23 about the one point rebate. He may or may not find out
24 about it. If he does find out about it, it will probably
25 be too late to do anything about it.

1 There is a group of brokers that don't operate
2 that way. They are called Upfront Mortgage Brokers
3 (UMBs), and they are listed on my web site
4 www.mtgprofessor.com. They set a fee for their services,
5 which includes any rebate from the lender, and they pass
6 through the wholesale price to the borrower. Currently,
7 36 of the approximately 30,000 mortgage brokers are UMBs.
8 Rebate abuse by lenders is similar. A loan
9 officer gets a retail price sheet from the head office
10 showing 6 percent at zero points, 5.75 percent at 2
11 points, and 6.25 percent at a 2-point rebate. If the loan
12 officer can get the borrower to accept 6.25 percent
13 without a rebate, then the rebate remains with the lender
14 and the loan officer gets a piece of it. It is called an
15 "overage".
16 In contrast to rebate abuse by brokers, which
17 can be discovered on the HUD1 form generated at closing
18 if you know what to look for, rebate abuse by lenders
19 leaves no trace. If the loan is sold in the secondary
20 market, the price is not disclosed. It's subject to
21 what's called the secondary market exemption under RESPA.
22 The last abuse I want to discuss is settlement
23 cost abuse. It is not related to developments in the
24 secondary market.
25 Settlement costs are higher than they should

1 be, higher than they would be in competitive markets,
2 higher than they would be if borrowers were well-
3 informed. There are two causes. One is the Good Faith
4 Estimate (GFE), a mandated disclosure form that HUD
5 administers under RESPA.
6 The GFE is a horrendous document because it
7 requires lenders to list each individual settlement
8 charge, which induces borrowers to ask the wrong
9 questions. I constantly get letters from borrowers asking
10 whether specific charges are valid or reasonable, which
11 is beside the point. The borrower should be concerned
12 with the total, not with the detail.
13 The GFE is also open-ended, which means that it
14 invites lenders to come up with new types of charges. In
15 addition, all the charges on the GFE are “estimates”
16 subject to change, even the lender charges that lenders
17 know with complete certainty. This invites changes at the
18 11th hour when borrowers are powerless. Such changes occur
19 frequently, and 99 percent of them are to the borrower's
20 disadvantage.
21 The second cause of excessively high settlement
22 costs is perverse competition in the market for third
23 party services. Perverse competition arises when one
24 party selects the seller of the service, but another
25 party pays for that service. For example, the lender

1 selects the mortgage insurer but the borrower pays the
2 insurance premium.
3 While it would be a RESPA violation for the
4 lender to receive payment from the mortgage insurer, the
5 mortgage insurer can compensate the lender in a lot of
6 legal ways, the net result of which is to raise the costs
7 of insurance.
8 HUD has recently developed proposals designed
9 to deal with most of the problems I have discussed. The
10 proposals are radical, far-ranging and, in my view,
11 beneficial, even though there are a lot of details that
12 need fixing. I'm going to summarize the proposals very
13 quickly because I'm running out of time.
14 HUD proposes to change the way mortgage broker
15 compensation is reported. Under the proposal, rebates
16 will be credited directly to the borrower. So, the
17 broker can no longer put them in his pocket.
18 The format of the Good Faith Estimate is going
19 to be changed. The individual listing of charges is
20 replaced by a small number of cost categories for which
21 only totals will be shown. Furthermore, the lender will
22 have to guarantee those charges that he has control over.
23 Finally, lenders and others will be empowered
24 to package a loan with a guaranteed interest rate and
25 guaranteed total of all settlement costs, called a

1 Guaranteed Mortgage Package or GMP. The GMP and the
2 revised GFE will be alternative options from which the
3 borrower can choose.
4 These will go a long way to fixing abuses.
5 While none of the nichification abuses would be touched,
6 float abuse, rebate abuse and settlement cost abuse would
7 all be substantially reduced, and possibly eliminated,
8 depending upon how the proposals are implemented. Thank
9 you.
10 MR. STATEN: Well, thanks very much for
11 inviting me to appear on this panel this afternoon. I'm
12 going to echo some of the thoughts that you've heard
13 earlier today but also try and provide a little bit of
14 data with respect to what little bit we know so far about
15 the regulatory impact of some attempts to try and curtail
16 predatory lending around the country. I will then offer
17 some observations of my own in terms of where I think
18 that regulatory effort is headed and perhaps what some of
19 the dangers are, just to echo some of the comments that
20 Charles made earlier. So, I'm going to stir the pot a
21 little bit here.
22 Let's just start with what predatory lending is
23 or isn't. I think it means a lot of different things to
24 a lot of different people. Some of the allegations are
25 that the credit price that borrowers receive in the

1 subprime market is not correlated with risk, and we've
2 heard a statistic earlier today that as many as half of
3 all subprime borrowers may have qualified for a lower
4 cost loan. So, that's one dimension of it, perhaps, just
5 overpricing.
6 Foreclosures have been rising in many cities
7 over the last five years, ten years, and, in particular,
8 in cities that have high concentrations of subprime
9 borrowing, and so, it may be the case that too many
10 borrowers are losing their homes as a result of high cost
11 mortgages because they can't afford the payments. Maybe
12 they shouldn't have been in those loans to begin with,
13 maybe lenders were just simply doing equity lending
14 without paying any attention to borrower ability to repay
15 in order to equity strip.
16 There have been charges of racial
17 discrimination, and Susan alluded to some of these sorts
18 of observations earlier where you have high
19 concentrations of subprime lending in areas that are
20 dominated by minorities, blacks, Hispanics. I guess the
21 elderly don't really classify as a racial group, but
22 another group that may be considered to be vulnerable in
23 some ways. The fact that these groups are targeted and
24 that we can't explain the high adoption of -- or choice
25 of -- subprime loans by these groups with other economic

1 factors that are available to us.
2 Certainly, there's been a theme throughout
3 today that subprime borrowers are inexperienced and
4 vulnerable, that they don't really understand, in many
5 cases, what they're doing and are often persuaded into
6 bad contracts with expensive terms. Then there's this
7 undercurrent throughout that maybe this credit's just too
8 expensive for people regardless of whether this is a
9 reasonably justifiable rate given the risk that they
10 present and that borrowers are really better off without
11 that loan than having to pay that much.
12 So, all of these things get wrapped into
13 allegations of what predatory lending is all about as
14 opposed to just plain old subprime lending. Notice that
15 throughout that previous list, price was a major factor.
16 In each of those subpoints there was the notion that the
17 price was really too high for what the borrower was
18 getting.
19 The regulatory approach that really began with
20 HOEPA and has been adopted increasingly around the
21 country has been to target high cost loans, based on APR
22 and fees, as potentially predatory. Price is the warning
23 signal. Then, you legislate a package of protections for
24 borrowers who have these high cost loans and those
25 packages or protections consist of basically three

1 categories of things.
2 You ban or sharply limit some of the
3 contractual features so that some become taboo or at
4 least very expensive. You require new disclosures,
5 procedures and maybe borrower counseling as part and
6 parcel of getting a loan. And you create, in some cases,
7 lender liability for inappropriate underwriting and
8 pricing. To trigger all of this, the third component of
9 the prevailing approach is -- and you just have to say in
10 looking at the different statutes that have floated
11 around the country, you arbitrarily, just out of the sky,
12 choose an interest rate and fee trigger that's going to
13 activate the package of protections.
14 Federal HOEPA does this. We all know about
15 HOEPA. It has been with us the longest of any of these
16 approaches. It imposes additional disclosure
17 requirements and limitations on mortgages that are
18 designated as high cost loans. The Fed has recently
19 lowered -- in fact, October 1st of this year, the new
20 lower triggers took effect along with a revised package
21 of protections for high cost loans that are covered under
22 HOEPA.
23 If you looked at the Fed commentary, there was
24 a great emphasis on the fact that they were trying to
25 strike a balance between greater protections for

1 borrowers and the risk that the additional costs of those
2 protections might impede the flow of subprime credit.
3 Basically they chose to try and do this
4 balancing act with their choice of trigger points.
5 Actually, the final proposal that just became effective
6 October 1st had slightly higher triggers than what had
7 been initially proposed, presumably because they were
8 worried about the risk of impairing the flow of
9 legitimate subprime credit.
10 We don't know yet what the impact of these new
11 revised triggers are going to be on the flow of subprime
12 credit. They've only been in effect two weeks.
13 That approach has spread to state and local
14 jurisdictions as you are all aware. Many governments
15 have proposed, and some have enacted, HOEPA-like laws.
16 They often have lower APR or fee thresholds and more
17 restrictive provisions than does HOEPA. Now, at some
18 point, if you believe economic analysis at all, you have
19 to concede that the restrictions will impose sufficiently
20 high costs such as to discourage mortgage lenders from
21 serving high-risk borrowers.
22 We don't really know what that point is. And,
23 in fact, that's really the point of my presentation
24 today. All of these triggers have been chosen
25 arbitrarily with almost no analysis of what the impact

1 would likely be. So, we are really navigating uncharted
2 waters here. But at some point, there is sufficient cost
3 imposed that it will drive up the cost of extending
4 credit to the point of eliminating some options that
5 borrowers have in the marketplace.
6 Now, what exactly is predatory lending? I
7 walked through a list of allegations. Let's stop and
8 think about it just for a second. Am I a predatory
9 lender if I charge a higher rate or fee than some of my
10 other competitors? Now, as Charles said, Washington,
11 D.C. passed a law that said that I was. If there is
12 anybody else in the market charging less than I do, then
13 I'm predatory. But, of course, that's not the approach
14 that we typically take in other markets. Yet, it's a
15 concern that -- given that high pricing of mortgages is a
16 concern, some policymakers could adopt that as a
17 definition of predatory lending. Indeed, maybe that is
18 your own definition.
19 Am I a predatory lender if I target customers
20 who are likely to be persuaded into a sale through a
21 convincing sales pitch? Maybe. But that also could be a
22 description of lots of sales practices for in other
23 markets for all kinds of goods and services. It doesn't
24 mean that there's anything necessarily wrong with the
25 product, it just means that perhaps I'm good at

1 persuading people that they need the product when maybe
2 they didn't realize they needed it otherwise.
3 Am I a predatory lender if I deceive customers
4 through misrepresentation of contract terms or borrower
5 qualifications or eligibility for a particular type of
6 product? In other words, am I predatory if I am engaging
7 in outright fraud, either in the statement or execution
8 of the contract? That might make me a predatory lender
9 and I think most people would agree that it probably
10 does.
11 At its core, my feeling is that predatory
12 lending boils down to a species of fraud and manipulation
13 in the loan-selling process. And it strikes me that this
14 should be the target of our regulatory efforts.
15 I think the current prevailing approach that we
16 see around the country is misguided. I'm going to show
17 you some evidence on this in a minute. The current
18 approach tries to get to the fraud part of it, if we
19 agree that there is a fraud part to it, indirectly by
20 limiting or prohibiting or otherwise penalizing contract
21 terms that might be used by unscrupulous lenders to dupe
22 borrowers, but could also be legitimate and appropriate
23 for other borrowers. It just addresses them all and
24 lumps them all together and creates a category of loans
25 that are subject to considerably higher costs.

1 In contrast, in most consumer markets where
2 we're worried about fraud, regulators typically combat
3 fraudulent sales practices through strong enforcement of
4 deceptive practices laws, plus education of the public so
5 that they don't fall into being duped into a misleading
6 sales pitch. I'm certainly no lawyer and no expert on
7 enforcement, but we're in the very building where there
8 are plenty of experts at doing this very thing in terms
9 of combating deceptive practices in other markets.
10 The advantage of targeted enforcement efforts
11 is that they don’t affect the whole market. They
12 typically only affect the bad guys, and I think there is
13 something to be said for that in the context of the
14 predatory lending problem.
15 The risk that you face with the prevailing
16 approach to predatory lending is that you may throw out
17 the baby with the bath. The risk in the prevailing
18 approach is that at some point the package of
19 restrictions is sufficiently onerous that it reduces
20 credit availability to subprime borrowers, and
21 particularly to the marginal borrowers who we have been
22 worried about getting access to credit all along. These
23 are the borrowers that we would most like to protect, the
24 lower income and traditionally under-served borrowers.
25 The potential harm from the predatory lending

1 laws increases as the pricing triggers for protection are
2 lowered and the package of protections becomes more
3 restrictive. Harm is really a function of both of those
4 things. It doesn't matter if you cover all loans if the
5 package of protections is not a constraint on lenders, or
6 you can cover just 10 percent of the loans, but the
7 package of protections can be so onerous that there will
8 be nobody lending to those borrowers who would be so
9 affected.
10 The big problem I see with the approach that is
11 being implemented now is that that, so far, the selection
12 of triggers and protections has been completely
13 arbitrary. It has been guided by no analysis whatsoever
14 of the likely impact on the affected market.
15 My colleague and I, Greg Elliehausen, have been
16 working on this at the Credit Research Center for a
17 little over a year now. We have available to us a large
18 database that has a number of advantages for looking at
19 the likely impact of this prevailing regulatory approach.
20 It is a database that was commissioned by the American
21 Financial Services Association and assembled by
22 PricewaterhouseCoopers in the fall of 2000. It contains
23 detailed loan level data including pricing and FICO
24 scores. This is like gold in this business because most
25 other data sets available for subprime mortgage lending

1 research don't have those very important loan level and
2 borrower level features. And, our dataset is big, 2.3
3 million closed-end subprime mortgage loans that were made
4 between 1995 and 2000.
5 How representative of the subprime market is
6 it? It contains all the mortgage loans from the subprime
7 units of nine participating members of the American
8 Financial Services Association. There are only nine
9 companies, which means it clearly doesn't capture the
10 entire subprime market. However, these are very large
11 national lenders. The originations in the database for
12 1998 equaled about 39 percent of the HMDA reported volume
13 of subprime lenders for 1998. Now, there is some overlap
14 there, but there are presumably some lenders in the AFSA
15 database that probably don't report under HMDA. The
16 point is, the volume is so large that it makes the
17 database useful for trying to gauge what the impact on
18 the marketplace is going to be associated with some of
19 these different coverage levels imposed by the different
20 triggers. It is also useful for looking in one state
21 where we have just enough post-statute experience to
22 begin to see the impact of predatory lending legislation.
23 That state is North Carolina.
24 Because the database contains loan-level data,
25 it can be used to simulate HOEPA coverage. We can plug

1 in the HOEPA triggers, and, given the loan contract
2 terms, see how many loans would have been covered under
3 HOEPA.
4 Here is an indication of the change that has
5 already been implemented by the new HOEPA coverage
6 standards. What we're doing here is looking at the
7 104,000 first-lien mortgage loans that were originated in
8 this database between January and June of 2000, a six-
9 month period. 9.3 percent of those loans were covered by
10 HOEPA under the old guidelines, the ones that were in
11 effect up until September 30th of this year. 41.8
12 percent of them would have been covered under the new
13 HOEPA guidelines, so already there's been a change
14 implemented in the marketplace two weeks ago that is
15 going to have some impact on lender activity in the
16 marketplace. This is a substantial boost in the coverage
17 level, just because of the lowering of the first lien
18 HOEPA pricing triggers.
19 The next chart shows coverage levels for second
20 mortgages. 54 percent of loans originated between January
21 and June of 2000 were covered under the old HOEPA
22 standards; 67.5 percent would have been covered under
23 the new revised HOEPA guidelines. The next chart gives
24 you a sense of who is at risk of being impacted by higher
25 rates of HOEPA coverage. The chart shows the percent of

1 loans, broken down by borrower income, that would be
2 covered under the new HOEPA triggers. Again, these
3 weren't actually covered because the new HOEPA triggers
4 weren't in effect when these loans were made. But it
5 gives you a sense of how income relates to the coverage
6 level. And that's simply because pricing is correlated
7 with income.
8 I could show you a similar chart with FICO
9 score and it would look exactly the same. The lower FICO
10 scores are going to have higher rates of coverage because
11 the pricing tends to be higher for those higher risk
12 borrowers and that's what gets you into the high cost
13 loan category.
14 We can look at the impact of some of these
15 local laws. This chart displays national coverage under
16 the prior and revised HOEPA regulations. But I've also
17 included analysis of a local-level and a state-level
18 predatory lending law. The chart shows coverage rates on
19 loans made from January through June 2000.
20 You will notice the coverage levels are
21 substantially higher under the Oakland statute and under
22 the Georgia statute than is the case even under the
23 revised HOEPA. Remember, we don't yet know what the
24 impact of the revised HOEPA will be on the supply of
25 mortgage credit. And, we see higher coverage rates and

1 significantly more restrictive and punitive packages of
2 protections with both the Oakland and the Georgia
3 statutes.
4 If you would just indulge me for two or three
5 slides here, I'll show you some other examples, too. The
6 next chart shows the coverage levels of the New York
7 State law that was recently signed into law, just in the
8 last couple of weeks I think. It compares the new HOEPA
9 coverage to the New York State coverage. The state's
10 coverage is substantially higher and the statute contains
11 more punitive provisions.
12 How about New York City? I don't recall if
13 this one has actually passed or not. It is a bill that
14 has certainly been proposed. Again, because the triggers
15 are written into the legislation, the implied coverage
16 rates can be modeled. The coverage rates are much higher
17 under the New York City ordinance than under the revised
18 HOEPA.
19 Detroit reveals the same sort of story. Hawaii
20 got into the act, with the same sort of story. A theme
21 begins to emerge from these slides that not only are
22 these local and state-level ordinances and laws imposing
23 higher coverage rates, but there is wide variance in the
24 percent of loans that will be covered, 40%, 50%, even as
25 high as 90% in instances.

1 In North Carolina we have a chance to observe
2 the impact of such laws on the supply of credit. The law
3 was implemented long enough ago that we have a little
4 window of opportunity to see what the supply side effect
5 was. The law passed in July 1999. Some provisions
6 (including limits on prepayment penalties) began phasing
7 in as early as October, 1999. All provisions were
8 implemented by July 1, 2000.
9 I see that I'm short on time, so I will move
10 quickly through these next few slides. Our hypothesis
11 basically is that the set of protections that were
12 implemented in North Carolina imposed higher costs on
13 lenders. We would expect those higher costs to decrease
14 the supply of loans to higher risk borrowers, resulting
15 in a reduction in the number of loans extended to such
16 borrowers. We happen to have about 140,000 loans for
17 North Carolina and three surrounding states that we can
18 look at that were made between the first quarter of '97
19 and second quarter of 2000 to begin to gauge the supply
20 side effects.
21 This is just a simple chart that doesn't
22 control for other factors, but it begins to give you a
23 sense that something was going on in North Carolina at
24 about the same time that the law was passed that was not
25 going on in the other surrounding states. This charts

1 shows changes in originations for mortgage loans made to
2 borrowers with incomes of less than $25,000. Recall that
3 I already showed you a chart that demonstrates that the
4 coverage rate is highest on borrowers with the lower
5 incomes, typically because they tend to get charged
6 higher prices because of higher risk. Originations of
7 loans to lower income borrowers turned sharply down in
8 North Carolina in the fourth quarter of 1999, but this
9 pattern was not repeated in the surrounding states. Yet,
10 we don't see that same effect in the next chart which
11 shows loans to borrowers with incomes of $50,000 to
12 $75,000.
13 This is consistent with our hypothesis. Higher
14 risk borrowers, here proxied by lower income, are going
15 to feel the brunt of the supply-side pull-back in
16 response to the high cost law in North Carolina.
17 We have followed up this analysis with a
18 multivariate regression approach and found that,
19 controlling for other factors, the trend that you saw in
20 the previous charts hold. I refer you to our research
21 paper for the details.
22 A couple more slides drive home the point of
23 what is happening here. The law apparently triggered a
24 shift in the risk distribution of borrowers who receive
25 loans. This chart shows you the shift. The lighter blue

1 bars are the period up to the point the law was passed;
2 the darker blue bars the period after the law was passed
3 in terms of the distribution of all North Carolina
4 borrowers across FICO scores categories. You see a
5 rightward shift in the distribution of borrowers who get
6 loans. Higher risk borrowers are being squeezed out of
7 the marketplace at the margin.
8 Now, maybe that was happening everywhere during
9 this period of time. But, the next chart displays North
10 Carolina's shift relative to three comparison states:
11 South Carolina, Virginia and Tennessee. You will see
12 that while there was a little bit of shift going on away
13 from the lower risk end of the spectrum, the shift is
14 bigger in North Carolina than it was in the other states.
15 This shift is statistically significant when you run it
16 through the multivariate analysis.
17 I'll show one last slide here and then I really
18 will be out of time. We talked earlier today about
19 inefficiency of the markets and pricing of loans. We
20 have the additional capability with the database of
21 looking at the correlation between risk and pricing.
22 Specifically, this chart plots what is going on across
23 the subprime market in these four states with North
24 Carolina singled out in a couple of those lines.
25 The chart shows a downward slope from the

1 lowest FICO scores to the highest FICO scores, meaning a
2 smaller risk premium for lower risk borrowers occurring
3 in all of the states and occurring in North Carolina both
4 before and after passage of the law.
5 Now, this chart suggests to me that at least on
6 average, pricing is corresponding to what our market
7 models would suggest would happen. Now, that does not
8 mean there is not a distribution around these averages
9 and that some of these borrowers may have been able to
10 get lower prices elsewhere in the market. But in
11 general, we see a strong correlation, between risk and
12 pricing.
13 Bottom line, we saw significant declines in
14 loan originations in North Carolina after passage of the
15 statute. This just emphasizes my worry and a worry that
16 has been expressed by at least a couple of the other
17 panelists today, that the prevailing regulatory approach
18 to the predatory lending problem runs the risk of
19 throwing the baby out with the bath by constraining
20 credit to deserving subprime borrowers.
21 Thank you.
22 MR. FARRIS: We'll just operate under the
23 assumption that everyone has a handout in their packet.
24 And if anyone has any question, just stop me.
25 So, I am on the first slide, the background

1 slide. We just want to thank the FTC for hosting today's
2 roundtable on this important topic. I am going to talk
3 briefly about predatory lending, our experiences with
4 predatory lending legislation in North Carolina and how
5 that legislation relates to other recent policy
6 developments in other states in the home mortgage arena
7 in general and how the North Carolina law has become the
8 focus of research and policy analysis, because there has
9 been some history. The law is about three years old, as
10 mentioned earlier.
11 So, I come as a representative of the Center
12 for Responsible Lending. We are a nonprofit research and
13 policy organization focusing on predatory lending issues
14 and asset protection. The Center is affiliated with the
15 organization of the Center for Community Self-Help.
16 Self-help is subprime lender in North Carolina. We made
17 over 24,000 loans to low-wealth borrowers in the State of
18 North Carolina and across the country, borrowers who
19 don't meet the conventional underwriting standards.
20 And, so, that's the perspective we bring to the
21 table. As a lender on the ground in North Carolina, we
22 think we have a unique and decent perspective of what's
23 going on in North Carolina.
24 Our best estimates are that predatory lending
25 costs American families an estimated $9.1 billion a year.

1 This is a pre-reform number. As mentioned, there are
2 many reforms going on around the country.
3 And, so, it's a major problem. And a little
4 bit more on the scope, before the North Carolina law
5 passed, it was estimated 10,000 families a year were
6 affected with predatory features or terms on their loans.
7 And those predatory features include fee-based equity
8 stripping items such as single premium credit insurance,
9 exorbitant fees, risk rate disparities and pre-payment
10 penalties.
11 The primary targets for predatory lending are
12 some of the most vulnerable populations. For instance,
13 older Americans are much more likely to receive subprime
14 mortgages, as well as African-Americans and Hispanic
15 groups. For this reason, a lot of groups have gotten
16 involved. For instance, AARP has taken on predatory
17 mortgage lending as a major consumer protection issue,
18 because over 80 percent of older Americans own their own
19 home and they feel it's necessary to help insure that
20 older Americans protect this valuable asset.
21 In addition, recently, the NAACP, at its
22 national convention, passed a predatory lending -- anti-
23 predatory lending resolution.
24 Predatory lending is a drain on equity that has
25 lasting consequences, primarily because home equity

1 comprises over 60 percent of the net worth of minority
2 and low-income individuals. And home equity is often
3 what allows families to send their children to college
4 and weather unforeseen events.
5 Our experience is that alternatives cannot
6 replace substantive protections. For this reason, we
7 believe that Federal and state protections are necessary
8 to prevent fee-based equity stripping and protect
9 Americans' most valuable asset.
10 While better disclosures and more public
11 education are encouraged, the home buying and refinancing
12 process is very complex, which we've heard a lot about
13 today. And, therefore, we think that additional Federal
14 and state protections are needed to protect Americans'
15 most valuable asset.
16 I'm going to talk now about the North Carolina
17 law. In 1999, North Carolina enacted what is considered
18 the first tough anti-predatory lending legislation. The
19 law prohibits the financing of single-premium credit
20 insurance. It prohibited lenders from refinancing an
21 existing loan when there was no reasonable net-tangible
22 benefit to the borrower. It prohibited pre-payment
23 penalties on first-lien mortgages of less than $150,000.
24 And there were additional protections on high-cost loans.
25 And recently we've noticed many echoes of the

1 North Carolina fee-based equity protections in other
2 state statues and federal regulatory changes. For
3 example, other states such as Georgia and New York have
4 enacted similar provisions to North Carolina. In
5 addition, the inclusion of single-premium credit
6 insurance and the recent expansion of fees covered under
7 HOEPA is a signal -- is an echo of the North Carolina
8 standard. And, also, the OTS recently giving states back
9 the right to regulate pre-payment penalties by changing
10 their interpretation of the Parity Act.
11 In addition, recent settlements with industry
12 subprime leaders, Citibank and Household in particular,
13 and their best practices announcements, that they are
14 going to cap their points and fees, and that they are
15 going to limit prepayment penalties and also ban the
16 practice of selling single-premium credit insurance is
17 encouraging and also an echo of the North Carolina
18 standard of protections against fee-based equity
19 stripping.
20 Because North Carolina does have some history,
21 it has become the focus of research and policy analysis.
22 By our count, there have been five studies of the effects
23 of the North Carolina law, and I'm just going to run
24 through these quickly. We've heard one in detail, so
25 I'll try to focus on the other four.

1 In March 2001, Inside B&C Lending reported
2 after a review of rate sheets that there was little to no
3 variation in the prices of subprime mortgages when
4 comparing North Carolina to other states. This is
5 important and the first indication that the law was
6 working as it was intended, not to hamper access to
7 credit and not to hamper the supply of subprime lending
8 in North Carolina.
9 Next, in April 2001, the study or a similar
10 study discussed by Mr. Staten found that North Carolina
11 law appears to have a decline in volume to low income
12 borrowers in North Carolina. And I'll just add that a
13 little insight on what is going on in Q4 in North
14 Carolina, in Q4 of 1999, there was a targeted educational
15 campaign to borrowers about predatory lending, especially
16 in low income neighborhoods, and that may be some of the
17 explanation of why there was a reduction in subprime
18 borrowing in Q4.
19 But I think it is important to also realize
20 that some of the -- most of the provisions of the law
21 didn't go into effect until after Q2 of 2000, and if you
22 look at further research, it may be telling us a little
23 bit more about what's going on in North Carolina because
24 Mr. Staten’s data set ends before important provisions of
25 the law go into effect in mid-2000.

1 We did a study using 1998 through 2000 HMDA
2 data, which is the largest publicly available data set.
3 We went through about 28 million home loans under HMDA
4 and looked at North Carolina versus the rest of the
5 nation. And we found that subprime lending is doing
6 quite well in North Carolina. You have to take into
7 account that lending, both subprime and prime, fell
8 dramatically in 2000 across the nation and that when you
9 look at that relative to the fall in North Carolina, the
10 additional decline in North Carolina was about 6 percent,
11 this points to a small relative decline in subprime
12 lending in North Carolina. This is consistent, actually
13 lower, than our estimate of loans that were made prior to
14 the reform with no reasonable or net-tangible benefit to
15 borrowers.
16 And, therefore, we think the law is having its
17 intended effect of weeding out predatory loans, and that
18 subprime lending is actually doing quite well in North
19 Carolina. There were 31,500 subprime loans that were
20 made, according to HMDA estimates, in 2000. And on those
21 loans, the terms of those subprime loans were reformed
22 and we believe lenders are still making a profit on those
23 loans, they just don't include some of the predatory
24 features and therefore are saving subprime borrowers a
25 tremendous amount of money.

1 Next, in August of 2002, Morgan Stanley
2 reported on a survey of 287 subprime branch managers and
3 they found that even in states with the toughest
4 predatory lending laws, like North Carolina, that laws
5 were not affecting volumes and that actually they were
6 surprised with their finding -- they went into the study
7 expecting to find that the subprime had actually dropped,
8 but they were surprised to find that the volumes are
9 about the same in states with tough laws and that
10 actually 84 percent of subprime branch managers in states
11 with tough laws said that the law was having a neutral
12 to positive impact because subprime borrowers feel like
13 they were going to receive a good deal. And, so, this is
14 what the law was intended to do. It was designed not to
15 hamper access to credit, but just to make sure that
16 subprime loans that were made were made with decent, fair
17 terms.
18 Finally, Peter Nigro at the OCC and Keith
19 Harvey at Boise State presented a paper at the Credit
20 Research Center Conference that concluded that the
21 decline in subprime lending – incidentally, they also
22 looked at HMDA data and used the regression analysis to
23 look at North Carolina versus Virginia, Tennessee, South
24 Carolina and Georgia, and that there was a decline in
25 subprime lending in North Carolina compared to these

1 other states, but that the change was not caused by a
2 change in denial rates but actually by less applications,
3 less applications from subprime borrowers. And that's --
4 in their mind, that suggests less aggressive push
5 marketing from non-bank lenders in North Carolina after
6 the imposition of the law.
7 Again, this is what we would intend for the
8 law's effects to be, not hampering the denial rates or
9 the supply of credit, but that borrowers are not
10 receiving as much push marketing from non-bank lenders,
11 which often results in loans with predatory-type
12 features.
13 I'd just like to conclude by saying that we
14 think that the law in North Carolina is having its
15 intended effects and we are encouraged of the echoes in
16 the North Carolina law throughout the country. We feel
17 like that provisions preventing fee-based equity
18 stripping are important to protect the most vulnerable
19 populations from predatory lending abuses.
20 And I would invite discussion and questions
21 abut any of these papers. And if you need a handout of
22 the presentations or any of the papers I mentioned, just
23 feel free to contact me and I will be happy to provide
24 them. Thank you.
25 MS. IPPOLITO: Okay, any questions? Yes.

1 MR. ERNST: Hi, my name is Keith Ernst, I'm
2 with the Center for Responsible Lending. I just had a
3 baseline clarification question and then a question
4 following that for Mr. Staten. But, first let me say
5 that I appreciate the notion that anti-predatory lending
6 regulation is still very young in terms of a reform
7 process, looking at the lending market overall, and that
8 it is important to struggle and grapple with what are the
9 actual effects of these laws, are they providing the
10 protections that consumers need, are they going too far
11 and hampering access to credit.
12 I noticed in terms of your presentation that
13 you noted that all the loans in your data were closed-end
14 loans. So is it the case that all the lenders in your
15 data reported only making closed-end loans over those
16 years or just that they included closed-end loans in your
17 loans.
18 MR. STATEN: Yes, the only data that we had in
19 this database were closed-end loans. Some of those
20 lenders were almost certainly in the open-end market, the
21 home equity line market. And there could have been
22 adjustments in terms of shifting customers to open-end
23 loans, since open-end loans were not covered by the North
24 Carolina statute. So that is one way the market may have
25 adjusted, at least for some borrowers who would qualify

1 for an open-end loan product.
2 MR. ERNST: Right, so that's a possible
3 alternative hypothesis. I mean, part of what I am trying
4 to do is grapple with all these different studies that
5 John Farris has presented and ask why does it look like
6 there's inconsistent information here.
7 I guess the other question I had was just in
8 terms of looking at some of the coverage of these laws,
9 it seems like one possible reaction lenders could have
10 would be to restructure pricing to move away from some
11 terms that have been called abusive. For example, while
12 there may be some debate in this room about single-
13 premium credit insurance, it largely has been abandoned
14 by the majority of lenders. So, if lenders are
15 restructuring the way in which they're making their money
16 on loans, would it necessarily follow that the coverage
17 post-law would actually be what was predicted by pre-law
18 pricing structures? I just wonder about these sorts of
19 alternative hypotheses while interpreting data on how
20 the laws have affected the market.
21 MR. STATEN: Almost certainly lenders are going
22 to adjust, as best they can. The point I wanted to make
23 with my series of slides showing what the coverage would
24 have been under different regulatory scenarios, was
25 simply to show how many loans would be at risk of some

1 sort of an adjustment on the part of the lender. I'm not
2 suggesting that it be the same coverage after actual
3 passage of the act, because lenders will adjust.
4 MR. ERNST: Okay, thank you.
5 MR. LERMAN: Yes, this is a question --
6 MS. IPPOLITO: Name and --
7 MR. LERMAN: Robert Lerman from the Urban
8 Institute and the American U., for Professor Guttentag.
9 The nichification, I would have thought that there would
10 be actual benefits that you seem to leave out in the
11 sense that, you know, the rate is better tailored to the
12 particular situation that the person is in and the true
13 risk that the -- you know, that the lender faces about
14 the probability of default or the consequences of default
15 and then foreclosure. And, so, you know, there may be --
16 you were talking about the information aspects, but there
17 may be other aspects, I would have thought, that would be
18 positive. I mean, in other markets we say, you know, if
19 the people selling are tailoring things effectively to
20 particular niches, that's a potentially good thing.
21 MR. GUTTENTAG: No, I agree with that. My talk
22 was not about nichification and all its ramifications.
23 My talk was about the problems, the abuses associated
24 with nichification. You're perfectly right, it's
25 nichification that's responsible for broadening the reach

1 of the system to the point where it encompasses niches
2 that aren't touched in other countries.
3 I recently wrote a paper on the New Zealand
4 Housing Finance System, which is just a model of
5 simplicity with none of the abuses that I discussed. It
6 only has one drawback. If you don't fall within the
7 framework of eligibility of the system, you are out of
8 luck. So, yeah, sure, there are those benefits. But
9 that wasn't the subject of my talk.
10 MR. LEARY: I'm Jesse Leary from the FTC. I
11 have a question for Mike and for John. All of the
12 studies in North Carolina that have actually used data on
13 loan volume have found a drop in volume following the
14 passage of the law. The studies that don't find an
15 effect are just based on survey questions, have you
16 lowered your amount of lending, as opposed to looking at
17 actual levels of lending. Is there any good evidence on
18 whether borrowers have been made better off or worse off
19 by this drop. If there isn't, what would be ways to go
20 about studying that question?
21 MR. FARRIS: I think we go into, in our paper,
22 some of the benefits of the law, the reform on the 31,000
23 -- according to HMDA, there were 31,500 subprime loans
24 made in North Carolina in 2000. A certain percentage of
25 those loans would have had some abusive terms, given pre-

1 reform, without the reform, so I think that we made an
2 estimate of cost savings of $100 million to low-income
3 borrowers, and also on your first point, yes most of the
4 studies have shown, I think if you looked at the two
5 studies using HMDA data, our study points out that there
6 was a decline in the rest of the country in 2000 and also
7 the additional in North Carolina was only 6 percent.
8 And if you look at the estimates of pre-reform
9 of flipping of around 10 percent, loans that would have
10 had no net-tangible benefit to the borrower, we think the
11 law is having its intended consequences of weeding out
12 the bad predatory loans and also in Mr. Nigro and Mr.
13 Harvey's paper, they point out that some of the drop or a
14 substantial portion of the drop is due, in their
15 estimation, from less aggressive push marketing from non-
16 bank lenders.
17 And I think that is important to note, that is
18 what the intention of the law was, to weed out the
19 predatory-type lenders, while continuing to allow access
20 to credit for subprime borrowers.
21 MR. CALOMIRIS: Can I jump into this? I think
22 that one of the things that makes this a confusing
23 discussion is people are using different definitions of
24 what they regard as a positive or a negative change. Let
25 me just read something to you that one observer of the

1 North Carolina market, Lampe maybe is how you pronounce
2 his name, I'm not sure. Lampe? Quote, this is from a
3 2001 survey that he did, "Virtually all residential
4 mortgage lenders doing business in North Carolina have
5 elected not to make 'high cost home loans' that are
6 subject to NCGS 24-11E. Instead, lenders seek to avoid
7 the thresholds established by the law."
8 Now, if you define a predatory loan as one that
9 has a high interest rate, per se, then you view this as a
10 very positive thing. That's why you like this, because
11 the law is working. The law is allowing subprime lending
12 to continue, but not predatory lending, because predatory
13 is defined, effectively, as very high interest rate
14 lending.
15 It's not surprising that if you prohibit one
16 kind of lending other kinds of subprime lending, lower
17 interest rate lending, will continue and maybe even grow,
18 and maybe the total volume of subprime lending won't
19 change that much, which, by the way, Mike's data showed,
20 too, for the higher income categories. So, it seems to
21 me like the way that you resolve this seeming
22 inconsistency is simply to note that people have
23 different definitions of what they like and don't like.
24 If you think that high interest rate loans are, per se,
25 bad, then you want to pass usury laws to get rid of them

1 and you're happy when that works. That is basically what
2 your group has done.
3 And then you point to growth in subprime, that
4 means low interest subprime, as a happy occurrence and
5 you see the change as look, all those loans that were
6 high interest rates, they were too high and unnecessarily
7 too high, we got rid of those, subprime continues to
8 grow, see, we told you so, those interest rates were too
9 high. Of course what they don't know and haven't shown
10 is that those interest rates previously were too high out
11 of abuse rather than out of some kind of necessary risk
12 pricing.
13 So, really what it comes down to is the
14 assumption, which hasn't been really tested, which is
15 whether high interest rates, per se, were a bad thing to
16 begin with. We know that we've gotten rid of them, as I
17 just read you here. The law has been very effective as a
18 usury law. And, so, I think that we have to go farther.
19 Now, Mike's slide, if you remember the one with
20 the different -- they were all different colors -- but
21 the one that looked at the change between pre-'99 and
22 post-'99 for the low FICO score borrowers, that was the
23 only place where the two -- within North Carolina the two
24 different lines diverged.
25 So, what did you see there? What you saw was

1 basically interest rates had flattened out, so of course
2 there's more to getting credit than a FICO score, there's
3 also the equity ratio in the house and there are some
4 other features of a loan. So, what I interpret as
5 happening is there was credit rationing. If you couldn't
6 make a loan at the low interest rate, you stopped making
7 that loan for the low FICO score borrowers. Now, some
8 people think that's a good thing; I don't.
9 At the same time, I would recognize and admit
10 that there's some benefit coming in the form of some
11 people who were being tricked are not being tricked
12 anymore. The point is, of course, how do we best attack
13 this problem. We don't best attack it with a usury law
14 that harms people who aren’t being tricked. The better
15 way is to work through, I think, the kinds of programs I
16 was recommending that are really attacking this problem
17 head on.
18 MR. STATEN: Let me just jump in here, too, if
19 I can. I think that our study and the Nigro/Harvey study
20 are quite consistent. They both found a drop-off or
21 decline in volume, and both found it to be greatest for
22 low income borrowers. We have quite a bit more borrower
23 characteristic and loan characteristic information
24 available for analysis than they do, and so we can make a
25 few more statements than they are able to make in terms

1 of exactly who was affected, or, to put it another way,
2 who is no longer in the pool of borrowers that are
3 getting loans after the passage of the statute.
4 The statement that the drop off is attributable
5 to a decline in push marketing by non-bank lenders is not
6 inconsistent with what we found, given that we have AFSA
7 members in our database, at least some of which are non-
8 bank lenders. These companies knew the law was passed.
9 They have marketing engines that are set up to get the
10 product information out to new borrowers, and
11 notwithstanding Jack's warning to some of his clients
12 that you ought to beware of those things that come
13 through the mail or through the phone, direct marketing
14 is an effective way to reach a lot of people. The fact
15 that firms pulled back on those efforts could account for
16 why we don't see many of those higher-risk, low income,
17 low FICO score borrowers left in the borrower pool after
18 passage of the statute. So, I think the message is
19 really the same coming out of both of those studies.
20 MS. IPPOLITO: Right here, the woman right
21 here.
22 MS. RHINE: Hi, my name is Sherrie Rhine, I'm
23 from the Chicago Fed. I haven't disagreed with anything
24 you guys have said, and, in fact, I'm glad to hear a lot
25 of what you have said today. I think we take a lot of

1 information with us from this Conference.
2 But I am a little confused about one basic
3 aspect of your paper and the list of other articles
4 described. While I admit to not having the opportunity
5 to read all of these studies, you guys are talking as if
6 those numbers we're seeing--whether it's application
7 volume or dollars—are going down only because of supply-
8 side factors. Is it the supply-side that we're trying to
9 get at here? Or is this a reduced form analysis? The
10 data really can't tell us if the number of applications
11 are going down because of demand- or supply-side factors.
12 I raise this because one of the first things I thought of
13 from the last paper by Harvey/Nigro was that perhaps
14 financial literacy is working. Maybe consumers aren't
15 walking through the door making applications because
16 they've started to hear stories about predatory lending
17 and are thinking twice before filling out an application.
18 So, I just wanted your thoughts on this possibility. Are
19 we really able to separate out supply and demand here?
20 MR. STATEN: No, you really can't. The only
21 comment I would make on the last statement you made there
22 is that if that's the case, if some borrowers are
23 exhibiting greater caution and choosing not to walk
24 through the door, then it is only borrowers with
25 particular characteristics. We know a lot about the

1 types of borrowers who are continuing to get loans, and
2 the only group experiencing significant declines are
3 those who have low incomes and high FICO scores.
4 MR. CALOMIRIS: That's also where the
5 educational effect would be larger.
6 MR. STATEN: Well, I'm not sure I agree with
7 that.
8 MR. CALOMIRIS: Her alternative explanation
9 wouldn't be inconsistent with that either.
10 MS. RHINE: Well, I'm wondering if it's really
11 not a combination.
12 MR. STATEN: Yes.
13 MS. RHINE: It's not necessarily all one or the
14 other.
15 MR. CALOMIRIS: There's another aspect, too, of
16 course, which doesn't apply so much to 2000, but if you
17 tried to bring this study forward more in time, you'd run
18 into another problem, which is, as you know, foreclosure
19 rates now are very high, higher than they've been in
20 decades. We are seeing a recession hitting. This
21 market's only about nine or ten years old now.
22 So, when all this was being priced, nobody had
23 experienced a recession before in the subprime market.
24 How exactly were they supposed to know how to price it?
25 It's kind of hard to tell, it's a new product, some of

1 this you could price off of experience with other
2 mortgage products, but you'd be reaching.
3 And, so, I think we've regulated it before we
4 even had a recession and an experience of foreclosure
5 rates to judge what these probabilities were and what
6 these costs were. And if the foreclosure rates are any
7 indication, there's a lot of risk in these loans.
8 Of course, on the other side, people would say
9 but they should never have been made.
10 MR. STATEN: Let me take one more stab at my
11 answer again, all right? This is consistent with the
12 theme of this whole conference today. We don't really
13 know what happened to those borrowers that don't appear
14 to be in that pool anymore. I mean, if it's education
15 that's working, did they just decide, "I don't need a
16 loan after all?" I doubt it. If they got a loan, where
17 did they go? I mean, who else is going to lend to them
18 if it's not these subprime lenders, given that we know
19 that they are low FICO score borrowers? What happened to
20 those guys? They went somewhere, they are out there.
21 And this is where I think we need more research to figure
22 out exactly what's going on in these markets. What's
23 happened to the borrowers? We have a lot of information
24 coming from the lenders, but what's happening to those
25 borrowers?

1 MR. ANDREWS: Hi, I'm Wright Andrews, a lawyer
2 at Butera & Andrews and I represent quite a few mortgage
3 lenders. A comment, I wanted to pick up on what
4 Professor Calomiris said. The North Carolina law very
5 clearly has had the effect of prohibiting high cost
6 loans. We all know that there is virtually no lender
7 making high cost loans in North Carolina, period, end of
8 discussion.
9 The point that he made, it effectively
10 functions as a usury law. Industry consumer groups and
11 regulators have got to start spending much more time to
12 begin to examine the effects on that borrower that Mike
13 was just talking about, because there are many people who
14 are not going to qualify for the lower priced loans.
15 Their risk is higher. It is wrong to prevent them from
16 being able to get a loan. North Carolina, I respectively
17 suggest, is, in my judgment at least, not a very good
18 example for us to look at today, even though it is in the
19 short term perhaps the best that we have.
20 We know -- many of us have read both of the
21 studies and the other studies there, that in North
22 Carolina there's no perfect data. There are lots of
23 reasons, be it the HELOC exception that you mentioned or
24 switching to FSB charters or what that the data is a
25 little fuzzy. But look at what's happening in Georgia

1 right now. The Georgia law has just kicked in. I have,
2 for one, been surveying clients and others around the
3 country trying to see what is going on in Georgia with
4 high cost.
5 I have not found a single lender, and I've
6 contacted most of the major lenders, that is making high
7 cost loans in Georgia. Now, that seems to be spreading
8 around the country. It is a horrible effect for the
9 borrowers. There are many people in Georgia that are not
10 making or buying covered loans, because some of the
11 provisions are so onerous and so questionable. But we've
12 got to start looking at that borrower who is often hurt,
13 not to say that these laws aren't needed in many cases or
14 that people are not really being harmed by some of the
15 practices there or that in some cases the laws are not
16 helping. They are helping some folks, but they are
17 hurting a lot of others, and we've got to get more
18 research on that problem. That's my comment.
19 MR. CALHOUN: Hi, I'm Mike Calhoun with the
20 Center for Responsible Lending. I think it is important
21 to clarify some misconceptions about the provisions of
22 the North Carolina law and the timing of the effective
23 date of that law. First of all, contrary to some of the
24 discussion here today, the law was not targeted at
25 interest rates. The concern was very much focused on

1 equity stripping through fees and prepayment penalties
2 that strip the borrower’s equity out of their home at
3 the time of closing.
4 What we had seen as a result of these practices
5 was that free market dynamics were being turned on their
6 head. Instead of there being competition to provide a
7 competitive loan that was sustainable and profitable, as
8 it should be for the lender, the race was to strip the
9 most equity out of the property at closing. For
10 instance, one of the biggest complaints we hear from the
11 industry is that the push marketing is so aggressive,
12 particularly by mortgage brokers, that as soon as lenders
13 put a loan on the books and it becomes public record, the
14 borrower is deluged with new requests and encouragement
15 to refinance.
16 And, so, those dynamics were creating this
17 perverse effect where in order for lenders to maximize
18 profits, they had to strip the equity out at closing
19 because there was such intense pressure coming to flip
20 the loan. Even if a lender had the best intentions,
21 their competitors would say “here's a low income borrower
22 who's taken one subprime mortgage, they're a prime
23 candidate for us to get them to flip over and over
24 again.” So the North Carolina law was very much
25 addressed to fees, points and prepayment penalties that

1 stripped the equity out as soon as the borrower signed
2 the loan.
3 Furthermore, the North Carolina law
4 incorporates the HOEPA interest rate triggers. So, for
5 everybody to understand, the North Carolina high cost
6 loan definition regarding interest rates is exactly the
7 same as HOEPA. Georgia follows the same approach. So,
8 during this period and up until the recent revision in
9 the HOEPA triggers, we were talking ten points over
10 comparable treasuries.
11 The second noteworthy point is that virtually
12 none of these provisions went into effect during the time
13 of this data set that you've been talking about. The law
14 went into effect, the high cost triggers and the high
15 cost protections, in July of 2000, after the completion
16 of the second quarter that you're putting up there.
17 MR. STATEN: Are you through?
18 MR. CALHOUN: No, I have a couple --
19 MR. STATEN: Keep going.
20 MR. CALHOUN: And, so, what did happen is that
21 probably the primary news story over the final four to
22 six months in 1999 in North Carolina was the predatory
23 lending debate. Furthermore, the Attorney General's
24 Office during the second half of 1999 used roughly a
25 million dollars of settlement funds from a consumer

1 action to run targeted anti-predatory lending
2 advertising, aimed primarily at minority neighborhoods
3 throughout the state through radio ads. So, there was an
4 unprecedented educational effort to make people,
5 particularly low income borrowers, aware of the dangers
6 of predatory lending.
7 But I wanted to clarify those. Again, I think
8 is important what you've said, that the market response
9 has been and will continue to be restructuring, just as
10 one of the problems that we saw in North Carolina was
11 nationally based lenders regularly charging 7.99 points
12 to stay under the HOEPA limit. They also pushed all the
13 points into single-premium credit insurance.
14 And, so, this is clearly a very dynamic market.
15 These are savvy businessmen. They'll look to, as they
16 should, maximize income and profits as they have, I
17 think, in North Carolina. The key is that in North
18 Carolina credit has not dried up. And, yes, there were
19 cries of that at first. But, you know, when we have
20 asked people to bring forward borrowers who could not
21 find a loan in North Carolina, there has been a dearth
22 of response.
23 And the North Carolina law is not a usury cap.
24 It imposes counseling requirements, but you can still
25 charge unlimited, triple-digit interest rates on a first-

1 lien loan in North Carolina and still be legal under the
2 North Carolina Predatory Lending Act. And let me close
3 with this, because I know there are other people who want
4 to make comments. Perhaps the most important provision
5 in the law is the counseling requirement. Much like we
6 require counseling for reverse mortgages, which are a
7 complex financial device, which can provide substantial
8 benefit if properly done, probably the key provision in
9 the North Carolina Law is a similar counseling
10 requirement for high cost loans. Once again, I think the
11 analogies are striking. They are a complex situation and
12 subject to abuse, but they can be justified in work-out
13 situations and unusual circumstances like a loan that you
14 described earlier today. And the counseling in North
15 Carolina has had the desired effect. It has operated
16 primarily as a deterrent.
17 We had one leading subprime lender say they
18 were sending people to counseling, and the counselors
19 were telling them to go somewhere else because they could
20 get a better loan. And it should be the rare case when
21 you can't get under five points and currently eight
22 points over comparable treasury on the rate. There are
23 going to be some such loans, but that should be a
24 relatively rare loan. And in examining the cost-benefit
25 analysis of those circumstances, it seems reasonable to

1 impose a counseling requirement.
2 So, that was the approach of the North Carolina
3 law. Clearly, we look with everyone else to see further
4 studies here. Our organization is about providing access
5 to credit. We price credit for risk, charging higher
6 prices for higher credit risk. So, I think we are closer
7 to that camp than perhaps many may perceive. But our
8 concern remains the equity stripping -- that the market
9 had been twisted to where the lenders were incented, if
10 not required, because of the heavy push marketing and the
11 flipping of these loans, to charge as many up-front fees
12 as possible.
13 MR. STATEN: I think the most common theme
14 across all the panelists today is that better education
15 of borrowers would be a good thing, that probably the
16 single biggest weakness we have in this subprime market
17 is that borrowers don't know either what they are getting
18 into or what they are eligible for. They don't do a good
19 risk self-assessment. Probably the best thing North
20 Carolina could have done is what you claimed that they
21 did right there at the end of 1999, which was put on a
22 big public relations campaign to alert borrowers to some
23 of the dangers out there and the pitfalls in the subprime
24 market.
25

1 As far as the study and the timing of the
2 statute, if memory serves, I believe the ban on
3 prepayment penalties took effect in October of 1999. I
4 believe the rest of the features of the statute were into
5 effect by July 1st of 2000. We admit that right upfront.
6 Our database allows us a very limited window where we can
7 begin to see a supply side impact. But, of course, all
8 the lenders knew a year in advance that this was coming.
9 I mean, they knew it as of July 1999 when it was actually
10 signed into law. And the law had actually begun being
11 implemented in October of 1999. Lenders aren't going to
12 make a certain kind of loan and market a certain kind of
13 loan right down to the last day they can do so without
14 restrictions and then suddenly stop. Actual operations
15 don't work that way. So, I believe it is reasonable to
16 expect that a supply response would have begun prior to
17 July 2000. We should be able to detect it in our
18 database, and we think we do.
19 As far as the emphasis on rate ceilings, you
20 are right. North Carolina used the same triggers for
21 these package of protections as HOEPA does. But one of
22 the points I tried to emphasize in my presentation is
23 that the impact of this regulatory approach is a function
24 of two things. It depends on the level of the triggers
25 and the degree of severity or the restrictiveness of the

1 protections. North Carolina's protections are much more
2 restrictive than HOEPA. So, it would be reasonable to
3 expect that there would be more of a response.
4 In effect, if you make high cost loans, however
5 you define high cost, if you make them sufficiently
6 onerous on the lender, that can have the same effect as
7 legislating a rate ceiling because no lender wants to
8 lend at that high rate.
9 MR. CALOMIRIS: And legal risk is the poison
10 pill. I mean, I=m reading now from the handout that you
11 presented before. It prohibits lenders from refinancing
12 existing loans when there=s no reasonable net tangible
13 benefit to borrowers. Now, I=ve spent some time trying
14 to come up with a rule for what would constitute a test
15 on that. It=s very hard to do, and as a lender, I might
16 be very worried about whether I would violate those rules
17 and I might not want to have to litigate it.
18 It seems that there is a lot of legal
19 uncertainty buried in some of the North Carolina law,
20 too, that=s discouraging to anyone who qualifies under
21 the law.
22 But I think there=s another issue here that you
23 raised that=s really worth getting into. Prepayment
24 penalties and points can be very useful ways to lower the
25 present value of costs on a risky mortgage. How do they

1 do that? They=re commitment devices to lower prepayment
2 risk. And you know that a lot of these borrowers that
3 are hoping that they=re going to make the transition from
4 very high rate to even eventually prime, they prepay.
5 The average life of these mortgages tends to be, I think,
6 three years.
7 A lot of the people make a transition into a
8 more positive credit risk situation, and therefore prepay
9 after only a few months or a year. Well, if you can make
10 sure that you have that loan lasting for three or four
11 years instead of six months or a year, you can lower the
12 rate being offered and basically force the borrower to
13 commit not to prepay so quickly.
14 Particularly, I think that that=s a relevant
15 explanation of why points can be very important, and
16 also, prepayment penalties can be very useful for the
17 borrowers.
18 But I would also emphasize there=s another
19 reason to try to frontload things, the overall payment
20 with points, and that is that some borrowers,
21 particularly elderly people, might not have a large
22 continuing income stream and they might prefer, just from
23 the standpoint of their own simplicity of money
24 management, to pay a large amount of the cost upfront,
25 just because they don=t want to have large payments

1 continuing.
2 So, I just don=t think we need to be in the
3 business of being out there micro-managing whether four
4 points or five points is the maximum that people should
5 feel they can charge without having to suffer these
6 inordinate legal risks.
7 Why not attack the problem head on?
8 MS. IPPOLITO: Kathy?
9 MS. ENGEL: I take issue with this prepayment
10 as an exchange for lower interest rates argument. I have
11 a sample of one that demonstrates it. I refinanced a few
12 weeks ago. The lender quoted me an interest rate and I
13 said I would be willing to accept a prepayment penalty in
14 exchange for a lower interest rate. The lender said,
15 "well, nobody=s has ever asked me that before. The answer
16 is no." I then spoke to various supervisors and the
17 answer was, "we just do not offer prepayment penalties in
18 prime mortgages unless they are commercial mortgages.
19 MR. CALOMIRIS: I=m sorry. Was this a first
20 trust? First trust note, first mortgage?
21 MS. ENGEL: First mortgage.
22 MR. CALOMIRIS: Yeah. Well, it=s not legal to
23 do it, right? We can=t --
24 MS. ENGEL: No, you can do it. Yeah, it
25 depends on the state.

1 MR. CALOMIRIS: Well, where do you live?
2 MS. ENGEL: Ohio.
3 MR. CALOMIRIS: Oh, okay. I figured you were
4 local.
5 MS. ENGEL: No. So, I said, "what if I wanted
6 a subprime mortgage?" "Well" the supervisor said, "then
7 you would have to have a prepayment penalty." Then I
8 asked, "if I was willing to pay more in interest, would
9 you let me pay a higher interest rate and get rid of the
10 prepayment penalty?" "No" said the supervisor. "we would
11 let you pay a higher interest rate if you volunteered to,
12 but you could not get rid of the prepayment penalty.
13 MR. CALOMIRIS: What a deal.
14 MS. ENGEL: I am only a sample of one, but my
15 experience tells us something. Although the secondary
16 market is a piece of the story, the point is that it is a
17 false assumption to say that the price of the loan is
18 always determined by risk and the features of the loan
19 I think that there is a correlation between price and
20 sophistication in many cases.
21 There are specific practices that we all agree
22 are bad news, for example, failing to tell borrowers that
23 their loans contain balloon payments, but where people
24 are paying more than the risk adjusted price, it is
25 harder to figure out solutions.

1 Somebody mentioned auto insurance. In most
2 states, it is illegal for insurers not to take risk into
3 account in pricing insurance. No one is saying , I can
4 not get car insurance because of this law that says the
5 pricing has to be risk based.
6 Why can=t there be a law that says that the
7 cost of borrowers' mortgages has to be risk based? I
8 know that economists would have to figure out appropriate
9 model to make this work. Perhaps we should rely on the
10 GSE=s proprietary measures. Or, maybe we could come up
11 with bands and say, anything within this band is
12 presumptively a safe harbor, and then lenders would have
13 to justify any deviations from that band. There would
14 still be competition; it would just happen within the
15 band.
16 We can simplify this whole discussion by
17 asking: has anybody demonstrated that prices do reflect
18 risk? And, if they don=t, how do we impose some kind of
19 requirement on lenders that is not usurious? I agree
20 with some of the concerns about usury limits.
21 MR. CALOMIRIS: There=s an important principle
22 here. I just think it=s crazy to think that regulation
23 of a market economy means that we=re going to require
24 everyone who sells something to be able to justify their
25 price. I think it=s better to regulate the process so

1 that we can have confidence that the process is
2 competitive and informed, and therefore, we believe that
3 the price basically will reflect what it should.
4 FEMALE PARTICIPANT: (Inaudible).
5 (Brief portion inaudible due to Female
6 Participant=s distance from the microphone.)
7 MR. CALOMIRIS: No, it=s not -- I=m not
8 assuming that at all. I=m saying a combination of
9 counseling, disclosure requirements, testers and other
10 kinds of regulatory interventions can help to protect
11 people.
12 I think it=s just wrong for the government to
13 get into the business of setting prices or setting rules
14 that map from characteristics into pricing.
15 MR. STATEN: Let's be clear about something
16 here, too. It sounds like this discussion has taken a
17 turn such that some of you believe that the relationship
18 between price and risk is just random. Well, we have a
19 database of two and a half million loans that shows,
20 without a doubt, that there is a correlation between
21 price and risk and it is the one you would expect, that
22 is, higher risk borrowers pay higher rates. Does that
23 mean it happens 100 percent of the time or 99 percent of
24 the time? No. There is a dispersion of rates around
25 every one of those FICO scores.

1 But that is going to happen in a marketplace,
2 and it seems to me, I would agree with Charlie, that the
3 essence of a free market is that you give people
4 sufficient information to help themselves and then you
5 let them make the choices that they want to make. If
6 they want to pay a higher rate because of some factors
7 that you and I don' see or don't understand, that's what
8 they do, and that's OK as long as they have enough
9 information to recognize that's what they're doing.
10 MR. GUTTENTAG: Let me make a comment on that.
11 There is a part of the market that is very efficient in
12 terms of pricing for risk and cost, and that's the
13 wholesale market. It is reflected in the price sheets of
14 wholesale lenders, one of which you saw this morning. It
15 was a very simple one. Most of them run 7 to 12 tightly,
16 packed pages. Price is adjusted to risk in a
17 multiplicity of ways. Those prices are extremely
18 competitive because the clients of wholesale lenders are
19 mortgage brokers who are shopping experts, as opposed to
20 the brokers' clients, who are anything but.
21 So, brokers find the best price, but the
22 brokers' customers have to negotiate their deals.
23 Whatever the wholesale price is, the broker's mark-up can
24 range anywhere from half a point to five points,
25 depending upon a whole range of circumstances.

1 Unsophisticated borrowers dealing with unscrupulous
2 brokers will pay a lot. At the other extreme, there are a
3 few sharp borrowers who end up exploiting the broker.
4 Most fall in-between.
5 So, that's the reality of the marketplace, and
6 I don't know that there is any really simple solution to
7 that problem.
8 MS. IPPOLITO: Can I ask a question, Jack?
9 MR. GUTTENTAG: Yes.
10 MS. IPPOLITO: If there are customers who are
11 being exploited in this way, and therefore, these loans
12 are very profitable, what is it that keeps other lenders
13 from trying to find those people and offering them the
14 better deal? I mean, what is it that keeps the natural,
15 competitive force from working here?
16 MR. GUTTENTAG: The competitive force works,
17 but it doesn't work the way we expect it to work or see
18 it work in other markets. From a competitive point of
19 view, there are too many loan providers.
20 MS. IPPOLITO: So, there are no reputations,
21 no --
22 MR. GUTTENTAG: No, no. When I say a loan
23 provider, I mean, a mortgage broker or a loan officer
24 working for a lender. Any individual borrower who wants
25 to can find dozens of them that will go after his

1 business. The intent of some loan providers is to get
2 the customer committed to them, and once they're hooked,
3 to make as much from the transaction as possible. Other
4 loan providers have a target markup. They expect to earn
5 a point and a half on a transaction or two points, unless
6 it's above $500,000 and then they will settle for three-
7 quarters of a point or something along those lines.
8 But having more loan providers doesn't really
9 help. These guys already spend 80 percent of their time
10 looking for customers.
11 MS. IPPOLITO: So, you=re arguing sort of a
12 rent erosion story, that there is actually over-fishing
13 here.
14 MR. GUTTENTAG: In that sense, yeah. They are
15 spending a lot of time looking for customers, and in a
16 refinancing market particularly, they are getting a lot
17 of customers who waste their time. Refinancers don't have
18 the drop-dead date of a house purchase, so they can drop
19 out of a loan at the last minute. If interest rates go
20 down, they can walk away from their lock and go to
21 another lender.
22 So, loan providers face very high costs, and
23 when they finally get a customer who goes through with
24 the deal, they may look to make enough on that deal to
25 make up for all the time they wasted on the deals that

1 didn’t go through.
2 MS. IPPOLITO: Let me take a question from the
3 audience.
4 MALE PARTICIPANT: If we ask why we=re here,
5 we=re looking at the mortgage industry and the mortgage
6 industry is unique. I mean, we=ve got a product that is
7 very expensive. It=s something that we buy very seldom,
8 for the most part. And maybe that=s the advantage for
9 people who get flipped, they buy it repeatedly. Maybe
10 they have a lot more experience than I do.
11 And it=s also something, though, that we don=t
12 have good observation data on. I mean, I know what a
13 house costs. I can see what a house costs. I don=t know
14 what all those other fees are. Isn=t that what we=re
15 here about? To hear you guys say, well, but don=t worry
16 about it, the market will make this band of prices
17 narrow.
18 I go shopping for a gallon of milk every week.
19 I know what the standard deviation is. I=m an economist
20 so I know what standard deviation means, but I have no
21 idea what the spread is. I have no idea what the spread
22 is as to what reasonable is. Until prices are posted in
23 such a way that I can make that reasonable idea in
24 mind -- you know, I=m an economist, but the average
25 person still does the same thing, they don=t call it a

1 standard deviation, but they=ve got a plus and minus in
2 their head that makes sense, and we don=t know what that
3 is.
4 MR. GUTTENTAG: Well, that's not completely
5 true, though. You can go online and --
6 MALE PARTICIPANT: Well, I can do that now. My
7 guess is in 20 years we won=t worry about this because
8 the middle guys are going to be gone -- I just look
9 and -- you can look and you can see what happened in the
10 travel agency business where technology has changed in
11 such a way that the brokers there, the travel agents,
12 they=re gone for most products. I=m going to guess we
13 can see it -- it=s happened in the insurance business
14 where basically the insurance companies have released
15 their agents and they keep them captive in their own way,
16 but that middle spread is going away.
17 I=m going to guess sooner or later the housing
18 industry, this stuff will become public. As you said,
19 there=s one subprime lender out there willing to make his
20 information clear to the public. Eventually that will
21 happen.
22 What are we going to do between now and 20
23 years from now when that finally happens, I guess? It
24 seems to me that that=s what we=re --
25 MR. GUTTENTAG: Well, God forbid we should ever

1 get to that point where there will be one subprime lender
2 in the country.
3 MALE PARTICIPANT: Well, no, I=m saying there=s
4 one who=s making that information known. Eventually, as
5 more of that stuff becomes public, maybe that won=t be as
6 big an issue.
7 MR. CALOMIRIS: I guess I feel like I=m saying
8 the same thing that you=re saying and that somehow you=re
9 not hearing me. I think that it would be a really good
10 idea for us to make part of a taxpayer financed program
11 subsidized and strongly encouraged -- although I=m not in
12 favor of mandating that someone use a counselor. I don=t
13 think that=s right. That=s just not the country I=d like
14 to live in. But strongly encouraged and taxpayer
15 financed, mortgage counseling, I think, is a great idea.
16 MALE PARTICIPANT: (Inaudible).
17 (Brief portion inaudible due to Male
18 Participant=s distance from the microphone.)
19 MR. CALOMIRIS: I=m not sure that that=s good -
20 - to be honest, I=m not sure that it=s good enough. I
21 could tell you that when I shop for a mortgage, I don=t
22 go online because there are a lot of mortgage originators
23 who aren=t online, and mortgage products are very
24 complicated. I didn=t even know about Jack=s website.
25 If I had known about that, maybe I would have gone

1 online.

2 MR. GUTTENTAG: mtgprofessor.com.

3 MR. CALOMIRIS: What I do when I want to get a

4 mortgage is I hire a mortgage broker. I don=t know.

5 Now, I=ve gotten probably about a dozen mortgages in my

6 life personally.

7 MR. GUTTENTAG: When you say you hire a

8 mortgage broker --

9 MR. CALOMIRIS: Yes.

10 MR. GUTTENTAG: -- did you arrange with the

11 mortgage broker to retain his services for a fee?

12 MR. CALOMIRIS: No.

13 MR. GUTTENTAG: You didn't? So, he marked up

14 the price on you like he does with all the other schmoes.

15 MR. CALOMIRIS: Absolutely. I didn=t just hire

16 a mortgage broker, and also, I have a relationship with

17 this mortgage broker and I=m confident I=m being treated

18 fairly.

19 My point is that not everybody=s capable maybe

20 of doing all of those things. It=s a big decision. As

21 you say, it happens infrequently enough. I don=t see why

22 we can=t make a public policy initiative that tries to

23 solve that problem, but I don=t want to do it at the

24 expense of creating a lot of other unnecessary problems.

25 MR. GUTTENTAG: Your view is to socialize

1 counseling.
2 MR. CALOMIRIS: I think we already have a lot
3 of government-sponsored consumer information agencies,
4 don=t we? And isn=t this just another one?
5 MR. GUTTENTAG: Well, a counselor is someone
6 who works with the borrower one-on-one. That's what
7 counseling is. We're not talking about my website, which
8 has general information. We're talking about someone who
9 works one-on-one. A time-consuming, costly process.
10 MR. CALOMIRIS: Not necessarily. Counseling
11 could simply be, you know, I answer the telephone, you
12 tell me what your attributes are in terms of the amount,
13 your various things about you over the phone, it might
14 take five minutes, and I=d say, it sounds like the deal
15 you=re getting might be reasonable, but I=d suggest that
16 you also go to other lenders. I don=t think this is such
17 a terribly time-consuming, difficult process. I think
18 what you want to do is empower people to ask questions.
19 People I know who talk to me as a banker, a lot
20 of times I feel like they=re a little intimidated or not
21 knowledgeable about what questions to ask.
22 MR. GUTTENTAG: That's true.
23 MR. CALOMIRIS: -- or they think that whatever
24 the standard form is or the standard procedure, is what
25 they must do. But they should have choices. Sometimes

1 they don=t really understand that they have choices, and
2 we want to empower people, not necessarily guide them and
3 treat them like they=re idiots or treat them with a
4 paternalistic attitude. I think it=s really just
5 empowering them a little bit.
6 MR. GUTTENTAG: That’s true.
7 MS. IPPOLITO: Can I ask --
8 MR. GUTTENTAG: I answer about 20 questions a
9 day.
10 MS. IPPOLITO: Can I ask Jack and the other
11 panelists as well, do you think it will be an important
12 innovation if and when the bundling of mortgage services
13 and the commitment pricing goes through in the RESPA
14 reform? One of the things that is unusual about this
15 market is that you get this detailed breakout of all
16 these subparts in the price of this good that you=re
17 purchasing. You don=t get that with cars, except for a
18 few fringe elements. Nobody tells you what the price of
19 the transmission is and what the price of the wheels are
20 and the price of the body and so on. They say, here=s
21 the price of the car. And then if you want three
22 options, here=s their price.
23 Is that going to be an important innovation, if
24 it goes through in the mortgage market that there would
25 be this committed price of the entire bundle that

1 potentially would facilitate shopping?
2 MR. GUTTENTAG: I don’t know if everybody is
3 aware of this particular HUD proposal. It’s for a
4 guaranteed mortgage package, GMP, which would have an
5 interest rate and a single dollar price that would cover
6 points and all settlement costs. It’s not just lenders
7 who are empowered to do this, other market players can do
8 it as well. Whoever offers a GMP has to provide an
9 objective means of adjusting the rate to the market
10 change between the time of an initial quote and the lock
11 date.
12 So, this is a bold proposal and one with great
13 potential for substantially transforming the market. The
14 only major adjustment that I would like to see would be
15 to break the package into two packages, a lender package,
16 where the lender’s price would include the rate and all
17 the fees that the lender charges, and a real estate
18 package, which would then be offered by real estate
19 players, probably title insurers, possibly mortgage
20 insurers. Borrowers would be able to buy either the
21 complete package, or separate loan and real estate
22 packages. There would be many more market players with
23 the dual package approach.
24 I’m just afraid that with a single package
25 approach, a small number of very large players could end

1 up dominating the market.
2 MR. FISHBEIN: Hi, I am Allen Fishbein with the
3 Center for Community Change. I know the hour is late;
4 however, I want to comment on some things said towards
5 the end of this session. The problems that are being
6 described of abusive lending are not problems that are
7 generally found throughout society. I am sure there are
8 abuses to wealthy people and middle income people, but
9 the research certainly indicates that most of the abuses
10 occur in the part of society where consumers have the
11 fewest choices available to them.
12 The victims are not people who typically are
13 out in the marketplace weighing a variety of different
14 offers. In the case of many minorities, they are people
15 living in communities where the mainstream lenders have
16 all but abandoned those communities. In these communities
17 subprime lenders are viewed as the only form of financing
18 that is realistically available to them. Certainly,
19 research by our friends at Freddie Mac and Fannie Mae
20 have suggested that a significant portion of people
21 obtaining subprime -- higher cost subprime loans --would
22 qualify for cheaper, and in many cases, prime loans.
23 These borrowers turn to subprime loans because they do
24 not feel they have the choice or that receiving a prime
25 loan is a viable option for them.

1 An operating principle in our society is that
2 those segments that have the least choice and are the
3 most vulnerable to unscrupulous practices, should be
4 afforded the greatest protections, be they consumer
5 protections or others. We need to keep the focus on that
6 aspect of the discussion and keep it distinct from
7 proposals that are directed at the general consumer
8 population, and not the particularly vulnerable parts of
9 society that are most affected by abusive practices.
10 MS. IPPOLITO: Can I rephrase that question a
11 little bit as a follow-on question to my earlier
12 question? For the say high-risk borrower, will we have
13 packaged pricing, do you think? I mean, is there enough
14 standardization that could occur there that that market
15 would develop?
16 MR. GUTTENTAG: I don't see any reason why you
17 couldn't. It's not a matter of standardization.
18 Packaging has nothing to do with standardization. The
19 same pricing issues arise with the package.
20 MS. IPPOLITO: So, it would just be a fixed
21 price for a given borrower for a given home?
22 MR. GUTTENTAG: Yes. It might be a high price,
23 but it would still be a price, a fixed price.
24 MS. IPPOLITO: But a one dimensional or two
25 dimensional price.

1 MR. GUTTENTAG: Right, right.
2 MS. IPPOLITO: Instead of the 10 dimensions
3 that we see in the current loans.
4 MR. GUTTENTAG: Yeah.
5 FEMALE PARTICIPANT: Well, the current HUD
6 proposal would not allow packaging for HOEPA loans,
7 though. The current HUD proposal would not allow the
8 packaging for HOEPA loans.
9 MS. IPPOLITO: Is that right? So, that=s --
10 why is that?
11 MR. CALOMIRIS: In what sense would it not
12 allow it?
13 FEMALE PARTICIPANT: It prohibits it.
14 MR. CALOMIRIS: Outright just prohibited?
15 MS. IPPOLITO: It=s banned. Down there? Can
16 you can answer our question?
17 MALE PARTICIPANT: No, I -- I guess I don=t see
18 anybody else from HUD here, so I=ll take responsibility
19 for answering that.
20 MS. IPPOLITO: You=re being recorded. He
21 doesn=t speak for HUD.
22 MALE PARTICIPANT: I was about to say who I
23 was, but now that I=m being recorded, I=ll just say I=m
24 from HUD. I think I can safely say that that=s one of
25 the many questions and those questions are not pro forma.

1 They=re very much open questions. We=ve had a lot of
2 internal debate within HUD whether HOEPA loans should be
3 allowed to package or not. So, if you have an opinion on
4 that, please let us know. That=s not a final decision by
5 any extent.
6 MR. CALOMIRIS: What would be the logic --
7 could you just spell out for us very briefly what would
8 be the logic of why you wouldn=t want them to be? What
9 would be the argument against it?
10 MS. IPPOLITO: He doesn=t speak for anyone who
11 matters, but go ahead and give us your opinion.
12 MALE PARTICIPANT: Well, I guess in that case,
13 I=m not sure I=m speaking for myself at this point. My
14 personal bias is I would tend toward allowing HOEPA loans
15 prepackaged. I mean, I think there=s a lot there. But I
16 know that there=s some concern that people in that end of
17 the market would not be able to have other constraints.
18 The biggest thing that I=ve heard from consumer activists
19 is that you wouldn=t be able to sue -- there are TILA
20 considerations that you wouldn=t get the itemization they
21 like to see for TILA litigation if you had packaging.
22 That=s the number one primary concern I=ve heard.
23 Now, if there are others, I=d certainly like
24 people to comment and have input.
25 MR. GUTTENTAG: I was not even aware that that

1 was a provision in there, that HOEPA loans were not
2 included. Now that I know, I'm going to amend my report
3 to HUD.
4 MS. IPPOLITO: So, we=ve done something today.
5 I saw a hand over here.
6 MALE PARTICIPANT: No, I just wanted to say
7 that brings us back all the way around to some of my
8 original points this morning and that is that we have an
9 awful lot of investment, it seems, in a particular kind -
10 - let=s call it counseling or education, and that is the
11 Truth-In-Lending Act and RESPA and things that have a lot
12 of social cost involved in doing it this way.
13 The second aspect is there=s very great
14 difficulties in making any changes in that, and I think
15 you just pointed one out. There=s some people who want
16 to sue under the old law, and so, therefore, we don=t
17 want to have a new law. Is that a good idea? I don=t
18 think so.
19 MS. IPPOLITO: Anyone else? I mean, it is
20 certainly a point of conventional wisdom in consumer
21 research more broadly that the fewer dimensions that
22 consumers have to shop on, especially lower income
23 consumers and lower education consumers, the easier it is
24 for them to sort through the options available in the
25 market. So, drawing from the broad body of consumer

1 research, I don=t understand the argument for restricting
2 HOEPA loans as a concept.
3 Normally, the finding is, the more dimensions
4 that are to shop on, the harder it is for people to shop,
5 especially people with limited ability or limited
6 resources to draw on.
7 Have I had the last word? No? Okay, go ahead.
8 We should know your name by now, but go ahead.
9 MR. CALHOUN: This is Mike Calhoun with the
10 Center for Responsible Lending. There is another
11 component to this HUD rule that does provide concerns
12 about the packaging in the context of HOEPA loans or
13 very high cost loans, and that is that packaging would
14 come with a safe harbor for RESPA Section 8 liability,
15 which currently prohibits illegal referral fees or mark-
16 ups of the settlement services.
17 So, if the entire HUD proposal were applied
18 fully to HOEPA loans, that would mean that the lender
19 would have unlimited capacity to mark-up unrelated
20 settlement services, the appraisal and the title
21 insurance as part of this process. I mean, they=re
22 subject to some limitations by the market and such, and
23 that is the idea, I think, that HUD has expressed in the
24 rules, that in the prime market, there=s going to be a
25 lot of price shopping, comparison shopping, and those

1 competitive pressures will offset the lifting of the
2 anti-kickback and the illegal mark-up types of
3 activities.
4 There is concern, however, that in the HOEPA
5 market, those competitive pressures will not be
6 sufficient to offset the profitability that could come
7 from the up-pricing of the services and the kickbacks in
8 those services and that the net result would be negative.
9 MR. GUTTENTAG: Thank you for clarifying the
10 argument that we’re going to have to refute. I don’t
11 really think there’s a lot of merit in that position
12 because once these packages start to emerge with a dollar
13 price connected to them, even the subprime borrowers are
14 going to get the message.
15 MS. IPPOLITO: I saw a hand over there. Go
16 ahead.
17 MR. ERNST: Keith ERNST with the Center for
18 Responsible Lending. There is a relevant piece of
19 information in Mr. Durkin=s materials. I think he had
20 cited some percentages saying 70 percent of consumers
21 felt like they had relatively easy access to information.
22 But over lunch just kind of scanning through the charts,
23 also in that same information, when asked how many people
24 actually shopped around or gathered information before
25 entering a closed-end loan, I think it was somewhere

1 around one-third, and within that, there were specific
2 breakdowns in terms of, did you seek information on
3 interest rate or other things, and it declined from
4 there, I mean, to the point where if you did the math,
5 you were getting down to the single digits on some of
6 these items in terms of the whole population of
7 consumers.
8 Given this data, I would echo one of the points
9 made by Allen Fishbein which is to wonder, particularly
10 in the context of the HOEPA market, what we might think
11 those numbers actually look like. I think it=s important
12 to recognize -- I mean, we talked a lot today about the
13 realities in the marketplace as opposed to the
14 theoreticals of the marketplace and to ask these hard
15 questions in that context as HUD is thinking through what
16 is the appropriate response.
17 MR. DURKIN: I agree with you. That=s exactly
18 what those charts say. It does vary by credit type and
19 not everybody shops. I think that is the point of the
20 HUD proposal, as I understand it. It is an attempt to
21 get people away from multiple dimensions. Even
22 economists don=t like to see multiple dimensions in
23 things; they can=t even solve for them in their models.
24 So, they typically talk about price and quality .
25 How many people shop for title insurance rates?

1 I don=t know. How many people shop for points or fees or
2 pest inspections or flood insurance? I don=t think it=s
3 very many.
4 But the HUD proposal -- and I=m not going to
5 defend it, I don=t have to, they can -- attempts to get
6 mortgage shopping down to two dimensions, and I think
7 that=s a big step in the right direction. Whether or not
8 there are some aspects of the proposal that I don=t know
9 about yet and that should be clarified I do not know yet.
10 I will be interested in reading Jack's comment and others
11 as well, but the fewer the dimensions, it seems to me the
12 better off the consumer is.
13 MR. GUTTENTAG: My detailed comments on the HUD
14 proposals can be found on my website.
15 MR. DURKIN: Actually, I already did look at
16 them.
17 MR. GUTTENTAG: Thank you.
18 MR. DURKIN: What about the new ones? Those
19 are the ones I mean I want to see.
20 MS. IPPOLITO: They will be revised shortly.
21 Anyone else? One more.
22 MS. TRAN: I=m Lien Tran. I=m a staffer here
23 at the FTC. My question is directed to the panelists who
24 have done research in this area. My question has to do
25 with risk selection. Obviously, the subprime lenders --

1 there has to be something beneficial to the participation
2 of lenders in the subprime market, and if there is any
3 benefits at all, it would be that they are able to pick -
4 - in the pool of high risk borrowers, those subprime
5 lenders are able to find a way either through sifting
6 through borrower characteristics or some other
7 characteristics to pick out in the pool of high risk
8 borrowers, the ones who are relatively good, even in that
9 pool of high risk borrowers.
10 Is there anything in the data that could
11 validate that, perhaps by running some statistical models
12 that would show that, in fact, the subprime lenders are
13 doing a pretty good job at selecting the borrowers to
14 which they give the loans to?
15 MR. CALOMIRIS: I think what you=re asking --
16 the way I would specifically ask your question is, is it
17 true that you can show that a randomly selected group of
18 borrowers with certain loan to value ratios and FICO
19 scores would not be as good performing as the same FICO
20 score, LTV group but that has been screened by a bank?
21 Would that be a way to ask your question?
22 The answer is clearly yes. I can tell you -- I
23 can give you some great examples. A borrower can get his
24 FICO score screwed up very easily, but if you look at the
25 credit history, you can often see why the FICO score was

1 600 instead of 700. It really may have been effectively
2 700 but it was lowered by some minor things.
3 Also, self-employed people tend to not have
4 very great credit scores. So, the answer, I think, is
5 obviously yes.
6 MR. STATEN: Let me follow up on that. To some
7 degree, we can test that as well. We have performance
8 data along with that loan pricing and borrower
9 characteristic data in our database -- we don't have a
10 lot of performance, but for some of those older loans, we
11 have a good four or five years. We can show that as you
12 would expect, the FICO score is predictive of default
13 performance. It is not a perfect correlation by any
14 stretch because, as Charles mentioned, a FICO score is
15 only one dimension of the risk of the loan.
16 But there is a clear correlation. You know,
17 the lower the FICO score to begin with, at the
18 application time, the higher the default rate three years
19 out, two years out, four years out, whatever. And that
20 is what you would expect.
21 MR. FARRIS: I=d like to comment on that. I
22 think that it=s true in some lenders= cases that they are
23 able to price very well for risk, especially in the
24 subprime market arena. But notably with the rise in
25 foreclosure rates and the failure of a few subprime

1 lenders in the last few years, some aren=t so good at
2 pricing for risk, and I think that should be mentioned as
3 well.
4 MR. CALOMIRIS: Especially since -- you know,
5 as I was saying before, we=ve got a recession now. It=s
6 the first time we=ve even seen relevant data -- I would
7 even say what we were really pricing before was
8 ambiguity, not just risk in the sort of formal sense of
9 finance. So, it=s not surprising that we haven=t gotten
10 it all so right, this year especially.
11 MR. GUTTENTAG: Everybody should also
12 understand that FICO scores can be gamed, there are
13 people who for a sum of money will get your FICO score
14 raised within six or eight weeks.
15 MR. CALOMIRIS: What do I have to pay per
16 point?
17 MR. GUTTENTAG: Some mortgage brokers do it as
18 a matter of course.
19 MS. IPPOLITO: Jan?
20 MS. PAPPALARDO: I=m Jan Pappalardo from the
21 FTC. I just have a question for Professor Calomiris. I
22 think it=s very interesting to talk about the
23 unobservable characteristics or things that you learn
24 about a person that might make you think that they=re a
25 better credit risk than their record might indicate

1 I=m wondering if that would help to explain the
2 question that Pauline raised before about why it is that
3 we still see one-on-one visits with mortgage brokers
4 going to somebody=s home still in existence when the
5 Fuller Brush salesman no longer comes to the house. Can
6 you get unique information by visiting the individual?
7 MR. CALOMIRIS: I don=t know. If you had asked
8 me whether mortgage brokers go to people=s homes, I would
9 have guessed that that=s very rare. I must be wrong.
10 MR. GUTTENTAG: No.
11 MR. CALOMIRIS: It=s not rare?
12 MR. GUTTENTAG: No, it's not rare. No. They
13 have to get a lot of information from a borrower in order
14 to price. And then frequently borrowers have various
15 kinds of problems that have to be cleared up sometimes,
16 oftentimes, connected to credit. When I made the
17 comments about gaming the FICO scores, that could be part
18 of it or part of it could just be cleaning up mistakes.
19 A lot of people have mistakes on their credit report and
20 getting rid of the mistake can cause the FICO score to
21 jump sharply.
22 So, mortgage brokers oftentimes earn their
23 money several times over by what they do with the
24 borrower.
25 MR. CALOMIRIS: If you look at what the source

1 of the FICO score problem is, sometimes there isn=t a lot
2 of distinction between a small balance problem and large
3 balance problem. There are some people who are just a
4 little bit scatterbrained. I guess I might be one of
5 them. I might let a bill go more than 30 days by mistake
6 once, but it=s a small amount and I immediately repay it.
7 But that could hurt you.
8 Then there are people who are habitually late
9 with payments, and they=re very large amounts over longer
10 periods of time, and the scores don=t always distinguish
11 at that kind of level of detail. So, you really have to
12 look at what=s going on in this credit. Is it a zero
13 balance that was once 30 days overdue and he=s done that
14 four times because he=s a little bit of a scatterbrain?
15 That can get you. That can take 60 points off your FICO
16 score.
17 MS. IPPOLITO: Anyone else?
18 (No response.)
19 MS. IPPOLITO: Well, thank you all for coming.
20 It=s been a very interesting day. We certainly
21 appreciate your involvement as an audience. You=ve
22 certainly been here. We expect to have an edited
23 transcript available on our website in three or four
24 weeks, but hopefully sooner than that that will be
25 accessible, and if anybody wants it, I can make that

1 available to you later.

2 If you have questions, as was mentioned before,

3 we do have the Georgetown disk of the preliminary papers

4 and revised papers will be available shortly, as well.

5 So, thank you very much. I appreciate it.

6 (Whereupon, at 4:17 p.m., the roundtable

7 discussion was concluded.)

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1 C E R T I F I C A T I O N O F R E P O R T E R
2
3 MATTER NUMBER: P025617
4 CASE TITLE: MORTGAGE MARKET ROUNDTABLE
5 DATE: OCTOBER 16, 2002
6
7 I HEREBY CERTIFY that the transcript contained
8 herein is a full and accurate transcript of the notes
9 taken by me at the hearing on the above cause before the
10 FEDERAL TRADE COMMISSION to the best of my knowledge and
11 belief.
12
13 DATED: October 24, 2002
14
15 ______________________________
16 SONIA GONZALEZ
17
18 C E R T I F I C A T I O N O F P R O O F R E A D E R
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20 I HEREBY CERTIFY that I proofread the transcript for
21 accuracy in spelling, hyphenation, punctuation and
22 format.
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25 ELIZABETH M. FARRELL