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ROLE OF THE LENDING INDUSTRY IN THE HOME FORECLOSURE CRISIS

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

SEPTEMBER 9, 2009

Serial No. 111–50

Printed for the use of the Committee on the Judiciary

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Enclosures to the Response to Post-Hearing Questions from Suzanne Sangree, City of Baltimore Law Department, have been retained in the official Committee hearing record

ROLE OF THE LENDING INDUSTRY IN THE HOME FORECLOSURE CRISIS

WEDNESDAY, SEPTEMBER 9, 2009

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL
AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:10 p.m., in room 2141, Rayburn House Office Building, the Honorable Steve Cohen (Chairman of the Subcommittee) presiding.

Present: Representatives Cohen, Conyers, Johnson, Scott, Franks, and King.

Staff Present: James Park, Majority Counsel; Zachary Somers, Minority Counsel; and Adam Russell, Majority Professional Staff Member.

Mr. COHEN. This hearing of the Committee on the Judiciary, Subcommittee on Commercial and Administrative Law now comes to order. Without objection, the Chair will be authorized to declare a recess of this hearing. I now recognize myself for a short statement.

Today the Subcommittee continues its examination of the ramifications of the home foreclosure crisis. At this time we will focus on the role of the lending industry both in contributing to the crisis and in mitigating its effects. This hearing is certainly not intended to be an attack on the lending industry, but rather is a chance for the Subcommittee to offer constructive criticism of some of the industry's past and current practices to better serve its customers which are our constituents and America's citizens.

I represent Memphis, Tennessee, which is 60 percent African American. Memphis also has one of the highest foreclosure rates in the Nation, and African American homeowners have been particularly hard hit. Memphis homeowners were targeted with aggressive marketing of subprime mortgage loans. According to many observers, many such loans were the principal cause not only of the home foreclosure crisis but also of the Nation's continuing economic troubles.

Baltimore, Maryland shares many demographic similarities with Memphis, including roughly the same percentage African American population. Baltimore, like Memphis, is facing a particular severe home foreclosure crisis with African American homeowners bearing the disproportionate brunt of such foreclosures.

Therefore, I was intrigued when I learned of the lawsuit filed by the City of Baltimore against one of the Nation's largest mortgage lenders, Wells Fargo. This suit alleges that Wells Fargo deliberately steered African Americans to high cost subprime mortgage products, even in cases where the borrower would have qualified for a traditional prime loan.

These are very troubling allegations. This phenomenon, referred to as reverse redlining, is illegal and a perversion of the laudable goal of increasing home ownership among traditionally disadvantaged groups. At this point Memphis has been considering filing a lawsuit similar to Baltimore's. Shelby County, which includes Memphis, and Memphis is the county seat thereof, has already authorized the filing of such a lawsuit.

In addition, recent media reports are suggesting a growing frustration on the part of judges nationwide with improper documentation and poor administrative practices on the part of mortgage servicers. This improper documentation or handling of records often impedes voluntary loan modification efforts, and in some instances ownership of a note on a mortgage and the attendant legal right to foreclose on a home have been called into question.

We will examine the experience of financially troubled homeowners and their interactions with servicers and their attempts to seek a meaningful modification of their mortgage terms. The voluntary system apparently has not been working, and that is quite unfortunate.

I welcome our witnesses, look forward to their testimony, and I will now recognize my colleague Mr. Franks, the distinguished Ranking Member of the Subcommittee, for his opening remarks.

Mr. FRANKS. Thank you, Mr. Chairman. And welcome back to everyone.

Mr. Chairman, the title of today's hearing is the Role of the Lending Industry in the Home Foreclosure Crisis. And I think that no one here doubts that the lending industry has had a role in that crisis. Lenders made irresponsible underwriting decisions for many of the loans that are currently distressed, and lenders and servicers probably could have done more at the outset of the crisis to modify troubled mortgages to make them more affordable.

However, I am concerned that if we focus only on the role of the lending industry we will be missing the major part of the problem. We will fail to acknowledge that the lending industry is not the only culpable party in this crisis. There is certainly plenty of blame to go around, including to the Federal Government itself. Through the Community Reinvestment Act the quasi-government entities like Fannie Mae and Freddie Mac and efforts like that on our part, the Community Reinvestment Act and Fannie Mae and Freddie Mac lending guidelines actually encouraged and sometimes almost coerced the underwriting of questionable loans.

That said, we need to find solutions, and the lending industry unquestionably has a role to play in getting us out of our current predicament. But many aspects of this crisis, unemployment, falling home values, are simply outside of the lending industry's control. So while I look forward to the witnesses' testimony regarding what additional steps the lending industry can make to help stem

foreclosures, we must be mindful that not all of the solutions or the blame rests with the lenders.

What is more, as we continue to search for solutions to this crisis, there is one so-called solution that I hope we can avoid, and that is bankruptcy cramdown. Allowing bankruptcy courts to modify home mortgages will have adverse consequences for all while providing little real relief to distressed borrowers. Bankruptcy cramdown will invariably lead to higher interest rates and less generous borrowing terms for all borrowers, and I think that will especially hit the very hardest those at the lowest income levels.

Moreover, given that unemployment has been a driving factor behind most foreclosures and that those who do not have regular income may not file under Chapter 13 bankruptcy, cramdown will do nothing for those most in need of relief, those being the unemployed. Combine the unemployed with speculators, another large segment who would be unhelped by cramdown, and one quickly realizes that cramdown will really do nothing to help the vast majority of borrowers facing foreclosure. There is no reason to enact cramdown legislation with its attendant high costs when it will only produce modest results at very best.

Furthermore, we must not forget that cramdown will not only impact lenders but investors as well. These investors include in large part pension funds representing the retirement savings of millions of Americans. We should not pass the cost of irresponsible borrowing and lending off on current and future retirees.

I understand that cramdown is not the focus of this hearing, but because of this Subcommittee's jurisdiction I feel that every time we examine the foreclosure crisis we are really revisiting cramdown. The Senate put cramdown to rest earlier this year, and I hope that we can leave it there.

And I look forward to the witnesses' testimony and hope they have some positive suggestions for actions the lending industry can take to help alleviate the foreclosure crisis. And with that, Mr. Chairman, I yield back.

Mr. COHEN. Thank you. I appreciate the gentleman for his statement. And now recognize Mr. Conyers, the Chairman of this Committee, the distinguished Member of this Subcommittee and the father of universal coverage and the father of cramdown.

Mr. CONYERS. Thank you, Mr. Chairman. And I want to join all of us in welcoming our witnesses. I am glad cramdown was mentioned before. I wish I could say I wasn't going to mention it until you mentioned it, Mr. Ranking Member, but I probably would have anyway.

Mr. FRANKS. It is all right. You can blame it on me.

Mr. CONYERS. The House passed our provision. And cramdown is such a tacky term, isn't it? I mean what we are talking about is giving the bankruptcy judge the same authority to review property matters that come before him on everything but houses; homeowners. So home, no good. And so all we are asking the judge to do, and fortunately we have a very distinguished member of the court here, is to look at it and see if the people that are the mortgagors are worthy of having the mortgage rewritten, the terms extended, the interest rate maybe reduced, the note itself lowered.

And it is not mandatory. It would be discretionary. What is wrong with that? Especially when we are having—is it in Wayne County? 200,000—what is the number? 200 a day. We are going in—and I love the President's diplomacy in saying this is a deep recession. We are in a depression. 200 every single day in Wayne County. I used to say 127 a day. Now it is 200 enter the process of being foreclosed on for failure to—to be delinquent in their mortgage payments.

Now, this Committee has had six hearings on this subject—six. This is the seventh. I commend all of the Members, especially my dear friend from Virginia, Mr. Franks, for his participation and making us stick to the proposition and prove what it is that we are doing is in the best interest of all the people losing their homes in my area and in his and across the country. He is concerned about that. He just wants to do it right. And so he is making sure that we do it right. And if we don't he doesn't hesitate to tell us about it.

But all of this started with the subprime mortgage meltdown. This is what created it. And the meltdown was created, from this Member's point of view, because of the fact that people were enticed into mortgage contractual agreements in which when they said there would be an adjustable rate mortgage they didn't know that adjustable meant up, and many didn't know how soon up would kick in. Sometimes it was years, sometimes it was months, but it was always—and then sometimes it was a big increase that everybody knew, including the people that gave them the mortgage, that they could never ever sustain it.

But now what about this? What about the people that were paying their mortgage and Chrysler Corporation announced that they were going to close down the Hamtramck plant in my district. And everybody goes; white collar, industrial, the janitor. And you lose your income, which leads to you becoming delinquent in your mortgage, but you also lose your health care benefits and your pension. So to tell people that 200 new people, I could see in my county every day new, there will be 200 more tomorrow, there will be 200 more Friday, that's too bad, the bankruptcy court can't do anything about it.

And so I am just here to start our conversation off with the observation that this Administration business about voluntary, moderating the problem through volunteerism hasn't been working. As a matter of fact, fewer and fewer people each month work into any agreement. But worse than that, the people that do work into agreement frequently fall off the wagon because they don't have the money, so they end up getting socked anyway.

So the servicers aren't bad guys or these are not evil people. There was a contract. The first thing somebody says is, when you signed it didn't you, buddy, Mr. and Mrs. Jones, you didn't know that this was in there. These provisions, we didn't make them up. That was the terms of the agreement that we got you a mortgage for your dream house. Everybody knows to own a home in America is the standard. That is the gold standard. We want everybody to be homeowners. At one time Detroit had the record of more working people owning homes than any other city in the country. That

is when the automobile industry was booming and people, ordinary working people, were able to do that.

But there has been some negligence in what the servicers do. And by the way, after the mortgage is executed the bank, Wells Fargo, sells it to somebody else. And guess what, somebody else sells it to somebody else. And then they bundle them up and they infuse not only the American financial system, but these things traveled around the world in every financial system; in Europe and the Far East and Latin America. And that is what created the problem that brought us to what is now called the recession, the deep recession.

Now I exclude from that the people that were catching hell before there was a subprime mortgage. There were some people losing their homes and jobs before this thing hit big time. And so, no, I don't think anybody is here to criticize unduly the servicers, the people who ended up getting all this. But I do think they have done some things that they shouldn't have done, and I do think they did some things wrong, and I do think that the bankruptcy judges are strapped by the regulations that we were—we were trying to—we came within—what was it in the Senate, 51 to 45? Yeah, we came within six votes, seven votes, of getting a bill that would go before the President.

Now, I am working on Trent Franks because I know of his concerns. He is going to be one of those that might reconsider his vote if we handle this hearing properly to his satisfaction and the Chairman's.

I yield back.

[The prepared statement of Mr. Conyers follows:]

PREPARED STATEMENT OF THE HONORABLE JOHN CONYERS, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN, CHAIRMAN, COMMITTEE ON THE JUDICIARY, AND MEMBER, SUBCOMMITTEE ON THE CONSTITUTION, CIVIL RIGHTS, AND CIVIL LIBERTIES

Central to our Nation's current economic troubles is the endless cycle of home mortgage foreclosures, a cycle that unfortunately appears to be gaining momentum rather than drawing to a close.

In addition to undermining our Nation's economy, these foreclosures devastate families, neighborhoods, and local governments.

In 2008, 1 in 10 American homeowners fell behind in their mortgage payments or were in foreclosure. The Federal Reserve estimates that in 2009, there will be 2.5 million home foreclosures. Others estimate that the number could be as high as 3 million.

Over the next four years, there could be between 8 and 10 million foreclosures. As of July, in my hometown of Detroit, 1 out of every 275 housing units faces foreclosure. Also, there were 127 foreclosures a day in Wayne County.

Vanessa G. Fluker, an attorney in Detroit, has shared with me many stories of clients who were treated poorly by the lending industry. For example, one of her clients requested a mortgage modification from Countrywide Financial, now part of Bank of America. Countrywide refused and, instead, sold her client's home to a third-part investor for $800. The lending industry would rather throw people on the street and sell their homes for pennies on the dollar rather than engage in a reasonable modification.

Others of Ms. Fluker's clients who have been refused modification by mortgage servicers include a member of our armed forces, whose mortgage servicer refused to provide a mortgage modification after he fell behind on his payments while he was serving in Iraq and a woman and her mother who is dying of cancer.

Despite the billions of dollars that the Administration has provided to lenders and servicers to encourage voluntary mortgage modification, we continue to hear stories like those of Ms. Fluker's clients. And these are just a sampling of stories from one attorney in Detroit.

I also note that some of Ms. Fluker's clients are senior citizens who originally had equity in their homes. Then, they were induced into taking on adjustable rate mortgages by aggressive marketing, and now they face usurious interest rates and mortgage payments that exceed their fixed incomes. We cannot forget how this foreclosure crisis began.

We have not seen foreclosure numbers like these since the Great Depression, and the mortgage foreclosure crisis continues to grow at an alarming rate, with devastating consequences for communities across the Nation.

The Judiciary Committee, including this Subcommittee, has been examining the causes and consequences of the home foreclosure crisis for more than two years. Between the full Committee and this Subcommittee, we have held at least six hearings in that period.

We have also marked up legislation to help address the foreclosure crisis. My bill, H.R. 1106, the "Helping Families Save Their Homes Act of 2009," offered a meaningful yet modest solution to the foreclosure crisis by granting bankruptcy judges the authority to modify mortgage terms, including a so-called "cramdown" of mortgage principal to more reasonably reflect actual market values.

The version of the legislation that ultimately was signed into law, however, failed to include this critical provision, which was perhaps the one provision that would have most effectively helped families save their homes from foreclosure.

I am disappointed not for myself or for the Members of this Committee. Rather, my disappointment stems from my deep concern for the millions of families now facing the loss of their homes and a life of insecurity and desperation.

Today, as part of our continuing oversight of this issue, we look at how the lending industry has contributed to the foreclosure crisis. There are three issues I want to raise.

First, anecdotal evidence suggests that mortgage servicers have not been cooperative or even communicative with borrowers who have sought mortgage modifications.

Back in July, this Subcommittee held an oversight hearing on the Treasury Department's Home Affordable Modification Program. This Program is intended to address the home foreclosure crisis by providing financial incentives to servicers to voluntarily modify mortgages at risk of default.

Central to the Program's success, however, is that it is voluntary. Accordingly, the quality of the participation by lenders and servicers is critical.

It is no secret that I am deeply skeptical of allowing an industry, which caused this financial crisis, to be given total control to resolve it. I continue to question whether the industry's voluntary efforts to modify mortgages—absent the possibility of involuntary judicial modification in bankruptcy—will be sufficient.

At our last hearing in July, it unfortunately became very clear that the hoped-for success of these efforts was not materializing. Empirical studies suggest that voluntary modifications continue to be ineffective. Even worse, the number of modifications appears to be *decreasing rather than increasing.*

According to Professor Alan White, one of our witnesses from the previous hearing, mortgage modifications peaked in February at 23,749 modified loans. By contrast, there were only 19,041 modified loans in May and 18,179 modified loans in June.

Today's hearing will likely help us better understand why these efforts are ineffective. In particular, mortgage lenders and their servicers appear to be hampered by a series of shortcomings, including inadequate staff to handle modification requests, sloppy administrative practices, and a lack of responsiveness to borrowers desperate to know how they can save their homes from foreclosure.

In the meantime, the number of foreclosures continues to rise, going from 242,000 foreclosures in January to 277,847 in May and 281,560 in June.

Second, I want to know how our judicial system is currently addressing these deficiencies.

For example, the *New York Times* reported last week on the rising frustration of bankruptcy judges nationwide with mortgage servicers who lack necessary documentation for the mortgages that they purportedly service. These servicers are often unable to accurately respond to borrowers' questions about their mortgages, and they cannot determine whether these borrowers, in fact, qualify for requested mortgage modifications.

Additionally, judges are citing lenders and their servicers for their improper practices, which include attempts to impose and collect unjustified fees, charging homeowners for unnecessary insurance, and failing to properly credit homeowners' payments.

Other judges simply refuse to authorize foreclosure sales, because the party seeking relief lacks critical documentation to establish that it is entitled to seek foreclosure.

Given that we are being asked to trust the lending industry to work with homeowners to help families keep their homes, I find these reports of mortgage companies' administrative incompetence to be deeply troubling.

Third, what more can Congress do to ensure that racially discriminatory lending practices do not recur?

I applaud the City of Baltimore for pursuing fair housing claims against lenders suspected of engaging in "reverse redlining," the deliberate attempt to steer racial minorities to high-cost, subprime mortgages.

Nevertheless, it is as much, if not more, of a federal obligation to ensure that Americans' civil rights are protected, as highlighted at an oversight hearing held by our Constitution Subcommittee last year. That hearing clearly established that enforcement of the Fair Housing Act was severely lax.

In addition, there have been various studies identifying predatory mortgage lending practices as having played a key role in fueling the home foreclosure crisis, which has, in turn, devastated communities of color across our Nation.

With the arrival of new management at the Justice Department, which has expressed a renewed desire for vigorous civil right enforcement, I am hopeful that federal enforcement of our fair housing laws will once again be a priority.

I thank the witnesses for being here today, and I eagerly await their testimony.

Mr. COHEN. That puts a high burden on me. Two votes. Thank you, Mr. Chairman.

Without objection, the other Members' opening statements will be included in the record. I would like to thank all of the witnesses for participating in today's hearing. Without objection, your written statement will be placed in the record and we would ask you to limit your oral remarks to 5 minutes. There is a lighting system that kind of tells you what your time is. Green means you are within the first four, yellow you are on your last, and by red you should have finished quickly. Nobody seems to pay attention to it. I hope you will be the first panel that does.

After you have presented your testimony Subcommittee Members will be permitted to ask questions. It is also subject to the 5-minute limitation. We might have votes come up, and if we do we will recess and will come back.

Our first witness is Judge Elizabeth Magner. Judge Magner was sworn in on September 9, 9/9, of 2005, and prior to that was in private practice with Lemle and Kelleher, and then with her own firm. During 23 years in private practice Judge Magner specialized in bankruptcy foreclosures, seizures, and other commercial litigation matters. She has a broad range of experience in representing and presiding over matters concerning debtors, creditors, trustees and committees.

Thank you for being here, Judge Magner, and we now ask you to begin your 5 minutes of testimony.

TESTIMONY OF THE HONORABLE ELIZABETH W. MAGNER, UNITED STATES BANKRUPTCY COURT FOR THE EASTERN DISTRICT OF LOUISIANA

Judge MAGNER. Thank you, Congressman Cohen, Ranking Member Franks, and Congressman Conyers, and the other Members of the Subcommittee. I appreciate this opportunity to speak to you about the home mortgage crisis. Obviously I am just one of 330 bankruptcy judges in the United States, but I hope my observations may be of some assistance to you.

The historic model of a lender originating and then holding a mortgage loan has been lost, perhaps forever. While the change in this practice has created tremendous opportunities for consumers, we also know that it had its dark side in the form of predatory lending and shoddy underwriting. But more devastating to consumers and the economy than either of these issues is another largely untold issue, the inaccurate accounting of loans.

The pooling of loans for sale often to special purpose trusts with far flung investor owners has resulted in the rapid rise of the mortgage servicing industry. More and more the owners or the holders of notes are not typical financial institutions with the ability to administer a loan. Third-party loan servicing companies fill that need. These companies bid for the right to service millions of loans. In order to keep costs low they rely on sophisticated computer software that handles virtually every aspect of a loan's administration. With disturbing regularity, however, these programs have improperly applied loan payments in derogation of the terms of notes and mortgages, failed to recognize and honor the terms of plans of reorganizations and court orders, and falsely place consumers into foreclosure. The amounts claimed on proofs of claim and in motions of relief are very often wrong by more than trifling amounts.

Because there is no standard software platform for managing a loan, no industry accepted format for reporting, nor uniform set of guidelines for administration, inconsistencies in loan administration are rampant and can vary even on one loan from year to year as servicers change. In addition to these issues, the records of one servicing company probably will not interface with those of others. As the note holder changes servicers, perhaps as often as every year, the historical information on a loan may be lost, become inaccessible or unintelligible. This creates an obvious and serious problem when a loan balance is questioned or needs to be verified.

As amazing as this might sound, the fact is that most national servicers cannot produce a simple spreadsheet which shows a loan's history. Without the ability to examine the loan's amortization in a quick and clear format, answering a question regarding the amount owed produces an almost insurmountable barrier to consumers. When a consumer files for bankruptcy relief his home is probably already in foreclosure. Determining the amount of the debt due is critical to his plan's feasibility, yet mortgage lenders routinely fail to produce the most basic of information necessary to validate their balances and check the cost and fees assessed. At least one study has found that 40 percent of all proofs of claim check did not attach a copy of the note or the mortgage even though that is required by bankruptcy rule 3001.

Of greater concern to me is the absence of an accounting for the loan. Typically, either before or after a bankruptcy, a lender will advise a debtor that a fee or charge has been placed on their account. Because of this borrowers can become quickly confused when they make a payment and much to their surprise the note is still past due. If a loan goes 60 days past due, significant charges are usually incurred. Again, this is without notice or detail, making it even harder for a borrower to cure a default.

When a borrower files for bankruptcy his home in foreclosure has already incurred sizeable fees and costs. If a mortgage debt is

itemized at all on the proof of claim, broad categories of expenses are utilized, such as corporate advances or prior servicer fees. Finding out any detail on this is an arduous task. In my experience it takes 4 to 6 hearings and over 4 months of time for a national servicing company to produce a single loan history or the documents to support third-party charges on the account. Over 80 percent of the lenders who appear before—excuse me, the borrowers who appear before me make less than $40,000 per year. They simply don't have the financial resources to force through litigation the documents they need to assess the accuracy of the loans they are being asked to pay. So they tend to accept the proofs of claim without any challenge whatsoever.

But why am I so concerned about the accuracy of the proofs of claim; aren't they correct? I am afraid to tell you my concern is no. In every trial I have presided over payments were applied first to fees and costs—excuse me, fees and costs, then principal, interest, and escrow, exactly the opposite of what is required by the loan documents.

Now, why is this important? Because the application of payments first to fees and costs will always result in additional fees and costs assessed against the borrower as well as additional accrued interest. It is simply math. After a bankruptcy is filed post petition payments are commonly applied against pre-petition costs, installments and undisclosed post-petition charges contrary to the terms of plans or court orders. Escrow amounts are routinely—I am sorry. I have gone over my time, Chairman. I will stop now, and if there are any further questions I will go forward. I couldn't see the light.

[Material submitted by Judge Magner follows:]

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF LOUISIANA

IN RE:	(	**NO. 03-16518, SECTION A**
	(	
MICHAEL L. JONES	(	**CHAPTER 13**
DEBTOR	(	
	(	
MICHAEL L. JONES	(	**ADVERSARY PROCEEDING**
PLAINTIFF	(	
	(	**CASE NO. 06-01093**
VERSUS	(	
	(	
WELLS FARGO HOME MORTGAGE	(	
DEFENDANT	(	

MEMORANDUM OPINION

This matter came before the Court on Michael L. Jones' ("Debtor") Complaint to Recover Property of the Estate, filed against Wells Fargo Home Mortgage, Inc. ("Wells Fargo"). Defendant Wells Fargo filed a timely Answer, and on January 5, 2007, the Court conducted a trial on the merits. Entering appearances at the trial were:

Robin R. DeLeo
Allan Ronquillo
Counsel for debtor, Michael L. Jones

Joseph Paul Rumage, Jr.
Counsel for Wells Fargo

At the conclusion of the trial, the parties were given leave to submit post-trial briefs on or before February 1, 2007, after which the Court took the matter under advisement. The Court having considered the pleadings, evidence presented, and arguments of counsel, issues the following Memorandum Opinion.

Jurisdiction

This Court has jurisdiction over the issues presented pursuant to 28 U.S.C. §§ 157 and 1334; 11 U.S.C. §§ 362, 506, 1306, 1322, and 1328; Bankruptcy Rule 2016.

I. Factual Findings

Debtor filed a voluntary petition for relief under Chapter 13 of the Bankruptcy Code on August 26, 2003. At the time of his filing, Debtor was obligated to Wells Fargo on a debt secured by his residence. Prior to the institution of this case, Wells Fargo had filed a foreclosure action against Debtor in State Court. After this case was filed, Wells Fargo stayed the prosecution of the foreclosure action but did not dismiss its suit. It also filed a proof of claim setting forth the amounts owed by Debtor as of the petition date. The proof of claim contained a schedule reflecting the following prepetition amounts as due:

1. Eight (8) mortgage payments totaling[1]	$18,796.19
2. Accrued late charges	823.04
3. Foreclosure fees	750.00
4. Court costs	1283.87
5. Inspection fees	60.00
6. Escrow shortage	111.59
7. Broker's price opinion charges	435.00
Total	$22,259.69

Attached to the proof of claim was a copy of an adjustable rate note dated April 4, 2001, evidencing the Wells Fargo debt ("Wells Fargo Note").[2]

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[1] The proof of claim listed installments due for the months of January 2003-April 2003 at $2,561.83 per month, May 2003's installment was scheduled for $2,125.30; and those due for June 2003-August 2003 at $2,141.19 per month. The Wells Fargo Note had an interest rate that adjusted on April 1and October 1 potentially changing the monthly note payments due the following May or November, respectively. Contractual installments were comprised of interest accrued in arrears from the previous month on the outstanding principal balance then due, plus a principal payment and escrow contribution. Joint Trial Exhibit ("Exh.") 1.

[2] Exh. 2.

Debtor's plan of reorganization provided for payments to the Chapter 13 Trustee ("Trustee") of $2,105.35 per month for thirty-six months followed by a final payment of $625.97. From these payments, Wells Fargo was to be repaid on the prepetition arrearage represented by Wells Fargo's proof of claim.[3] Debtor also agreed to make the monthly installment payments arising postpetition under the Wells Fargo Note directly to Wells Fargo. Debtor's plan was confirmed by this Court on October 28, 2003.[4]

On November 1, 2003, Debtor suffered a heart attack. As a result of his illness, Debtor failed to make three payments to the Trustee under the plan and missed four mortgage payments to Wells Fargo. By Order of this Court, the term of Debtor's plan was extended three months, and his obligation to immediately make the three missed payments was excused.[5] By Consent Order with Wells Fargo, Debtor agreed to pay $9,348.22, including $650.00 in attorney's fees and costs incurred by Wells Fargo,[6] to cure the postpetition default (the "Consent Order Sum") on his mortgage. These amounts were to be paid directly by Debtor to Wells Fargo.[7]

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[3] The plan provided that arrears of $22,259.69 would be paid through the Trustee. Claim no. 1.

[4] Docket nos. 4 and 7.

[5] The Order authorizing the modification to Debtor's plan was signed on December 16, 2003. Docket no. 14.

[6] It is unclear how Wells Fargo arrived at the Consent Order Sum. However, as Wells Fargo represented to Debtor, the Trustee, and Court that this sum was necessary to satisfy the outstanding obligations due for the four missed installment payments and said sum was memorialized by a Court Order prepared by Well Fargo and consented to by Debtor, it will be accepted.

[7] The Consent Order was signed on May 12, 2004 and amended on July 16, 2004. Docket nos. 8 and 71. Debtor satisfied the Consent Order Sum by making a lump sum payment, credited by Wells Fargo on May 25, 2003, in the amount of $4,355.08. Thereafter, Debtor forwarded amounts over and above his mortgage payment until the remaining balance on the Consent Order Sum was satisfied. Exh. 8.

Thereafter, Debtor made payments to both the Trustee and Wells Fargo. The Trustee forwarded payments to Wells Fargo to pay its prepetition arrearage.[8]

In August of 2005, Debtor filed a motion requesting authority from the Court to refinance the Wells Fargo debt. Debtor represented that he had a commitment from Option One in the amount of $275,000.00: a sum sufficient to satisfy the costs of refinancing, outstanding claims of Wells Fargo, and pay off the remaining obligations due under his plan. As a result of Hurricane Katrina, a hearing on the motion was delayed until November 15, 2005. Wells Fargo did not oppose the motion. On December 7, 2005, this Court approved the request for authority to refinance the Wells Fargo debt.[9] On December 15, 2005, Debtor requested a payoff of the amounts due under the Wells Fargo Note as a closing on the refinancing was scheduled for January 4, 2006.[10] On January 3, 2006, Wells Fargo faxed a payoff statement to Winters Title, the closing notary, indicating a payoff balance of $231,463.97. The payoff was itemized:

1. Principal due	$210,920.72
2. Interest due from July 1, 2005 - January 10, 2006	13,801.58
3. Sheriff's Commissions	6,741.67
Total	$231,463.97[11]

No explanation or substantiation for the amounts owed accompanied the payoff statement.

Debtor testified that when he received the payoff statement he contacted his counsel. Although Debtor questioned the amounts Wells Fargo alleged were due, he was unable to obtain an accounting from Wells Fargo explaining its calculations or any other substantiation for the payoff.

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[8] Exh. 16.

[9] Docket no. 9.

[10] Trial representation by Paul Rummage, trial counsel for Wells Fargo.

[11] Exh. 4.

Because the new loan could not be closed without a release of the Wells Fargo mortgage, and the mortgage would not be released by Wells Fargo unless it received its payoff demand, Debtor was forced to remit the sums demanded or lose his loan commitment.[12] The refinancing left insufficient funds, after the satisfaction of refinancing costs and Wells Fargo's payoff, to satisfy any of Debtor's remaining obligations under the plan.

Following the closing, Debtor requested an accounting of the amounts Wells Fargo alleged were due to payoff his debt. On January 12, 2006, Wells Fargo wrote Debtor acknowledging that it had collected sums in excess of the amounts necessary to satisfy the loan. Wells Fargo gave no explanation as to how much was due or why the amounts collected were in excess of the amounts owed. Debtor was advised that in "approximately 15 days" a check would be issued to him in reimbursement for the excess amount paid.[13]

On March 30, 2006, Debtor instituted this adversary proceeding when no reimbursement was received. Thereafter, on April 20, 2006, Wells Fargo forwarded $7,598.64 in reimbursement for excess funds collected.[14] The funds received were placed in the registry of the Court pending the outcome of this adversary proceeding. At trial, Wells Fargo offered into evidence an accounting from the date of the loan's inception to payoff, reflecting charges made against the loan, as well as, the amounts received in payment.[15]

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[12] Tr.T. Jones, 69:20-70:6.

[13] Exh. 10.

[14] Exh. 13.

[15] Exh. 8.

Debtor disputes the accounting. In particular, Debtor disputes the accrual and payment of post petition inspection fees, attorney's fees, and statutory expenses as well as prepetition Sheriff's commissions. Debtor also objects to the calculation of interest under the Wells Fargo Note. Debtor alleges, and it has not been challenged by Wells Fargo, that none of the disputed charges were previously disclosed to Debtor, the Court, or the Trustee. Further, in the case of the $6,741.67 in Sheriff's commissions collected from the proceeds of the January 4, 2006, refinancing, Debtor avers that Wells Fargo represented in its proof of claim that the costs and commissions of the foreclosure were only $1,283.87. This sum was included in his plan and paid by the Trustee. As a result, Debtor avers that the inclusion of an additional $6,741.67 in commissions in the Wells Fargo payoff was unwarranted and unauthorized.

Wells Fargo responds that the amounts claimed were correctly calculated and that any charges assessed postpetition were authorized under the terms of the Wells Fargo Note and other security documents evidencing the loan. It further maintains that because Debtor voluntarily paid the sums owed under the Wells Fargo Note, he may not recover any amounts improperly charged.

II. Law and Analysis

A. Calculation of Amounts Due Under the Wells Fargo Note

The indebtedness due to Wells Fargo is represented by an adjustable rate note dated April 4, 2001. The interest rate on the Wells Fargo Note is based on a published financial index plus 8.25%.[16] The initial interest rate was 12.375%, but the Wells Fargo Note was subject to adjustment

[16] The index rate is the average of interbank offered rates for six month U.S. dollar-denominated deposits in the London market ("LIBOR") as published in The Wall Street Journal. The interest rate was subject to adjustment beginning on April 1, 2003 and continuing every six months thereafter. The most recent index figure available as of the first business day of the month immediately preceding April 1 or October 1, depending on the date of adjustment, was utilized. To this index rate, 8.25% was added. Exh. 2.

beginning on April 1, 2003, and every six months thereafter. However, under the Wells Fargo Note the interest rate was in no event to be greater than 15.375% nor less than 12.375%. If the rate were to change, Wells Fargo was required to notify Debtor in writing.

Despite the terms of the Wells Fargo Note, the interest rate charged from April 1, 2003, through April 1, 2005, was lower than the contractual floor rate. During a review of Debtor's loan records, Wells Fargo discovered this error and in a letter dated November 30, 2005, agreed to waive any claim for additional interest.[17] Since the rate in effect at the time the error was discovered was equal to the floor rate of interest under the Wells Fargo Note, no adjustment to Debtor's existing installment payment amount was necessary.

In the accounting prepared by Wells Fargo and presented at trial, Wells Fargo applied Debtor's direct postpetition installment payments to those payments owed prepetition. This was in derogation of the plan, which required that the payment satisfy postpetition installments.

Wells Fargo's accounting did not reflect its agreement that four installments and attorney's fees would be paid through an agreed figure of $9,348.22 under the Consent Order. Wells Fargo's accounting also failed to recognize that prepetition charges, fees, and missed payments were to be separately paid by the Trustee under the plan and did not bear interest. All of these mistakes had the combined effect of increasing the interest charged and paid on the loan above that actually due.

[17] Exh. 7.

The historical rates charged on this debt are:

April 1, 2001-March 31, 2003	12.375%
April 1, 2003-September 30, 2003	9.625%[18]
October 1, 2003-March 31, 2004	9.500%[19]
April 1, 2004-September 30, 2004	9.375%[20]
October 1, 2004-March 31, 2005	10.375%[21]
April 1, 2005-January 4, 2006	12.375%[22]

It is important for the Court to note at this juncture how prepetition past due debt and installments accruing postpetition are satisfied under this and most plans. In their plans, debtors commit a single monthly payment from which the Trustee pays administrative, priority, secured, and unsecured claims. Included in the amount to be paid by the Trustee are past due amounts owed to secured lenders.[23] The prepetition past due amounts do not bear interest postpetition and are paid

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[18] On March 7, 2003, Wells Fargo notified Debtor that the interest rate on the Wells Fargo Note was to change effective April 1, 2003. According to Wells Fargo, the new rate was 9.625%. Thereafter, beginning with the May 1, 2003 payment, Wells Fargo calculated Debtor's new payment as $2,137.95. Exh. 6.

[19] On September 8, 2003, Wells Fargo notified Debtor that the interest rate on the Wells Fargo Note would again change effective October 1, 2003. According to Wells Fargo, Debtor's new rate was 9.5%, and his adjusted payment, beginning on November 1, 2003, was $2,123.77. Exh.6.

[20] On March 8, 2004, Wells Fargo notified Debtor that the interest rate on the Wells Fargo Note was again changing, effective April 1, 2004. According to Wells Fargo, the new rate was 9.375%, which resulted in a new payment amount of $2,104.98 effective May 1, 2004. Exh. 6.

[21] On September 7, 2004, Wells Fargo notified Debtor that the interest rate on the Wells Fargo Note was adjusting, effective October 1, 2004. According to Wells Fargo, the new rate was 10.375%, and his new installment payment was $2,429.86, beginning on November 1, 2004. Exh. 6.

[22] Finally, on March 7, 2005, Wells Fargo notified Debtor that the interest rate on the Wells Fargo Note was changing, effective April 1, 2005. According to Wells Fargo, the new rate was 12.375%. Beginning with the May 1, 2004, payment, Wells Fargo calculated Debtor's new installment to be $2,748.07. The rate did not change on October 1, 2005, as confirmed by letter dated September 6, 2005, from Wells Fargo; however, the installment was adjusted to $2,610.23, presumably as a result of reductions in the amounts needed to satisfy future demands against the escrow account. Exh. 6.

[23] 11 U.S.C. § 1322 and Fed. R. Bankr. P. 3001.

out over the life of the plan in installments calculated by the Trustee.[24] The precise allocation between the various constituencies of any one payment made by the debtor is left to the Trustee. As a result, Wells Fargo often received payments from the Trustee in differing amounts delivered in less than predictable intervals.[25]

The repayment of a prepetition arrearage is generally a simple calculation that begins with the amount claimed by the creditor in its proof of claim. That amount is reduced by the Trustee's payments until paid in full.

As for the postpetition debt, the confirmation of a plan recalibrates the amounts owed by Debtor as of the petition date. Because the prepetition arrearage is paid by the Trustee under the plan, Debtor's account gets a fresh start, free of all past due sums.[26] Thus, going forward, Debtor's balance should only reflect the principal amount due under the Wells Fargo Note as of the petition date, and all other charges, fees, or negative escrow balances should be zero.

In this Court's experience, few, if any, lenders make the adjustments necessary to properly account for a reorganized debt repayment plan. As a result, it is common to see late charges, fees, and other expenses assessed to a debtor's loan as a result of postpetition accounting mistakes made by lenders. If the lender does not recalibrate the loan to reflect the terms of the plan, more likely than not, it will miscalculate the amounts due by a debtor. It appears to this Court that lenders

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[24] Prepetition past due amounts owed to a secured claimant like Wells Fargo are rarely paid with interest. The reason is simple, the bulk of most claims consists of past due interest accrued in the form of missed installment payments. Since the repayment of interest cannot bear interest under Louisiana law, lenders are not allowed to request that these past due sums bear interest until paid. 11 U.S.C. § 1322(e) and La.C.C. art. 2001.

[25] At trial, Wells Fargo asserted that the failure of the Trustee to deliver plan payments to it as provided by the plan constitutes a default under the plan and Wells Fargo loan documents. The Fifth Circuit has held that a debtor is not responsible for the way a trustee disburses payments. *See, In re Lee*, 167 B.R. 417 (Bank.S.D. Miss. 1992) *aff'd*, 22 F.3d 1094 (5th Cir.1994).

[26] *See, e.g., Grogan v. Garner*, 498 U.S. 279, 111 S. Ct. 654, 112 L. Ed. 2d 755 (1991).

refuse to make these adjustments because few debtors challenge their accounting and even less pay out their entire loan before discharge. There are also a sizeable number of debtors that default on their plans or the direct postpetition payments on their loans, resulting in the lifting of the automatic stay and a return to foreclosure. Thus, many lenders appear to take a "wait and see" attitude rather than provide the type of individualized administration that a reorganized debt requires.

Such was the case with Wells Fargo. Rather than recalibrate the loan as current on the petition date, Wells Fargo continued to carry the past due amounts contained in its proof of claim in Debtor's loan balance. Wells Fargo applied any amounts received, regardless of source or intended application, to pre and postpetition charges, interest and noninterest bearing debt. This resulted in such a tangled mess that neither Debtor, who is a certified public accountant, nor Wells Fargo's own representative could fully understand or explain the accounting offered.[27]

1. Prepetition Debt Calculation

A review of Wells Fargo's accounting from the date of the loan's inception until the petition date reveals several accounting errors. These errors can be generally described as: 1) simple mathematical errors and 2) mistakes in the amount Wells Fargo reported were incurred. There do not appear to be any errors caused by an improper calculation of interest as the loan's effective interest rate was constant through the date the last prepetition payment was received in December of 2002.

[27] The Court notes for the record that Debtor's counsel propounded written discovery and interrogatories on Wells Fargo's accounting before trial and conducted a pretrial deposition of Wells Fargo's representative, the same person that testified at trial. Despite these efforts, Wells Fargo was still unclear and unknowledgeable about the calculation of its own debt history, often offering new explanations and facts on the stand from those given during discovery.

The first mistake in the calculation of the prepetition arrearage involved Wells Fargo's representations as to the amount of foreclosure costs it incurred. Wells Fargo alleged in its proof of claim that it had incurred $1,283.87 in prepetition foreclosure costs. At trial, the Sheriff's representative testified that the sum of $1,283.87 was the *deposit* made by Wells Fargo on the institution of the foreclosure action. The actual costs incurred as a result of the foreclosure were only $743.87.[28] The Sheriff's representative testified that had Wells Fargo requested an accounting of the costs, one would have been supplied. The Sheriff also testified that if the foreclosure suit had been dismissed on the petition date, no commissions or other charges would have been due, and the Sheriff would have refunded the unused portion of the deposit.[29] As a result, Wells Fargo's proof of claim contained errors as to this charge, and this Court has reduced that figure to reflect prepetition foreclosure costs of $743.87, not the $1,283.87 claimed.

Calculation errors also resulted in the inclusion of $435.00 in broker's price opinion fees (only $250.00 were actually due at filing) and an escrow shortage of $111.59, when the escrow account had an actual shortage of $546.94. Both of these items have also been adjusted to reflect the actual amounts due, as calculated through Wells Fargo's own accounting and the testimony taken at trial.[30]

One final adjustment was also made to the total past due installments owed prepetition. As previously explained in footnote one (fn.1), the eight (8) installments included in the Wells Fargo

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[28] T.Tr. Sandra Williams, 149:3-13.

[29] Tr.T. Williams, 145:21-146:12

[30] Exh. 8. Under the terms of Wells Fargo's loan documents, payments are first applied to accrued and outstanding interest, then principal, then escrow charges. Fees and other expenses are satisfied only after all outstanding installment payments are paid and escrow charges are current.

proof of claim are the aggregate of accrued interest, principal, and escrow contributions. However, since the escrow account was kept current postpetition through Debtor's direct payments, and the negative prepetition balance was separately itemized and included in the proof of claim, there is no need for Wells Fargo to include additional escrow contributions as part of the prepetition installment payments owed under the plan. Additionally, the portion of the installments designed to amortize principal should not be included in the prepetition arrearage amount because the full principal balance was also paid postpetition. To collect any principal or escrow payments from the Trustee (as part of the prepetition past due installments) would result in an overpayment of principal and escrow. Therefore, the prepetition installments have been reduced to eliminate escrow and principal repayment and now only provide for past due interest.[31]

Attached as Exhibit "A" to this Opinion is a schedule reflecting the prepetition loan history for this debt and the amounts actually due as of the petition date. On Exhibit "B," also attached to this Opinion, are the past due amounts owed as of the petition date (as reflected at the conclusion of Exhibit "A") reduced for the payments made by the Trustee. The end result is that as of January 4, 2006, Wells Fargo was owed a prepetition past due balance of $2,251.21.

2. Assessment of Additional Prepetition Charges

Wells Fargo has also added to its prepetition arrearage, without amendment to its proof of claim or disclosure to the Trustee or Court, additional prepetition charges. As previously stated, Wells Fargo's prepetition arrearage was calculated based on its proof of claim and included in Debtor's confirmed plan. Nevertheless, when Wells Fargo learned of the refinancing and a payoff

[31] Wells Fargo's representative could not explain how interest was calculated in the accounting Wells Fargo supplied. The Court's review of Wells Fargo's accounting reveals that interest was calculated by applying the applicable interest rate on the full outstanding principal balance due at the time a payment was applied for a 360 day year. The Court's interest calculations have adopted this formula. Exh. 8.

quote was requested, it added additional Sheriff's commissions to its debt based on the amounts it anticipated receiving.[32]

After receiving the tender of payoff, Wells Fargo contacted the Sheriff and requested a calculation of the commissions owed. The Sheriff's office based its fee on the information communicated to it by Wells Fargo, that the payoff of the Wells Fargo loan was as a result of refinancing. Wells Fargo failed to advise the Sheriff that a bankruptcy had been previously filed. If that information had been delivered to the Sheriff, his representative's testimony was that all commissions would have been waived because no commissions are assessed on writs of seizure if a bankruptcy is filed prior to the Sheriff's sale.[33] As a result of this error, the Sheriff's commission of $6,741.67 was improperly added to Debtor's loan account and collected at closing.

3. Calculation of Postpetition Debt

Starting on August 26, 2003, Debtor's loan was current. From that date forward, Debtor's past due account was "zeroed out" because the arrearage was payable through the plan. Therefore, Debtor's postpetition balance consisted of only principal, or $213,949.06, and Debtor's next installment was due for September 1, 2003.[34]

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[32] Under state law, Sheriffs may assess a commission against amounts the secured lenders receive after seizure of a property. The calculation of commissions varies from parish to parish based on the Sheriff's interpretation of the phrase "received as a result of seizure." Wells Fargo assumed the most expansive of views, that any sums received on its loan from any source would result in a commission due to the Sheriff.

[33] Had Wells Fargo dismissed its foreclosure action upon the institution of this case, this problem would have never occurred. Wells Fargo did not dismiss the foreclosure because it wanted to save itself the time and additional expense should a default occur postpetition, resulting in a return to foreclosure. The stay of a pending foreclosure action during a bankruptcy's administration might result in the imposition of additional fees or expenses against even a fully performing debtor, depending on the position taken by the local sheriff. In this case, the Sheriff did not seek to impose any additional fees or commissions. The Court leaves for another day how it will address the consequences of a lender's postpetition maintenance of a foreclosure action that results in additional costs to a debtor or the estate.

[34] Exh. 8

Initially, Debtor's case did not go well. Because Debtor suffered a heart attack in November 2003, he immediately fell behind in his direct payments to Wells Fargo. These payments were aggregated into the Consent Order Sum, once again bringing Debtor's account current by agreement.

Wells Fargo's subsequent actions, however, caused Debtor to pay almost $13,000.00 in additional interest charges over the life of the plan. Throughout the succeeding years, Debtor made his payments in the amounts directed by Wells Fargo. However, rather than apply the amounts received to the postpetition installments for which they were intended, Wells Fargo applied them to prepetition installments, prepetition costs or fees, and postpetition charges not authorized or disclosed to Debtor, the Court, or the Trustee.

The error began with the application of Debtor's payments to prepetition debt. Wells Fargo's proof of claim correctly reflects past due installment payments for the months of January through August 2003. Postpetition, Debtor owed the installment for September 1, 2003. That installment was to bear interest at the rate of 9.625%. Instead, Wells Fargo, in its accounting, applied Debtor's September 2003 payment to the prepetition installment due for January 1, 2003. The amounts due for September 2003 and January 2003 were substantially different because of the different interest rates charged during the two periods. In January, Debtor's installment was higher simply because a higher rate of interest (12.375%) was in effect. Debtor's payment of the September 2003 was insufficient to satisfy the January 2003 installment because it was never intended to pay the earlier installment. By applying the payment intended for the September 2003 installment payment to the January 2003 installment three problems occurred: 1) the payment was insufficient to satisfy the amounts due for January 2003; 2) a postpetition default occurred on the loan because the payment

was not correctly applied; and 3) Wells Fargo collected additional interest to which it was not entitled. The collection of additional interest occurred because Wells Fargo had already made a claim for this same installment in its proof of claim. Therefore, the Trustee was already scheduling payments to Wells Fargo to satisfy this earlier installment. By taking a payment due for September 2003 at a lower interest rate and applying it to a payment at a higher rate, while still collecting from the Trustee the higher interest bearing installment, Wells Fargo denied Debtor the benefit of the lower rate by collecting two installments at the higher rate.[35]

On October 1, 2003, the rate in effect on the Wells Fargo Note was 9.5%. Wells Fargo advised Debtor of the rate change and that his new monthly payments were $2,123.77.[36] On December 31, 2003, Wells Fargo received two payments from Debtor in the total amount of $4,247.54. The amount received was intended to pay the installments of November and December 2003. However, instead of applying the payments to the November and December 2003 installments, Wells Fargo applied part of the funds to the prepetition installment due for February 1, 2003; a payment already included in the prepetition arrearage to be satisfied under the plan. The February 2003 payment carried a higher interest rate than that applicable to the November or December 2003 installment payments.[37] Therefore, in effect, Wells Fargo collected two installment payments for February 2003, one from the Trustee and one from the Debtor. Both were at the higher interest rate.

There was an additional problem with the December double payment. Because the payment was insufficient to satisfy two early 2003 installments (the amount of those installments being about

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[35] Exh. 8.

[36] Exh. 6.

[37] Exh. 8

$200.00 higher than the two due at the end of the same year) after Wells Fargo applied the funds to the February payment, it placed the remaining funds in a suspense account rather than apply those funds to the outstanding loan.[38] This had the effect of making the Debtor past due on his postpetition installments. It also kept the outstanding principal balance artificially higher than it should have been because a payment was not applied. The failure to reduce principal ultimately affected the calculation of future interest, making interest payments higher than what was actually owed.

This same error was compounded month after month throughout the loan's postpetition history. Additional accounting errors were committed by the misapplication of the Trustee's payments to postpetition charges and loan installments. The result was the addition of significant interest charges not really due and a loan balance out of sync with the actual amounts owed.

4. Assessment of Postpetition Fees and Charges

a. Postpetition, Preconfirmation Fees

Postpetition charges incurred prior to confirmation may be included in the debts necessary to cure a default under a plan.[39] Therefore, they must be disclosed and are subject to review by the bankruptcy court for reasonableness.[40] According to Wells Fargo's accounting, Wells Fargo assessed $150.00 in attorney's fees postpetition, but prior to confirmation. However until discovery was conducted some three years later, they were never disclosed. The attorney's fees were unwittingly paid by Debtor through the application of either Trustee payments or Debtor's direct mortgage payments, neither of which were designated for this purpose.

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[38] Exh. 8.

[39] *See, Mendoza v Temple-Inland Mortgage Corp. (In re Mendoza)*, 111 F.3d 1264 (5th Cir. 1997).

[40] *See, Rake v. Wade*, 508 U.S. 464, 113 S. Ct. 2187, 124 L. Ed. 2d 424 (1993); *In re Telfair*, 216 F.3d 1333 (11th Cir. 2000); 11 U.S.C. §§ 506(b) and 1322(e).

Legal fees incurred postpetition and prior to confirmation must be approved by the Court as reasonable under §506(b) and Bankruptcy Rule 2016(a). Preconfirmation, postpetition fees are proven by application. Bankruptcy Rule 2016(a) mandates that "an entity seeking compensation for services or reimbursement for expenses shall file an application setting forth a *detailed* statement of (1) the services rendered, time expended and expenses incurred, and (2) the amounts requested."[41]

At trial, Wells Fargo offered no evidence as to the nature of the fees or their reasonableness. It neglected to produce invoices identifying the counsel who performed the services or any description regarding the services performed, time spent, or amounts charged. Wells Fargo simply failed to meet its burden of proof on this issue.[42] Therefore, the attorney's fees not previously approved by the Court and identified on Wells Fargo's accounting as owed postpetition and preconfirmation are denied.[43]

b. Post Confirmation Fees and Charges

At the outset, the Court notes that Wells Fargo has charged Debtor's account, post confirmation, with previously undisclosed attorney's fees, inspection charges, and a "statutory expense." These fees were accrued and paid from amounts delivered by the Trustee to satisfy Debtor's arrearage claim or from direct mortgage installment payments of Debtor tendered to satisfy principal, accrued interest, and escrow charges. Only after the institution of this adversary did

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[41] *In re Hudson Shipbuilders, Inc.*, 794 F.2d 1051 (5th Cir. 1986); *In re Allen*, 215 B.R. 503 (Bankr. W.D.Tex. 1997); *In re Tate*, 253 B.R. 653, 665 (Bankr. W.D.N.C. 2000); *In re Gifford*, 256 B.R. 661 (Bankr. D.Conn. 2000). The only postpetition attorney's fees, costs or other charges for which Wells Fargo received Court approval were those related to the Motion for Relief from Stay.

[42] *See, In re Ransom*, –B.R.–, 2007 WL 431571 (Bankr. D. Mont. 2007)(noting creditor has burden of proof to establish the reasonableness of fees and costs), *see also*, *In re Hudson Shipbuilders, Inc.*, 794 F.2d 1051 (5th Cir. 1986).

[43] The fees are described as $150.00 in bankruptcy counsel fees.

Debtor discover, through discovery, the existence of these charges as they were not previously disclosed on any statement, coupon, or notice to Debtor, nor were they identified for the Trustee or Court. The diversion of Trustee and Debtor payments to satisfy these charges caused a corresponding deficiency in Debtor's plan and postpetition balance. Because Wells Fargo has not only charged Debtor's account with undisclosed post confirmation charges, *but satisfied* those charges with estate funds delivered to it to pay other debt, there can be no doubt that Wells Fargo's assessment of post confirmation attorney's fees and expenses directly relates to Debtor's estate. This is because any amounts charged will "correspondingly enlarge the debt of the estate, make reorganization more difficult for the debtor, and adversely impact upon the claims of the remaining creditors."[44]

The application of Trustee and Debtor's monthly mortgage installments to additional, undisclosed charges diverted payments ordered by this Court under the confirmation of Debtor's plan to satisfy other debt. There is no doubt that Wells Fargo's satisfaction of these heretofore undisclosed fees and charges was from property of the estate and directly impacted the status of Debtor's plan. Since Wells Fargo seeks satisfaction of post confirmation charges from property of Debtor's estate, albeit after the fact, the Court has jurisdiction over this request, including whether or not the claims are appropriate under applicable law.

Additionally, under Fifth Circuit jurisprudence, post confirmation fees and charges may be added to a prepetition arrearage and satisfied under a modified plan.[45] Reasoning that under

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[44] *In re Hudson Shipbuilders, Inc.*, 794 F.2d 1051, 1055 (5th Cir. 1986).

[45] *Mendoza v Temple-Inland Mortgage Corp. (Matter of Mendoza)*, 111 F.3d 1264 (5th Cir. 1997); *see also, Green Tree Acceptance, Inc. v Hoggle (In re Hoggle)*, 12 F.3d 1008 (11th Cir. 1994); *Metmor Fin., Inc v. Bailey (In re Bailey)*, 111 B.R. 151 (W.D. Tenn. 1988); *In re Binder*, 224 B.R. 483 (Bankr. D. Colo. 1998); *In re Steele*, 182 B.R. 284 (Bankr. W.D. Okla. 1995); *In re Bellinger*, 179 B.R. 220, 223 (Bankr. D. Idaho 1995); *In re Comans*, 164 B.R. 539 (Bankr. S.D. Miss. 1994); *Central Bank v. Thomas (In re Thomas)*, 121 B.R. 94 (Bankr. N.D. Ala 1990); *In*

§1322(b)(3) and (5) a debtor can cure any default through a plan, the Fifth Circuit provided that modification of a debtor's confirmed plan could cure post confirmation defaults, including fees and charges imposed as a result of post confirmation breaches of a debtor's loan agreements. As such, it is imperative that debtors be advised when post confirmation fees and charges are being assessed against their accounts. As at least one court has explained,

> Creditors should not be able to assess fees to the account of a person in bankruptcy without the person's knowledge. A bankruptcy case's purpose is to allow a debtor to get out of financial trouble. At discharge, a debtor ought to be able to expect he or she has brought his or her secured debts current and wiped out all unsecured debts not paid through a plan. Undisclosed fees prevent a debtor from paying the fees in his or her plan-an option that should not be lost simply because a creditor chooses to not list the fee and expects to collect it later.[46]

Post confirmation, debtors have at least three options regarding the payment of accruing post confirmation charges. The charges can be paid through a modified plan, deferred until completion of the case, or voluntarily paid outside of the plan. However, in order for a debtor to exercise his choice, the post confirmation fees and charges must be disclosed. The right to modify a plan for post confirmation defaults is meaningless if a lender can decide which fees and charges it will disclose and which it will hide until the case is complete and execution on debtor's collateral can be accomplished. Post confirmation charges, if not disclosed, could also thwart the real purpose of a bankruptcy case. A debtor that completes his plan by paying off his lender's entire arrearage and postpetition installments may find himself in foreclosure the day after a discharge is granted, based on unpaid and undisclosed post confirmation charges and fees. This result is clearly at odds with

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re Gadlen, 110 B.R. 341 (Bankr. W.D.Tenn. 1990); *In re Davis*, 110 B.R. 834 (Bankr. W.D. Tenn. 1989); *In re McCollum*, 76 B.R. 797 (Bankr. D. Or. 1987); *In re Minick*, 63 B.R. 440 (Bankr. D.D.C. 1986); *In re Parker*, 46 B.R. 106 (Bankr. N.D. Ga 1985); *In re Canipe*, 20 B.R. 81 (Bankr. W.D.N.C. 1982); *In re Ford*, 84 B.R 40 (Bankr. E.D. Pa. 1988).

[46] *In re Harris*, Case Nos. 96-14029-MAM, 00-11321-MAM, Adv. No. 99-1144 at *5 (Bankr. S.D. Ala. May 10, 2002) (Text available at <www.alsb.uscourts.gov>).

the notion of providing a successful debtor a fresh start.

For the above reasons, this Court has the authority to review the post confirmation expenses assessed by Wells Fargo against Debtor and address the challenges raised by Debtor to their payment.

Fees and charges incurred post confirmation in connection with a loan over Debtor's residence are not governed by 11 U.S.C. §506(b). The Supreme Court, in *Rake v Wade*,[47] held that 11 U.S.C. §506(b) "applies only from the date of filing through the confirmation date."[48] Therefore, a creditor's right to assess postpetition attorney's fees and charges is prescribed by state law and the terms of its contract with Debtor. Unless allowed under state law and Wells Fargo's documents, no fee or charge may be assessed.

The postpetition, postconfirmation charges and fees assessed by Wells Fargo are itemized as: 1) attorney's fees,[49] 2) statutory expenses,[50] and 3) inspection charges.[51] Under the terms of the Wells Fargo Note and mortgage, Wells Fargo was entitled to charge Debtor's account for attorney's fees and inspection charges incurred in connection with the loan.[52] Beyond the actual right to charge the amounts requested, the Wells Fargo documents also require that the assessments be

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[47] 508 U.S. 464, 468, 113 S.Ct. 2187, 124 L.Ed.2d 424 (1999).

[48] *See also, Telfair v First Union*, 216 F.3d 1333, 1338 (11th Cir. 2000).

[49] Attorney's fees assessed post confirmation were $659.61 and $857.81 in November and December of 2003. Legal fees and costs in the amount of $650.00 assessed in August of 2004 were approved by the Court under the Consent Order and included in the Consent Order Sum. They have not been removed from the accounting.

[50] A statutory expense of $106.58 was charged and paid in August of 2003.

[51] Inspection charges were assessed against this loan on October 14 and November 4 of 2003; January 8, February 17, March 5, April 5, May 7, June 4, July 7, August 9, and September 28 of 2004; September 29, 2005; and January 30, 2005. The inspection charges total $225.00.

[52] Exh. 2.

reasonable. *See*, Exh 2, Mortgage of Wells Fargo, page 8, ¶ 7 (Lender or its agent may make reasonable inspections of the property), page 8, ¶9(if borrower fails to perform or if there is a significant proceeding that may affect lender's rights such as bankruptcy, lender may do *whatever is reasonable* to protect its interests in the property and borrower will be obligated to reimburse lender for said expenses, including reasonable attorney's fees); Wells Fargo Note, ¶9, (borrower commits to reimburse lender for costs of collection including *reasonable* attorney's fees.)(emphasis supplied).

Under Louisiana law, the creditor bears the burden of establishing its debt.[53] Additionally, the fees and charges must be reasonable. The right to seek reimbursement for a charge is not the equivalent of an unfettered right to assess the charge against the loan. For example, Louisiana law provides that attorney's fees and charges may be contractually authorized, but even if contractually allowed, their assessment must be reasonable.[54] Thus, both under the terms of the Wells Fargo Note and mortgage and Louisiana law, this Court reviews the charges and fees assessed for reasonableness.

At trial, Wells Fargo offered no evidence as to the nature of the attorney's fees imposed post confirmation or their reasonableness. It neglected to produce invoices identifying the counsel who performed the services or any description regarding the services performed, time spent, or amounts charged. As a result, the Court cannot determine the reasonableness of the fees incurred because the Court was given no evidence as to what services were performed, much less, why they were necessary. Wells Fargo simply failed to meet its burden of proof on this issue. Therefore, the

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[53] *See.* La. C.C. art. 1831.

[54] *See, Central Progressive Bank v Bradley*, 502 So.2d 1017 (La. 1987); *Wuertz v Tobias*, 512 So.2d 1209 (La. App. 5th Cir. 1987); and *City of Baton Rouge v Stauffer Chemical Company*, 500 So.2d 397 (La. 1987).

attorney's fees not previously approved by the Court and identified on Wells Fargo's accounting as owed post confirmation are denied.

At trial, Wells Fargo offered no explanation or evidence to support its "statutory charge" of $106.58. Therefore, it is also disallowed.

Following the institution of this case, Wells Fargo ordered sixteen (16) inspections against Debtor's property during the twenty-nine (29) months the case was pending and Wells Fargo's debt remained outstanding. Wells Fargo testified that, upon default, the employee in charge of administering the loan had discretion to order an inspection as often as he or she deemed advisable. Wells Fargo also testified that once a bankruptcy is filed, the loan is considered to be in default whether or not any amounts are actually past due. It also admitted that inspections are not performed on all property subject to bankruptcy administration. No other criteria or parameters for requiring an inspection were delineated.

Following the filing of the bankruptcy petition,[55] Wells Fargo performed monthly inspections beginning in October 2003 and continuing until September 2004. Reports delivered as a result of these inspections, were admitted into evidence. Throughout this period, the reports reflect that the property was generally in good condition. In fact, there is little to no change in the property's condition from month to month reflected in the reporting. Under questioning by Debtor's counsel, Wells Fargo's representative could not list a single reason why an inspection would have been ordered postpetition, nor could she detail any reason why continuous monthly monitoring of the property was necessary or reasonable. Wells Fargo appears to have no policy guidelines regarding

[55] In the four months leading up to the bankruptcy, Wells Fargo conducted monthly inspections of its collateral and charged Debtor a fee for this service. It also secured a broker's price opinion on the property which presumably entailed a drive-by review of the property. These charges indicate that Wells Fargo was fully aware of the property's condition at the time the bankruptcy case was filed.

the taking of inspections, and its representative could offer nothing approximating a justification for same.

Wells Fargo bears the burden of establishing that the charges it seeks to impose against Debtor's loan are reasonable. Based on the testimony of Wells Fargo and the inspection reports offered into evidence, this Court concludes that Wells Fargo has failed to meet its burden. Wells Fargo did not show that Debtor's property was improperly maintained, nor did it show that Debtor had a history of failure to maintain his property.[56] The inspection reports change little from month to month, and nothing in them gives cause for concern. Thus, nothing in the reports justified continued monitoring. Given Wells Fargo's failure to explain the necessity of the services or their reasonableness, the charges may not be assessed against Debtor's account.

Exhibit "C" to this Opinion, reflects the post filing loan history for this debt after taking into account the above findings. All postpetition charges not previously approved by the Court and denied as set forth in this Opinion, have been removed from the history.

Debtor's postpetition balance, as reflected on Exhibit "C", was $204,762.11.[57] As can be seen from the accounting, one installment payment was due, and the escrow account had a positive balance.

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[56] Two additional inspection charges were assessed against the loan in September 2005 and January 2006. The inspection in September followed Hurricane Katrina and would have been reasonable except the inspector's report indicates that the inspection was not conducted because access to the property was impossible. The inspection charge in January of 2006 was incurred after the refinancing and payoff were requested. As a result, neither inspection charge was appropriate.

[57] This sum includes outstanding principal of $211,222.39, less a positive escrow of $8,638.51, plus accrued interest of $2,178.23 for December 2005.

B. Recovery of Amounts Paid for Postpetition Charges and Damages for Violation of the Stay

Section 1306 defines property of the estate, and provides:

> (a) Property of the estate includes, in addition to the property specified in section 541 of this title-
>
> (1) all property of the kind specified in such section that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted....; and
>
> (2) earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed or converted....

In order to confirm a plan, a chapter 13 debtor must commit his projected disposable income to the satisfaction of claims. Projected disposable income is all income earned by debtor, less expenses allowed for the necessary and reasonable costs of his support and that of his family.[58] A debtor's disposable income may fluctuate during the course of the plan's administration based on a change in the debtor's earnings or expenses.[59] The calculation of Debtor's disposable income includes the installment payments accruing post confirmation on Wells Fargo's loan. However, the amounts due by Debtor do not include an allowance for additional fees and costs. Thus, when Wells Fargo applies any portion of Debtor's earnings to undisclosed fees and charges, rather than the installments owed under the note and payable under the plan, it reduces Debtor's ability to pay either the reasonable and necessary costs of his support or the amounts due under his plan. As such, Wells Fargo's satisfaction of postpetition charges constitutes a taking of property of the estate and impacts the Debtor's ability to comply with the terms of the plan.

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[58] 11 U.S.C. §§707(b) and 1325(b).

[59] *See,* 11 U.S.C. §1329; *In re Devilliers*, – B.R.–, 2007 WL 92504 (Bankr. E.D. La. 2007).

Bankruptcy Code section 362(a) provides that, notwithstanding certain exceptions, the filing of a bankruptcy petition operates as a stay, applicable to all entities, of...

> (3) any act to obtain possession of the property of the estate or of property from the estate or to exercise control over property of the estate;
>
> * * *
>
> (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title...

The automatic stay helps protect a debtor's assets by preventing creditors from scrambling to obtain as much property of the debtor's estate as possible. Additionally, the stay gives the debtor breathing room so he or she can institute an organized repayment plan allowing for equitable disbursement among the creditors.[60] Debtor alleges that Wells Fargo violated sections 362(a)(3) and (6) by assessing and paying for undisclosed post confirmation charges from property of the estate. Further, by overstating the payoff, Wells Fargo collected estate funds to which it was not entitled and deprived Debtor, and the creditors of this estate, access to property sufficient to satisfy the plan. Debtor further asserts that said stay violations were willful and that he is entitled to recover fees, costs, and damages under 11 U.S.C. § 362(h).

Section 362(h) provides, "[a]n individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages." The Fifth Circuit noted that there are "three elements to a claim under 362(h): (1) the defendant must have known of the existence of the stay; (2) the defendant's acts must have been intentional; and (3) these acts must have violated the stay."[61]

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[60] *See, In re Chesnut*, 422 F.3d 298, 301 (5th Cir. 2005).

[61] *In re Chesnut*, 422 F.3d at 302.

For the reasons explained below, this Court finds that Wells Fargo's actions constitute a wilful violation of the automatic stay.

1. Violations of the Stay

Wells Fargo charged Debtor's account with unreasonable fees and costs; failed to notify Debtor that any of these postpetition charges were being added to his account; failed to seek Court approval for same; and paid itself out of estate funds delivered to it for the payment of other debt. All of this was accomplished without notifying anyone, Debtor, the Trustee, or the Court, that Wells Fargo was assessing postpetition charges and diverting estate funds for their satisfaction.

The contractual right to seek reimbursement is not the equivalent of a right to collect an undisclosed charge from the estate.[62] While Wells Fargo argues that the accrual of fees is not a violation of the automatic stay, the application of estate funds to their payment without Court authority is clearly a violation. In this instance, Wells Fargo assessed *and paid* itself for additional pre and postpetition charges from payments designed to satisfy a prepetition arrearage contained in its proof of claim and accruing postpetition installment payments. The payments were tendered by Debtor or Trustee for the specific purposes outlined in Debtor's plan and authorized by the Order confirming same. Wells Fargo had absolutely no right to divert these payments to other obligations without Court authority.

The filing of a bankruptcy is supposed to be a respite for a debtor, allowing time for reorganization. It stops the accrual of unnecessary fees and costs as well as additional interest and charges on past due amounts in an effort to allow debtors a fresh start. The automatic stay prohibits the collection of any amounts owed by a debtor during the administration of the case in order to

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[62] *See, In re Campbell*, – B.R. –, 2007 WL 878518 (Bankr. S.D. Tex. 2007).

effect these goals.[63] Therefore, Wells Fargo's failure to disclose other fees or request permission of the Court to seek their payment from estate property resulted in an illegal collection of fees not due from estate property and violated the automatic stay.[64]

2. Recovery of Amounts Collected in Violation of the Stay

Louisiana Civil Code art. 2299 provides that a person receiving payment of a thing not owed is bound to restore it. Louisiana Civil Code art. 2302 states that a person who receives that which is not due is obliged to return it. Numerous Louisiana cases hold that even a payor's negligence in making a payment will not bar his claim for recovery of an amount not due.[65] *In the Matter of Ark-La-Tex Timber Co., Inc*,[66] recently decided by the Court of Appeals for the Fifth Circuit, cited this principle with approval.

As set forth above, the Sheriff's commissions added to Wells Fargo's payoff were not due. Their inclusion in a payoff delivered the day before the refinancing left Debtor no time to verify or question the propriety of the charges. No detail was provided with the payoff, and although Debtor attempted to verbally verify the amounts claimed, no information could be accessed through Wells

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[63] *See, e.g., Matter of S.t. Acquisition, Inc.*, 817 F.2d 1142 (5th Cir. 1987).

[64] *See, In re Han*, 333 B.R. 881 (Bankr. N.D. Fla. 2005)(creditor violated automatic stay by charging debtor a higher interest rate than provided by note); *see also, In re Campbell*, – B.R. –, 2007 WL 878518(Bankr. S.D. Tex. 2007)(creditor violated automatic stay when it collected prepetition property taxes through postpetition payments); *In re Chesnut*, 422 F.3d 298 (5th Cir. 2005)(finding that the automatic stay has broad application and that creditor should seek court permission before seizing property that is arguably not property of debtor's estate); *but c.f. Mann v. Chase Manhattan Mortgage Corp.*, 316 F.3d 1(1st Cir. 2003)(no stay violation when creditor kept fees and costs in its books but made no attempt to collect said charges from debtors).

[65] *See e.g. Gootee Constr., Inc. v. Amwest Sur. Ins. Co.*, 856 So.2d 1203 (La. 2003); *Tischler v. City of Alexandria*, 471 So.2d 1099 (La. App. 3rd Cir. 1985); *Williams v. Bank of Louisiana in New Orleans*, 454 So.2d 1138 (La. App. 4th Cir. 1984); *Pioneer Bank & Trust Co. v. Dean's Copy Prods., Inc.*, 441 So.2d 1234 (La. App. 2nd Cir. 1983); *Jackson v. State, Teachers' Ret. Sys. of La*, 407 So.2d 416 (La. App. 1st cir. 1981); and *DeVillier v. Highlands Ins. Co.*, 389 So.2d 1133 (La. App. 3rd. Cir. 1980). Federal jurisprudence on the issue includes *Am. Int'l Speciality Lines Ins. Co. v. Canal Indem. Co.*, 352 F.3d 254 (5th Cir. 2003); *Owl Constr. Co., Inc. v. Ronald Adams Contractor, Inc.*, 642 F.Supp. 475 (E.D.La.1986).

[66] – F.3d. –, 2007 WL 766208 (5th Cir. 2007).

Fargo. Rather than lose his refinancing, Debtor closed the new loan.[67] The payment of Sheriff's commissions was clearly an amount that was not owed,[68] and Wells Fargo is obligated to provide for its return. The other postpetition charges and fees are similarly reimbursable since Wells Fargo did not disclose their imposition or payment to Debtor at any point in time prior to the institution of this adversary proceeding. After they were brought to light during discovery, they were successfully challenged at trial. The result is that they too were not due and reimbursement is owed to Debtor.

In its post trial brief, Wells Fargo argues that it is irrelevant whether or not these charges are actually due because Debtor has forfeited the right to reclaim the amounts owed. Ignoring the applicable Civil Code articles on the subject, Wells Fargo bases its position on a jurisprudential rule set forth in *New Orleans & N.E.R. Co. v. Louisiana Const. & Imp. Co.*[69] That rule states " if a party, *with full knowledge of the facts*, voluntarily pays a demand unjustly made on him *and attempted to be enforced by legal proceedings*, he cannot recover the money, as paid by compulsion, unless there be fraud in the party enforcing the claim and a knowledge that the claim is unjust." (emphasis added).[70]

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[67] Under these circumstances the Court finds that Debtor's payment of the disputed fees and charges was not voluntary or knowing.

[68] It is worth noting that the Sheriff's representative was a *Wells Fargo witness*. Presumably, Wells Fargo knew of the content of the Sheriff's testimony long before trial. Yet Wells Fargo has not offered to reimburse the commissions it erroneously collected or request, on its own accord, a court order directing their repayment by the Sheriff to Debtor. At trial, the Sheriff's office expressed a willingness to refund the commissions erroneously paid. Incredibly, Wells Fargo continues to insist that the commissions were due even in the face of testimony from the Sheriff that they were improperly paid!

[69] 33 So. 51 (La. 1902).

[70] *Id.* at 55.

The *New Orleans & N.E.R. Co.* case involved the seizure of several vessels for wharfage fees associated with improvements made by the defendant, Louisiana Construction. While the case was pending, a similar but separate suit involving the same type of fees was decided at trial in favor of Louisiana Construction and upheld on appeal. As a result of this adverse ruling, a third party non-owner, New Orleans & N.E.R. Co., decided to pay the wharfage fees "under protest" in order to secure the release of the vessels. The seizures were lifted and New Orleans & N.E.R. Co. then instituted suit for reimbursement. The Supreme Court announced its jurisprudential rule based on New Orleans & N.E.R. Co.'s failure to assert its defenses to payment during the pendency of the original suit in admiralty. Explaining that the purpose of the rule was to end litigation and protect the finality of settlement, the Court refused to allow a third party to re-litigate issues presented in the first action. As the Court noted, the time to raise defense to payment was during the first suit where the parties had access to the court and the issues were joined.

This rule is easily distinguishable from the case at hand. First, there was no pending action at the time Debtor made his payments to Wells Fargo. Debtor's bankruptcy is not a "pending action" for the purposes of this rule as it did not adjudicate the financial accuracy of Wells Fargo's loan, nor was this issue ever before the Court. Second, as Debtor's testimony made clear, he did not have full knowledge of the facts involving all the charges, interest and expenses assessed. Wells Fargo has admitted that, except for the inclusion of the additional Sheriff's commission in its payoff statement, it did not disclose any of the additional fees and charges to Debtor at any point in time. For these reasons, Debtor's payment of additional interest, postpetition attorney's fees, inspection fees, and unspecified statutory charges does not fall within the principles enunciated in *New Orleans & N.E.R. Co.* As for the imposition of additional Sheriff's commissions, the Court finds that because there was no pending litigation regarding the propriety of the charges at the time the

payment was made, the jurisprudential rule of *New Orleans & N.E.R. Co.* is inapplicable. Therefore, Wells Fargo will be ordered to return all previously assessed and disallowed charges and fees.

3. Damages for Violation of Stay

As noted above, under § 362(h), Debtor is entitled to recover actual damages, including costs and attorneys' fees, if he was injured by any willful stay violation. A willful violation does not require a specific intent to violate the stay, as the statute provides for damages if Wells Fargo knew of the automatic stay and its actions were intentional.[71] This Court finds that Wells Fargo knew of the stay and that its actions were wilful. Wells Fargo participated in the bankruptcy by filing a proof of claim and by filing a Motion to Lift Stay when Debtor fell behind in his mortgage payments. Additionally, this Court finds that Wells Fargo intentionally assessed and collected fees and costs against Debtor's account postpetition and without Court authority. Its intent was apparent at trial as it defiantly proclaimed its right to not only assess, but collect from estate property, substantial fees and charges without notifying anyone, Debtor, the Trustee or the Court.

Wells Fargo avers that it was Debtor's burden to discover that it had clandestinely assessed and paid itself for undisclosed fees and charges, miscalculated interest and added into the loan charges otherwise not due. Incredibly, Wells Fargo also argues that it was Debtor' s burden to verify that its accounting was correct, even though Wells Fargo failed to disclose the details of that accounting until it was sued. It took no responsibility for any of its mistakes or errors, nor did it apologize for the delays experienced in obtaining the poor accounting it finally produced.[72] This position completely absolves Wells Fargo from any duty to the Court or Debtor for an accurate and

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[71] *In re Chesnut*, 422 F.3d 298, 302 (5th Cir. 2005).

[72] Wells Fargo, as the lender, holds the primary responsibility for keeping accurate records. *See, In re Parrish*, 326 B.R. 708, 721 (Bankr. N.D. Ohio 2005), and *In re Jacobson*, 5 B.R. 274, 277 (Bankr. D.S.D. 1980).

correct accounting of amounts it claims are due as well as its responsibility to the Court to only claim sums to which it is entitled under its documents and the Bankruptcy Code.

Wells Fargo's position is untenable and unworkable. Bankruptcy courts can not function if secured lenders are allowed to assess postpetition fees without disclosure and then divert estate funds to their satisfaction without court approval. Plans of reorganization and confirmation orders are based on court approved schedules to repay debts disclosed at confirmation and sworn by the creditor to be owed under penalty of perjury. It is unconscionable that a lender would represent a certain debt was due, allow debtor to base his repayment plan on that sum, and then arbitrarily and without notice change the amounts owed without disclosure or amendment to its proof of claim. It is equally disturbing that in clear derogation of the Bankruptcy Code, lenders would add additional attorney's fees and charges to a loan without court approval, and again without disclosure to any interested party.

The final assault on the Bankruptcy Court is Wells Fargo's position that not only can it secretly assess a debtor's account postpetition, but it can *collect* payment on these charges, without seeking Court permission, from payments intended for the satisfaction of other court approved debt. If this position were sanctioned, the Court could never be certain that implementation of a plan would be in accordance with its terms. Depending on how much and how often the lender syphoned off funds, payable under a confirmed plan for other purposes, a debtor might or might not satisfy the obligations contemplated by his or her plan. To allow such a practice is to eviscerate the provisions of the automatic stay and this Court's power to protect Debtor and property of the estate.[73]

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[73] *In re Rathe*, 114 B.R. 253 (Bank. D. Idaho 1990)(Creditor may not apply plan or direct payments other than as set forth in the confirmed plan. Application of payments to post confirmation charges without court permission constitutes a collateral attack on the order of confirmation).

Wells Fargo's position challenges the Court's authority to seek reimbursement of sums clearly not due (illegally assessed interest and Sheriff's commissions), as well as sums not authorized (postpetition attorney's fees), those not reasonably owed (inspection fees), and those as yet unexplained (statutory fees). The Court has already addressed the merits of Wells Fargo's charges. The Court, may recover property of the estate[74] and sanction those that appear before it for violations of its orders.[75] Wells Fargo has violated the automatic stay and defiantly refused to return funds which it has no right to hold.

III. Insurance Escrow

As a final note, Wells Fargo included in its accounting the details of an insurance escrow it maintained for Debtor's benefit. Following Hurricane Katrina and prior to the payoff, Wells Fargo received insurance proceeds as a result of damages to Debtor's home. These proceeds were placed in a separate insurance escrow and disbursed to Debtor as repairs were made. The Court notes that according to Wells Fargo's accounting, $68.06 remains owing to Debtor on this account and should be immediately disbursed.[76]

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[74] *See, U.S. v. Whiting Pools, Inc.*, 462 U.S. 198, 103 S. Ct. 2309, 76 L. Ed. 2d. 515 (1983)(ordering IRS to turn over seized property determined to be property of estate); *Matter of Wischan*, 77 F.3d 875 (5th Cir. 1996); *see also*, 11 U.S.C. §§ 105(a), 541, 542(a), and 1306.

[75] *See, Matter of Terrebonne Fuel & Lube, Inc.*, 108 F.3d 609 (5th Cir. 1997); *see also, In re Hardy*, 97 F.3d 1384 (11th Cir. 1996); *In re Rainbow Magazine, Inc.*, 77 F.3d 278 (9th Cir. 1996); *In re Power Recovery Systems, Inc.*, 950 F.2d 798 (1st Cir. 1991); *In re Skinner*, 917 F.2d 444 (10th Cir. 1990); *In re Walters*, 868 F.2d 665 (4th Cir. 1989). *In re Mooney* 340 B.R. 351, 360 (Bankr. E.D. Tex. 2006), *In re Cherry*, 247 B.R. 176 (Bankr. E.D. Va. 2000).

[76] See Exhibit "D."

IV. Conclusion

For the above stated reasons, this Court determines that the amount owed by Debtor on the loan as of January 4, 2006, was $207,013.32[77]and that the collection of $231,463.97 from Debtor at the closing of his refinancing was substantially in excess of the sums due. As a result, Wells Fargo owed Debtor the full sum of $24,450.65 as of January 4, 2006. Since $7,598.64 was returned on April 20, 2006, a remaining balance of $16,852.01 is still outstanding and due to Debtor. For the reasons set forth above, Wells Fargo will be ordered to return the sum of $16,852.01 in accordance with this Opinion. The amounts due will bear interest at the legal rate from date of judicial demand until paid in full.[78]

Debtor's request for damages incurred as a loss of personal time are denied because he did not prove at trial that he suffered any monetary loss as a result of the time he spent working.[79] Although Debtor testified that he spent nights and weekends working on this matter, there was no testimony that he missed work or incurred a loss of income due to the time he spent.

However, since the collection of these sums was far in excess of the amounts reasonably necessary to satisfy this loan; Wells Fargo collected both pre and postpetition charges from property of the estate without authorization and in contravention of several court orders including, but not limited to, the automatic stay imposed by 11 U.S.C. §362 and the Order confirming Debtor's plan

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[77] The payoff is calculated by taking $211,222.39 in principal, deducting a positive escrow balance of $8,638.51 and adding accrued and unpaid interest of $2,178.23 for the month of December, 2005. To this sum is added the amounts remaining on the prepetition arrearage of $2,251.21 for a total of $207,013.32.

[78] *See, e.g., In re Henry*, 266 B.R. 457, 480 (Bankr. C.D.Cal. 2001)(Awarding interest in addition to compensatory damages under 362(h)). Legal interest will be charged on the $7,598.64 from March 30, 2006 until paid on April 20, 2006. Legal interest will be charged on the remaining judgment from March 30, 2006 until paid in full.

[79] *See, In re Riser*, 298 B.R. 469 (Bankr. M.D. Fla. 2003).

of reorganization; Wells Fargo delayed returning Debtor's property for over one year; failed to provide a reasonable accounting of the loan history from which the correct amounts due could have been ascertained; and improperly applied payments from the Trustee and Debtor resulting in significant additional and unwarranted interest charges; this Court will consider an award for sanctions for violation of the automatic stay and its Order of confirmation at a separate hearing.

New Orleans, Louisiana, April 13, 2007.

Hon. Elizabeth W. Magner
U.S. Bankruptcy Judge

Exhibit "A"

Pre-Petition Debt Calculation

Date Applied	Description	Amount	Principal	Interest	Escrow	Late Charge	Other Fees	Principal Forward
4/12/2001	Initial Escrow Deposit	$863.71			$863.71			$215,200.00
5/15/2001	Payment 5/01/01	$2,560.42	$56.64	$2,219.25 [A]	$284.53			$215,143.36
6/15/2001	Payment 6/01/01	$2,560.42	$57.22	$2,218.67	$284.53			$215,086.14
7/13/2001	Payment 7/01/01	$2,560.42	$57.81	$2,218.08	$284.53			$215,028.33
8/16/2001	Late Charge 8/01/01					$113.79		
9/19/2001	Late Charge 9/01/01					$113.79		
9/20/2001	Payment - Escrow	$744.00			$744.00			
10/3/2001	Hazard Insurance Premium				($64.00)			
10/16/2001	Late Charge 10/01/01					$113.79		
11/16/2001	Late Charge 11/01/01					$113.79		
11/20/2001	Hazard Insurance Premium				($1,128.00)			
12/4/2001	Attorney's Fee						$125.00	
12/5/2001	Inspection Fee						$30.00	
12/5/2001	NSF Charge						$25.00 [B]	
12/5/2001	Payment 08/01/01	$13,312.26	$58.41	$2,217.48	$284.53	($455.16)	($55.00)	$214,969.92
	Payment 09/01/01		$59.01	$2,216.88	$284.53			$214,910.91
	Payment 10/01/01		$59.62	$2,216.27	$284.53			$214,851.29
	Payment 11/01/01		$60.24	$2,215.65	$284.53			$214,791.05
	Payment 12/01/01		$60.86	$2,215.03	$284.53			$214,730.19
12/7/2001	Property Taxes Paid				($2,241.90)			
1/16/2002	Late Charge 1/01/02					$113.79		
1/17/2002	Payment 1/1/02	$2,560.42	$61.48	$2,214.41	$284.53			$214,668.71
2/16/2002	Late Charge 2/01/02					$113.79		
2/25/2002	Payment 2/01/02	$2,560.42	$62.12	$2,213.77	$284.53			$214,606.59
3/18/2002	Late Charge 3/01/02					$113.79		
3/19/2002	Attorney's Fee						$775.00	
3/19/2002	Title Policy						$300.00	
4/16/2002	Late Charge 4/01/02					$113.79		
4/18/2002	Hazard Insuance Refund				$10.00			
5/16/2002	Late Charge 5/01/02					$113.79		
6/5/2002	Broker's Price Opinion						$125.00	
6/27/2002	Payment 3/01/02	$12,372.04	$62.76	$2,213.13	$284.53	($568.95)	($3,438.54)	$214,543.83
	Payment 4/01/02		$63.41	$2,212.48	$284.53			$214,480.42
	Payment 5/01/02		$64.06	$2,211.83	$284.53			$214,416.03
	Excess to Escrow				$683.29			
7/10/2002	Title Policy						$244.54	

Exhibit "A"

Pre-Petition Debt Calculation

Date Applied	Description	Amount	Principal	Interest	Escrow	Late Charge	Other Fees	Principal Forward
7/10/2002	Foreclosure Fee						$350.00	
7/10/2002	Sheriff's Commission						$619.00	
7/10/2002	Attorney's Fee						$900.00	
7/16/2002	Late Charge 6/1/02					$113.79		
7/26/2002	Late Charge 7/1/02					$113.79		
8/13/2002	Hazard Insurance Premium				($1,314.00)			
8/16/2002	Late Charge 8/1/02					$113.77		
8/23/2002	NSF Fee Paid from Escrow				($25.00)		($25.00)	
8/23/2002	Late Charges Paid fromEscrow				($341.37)	($341.37)		
							$25.00 C	
9/16/2002	Late Charge 9/1/02					$113.79		
10/16/2002	Late Charge 10/1/02					$113.79		
11/18/2002	Late Charge 11/1/02					$113.79		
12/13/2002	Property Taxes Paid				($2,269.04)			
12/16/2002	Late Charge 12/1/02					$113.79		$214,351.64
12/31/2002	Payment 6/1/02	$19,056.33	$64.72	$2,211.17	$285.94			$214,286.25
	Payment 7/1/02		$65.39	$2,210.50	$285.94			$214,220.19
	Payment 8/1/02		$66.06	$2,209.83	$285.94			$214,153.45
	Payment 9/1/02		$66.74	$2,209.15	$285.94			$214,086.02
	Payment 10/1/02		$67.43	$2,208.46	$285.94			$214,017.89
	Payment 11/1/02		$68.13	$2,207.76	$285.94			$213,949.06
	Payment 12/1/02		$68.83	$2,207.06	$285.94			
	Excess to Escrow				$668.36			
1/1/2003	Foreclosure Broker's Price Opinion						$125.00	
1/16/2003	Late Charge 1/1/03					$113.79		
1/22/2003	Escrow Returned to Borrower				($451.43)			
2/18/2003	Late Charge 2/1/03					$113.79		
3/3/2003	Insection Fee						$15.00	
3/13/2003	Inspection Fee Paid	$15.00					($15.00)	
3/17/2003	Late Charge 3/1/03					$113.79		
4/16/2003	Late Charge 4/1/03					$113.79		
5/16/2003	Late Charge 5/1/03					$91.97		
6/16/2003	Late Charge 6/1/03					$91.97		
6/26/2003	Broker's Price Opinion						$125.00	
7/8/2003	Inspection Fee						$15.00	

Exhibit "A"

Pre-Petition Debt Calculation

Date Applied	Description	Amount	Principal	Interest	Escrow	Late Charge	Other Fees	Principal Forward
7/16/2003	Inspection Fee						$15.00	
7/16/2003	Late Charge 7/1/03					$91.97		
8/12/2003	Inspection Fee						$15.00	
8/16/2003	Late Charge 8/1/03					$91.97		
8/26/2003	Hazard Insurance Premium				($1,372.00)			
					($546.94)	**$823.04**	**$310.00**[D]	**$213,949.06**
	Footnotes							
A	Interest Rate 12.375%.							
B	Debtor's payment received 8/31/01 NSF, not included in accounting							
C	Debtor's payment received 7/15/02 NSF, not included in accounting							
D	Broker's Price Opinion charges outstanding: $250.00, Inspection fees outstanding: $60.00							

Exhibit "B"

Post Petition Arrearage Balance

	Past Due Interest Payments 1/03 - 4/03 [A]	$8,825.40	
	Past Due Interest Payments 5/03 - 8/03 [B]	$6,864.20	
	Foreclosure Attorney's Fee	$750.00[C]	
	Costs - Foreclosure (Actual)	$743.87	
	Inspection Fees	$60.00	
	Broker's Price Opinion	$250.00	
	Escrow Balance	$546.94	
	Late Charges	$823.04	
		$18,863.45	
Date	Description		
11/7/2003	Trustee Payment	($857.81)	
12/11/2003	Trustee Payment	($1,615.47)	
1/15/2004	Trustee Payment	($126.40)	
2/10/2004	Trustee Payment	($25.89)	
6/10/2004	Trustee Payment	($1,767.42)	
7/11/2004	Trustee Payment	($1,408.72)	
9/10/2004	Trustee Payment	($1,378.17)	
10/12/2004	Trustee Payment	($881.33)	
11/1/2004	Trustee Payment	($1,160.76)	
12/13/2004	Trustee Payment	($874.15)	
2/9/2005	Trustee Payment	($1,164.24)	
4/12/2005	Trustee Payment	($818.32)	
5/9/2005	Trustee Payment	($818.32)	
6/8/2005	Trustee Payment	($818.32)	
7/13/2005	Trustee Payment	($818.32)	
11/2/2005	Trustee Payment	($1,236.64)	
1/3/2006	Trustee Payment	($1,854.96)	
	Total Payments	$16,612.24	
	Balance Due	$2,251.21	
	Footnotes		
A	Interest rate applied, 12.375%, on principal balance of $213,949.06.		
B	Interest rate applied, 9.625%, on principal balance of $213,949.06.		
C	Not reflected on pre-petition accounting. Identified as post petition bankruptcy legal fees but explained at trial as foreclosure fees		

Exhibit "C"

Post Petition Debt Calculation

Date Applied	Description	Amount	Principal [A]	Interest [B]	Escrow [C]	Mendoza Suspense [D]	Mendoza [E]	Principal Forward [F]
8/26/2003	Filing Date							
8/26/2003	Principal Balance Forward							$213,949.06
1/21/2003	Payment 9/1/03	$2,142.78	$69.54	$1,716.05 [G]	$357.19			$213,879.52
12/31/2003	Payment 10/1/03	$4,247.54	$70.26	$1,715.49	$338.02			$213,809.26
12/31/2003	Payment 11/1/03		$70.79	$1,692.66 [H]	$360.32			$213,738.47
12/31/2003	Payment 12/1/03		$70.98	$1,692.10	$414.46			$213,667.49
5/17/2004	Consent Order Sum Payments 1/1/04 - 4/1/04						$9348.22 [I]	$213,667.49
5/25/2004	Mendoza Payment	$4,355.08					($4,355.08)	$213,667.49
	Payment 1/1/04		$71.71	$1,691.53	$360.53			$213,595.78
	Payment 2/1/04		$125.58	$1,690.97	$307.22	$107.54		$213,470.20
5/25/2003	Mendoza Payment	$123.77				$123.77		$213,470.20
5/17/2004	Payment 5/1/04	$3,000.00	$126.58	$1,667.74 [J]	$310.66	$895.02	($895.02)	$213,343.62
6/16/2004	Payment 6/1/04	$2,811.45	$127.60	$1,666.75	$310.63	$706.47	($706.47)	$213,216.02
7/15/2004	Payment 7/1/04	$2,967.61	$128.62	$1,665.75	$310.61	$862.63	($862.63)	$213,087.40
	Payment Applied from Mendoza Suspense to 3/1/04 Payment		$129.65	$1,664.75 [K]	$329.37	($2,123.77)		$212,957.75
7/30/2004	Payment	$239.58				$239.58		$212,957.75
8/13/2004	Hazard Insurance Premium				($1,458.00)			$212,957.75
8/16/2004	Payment 8/1/04	$3,111.36	$130.69	$1,663.73	$310.56	$1,006.38	($1,006.38)	$212,827.06
9/14/2004	Payment 9/1/04	$3,111.36	$134.91	$1,662.71	$307.36	$1,006.38	($1,006.38)	$212,692.15
	Payment Applied from Mendoza Suspense to 4/1/04 Payment		$135.98	$1,683.81 [L]	$303.98	($2,123.77)		$212,556.17
	Attorney's fees and charges					($700.23) [M]	($700.23) [N]	$212,556.17
10/19/2004	Payment 10/1/04	$3,111.36	$137.05	$1,660.60	$1,160.79		($152.91) [O]	$212,419.12
11/16/2004	Payment 11/1/04	$2,279.17	$79.90	$1,836.54 [P]	$362.73			$212,339.22
12/16/2004	Payment 12/1/04	$2,429.86	$80.72	$1,835.84	$513.30			$212,258.50
1/19/2005	Payment 1/1/05	$2,559.14	$81.55	$1,835.15	$642.44			$212,176.95
2/15/2005	Payment 2/1/05	$2,557.14	$82.40	$1,834.45	$640.29			$212,094.55
3/15/2005	Payment 3/1/05	$2,557.14	$83.24	$1,833.73	$640.17			$212,011.31
4/15/2005	Payment 4/1/05	$2,557.14	$84.10	$1,833.01	$640.03			$211,927.21
5/16/2005	Payment 5/1/05	$2,748.07	$84.97	$2,185.50 [Q]	$477.60			$211,842.24
6/15/2005	Payment 6/1/05	$2,610.22	$85.85	$2,184.62	$339.75			$211,756.39
7/18/2005	Payment 7/1/05	$2,610.22	$86.73	$2,183.74	$339.75			$211,669.66

Exhibit "C"

Post Petition Debt Calculation

Date Applied	Description	Amount	Principal	Interest	Escrow	Mendoza Suspense	Mendoza	Principal Forward
8/12/2005	Payment 8/1/05	$2,610.22	$87.63	$2,182.84	$339.75			$211,582.03
8/17/2005	Hazard Insurance Premium				($1,680.00)			$211,582.03
10/10/2005	Payment 9/1/05	$2,610.22	$88.53	$2,181.94	$339.75			$211,493.50
10/28/2005	Payment 10/1/05	$2,610.22	$89.44	$2,181.03	$339.75			$211,404.06
11/30/2005	Payment 11/1/05	$2,610.22	$90.37	$2,180.10 R	$339.75			$211,313.69
12/15/2005	Payment 12/1/05	$2,610.22	$91.30	$2,179.17	$339.75			$211,222.39
					$8,638.51	**$0.00**	**$0.00**	**$211,222.39**
	Footnotes							

A.	Principal reductions are allocated from each post petition direct pay installment applied based on the amounts allocated by Wells Fargo in its accounting chronologically from the petition date forward. For example, on Exhibit 8, Wells Fargo deducted $69.54 from the first post petition installment payment Wells Fargo received from Debtor. On the second installment, $70.26 was allocated to principal.
B.	Interest is calculated based on the prevailing rate at the time the post petition installment accrued multiplied by the principal balance outstanding at the time of payment and divided by 12. For example, the installment due on 9/1/03 bears interest at the rate of 9.625% which when multiplied by the beginning principal balance of $213,949.06 and divided by 12 gives the monthly interest due, $1,716.05. Payments applied based on the Consent Order are calculated at the applicable interest rate at the time the payment became contractually due.
C.	The portion of installment payments added to the escrow account is equal to the amount paid less amounts allocated to principal and interest. For example, the payment received on 10/21/03 in the amount of $2,142.78 required principal and interest allocations of 1,785.59 leaving $357.19 to be deposited into escrow.
D.	The Consent Order Suspense Account contains additional payments made by the Debtor post petition in excess of that contractually due for the month in which payment is made, but insufficient to satisfy a past due post petition installment owed under the Consent Order. For example, on 5/25/04, Debtor paid $4,355.08 on the total Consent Order Sum of $9,348.22. The Consent Order is composed of 4 installment payments due from January, 2004-April, 2004 in the amount of $2,123.77. From the $4,355.08 paid, 2 installments can be satisfied leaving a residual balance of $107.54. That sum is added into the suspense account pending receipt of additional payments and later application to the amounts owed.
E.	The Consent Order Account contains the amounts authorized by the Consent Order less payments received from Debtor towards its satisfaction.
F.	The Principal Balance Forward Column reflects a running total of principal due on the post petition debt.
G.	Interest is calculated at 9.625%.
H.	Interest is calculated at 9.5%
I.	Amounts due under the Consent Order.
J.	Interest is calculated at 9.375%. The contractual installment amount for May, 2004 was noticed

Exhibit "C"

Post Petition Debt Calculation

	by Wells Fargo to be $2,104.98. Therefore after paying the installment from the $3,000.00 received from Debtor, $895.02 was placed into the Consent Order Suspense Account.
K.	A payment on the post petition past due installment for March of 2004 was applied based on sufficient sums having accrued in the Consent Order Suspense Account. Interest was calculated based on a 9.375% in effect in March of 2004 multiplied by the outstanding principal balance due at the time payment was applied, $213,087.40.
L.	A payment on the post petition past due installment for April of 2004 was applied based on sufficient sums having accrued in the Consent Order Suspense Account. Interest was calculated based on a 9.375% in effect in April of 2004 multiplied by the outstanding principal balance due at the time payment was applied, $212,692.15.
M.	Attorney's fees and costs of $650.00 were satisfied based on sufficient sums having accrued in the Consent Order Suspense Account. Additional, unidentified charges were also paid of $50.23 to clear out the Consent Order Suspense Account.
N.	Attorneys fees and costs were allowed under the Consent Order in the amount of $650.00. However, the Consent Order Sum does not equal the sum of 4 installment payments ($2,123.77 x 4 = $8,495.08) and $650.00 ($9,145.08). Therefore this column contains not only the $650.00 in itemized fees and costs but an additional $203.14 in unaccounted for sums.
O.	Additional, unidentified charges were paid of $152.91 to clear out the Consent Order Account. With this payment, Debtor completed the repayment of the Consent Order Sum.
P.	Interest is calculated at 10.375%.
Q.	Interest is calculated at 12.375%.
R.	Interest is calculated at 12.375%.

Exhibit "D"

Insurance Escrow

Date		
10/4/2005	Deposit	$35,175.99
12/2/2005	Remittance	($11,725.33)
12/6/2005	Deposit	$32,791.76
12/16/2005	Remittance	($10,930.59)
12/30/2005	Interest Paid	$68.06
2/3/2006	Remittance	($45,311.83)
2/3/2006	Interest Paid	$84.42
2/3/2006	Interest Remitted	($84.42)
	Balance Due	**$68.06**

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF LOUISIANA

IN RE:	(	**NO. 03-16518, SECTION A**
	(	
MICHAEL L. JONES	(	**CHAPTER 13**
DEBTOR	(	
	(	
MICHAEL L. JONES	(	**ADVERSARY PROCEEDING**
PLAINTIFF	(	
	(	**CASE NO. 06-01093**
VERSUS	(	
	(	
WELLS FARGO HOME MORTGAGE	(	
DEFENDANT	(	

SUPPLEMENTAL MEMORANDUM OPINION

A trial on the merits was conducted on January 5, 2007. At the conclusion of the trial, the parties requested and were granted time to file post-trial briefs, after which the Court took the matter under advisement.

On April 13, 2007, this Court rendered a partial judgment on the merits of the Complaint ("Partial Judgment"). In the Partial Judgment, the Court reserved for later determination, the claims of Michael L. Jones ("Debtor") against Wells Fargo Home Mortgage ("Wells Fargo") seeking damages and sanctions.[1] The Court directed Debtor's counsel to submit, prior to the hearing on Debtor's request for sanctions and damages, an affidavit of legal fees and costs incurred in connection with the proceeding. Counsel were given the opportunity to brief the issues, and a hearing on Debtor's request for sanctions and damages was held on May 29, 2007.

On May 10, 2007, Wells Fargo filed a Notice of Appeal of the Partial Judgment ("Notice of Appeal").

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[1] April 13, 2007, Judgment (P-68) and Memorandum Opinion (P-69).

Subject Matter Jurisdiction

Debtor's request for sanctions and damages is based on allegations, which this Court has previously found to be true, of Wells Fargo's willful violation of the automatic stay[2] and the confirmation order entered in this case. Wells Fargo begins its defense by averring that subject matter jurisdiction is lacking as a result of its appeal of the Partial Judgment.

At the trial on the merits, both parties requested that the presentation of evidence on the amount of damages incurred or the availability of sanctions be deferred. The Court granted the request, severing for later determination the appropriateness of assessing sanctions and awarding damages .[3] Upon finding that a violation of the automatic stay had occurred, the Partial Judgment directed Debtor to file an affidavit itemizing all fees and costs incurred in connection with the stay violation. The Partial Judgment also set forth a schedule for additional briefing on the issue and set an evidentiary hearing.

Prior to the final hearing on this matter, Wells Fargo filed its Notice of Appeal. Upon the filing of the Notice of Appeal, Debtor filed a Motion for Sanctions,[4] separate and apart from the request already pending in its Complaint. Both were heard on May 29, 2007.[5]

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[2] Imposed pursuant to 11 U.S.C. § 362.

[3] Trial Transcript, January 5, 2007. 127:3-128:6.

[4] Filed April 25, 2007 (P-77).

[5] The original hearing was continued at the request of Wells Fargo in order to accommodate the availability of witnesses. This Supplemental Memorandum Opinion was further delayed at the request of the parties while settlement negotiations were explored. Having tried unsuccessfully to amicably resolve their differences, the parties informed the Court that a judicial decision would be required.

In response to the Motion for Sanctions, as well as in its memorandum on the severed issues, Wells Fargo avers that the Notice of Appeal deprives this Court of subject matter jurisdiction over any determination as to the amount of damages or sanctions available.[6]

The Bankruptcy Code requires the entry of a final judgment before an appeal may be lodged unless the district court grants leave to appeal an interlocutory order.[7] In *In re Morrell*, 880 F.2d 855 (5th Cir. 1989), the Fifth Circuit held that a civil contempt order is not "final" for purposes of appeal unless two actions occur: (1) a finding of contempt is issued, and (2) an appropriate sanction is imposed.[8]

> Determinations of liability without an assessment of damages are as likely to cause duplicative litigation in bankruptcy as they are in civil litigation, and because bankruptcy litigants may appeal to district as well as to appellate courts, the waste of judicial resources is likely to be greater. The rule for appeals from bankruptcy decisions determining liability but not damages under 28 U.S.C. §158(d) must...be the same as the rule under [28 U.S.C.] §1291. *Morrell*, at 856-57.

The holding was further solidified by *In the Matter of United States Abatement Corporation,* 39 F.3d 563 (5th Cir. 1994). The facts of *Abatement* are almost directly on point. *Abatement* involved a claim against a creditor for a stay violation. After finding that the creditor's conduct violated the automatic stay, the Court ordered the debtor to file an itemization of damages, but conditioned further hearing on request of any party. The creditor filed a motion for reconsideration, followed by a notice of appeal. Thereafter, the Court granted the creditor's motion for

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[6] Trial Transcript, May 29, 2007, 18:3-21.

[7] 28 U.S.C. §158(a); *In re Moody*, 817 F.2d 365, 366 (5th Cir. 1987); *Matter of U.S. Abatement Corp.*, 39 F.3d 563, 566 (5th Cir. 1994).

[8] *In re Morrell*, 880 F.2d 855, 856-57 (5th Cir. 1989); *Abatement,* F.3d at 567.

reconsideration and vacated its previous order of contempt. The debtor appealed the vacation of the contempt order, but the district court affirmed the decision. On appeal to the Fifth Circuit, the debtor argued that the bankruptcy court lacked subject matter jurisdiction to reconsider its order of contempt because the notice of appeal of the order was already on file. In recognizing the jurisdiction of the bankruptcy court, the Fifth Circuit noted that the order of contempt required the debtor to file an itemization of damages incurred as a result of the stay violation. It also contemplated a further hearing on damages on request of any party. As such, the order was not final as it clearly contemplated an assessment of damages in the future. Without an assessment of damages, the contempt order was merely interlocutory.[9]

The facts of this case fall squarely within the parameters of the *Morrell* and *Abatement* decisions. As such, subject matter jurisdiction continues to exist with this Court despite Wells Fargo's filing of the Notice of Appeal.

In addition to Debtor's request for sanctions and damages, Wells Fargo's willful violation of the automatic stay and the confirmation order entered in this case entitles this Court to, *sua sponte*, impose sanctions for civil contempt. Section 105(a) provides:

> The court may issue any order...or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

A bankruptcy court has the inherent authority to enforce its own orders.[10]

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[9] *Abatement* 39 F.3d at 567.

[10] *Chambers v. NASCO, Inc.*, 501 U.S. 32, 111 S.Ct. 2123, 115 L.Ed.2d 27 (1991); *In re Terrebonne Fuel & Lube, Inc.*, 108 F.3d 609, 613 (5th Cir. 1997); and *In re Hipp, Inc.*, 895 F.2d 1503, 1516 (5th Cir. 1990).

The bankruptcy court has exclusive jurisdiction over all property of the estate wherever located.[11] Upon the filing of the case, all actions to collect, enforce, or possess property of the estate are automatically enjoined.[12] Proceedings to prosecute violations of the automatic stay are core proceedings.[13] A proceeding to enforce the automatic stay by means of civil contempt is a "core proceeding" within the meaning of 28 U.S.C.A. §157 and within the scope of the bankruptcy court's powers.[14]

An order of confirmation defines the rights of the debtor and interested parties to payment post-confirmation. The provisions of a confirmed plan bind the debtor and each creditor to its terms.[15] The creditor is not entitled to collect or enforce its claims except as provided by the plan and the confirmation order. The automatic stay operates to protect property of the estate from the collection efforts on claims until the debtor is discharged or the case is dismissed.[16]

Thus, whether jurisdiction over Debtor's request for sanctions and damages was reserved or this Court, *sua sponte,* exercised its inherent powers to enforce its own orders and protect property of the estate, subject matter jurisdiction exists.

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[11] 28 U.S.C. §§1334(e) and 157(a).

[12] 11 U.S.C. §362(c)(1) and (2).

[13] *In re Hamrick,* 175 B.R. 890 (Bankr. W.D.N.C. 1994); *Divane v. A and C Elec. Co., Inc.,* 193 B.R. 856 (Bankr. N.D. Ill. 1996).

[14] 11 U.S.C. §105(a); *Better Homes of Virginia, Inc. v. Budget Service Co.,* 52 B.R. 426 (Bankr. E.D.Va. 1985) *aff'd,* 804 F.2d 289 (4th Cir. 1986).

[15] 11 U.S.C. §1327(a).

[16] *See, e.g., In re Chesnut*, 422 F.3d 298, 301 (5th Cir. 2005).

Civil Sanctions Under Section 105 and Damages Under Section 362

A. Relief Available

The authority of bankruptcy courts to issue civil sanctions has been clearly settled.[17] The source of that authority comes from the Bankruptcy Code itself, specifically section 105.[18] The authority is not limitless, however. The purpose of civil sanctions, whether monetary or nonmonetary, is to prevent an abuse of the bankruptcy process.[19]

Sanctions may include the imposition of a monetary fine, reimbursement of fees and costs to debtors' counsel, punitive damages, and other relief as the court may direct in order to enforce its orders. Nevertheless, sanctions are not designed to compensate aggrieved parties for damages sustained as a result of wrongful conduct. Nor are they a substitute for legal proceedings between litigants on the merits of their complaints.[20] While a monetary sanction may be imposed by the court, and payment can be directed to a third party, the nature of a monetary sanction is a fine or penalty.

Conversely, section 362(k) allows for the award of actual damages as a result of a stay violation. It is designed to compensate an injured party for losses sustained as a result of the defendant's conduct. In appropriate circumstances, courts may also award punitive damages.

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[17] *Matter of Terrebonne Fuel & Lube, Inc.*, 108 F.3d 609 (5th Cir. 1997); *see also, In re Hardy*, 97 F.3d 1384 (11th Cir. 1996); *In re Rainbow Magazine, Inc.*, 77 F.3d 278 (9th Cir. 1996); *In re Power Recovery Systems, Inc.*, 950 F.2d 798 (1st Cir. 1991); *In re Skinner*, 917 F.2d 444 (10th Cir. 1990); *In re Walters*, 868 F.2d 665 (4th Cir. 1989); and *In re Sanchez*, –B.R.–, 2007 WL 2137790 (Bankr. S.D.Tex. 2007).

[18] *Terrebonne*, 108 F.3d at 613.

[19] *Terrebonne, supra; Port Drum Co. v. Umphrey*, 852 F.2d 148 (5th Cir. 1988).

[20] *Elliott v. The M/V Lois B.*, 980 F.2d 1001 (5th Cir. 1993); *Port Drum, supra; Business Guides Inc., v. Chromatic Communications Enterprises, Inc.*, 121 F.R.D. 402 (N.D.Cal. 1988), *rev'd on other grounds, Business Guides, Inc. v. Chromatic Communications Enterprises, Inc.*, 892 F.2d 802 (9th Cir. 1978).

This Court has found that Wells Fargo violated the Court's order of confirmation and the statutory provisions of the Bankruptcy Code which create the automatic stay. For the reasons set forth in its previous Memorandum Opinion, both an award for damages and sanctions will be imposed against Wells Fargo for these violations.

B. Attorney's Fees and Costs

A sanction award requiring the reimbursement of a debtor's costs and attorney's fees by a party whose conduct is sanctionable is generally discretionary. However, some courts have held that compensation for the costs associated with a willful violation of the automatic stay, including attorney's fees, are mandatory under section 362(k).[21] In either case, courts maintain a great deal of discretion in reviewing and determining the appropriate amount of attorney's fees.[22]

The review begins with an examination of counsel's fee statements and the factors set out in *Johnson v. Georgia Highway Express, Inc.*[23] The relevant *Johnson* factors include a review of the time and labor incurred, the nature and complexity of the issues presented, the rate charged in relation to customary rates in the community, the experience and expertise of counsel, the extent to which the case precluded other employment, and the results obtained.

The time-sheets submitted by Debtor's counsel indicate that 350.90 attorney hours were spent on the case between February 20, 2006, and April 25, 2007.[24] The Court finds that the time spent on

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[21] 11 U.S.C. §362 (k)(1); *In re Freigo*, 149 B.R. 224 (Bankr. M.D. Fla. 1992); *In re Rameriz*, 183 B.R. 583 (9th Cir. BAP 1995).

[22] *U.S. Leather, Inc. v. H & W Partnership*, 60 F.3d 222, 229 (5th Cir. 1995)("[t]he court is limited in its discretion only by the considerations espoused in *Johnson*"), *see also, Riley v. City of Jackson, Miss.*, 99 F.3d 757, 760 (5th Cir. 1996).

[23] 488 F.2d 714, 717-19 (5th Cir. 1974).

[24] Pleading 75, filed April 25, 2007.

the case is high, but not unreasonably so. The rate charged by counsel, $175-200 per hour, is a customary rate for bankruptcy litigation. The issues involved were novel, difficult, complex, and ones of first impression in this district. As a result, the issues presented required a level of expertise in bankruptcy not generally possessed by those with general litigation skills. Although the issues were complex and the litigation of this matter was time consuming, there is no evidence before the Court to suggest that Debtor's counsel actually turned away clients due to the acceptance of this case. However, the Court notes that Debtor's counsel is a small firm, and Debtor's counsel did spend a considerable amount of time on the case.

Perhaps the most important factor concerns the results obtained. The Court entered a Partial Judgment in the amount of $16,852.01 for unreimbursed overcharges on Debtor's loan. While the amounts obtained are relatively small, particularly in relation to the fees generated, the importance of the issues settled by this litigation are significant and far reaching. The conduct of Wells Fargo is neither limited to this case nor unique to this lender. Therefore, this decision will have ramifications on many other cases pending in the district and perhaps beyond. This Court considers the litigation of this matter to have benefitted both debtors and lenders alike. It provides guidance in the post-petition administration of home mortgage loans to a degree that has heretofore been lacking. It will presumably streamline the process of review in the future for countless parties.

Debtor's counsel has submitted an affidavit of the fees and costs incurred by Debtor in connection with the representation of his interests in these proceedings. Wells Fargo has had the opportunity to submit memoranda on the subject, and the Court conducted a hearing on Debtor's request for reimbursement of fees. The Court finds that the fees and costs incurred by Debtor are high, but given the nature of the proceedings, the length of time and effort required to bring this

matter to trial, and the post-trial work required to address the substantive and procedural issues raised, not so high as to be unreasonable. Therefore, the Court will award $67,202.45 in sanctions against Wells Fargo, payable to Debtor in reimbursement for attorney's fees and costs incurred in connection with this matter.

C. Punitive Damages

The Court next turns its attention to Debtor's request for punitive damages.[25] Punitive damages are warranted when the conduct in question is willful and egregious,[26] or when the defendant acted "with actual knowledge that he was violating the federally protected right or with reckless disregard of whether he was doing so."[27] There is no question that Wells Fargo's conduct was willful. As previously decided, Wells Fargo clearly knew of Debtor's pending bankruptcy and was represented by bankruptcy counsel in this case. Wells Fargo is a sophisticated lender with thousands of claims in bankruptcy cases pending throughout the country and is familiar with the provisions of the Bankruptcy Code, particularly those regarding the automatic stay.

Wells Fargo assessed post-petition charges on a loan being paid through a plan of reorganization. However, it was not the assessment of the charges, but the conduct which followed that this Court finds sanctionable. Despite assessing post-petition charges, Wells Fargo withheld this fact from its borrower and diverted payments made by the Chapter 13 Trustee ("Trustee") and Debtor to satisfy claims not authorized by the plan or Court. Wells Fargo admitted that these actions were part of its normal course of conduct, practiced in perhaps thousands of cases. The Court finds this

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[25] Section § 362(k)(1) provides for the recovery of punitive damages.

[26] *In re Ketelsen*, 880 F.2d 990, 993 (8th Cir. 1989).

[27] *In re Sanchez*, –B.R.–, 2007 WL 2137790, at * 18 (Bankr. S.D.Tex. 2007)(citations omitted).

conduct to be egregious, Sanctions are "not merely to penalize those whose conduct may be deemed to warrant such a sanction, but to deter those who might be tempted to such conduct in the absence of such a deterrent."[28]

The imposition of monetary sanctions to reimburse Debtor for costs and legal fees incurred will not, in this Court's opinion, deter Wells Fargo from future objectionable conduct. Wells Fargo is a national lender, listed on the New York Stock Exchange, with considerable financial resources. The imposition of a $67,202.45 damage award is *de minimus*, and insufficient to act as a deterrent to future misconduct.[29]

As an alternative to the imposition of punitive monetary damages, Wells Fargo has offered to revise its practices in connection with all loans administered in the Eastern District of Louisiana. In keeping with this Court's previous Memorandum Opinion, Wells Fargo has proposed:

> 1. Upon the filing of a chapter 13 bankruptcy petition, the amounts outstanding on a debtor's loan will be divided into two new, internal administrative accounts. The first account will contain the sums to be paid under debtor's plan by the Chapter 13 Trustee; typically the pre-petition past due amounts including past due interest, costs, charges, and fees ("Account One").[30] The opening balance on Account One should

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[28] *National Hockey League v. Metropolitan Hockey Club, Inc.*, 427 U.S. 639, 643, 96 S. Ct. 2778, 2781, 49 L. Ed. 2d 747 (1976).

[29] The dollar amount of sanctions imposed against Wells Fargo in this case is considerably less than the $2,000,000 imposed against Wells Fargo's predecessor for similar conduct in *In re Slick*, Case No. 98-14378-MAM, Adv. No. 99-1136 (Bankr. S.D. Ala. May 10, 2002) (Text available at <www.alsb.uscourts.gov>). As Wells Fargo has continued with its sanctionable actions, it is apparent that even a multi-million dollar sanction is not enough of a sanction to act as a deterrent.

[30] Account One should not contain any estimated charges, for example, unpaid escrow charges on past due monthly installments. It should only contain actual deficiencies in payment. Wells Fargo may elect to carry a positive escrow balance existing on the petition date in Account Two rather than Account One in order to assist debtor's with the amortization of future property tax and insurance expenditures. If this practice is elected, it shall be noted on the proof of claim filed by Wells Fargo.

directly correlate to the amounts reflected on Wells Fargo's proof of claim. Account One will also include any amounts added by subsequent court order to the plan for payment by the Trustee during the case's administration. All payments made by the Trustee will be applied to the reduction of the amounts owed on Account One.

The second account will reflect the principal amount due on the petition date[31] ("Account Two"). No other sums should be owed on Account Two at the start of the case. Account Two will include post-petition interest accrual, post-petition property insurance or property tax expenditures, and other court authorized post-petition charges as provided in paragraph 2 below.[32] A debtor's regular monthly note payments will be posted to this account, reducing post-petition interest accrual, post-petition property and tax expenditures, and principal. The account's first posting will typically be the first installment payment due on the loan following the petition date.

Wells Fargo may maintain, post-petition, its customary records on the loan provided that the two new internal accounts shall control the loan's administration during the pendency of the case.

2. With the exception of post-petition property taxes and property insurance expenditures, Wells Fargo may provisionally accrue, but not assess or collect, any post-petition charges, fees, costs, etc.[33] allowed by the note, security agreement and state law. Post-petition property tax and insurance expenditures may be assessed against debtor's account and collected after the delivery of a ten day written notice to debtor, debtor's counsel, and the Trustee. The assessment and collection of expenditures for post-petition property inspections and taxes will not require approval of the bankruptcy court unless a written objection is filed within ten days of the notice of assessment and collection. If authorized by Wells Fargo's note, security agreement, and state law, the collection of amounts necessary to pay post-petition insurance and property tax expenditures may be made in advance through the use of escrow accounts. If escrows are utilized, Wells Fargo must give a written accounting of the amounts collected at the time it seeks to apply the escrowed funds

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[31] Typically, proofs of claim include the entire installment payments that are past due. If this is done, the principal amount reflected in the second account must be adjusted downward to accommodate the anticipated principal payments being made through the plan in order to avoid a double payment. Alternatively, the past due installments reflected in the proof of claim can be adjusted to eliminate principal. If this opinion is chosen, disclosure as to how this will affect the future amortization of debtor's loan must be provided.

[32] The posting of post-petition charges is constrained by the provisions of paragraph 2 which follows.

[33] Court approved post-petition charges other than post-petition interest, property tax or insurance expenditures will hereafter be referred to as "Post-Petition Charges."

to payment of the insurance or property tax expenditures.

As to Post-Petition Charges, annually, between January 1 and February 28 of each year during a case's administration, Wells Fargo shall file with the Court and serve upon the debtor, debtor's counsel, and the Trustee, notice of any Post-Petition Charges (which do not include property taxes or insurance), accrued in the preceding calendar year. The notice shall contain an itemization describing the charge, amount provisionally incurred, the date incurred, and if relevant, the name of the third party to whom the charge was paid. The notice will also provide a direct reference to the provisions of the note, security agreement, or state law under which Wells Fargo asserts its authority to assess each type of charge.

The notice shall also state that debtors, the Trustee, and any other interested party, shall have 30 days within which to object to any or all assessments outlined in the notice. It shall contain a statement to the effect that debtor may elect to add the charges to his plan with approval of the bankruptcy court, satisfy the charges directly outside the plan, or defer repayment until the conclusion of his case.

If no objection to the amounts provisionally assessed is filed, or if filed, upon entry of an order approving some amount of the provisional charges, Wells Fargo may submit a proposed *ex parte* order authorizing assessment of the Post-Petition Charges as set forth in its notice or as approved by the court, as applicable. However, Wells Fargo may not collect on any approved Post-Petition Charges unless the debtor voluntarily delivers payment separate and above from that due as a regular monthly installment or obtains approval of the court to modify the plan and satisfy the amounts due through periodic payments by the Trustee. If the approved Post-Petition Charges are to be paid through the modified plan, they will be added to Account One and satisfied by the Trustee. If to be paid by the debtor, they may be added to Account Two.

If no provision for payment is made by a debtor, the collection of the approved Post-Petition Charges must be deferred until the close of the case or relief from the stay is obtained.

3. If Wells Fargo does not issue a notice of Post-Petition Charges, in accordance with paragraph 2, for any given year of the case's administration, then Wells Fargo shall be prohibited from collecting or assessing any charges accrued against the debtor for that year and shall treat the debtor as fully current at the time of discharge.

4. Upon the issuance of a discharge, Wells Fargo shall adjust its permanent records to reflect the current nature of debtor's account. Provided however, that if debtor elected to defer the payment of approved Post-Petition Charges until the conclusion of the case's administration, then Wells Fargo shall be authorized to

> collect said sums in accordance with the provisions of its note, security instrument, and state law.[34]

Wells Fargo also offered to memorialize this agreement into an order of the Court, enforceable in any case pending or subsequently filed before any court in the country.[35]

The imposition of punitive awards are designed to discourage future misconduct and benefit society at large.[36] The imposition of a large monetary fine may have a deterrent effect on Wells Fargo's future dealings with this and other courts, however, more often than not, punitive damages serve to enrich the immediate plaintiff with no guarantee that society will benefit. The Court believes it to be more productive and effective to accept Wells Fargo's offer to modify its practices. The imposition of a fine or penalty may be the only means of deterring a recalcitrant litigant, but the Court is convinced that it has secured Wells Fargo's attention and that its offer to amend its practices is real.[37] As further assurance that Wells Fargo will implement the changes it has offered, the required changes will be implemented through the mechanism of a court order. This will allow this Court to monitor Wells Fargo's practices and supply the means to address any future violations. Through the Order that accompanies this Opinion, the goals of a punitive award will be realized, or if not, the

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[34] This is the Court's interpretation of Wells Fargo's offer, and not a verbatim quote of the offer.

[35] Trial Transcript, May 29, 2007. 89:13-17.

[36] *See, City of Newport v. Fact Concerts, Inc.*, 453 U.S. 247, 266-67, 101 S.Ct. 2748, 2759, 69 L.Ed.2d 616 (1981)("[punitive damages by definition are not intended to compensate the injured party, but rather to punish the tortfeasor whose wrongful action was intentional or malicious, and to deter him and others from similar extreme conduct."); Restatement (Second) of Torts § 908, cmt. b (1979) ("the purpose of punitive damages is not compensation of the plaintiff but punishment of the defendant and deterrence").

[37] National counsel for Wells Fargo, Hilary Bonial, and Kim Miller, a Vice President at Wells Fargo, appeared at the hearing on this issue and pledged to immediately implement the accounting procedures outlined above should the Court accept Wells Fargo's offer.

means to enforce those goals will be created.

The Supreme Court, in *Pacific Mutual Life Ins. Co. v. Haslip*, ruled that punitive damages awards must address both reasonableness and adequate guidance concerns to satisfy the Fourteenth Amendment's due process clause.[38] The Fifth Circuit developed a two part test to help courts determine whether the requirements set forth under *Haslip* are met: "(1) whether the circumstances of the case indicate that the award is reasonable; and (2) whether the procedure used in assessing and reviewing the award imposes a sufficiently definite and meaningful constraint on the discretion of the factfinder."[39]

The first prong, reasonableness of the award, may be determined by considering two factors: "(1) the reprehensible nature of the conduct, and (2) a significant societal interest in preventing similar conduct."[40] As explained in the Court's Memorandum Opinion entered in this case,[41] Wells Fargo's actions are reprehensible and effectively seek to undermine the operation of this Court. Additionally, this Court finds that there is a significant societal interest in preventing similar conduct for a number of reasons. First, Wells Fargo's actions are not limited to this case.[42] Furthermore, the

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[38] 499 U.S. 1, 17, 111 S.Ct. 1032, 113 L.Ed.2d 1 (1991).

[39] *Eichenseer v. Reserve Life Ins. Co.*, 934 F.2d 1377, 1981 (5th Cir. 1991).

[40] *Id., see also, In re Sanchez*, –B.R.–, 2007 WL 2137790, at * 19 (Bankr. S.D.Tex. 2007).

[41] *In re Jones*, 366 B.R. 584, 602-03 (Bankr. E.D.La. 2007).

[42] *See, In re Padilla*, 2007 WL 2264714 (Bankr. S.D.Tex. 2007)(Wells Fargo and Novastar Mortgage, Inc.); *In re Riser*, 289 B.R. 201 (Bankr. M.D.Fla. 2003); and *In re Slick*, Case No. 98-14378-MAM, Adv. No. 99-1136 (Bankr. S.D. Ala. May 10, 2002) (Text available at <www.alsb.uscourts.gov>).

problems appear to be common in the mortgage servicing industry.[43] Based upon the prevalence and seriousness of Wells Fargo's actions, the Court finds that the award in this case is very reasonable.

The second prong, procedural safeguards, exists to ensure that "there is some meaningful procedural assurance that the amount of the award is not an impulsive reaction to the wrongful conduct of the defendant."[44] While a multi-million dollar award might get the mortgage industry's attention, the Court believes that the terms of the Order will be more effective than a simple money judgment. This Order is not an impulsive reaction to Wells Fargo's conduct as it has been fashioned after much deliberation and input from the parties themselves.

Conclusion

For the reasons set forth in this Supplemental Memorandum Opinion, the Court will award $67, 202.45 in sanctions and as actual damages. The Court will also order Wells Fargo to implement and use the accounting procedures as set forth in this Supplemental Memorandum Opinion. A separate Order will be entered.

New Orleans, Louisiana, August 29, 2007.

Hon. Elizabeth W. Magner
U.S. Bankruptcy Judge

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[43] Decisions reviewed by this Court indicate that other lenders and servicers commit similar violations. *See, e.g., In re Sanchez*, –B.R.–, 2007 WL 2137790, (Bankr. S.D.Tex. 2007) (Ameriquest Mortgage Company); *In re Campbell*, 361 B.R. 831 (Bankr. S.D.Tex. 2007)(Countrywide); and *In re McCormack*, 203 B.R. 521 (Bankr. D.N.H. 1996)(Chase Manhattan Mortgage Company). *See also, In re Harris,* Case Nos. 96-10429, 00-11321 Adv. No. 99-1144 (Bankr. S.D. Ala. May 10, 2002) (Text available at <www.alsb.uscourts.gov>) (First Union Mortgage Co.).

[44] *Eichenseer*, 934 F2d at 1385.

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF LOUISIANA

IN RE:	NUMBER
DOROTHY CHASE STEWART	**07-11113** **SECTION A**
DEBTOR	CHAPTER 13

MEMORANDUM OPINION

On August 23, 2007, Debtor, Dorothy Chase Stewart ("Debtor"), filed an Objection to Wells Fargo Home Mortgage, Inc., as agent to Lehman Brothers' ("Wells Fargo") second amended claim. The proof of claim was signed by Hilary Bonial ("Bonial") of Brice, Vander Linden & Wernick, P.C. ("Brice"), national counsel to Wells Fargo. Debtor objected to the amounts claimed, demanded a payment history and support for items included in the claim described as "Other Amounts for Inspection Fees, Appraisal Fees, NSF Check Charges, and Other Charges" as well as "Pre-Petition Attorney [sic] Fees and Costs" and "Escrow Advance."

Wells Fargo filed a timely Response to the Objection ("Response") further itemizing the amounts included in the line item categories to its proof of claim. Wells Fargo listed the individual taxes and insurance payments made from Debtor's escrow account by amount and date of payment. It also attached copies of the invoices which it alleged substantiated its claim for prepetition attorneys' fees and costs. It identified property inspections, appraisal fees, title research fees, and property preservation fees as the other charges owed. These charges were itemized by type, but Wells Fargo did not supply any additional information as to the amount, date, or payee for each charge, nor did it supply copies of invoices or proof of payment for the other charges claimed.

Wells Fargo's Response also admitted that the negative escrow balance contained in its proof of claim was still under review. Specifically, Wells Fargo was not able to ascertain if the amounts claimed for escrow included a credit for the portions of the past due monthly installments attributable to escrow. Without this information, or a full history of the escrow account, Wells Fargo admitted that Debtor would not be able to verify the amounts it claimed on its proof of claim, and conversely, Wells Fargo would not be able to prove the amounts owed.

The Response was signed by Hershel C. Adcock, Jr., as local counsel to Wells Fargo. Approximately one week later, the Response was supplemented to provide a credit against the escrow account for a property tax deduction that was not owed.[1] The Response also detailed the individual past due monthly installments by date, principal, interest, and escrow portions. A schedule reflecting amounts paid into and deducted from escrow over the life of the loan was also supplied.

The initial hearing on this matter was held on September 25, 2007. Paul Rummage of the Law Offices of Paul Rummage and Herman Wessels of Dean Morris, LLP, appeared on behalf of Wells Fargo. Counsel were the third and fourth law firms to represent Wells Fargo since the inception of the case. Neither Ms. Bonial nor Mr. Adcock appeared. As of the initial hearing date, Wells Fargo still had not supplied a full loan history nor had it produced any documentation to substantiate the amounts it claimed for fees and costs, save the invoices of foreclosure counsel. At the start of the hearing, it was evident that counsel were uninformed as to the nature or amounts due on the claims filed, with one limited exception.

[1] Debtor's home is exempt from property taxes.

Herman Wessels of Dean Morris represented that after reviewing the invoices his firm had submitted to Wells Fargo in connection with the foreclosure and eviction proceedings against Debtor, errors in billing became evident. Specifically, the invoices contained a charge for a deposit forwarded to the sheriff in connection with an eviction action. When the eviction suit was dismissed, the deposit was returned to Dean Morris, and $1,800.00 should have been refunded to Wells Fargo and credited toward Debtor's account. Upon further questioning, it was also admitted by Dean Morris that a deposit might also exist in connection with the foreclosure action, but further research was necessary.

The Court continued the hearing to November 1, 2007, ordered the appearance of Ms. Bonial and Mr. Adcock at the continued hearing date, and ordered production no later than October 25, 2007, of a loan history and copies of all invoices, cancelled checks, and other evidence to support the costs, fees, and charges claimed.

On October 24, 2007, Wells Fargo filed a request for an extension of the deadline to produce the documentation and accounting. The request for extension was considered at the hearing on November 1, 2007, during which the Debtor painstakingly identified the additional information needed, or explanations required, to review the accounting Wells Fargo supplied. Wells Fargo was instructed to bring to the next hearing a representative with personal knowledge of this loan as well as Wells Fargo's administrative policies. It was also ordered to provide documentation from the sheriff regarding the amounts charged in connection with the foreclosure. Wells Fargo committed to verify the amounts claimed in connection with the escrow account and to reconcile the amounts claimed on proofs of claim filed in previous cases against its loan history. The Court also ordered the production of any notices delivered to Debtor regarding 1) changes in her adjustable interest rate

or escrow account; or 2) the imposition of fees, costs, or charges against her account.

At the second continued hearing on December 4, 2007, Hilary Bonial and Paul Rumage appeared on behalf of Wells Fargo with Kimberly Miller, Vice President in charge of Bankruptcy, Foreclosure, and the Litigation Management Department ("Bankruptcy Dept.").

Jurisdiction

This Court has jurisdiction pursuant to 11 U.S.C. §§ 501 and 502 and Fed R. Bankr. P 3001, 3002, and 3007; this is a core proceeding under 28 U.S.C. § 157(b)(2)(B).

Facts

Debtor, along with her now deceased husband William Chase, Jr., obtained a loan from Norwest Mortgage, Inc., in 1999. The loan is secured by a mortgage on her home and the debt is currently being serviced by Wells Fargo, as agent for Lehman Brothers, the assignee of Norwest Mortgage, Inc.

The current bankruptcy was filed on June 12, 2007; it is the third bankruptcy filed by the Debtor or her deceased husband. The first bankruptcy was filed by William Chase, Jr.,[2] on January 11, 2002, and dismissed on January 29, 2004, for failure to make payments to the trustee. The second bankruptcy was filed *pro se* on April 20, 2004, and dismissed on July 26, 2005, for failure to make payments to the trustee. In this case, Debtor is represented by counsel.

Wells Fargo has filed three proofs of claim in this case. The first, filed on July 12, 2007, listed $33,641.80 in past due sums accruing prepetition. On August 20, 2007, Wells Fargo amended its original claim to add two additional past due monthly installments for July and August 2007.

[2] Although William Chase, Jr., filed the first bankruptcy individually, in an attempt to reduce confusion, the Court will often refer to the Debtor when discussing the details of that bankruptcy.

Technically, these installments accrued postpetition and should not have been added to the prepetition amounts itemized by Wells Fargo.

Wells Fargo itemized its past due balance:

Total Arrearage as of August 31, 2007

●Regular Monthly Installments July 1, 2004, through August 31, 2007	$26,582.67
●Late Charges	776.44
●Pre-petition Attorney Fees and Costs	6,663.96
●Other pre-petition fees, expenses and charges as reflected in 1A above	1,013.75
●Interest accruing at the contract rate of 10.38% on pre-petition arrearage if allowed by 11 U.S.C. §1322(e)	(0.00)
	$35,036.82

The proofs of claim were all signed by Bonial as Wells Fargo's authorized agent. They all bear the following assertion:

> Please be advised that reasonable fees and costs for the review of the bankruptcy pleadings, review of client information, preparation and filing of the Proof of Claim will be charged to the lender/servicer for post-petition services rendered subsequent to the filing of this bankruptcy matter. Further, note that future fees and costs for bankruptcy related services are expected to accrue throughout the life of this bankruptcy case, and will be charged to the lender/servicer. If such fees and costs or charges are not paid through the bankruptcy, the lender reserves the right, at the lender's discretion, to seek future reimbursement for the fees, costs and charges related to services rendered and expenses incurred pursuant to the terms provided for in the underlying security instrument, the bankruptcy code and other applicable law.[3]

[3] This language was further amended on September 9, 2007.

Loan Documents

Debtor's note requires monthly payments of principal and interest sufficient to amortize her original principal balance of $61,200.00 over 30 years ("Note").[4] During the first three (3) years of the Note, the interest rate was 10.375% per annum. On the third anniversary of the Note's execution, and every year thereafter, the interest rate is subject to adjustment by adding 7% to the average weekly yield on United States Treasury Securities adjusted to a constant security of one year. Monthly payments are due on the first day of the month and considered late after the fifteenth day.

If full payment of principal and interest is not received on time, the Note provides that the holder may assess a late charge equal to 5% of the past due principal or interest outstanding. The Note states that only one late charge may be assessed on each late payment.[5]

The Note is secured by the mortgage encumbering Debtor's home ("Mortgage"). Both the Note and Mortgage allow, as a reimbursable expense, up to 25% of the sums due as attorney's fees.[6]

The lender did not initially establish an escrow account for the payment of insurance premiums and property taxes incurred in connection with the property securing this loan. Debtor is elderly and the assessed value of her home is exempt from property taxes due to the homestead exemption and her age. Insurance was initially acquired and paid for by Debtor outside of the loan. The Mortgage provides that if the lender advances money for the payment of insurance premiums or property taxes on behalf of the borrower, then those amounts are immediately reimbursable, or

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[4] Exh. C. Note.

[5] Exh. C, Note ¶ 7(A).

[6] Exh. C, Note ¶ 7(E); Mortgage, ¶ 21.

at the lender's sole discretion, may be repaid in twelve monthly installments.[7]

The Mortgage also authorizes lender's collection, on a monthly basis, of the amounts it reasonably estimates will be necessary to satisfy future property tax or insurance premium demands. It allows the lender to assess and hold the maximum sum provided by 12 U.S.C. §2603, *et. seq.*, ("RESPA").[8]

The Mortgage allows Wells Fargo to make reasonable entries upon and inspections of the property. However, the Mortgage also provides that Wells Fargo "*shall* give Borrower notice at the time of or prior to an inspection specifying *reasonable* cause for the inspection."[9] Finally, the Mortgage requires that "[a]ny notice to Borrower provided for in this Security Instrument shall be given by delivering it or by mailing it by first class mail unless applicable law requires use of another method."[10]

The Mortgage also provides that if Debtor fails to perform under the terms of the loan documents, Wells Fargo may:

> ...do and pay for whatever is necessary to protect the value of the Property and Lender's rights in the Property. Lender's actions may include . . . paying reasonable attorney's fees . . . Any amounts disbursed by Lender under this paragraph 7 shall become additional debt of Borrower secured by this Security Instrument. Unless Borrower and Lender agree to other terms of payment, these amounts shall bear interest from the date of disbursement at the Note rate and shall be payable, with interest, *upon notice* from Lender to Borrower requesting payment.[11]

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[7] Exh. C, Mortgage ¶ 2.

[8] Exh. C, Mortgage ¶ 2. The provisions set forth in 12 U.S.C. § 2603, *et. seq.*, are also known as the Real Estate Settlement Procedures Act, or RESPA.

[9] Exh. C, Mortgage ¶ 9, emphasis added.

[10] Exh. C, Mortgage ¶ 14.

[11] Exh. C, Mortgage ¶ 7, emphasis added.

The order of application of payments collected under the Note is set forth in the Mortgage. The Mortgage provides that payments will be applied to: 1) prepayment charges; 2) funds necessary to satisfy property taxes or insurance premiums; 3) accrued interest; 4) accrued principal; and finally, 5) late charges.[12] The Note does not address how attorneys fees, costs, or fees other than late fees, property taxes, or insurance charges are to be satisfied.

Specific provisions control over the general terms of an agreement.[13] Because the Mortgage specifically requires that any payment received must first be applied to satisfy outstanding escrow charges, accrued interest, accrued principal and late charges, in that order, the Court finds that these obligations must be satisfied prior to the satisfaction of any additional sums incurred in connection with protecting the property or enforcing the terms of the Note.

The Note and Mortgage are governed by Louisiana law, which provides that attorney's fees and charges may be contractually authorized, but even if contractually allowed their assessment must be reasonable.[14]

Based on the law and analysis set forth below, the Court has applied the payments received on this debt and in accordance with the terms of the Note and Mortgage. It has also allowed or disallowed various charges, costs, or fees based on the terms of the Note and Mortgage; the accounting, testimony, and documentation supplied by Wells Fargo; Louisiana Law; and RESPA. The new loan history is reflected as Table I, attached to this Memorandum Opinion. The payments,

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[12] Exh. C, Mortgage ¶ 3.

[13] *See, e.g., Godchaux v. Conveying Techniques, Inc.*, 846 F.2d 306, 314 n.17 (5th Cir. 1988); *Carpenters Amended and Restated Health Ben. Find v. Holleman Const. Co. Inc.*, 751 F.2d 763, 766 (5th Cir. 1985); *Weingarten Realty Investors v. Albertson's Inc.*, 66 F.Supp.2d 825, 839 (S.D.Tex. 1999).

[14] *See, Central Progressive Bank v Bradley*, 502 So.2d 1017 (La. 1987); *Wuertz v Tobias*, 512 So.2d 1209 (La. App. 5th Cir. 1987); and *City of Baton Rouge v Stauffer Chemical Company*, 500 So.2d 397 (La. 1987).

costs, fees, and charges reflected on Table I are incorporated into this Memorandum Opinion as findings of fact.

Law and Analysis

In this case, Debtor claims Wells Fargo abused its discretion when it imposed the fees, costs, and charges against her account. It, therefore, becomes necessary to examine what, when, how and why any particular charge, fee, or cost is assessed. In order to evaluate Debtor's claims, some background regarding the administrative practices of Wells Fargo is necessary.[15]

Loan Administration

Ms. Miller explained that Wells Fargo administers 7.7 million home mortgage loans.[16] The management or administration of these loans is accomplished through several computer software packages, some owned by Wells Fargo, some licensed from third party vendors. Entries on the loan account are tracked with a licensed computer software platform commonly known as Fidelity Mortgage Servicing Package or Fidelity MSP. Fidelity MSP provides extremely sophisticated computer software for the management of home mortgage loans and is one of the largest providers of this service nationally. When a payment is received on a mortgage loan, it is entered into the Fidelity MSP system and then deposited. Fidelity MSP applies the payment to a borrower's account; in this case, satisfying outstanding fees and costs first.

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[15] A properly filed proof of claim constitutes *prima facie* evidence of the claim's validity and amount. An objecting party must present sufficient evidence to overcome the *prima facie* effect of the claim. If the objecting party succeeds, the creditor must prove the validity of the claim. *See, Matter of O'Connor*, 153 F.3d 258, 260 (5th Cir. 1998) and Bankruptcy Rule 3001. Wells Fargo admitted at the September 25, 2007, hearing that there were errors in its proof of claim. In addition, the Court finds that inconsistencies between the proof of claim filed by Wells Fargo and its accounting substantiate this admission. The Court finds that this admission is sufficient to rebut the *prima facie* presumption and shift the burden to Wells Fargo.

[16] *See,* December 4, 2007, Tr.T. 18:14 - 147:13 for Ms. Miller's description of Wells Fargo's procedures.

In this Court's experience, virtually every home mortgage executed in the United States contains provisions that determine when payments are due, when they are considered late, what fees or charges may accrue if late, when a default can be declared, the remedies available on default, and which collection fees or charges are recoverable after default. In addition, most notes and mortgages provide fairly clear directives regarding the application of payments between principal, accrued interest, fees, costs, and amounts due to satisfy insurance and property taxes. Mercifully, most home mortgage loans have relatively standard, predictable language. However, the right to assess certain charges or fees on late payment or default is often at the discretion of the holder of the note. How this discretion is exercised is subject to guidelines not contained in the note or mortgage.

In this Court's opinion, the exercise of that discretion may be impacted by the relationship between the holder of the note and the party that administers its collection. In the present financial market, almost every home mortgage loan is packaged with thousands of other loans and sold to investors assembled on Wall Street. The securitization of mortgage loans allows the original lender to immediately recover the amounts lent, providing it with liquidity and reducing its risk of default. The investors that acquire these bundled loans or portfolios are most often not banks or credit unions, the traditional members of the lending community. Instead, they are investment or brokerage houses; insurance companies; hedge, pension, or mutual funds; and other investment groups. They then hire a loan service provider to administer the loan portfolio.

The securitization of home mortgage loans has divorced the lending community from borrowers. Not only are the new holders of the mortgage notes nontraditional lenders, but a mortgage service provider is a buffer in the relationship between lender and borrower. The holders of notes do not see themselves as lenders, but investors in an asset. They have little interest in the

relationship between lender and borrower except as it might affect their return on investment.

Mortgage service providers administer notes for a fee. The terms of their agreements with investors, as well as the guidelines the investors set for administration of the loan, have ramifications for the borrower. Most servicing agreements allow the service provider to charge a flat fee, usually stated as a percentage of the portfolio under administration. All principal and interest payments collected are paid to the note holder. Usually, fees are additional income to the service provider while costs are simply a pass through, or reimbursable items. In addition, servicers invest the "float," or funds held on deposit, and retain earnings on that investment. Therefore, amounts held in escrow or in debtor suspense are an addition source of revenue for the servicer. While a mortgage service provider and note holder's interests are closely aligned, they are not perfectly aligned. It is in a mortgage service provider's interest to collect fees and hold funds, both of which generate additional income for its account. Conversely, a note holder or investor is interested in the collection and application of payments to principal and interest.

Since many fees and charges are imposed at the discretion of the lender and must be "reasonable" under the law, servicing agreements may establish guidelines for the exercise of that discretion.[17] In this case, Wells Fargo did not produce its servicing agreement. Therefore, the exact terms of its relationship with Lehman Brothers and the financial incentives available to Wells Fargo are not in evidence.

In any event, Ms. Miller testified that once the guidelines for management of a loan are determined by the loan's investor, Fidelity MSP imports the guidelines into its internal logic.[18] For

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[17] In many cases the service agreements will simply refer to a published set of guidelines used by federal agencies.

[18] *See, supra,* note 16.

example, if investor guidelines suggest the assessment of a late charge every time a payment is fifteen (15) days past due, the Fidelity MSP system will automatically assess a late charge if payment is not posted to the account within fifteen (15) days of its due date.

Other charges or fees are assessed against the account by virtue of "wrap around" software packages maintained by Wells Fargo. These software packages interface with Fidelity MSP and implement decisions based on their own internal logic. For example, if a borrower is delinquent in making a payment, Wells Fargo's computer system may automatically send a demand letter to the borrower. Guidelines might also recommend a property inspection if a loan is past due. If such an event occurs, the computer system will automatically generate a work order for an inspection, allow the vendor to upload the completed report, generate a check to the vendor for the inspection, and charge the customer's account - all without human intervention.

When a loan is involved in foreclosure, bankruptcy, or other litigation, Wells Fargo manages that loan through its Bankruptcy Department located in Fort Mill, South Carolina. Ms. Miller is the Vice President who oversees this department of 375 people.

The transfer of loans involved in a bankruptcy to Ms. Miller's department begins with America InfoSource ("AIS"), a third party vendor hired by Wells Fargo to provide daily information regarding new bankruptcy filings that may potentially involve Wells Fargo loans. At the inception of this relationship, Wells Fargo supplied AIS with a listing of every credit relationship it held or serviced, as well as certain fields of information (debtor's name, address, social security number, etc.) on each borrower. The information is updated daily as Wells Fargo acquires new relationships and old ones are closed.

AIS scans the electronic databases of all the bankruptcy courts in the country and attempts to match debtors to any of the information supplied by Wells Fargo. If a match is made for one field of information, Wells Fargo is immediately notified. The notification provides Wells Fargo with the debtor's name, address, social security number, the bankruptcy court, case number, chapter type, and judge assigned. Once notified, Wells Fargo verifies that the debtor is a borrower. To verify the "match," Wells Fargo scans the information supplied by AIS against its own records. Ideally, three fields or pieces of information will be verified and matched.[19] If a three field match is not secured by Wells Fargo's internal computer system, the system will reject the borrower and a manual match will be attempted. This is one of the few times any human being touches or reviews a loan's electronic record.

Once Wells Fargo's computers have verified the AIS borrower match, the program automatically activates a system within the Fidelity MSP software platform called a Bankruptcy Work Station ("BWS"). This sub-part of Fidelity MSP is allegedly infused with computer logic designed to manage a loan during a pending bankruptcy. The supervision of that loan then falls to Ms. Miller.

Once a borrower's status as a bankruptcy debtor has been confirmed, the Fidelity MSP/BWS automatically advises counsel for Wells Fargo when a loan is referred for legal action. Who is selected to represent Well Fargo is dependent on who owns the loan. If a loan is owned by Wells Fargo, it is automatically referred to one of its national counsel; either Brice or McCalla Raymer. If held by one of the federal agencies, Wells Fargo will refer the loan to a firm on an approved list

[19] Wells Fargo's computer system for this function is called Hogan. Hogan will typically attempt to match the customer's name, address and social security number. If this does not result in a complete three field match, other file information may be used.

supplied by the agency. If held by a private investment group, that group can specify counsel or can delegate the responsibility to Wells Fargo as the service provider. If the loan is managed by national counsel, local counsel are retained to physically file pleadings and make court appearances when necessary. Local counsel are not given access to either the electronic files or accounting history but receive all of their information from national counsel. They typically do not have direct client access and may even be prohibited from contacting the service provider or note holder by their retainer agreements.[20]

Once the BWS notifies Brice that it has been retained, Brice is given immediate access to Wells Fargo's mainframe computer platform. In addition, the computer automatically searches different parts of Wells Fargo's multiple software packages and compiles a storage file where counsel can obtain all the information necessary to perform his or her duties. For example, when

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[20] *See, In re Parsley*, —B.R.—, 2008 WL 622859, (Bankr. S.D.Tx. 2008). Although the *Parsley* opinion involved Countrywide, it contains an excellent explanation of the typical relationship between national counsel and local firms with regard to their representation of parties in this industry. In this Court's experience, the relationships and practices are similar from service provider to service provider, note holder to note holder. Wells Fargo's testimony substantiates this belief.

This Court has already remarked on the obvious problems with this system. Local counsel are rarely prepared to answer specific questions about the information contained in a proof of claim or a motion for relief from the automatic stay. They do not have access to either a loan history or the documents necessary to substantiate any charge or discrepancy. Typically they assume the role of dutiful scribes, taking notes on the Court or Debtor's questions and promising to deliver documents or answers at the next hearing. This practice is both wasteful and inefficient. It also does not comport with the Canons of Ethics or the Local Rules of the District Court. *See, generally,* Bankruptcy Rule 9011, E.D. La. Loc. R. 11, Louisiana State Bar Assc. Rules of Professional Conduct, Art. 16, Rules 1.3, 5.1, 5.4, and 5.5; *see also, In re Porcheddu*, 338 B.R. 729 (Bankr. S.D.Tex 2006); *In re Ulmer*, 363 B.R. 777 (Bankr. D.S.C. 2007); *In re Osborne*, 375 B.R. 216 (Bankr. M.D.La. 2007); and *In re Parsley, supra.*

Four different firms have appeared for Wells Fargo in this case alone. Only Brice, Wells Fargo's national counsel, appears to have the information or access necessary to address the issues presented in this case. It is worth noting that despite Debtor's Objection to the proof of claim prepared and signed by Brice, they did not make an appearance in this matter until ordered to do so by this Court.

Since this Court's decision in *Jones v. Wells Fargo*, 366 B.R. 584 (Bankr. E.D.La. 2007), Wells Fargo has represented that it will no longer utilize national counsel for bankruptcy or foreclosure files. Having realized the significant difficulties that were created by its former employment practices, Wells Fargo has elected to employ one firm in each state that will handle all matters involving borrowers located in that state. Local counsel will have the same access to Wells Fargo's computer systems heretofore only enjoyed by national counsel. However, this case was handled under the prior system. Wells Fargo selected its national counsel to represent it in connection with this case. They in turn employed local attorneys: one firm to handle the foreclosure, another firm the bankruptcy, and still another the litigation over the Objection to the proof of claim.

a loan is owned or serviced by Wells Fargo, the documents evidencing the initial loan transaction are kept in pdf format under a software platform called FileNet. FileNet is scanned for copies of the note, mortgage, recordation certificate, and other relevant closing documents. Those electronic files are then assembled in a storage file for counsel's use. The Fidelity MSP system, containing the loan's account history, is open to review by counsel. iClear, another computer program, contains copies of the invoices that represent costs billed to the loan.[21]

The first task of counsel, once a bankruptcy is filed, is to prepare a proof of claim. Because counsel has direct access to Wells Fargo's complete loan accounting, as well as the documents that support its debt and security interest, national counsel prepares the proof of claim without ever speaking to a Wells Fargo representative. In fact, Wells Fargo testified that it does not review any proof of claim prior to its filing. Wells Fargo's testimony was that *only after filing* was the proof of claim reviewed for accuracy.[22] Other legal assignments are executed in a similar fashion.

For example, when a loan goes into postpetition default, the BWS automatically notifies legal counsel of this fact. Legal counsel then prepares a motion for relief utilizing information obtained from the Fidelity MSP system and BWS, including attaching any necessary documents to support the motion and the financial allegations of the default. The motion is typically filed without Wells Fargo's input or review. Wells Fargo testified that it does not maintain records of the legal documents filed on its behalf but relies exclusively on counsel for this service.

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[21] December 4, 2007 Tr.T. 53:24 - 55:25. It does not appear that copies of the inspection reports are available to counsel as they are kept with property management, nor are other reports such as brokers price opinions or appraisals made available.

[22] December 4, 2007 Tr.T. 57:2-15.

The logic utilized by the BWS in its decision making process is both detailed, court, and *even judge* specific. For example, if under local rules, or even local custom of a particular district or judge, a motion for relief may not be filed until the loan is at least ninety (90) days past due, the computer can be adjusted to notify counsel of the need to file a motion for relief when the debtor's account is past due ninety (90) days rather than the typical sixty (60). Other adjustments to the system can be made to eliminate fees or charges prohibited by a particular jurisdiction or judge within a jurisdiction. In summary, Fidelity MSP and BWS allow Wells Fargo to input the individual demands of a particular investor or note holder as well as a court district or even judge.

Debtor has raised several objections to the administration of her loan by Wells Fargo. The objections involve the imposition of inspection fees; appraisal and broker's price opinion fees; sheriff's costs and commissions; legal fees both incurred both prior to and after bankruptcy; the calculation of Debtor's escrow balance; and language included in Wells Fargo's proof of claim which Debtor maintains is illegal and inappropriate. Debtor complains that the fees, costs, and charges claimed were erroneously imposed, unreasonable, inaccurate and/or not legally due.

In addition, Debtor complains that Wells Fargo failed to properly notify her of changes in the amounts estimated to cover demands against her escrow account and interest rate. Debtor also complains of Wells Fargo's failure to notify her both prior to filing and subsequently thereafter of any costs, charges, or fees imposed on her account. Finally, Debtor complains that Wells Fargo's application of her payments is contrary to the terms of the Note, Mortgage, and applicable law.

Failure to Notice

In the current case, after the Objection was filed, Wells Fargo amended its proof of claim yet again. The Second Amended Proof of Claim, filed on September 9, 2007, alters the First Amended

Proof of Claim by changing the language in "Section 3. Other Information." The new language provides, in part:

> A. Claimant is entitled, and reserves the right to receive all amounts which are payable after the petition date under the loan documents described above . . . including the following payments upon and additions to the total debt:
>
> 1. Regular monthly installments as are provided by the loan documents, subject to future adjustments for escrow deposit or interest rate changes
>
> 2. As of August 20, 2007, regular monthly payments are due for the months of September 1, 2007 in the amount of $697.51, late charges have been accrued in the amount of ($0.00), and reasonable and necessary attorney's fees have been incurred for creditor's representation in this proceeding.
>
> 3. Late charges, reasonable attorneys' fees, and other amounts of the type described in Section 1A above, as provided for in the loan documents.

This Court's procedures, set forth in Administrative Order 2008-1, dictate the proper method for requesting payment of post-petition fees or costs. The Court finds that this disclaimer is impermissible and notes that Wells Fargo will be subject to sanctions if it attempts to collect any costs or fees in contravention of the Administrative Order or places this language in any proofs of claim on file in the District.

With regard to the noticing of prepetition charges and costs, this Court previously addressed Wells Fargo's questionable loan administration practices in *In re Jones*, 366 B.R. 584 (Bankr. E.D.La. 2007)("*Jones I*") and *In re Jones*, 2007 WL 2480494 (Bankr. E.D. La. 2007)("*Jones II*"); both opinions were entered in the same adversary. The Debtor in *Jones* owned a home that was encumbered by a mortgage held by Wells Fargo. The debtor sold his home in an attempt to use the equity to payoff the amounts due under his plan. The payoff provided by Wells Fargo was considerably larger than the debtor expected, however. As a result, the debtor filed an adversary after Wells Fargo refused to provide a detailed explanation of the charges and fees contained within

the payoff. In *Jones I*, this Court thoroughly reviewed Wells Fargo's accounting and determined that $24,450.65 more than was actually due was collected by Wells Fargo at closing. The discrepancy between Wells Fargo's payoff and the amount actually due was the result of a number of errors. First, with regard to the prepetition debt calculation, Wells Fargo improperly reported prepetition foreclosure costs. Second, Wells Fargo assessed additional prepetition charges without amending its claim, notifying the debtor, Court, or Chapter 13 Trustee. Third, Wells Fargo improperly calculated the postpetition debt by failing to show the debtor's account as current on the petition date, an error which caused Debtor to pay thousands of dollars in additional interest. Fourth, Wells Fargo did not report or request Court approval for postpetition fees assessed against the debtor's account and unknowingly paid by debtor from either Trustee or regular installment payments.[23]

The testimony in *Jones* indicated that this conduct was not unique to Jones' account but systematic. One of the primary problems discovered in *Jones* was Wells Fargo's failure to notify borrowers of the assessment of fees, costs, or charges at the time they are incurred. This practice exists during all stages of the loan's administration and is not peculiar to loans involved in a bankruptcy. As a result of its previous experience, the Court specifically directed Wells Fargo to submit into evidence copies of any and all notices to Debtor of fees, costs, or charges incurred.

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[23] The Court conducted a hearing on the propriety of sanctions, at which time Wells Fargo offered, *in lieu* of sanctions, to impose certain procedures to notify debtors, counsel, and the Chapter 13 Trustee of fees and costs incurred postpetition. This Court accepted Wells Fargo's offer, and in *Jones II*, set forth the procedures by which Wells Fargo is to handle its loans in cases pending before this Court. *In re Jones*, 2007 WL 2480494 , at *5-6 (Bankr. E.D.La. 2007). This procedure was implemented by Administrative Order 2008-1. Wells Fargo is in the process of complying with this judgment and a filed a Statement of the Accrual of Post Petition Charges into the record of this case on February 28 and 29. See Docket nos. 56-57. The Statement reflects that no fees, costs, or charges have been incurred on this account since the Petition date.

Wells Fargo supplied a listing of computer generated tasks allegedly applicable to this account.[24] The list provides a date, letter or task number, and description of the event. Copies of the letters allegedly sent were not produced nor were any form letters made available to the Court.[25]

According to the list, no correspondence was forwarded to Debtor during the first year of her loan's administration. On December 15, 2000, Debtor was fifteen days late on her monthly installment payment. According to Wells Fargo's accounting records, it assessed a late fee of $27.71 on December 18, 2000, without notice to Debtor. On January 3, 2001, an acceleration letter was allegedly forwarded. What demands or information it included are unknown. On the same day a "30 day solicitation" was performed. Again, what this involved is unclear. Debtor made a payment on January 12, 2001, in the amount of $654.11. Wells Fargo applied the payment to the December installment, then assessed and paid itself a late fee on that installment. The remainder, $72.29, was placed in a suspense account.

On January 17, 2001, the list reflects a "15 day delinquency." It was followed by a "22 day delinquency" on January 23, 2001. Also provided on that date was a "Short Pmt in Suspense" task. Again, no evidence was presented as to the nature or content of these tasks. A review of the entire list indicates that many of the entries that appear are not correspondence, but tasks undertaken by Wells Fargo employees or counsel. Therefore, the Court cannot conclude that the above described delinquencies are notices of past due account delivered to Debtor.[26] The opposite conclusion is

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[24] Exh. A.

[25] An exception to this general statement involves escrow and change of interest rate notices which were produced.

[26] See for example, entry on 10/30/01, "Active Foreclosure" obviously indicating that the file had be transferred for foreclosure action; or entry on 12/27/01 "Foreclosure Payoff." Was this prepared at the Debtor's request or more likely, for Wells Fargo's counsel who needed the payoff for bidding purposes at the pending foreclosure sale in December of 2001?

more likely, given that several other entries designate "letter" when correspondence is sent.[27]

On January 18, 2001, Debtor's account was charged an additional $27.71 late fee because her payment on January 12th had been applied to the December 1, 2000, installment leaving her January 2001 installment past due. On February 1, 2001, a "30 day solicitation" was allegedly performed. The nature of that solicitation is unknown. On February 9, 2001, another "Short Pmt in Suspense" task is specified on the listing, presumably, a reference to the $72.29 still held in suspense from the January payment. This is the last time Wells Fargo's task records reflect any entry with regard to the Debtor's suspense account despite almost continual use throughout the remaining period of the loan's administration.

On February 12, 2001, Debtor forwarded another payment of $654.11. Wells Fargo applied the payment to the January installment and the late fee assessed on that payment. The remainder of the funds were placed in suspense. On February 17, 2001, a "15 day delinquency" is noted of unknown content, followed by a "22 day delinquency " on February 23, 2001.

For the remaining year, Wells Fargo appears to have entered 15, 22, and 30 day delinquencies as well as acceleration letters. Nothing produced indicates that Debtor was advised that late fees or other charges were being imposed on her account or that funds were being held in suspense rather than being applied to reduce her past due installment. Ms. Miller testified that Debtor was not notified of past due payments, the imposition of late charges, or inspection fees.[28]

Between December 2000 and the filing of the first bankruptcy, approximately one year, thirteen (13) late fees were charged, without notice, for a total of $360.23. Each of these fees were

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[27] See for example, entry on 1/3/01, "Acceleration letter;" or the 5/16/02 entry, "Search letters sent to Tax Auth." On 9/21/01 Wells Fargo's listing reflects an "ARM change notice."

[28] December 4, 2007, Tr.T 221:17-224:5.

deducted from Debtor's monthly payments, again without notice, deepening her default and ultimately triggering seven (7) property inspections for which Debtor was charged an additional $15.00 each. Again, these charges were assessed against Debtor's account and paid from the monthly installments she was forwarding without notice. The total cost to Debtor for one missed $554.11 installment in December of 2000 was $465.36 in late fees and property inspection charges. Debtor paid an additional $400.00 towards her past due balance in the four months following her default, all of which was promptly applied to satisfy late fees and property inspections charges rather than the past due interest and principal installment as required by the Mortgage. Although Debtor paid her monthly principal and interest payments throughout 2001, plus $400.00, Wells Fargo showed her $619.47 in arrears by October, 2001.

Debtor's October installment payment appears to have been returned by Wells Fargo.[29] Instead of applying her payment, Wells Fargo placed the loan in foreclosure and actively returned at least one other tender in November, 2001.[30] Putting aside late fees and inspection charges, Debtor was only $154.11 in arrears on her monthly installment at the time her loan was referred for foreclosure.

By the time Debtor's husband filed his case on January 11, 2002 ("2002 Bankruptcy"), Wells Fargo claimed attorney's fees and costs of foreclosure amounting to $2,218.33 in addition to missed installment payments, inspection fees, and late charges. The proof of claim filed in that case itemizes a past due balance of $6,098.10.

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[29] Exh. A, entry 10/12/01 "Return Funds."

[30] Exh. A, entry 11/19/01 "Return Funds."

Following the dismissal of the 2002 Bankruptcy[31] and during the entire administration of the loan thereafter, Wells Fargo appears to have had little or no contact with Debtor. Save for the delivery of incoherent escrow adjustments and letters regarding a change in interest rate, none of the thousands of dollars in fees, charges, or costs were noticed to Debtor.[32] The Court concludes, just as in *Jones*, that Wells Fargo has a corporate practice that fails to notify borrowers that fees, costs, or charges are being assessed against their accounts. This failure is fatal to Wells Fargo's decision to pay itself from payments sent by Debtor for other purposes and is contrary to the requirements of the Note and Mortgage.

The Triumph of Computer Logic Over Human Logic

Property or "Drive By" Inspections

As previously indicated, the Fidelity MSP and BWS will apply computer logic to certain events, triggering automatic action on a loan file. Wells Fargo testified that in this case the decision paradigm allowed for property inspections if the loan was twenty (20) days past due. According to Wells Fargo, this principle controlled the loan's management both prior to and after bankruptcy filing. Wells Fargo has produced 43 of the 44 inspection reports prepared on Debtor's property.[33] *Since Debtor's first missed payment in December of 2000, Wells Fargo has inspected this property on average every 54 days.*

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[31] Case No. 02-10228 was dismissed on January 29, 2004.

[32] Wells Fargo did notify Debtor, in accordance with the terms of the Note, of any adjustment to her interest rate. It also frequently reviewed and adjusted Debtor's escrow account. Unfortunately, the escrow notices were both confusing and in error.

[33] The report for the inspection allegedly performed on 7/14/06 has not been produced and Wells Fargo admits it cannot be substantiated.

Wells Fargo argues that the decision to conduct drive-by inspections every time a loan is twenty (20) days past due is reasonable. It maintains that once a debtor is past due, industry experience supports the belief that the collateral is often at risk. As such, inspections are ordered to guard against a potential loss. Wells Fargo further argues that the charges are minor and constitute a reasonable exercise of discretion to manage the risk.[34]

Wells Fargo requests blanket authority to charge every debtor or borrower a fee for a drive-by inspection no matter what the circumstances, provided, in Wells Fargo's view, the loan is twenty (20) days past due. While this might seem both logical and practical at first blush, in practice it is much less so.

In this case, Debtor fell one month behind in December of 2000. Despite Wells Fargo's assertion that property inspections are always ordered when a loan is twenty (20) days past due, this does not appear to be the case. Although Debtor was one month past due in December 2000, and according to Wells Fargo remained so for the rest of 2001, property inspections were not ordered until July 2001.[35] What risk suddenly existed in July 2001 was not explained, but it is clear that Wells Fargo does not have a policy of automatically inspecting properties once a loan is twenty (20) days past due. The six month delay in ordering an inspection calls into question Wells Fargo's assertion that loans twenty (20) days past due constitute a risk to the note-holder justifying immediate inspection.[36]

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[34] While a $15.00 inspection charge might be minor in an individual case, if the 7.7 million home mortgage loans Wells Fargo services are inspected just once per year, the revenue generated will exceed $115,000,000.00.

[35] Wells Fargo represented that it did not fully automate property inspection requests until July, 2001. December 4, Tr.T. 154:22-155:17.

[36] For example, in 2003, Debtor fell one month behind but property inspections were not ordered until seven (7) months later. Ten (10) inspections were then ordered over a six (6) month period despite Debtor's continuing payments on a monthly basis. Exh. H.

Once the Fidelity MSP system went into action, a drive by inspection was ordered, performed, and its cost charged to Debtor's account. The first report revealed that the property was occupied, well maintained, and in good condition.[37] The next month, Debtor paid her monthly installment. However, upon its receipt, the computer posted the payment to the previous month's installment. The computer then read a delinquency for August, now twenty (20) days past due. The Fidelity MSP system dutifully recognized the triggering event and ordered yet another drive-by inspection which was performed and charged to Debtor. This chain of delayed payment continued for eight (8) months until the 2002 Bankruptcy was filed. Each month, a drive-by inspection was ordered, performed, and charged to Debtor's account.

All eight (8) inspections indicated that the property was occupied and well maintained.[38] Because the vendor uploads the finished report directly into Wells Fargo's computer mainframe, the system, rather than a person, checks for the condition of the property and alerts Wells Fargo if a property appears to be at risk.[39] The actual electronic file of the report is stored in the Property Management Department of Wells Fargo but never appears to be read by anyone.

All forty-three (43) reports describe the property as being in good condition. Further, since most were obtained while the Debtor was making regular monthly payments, the paradigm that signaled a risk to the property was imperfect if not inapplicable. In addition, the inspections were of little use to Wells Fargo because *a review of the inspections reveals that many were performed on property other than Debtor's.*

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[37] Exh. E.

[38] Exh. E.

[39] December 4, 2007, Tr. T. 86:3 - 87:18.

For example, the inspection completed on July 5, 2001, indicates that Debtor's house is of brick construction, while the inspections completed from August to February of 2002 describe a house of frame construction. Obviously, two different properties were inspected. However, since Wells Fargo blindly relied on a computer to both order inspections and evaluate their conclusions, it did not know that the erroneous inspections it received were of no benefit.[40] The failure of Wells Fargo to notice such significant inconsistencies evident on the face of the reports further confirms that they were not reviewed by any human being. If Wells Fargo did not believe the reports were important enough to read, this calls into question the importance of obtaining the reports in the first place.

Assuming the inspections were properly performed, the other troubling point raised is the frequency of their performance. Forty-four (44) inspections were ordered on one property over a period of seventy-nine (79) months. Every report indicates that the property inspected was in good condition. Why was there a need to continuously reinspect? No answers were supplied. In short, the Court concludes that Wells Fargo's computer system automatically generates these inspections for no discernable purpose or benefit to the lender.

The Court can only conclude that the necessity of performing drive-by inspections is not critical to the administration of a loan. If the first report reveals a property in fair to good condition, nothing justifies, without further evidence of a problem, monthly inspections thereafter. The fact that Wells Fargo does not appear to read the inspections it orders further substantiates this finding.

Paragraph 9 of the Mortgage provides that "[l]ender or its agent may make reasonable entries upon and inspections of the Property. Lender *shall* give Borrower notice at the time of or prior to

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[40] Exh. E. This discrepancy is found throughout the reports. Twenty-four (24) reports describe Debtor's home as brick while sixteen (16) describe it as frame construction.

an inspection specifying *reasonable cause* for the inspection."[41] Ms. Miller testified that Wells Fargo does not send borrowers notice when it performs a property inspection.[42] The Court has already found that Wells Fargo does not notify the borrower that she has incurred a charge for this service.

Wells Fargo is entitled to recover necessary costs incurred in connection with the protection of its rights in the property. The Mortgage specifies that the disbursements shall be payable *upon notice from Lender to Borrower*.[43] Even after notice, the assessment of disbursements attributable to protect the property must be reasonable. In this case, Wells Fargo's imposition of inspection fees was neither noticed nor reasonable.

Broker's Price Opinions/ Appraisal Charges

Wells Fargo ordered nine (9) broker's price opinions ("BPOs"), originally characterized as appraisals in Wells Fargo's proof of claim, on this property in the same seventy-nine (79) month period. Only two BPOs were produced, although invoices delivered by Premiere Asset Services ("Premiere") to Wells Fargo for every BPO were entered into evidence. None of these charges were noticed to Debtor at the time they were incurred.

Wells Fargo testified that when a property is placed in foreclosure, a BPO is ordered.[44] Wells Fargo testified that this property was in a continuous foreclosure proceeding from 2002 until

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[41] Emphasis added.

[42] December 4, 2007, Tr.T. 92:1-13.

[43] Exh. C, Mortgage ¶ 7.

[44] In Louisiana, because all foreclosures are by judicial process, if a lender wishes to preserve a deficiency claim, the sheriff must begin the bidding at the initial public auction at 66 2/3% of appraised value. Prior to sale, both borrower and lender are entitled to submit evidence of appraised value. If the values differ, the sheriff will appoint a third party appraiser to reconcile the difference.

2007. Multiple BPOs were required because Debtor (or her spouse) filed for bankruptcy relief multiple times. Each time a bankruptcy case was filed, the foreclosure sale was stopped. However after each case's dismissal, the foreclosure sale was rescheduled and a new BPO was necessary.

Debtor did not contest the logic of this explanation, but a review of the account indicates that Wells Fargo ordered many more BPOs than were necessary. Over the life of the loan Wells Fargo charged Debtor:

$125.00	1/09/02
125.00	3/02/04
125.00	9/30/04
125.00	9/30/04
125.00	9/12/05
125.00	9/12/05
95.00	3/30/06
95.00	3/30/06
390.00	3/06/07

The BPOs performed in January 2002 and March 2004 appear to have been completed while Wells Fargo was actively foreclosing on the property.[45] The two BPOs in September of 2004 were completed while Debtor had a bankruptcy pending and an adequate protection order in place.[46] No explanation as to the necessity of these charges was offered and the reports were not produced. In addition, the charges appear to be duplicative.

In September of 2005, two identical BPO charges appear on the account. While one charge appears to be duplicative of the other, it is also unlikely that inspections could have been performed at this time given that Jefferson Parish was under an evacuation order due to Hurricane Katrina and closed to all but emergency personnel. Again, copies of the reports were not produced.

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[45] These are the only two BPOs produced. Exh. G.

[46] One of these charges appears to be a duplicate of the other. Wells Fargo may have discovered this sometime later when it reviewed the file for foreclosure. A reversal of costs was entered six months later, in March of 2005, for $125.00. Exh. H.

In March of 2006, two identical BPO charges again appear. Both, along with the BPO charges in September of 2005 and the property inspections ordered post Hurricane Katrina seem to have been reversed on October 13, 2006, due to the "hurricane."[47] The last BPO, in March of 2007, was after the foreclosure on Debtor's home and when the property was owned by Wells Fargo. This charge would not be attributable to Debtor. The Court finds that the only two BPOs properly ordered under Wells Fargo's stated policies were the BPOs ordered in January 2002 and March 2004.

An additional objection to the BPOs was asserted by Debtor regarding the amounts charged by Wells Fargo. Wells Fargo's testimony at the trial was that BPOs were secured from Premiere, an independent entity, although affiliated with Wells Fargo. Copies of the invoices representing the amounts "paid" to Premiere were produced. Wells Fargo admitted that the invoices included profit for Premiere although it did not know how much. Wells Fargo insisted that all costs are "passed through" to a borrower's account at the amount actually billed by the third party.

Following this trial, Wells Fargo stipulated in another matter that Premiere is *a division*, not an affiliate, of Wells Fargo, and "invoices" produced as evidence of the costs associated with the acquisition of BPOs are internal memos between departments allocating costs of administration. While it remains true that the BPOs are performed by third party vendors, the amount paid is not what is reflected on the "invoices." Wells Fargo's national counsel has represented to this Court that only $50.00 of each invoice represents the actual cost incurred by Wells Fargo for a BPO.[48] The

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[47] Exh. H. Entries on 9/12/05, 3/30/06, and $15.00 of inspection charges on 1/12/06, 2/21/06, 3/14/06, 4/11/06, 5/19/06, 6/12/06, 7/05/06, 7/14/06, 8/3/06, 9/8/06, as well as a trip expense charge for property preservation on 10/10/06 were written off on 10/13/06 for $625.00. Costs of photographs totaling $12.00 remained on the account.

[48] *See, In re Fitch, Case. No 04-14039.* February 13, 2008 Tr.T. 5:10-6:21.

remaining amounts, approximately $880.00 in total, were added to the actual costs by Wells Fargo. The Court concludes that these additional charges are an undisclosed fee, disguised as a third party vendor cost, and illegally imposed by Wells Fargo.

Escrow for Insurance and Property Taxes

At closing, borrowers on home mortgage loans must typically prove that adequate insurance exists against the property's loss. Property taxes must also be current. Most mortgage lenders demand at closing assurances that future insurance premiums and property taxes will be paid. Typically, this is accomplished through the use of escrow accounts. Debtor's Note and Mortgage are no exception. The Mortgage allows Wells Fargo to set up an escrow account if Debtor does not maintain adequate insurance. Debtor's loan was not originally set up to include a monthly escrow payment.

In year two, Debtor failed to maintain property insurance. Wells Fargo sent several notices reminding Debtor to provide proof of insurance and warning that Wells Fargo would "force-place" insurance on Debtor's behalf if proof of insurance were not supplied.[49] Despite these warnings, Debtor failed to secure insurance on her home. On March 11, 2001, Wells Fargo paid for a force-placed property insurance policy at a cost of $651.00. Because there was no escrow fund from which to make this payment, Debtor was immediately responsible for reimbursing Wells Fargo for this expense.

On April 13, 2001, Wells Fargo sent Debtor a letter notifying her that $144.66 would be added to her monthly installment to reimburse Wells Fargo for this advance.[50] Because force-placed

[49] Exh. A; December 4, 2007 Tr.T. 162:3-163:15.

[50] The Mortgage provides that should Wells Fargo advance funds for insurance or property taxes, it may at its discretion amortize the amounts due from the borrower over twelve months. Through this notice, Wells Fargo elected this option of repayment.

insurance was necessary, Wells Fargo also exercised its right to escrow for estimated future premiums accruing at the policy's annual renewal date.[51]

The monthly escrow amount was allegedly calculated by adding the estimated premium for the next year's renewal to the amounts already paid. In order to ensure that the escrow account would always have a "cushion" over and above that needed to pay for next year's insurance premium, two additional months worth of escrow were collected.[52] To arrive at a borrower's monthly escrow payment, the total of these sums is divided by 12.

Beginning with the June 2001 payment, Wells Fargo increased Debtor's monthly installment by $144.66.[53] This increase does not comply with the terms of the Note, Mortgage, RESPA, or the facts of this case. The Court calculates the amounts required were instead $84.22 per month.[54]

Debtor did not make the additional $144.66 per month payments. Instead, she continued to make regular monthly principal and interest payments of $554.11.[55] Wells Fargo instituted foreclosure proceedings in October of 2001 and Debtor's husband filed the 2002 Bankruptcy in

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[51] Although the policy was not placed until March 2001, the policy period ran from November 2000 (the date Debtor's original policy terminated for non-renewal) until November 2001.

[52] Pursuant to RESPA, a lender may increase the annual amounts held on deposit in escrow by 1/6 of the estimated amount due. Section 10, RESPA. This arguably would keep Debtor's escrow account in positive balance even if the premium for the following year increased. However, since the change in Debtor's monthly payment did not take effect until June of 2001, even at its inception, the calculations used by Well Fargo would render Debtor's escrow account short in November 2001 when the next premium payment was due.

[53] Exh. B.

[54] Mathematically the amounts owed included $651.00 for the 2001-2002 premium and $651.00 estimated as necessary to satisfy the 2002-2003 premium. To this sum is added $108.50 (calculated as (($651.00 divided by 12) x 2)). Then the total is divided by 12. The result is a monthly escrow payment of $117.54. However, since Wells Fargo should have held $399.89 in Debtor's suspense account at the time, the total due should have been reduced by the balance in Debtor's suspense account. The over-payments reduced Debtor's monthly escrow payment to $84.22.

[55] Debtor paid at least $554.11 every month from January 2001-November 2001. In September of 2001 her entire payment was placed in suspense and remained unapplied as late as January 2002 when the bankruptcy was filed. Her October and November 2001 payments were returned.

January 2002 after their payments for the October and November installments were refused.

Shortly after the institution of the 2002 Bankruptcy, Wells Fargo again reviewed Debtor's escrow account. The renewal premium of $651.00 for the 2001-2002 policy year had been paid the previous December. Wells Fargo's records reflected a *negative* $1,111.08 balance in Debtor's account as of January 2002.[56] However, Wells Fargo's proof of claim filed in that proceeding reflected no past due escrow balance.[57]

Under questioning by Debtor, Ms. Miller explained that when a proof of claim is generated, the computer will assume that any past due installment payments included in the proof of claim are current. This updates the escrow balance because the computer "assumes" that the portion of the past due installments attributable to escrow have been added to the balance on the petition date. The computer then compares the adjusted balance to the balance actually needed in the account and only schedules the difference as either a positive or negative on the proof of claim.[58]

Assuming this testimony is correct, the computer would have added $144.66 for the six (6) past due monthly installments included in the proof of claim. This would have adjusted the negative balance to $243.12, which together with $108.50, should have been reflected on the proof of claim. According to Ms. Miller, this sum should have been included on the proof of claim.[59] Obviously this was not done, calling into question Ms. Miller's understanding of how the Fidelity MSP/BWS system calculates escrow balances.

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[56] Exh H.

[57] See Wells Fargo's Proofs of Claim filed in bankruptcy case no. 02-10228.

[58] December 4, 2007 Tr.T. 204:10 - 205:22.

[59] Under Ms. Miller's explanation, the negative balance was really $351.62 because an additional $108.50 (1/6 of the estimated yearly insurance premium) should have also been included.

But there are greater problems with Wells Fargo's calculations. As previously stated, the Mortgage requires Wells Fargo to apply any funds received first to the payment of outstanding escrow charges, then to accrued interest, then to outstanding principal. Only after all these amounts are paid can late fees or inspection charges be satisfied. Throughout 2001, and while a single monthly installment of principal and interest remained outstanding, Wells Fargo satisfied late charges and inspection fees instead of the principal and interest outstanding. Then, in March of 2001, when the first insurance premium payment was made, Wells Fargo again preferred the payment of late fees and inspection charges to that of insurance. The result is that Debtor's escrow account is wholly incorrect.[60]

Table II reflects the Court's calculations for the escrow account after reapplying the payments as required by the Mortgage and using correct escrow calculations. The balance in January 2002 was negative $396.79, with escrow payments current through December 31, 2001. Assuming this discrepancy was added to the proof of claim, Debtor's new escrow payment would be $63.29 for 2002.[61]

In April of 2003, the escrow account was reviewed again. This time the premium paid in December of 2002 was $744.00. Wells Fargo calculated the necessary escrow payment at $158.48 per month. Wells Fargo advised Debtor that her new payment, beginning June 2003, would increase to $712.59.[62] The Court finds this is erroneous and holds that the proper amount was $625.15. The Court calculates that the escrow payment was actually $71.04.[63]

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[60] Exh. H.

[61] *See* Table II.

[62] Exh. B.

[63] *See* Table II.

Wells Fargo apparently realized that it had over-calculated Debtor's escrow deficiency for 2003, because its next analysis, performed on May 4, 2004, calculated an estimated surplus of $784.68 rather than the allowable low point of $108.50. This dropped the monthly payments back down to $608.33 or $54.22 per month for escrow.[64]

In April 2005, the escrow review changed Debtor's payment to $613.10.[65] In September 2005, her Note interest rate changed increasing her payment to $628.67.[66] The following August, the escrow review changed the payment to $623.91,[67] and in December 2006, the interest rate changed yet again modifying the payment to $675.79.[68] Finally, in June 2007, Wells Fargo changed Debtor's installment payment to $697.51.[69] Throughout this period, Debtor continued to pay $712.59 per month, at least until Hurricane Katrina occurred.[70] After August 2005, all payments ceased.

The correct escrow calculations based on the Note, Mortgage, and RESPA are set forth on Table II attached to these Reasons. These figures are used by the Court to amortize the loan rather than the incorrect calculations presented by Wells Fargo.

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[64] Exh. B.

[65] Exh B.

[66] Exh. D.

[67] Exh. B.

[68] Exh. D.

[69] Exh. B.

[70] Exh. H.

Late Charges

Debtor missed her first installment payment in December, 2000, however, she resumed making timely payments on January 12, 2001. Wells Fargo assessed a late charge for the missed December, 2000, payment and it assessed a $27.71 late charge for each month that followed because Debtor remained contractually one month behind.[71]

Paragraph 27 of the Mortgage allows the lender to assess late charges, and provides: "[b]orrower shall pay to Lender a late charge of 5 percent of any monthly installment of principal and interest as provided in the Note not received by Lender within 15 days after such installment is due." Additionally, Paragraph 7(A) of the Note provides that the Debtor will pay the "late charge promptly, but only once on each late payment." Louisiana law permits lenders to assess late charges if agreed to by the parties.[72]

As stated above, the Mortgage allows Wells Fargo to collect a late charge if a payment is more than fifteen (15) days delinquent. The Mortgage does not, however, allow Wells Fargo to assess a late charge for each subsequent month until the default is cured. If a borrower misses a payment in December 2000, but makes timely payments in January, February, and March of 2001, the borrower has missed one payment, not four. Wells Fargo, however, reads the relevant provision to allow an assessment for each month until the borrower cures the initial default. This interpretation is unreasonable.[73]

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[71] Exh. H.

[72] *See* La.R.S. §§ 6:1097 and 9:3505.

[73] *See* 12 C.F.R. § 227.15, which provides that "it is an unfair act or practice for a bank to levy or collect any delinquency charge on a payment, when the only delinquency is attributable to late fees or delinquency charges assessed on earlier installments, and the payment is otherwise a full payment for the applicable period and is paid on its due date or within an applicable grace period." While this section regulates consumer credit transactions, the Court cannot see how such an act is any less unfair when it concerns a real estate transaction.

The result of Wells Fargo's position in this case is the imposition of a fine or penalty of $360.23 in late fees over a thirteen (13) month period for one $554.11 missed payment.[74] During this same period the past due principal balance on the missed payment continued to bear interest. Therefore, the imposition of the late fee was a penalty for the failure to pay accrued interest. The penalty amounted to an additional charge of 100% per annum.[75] The Court does not find this a reasonable interpretation of the contract's terms.

Ambiguity in a contract is construed against the drafter; Wells Fargo.[76] The Note provides that only one penalty may be assessed for a missed payment. Given that the Debtor made regular installment payments throughout the life of her loan, the Court interprets the Mortgage to allow the assessment of one late charge on any payment not received within fifteen (15) days of the date due, but not for each and every month following until the initial default is cured.

The Adequate Protection Order

On April 20, 2004, Debtor filed her own bankruptcy ("2004 Bankruptcy").[77] Thereafter, Debtor failed to make postpetition payments to Wells Fargo for May 2004 through August 2004. A motion for relief was filed and a consent order entered allowing Debtor to add the "June 2004 through and including August 2004 post petition payments, late charges and attorneys fees and costs of $500.00..." to her plan. Wells Fargo represented that this totaled $2,859.99.[78] In reviewing this

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[74] Added to this outrage are an additional $105.00 in inspection fees charged over seven (7) months. If Wells Fargo had followed its policies to the letter, this sum could have been as high as $195.00.

[75] The imposition of a 100% penalty is particularly unreasonable given that Wells Fargo never notified Debtor that it had imposed a late fee and never demanded payment.

[76] *Matter of U.S. Abatement Corp.*, 79 F.3d 393, 400 (5th Cir. 1996).

[77] Case No. 04-12889.

[78] *In re Stewart*, Case No. 04-12889, P-43.

case, the Court noticed that Wells Fargo's amended proof of claim filed on November 4, 2004, itemized the new additions as follows:

3 payments @ 608.33	$1,824.99
Bankruptcy fees	125.00
Property preservation fee	380.00
NSF fees	30.00
Attorney's fees	500.00
	$2,859.99[79]

The Court Order did not approve a bankruptcy fee of $125.00, nor did it approve property preservation fees of $380.00. Further, NSF fees were not disclosed or approved. Judging from its accounting, it appears Wells Fargo attempted to claim approximately twenty-six (26) prepetition property inspections dating back to October 2001 in this Adequate Protection Order without disclosing this to the Court or trustee.[80] This action was a clear violation of counsel's duty to be candid with the Court, but even more disturbing is Wells Fargo's willingness to take advantage of an elderly, *pro se,* widow. Needless to say, the additional charges are disallowed if not already stricken under the other findings contained in these Reasons. [81]

Attorney Fees and Costs

Between Debtor and her deceased husband, her home has been the subject of a continuous foreclosure proceeding as well as three bankruptcies. As might be expected, Wells Fargo has incurred a considerable amount of attorneys' fees and costs since Debtor missed her first payment in December, 2000. Both the Mortgage, Note, and Louisiana law allow a lender to collect the reasonable fees and costs incurred by legal counsel in connection with enforcement of the lender's

[79] *In re Stewart*, Case No. 04-12889, claim No. 3.

[80] Exh. H.

[81] The amounts due are reflected on Table IV.

rights.

Wells Fargo has submitted invoices totaling $8,632.46 in fees and costs associated with foreclosure actions. The accounting also reflects a $614.91 refund by the sheriff that is not included in its counsel's invoices.[82] The costs of a separate eviction proceeding were also charged to Debtor. They amounted to $3,082.00, but on further research, Wells Fargo determined that a credit of $1,800.00 was due on these fees, reducing them to $1,282.00.[83]

Wells Fargo also included two charges of $150.00 for bankruptcy fees and $500.00 for costs and fees associated with the filing of its Motion for Relief from the Automatic Stay.

The foreclosure fees and costs reflected in Wells Fargo's accounting and invoices, as of January 2002, match exactly the amounts set forth in its initial proof of claim filed in the 2002 Bankruptcy, with one exception. Legal fees were not charged at the rate of $900.00, but $775.00, according to counsel's invoice. The foreclosure fees, as of 2002, are therefore reduced to $1,968.33.

A charge of $150.00 was assessed for preparation of the proof of claim in the 2002 Bankruptcy. That fee was neither approved by the Court nor disclosed to anyone. It is therefore disallowed.

After the dismissal of the 2002 Bankruptcy, Wells Fargo rescheduled the property for sheriff sale. Additional fees and costs of $1,528.61 were incurred. Therefore, as of April 2004, the total fees and costs incurred were $3,496.94.

After the 2004 Bankruptcy was filed, another $150.00 proof of claim fee was assessed. This fee was not approved by the Court in the 2004 Bankruptcy and it is disallowed. Also, during the 2004 Bankruptcy, Wells Fargo filed a Motion for Relief from the Automatic Stay. A consent order

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[82] Exh. H, entry November 14, 2005.

[83] September 25, 2007 Tr.T. 10:15-18.

for adequate protection was entered by the Court.[84] That Order awarded Wells Fargo fees and costs incurred in connection with the motion of $500.00. The Court recognizes that award as additional fees due Wells Fargo.

Following the dismissal of the 2004 Bankruptcy, the foreclosure process began anew. This time a sheriff's deposit of $1,500.00 was posted. Costs of $185.00 were billed against this deposit, then Hurricane Katrina interrupted the foreclosure. On November 14, 2005, the sheriff refunded $614.91 to Wells Fargo of the $1,315.00 remaining on deposit. Since Wells Fargo did not supply an accounting of the $700.09 in additional costs incurred, they are disallowed. Allowed fees now total $4,181.94.[85]

In late 2006, Wells Fargo rescheduled its foreclosure sale. Following the sale, counsel billed Wells Fargo an additional $3,772.61. The amounts reflected on counsel's statement cannot be reconciled with the previous invoices supplied. The statement gives a credit for previous billings by the sheriff of $2,612.44 but the previous invoices indicate that $3,607.03 had been paid. Without detail on the credit, these invoices must be reduced to $2,779.02.[86]

In December 2006, Wells Fargo instituted an eviction proceeding against Debtor. Fees and costs billed to Debtor's account totaled $2,120.00. However, $1,800.00 was refunded and is due to Debtor. Wells Fargo also charged Debtor's account $450.00 for the cost of a title policy. This is not appropriate as the policy was acquired after Wells Fargo foreclosed on the property and this cost is associated with ownership, not collection. Wells Fargo also charged for clerk and sheriff's

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[84] *In re Stewart*, Case No. 04-1288, P-43.

[85] Exh. F.

[86] Exh. F.

costs of $122.00 already included in the original $2,120.00 billed.[87] Total fees and costs allowed for the eviction are therefore $320.00.

Total fees and costs as of March 2007 are:

Fees and costs 2002	$1,968.33
Fees and costs 2004	1,528.61
Bankruptcy Fees	500.00
Fees and costs 2005	185.00
Fees and costs 2006	2,779.02
Eviction	320.00
Total Fees and costs	$7,280.96

Suspense Accounts and the Application of Payments

Debtor's first payment was due January 1, 2000, in the amount of $544.11. She paid $556.00 on January 10, 2000, and Wells Fargo applied $554.11 toward principal and interest. The excess payment of $1.89 was applied toward principal. Debtor made timely payments in the amount of $554.11 for the months of February through November of 2000.[88]

Debtor missed her December 2000 payment. Wells Fargo did not provide evidence that a past due notice was delivered to Debtor. Debtor's next payment was made January 12, 2001 in the amount of $654.11. Wells Fargo applied $554.11 toward the December 2000 installment, paid a $27.71 late fee, and placed the remaining $72.29 into a "suspense account."[89]

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[87] Exh. F.

[88] Exh. H.

[89] Suspense accounts are utilized by Wells Fargo when the payment received does not match the monthly installment. For example, on May 11, 2001, Debtor forwarded a payment of $554.11 to Wells Fargo which was immediately placed in suspense rather than immediately applied because it did not include the unnoticed late fee of $27.71. In January of 2001, Debtor's payment was sufficient to pay her December installment but was not enough to also fully satisfy her January 2001 installment. Rather than apply a partial payment, Wells Fargo simply deposited the money into a suspense account. *See also, In re Nosek,* 2006 WL 1867096, at *3 (Bankr. D.Mass. 2006).

Ms. Miller did not know if Debtor was advised of her suspense balance, nor could she prove that Debtor had been notified that a late fee had been charged against her account. For all Debtor knew, her payment of $654.11 had satisfied her January 2001 installment and $100.00 of the past due December payment. Instead, Wells Fargo applied the payment to one installment and charged her an unnoticed late fee. Not only does this Court have a serious problem with the application of a payment to an undisclosed fee, but it also finds that Wells Fargo's application of funds is contrary to the terms of its Note and Mortgage.

Under the Note and Mortgage, payments are to be applied first to outstanding escrow installments, then accrued interest, then accrued principal, *and last to late fees*. Therefore, the $654.11 payment should have been applied to her past due December installment.

This would have left January's installment of $554.11 outstanding, as well as the late fee of $27.71. Debtor's balance in suspense would have been $100.00 because, until the January installment was satisfied, late charges could not be paid. This misapplication of payments continued throughout 2001.

The problem worsened after July 2001, when Wells Fargo began ordering property inspections because the loan was technically twenty (20) days past due. The costs of inspection, $15.00 per month, were assessed and paid without notice, prior to the satisfaction of outstanding principal, accrued interest, and insurance premiums.

This created not only a burgeoning default but also another review of Debtor's escrow account. The review resulted in the third adjustment to her monthly installment in a six month period. Yet again, Wells Fargo miscalculated the amount required.

Debtor attempted to keep pace with this rising tide, but in November of 2001, after having two payments refused and a foreclosure instituted, Debtor appears to have given up. Debtor's

spouse filed bankruptcy *pro se* in January of 2002.

The proof of claim filed by Wells Fargo in that case reflected the following charges:

6 payments @ 698.77 (8/1/01-1/1/02)	$4,192.62
Accrued late charges (3)	83.13
Foreclosure fees and costs	
1193.33	
900.00	2,093.33
Inspection fees	30.00
Property preservation	15.00
Suspense Balance	(440.98)
Misc foreclosure fees (BPO)	125.00
Total:	$6,098.10[90]

Based on Wells Fargo's accounting, this proof of claim was substantially in error. The correct amount of her monthly installment should have been $638.33 not $698.77. Had Wells Fargo properly applied Debtor's extra payments to escrow, Debtor would have been current in her escrow account through December 31, 2001. Based on the Court's revised accounting, Debtor owed six (6) principal and interest payments of $554.11 when the 2002 Bankruptcy was filed. Debtor's suspense account had a positive $48.79 balance and her escrow account a negative $396.79. To this must be added the escrow payment of $63.29 due for January 2002. The BPO charge listed on the proof of claim has been addressed and reduced from $125.00 to $50.00 and all late fees but one have been disallowed. An inspection fee of $15.00 is allowed because Debtor was twenty (20) days late on the December 2000 payment. Because no proof of the property preservation fee was presented at trial, that charge is disallowed. Attorney's fees and costs have been previously reduced due to the credit for $125.00 on counsel's invoice. The net effect is a past due balance of $5,796.99.[91]

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[90] *In re Stewart*, Case No. 02-10228, Claim No. 2.

[91] See Table III.

Debtor paid her monthly installments on a timely basis from February 2002 through October 2002. She missed her November 2002 payment but managed to become current through later payments. At the dismissal of the case in January of 2004, Debtor was postpetition current. Debtor's husband's plan payments netted Wells Fargo an additional $1,090.46 on its past due claim. She also had $40.64 in her suspense account. The Court has applied the plan payments and prepetition Debtor suspense account to satisfy the proof of claim escrow balance of $411.29. The remaining plan payments and postpetition suspense account balance have been applied to Debtor's past due installment payments.[92]

Three months later, in April of 2004 when Debtor filed the 2004 Bankruptcy, Wells Fargo's proof of claim stated:

5 Payments @ 712.59		$3,562.95
5 Payments @ 712.58		3,562.90
Accrued late charges (22)		609.46
Foreclosure fees and costs		
	$1,302.42	
	561.89	
	750.00	2,614.31
Bankruptcy fees		150.00
Inspection fees (20)		300.00
BPO fees (2)		250.00
Property preservation		240.00
Tax research fee		20.00
Total		$11,309.62[93]

This proof of claim is also significantly in error. As previously stated, at the time the 2002 Bankruptcy was dismissed, Debtor had made all postpetition installment payments to Wells Fargo. Therefore, only the past due installments from the previous case were outstanding, and even they

[92] *See*, Table III.

[93] To this, Wells Fargo added $2,859.99, under the Adequate Protection Order, for a total claim of $11,555.35. *In re Stewart*, Case No. 04-12889, Claim No. 3.

had been partially satisfied by the Trustee in the 2002 Bankruptcy. Debtor had missed three additional payments between the bankruptcy cases (February 1, 2004 - April 1, 2004). Added to this were additional foreclosure costs and fees. Since Debtor had made every postpetition payment timely save one, there should not have been any additional late charges or inspection fees on the account except perhaps one of each in November of 2002. Late fees were assessed between January 2004 and April 2004. As a result, only four (4) additional late fees are recognized. Wells Fargo's assessment of twenty-two (22) late charges is directly attributable to the incorrect assessment of escrow charges and, therefore, the calculation of the monthly installment. Because the assessment was due to Wells Fargo's error, they are disallowed, along with the inspection fees which were never noticed. The bankruptcy attorney's fees have been previously discussed and disallowed. Property preservation fees have not been substantiated, and, therefore, are disallowed as is the tax research fee which does not appear in the accounting at all. The allowed BPO fees (one prior to the 2002 Bankruptcy and one prior to the 2004 Bankruptcy) are reduced to a total of $100.00.

The arrearage in the second case was $8,153.30.[94] To this amount, adequate protection sums ordered in September 2004 must be added:

3 payments (6/04-8/04) @ $554.11	$1,662.33	
3 escrow payments @ 38.65	135.63	
5 late charges		138.55
Attorney's fees and costs	500.00	
Total	$2,436.51	

Against this arrearage Debtor paid $3,120.00, of which $271.26 should have been applied to Debtor's escrow account and the rest to accrued interest and principal. In addition, Debtor's

[94] See Table IV.

suspense account contained $483.73. As of July 2005, Debtor had a past due balance of $6,986.08.[95]

Hurricane Katrina hit the New Orleans area approximately one month after Debtor's 2004 bankruptcy was dismissed. She did not make any payments after the date of her dismissal. By directive from Fannie Mae and Freddie Mac, payments on all home mortgage loans in the New Orleans area were suspended.[96] In 2006, Wells Fargo resumed its foreclosure proceedings, selling the property at public auction. Thereafter, it began eviction proceedings.

Following the foreclosure, Debtor was contacted by another division of Wells Fargo regarding the possibility of a reverse mortgage. Convinced by Wells Fargo that she could qualify for a reverse mortgage, Debtor in turn convinced Wells Fargo's mortgage loan department to unwind the foreclosure sale. Debtor was refused the reverse mortgage loan and the entire foreclosure process was put back in motion. During the period between August 2005 and June 2007, Wells Fargo ordered eleven (11) more property inspections and four (4) BPOs. All these charges were reversed in March of 2007. Sheriff's fees of $185.00 incurred in July 2005 have been allowed. Legal fees and costs associated with the eviction proceeding have been previously adjusted to $320.00.

The Court has made the above corrections to Debtors's loan history. The corrected accounting appears on Table I. The past due amount owed to Wells Fargo as of the petition date is $24,924.10, not the $35,036.00 claimed by Wells Fargo in its latest proof of claim.[97]

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[95] See Table V.

[96] December 4, 2007 Tr.T 304:20-25.

[97] See Table VI.

Damages and Sanctions

Accounting and Administrative Abuses

The reconciliation of Debtor's account took Wells Fargo four months to research and three hearings before this Court to explain. An account history was not produced until two months after the filing of the Objection. An additional two months were spent obtaining the necessary information to explain or establish the substantial charges, costs, and fees reflected on the account.

In the end, Wells Fargo charged nine (9) BPOs to Debtor's account but could only produce two corresponding reports. At least three sets of BPOs were duplicative of each other; two BPOs were probably never performed due to the closure of Jefferson parish following Hurricane Katrina; and all contained hidden fees for Wells Fargo disguised as costs. Only two BPOs were ultimately accepted as validly performed.

Wells Fargo charged Debtor with forty-four (44) inspections; the Court allowed one (1). Wells Fargo also charged Debtor forty-nine (49) late charges; only ten (10) of which were approved. Almost every disallowed inspection and late fee was imposed while Debtor was making regular monthly payments, was assessed under circumstances contrary to Wells Fargo's stated policies or the Note's terms, and was unreasonable under the circumstances. Substantial legal fees were also claimed without over $1,800.00 in credits being posted.

The calculation of Debtor's monthly escrow was almost incomprehensible and virtually incorrect in every instance. This caused Wells Fargo to demand substantially erroneous and increased payments from Debtor. But one of the most troubling problems with the accounting delivered by Wells Fargo was the preference for the payment of fees and charges over escrow, principal, and interest payments in contravention of the Note and Mortgage's clear terms.

In *Brantley v. Tremont & Gulf Railway Co.*,[98] the Louisiana Supreme Court established that a plaintiff that sustained damages as a result of the fault of the defendant, will not be denied a recovery merely because he cannot establish exactly the amount suffered. La Civil Code Art. 1999 provides, "[w]hen damages are insusceptible of precise measurement, much discretion shall be left to the court for the reasonable assessment of these damages."[99]

In cases where there are no intentional breaches of contract and no actual damages are proven, Louisiana courts have allowed for the recovery of nominal damages for technical breach of a contract.[100] Damages in excess of nominal amounts have also been awarded.[101]

In addition, Louisiana law recognizes the doctrine of abuse of rights. Although invoked sparingly, it was affirmed in *Illinois Central Gulf Railroad Co. v. International Harvester Co.*[102]

> In its origin, the abuse of rights doctrine was applied to prevent the holder of rights or powers from exercising those rights exclusively for the purpose of harming another, but today most courts in civil law jurisdictions will find an act abusive if the predominant motive for it was to cause harm....The doctrine has been applied where an intent to harm was not proven, if it was shown that there was no serious and legitimate interest in the exercise of the right worthy of judicial protection...Although there are still pending important questions concerning its scope as well as criteria for the definition of abusive use of rights, this we may safely say now: it will be difficult for a holder of an individual right, in most of the civil jurisdictions today, to exercise such right to the detriment of other parties, just for the sheer sake of exercising it.

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[98] 75 So.2d 236, 239 (La. 1954).

[99] La Civ. Code Ann. art 1999 (1985).

[100] *Levy v. Southern Bell Telephone and Telegraph Co.*, 172 So.2d 371 (La. App. 4th Cir. 1965); *Fiesta Foods, Inc. v. Ogden*, 159 So.2d 577 (La. App. 1st Cir. 1964); *Mayeaux, Bennett, Hingle Ins. Agency, Inc. v. Southern Bell Telegraph & Telephone*, 148 So.2d 771 (La.App. 4th Cir. 1963), *cert. denied*, 150 So.2d 589, and *Meyer v Succession of McClellan*, 30 So.2d 788 (La. App. Orleans 1947).

[101] *See, Scheimuk The Florist, Inc., v Southern Bell Telephone & Telegraph Co.*, 128 So.2d 683 (La. App.4th Cir. 1961) and *Mayeaux, supra.*

[102] 368 So.2d 1009 (La. 1979).

> At least a 'serious and legitimate interest' will have to be shown in order to justify the exercise of its right.[103]

Because this Court awards Debtor the sums set forth below as sanctions, it will not award nominal damages for the technical breaches of the Note and Mortgage's terms including, the illegal imposition of fees disguised as costs (BPO charges); the negligent imposition of fees and costs not due (legal charges and deposits reimbursed); the improper calculation of escrow payments; the misapplication of payments contrary to the terms of the Note and Mortgage; the failure to notify Debtor of fees and charges imposed on her account; or Wells Fargo's abusive behavior with regard to its rights under the Note and Mortgage, in particular, the abusive imposition of unwarranted fees and charges (late fees and inspection costs).

Improper Conduct in Connection With Bankruptcy Filings

Although Wells Fargo was specifically asked to reconcile the amounts reflected on its prior proofs of claim with the amounts claimed on its account history, it did not. A review by the Court revealed why: the proofs of claim filed in the 2004 and 2007 Bankruptcies were so significantly erroneous that a reconciliation was not possible. Charges for NSF fees, tax searches, property preservation fees, and unapproved bankruptcy fees appeared on the proofs of claim filed in this and previous cases without explanation or substantiation. Further, these charges never appeared as entries on the account history.

Another problem with the proof of claim was the incorrect reporting of Debtor's escrow account balance. First, the escrow account was wholly inaccurate because Wells Fargo miscalculated the amounts due. This caused Wells Fargo to demand substantially more each month than was allowed under RESPA. Wells Fargo also misapplied payments on the Note, further

[103] *Id.* at 1014, citations omitted.

compounding the problem.

The miscalculation of monthly escrow payments also overstated Debtor's monthly installment and corresponding arrears. The combination of all these errors led to substantial overstatements in the past due amounts owed by Debtor in the approximate amount of $3,100.00 in 2004 and over $10,000.00 in 2007.

The Court is also offended by the insertion of additional bankruptcy fees and charges in the consent adequate protection order entered in the 2004 Bankruptcy. Wells Fargo represented to the Court that the $2,859.99 contained in the order represented "June 2004 through and including August 2004 post petition payments, late charges and attorneys fees and costs of $500.00..." Instead, Wells Fargo included additional "bankruptcy fees" of $125.00, property preservation fees of $380.00, and NSF fees of $30.00. The property preservation fee was actually composed of twenty-six (26) *prepetition,* previously undisclosed, property inspection charges left off the proof of claim. The Court finds the actions of Wells Fargo to have been duplicitous and misleading.

The Court finds that Wells Fargo was negligent in its practices and took insufficient remedial action following this Court's rulings in *Jones v. Wells Fargo* to remedy problems with its accounting. The Court will assess damages in the amount of $10,000.00, plus $12,350.00 in legal fees, for the abusive imposition of unwarranted fees and charges (late fees and inspection costs); the illegal imposition of fees disguised as costs (BPO charges); the negligent imposition of fees and costs not due (legal charges and deposits reimbursed); the improper calculation of escrow payments; the misapplication of payments contrary to the terms of the Note and Mortgage; the failure to notify Debtor of fees and charges on her account; and the improper payment of unnoticed fees and charges during pending bankruptcies. The Court will also sanction Wells Fargo in the amount of $2,500.00 for its actions in connection with presenting a consent adequate protection order to the Court, which

did not reflect the agreement between the parties as represented to the Court. Finally, the Court will sanction Wells Fargo $2,500.00 for filing significantly erroneous proofs of claim in 2004 and 2007 and misrepresenting the costs associated with Premiere.

In order to rectify this problem in the future, the Court orders Wells Fargo to audit every proof of claim it has filed in this District in any case pending on or filed after April 13, 2007, and to provide a complete loan history on every account. For every debtor with a case still pending in the District, the loan histories shall be filed into the claims register and Wells Fargo is ordered to amend, where necessary, the proofs of claim already on file to comply with the principles established in this case and *Jones*. For closed cases, Wells Fargo is ordered to deliver to Debtor, Debtor's counsel and Trustee a copy of the accounting.

The Court will enter an administrative order for the review of these accountings and proofs of claim. The Court reserves the right, if warranted after an initial review of the accountings, proofs of claim and any amended claims filed of record, to appoint experts, at Wells Fargo's expense, to review each accounting and submit recommendations to the Court for further adjustments based on the principles set forth in this Memorandum Opinion and *Jones*.

New Orleans, Louisiana, April 10, 2008.

Hon. Elizabeth W. Magner
U.S. Bankruptcy Judge

Table I

Date Rcvd	Description	Installment Date	Amt Rcvd	Trustee Arrears	Principal	Interest	Escrow	Late Fees	Other	Principal Balance	Debtor Suspense	Comments
01/01/00	Origination; interest 10.375%	01/01/00								$61,175.01		
01/10/00	Installment Payment	01/01/00	$556.00		$27.09	$528.91				$61,147.92		Surplus $1.89 paid toward principal
02/08/00	Installment Payment	02/01/00	$554.11		$25.44	$528.67				$61,122.48		
03/13/00	Installment Payment	03/01/00	$554.11		$25.66	$528.45				$61,096.82		
04/10/00	Installment Payment	04/01/00	$554.11		$25.88	$528.23				$61,070.94		
05/08/00	Installment Payment	05/01/00	$554.11		$26.10	$528.01				$61,044.84		
06/12/00	Installment Payment	06/01/00	$554.11		$26.33	$527.78				$61,018.51		
07/13/00	Installment Payment	07/01/00	$554.11		$26.55	$527.56				$60,991.96		
08/14/00	Installment Payment	08/01/00	$554.11		$26.78	$527.33				$60,965.18		
09/11/00	Installment Payment	09/01/00	$554.11		$27.02	$527.09				$60,938.16		
10/16/00	Installment Payment	10/01/00	$554.11		$27.25	$526.86				$60,910.91		
11/10/00	Installment Payment	11/01/00	$554.11		$27.48	$526.63				$60,883.43		
12/18/00	Late Charge							$27.71	$15.00			
01/12/01	Installment Payment	12/01/00	$654.11		$27.72	$526.39				$60,855.71	$100.00	
02/12/01	Installment Payment	01/01/01	$654.11		$27.96	$526.15				$60,827.75	$100.00	
03/01/01	Hazard Premium						($651.00)					
03/12/01	Installment Payment	02/01/01	$654.11		$28.20	$525.91				$60,799.55	$100.00	
04/11/01	Installment Payment	03/01/01	$654.00		$28.45	$525.66				$60,771.10	$99.89	
05/11/01	Installment Payment	04/01/01	$554.11		$28.69	$525.42				$60,742.41		
06/01/01	Applied Debtor Suspense		$399.89				$399.89				($399.89)	
06/08/01	Installment Payment		$554.11				$84.22				$469.89	Table II for monthly escrow calculation
07/10/01	Installment Payment	05/01/01	$554.11		$28.94	$525.17	$84.22			$60,713.47	($84.22)	
08/13/01	Installment Payment	06/01/01	$554.11		$29.19	$524.92	$84.22			$60,684.28	($84.22)	
09/12/01	Installment Payment	07/01/01	$554.11		$29.42	$524.69	$84.22			$60,654.86	($84.22)	
10/01/01							$84.22				($84.22)	
11/01/01							$84.22				($84.22)	
12/12/01	Hazard Premium						($651.00)					
01/11/02	02-10228 Bankruptcy filed	Totals					($396.79)	$27.71	$15.00		$48.79	Table III
01/11/02	Debtor Suspense Applied						$48.79				($48.79)	
01/11/02	Adjustment to Escrow for POC						$348.00					
01/11/02	Adjustment to Escrow for POC						$63.29					1/01/02 escrow payment
02/11/02	Installment Payment	02/01/02	$608.00				$63.29			$60,625.16	$544.71	Table II for monthly escrow calculation
03/15/02	Installment Payment	02/01/02	$789.18		$29.70	$524.41				$60,595.20	$235.07	
	Applied Debtor Suspense	03/01/02	$617.40		$29.96	$524.15	$63.29				($67.40)	
04/08/02	Installment Payment	04/01/02	$608.36		$30.21	$523.90	$63.29			$60,564.99	($9.04)	
05/09/02	Installment Payment	05/01/02	$608.36		$30.48	$523.63	$63.29			$60,534.51	($9.04)	
06/07/02	Installment Payment	06/01/02	$608.36		$30.74	$523.37	$63.29			$60,503.77	($9.04)	
07/08/02	Installment Payment	07/01/02	$608.00		$31.00	$523.11	$63.29			$60,472.77	($9.40)	
08/12/02	Installment Payment	08/01/02	$608.36		$31.27	$522.84	$63.29			$60,441.50	($9.04)	

Table I

Date Rcvd	Description	Installment Date	Amt Rcvd	Trustee Arrears	Principal	Interest	Escrow	Late Fees	Other	Principal Balance	Debtor Suspense	Comments
09/09/02	Installment Payment	09/01/02	$608.36		$31.54	$522.57	$63.29			$60,406.96	($9.04)	
09/13/02	Trustee Payment			$28.07								
10/14/02		10/01/02	$608.36		$31.82	$522.29	$63.29			$60,375.14	($9.04)	
11/08/02		11/01/02	$150.00				$63.29	$27.27			$86.71	
11/09/02	Installment Payment	11/01/02	$608.34		$32.37	$521.74				$60,342.77	($9.04)	
		12/01/02					$63.29					
12/11/02	Hazard Premium						($744.00)					
12/12/02	Trustee Payment			$291.86								
01/10/03	Installment Payment	12/01/02	$608.34		$32.37	$521.74				$60,310.40	($9.04)	
		01/01/03					$71.04				($16.81)	Table II for monthly escrow calculation
01/17/03	Trustee Payment			$71.43								
02/07/03	Installment Payment	01/01/03	$608.34		$32.37	$521.74				$60,278.03		
		02/01/03					$71.04				($16.81)	
02/17/03	Trustee Payment			$91.80								
03/10/03	Installment Payment	02/01/03	$608.34		$32.93	$521.18				$60,245.10		
		03/01/03					$71.04				($16.81)	
03/26/03	Trustee Payment			$121.46								
04/07/03	Installment Payment	03/01/03	$608.34		$33.22	$520.89				$60,211.88		
		04/01/03					$71.04				($16.81)	
04/23/03	Trustee Payment			$121.46								
05/09/03	Installment Payment	04/01/03	$608.34		$33.50	$520.61				$60,178.38		
		05/01/03					$71.04				($16.81)	
05/22/03	Trustee Payment			$121.46								
06/09/03	Installment Payment	05/01/03	$608.34		$33.79	$520.32				$60,144.59		
		06/01/03					$71.04				($16.81)	
06/24/03	Trustee Payment			$121.46								
07/15/03	Installment Payment	06/01/03	$608.34		$34.06	$520.03				$60,110.53		
		07/01/03					$71.04				($16.81)	
07/23/03	Trustee Payment			$121.46								
08/07/03	Installment Payment	07/01/03	$712.59		$34.36	$519.73				$60,076.17		
		08/01/03					$71.04				$87.44	
09/08/03	Installment Payment	08/01/03	$712.59		$34.66	$519.43				$60,041.51		
		09/01/03					$71.04				$87.44	
10/13/03	Installment Payment	09/01/03	$712.59		$34.96	$519.13				$60,006.55		
		10/01/03					$71.04				$87.44	
11/07/03	Installment Payment	10/01/03	$712.59		$35.26	$518.83				$59,971.29		
		11/01/03					$71.04				$87.44	
12/08/03	Installment Payment	11/01/03	$712.58		$35.56	$518.53				$59,935.73		
		12/01/03					$71.04				$87.43	

Table I

Date Rcvd	Description	Installment Date	Amt Rcvd	Trustee Arrears	Principal	Interest	Escrow	Late Fees	Other	Principal Balance	Debtor Suspense	Comments
01/09/04	Installment Payment	12/01/03	$712.59		$35.87	$578.22				$59,899.86		
		01/01/04					$45.21				$113.27	
	Debtor Suspense Applied	01/01/04			$36.18	$517.93				$59,863.68	($554.11)	
01/29/04	02-10228 Dismissed	Totals		$1,090.46			$262.17	$27.71	$15.00	$59,863.68	$40.64	
	Trustee Payments Applied	08/01/01		($1,090.46)	$36.49	$517.60				$59,827.19		$411.29 applied to poc escrow balance
												$125.06 unapplied
02/16/04	Late Charge							$27.71				
03/16/04	Late Charge							$27.71				
04/16/04	Late Charge							$27.71				
04/20/04	04-12889 Bankruptcy Filed	Totals					$262.17	$110.84	$15.00	$59,827.19	$40.64	Table IV
05/01/04	Debtor Suspense Applied		$40.65								($40.64)	Suspense applied to POC
	Unapplied Trustee payment											$125.06 applied to POC
	POC adjustment	1/04-3/04	$135.63				$135.63					added to POC
05/16/04	Late Charge							$27.71				
06/16/04	Late Charge							$27.71				
07/16/04	Late Charge							$27.71				
08/16/04	Late Charge							$27.71				
09/16/04	Late Charge							$27.71				
09/22/04	Adj. to Escrow for Adequate Prot	6/04 - 8/04	$135.63				$135.63					added to POC
10/13/04	Installment Payment	08/01/04	$712.08		$36.18	$517.91	$45.21			$59,791.01	$112.76	
10/05/04	Installment Payment	09/01/04	$608.00		$36.81	$517.28	$45.21			$59,754.20	$9.01	
	Applied Debtor Suspense	10/01/04	$45.21				$45.21				($45.21)	
11/09/04	Installment Payment	10/01/04	$712.08		$37.13	$516.96				$59,717.07		
		11/01/04					$45.21				$112.76	
11/12/04	Trustee Payment			$786.54								
12/08/04	Hazard Premium						($651.00)					
12/13/04	Trustee Payment			$944.00								
12/27/04	Installment Payment	11/01/04	$712.08		$37.45	$516.64				$59,679.62		
		12/01/04					$45.21				$112.76	
01/07/05	Installment Payment	12/01/04	$712.08		$37.76	$516.32				$59,641.86		
		01/01/05					$54.25				$103.72	
02/08/05	Installment Payment	01/01/05	$712.08		$38.09	$515.99				$59,603.77		
		02/01/05					$54.25				$103.72	
03/09/05	Installment Payment	02/01/05	$712.08		$38.42	$515.66				$59,565.35		
		03/01/05					$54.25				$103.72	
03/09/05	Applied Debtor Suspense	03/01/05	$544.11		$38.75	$515.33				$59,526.60	($554.11)	
04/08/05	Installment Payment	04/01/05	$712.58		$39.08	$515.00	$54.25			$59,487.52	$104.22	
05/06/05	Installment Payment	05/01/05	$712.58		$39.42	$514.66	$54.25			$59,448.10	$104.22	
07/08/05	Installment Payment	07/01/05	$712.59		$40.12	$513.99	$54.25			$59,368.22	$104.23	

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Table I

Date Rcvd	Description	Installment Date	Amt Rcvd	Trustee Arrears	Principal	Interest	Escrow	Late Fees	Other	Principal Balance	Debtor Suspense	Comments
07/26/05	04-12889 Dismissed	Totals		$3,120.00			$488.23	$277.10	$15.00	$59,368.22	$483.73	Table V
	Application of Trustee Payments	9/01/01-01/01/02	$3,120.00	($3,120.00)	$205.83	$2,564.72						$271.26 applied to escrow poc balance
												$78.19 + $125.06 = $203.25 unapplied
	Applied Debtor Suspense	02/01/04	$554.11		$42.24	$511.87					($483.73)	$483.73 + 40.54 from debtor suspense; and
	Applicacation of POC credits											$29.74 from Trustee unapplied;
08/29/05	Hurricane Katrina Landfall										$173.51	Remaining balance of Trustee
												unapplied 173.51
12/01/05	Interest Rate Change	Interest = 10.75%, P&I = $569.66										
12/07/05	Hazard Premium						($651.00)					
	Unapplied Trustee payments						$173.51					
12/01/06	Interest Rate Change	Interest = 12.00%, P&I = $621.54										
08/20/07	Hazard Premium						($687.23)					
05/12/07	07-11113 Bankruptcy Filed	Totals					($675.49)	$277.10	$15.00			Table VI

Table II

Description	Balance		Comments
1/00 - 3/01	$0.00		
3/12/01 Hazard Premium	($651.00)		
5/01 Debtor Suspense Payment	$399.89		
6/01 Payment	$84.22		Initial Escrow Calculation (($651 + $651 + $108.50)-$399.89) / 12 = $84.22
7/01 Payment	$84.22		
8/01 Payment	$84.22		
9/01 Payment	$84.22		
10/01 Payment	$84.22		
11/01 Payment	$84.22		
12/12/01 Hazard Premium	($651.00)		
Balance 12/31/01		($396.79)	
02-10228 Bankruptcy filed			
Application of Debtor Suspense	$48.79		
POC Balance Adjustment	$348.00	$0.00	POC Escrow Calculation $396.79 + $63.29 = $460.08
POC 1/02 payment adjustment	$63.29	$63.29	2002 Mo Escrow Calculation: 651 + 108.50 = 759.50 / 12 = 63.29
2/02 Payment	$63.29		
3/02 Payment	$63.29		
4/02 Payment	$63.29		
5/02 Payment	$63.29		
6/02 Payment	$63.29		
7/02 Payment	$63.29		
8/02 Payment	$63.29		
9/02 Payment	$63.29		
9/02 Payment	$63.29		
10/02 Payment	$63.29		
11/02 Payment	$63.29		
12/02 Payment	$63.29		
12/11/02 Hazard Premium	($744.00)		
Balance 12/31/02		$15.48	2003 Mo. Escrow Calculation $15.48 - ($744 + 124) = $852.52/12 = $71.04
1/03 Payment	$71.04		
2/03 Payment	$71.04		
3/03 Payment	$71.04		
4/03 Payment	$71.04		
5/03 Payment	$71.04		
6/03 Payment	$71.04		

Table II

Description	Balance		Comments
7/03 Payment	$71.04		
8/03 Payment	$71.04		
9/03 Payment	$71.04		
10/03 Payment	$71.04		
11/03 Payment	$71.04		
12/03 Payment	$71.04		
12/10/03 Hazard Premium	($651.00)		
Balance 12/31/03		$216.96	2004 Mo. Escrow Calculation: 216.96-(651 + 108.50) = 542.54 / 12 = 45.21
1/04 Payment	$45.21		
04-12889 Bankrupcy filed		$262.17	
2/04 - 4/04	$135.63		3 (2/04 - 4/04)@ $45.21 = 135.63 Per 2004 Proof of Claim
5/04 Payment	$45.21		
6/04 - 8/04	$135.63		3 (6/04 - 8/04)@ $45.21 = 135.63 Per 2004 Adequate Protection Order
9/04 Payment	$45.21		
10/04 Payment	$45.21		
11/04 Payment	$45.21		
12/04 Payment	$45.21		
12/08/04 Hazard Premium	($651.00)		
Balance 12/31/04		$108.48	2005 Mo. Escrow Calculation: 108.48- (651 + 108.50) = 651.02 / 12 = 54.25
1/05 Payment	$54.25		
2/05 Payment	$54.25		
3/05 Payment	$54.25		
4/05 Payment	$54.25		
5/05 Payment	$54.25		
7/05 Payment	$54.25		
Balance 7/31/05		$488.23	
12/05 Hazard Premium	($651.00)		
Application of Debtor Suspense	$173.52		
3/07 Hazard Premium	($687.23)		
Balance 3/31/07		($676.48)	
07-11113 Bankruptcy filed			POC calculation: 2007 Mo Escrow Calculation--687.23 + 114.54 = 801.18 / 12 = 66.81
			676.48 + (1/07-6/07 @ 66.81) = 1077.34
POC Adjustment 1/07-6/07	$400.86		
POC Adjustment	$676.48	$400.86	

Table III
2002 Proof of Claim Reconciliation

6 Payments @ $554.11	$3,324.66
Accrued Late Charges	27.71
Foreclosure Fees and Costs	1,968.33
Inspection Fee	15.00
Suspense Balance	(48.79)
Escrow Balance	396.79
Escrow Payment 1/1/02	63.29
BPO	50.00
Total	$5,796.99

* * *

Past Due Balance Due at Dismissal of 2002 Bankruptcy

Past Due Payments		
8/1/01 - 1/1/02 @ $554.11	$3,324.66	
Less Trustee Payment (8/1/01 installment	(554.11)	
5 Past Due 9/1/01 - 1/1/02		$2,770.55
Past Due Escrow		
Negative Balance on Filing	396.79	
Add Escrow Charge 1/1/02	63.29	
Less Debtor Suspense Account on Filing	(48.79)	
	411.29	
Less Trustee Payment	(411.29)	
		0.00
Accrued Late Charges (2)	55.42	
Inspection Fee	15.00	
Attorneys' Fees and Costs	1,968.33	
BPO	50.00	
Total Costs and Fees		2,061.04
Subtotal		$4,831.59
Less Unapplied Trustee Payment		(125.06)
		$4,734.24

Table IV
2004 Proof of Claim Reconciliation

Balance Due at Dismissal of 2002 Case	$4,734.24	
Additional Past Due Payments		
3 (2/1/04-4/1/04) @ $554.11	1,662.33	
Additional Past Due Escrow Payments		
3 (2/1/04-4/1/04) @ $45.21	135.63	
Additional Late Charges		
3 (2/1/04-4/1/04) @ $27.71	83.13	
Additional BPO	50.00	
Additional Attorneys' Fees and Costs	1,528.61	
Less Debtor Suspense Balance (4/1/04)	(40.64)	
		$8,153.30
Plus Consent Order:		
Attorneys' Fees and Costs	500.00	
Postpetition Past Due Payments		
3 (6/04-8/04) @ $554.11	1,662.33	
Late Charges		
5 (5/04-9/04) @ $27.71	138.55	
Postpetition Past Due Escrow Payments		
3 (6/04-8/04) @ $45.21	135.63	
		$2,436.51
Total		$10,589.81

Table V
Past Due Balance July 2005

Previous Past Due Installments			
5 (9/1/01-1/1/02) @ $554.11		$2,770.55	
Less 2004 Trustee Payments		(2,770.55)	
3 (2/1/04-4/1/04) @ $554.11		1,662.33	
3 (6/1/04-8/1/04) @ $554.11		1,662.33	
			$3,324.66
Additional Credits			
Debtor Suspense Balance 4/04	40.64		
Debtor Suspense Balance 7/05	483.73		
Unapplied Trustee Payments[1]	203.25		
(2002 of $125.06 plus	727.62		
2004 ($3,120.00 - $2,770.55-			
$78.19))			
Pay 2/1/04 Installment			($554.11)
Less Unapplied Funds			($173.51)
			$2,597.04
Past Due Escrow			
3(2/1/04 - 4/1/04) @ $45.21		135.63	
3(6/1/04 - 8/1/04) @ $45.21		135.63	
Less 2004 Trustee Payments		(271.26)	
			$0.00
Late Charges (910			
12/00, 11/02, 2/04-9/04		277.10	
Inspection Fees		15.00	
BPOs (2)		100.00	
Attorney's Fees and Costs		3,996.94	
			$4,389.04
Total			$6,986.08

[1] Unapplied funds from 2002 Bankruptcy of $125.06 plus unapplied funds from 2004 bankruptcy (($3,120.00 - $2,770.55- $274.26)= $78.19)

Table VI
Past Due Balance June 12, 2007

Past Due installments		
5 (3/04 - 4/04; 6/04 - 8/04) @$554.11	$2,770.55	
4 (8/05 - 11/05) @ $554.11	2,216.44	
12 (12/05 - 11/06) @ $569.66	6,835.92	
7 (12/06 - 6/07) @ $621.54	4,350.78	
Negative Escrow (balance 12/31/06)	(676.49)	
Escrow 6 (1/1/07 - 6/1/07) @ $66.81	400.86	
Attorneys' Fees and Costs	7,280.96	
Late Charges (10)	277.10	
Inspection Fee	15.00	
BPO (2)	100.00	
Total		$24,924.10

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF LOUISIANA

IN RE:	CASE NO. 07-11319
IRBY FITCH BRITTANY FITCH Debtors	SECTION A CHAPTER 13

AMENDED MEMORANDUM OPINION[1]

On September 5, 2007, Irby and Brittany Fitch ("Debtors") filed an Objection to Claim against Wells Fargo Home Mortgage, Inc., d/b/a America's Servicing Company as servicing agent for EMC ("Wells Fargo"). The Objection requested a full history of Debtors' mortgage loan and support for certain charges or fees claimed by Wells Fargo in its proof of claim. Specifically, Debtors requested documentation to support Wells Fargo's claim for broker's price opinion charges, inspection fees, foreclosure fees and costs, as well as all amounts due under Debtors' escrow account. The Objection was served on Wells Fargo on September 5, 2007, and was accompanied by a qualified written request delivered to Wells Fargo under the Real Estate Settlement Procedures Act ("RESPA").

An initial hearing on this matter was conducted on October 9, 2007. Debtors stipulated that the amounts claimed for foreclosure costs and attorney's fees were correct. Because Wells Fargo failed to produce documentation to support the broker's price opinions and property inspection charges, they were disallowed. The next issue for consideration involved the past due amounts claimed for escrow.

[1] This Memorandum Opinion is being amended to correct typographical errors on pages 6, 8 and 9.

Wells Fargo's proof of claim, filed on August 3, 2007, listed a past due escrow balance of $2,065.80. To its initial Response filed on September 28, 2007, Wells Fargo attached a partial accounting for escrow that showed a negative escrow balance of $3,078.20. Wells Fargo's Response also revealed $2,988.88 in "Available Escrow Deposits," but claimed an additional $1,976.48 in sums "needed for ongoing disbursements." Although both the credit and deduction were listed in Wells Fargo's Response, Wells Fargo never produced evidence, nor could it explain how these amounts were calculated. Wells Fargo also failed to explain whether or not the escrow portion of past due installment payments included in the proof of claim had been credited to Debtors' past due escrow balance. Finally, only a partial accounting for escrow was supplied and did not reflect the account's entire history, nor did it reveal the history of Debtors' loan. As a result, the Court declared the escrow account current, striking all past due sums.

Having ruled on the itemized charges contained in Wells Fargo's proof of claim, the Court turned its attention to Debtors' challenge of the entire balance. Because Wells Fargo had not produced a satisfactory accounting of Debtors' loan history and had yet to completely respond to Debtors' RESPA request, the Court continued the hearing pending the delivery of additional information from Wells Fargo. The continued hearing was held on November 27, 2008, at which time the Court directed Wells Fargo to provide a prepetition payment history on or before November 30, 2007.

The next hearing was held on January 8, 2008, after Debtors had time to review the payment history and documentation supplied by Wells Fargo. The documentation, however, was still incomplete and the Court ordered the production of the following: inspection/broker's price opinion reports and invoices showing what Wells Fargo paid for these services; a copy of Wells Fargo's

private mortgage insurance policy; additional detail regarding the force-placed insurance policy; the servicing agreements; additional information regarding the life insurance premiums charged to Debtors; and copies of the prospectus supplement and SEC form 424B5. The Court continued the hearing to provide Wells Fargo additional time to supply the required documents.

By the final hearing on February 13, 2008, Wells Fargo had satisfied the qualified written request, although it did so well after the time limit set by RESPA.

Request for Sanctions

After the receipt of the full loan history on November 30, 2007, Debtors did not assert any additional challenges to the amounts owed. Instead, Debtors are seeking sanctions and damages for Wells Fargo's failure to timely provide the information requested under RESPA.

The purpose of RESPA is "to protect home buyers from material non-disclosures in settlement statements and abusive practices in the settlement process. RESPA applies not only to the actual settlement process, however, but also to the servicing of federally regulated mortgage loans."[2] RESPA details the procedure for borrowers to obtain information regarding their loan. The information must be sought through a qualified written request, which then imposes a duty upon the loan servicer to respond. A qualified written request is written correspondence that lists reasons why a borrower believes the account is in error or requests other information.[3] Once a qualified written request is delivered to a servicer, two obligations are created. The first is to acknowledge receipt of the request within 20 days.[4] The second obligation is to take one of three actions within 60 days:

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[2] *In re Thompson*, 350 B.R. 842, 851 (Bankr. E.D.Wis. 2006), *quoting*, *MorEquity, Inc. v. Naeem*, 118 F.Supp.2d 885, 900 (N.D.Ill. 2000).

[3] 12 U.S.C. § 2605(e)(1)(B).

[4] 12 U.S.C. § 2605(e)(1)(A).

1) make appropriate corrections to the account of the borrower; 2) provide the borrower with a written explanation as to why the servicer believes the account is correct; or 3) provide the borrower with the requested information or a written explanation of why the requested information is unavailable and cannot be obtained.[5] RESPA further provides that a servicer shall be liable to the borrower for actual damages, plus a maximum of $1,000.00 in additional damages should a pattern of noncompliance be proven, for failure to comply with the qualified written request.[6] Debtors served Wells Fargo with a qualified written request under RESPA on or about September 5, 2007.

Wells Fargo supplied copies of invoices for attorneys fees and costs as well as an accounting of the escrow account from September 29, 2004, to July 1, 2007, but failed to produce copies of inspection reports and broker's price opinions on a timely basis. It provided a full loan history to Debtors' counsel on November 30, 2007, after receiving an extension from the Court until that date. Wells Fargo's claims with regard to the escrow account were not revised based on the information presented to the Court and no explanation as to the conflicting information provided was made.

As previously stated, the Court struck Wells Fargo's claims for broker's price opinion charges, inspection fees, and the negative escrow because it failed to produce, on a timely basis, evidence of the propriety of the charges. In order to determine if sanctions are appropriate, the Court has reviewed the loan history supplied by Wells Fargo in an effort to ascertain the correct amounts owed. By calculating the prepetition arrearage owed by Debtors and comparing it to the amounts set forth on the proof of claim, the Court may or may not conclude that Wells Fargo's actions were sanctionable.

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[5] 12 U.S.C. § 2605(e)(2)(A) - (C).

[6] 12 U.S.C. § 2605(f)(1).

Escrow

By far, the largest problem with Wells Fargo's proof of claim appears to be the conflicting information it supplied on the calculation of Debtors' past due escrow balance. Initially, Wells Fargo claimed $2,065.80 in past due escrow payments on its proof of claim. It did not reveal the existence of funds in a debtor suspense account that evidently existed on the petition date, nor did it clarify whether the escrow portion of past due installment payments also claimed on the proof of claim had been credited to the balance owed. After the Objection was filed, Wells Fargo provided a partial history of Debtors' escrow account indicating a negative escrow balance of $3,078.82 on the petition date. This sum did not match the proof of claim balance. However, within its Response, Wells Fargo reconciled the two by explaining the existence of a debtor suspense account and claiming additional charges for "future disbursements." Wells Fargo still failed to explain what "future disbursements" might be required or how Debtors' suspense account balance was calculated. It also failed to acknowledge credits due for escrow installment amounts already claimed with past due monthly notes on the proof of claim.

Two months later, Wells Fargo filed a full loan history which revealed a negative escrow balance of $4,154.20. This new balance was prior to the application of Debtors' suspense account, credits for the escrow portion of past due installment also claimed on the proof of claim, or debts for any additional "needed funds for future disbursement." It provided no explanation as to why this accounting differed from the previous filings.

Both histories indicate that three charges are paid annually from Debtor's account: property taxes, flood insurance premiums, and hazard insurance premiums. Below is a chart, prepared by the Court, reflecting the last charge paid by Wells Fargo for each of these expenses, the date paid, and

the period of coverage.

Date paid	Description	Amount paid	Period covered
12/12/06	Property tax	$106.04	1/1/07-12/31/07
02/07/07	Flood Ins	$1,133.06	10/21/06-10/21/07
06/15/07	Hazard Ins	$896.14	6/15/07-6/15/08
06/25/07	Refund-hazard	(-$378.82)	

Based on this information, the Court can estimate the amounts necessary to balance Debtors' escrow account:

Type	Annual Amt	Mo.Amt	Mos to Petition date		Total due
Property tax	$106.04	$ 8.84	7 mos	1/07-7/07	$ 61.88
Flood Ins	$1,133.06	94.42	10 mos	10/06-7/07	944.20
Hazard	$517.32	43.11	2 mos	6/07-7/07	86.22
Total due to balance account as of petition date					$1,092.30

To this sum must be added two months worth of escrow payments allowed by RESPA, or $292.74.[7]

Thus, the total amount to bring the escrow account into balance as of the petition date is:

$4,154.20- Actual past due balance on the petition date
1,092.30- Additional amounts needed to bring the account current
292.74- RESPA allowed cushion
$5,539.24[8] Total past due sum

This would have been the correct amount to reflect on the proof of claim. It was not, nor was it the sum presented in Wells Fargo's Response or after the submission of the full loan history. Instead, Wells Fargo's calculation resulted in substantial overstatement of the amounts owed.[9] Since this has

[7] ($106.04 – $1,133.06 – $517.32) / 12 = $146.37 x 2 = $292.74

[8] $1,385.04 ($1,092.30 – $292.74) is Debtors' new starting postpetition escrow balance to which $146.37 will be added each month, postpetition, until readjusted if necessary.

[9] Based on the calculations contained within Wells Fargo's proof of claim and Response, the escrow balance would have been (-$836.54). This balance is calculated:

$ 836.54 -actual past due balance on petition date
- 2988.88 - Debtors' suspense account balance on petition date

been a common problem in this and other cases, the Court sets the following parameters for the calculation of amounts due as of the petition date for escrow and reflected on proofs of claim.

First, the debtor's actual escrow balance as of the petition date is to be listed on the proof of claim. Lenders are then required to list the last year's property tax payment and premiums for all related insurance, as well as the date of last payment made on each account. Each amount should then be divided by 12 and multiplied by the number of months between the date of last payment and the petition date. The sum of these amounts, plus two months worth of escrow payments as allowed by RESPA (collectively referred to as the "Catch Up Escrow Payments"), should then be subtracted from the actual escrow balance existing on the petition date. If the difference is a negative number, this amount should be reflected on the proof of claim as a past due sum. If the difference is a positive number, it should be a credit against other sums owed.

The calculations explained above should appear on the face of the proof of claim:

Escrow charges	Amount	Date paid	Mo amt	Mos to petition date	Total due
Hazard Ins	$A	X/X/XX	A/12=M	X/X/XX-Petition date=N	M*N
Flood Ins	$B	X/X/XX	B/12=O	X/X/XX-petition date=P	O*P
Taxes	$C	X/X/XX	C/12=Q	X/X/XX-Petition date=R	Q*R
Total			S		T

The two (2) months worth of escrow payments allowed under RESPA are calculated: [(A + B + C)/ 12] x 2 = U

U + T = Catch Up Escrow Payments

+ 2241.66 - 6 mos of past due escrow payments @ $373.61 each
+ 1976.48 - amounts allegedly needed for future disbursements
$ 2,065.80 - owed per proof of claim

However, according to Wells Fargo's accounting, the balance due on the petition date was either (-$3,078.82) or (-$4,154.20) *before* application of Debtors' suspense balance or credits for the escrow portion of past due installment payments or the addition of amounts needed for future disbursements.

The actual escrow balance on petition date minus the Catch Up Escrow Payments (U + T) = escrow balance on proof of claim

The debtor's postpetition escrow account should begin with a balance equal to the Catch Up Escrow Payments (U + T).

S = new monthly postpetition escrow payment added to postpetition installments of principal and interest

Because the escrow account is now balanced, past due installments should be listed on the proof of claim with only interest and principal components. Any amounts held in debtor's suspense should be separately listed as a credit. All other outstanding fees, costs, and charges should be separately listed.

The Calculation of the Arrearage

Wells Fargo's accounting reflected a positive suspense balance of $2,685.55. Monies held in suspense at the time of filing are due as a credit against the amounts owed on the petition date.

Prepetition attorney's fees and costs have been stipulated by Debtors to be $2,410.12.

Because the amount to balance the escrow account is separately calculated, the past due installments should only include principal and interest. Therefore, Debtors owe payments of $661.20 each month from February, 2007, through July, 2007, or $3,967.20 in total.

The revised prepetition escrow account balance is $5,539.24. Wells Fargo is authorized to offset Debtors' suspense balance, $2,685.30, against this amount despite the Court's prior ruling striking the past due escrow account.

The total amounts due as of the petition date are:

Past due installments-2/07-7/07, principal and interest only	$ 3,967.20
Attorneys fees and costs	2,410.12
Late fees	165.30
Total	$6,542.62[10]

The Court believes Well Fargo has attempted to implement its decision in *Jones*[11] with this proof of claim and the lessons learned from the trial in *Stewart*.[12] While the proof of claim filed in this case was still in substantial error, the problems with the accounting supplied by Wells Fargo are minute compared with previous cases. For the record, the Court has already stricken the past due escrow account, inspection fees, and broker's price opinion charges because Wells Fargo failed to provide proof of those amounts during trial. After the entire accounting was reconciled, this resulted in a reduction of $3,233.69 in Debtors' favor. [13]

The Court notes that Wells Fargo did present erroneous information on the profits charged for broker's price opinions in this case, but corrected the evidence when the truth came to light. While the Court does not condone Wells Fargo's action, Wells Fargo was sanctioned in *Stewart*[14] for this practice. With regard to the delays experienced by Debtors for the production of information, the Court does not find that the delays were so lengthy as to warrant sanctions.

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[10] Based on prior rulings, the $2,610.00 in outstanding escrow charges have been stricken.

[11] *In re Jones*, 366 B.R. 584 (Bankr. E.D.La. 2007), *supplemented by*, 2007 WL 2480494 (Bankr. E.D.La. 2007).

[12] *In re Stewart*, No. 07-11113 (Bankr. E.D.La. April 10, 2008).

[13] The elimination of broker's price opinion charges, inspection fees and negative escrow balance reduced Wells Fargo's claim by $2,990.00.

[14] *In re Stewart*, No. 07-11113 (Bankr. E.D.La. April 10, 2008).

Having found these failings, the Court also notes that Wells Fargo has produced a legible and presumably correct accounting of the loan's payment history based on Debtors' failure to object to any additional entries. It also appears that payments are being properly applied both to pre and postpetition sums. In short, the accounting supplied is a vast improvement over that delivered in *Jones* and *Stewart*.

Damages

Wells Fargo did not fully comply with Debtor's qualified written request until January 18, 2008. RESPA provides that Wells Fargo shall be liable for actual damages, plus an additional $1,000.00, should a pattern of noncompliance be proven. Debtors have requested $21,850.00 in attorneys' fees, which they claim are their actual damages.

In *Johnson v. Georgia Highway Exp., Inc.*,[15] the Fifth Circuit set forth twelve factors that courts should consider when evaluating a fee request. This Court will now consider Debtors' fee request, using the relevant *Johnson* factors for guidance.

This Court has relied heavily upon the comparison of the effort expended in this matter with that expended in *Stewart* because the debtors in both cases were represented by the same firm. The issues presented in each case were similar, but the complexity of the accountings offered and the time expended in trial was substantially less in this matter. The documentation and accounting work produced by Wells Fargo were also substantially improved. The Court does not believe that the fees requested for this matter, $21,850.00, are commensurate with the effort and results obtained, given that counsel charged $12,500.00 in the *Stewart* case for a considerably more involved and complex matter.

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[15] 488 F.2d 714, 717-719 (5th Cir. 1974).

The Court also notes that the fees charged are seven times the benefit received by Debtor. Debtors' counsel billed 109.25 attorney hours at $200.00 per hour. The Court finds that the amount of time that counsel spent on this case is excessive for a number of reasons. First, Eastern District of Louisiana Bankruptcy Court General Order No. 2007-2, and the accompanying Reasons, provide that routine claim objections and work related to confirmation are included in the "no-look' fixed fee counsel receives for representing debtors in chapter 13 bankruptcies. While this claim objection was not routine, the initial work of reviewing Wells Fargo's claim, discussing it with Debtors, and preparing for and attending confirmation hearings fall within the parameters of the "no-look" fee and are not appropriately charged to this matter. Additionally, counsel spent an inexplicable amount of time reviewing pleadings. For example, counsel spent 1.1 hours reviewing a one page Motion to Continue with a one page attachment.[16]

Counsel also spent a disproportionate amount of time preparing for hearings. The initial benefits obtained were achieved in the first hearing, which lasted only thirteen (13) minutes. Subsequent hearings were conducted almost exclusively to compel document production.

While the novelty and difficulty of the questions presented and the skill requisite to perform the legal service involved weigh in favor of a higher fee, the Court does not believe that they justify the fee requested. The remaining *Johnson* factors: the customary fee charged, the "undesireablility" of the case, and the nature and length of the professional relationship with the client,[17] are inapplicable.

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[16] October 17, 2007, entry on Affidavit of Debtors' Counsel as to Attorney Fees, P-38, referring to October 17, 2007, Motion to Continue Hearing, P-19.

[17] *Johnson*, 488 F.2d at 718-719.

For the above reasons, the Court does not find the $21,850.00 fee request to be reasonable and awards $3,500.00 in fees. The Court also finds that Debtors have not shown a pattern of noncompliance, nor did they prove that additional damages were warranted. Accordingly, the Court will not award any additional damages. Provided Wells Fargo complies with this Memorandum Opinion and the directives in *Stewart* and *Jones*, the Court hopes that further sanctions will not be necessary.

New Orleans, Louisiana, April 23, 2008.

Hon. Elizabeth W. Magner
U.S. Bankruptcy Judge

Mr. COHEN. Thank you, Judge. It just came on. That was great timing. This is the fourth anniversary of your being on the bench?

Judge MAGNER. Yes, it is.

Mr. COHEN. Well, do you have a king's pay for something like that?

Judge MAGNER. I was sworn in a week after Katrina.

Mr. COHEN. And you sit in New Orleans?

Judge MAGNER. In New Orleans.

Mr. COHEN. Great. Thank you so much. Are you going to get back tonight to get a good meal in New Orleans?

Judge MAGNER. Tomorrow.

Mr. COHEN. Tomorrow. Well, you are great to come up here with us and give up all that good cuisine.

Our next witness is Ms. Suzanne Sangree.

Ms. SANGREE. Sangree.

Mr. COHEN. Ms. Sangree is the Chief Solicitor for the Baltimore City Law Department, Baltimore, MD. The city has filed a lawsuit against Wells Fargo alleging the bank's lending practices discriminated against minority borrowers. It further alleges the bank's lending practices led to a wave of foreclosures that reduced city tax revenues and increased its costs.

And if you could do your 5 minutes, we can get away and run to vote. But we thank you, Ms. Sangree, and we look forward to your testimony.

TESTIMONY OF SUZANNE SANGREE,
CITY OF BALTIMORE LAW DEPARTMENT

Ms. SANGREE. Thank you, Chairman Cohen. Thank you, Chairman Conyers, Ranking Member Franks, and the rest of the Subcommittee Members. It is my pleasure to testify.

Baltimore is a case study of the damage that has befallen cities in the absence of Federal regulation. In particular, lax enforcement of the Fair Housing Act, relaxation of banking regulations, and Federal preemption of States' ability to regulate has created an environment in which racially discriminatory predatory lending has flourished.

Baltimore, a majority African American city, as Chairman Cohen pointed out, much like Memphis, is currently contending with the economic fallout. One of the city's strategies for staunching the damage that predatory lending has caused is litigation against the wrongdoers. And we have sued—under the Fair Housing Act, we have sued Wells Fargo for racially discriminatory predatory lending, as you mentioned earlier. Redlining, we have sued them for reverse redlining, which is the flip side of redlining. Redlining is the practice of drawing a boundary around a minority neighborhood and saying we are not going to lend prime credit inside that boundary. Reverse redlining is saying we are going to target that same neighborhood for predatory lending, for high cost, high fee, high interest rate, unfavorable loans.

The shapers of the Fair Housing Act smartly designed it so that cities could sue directly, would have standing to sue, but it was always envisioned that the Federal Government would play a leading role in enforcement of the act, and in the recent past it has not done that.

Like other American cities with large non-White populations, Baltimore is particularly vulnerable to predatory lending, and this vulnerability is caused by two related factors. One is a history of redlining, of denying credit to certain communities, and the other is racial segregation patterns in housing, so that those communities that have been denied or those people who have been denied credit in the past are geographically concentrated and so very easily targeted by abusive lenders.

As our history of redlining and racial segregation would predict, beginning in the late 1990's Baltimore became the target of predatory lending, and this fact is reflected in a wave of foreclosures. Since the year 2000 we have had over 33,000 foreclosure filings, homes that are subject to foreclosure filings.

Home Mortgage Disclosure Act data reveals racial disparities in Wells Fargo's lending practices, and Wells Fargo has been the biggest lender in Baltimore City since 2000. As documented in our amended complaint, in 2006 Wells Fargo made high cost loans to 65 percent of its African American borrowers compared to only 15 percent of White borrowers in the city, and Wells Fargo foreclosure rates are four times higher in African American neighborhoods than they are in White neighborhoods.

High level ex-employees of Wells Fargo have come forward to testify to the economic incentive structure at Wells Fargo that encouraged and rewarded employees handsomely for steering African American borrowers into unfavorable loans, and they describe practices of steering even borrowers who qualified for prime, steering them into subprime, assuring borrowers that pre-payment penalties could be waived when they could not be waived, assuring them that they were getting a fixed rate loan when they were getting a variable rate loan or that they would be able to refinance before the adjustment rate would begin to kick in. They were also encouraged to take more equity out of their homes or not to document their income even though they were salaried employees with W-2s of all of their income. And the purpose of encouraging borrowers to not do those things was that the lenders knew, the brokers knew, the agents knew, that this would cause the loan to flip to subprime from prime and they would make much higher commissions and the company would make much higher profits when that happened.

When people are locked into mortgages they cannot afford, it is very predictable they will fall behind and foreclosure will often result. And this has caused Baltimore great damage. Goldseker Foundation estimates that in 2006 alone the city lost $41.9 million in tax revenue. We have increased code enforcement, as well as fire and police, and all of our efforts to nurture our neighborhoods and have urban renaissance are being washed down the drain.

The legal claims and the facts and figures concerning the city's damages don't capture the devastating impact of foreclosure on African American families and neighborhoods. Adding injury to insult communities that for generations—and I have a red light too. It is hard to watch that light when you are reading. So I will stop as well.

[The prepared statement of Ms. Sangree follows:]

STATEMENT OF SUZANNE SANGREE

Oral Testimony of

Suzanne Sangree, Chief Solicitor

Baltimore City Law Department

Before the United States House Judiciary Committee

Subcommittee on Commercial and Administrative Law

Hearing on the Role of the Lending Industry in the Subprime Mortgage Crisis

Wednesday September 9, 2009

Baltimore City Department of Law

City Hall, 100 Holliday Street, Room 109

Baltimore, MD 21202

suzanne.sangree@baltimorecity.gov

Oral Testimony of

Suzanne Sangree, Chief Solicitor

Baltimore City Law Department

United States House Judiciary Committee

Subcommittee on Commercial and Administrative Law

Hearing on the Role of the Lending Industry in the Subprime Mortgage Crisis

Wednesday September 9, 2009

Members of the Committee, I am Suzanne Sangree, a Chief Solicitor in the Baltimore City Department of Law, testifying on behalf of the Mayor and City Council of Baltimore. Thank you for inviting me to speak with you today.

Baltimore is a case study of the damage that has befallen cities in the absence of aggressive federal enforcement of this nation's civil rights laws, especially the Fair Housing Act of 1968. In particular, lax enforcement of the Fair Housing Act, combined with federal relaxation of federal banking regulations and federal preemption of states' ability to regulate lenders, created an environment in which racially discriminatory predatory lending flourished. Baltimore, a majority African-American city, is currently contending with the devastating economic fall out of this petri dish for racially targeted predatory lending. The City has developed and continues to develop a six pronged approach to staunching the resulting economic damage and repairing it. Litigation against the wrong doers is one prong of our plan, beginning with our Fair Housing Act suit against Well Fargo for reverse redlining. In the absence of federal enforcement cities have been left to contend for themselves. Under the leadership of City Solicitor George Nilson and our co-counsel John Relman and Brad Blower of Relman & Dane, Baltimore

City turned to the Fair Housing Act as our best weapon for fending off reverse redlining and obtaining relief to repair the damage it has inflicted. The shapers of that Act smartly provided a broad capacity for standing to sue, thus the Supreme Court has long recognized that Cities have standing under the Act. However, it was always envisioned that the federal government would play a leading role in enforcement. It has not.

Like other American cities with large non-white populations and a history of racial segregation, Baltimore is particularly vulnerable to predatory lending. This vulnerability is caused by two complimentary factors: 1) a history of denying minorities access to credit; and 2) a history of racially segregated living patterns. As to the first factor, communities that for generations had been locked out of credit and housing opportunities, because of redlining are rendered desperate for credit and without the knowledge or experience required to identify loan products and lenders offering better terms. When one's only experience with loan applications has been no, it is common to jump on the first yes without much critical evaluation. The second factor is key because when these vulnerable communities are geographically concentrated they are easily targeted by abusive lenders. Unfortunately Baltimore fulfills both of these factors.

Our solid patterns of racial segregation were initially enforced by racially restrictive convenants. In 1954, within months of the Supreme Court's *Brown I* decision, forward looking Baltimore officials decided to desegregate the City's low-income housing units. However, well into the 1970's and later the siting and maintenance of racially segregated public housing continued to reinforce Baltimore's patterns of housing segregation. Importantly, redlining practices by federal and state government authorities-- and by private entities (mortgage lenders and insurers)—also created barriers to desegregation. The Secretary of the United States Department of Housing and Urban Development admitted in 1970 that the federal government had "refused to provide insurance in integrated neighborhoods, promoted the use of racially restricted covenants," and engaged in other methods of redlining. Data from the 1980's, long after the institutionalized government and corporate apparatus of discrimination had been formally dismantled, shows that the more African-American residents in a Baltimore neighborhood, the fewer the mortgage loans and dollars the neighborhood received. And while we are 64% African-American and 32% white, today's map of our neighborhoods shows that many still have very high concentrations of one race or the other.

As our history of redlining and racial segregation would predict, beginning in the late 1990's, Baltimore has been targeted for predatory loans. This fact is reflected in the wave of foreclosures currently wracking the City. Since 2000, more than 33,000 homes have been subjected to foreclosure filings. From the first to the second quarter of 2007, foreclosure activity in the City increased five-fold. Moreover, we expect this year to be even worse than last year as an additional 4,300 ARMs adjust to higher rates in the City, often to rates the borrowers cannot afford. Another 2,000 ARMs readjust in 2009. During the first quarter of 2008 alone, 1,447 foreclosure filings were made in Baltimore City.

On January 8, 2008, Baltimore City filed suit against Wells Fargo in the federal district court of Maryland alleging that Wells Fargo engaged in reverse redlining, i.e. that it has targeted Baltimore's African-American neighborhoods for bad loans. We chose Wells Fargo because it is one of the largest mortgage lenders in Baltimore and it has the greatest number of foreclosures in the City. Since 2004 to the present, Wells Fargo has made over a 1,200 mortgage loans per year in Baltimore City. No other lender made more than 1,000 mortgage loans in Baltimore during these years. In addition, the racial disparities in lending practices for Wells Fargo loans were among the greatest of all lenders. But there are certainly other bad actors in the City, and we hold them accountable as well.

Home Mortgage Disclosure Act (HMDA) data reveals the racial disparities in Wells Fargo lending practices in Baltimore. As documented in the attached complaint, in 2006 Wells Fargo made high-cost loans to 65% of its African-American mortgage customers in Baltimore, but to only 15% of its white customers in Baltimore. Wells Fargo's refinance loans were even worse: in 2004, 2005, and 2006, a Wells Fargo refinance loan to an African-American borrower was 2.5 times more likely to be high cost than a refinance loan to a white borrower. In addition, Wells Fargo's pricing sheets require that equally credit worthy borrowers in predominantly African-American neighborhoods pay higher interest rates than their counterparts in white neighborhoods, imposing thousands of dollars in extra interest payments on African-American borrowers.

High level ex-employees of Wells Fargo have submitted affidavits with our amended complaint (attached hereto) detailing the economic incentive structure at Wells Fargo which encouraged employees to engage in racial targeting—to steer African-Americans into subprime loans even when they qualified for prime loans, and to engage in numerous other deceptive practices to induce unsuspecting borrowers into unfavorable loans.

Interestingly, research recently conducted by Chris Herbert of Abt Associates Inc. for the Annie E. Casey Foundation confirms that race accounts for lenders' disparate lending practices in Baltimore neighborhoods and not credit scores or other risk factors. He has analyzed HMDA, Census Bureau and credit scores from the credit bureau Experian for selected neighborhoods in 13 cities, including the Sandtown/Winchester/East Side Revitalization Area in Baltimore. He concludes that **when one corrects for credit scores,** there is a "Very High" (over 15%) racial disparity in these Baltimore neighborhoods for refinances for 2006, and a "High/Med" (5-15%) racial disparity for purchase loans in 2006. Wells Fargo was the most active lender in both categories in Baltimore. In other words, even after taking the credit characteristics of borrowers into consideration, Wells Fargo was ranked first among lenders in Baltimore for having the largest disparity in the prices it charged African Americans versus whites. So while we are just commencing discovery now in our suit, we have every reason to believe that the loan files will bear out the allegations of our amended complaint.

As our amended complaint documents, Wells Fargo also has one of the highest foreclosure rates of any lender in Baltimore, and its foreclosure rate in majority African American neighborhoods is 4 times the rate in majority white neighborhoods. Two thirds

of Wells Fargo foreclosures in Baltimore in 2005 and 2006 were in census tracts more than 60% African-American, while only 16% were in tracts that are less than 20% African American. Wells Fargo's foreclosure rate for loans in African-American neighborhoods is nearly double the overall City average, while its rate for loans in white neighborhoods is less than half of the average.

An interesting fact about Wells Fargo loans in Baltimore is that fixed rate loans constitute the majority of Wells Fargo's foreclosures. With contemporary underwriting methods lenders can reliably predict whether a borrower will be able to repay a fixed rate loan (debt to income ratio/loan to value/FICO/work history etc.), and the loan payments do not change over the life of the loan. However, even though 70% of Wells Fargo's foreclosures in both African-American and white neighborhoods are on fixed rate mortgages, African Americans are nearly 4 times more likely to be foreclosed upon by Wells Fargo than whites. This is compelling evidence that Wells Fargo followed a policy of putting African-Americans into loans they could not afford.

When people are locked into mortgages that they cannot afford, they will soon fall behind on payments and foreclosure will often result. This pattern of predatory lending and foreclosure is ravaging our City. The TRF/Goldseker Study, "Foreclosures in Baltimore, Maryland" found that Baltimore lost $41.9 million in tax revenue in 2006 alone because of foreclosures. Lost property values across Baltimore in 2004 and 2005 total $17.8 billion.

Baltimore incurs increased code enforcement, police, and fire costs when buildings remain vacant. And the dollars and effort spent to nurture neighborhoods, and to spark and maintain the urban renaissance the City had been undergoing, are being washed down the drain, as up and coming neighborhoods are stalled and even reversed in their economic progress.

The City seeks compensatory and punitive damages from Wells Fargo in order to mend the damage the company's predatory lending has inflicted, and to deter such conduct in the future. Judge Legg denied Wells Fargo's Motion to Dismiss in July of this year and we are now engaging in discovery.

ATTACHMENTS

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND
BALTIMORE DIVISION

MAYOR AND CITY COUNCIL OF BALTIMORE, City Hall 100 N. Holliday St. Baltimore, MD 21202 Plaintiff, v. **WELLS FARGO BANK, N.A.** 464 California Street San Francisco, CA 94104 and **WELLS FARGO FINANCIAL LEASING, INC.,** 207 9th Street Des Moines, IA 50307 Defendants.	)	Case No. 1:08-cv-00062-BEL

FIRST AMENDED COMPLAINT FOR
DECLARATORYAND INJUNCTIVE RELIEF AND DAMAGES

NATURE OF THE ACTION

1. The City of Baltimore is facing an unprecedented crisis of residential mortgage foreclosures. From the third to the fourth quarter of 2008, foreclosure activity increased 26%. Since 2000, more than 33,000 homes have been subjected to foreclosure filings. The foreclosure crisis has caused severe economic damage to the City. The high rate of foreclosures has resulted in lost revenue in property taxes; additional costs in

social services and police and fire protection; and significant administrative and legal costs.

2. In Baltimore, the foreclosure crisis has hit African-American neighborhoods and homeowners the hardest. Foreclosure rates are significantly higher in Baltimore's minority neighborhoods, due in large part to the practice of "reverse redlining." In contrast to "redlining," which involves denying *prime* credit to specific geographic areas because of the racial or ethnic composition of the area, reverse redlining involves the targeting of an area for the marketing of deceptive, predatory or otherwise unfair lending practices because of the race or ethnicity of the area's residents. Reverse redlining has repeatedly been held to violate the federal Fair Housing Act.

3. Defendant Wells Fargo Bank, N.A., is one of the largest mortgage lenders in Baltimore and the country at large. Together with Defendant Wells Fargo Financial Leasing, Inc. (collectively "Wells Fargo"), it is also one of the leading causes of the disproportionately high rate of foreclosures in Baltimore's African-American neighborhoods. From 2005 to 2008, for example, over 60% of Wells Fargo's foreclosures were in Baltimore City census tracts that are more than 60% African-American, while only 12% were in tracts that are less than 20% African-American. Wells Fargo's foreclosure rate for loans in neighborhoods that are more than 80% African-American is nearly triple the overall average of the other major mortgage lenders in Baltimore, while the rate for its loans in neighborhoods that are less than 20% African-American is less than half of their average.

4. Wells Fargo's disproportionately high foreclosure rate in Baltimore's African-American neighborhoods is the result of reverse redlining. Wells Fargo has been, and continues to be, engaged in a pattern or practice of unfair, deceptive and

discriminatory lending activity in Baltimore's minority neighborhoods that have the effect and purpose of placing inexperienced and underserved borrowers in loans they cannot afford. These practices maximize short-term profit to Wells Fargo without regard to the borrower's best interest, the borrower's ability to repay, or the financial health of underserved minority neighborhoods.

5. Wells Fargo's lending practices, targeted in this manner at Baltimore's underserved and vulnerable minority neighborhoods, have resulted in the disproportionately high rate of foreclosure in Baltimore's African-American communities, caused substantial and irreparable damage to these neighborhoods, and caused direct and continuing financial harm to the City of Baltimore.

6. This suit is brought pursuant to the Fair Housing Act of 1968, as amended, 42 U.S.C. §§ 3601 *et seq.*, by the Mayor and City Council of Baltimore ("Baltimore" or "City") to seek redress for the injuries caused by Wells Fargo's pattern or practice of illegal reverse redlining. Specifically, Baltimore seeks to recover damages for the injuries caused by the foreclosures in Baltimore's minority neighborhoods as a result of Wells Fargo's unlawful, irresponsible, unfair, deceptive, and discriminatory lending practices, and to obtain injunctive and declaratory relief. Absent judicial relief, the extent of the City's injury resulting from Wells Fargo's actions will continue – and potentially accelerate – as the housing market continues to decline.

PARTIES

7. Plaintiff Mayor and City Council of Baltimore is a municipal corporation, organized pursuant to Article XI-A of the Maryland Constitution. The City is authorized by the Baltimore City Charter to institute suit to recover damages suffered by the City.

8. Defendant Wells Fargo Bank, N.A. is organized as a national banking association under the laws of the United States. Upon information and belief, its corporate headquarters are located in California. Wells Fargo Bank, N.A. maintains multiple offices in the State of Maryland and in Baltimore for the purposes of soliciting applications for and making residential mortgage loans and engaging in other business activities.

9. Wells Fargo Home Mortgage is a division of Wells Fargo Bank, N.A. that was formerly incorporated in California as a separate company and registered to do business in the State of Maryland under the name Wells Fargo Home Mortgage, Inc. Wells Fargo Home Mortgage, Inc. merged into Wells Fargo Bank, N.A. on May 5, 2004. Wells Fargo Bank, N.A. continues to do business under the name Wells Fargo Home Mortgage, including in the State of Maryland and in Baltimore.

10. Wells Fargo Bank, N.A. has been one of the three largest providers of mortgage credit to homeowners in Baltimore every year since at least 2000. From 2002 to 2007 (the most recent year for which data is available), Wells Fargo Bank, N.A. made at least 1,341 mortgage loans a year to Baltimore homeowners with a collective value of more than $1 billion. Upon information and belief, Wells Fargo Bank, N.A. continues to make loans in Baltimore at a comparable pace. No other lender made more than 1,200 mortgage loans in Baltimore in each year from 2004 to 2007, and only two others made more than 1,000 in each year.

11. Defendant Wells Fargo Financial Leasing, Inc. is an Iowa corporation that is registered to do business in Maryland. Upon information and belief, Wells Fargo Financial Leasing, Inc. engages in the solicitation of applications for and origination of residential mortgage loans in Baltimore.

12. Each of the Defendants was and is the agent, employee, and representative of the other Defendant. Each Defendant, in acting or omitting to act as alleged in this First Amended Complaint, was acting in the course and scope of its actual or apparent authority pursuant to such agencies, or the alleged acts or omissions of each Defendant as agent were subsequently ratified and adopted by each agent as principal. Each Defendant, in acting or omitting to act as alleged in this First Amended Complaint, was acting through its employees, agents, and/or representatives, and is liable on the basis of the acts and omissions of its employees, agents, and/or representatives.

JURISDICTION AND VENUE

13. This Court has jurisdiction over this matter pursuant to 42 U.S.C. § 3613 and 28 U.S.C. §§ 1331, 1343, because the claims alleged herein arise under the laws of the United States.

14. Venue is proper in this district under 28 U.S.C. § 1391(b) because Defendants conduct business in and are residents of the district and a substantial part of the events and omissions giving rise to the claims occurred in the district.

FACTUAL BACKGROUND

A. The Foreclosure Crisis and Baltimore

15. Like many cities across the country, Baltimore is facing an unprecedented crisis of residential mortgage foreclosures. Of the 45 million active mortgages throughout the country currently tracked by the Mortgage Bankers Association ("MBA"), approximately 343,000 entered foreclosure during the third quarter of 2007. This is the highest rate of foreclosures in more than 35 years. Overall, nearly 450,000 properties tracked by the MBA were in some stage of foreclosure during the third quarter of 2007, up 30% from the second quarter.

16. Nationwide, the foreclosure crisis is worsening rapidly and is expected to deteriorate further. Foreclosures continued to increase rapidly in 2008, with 2.2 million mortgages entering foreclosure during the year according to the MBA. Analysts predict that the number could rise to 4 million in 2009. One out of every thirteen mortgage holders is no longer able to make payments on time, the highest rate in over thirty-five years. Delinquent payments are a strong indicator of near-term foreclosure filings. On subprime loans alone, the Joint Economic Committee of Congress has predicted that from 2007 to 2009 there could be nearly 2 million foreclosures nationwide. Many of these foreclosures are linked to $362 billion in adjustable rate subprime loans resetting to higher interest rates last year. As the housing market continues to decline, many of these adjustments will result in foreclosures.

17. The foreclosure crisis in Baltimore is especially severe. There have been more than 33,000 foreclosure filings since 2000, and the Maryland Department of Housing and Community Development reported in October 2007 that the number of foreclosure-related events in Baltimore – notices of default, foreclosure sales, and lender purchases of foreclosed properties – increased an extraordinary five-fold from the first to the second quarter of the year. More recently, the Department reported that foreclosure-related events in the City increased to 1,111 in the fourth quarter of 2008, up 26% from the previous quarter.

18. Foreclosures have multiple and far-reaching impacts on the cities in which they occur, especially when they are concentrated in distressed neighborhoods that are already struggling with issues of economic development and poverty. Foreclosures in these neighborhoods frequently lead to abandoned and vacant homes. Estimates of the number of vacant homes in Baltimore range from 16,000 to 30,000. Concentrated

vacancies driven by foreclosures cause neighborhoods, especially ones already struggling, to decline rapidly. The United States Department of Housing and Urban Development ("HUD") and the United States Department of the Treasury ("Treasury") explained in a joint report on predatory subprime lending that "foreclosures can destabilize families and entire neighborhoods" and that "[f]oreclosed homes are often a primary source of neighborhood instability . . . ." HUD & Treasury, *Curbing Predatory Home Mortgage Lending* (2000) at 13, 51 (available at http://www.huduser.org/Publications/pdf/treasrpt.pdf) ("HUD/Treasury Report") (attached as Attachment B).

19. One example of how foreclosures and consequent vacancies harm neighborhoods is by reducing the property values of nearby homes. In Baltimore, as in cities around the country, foreclosures are responsible for the loss of hundreds of millions of dollars in the value of homes. This, in turn, reduces the City's revenue from property taxes. It also makes it harder for the City to borrow funds because the value of the property tax base is used to qualify for loans.

20. Cities with high rates of foreclosure, like Baltimore, also lose revenue from real estate transfer taxes because foreclosures depress the market for home sales. And these cities must spend additional funds for services related to foreclosures, including the costs of securing vacant homes, holding administrative hearings, and conducting other administrative and legal procedures. The funds expended also include the costs of providing additional police and fire protection as vacant properties become centers of dangerous and illicit activities.

B. The Role of Subprime Lending

21. The growing crisis of foreclosures in Baltimore and across the nation is due in large part to the rapid expansion of subprime lending. Subprime lending developed in the mid-1990s as a result of innovations in risk-based pricing and in response to the demand for credit by borrowers who were denied prime credit by traditional lenders.

22. Prior to the emergence of subprime lending, most mortgage lenders made only "prime" loans. Prime lending offered uniformly priced loans to borrowers with good credit. Individuals with blemished credit were not eligible for prime loans. Although borrowers with blemished credit might still represent a good mortgage risk at the right price, prime lending did not provide the necessary flexibility in price or loan terms to serve these borrowers.

23. In the early 1990s, technological advances in automated underwriting allowed lenders to predict with improved accuracy the likelihood that a borrower with blemished credit will successfully repay a loan. This gave lenders the ability to adjust the price of loans to match the different risks presented by borrowers whose credit records did not meet prime standards. Lenders found that they could now accurately price loans to reflect the risks presented by a particular borrower. When done responsibly, this made credit available much more broadly than had been the case with prime lending.

24. As the technology of risk-based pricing developed rapidly in the 1990s, so did the market in subprime mortgages. Subprime loans accounted for only 10% of mortgage loans in 1998, but within five years grew to 23% of the market. Currently, outstanding subprime mortgage debt stands at $1.5 trillion, up from $65 billion in 1995 and $332 billion in 2003. These subprime loans have allowed millions of borrowers to

obtain mortgages, at marginally increased prices, even though their credit profiles do not qualify them for lower-cost prime loans. They have opened the door to homeownership to many people, especially low- to moderate-income and minority consumers, who otherwise would have been denied mortgages. At the same time, subprime lending has created opportunities for unscrupulous lenders to engage in irresponsible lending practices that result in loans that borrowers cannot afford. This, in turn, has led directly to defaults and foreclosures.

25. Enticed by the prospect of short-term profits resulting from exorbitant origination fees, points, and related pricing schemes, many irresponsible subprime lenders took advantage of a rapidly rising real estate market to convince borrowers to enter into loans that they could not afford. Often this was accomplished with the help of deceptive practices and promises to refinance at a later date. These abusive subprime lenders did not worry about the consequences of default or foreclosure to their business because once made, the loans were sold on the secondary market.

26. As the subprime market grew, the opportunities for abusive practices grew with it. As a consequence, abusive and predatory practices "are concentrated in the subprime mortgage market," as the federal government has found. HUD/Treasury Report at 1. These practices, which in recent years have become the target of prosecutors, legislators and regulators, include the following:

a. Failing to prudently underwrite hybrid adjustable rate mortgages (ARMs), such as 2/28s and 3/27s. After the borrower pays a low "teaser rate" for the first two or three years, the interest rate on these loans resets to a much higher rate that can continue to rise based on market conditions. Subprime lenders often underwrite these loans based only on consideration of whether the borrower can

make payments during the initial teaser rate period, without regard to the sharply higher payments that will be required for the remainder of a loan's 30-year term. Irresponsible lenders aggressively market the low monthly payment that the borrower will pay during the teaser rate period, misleading borrowers into believing that they can afford that same low monthly payment for the entire 30-year term of the loan, or that they can refinance their loan before the teaser rate period expires.

b. Failing to prudently underwrite refinance loans, where borrowers substitute unaffordable mortgage loans for existing mortgages that they are well-suited for and that allow them to build equity. Such refinanced loans strip much or even all of that equity by charging substantial new fees, often hiding the fact that the high settlement costs of the new loan are also being financed. Lenders that aggressively market the ability of the borrower to pay off existing credit card and other debts by refinancing mislead borrowers into believing that there is a benefit to consolidating all of their debt into one mortgage loan, obscuring the predictable fact that that the borrower will not be able to repay the new loan. The refinanced loans are themselves often refinanced repeatedly with ever-increasing fees and higher interest rates, and with ever-decreasing equity, as borrowers seek to stave off foreclosure.

c. Allowing mortgage brokers to charge "yield spread premiums" for qualifying a borrower for an interest rate that is higher than the rate the borrower qualifies for and can actually afford.

d. Failing to underwrite loans based on traditional underwriting criteria such as debt-to-income ratio, loan-to-value ratio, FICO score, reserves,

and work history. These criteria ensure that a borrower is obtaining a loan that he or she has the resources and assets to repay, and ignoring these criteria results in many loans that bear no relation to borrowers' ability to repay them. This allows the lender to make a quick profit from the origination, but sets the borrower up for default and foreclosure.

e. Requiring substantial prepayment penalties that prevent borrowers whose credit has improved from refinancing their subprime loan to a prime loan. Prepayment penalties not only preclude borrowers from refinancing to a more affordable loan, but reduce the borrowers' equity when a subprime lender convinces borrowers to needlessly refinance one subprime loan with another.

f. Charging excessive points and fees that are not associated with any increased benefits for the borrower.

g. Placing borrowers in subprime loans even though they qualify for prime loans on better terms.

27. As long as housing prices continued to rise, the deleterious effect of these practices was delayed and thus, hidden. But the inevitable occurred when the real estate bubble burst in 2007 and home prices began to fall, and foreclosure rates began their dramatic rise. Bent on maximizing short-term profits and protected by the ability to sell their loans on the secondary market, irresponsible subprime lenders have left countless homeowners saddled with mortgage debts they cannot afford and no way to save their homes in a declining housing market. The median sales price of a home in Baltimore declined 19.35% from the first quarter of 2008 to the first quarter of 2009 and analysts predict that the housing market will continue to decline. This will continue to drive people with onerous mortgage terms into foreclosure.

C. The Foreclosure Crisis in Baltimore Hits African-American Neighborhoods the Hardest

28. In Baltimore, the impact of the foreclosure crisis is felt most acutely in minority communities. This is because of the prevalence of the practice of "reverse redlining." As used by Congress and the courts, the term "reverse redlining" refers to the practice of targeting residents in certain geographic areas for credit on unfair terms due to the racial or ethnic composition of the area. In contrast to "redlining," which is the practice of denying *prime* credit to specific geographic areas because of the racial or ethnic composition of the area, reverse redlining involves the targeting of an area for the marketing of deceptive, predatory or otherwise deleterious lending practices because of the race or ethnicity of the area's residents. This practice has repeatedly been held to violate the federal Fair Housing Act. *See, e.g.*, *Barkley v. Olympia Mortgage Co.*, 2007 WL 2437810 (E.D.N.Y. Aug. 22, 2007); *Hargraves v. Capital City Mortgage Corp.*, 140 F. Supp. 2d 7 (D.D.C. 2000).

29. The HUD/Treasury Report (discussed in ¶ 18 above) found that reverse redlining in subprime mortgage lending is a major problem: "Predatory lenders often engage in 'reverse redlining' – specifically targeting and aggressively soliciting homeowners in predominantly lower-income and minority communities . . . ." HUD/Treasury Report at 72. "Testimony at the forums [held by the HUD-Treasury National Predatory Lending Task Force in Baltimore and four other cities] strongly indicates that many predatory lenders may have engaged in reverse redlining, or targeting abusive practices to protected groups." *Id.*

30. There is a substantial body of empirical evidence that supports the HUD/Treasury finding and establishes that subprime mortgage lending and the predatory

practices often associated with subprime lending are targeted at African Americans and African-American neighborhoods. *See* Attachments C-L.

31. The Fannie Mae Foundation found that many borrowers who qualify for prime mortgage loans are instead given subprime loans, and that the problem is particularly acute for African-American borrowers. James H. Carr and Lopa Kolluri, Fannie Mae Foundation, *Predatory Lending: An Overview* (2001) (available at http://www.cra-nc.org/financial.pdf) (attached as Attachment C). Fannie Mae reported that "research by Freddie Mac reports that as much as 35 percent of borrowers in the subprime market could qualify for prime market loans" and that "Fannie Mae estimates that number closer to 50 percent." *Id.* at 37. Focusing on race, Fannie Mae concluded that "the level of subprime lending to black households and communities far exceeds the measured level of credit problems experienced by those households." *Id.*

32. A study by the National Reinvestment Coalition ("NCRC") reached the same conclusion. NCRC, *The Broken Credit System: Discrimination and Unequal Access to Affordable Loans by Race and Age – Subprime Lending in Ten Large Metropolitan Areas* (2003) (available at http://www.ncrc.org/images/stories/pdf/research/ncrcdiscrimstudy.pdf) (attached as Attachment D). The NCRC studied subprime mortgage loans in Baltimore and nine other major metropolitan areas. *Id.* at 6, 24-25. It combined data that lenders are required to release to the public under the federal Home Mortgage Disclosure Act ("HMDA") with credit scoring data on a census tract level that the authors obtained from one of the three major credit bureaus. *Id.* at 19-20, 25. (Credit scores are not released under HMDA.) The NCRC controlled for differences in credit scores and found a statistically significant and positive correlation

between the percentage of African Americans in a census tract and the percentage of subprime loans in the tract. *Id.* at 31-34.

33. HUD, though it did not have access to credit scores or other data about creditworthiness, studied 1998 HMDA data on almost 1 million mortgages and likewise concluded that the growth of subprime lending was disproportionately concentrated in African-American neighborhoods. HUD also found that the disparity persisted across income lines and actually increased as neighborhood income increased and stated that the problem requires "closer scrutiny." HUD, *Unequal Burden: Income and Racial Disparities in Subprime Lending in America* (2000) at 4-5 (available at http://www.huduser.org/Publications/pdf/unequal_full.pdf) (attached as Attachment E). HUD observed with alarm that "only one in ten families in white neighborhoods [receive subprime loans and] pay higher fees and interest rates, but *five in ten families in African-American communities are saddled with higher rates and costs*." *Id.* at 4 (emphasis in original). Describing HUD's research in their subsequent joint report, HUD and Treasury stated that "the research consistently revealed that, controlling for income, predominantly non-white census tracts showed much higher subprime refinance penetration rates than predominantly white census tracts." HUD/Treasury Report at 105.

34. A study of 2000 HMDA data covering every metropolitan statistical area in the country found a parallel racial disparity in the frequency of subprime loans. Calvin Bradford, Center for Community Change, *Risk or Race? Racial Disparities and the Subprime Refinance Market* (2002) at vii-ix (available at http://www.knowledgeplex.org/redir.html?id=1032&url=http%3A%2F%2Fwww.knowledgeplex.org%2Fkp%2Freport%2Freport%2Frelfiles%2Fccc_0729_risk.pdf) (attached as Attachment F).

35. The studies discussed above show that African Americans and residents of African-American neighborhoods receive subprime loans at a much greater frequency than whites and residents of white neighborhoods, and that the disparity is much greater than legitimate underwriting factors can explain.

36. The following studies provide empirical evidence that, after controlling for creditworthiness and other legitimate underwriting factors, there are likewise substantial disparities based on race in the terms and conditions of the subprime loans given to African Americans and residents of African-American neighborhoods.

37. A study by the Center for Responsible Lending ("CRL") found racial disparities in the pricing of loans. The study included loans made by Wells Fargo. The study found that African Americans receive higher-priced subprime mortgages than whites who are similarly situated with respect to credit and other underwriting criteria. CRL, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages* (2006) (available at http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf) (attached as Attachment G). This study combined HMDA data with a proprietary database to determine whether race had a statistically significant effect on the pricing of subprime loans in 2004. *Id.* at 3, 9. The proprietary database covered 87% of the U.S. subprime market. *Id.* at 9. It included credit criteria such as the credit score and loan-to-value ratio for each loan; such data is not released under HMDA and is not publically available. *Id.*

38. The CRL found that, after controlling for credit and other underwriting factors, the odds were 40% to 84% higher that an African-American borrower would receive a high-cost purchase loan than a similarly-situated white borrower. *Id.* at 16. The difference was statistically significant for most types of purchase loans. *Id.* Similarly,

the study found that the odds were 4% to 62% higher that an African-American borrower would receive a high-cost refinance loan than a similarly-situated white borrower, also after controlling for credit and other underwriting factors. *Id.* at 17. The difference was statistically significant for refinance loans with prepayment penalties, which constituted nearly two-thirds of the refinance loans analyzed. *Id.*

39. Another study by the Center for Responsible Lending found that subprime borrowers in predominantly African-American and other minority neighborhoods are much more likely to be given loans with prepayment penalties than subprime borrowers in predominantly white neighborhoods who are similarly situated with respect to credit and other characteristics. CRL, *Borrowers in High Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans* (2005) (available at http://www.responsiblelending.org/pdfs/rr004-PPP_Minority_Neighborhoods-0105.pdf) (attached as Attachment H). The Center analyzed proprietary data from The First American Corporation on 1.8 million subprime loans originated from 2000 to mid-2004. First American's proprietary database allowed the Center to control for a variety of underwriting factors, such as credit score, loan-to-value ratio, debt-to-income ratio, and more. *Id.* at 5, App.-1. The study found that "[t]he odds of borrowers receiving prepayment penalties are consistently and positively associated with minority concentration, and the differences are statistically significant." *Id.* at 1-2. It concluded, "[i]n the simplest terms, the odds of avoiding a prepayment penalty on a subprime loan are significantly better for borrowers who live in predominantly white neighborhoods." *Id.* at 7.

40. Another study found racial disparities with respect to requiring borrowers to pay yield spread premiums. Howell E. Jackson & Jeremy Berry, "Kickbacks or

Compensation: The Case of Yield Spread Premiums" (2002), *available at* http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf (attached as Attachment I). The authors analyzed data on creditworthiness and other underwriting criteria, including credit scores and loan-to-value ratios, that was obtained in discovery in a mortgage lending lawsuit under the federal Real Estate Settlement Procedures Act, 12 U.S.C. § 2601, *et seq.* *Id.* at 7, 122-23 & n.147. They found that, after controlling for such criteria, African Americans (and Hispanics) paid substantially more in yield spread premiums than other borrowers, and that the disparity was statistically significant. *Id.* at 9, 125. Moreover, they found that for every dollar paid by borrowers in yield spread premiums, the borrowers gained only 20 to 25 cents of value. *Id.* at 127.

41. Reverse redlining typically flourishes in cities where two conditions are met. First, the practice afflicts cities where minorities historically have been denied access to credit and other banking services. The legacy of historic discrimination, or redlining, often leaves the residents of minority communities desperate for credit, and without the knowledge or experience required to identify loan products and lenders offering products with the most advantageous terms for which they might qualify. Instead, residents of underserved minority communities often respond favorably to the first offer of credit made, without regard to the fairness of the product. This makes them especially vulnerable to irresponsible subprime lenders who, instead of underwriting carefully to ensure that the loans they offer are appropriate for their customers, engage in the unscrupulous lending practices described in paragraph 26 above.

42. Second, reverse redlining arises in cities where there are racially segregated residential living patterns. This means that the people who are most

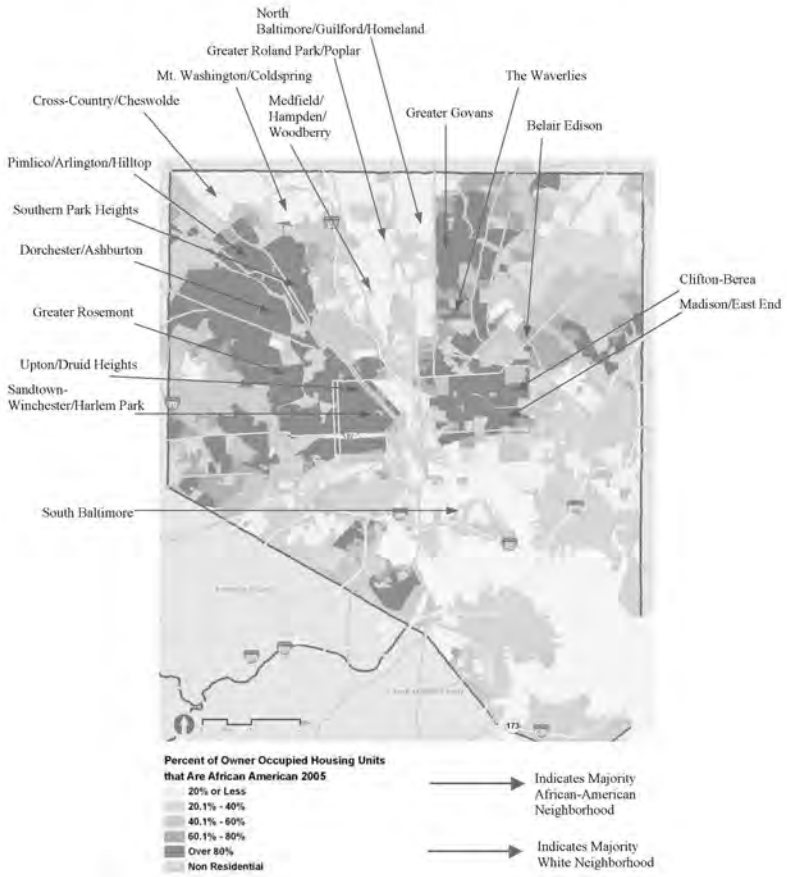
vulnerable to abusive lending practices are geographically concentrated and therefore easily targeted by lenders.

43. Both of these conditions are present in Baltimore. First, Baltimore's minority communities historically have been victimized by traditional redlining practices. Through much of the twentieth century the federal government, mortgage lenders, and other private participants in the real estate industry acted to deny homeownership opportunities and choices to the City's African Americans. The Secretary of the United States Department of Housing and Urban Development admitted in 1970 that the federal government had "refus[ed] to provide insurance in integrated neighborhoods, promot[ed] the use of racially restrictive covenants," and engaged in other methods of redlining. *Thompson v. U.S. H.U.D.*, 348 F. Supp. 2d 398, 466 (D. Md. 2005). The federal government even published a map in 1937 titled "Residential Security Map for Baltimore" designed to facilitate private redlining by mortgage providers. *See id.* at 471. Mortgage lenders actively engaged in redlining for decades, treating "black and [the few] integrated neighborhoods as unstable and risky." Garrett Power, *Apartheid Baltimore Style: The Residential Segregation Ordinances of 1910-1913*, 42 Md. L. Rev. 289, 319, 322 (1983).

44. The practice and effects of widespread redlining in Baltimore persisted for decades. An analysis of data from the 1980s, long after much of the institutionalized governmental and corporate apparatus of discrimination had been dismantled, found that the more African-American residents in a Baltimore neighborhood, the fewer mortgage loans and dollars the neighborhood received. Anne B. Shlay, *Maintaining the Divided City: Residential Lending Patterns in the Baltimore SMSA* (Maryland Alliance for Responsible Investment, March 1987). The study also found that while 73% of majority

white census tracts received a medium or high volume of single family mortgage loans, the same was true of only 5% of majority African-American tracts.

45. Second, the City is highly segregated between African Americans and whites. As the following map shows, even though Baltimore is 64% African-American and 32% white, many neighborhoods have a much higher concentration of one racial group or the other. For example, the African-American population exceeds 90% in East Baltimore, Pimlico/Arlington/Hilltop, Dorchester/Ashburton, Southern Park Heights, Greater Rosemont, Sandtown-Winchester/Harlem Park, and Greater Govans. It exceeds 75% in Waverly and Belair Edison. At the same time, the white population of Greater Roland Park/Poplar, Medfield/Hampden/Woodberry, and South Baltimore exceeds 80%, and the white population of Cross-Country/Cheswolde, Mt. Washington/Coldspring, and North Baltimore/Guilford/Homeland exceeds 70%.

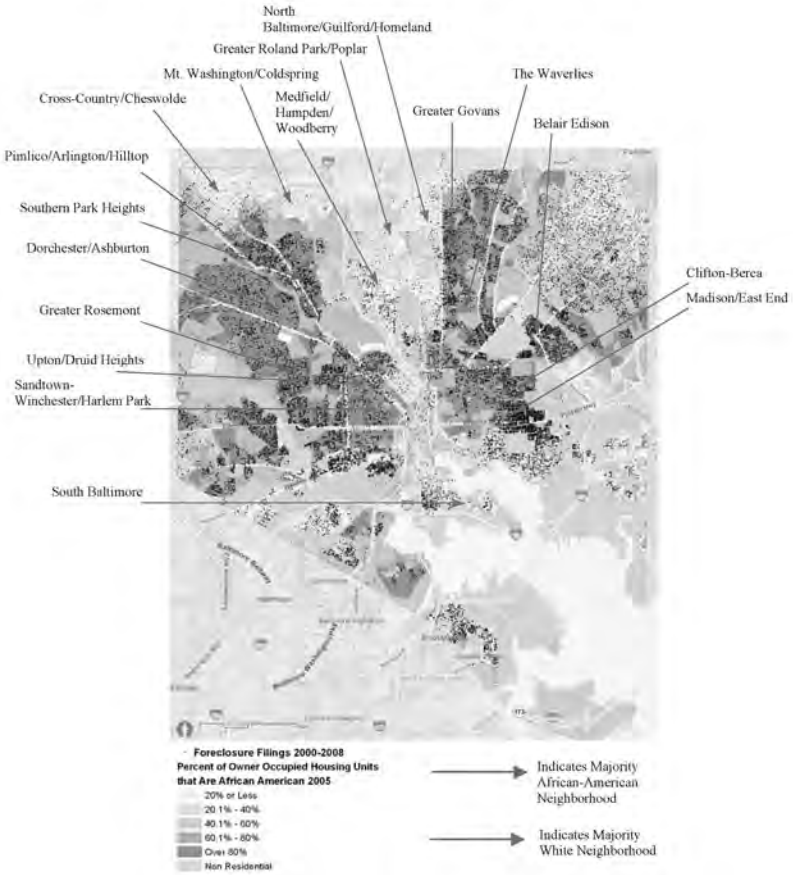

North Baltimore/Guilford/Homeland
Greater Roland Park/Poplar
Mt. Washington/Coldspring
The Waverlies
Cross-Country/Cheswolde
Medfield/ Hampden/ Woodberry
Greater Govans
Belair Edison
Pimlico/Arlington/Hilltop
Southern Park Heights
Dorchester/Ashburton
Clifton-Berea
Madison/East End
Greater Rosemont
Upton/Druid Heights
Sandtown-Winchester/Harlem Park
South Baltimore
Percent of Owner Occupied Housing Units that Are African American 2005
20% or Less
20.1% - 40%
40.1% - 60%
60.1% - 80%
Over 80%
Non Residential
Indicates Majority African-American Neighborhood
Indicates Majority White Neighborhood

46. A recent study of lending in Baltimore is consistent with the existence of a pattern and practice of reverse redlining by lenders providing mortgages to residents of the City. Abt Associates, *Using Credit Scores to Analyze High-Cost Lending in Central City Neighborhoods* (2008) (attached as Attachment J). The study combined 2004 HMDA and other publically available data with credit scores obtained from one of the three major credit bureaus. *Id.* at 1. The study found that, after controlling for credit scores and other legitimate underwriting factors, the prevalence of high-cost (*i.e.*, subprime) purchase and refinance mortgage loans increased with increases in the African American concentration of Baltimore neighborhoods. *Id.* at 2, 13-14. The racial disparity was statistically significant. *Id.* at 18.

47. The location of foreclosures in the City of Baltimore is also consistent with the existence of a pattern and practice of reverse redlining by lenders providing mortgages to residents of the City. As shown in the map following paragraph 48, although foreclosures have occurred in many parts of Baltimore, they are disproportionately concentrated in Baltimore's African-American neighborhoods. Neighborhoods like Greater Govans, Greater Rosemont, Madison/East End, and Southern Park Heights, all with African-American populations above 90%, are at the center of the foreclosure crisis. Citywide, census tracts that are above 80% African-American account for 48% of Baltimore's foreclosure filings, even though they account for only 40% of the City's owner-occupied households.

48. HUD analyzed foreclosures in Baltimore filed during the first quarter of 2000 and reached the same conclusion: "Subprime loans had a disproportionate share of foreclosures in Baltimore City's predominantly black neighborhoods." HUD, *Unequal Burden in Baltimore: Income and Racial Disparities in Subprime Lending* (2000) at 8

(available at http://www.huduser.org/Publications/pdf/baltimore.pdf) (attached as Attachment K). Subprime loans accounted for 42% of the purchase and refinance loan originations in predominantly African-American neighborhoods in the City, but 57% of the foreclosures. *Id.* at 8, fig. 11.


North Baltimore/Guilford/Homeland
Greater Roland Park/Poplar
Mt. Washington/Coldspring
The Waverlies
Cross-Country/Cheswolde
Medfield/ Hampden/ Woodberry
Greater Govans
Belair Edison
Pimlico/Arlington/Hilltop
Southern Park Heights
Dorchester/Ashburton
Clifton-Berea
Madison/East End
Greater Rosemont
Upton/Druid Heights
Sandtown-Winchester/Harlem Park
South Baltimore
Foreclosure Filings 2000-2008
Percent of Owner Occupied Housing Units that Are African American 2005
20% or Less
20.1% - 40%
40.1% - 60%
60.1% - 80%
Over 80%
Non Residential
Indicates Majority African-American Neighborhood
Indicates Majority White Neighborhood

D. Wells Fargo is a Major Contributor to the Foreclosure Crisis in Baltimore's African-American Neighborhoods

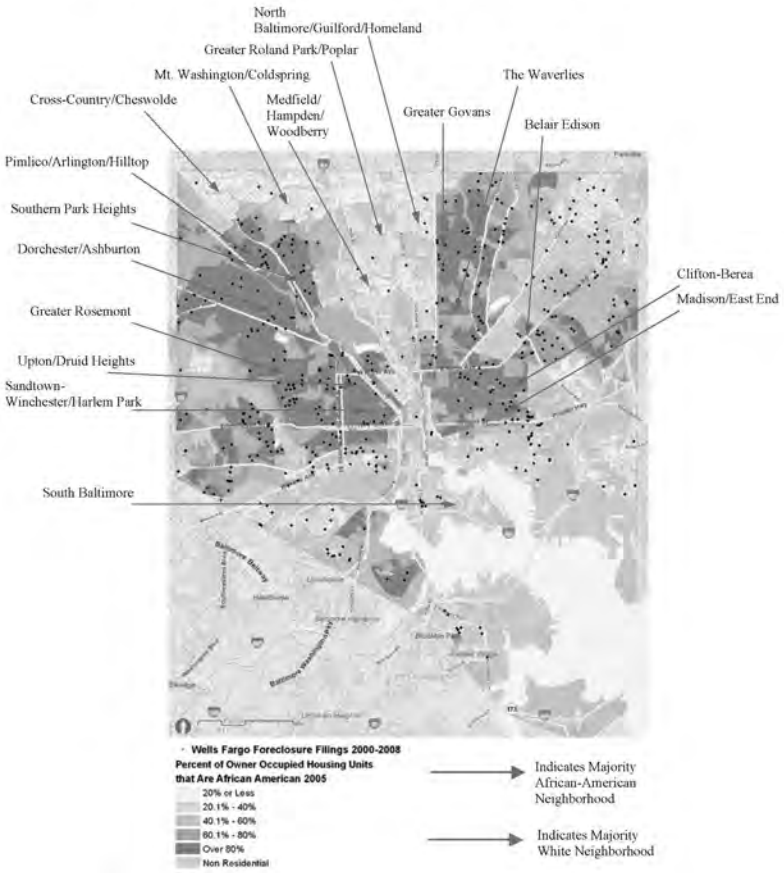
49. Wells Fargo is one of the largest mortgage lenders in Baltimore. It has made at least 1,341 mortgage loans in Baltimore in each of the last six years for which data is available (2002-2007), with a collective value of more than $1 billion. In each of these years, it has been one of the top three mortgage lenders in the City. Wells Fargo makes loans in both the white and African-American neighborhoods of Baltimore.

50. Far from being a responsible provider of much-needed credit in minority communities, however, Wells Fargo is one of the leading causes of the disproportionately high rate of foreclosures in Baltimore's African-American neighborhoods. Its foreclosures since at least 2000 have been concentrated in Belair Edison, East Baltimore, Pimlico/Arlington/Hilltop, Dorchester/Ashburton, Southern Park Heights, Greater Rosemont, Sandtown-Winchester/Harlem Park, Greater Govans and Waverly, and other neighborhoods with African-American populations exceeding 75%.

51. Fifty-four percent of Wells Fargo's foreclosures from 2005 to 2008 were in census tracts that are more than 80% African-American and 63% were in tracts that are over 60% African-American, but only 12% were in tracts that are 20% or less African-American. The figures are virtually identical for Wells Fargo's foreclosures from 2000 to 2004 with more than half in tracts that are more than 80% African-American, 64% in tracts that are over 60% African-American, and only 14.8% in tracts that are 20% or less African-American.

52. At the same time, Wells Fargo has the third largest number of foreclosures in Baltimore of any lender from 2005 to 2008. At least 108 additional Wells Fargo loans in Baltimore resulted in foreclosure from 2000 to 2004. The number of foreclosures from 2000 to 2004 is probably much higher because in many cases the foreclosure records

analyzed by Plaintiff do not indicate the original lender. The following map represents the concentration of Wells Fargo's foreclosures in African-American neighborhoods from 2000 through 2008.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Southern Park Heights
Dorchester/Ashburton
Clifton-Berea
Madison/East End
Greater Rosemont
Upton/Druid Heights
Sandtown-Winchester/Harlem Park
South Baltimore
Wells Fargo Foreclosure Filings 2000-2008
Percent of Owner Occupied Housing Units that Are African American 2005
20% or Less
20.1% - 40%
40.1% - 60%
60.1% - 80%
Over 80%
Non Residential
Indicates Majority African-American Neighborhood
Indicates Majority White Neighborhood

53. The likelihood that a Wells Fargo loan in a predominantly (60% or greater) African-American neighborhood will result in foreclosure is significantly greater than the likelihood of foreclosure for a loan in a predominantly white neighborhood. While 4.82% of Wells Fargo's loans in predominantly African-American neighborhoods result in foreclosure, the same is true for only 1.63% of its loans in predominantly white neighborhoods. In other words, a Wells Fargo loan in a predominantly African-American neighborhood is three times as likely to result in foreclosure as a Wells Fargo loan in a predominantly white neighborhood.

54. Wells Fargo's foreclosure rate for loans in neighborhoods that are 80% or more African-American is nearly three times as high as the overall average of the other major mortgage lenders in Baltimore, while the ratio for its loans in neighborhoods that are less than 20% African-American is less than half the average.

E. Wells Fargo Targets Baltimore's African-American Neighborhoods for Improper and Irresponsible Lending Practices

55. Wells Fargo's failure to underwrite loans in minority and underserved communities in a responsible manner has been the subject of public attention and concern for years. For example, its practices are the focus of a 2004 report from the Center for Responsible Lending. The report concluded that the company's customers "too often face the loss of their home or financial ruin as a result" of its "predatory practices." Center for Responsible Lending, *A Review of Wells Fargo's Subprime Lending* (Apr. 2004) at 10 (available at http://www.responsiblelending.org/pdfs/ip004-Wells_Fargo-0404.pdf) (attached as Attachment L). The predatory practices identified in the report include charging excessive fees; charging excessively high interest rates that are not justified by borrowers' creditworthiness; requiring large prepayment penalties while deliberately misleading borrowers about the penalties; using deceptive sales practices to

wrap insurance products into mortgages; convincing borrowers to refinance mortgages into new loans that only benefit Wells Fargo; and deceiving borrowers into believing that they are getting fixed rate loans when they are really getting adjustable rate loans, and more.

56. Wells Fargo's pattern or practice of failing to follow responsible underwriting practices in Baltimore's African-American neighborhoods is evident from the type of loans that result in foreclosure filings in those neighborhoods. Approximately 65% of Wells Fargo's Baltimore loans that result in foreclosure are fixed rate loans. This ratio is the same in both African-American and white neighborhoods. This establishes that there is no legitimate reason for the stark difference in Wells Fargo's foreclosure rates by race.

57. Unlike adjustable rate loans, where the price may fluctuate with changing market conditions, the performance of fixed rate loans is relatively easy to predict using automated underwriting models and loan performance data because monthly payments do not vary during the life of the loan. Using these sophisticated risk assessment tools, and relying on traditional underwriting criteria such as FICO scores, debt-to-income ratios, loan-to-value ratios, and cash reserves, any lender engaged in responsible underwriting practices designed to identify qualified borrowers can predict with statistical certainty the likelihood of default and/or delinquency. Lenders engaged in marketing fixed rate loans in a fair and responsible manner should have no difficulty sifting out unqualified borrowers, or borrowers whose loans would likely result in delinquency, default or foreclosure.

58. Because the percentage of fixed rate loans is so high and the same in both African-American and white neighborhoods, Wells Fargo should, if it properly

underwrites, have comparable foreclosure rates in both communities. The fact that Wells Fargo's underwriting decisions result in foreclosure three times as often with respect to African-American than white neighborhoods means that it is not following fair or responsible underwriting practices with respect to African-American customers.

59. The disparate foreclosure rates are instead consistent with the type of unscrupulous subprime lending practices described in paragraphs 26, 55, and 61-86. Wells Fargo engages in these and similarly inappropriate practices when making loans to African Americans and in African-American neighborhoods. This pattern or practice of targeted activities fully explains the disparate rates of foreclosure. The disparities are not the result of or otherwise explained by legitimate non-racial underwriting criteria.

60. A closer look at Wells Fargo's lending practices and the characteristics of its loans in Baltimore demonstrates that it is engaged in a pattern or practice of reverse redlining with respect to the City's African-American neighborhoods. As described in sections E.1 through E.7 below, sworn statements of former Wells Fargo employees and examination of Wells Fargo's loans indicates it is engaged in unfair and discriminatory practices in Baltimore's African-American neighborhoods that have the effect and purpose of placing inexperienced and underserved borrowers in loans they cannot afford. These practices maximize short-term profit without regard to the borrower's best interest, the borrower's ability to repay, or the financial health of underserved minority neighborhoods. This targeted pattern or practice has resulted in the disproportionately high rate of foreclosures found in Baltimore's African-American neighborhoods.

1. Former Wells Fargo Employees Explain How the Company Targets African Americans in Baltimore for Subprime Loans and Abusive Subprime Lending Practices

61. Attached to this First Amended Complaint are sworn declarations from two former Wells Fargo employees, Elizabeth Jacobson and Tony Paschal. Until late in 2007, Ms. Jacobson and Mr. Paschal were responsible for making loans on behalf of Wells Fargo in the greater Baltimore region. *See* Attach. M ("Jacobson Decl."); Attach. N ("Paschal Decl."). Jacobson and Paschal describe in great detail how Wells Fargo has targeted African Americans and residents of African-American neighborhoods in and around Baltimore for abusive subprime lending practices.

62. Jacobson began working for Wells Fargo as a loan officer in August 1998. Jacobson Decl. ¶ 2. She was subsequently promoted to Sales Manager and remained in that position until leaving the company in December 2007. *Id.* ¶¶ 2, 34. Jacobson made subprime loans exclusively. *Id.* ¶ 3, 10. She made the loans in a geographic area called "Region 12" that included Baltimore, Prince George's County, Northern Virginia, and other places. *Id.* ¶ 3. Most of her customers were African Americans, including African Americans in Baltimore. *Id.* ¶ 26. She was one of Wells Fargo's top three subprime loan officers nationally year after year, and in some years was the company's top subprime loan officer in the country. *Id.* ¶ 4. Between 2003 and 2007, Jacobson completed approximately $50 million in subprime loans per year. *Id.* ¶ 5. This translates into about 180 loans per year. *Id.* Jacobson is white.

63. Paschal was a Wells Fargo loan officer from September 1997 to September 2007 (with a hiatus of approximately 2½ years beginning in June 1999). Paschal Decl. ¶¶ 2-3. His job was to solicit Wells Fargo borrowers to refinance their home mortgage with a prime or Federal Housing Administration ("FHA") loan. *Id.* ¶¶ 3,

7. FHA loans have interest rates that are closer to prime than subprime rates. *Id.* ¶ 23. Paschal referred the borrowers who did not qualify to the Mortgage Resources division, known as "MORE," which exclusively originates subprime loans. *Id.* ¶ 7. He worked on the same floor of the same building as the MORE employees and he communicated with them daily. *Id.*

64. Jacobson's and Paschal's declarations confirm that Wells Fargo targeted African Americans and African-American neighborhoods in Baltimore and elsewhere for deceptive, abusive and predatory subprime loans and that Wells Fargo's subprime loan officers engaged in a myriad of deceptive, abusive and predatory practices. This constitutes reverse redlining.

A. Targeting African Americans for Subprime Mortgage Loans

65. The declarations show that Wells Fargo targeted African Americans in Baltimore in a variety of ways. One was by marketing its subprime products to predominantly African-American zip codes in Baltimore, Prince George's County, and Washington, D.C. Paschal Decl. ¶¶ 8, 10. Wells Fargo did not target white areas for subprime loans. Paschal Decl. ¶ 8. Paschal "heard employees in the MORE division comment that Howard County was not good for subprime loans because it has a predominantly White population." *Id.*

66. Wells Fargo also targeted African-American churches in the City and their congregations for subprime loans. Jacobson Decl. ¶¶ 27-28, 30; Paschal Decl. ¶ 12. Wells Fargo did not target white churches – "[w]hen it came to marketing, any reference to 'church' or 'churches' was understood as code for African-American or black churches." Jacobson Decl. ¶ 30.

67. Wells Fargo even assigned employees to make presentations at the churches on the basis of race. During a conference call in 2005 with subprime loan officers and branch managers about making presentations to black churches in Baltimore, the loan officers were told that only employees "of color" could attend. Jacobson Decl. ¶ 28. Jacobson was later told that she could come, but only if she "carried someone's bag." *Id.*

68. Wells Fargo also targeted African Americans for subprime loans through a variety of special events. Jacobson Decl. ¶ 29. Wells Fargo selected employees to make presentations at these events on the basis of race, as it did with church presentations. One such event was a "'wealth building' seminar" designed to promote subprime products in 2005 in Greenbelt, Maryland, where the audience was expected to be predominantly African-American. *Id.* Jacobson was told by the manager of Emerging Markets, a subprime unit that targeted African Americans, that she was "too white" to appear before the audience at the seminar. *Id.* ¶¶ 27, 29. Jacobson complained to higher management, but received no response and no action was taken. *Id.* ¶¶ 29, 31.

69. Wells Fargo also created a unit called the "Affinity Marketing Group" in its Silver Spring, Maryland office to target African Americans, including members of African-American churches. Paschal Decl. ¶ 12. All the employees of the Affinity Marketing Group were African-American. *Id.* Subprime loan officers in the group who targeted African Americans were selected on the basis of their race and Wells Fargo's desire to use African-American employees to target African-American customers. *Id.*

70. Another way in which Wells Fargo targeted African Americans was by tailoring its subprime marketing materials on the basis of race. *Id.* ¶ 11. It devised software to print out subprime promotional materials in different languages, one of which

was called "African American" by Wells Fargo *Id.* A computer screen shot from 2006 showing this option is attached to Paschal's declaration as Exhibit A. Wells Fargo did not remove the African American "language" option until Paschal complained. *Id.*

71. Wells Fargo's subprime loan officers held derogatory stereotypes of African Americans, which contributed to their targeting of African Americans in and around Baltimore for subprime loans. Jacobson Decl. ¶ 28; Paschal Decl. ¶ 8, 16. Subprime loan officers described African American and other minority customers by saying "those people have bad credit" and "those people don't pay their bills," and by calling minority customers "mud people" and "niggers." Paschal Decl. ¶¶ 8, 16. They referred to loans in minority communities as "ghetto loans." *Id.* They described Prince George's County, which has a slightly higher percentage of African-American residents than Baltimore, as the "subprime capitol of Maryland." Jacobson Decl. ¶ 26. At the same time, they believed that areas such as Howard County that are predominantly white were bad locations for making subprime loans. Paschal Decl. ¶ 8.

B. Steering People Who Qualify for Prime Mortgages into Subprime Mortgages

72. Jacobson's and Paschal's declarations demonstrate that Wells Fargo regularly steered borrowers who qualified for prime loans into subprime loans. Wells Fargo gave loan officers substantial financial incentives and the discretion to steer borrowers in this manner. Jacobson Decl. ¶¶ 8, 10-12, 15-16, 32; Paschal Decl. ¶¶ 12-13. Paschal was instructed by management to refer borrowers who could have qualified for more advantageous prime or FHA loans to the subprime unit. Paschal Decl. ¶ 9. He was even reprimanded for giving too many people FHA loans instead of referring them for subprime loans. *Id.* ¶ 19.

73. Paschal saw many files of "minority customers who had good credit scores and credit characteristics in subprime loans who should have qualified for prime or FHA loans." Paschal Decl. ¶ 12. Jacobson likewise made subprime loans to many people with prime credit who were referred to her by loan officers responsible for making prime loans. Jacobson Decl. ¶ 9. She could identify people steered in this manner if she had the opportunity to review Wells Fargo's loan files. *Id.*

74. The financial incentives to steer people into subprime loans were very substantial. "A reps," who made prime loans, generally made more money in referral fees by referring a person with prime credit to a subprime loan officer than by originating a prime loan. Jacobson Decl. ¶ 8. Subprime loan officers, whose pay was based on commissions and fees, likewise made more money by originating loans with higher interest rates and fees. *Id.* ¶ 6. This allowed Jacobson to gross well over half a million dollars in 2004 and again in 2005. *Id.* The effect of Wells Fargo's compensation system for subprime loans was to put "bounties" on minority borrowers. Paschal Decl. ¶ 13.

75. Wells Fargo also gave lavish gifts and trips to successful subprime loan officers, even as foreclosures increased in recent years. Jacobson Decl. ¶ 32. This was part of a culture that focused only on making the most money possible and not on putting borrowers in loans that were appropriate for them. *Id.*

76. Loan officers were able to steer people with good credit into subprime loans because Wells Fargo gave them broad discretion. As Jacobson states, "underwriting guidelines and pricing rules for prime and subprime loans . . . . [provided] more than enough discretion to allow A reps to steer prime loan customers to subprime loan officers like me. Likewise, the guidelines gave me enough discretion to figure out how to qualify most of the referrals for a subprime loan once I received the referral."

Jacobson Decl. ¶ 11. This included "discretion to decide which subprime loan products to offer the applicant" "[o]nce I received a referral from an A rep." *Id.* ¶ 13.

77. Wells Fargo loan officers developed a multitude of unscrupulous ways to apply their discretion to get away with steering subprime loans to people who qualified for prime or FHA loans. One method was to intentionally mislead customers by, for example, giving "stated income" loans to customers who could document their income, or telling customers not to make a down payment or to take more cash from their home equity, which would automatically cause a prime loan to "flip" into a subprime loan. Jacobson Decl. ¶ 17, Paschal Decl. ¶ 14. Another was to intentionally mislead underwriters by "telling the underwriting department that the customer did not want to provide documentation for the loan, had no source[d] or seasoned assets, or needed to get the loan closed quickly." Jacobson Decl. ¶¶ 15. Some loan officers would simply falsify loan applications. *Id.* ¶ 18. Loan officers used such techniques to increase their commissions while discriminating against minority applicants. Paschal Decl. ¶ 13.

78. In 2004 Wells Fargo responded to public criticism by creating "filters" that were supposed to prevent the steering of prime customers into subprime loans. Jacobson Decl. ¶ 19; Paschal Decl. ¶ 18. It was widely understood that the filters were not effective. *Id.* Loan officers learned many ways to work around the filters by using the broad discretion they were afforded by Wells Fargo. *Id.* These techniques were widely used. *Id.* Senior managers were aware of their use and eventually made certain changes in response, but the loan officers continued to easily undermine the filters. Jacobson Decl. ¶ 19. The filters were also ineffective because Wells Fargo did not create disincentives to steering prime customers into subprime loans. Paschal Decl. ¶ 18. To the contrary, employees continued to have substantial financial incentives to engage in

such steering and continued to do so. *Id.* Management knew that these practices continued.

C. Other Abusive Subprime Lending Practices Engaged in by Wells Fargo

79. Jacobson's and Paschal's declarations further demonstrate that Wells Fargo loan officers had substantial discretion to increase the costliness of subprime loans and that they regularly used this discretion at the expense of subprime borrowers.

80. The loan officers had broad discretion to set the pricing, points, and fees for subprime loans. Jacobson Decl. ¶¶ 22, 24; Paschal Decl. ¶¶ 5, 13. Even when Wells Fargo created some limits in 2007, loan officers retained significant discretion. Jacobson Decl. ¶ 24. Loan officers had strong financial incentives to increase the pricing, points, and fees because it would increase their commissions. *Id.*; Paschal Decl. ¶ 13.

81. Loan officers also used this discretion to harm African-American and other minority customers by telling them that interest rates were "locked" when, in fact, the rates were not locked. Paschal Decl. ¶ 5. This prevented minority customers from getting lower interest rates, but loan officers lowered interest rates for whites in the same situation. *Id.*

82. Loan officers also used their discretion to select loan products and set rates and fees to "discriminate[] against minority loan applicants by not offering them [] better or newer products which had lower fixed interest rates and fees." Paschal Decl. ¶ 14.

83. Jacobson's and Paschal's declarations further demonstrate that Wells Fargo loan officers deceived subprime borrowers about the inclusion and significance of onerous prepayment penalties in the terms and conditions of their loans. Jacobson Decl. ¶ 13; Paschal Decl. ¶ 15. The prepayment penalties typically made it difficult for borrowers to refinance into new and better loans. Jacobson Decl. ¶ 13. Loan officers

were encouraged by Wells Fargo trainers not to tell applicants about the prepayment penalties. Paschal Decl. ¶ 15. When the subject was raised, loan officers told borrowers that prepayment penalties could be waived, even though they could not be, or otherwise downplayed their significance. Jacobson Decl. ¶ 13; Paschal Decl. ¶ 15.

84. Jacobson identifies another abusive subprime lending practice by showing that some Wells Fargo subprime loan officers intentionally falsified loan files so that they could make loans to borrowers who could not afford them. Loan officers falsified applications by cutting and pasting the credit report or income documentation of borrowers who had been approved in the past into the file of applicants who would otherwise not qualify for a loan. Jacobson Decl. ¶ 18. These tactics made the applicants appear to the underwriters to satisfy the qualifications for subprime loans even though the loan officers knew that they did not. *Id.* Jacobson reported this conduct to management but is not aware of any corrective action that was taken. *Id.* ¶¶ 18, 31. Foreclosures are a predictable result of this practice.

85. Wells Fargo also qualified adjustable rate subprime loans "with the assumption that the borrower would pay the teaser rate for the full life of the loan even though this lower rate only applied during the first two or three years of the loan." Jacobson Decl. ¶ 16. Foreclosures are a predictable result of this practice.

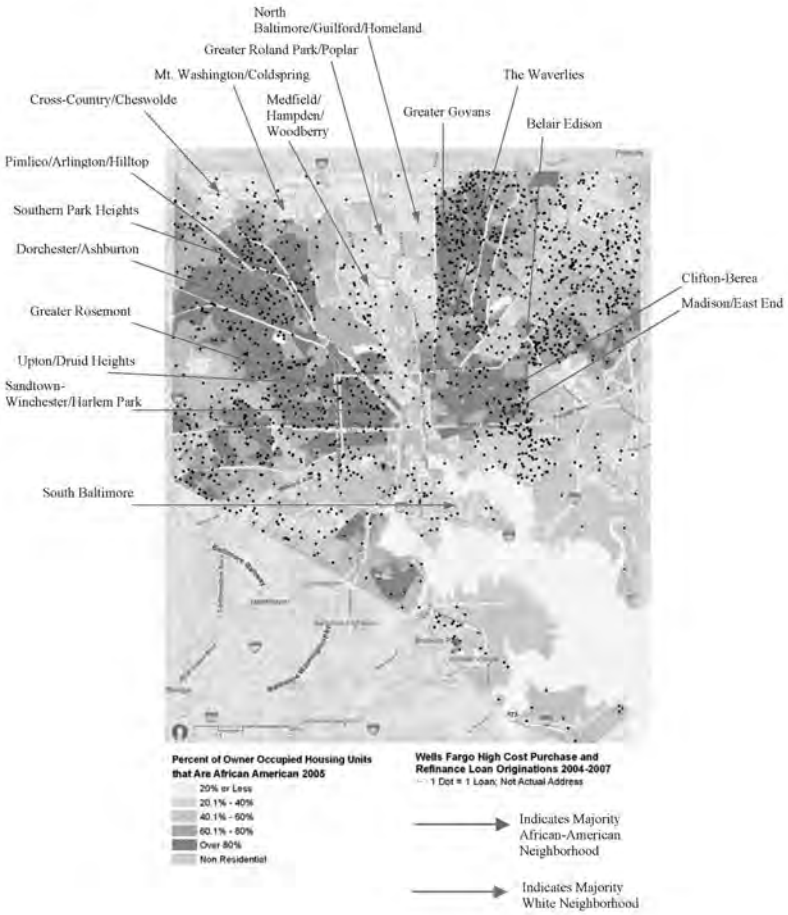
86. Wells Fargo also used mortgage brokers and listing agents to target African Americans and African-American neighborhoods in Baltimore and Prince George's County and to engage in the other abusive lending practices described by Jacobson and Paschal. These brokers and listing agents are Wells Fargo's agents and Wells Fargo is responsible for their acts and omissions.

2. Publicly Available Home Mortgage Disclosure Act Data Shows that Wells Fargo's High-Cost Loans are Disproportionately Located in African-American Neighborhoods in Baltimore

87. Publicly available data reported by Wells Fargo to federal regulators pursuant to the Home Mortgage Disclosure Act shows that in 2007, Wells Fargo made high-cost loans (*i.e.*, loans with an interest rate that was at least three percentage points above a federally-established benchmark) to 43% of its African-American mortgage customers in Baltimore, but only to 9% of its white customers in Baltimore. In 2006, the respective rates were 65% and 15%; in 2005, the respective rates were 54% and 14%; in 2004, the respective rates were 31% and 10%. The proportion of refinance loans that are high cost is especially pronounced. In 2004, 2005, 2006, and 2007, a Wells Fargo refinance loan to an African-American borrower was 3.2 times more likely to be high cost than a refinance loan to a white borrower.

88. Racial disparities in the pricing of Wells Fargo's mortgage loans are confirmed by a study released this year, which also found that the disparity actually increased at higher income levels. National People's Action, *The Truth About Wells Fargo: Irresponsible Lending and African Americans* (2009) at 2 (available at http://www.npa-us.org/downloads/truthaboutwellsfargo.pdf).

89. The maps that follow show the geographic distribution of high-cost loans in African-American and white neighborhoods in Baltimore. These maps demonstrate that Wells Fargo's high-cost loans are disproportionately located in Baltimore's African-American neighborhoods, including, among others, Sandtown-Winchester/Harlem Park, Upton/Druid Heights, Dorchester/Ashburton, and Madison/East End.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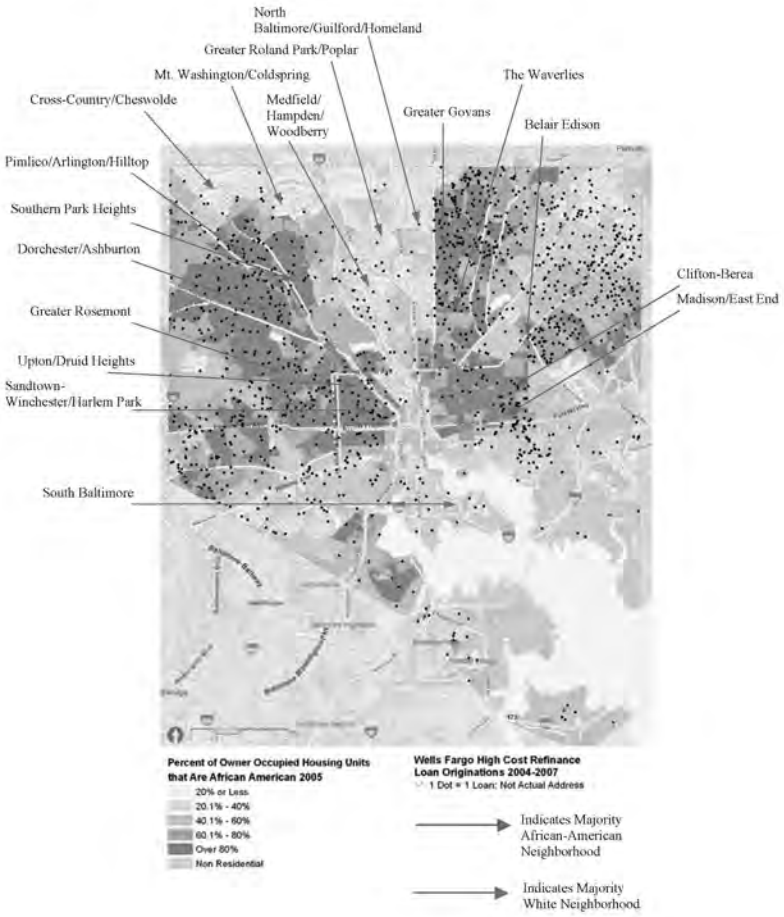
Over 80%
Non Residential
Wells Fargo High Cost Purchase and Refinance Loan Originations 2004-2007
1 Dot = 1 Loan; Not Actual Address
Indicates Majority African-American Neighborhood
Indicates Majority White Neighborhood


North Baltimore/Guilford/Homeland
Greater Roland Park/Poplar
Mt. Washington/Coldspring
The Waverlies
Cross-Country/Cheswolde
Medfield/ Hampden/ Woodberry
Greater Govans
Belair Edison
Pimlico/Arlington/Hilltop
Southern Park Heights
Dorchester/Ashburton
Clifton-Berea
Madison/East End
Greater Rosemont
Upton/Druid Heights
Sandtown-Winchester/Harlem Park
South Baltimore
Percent of Owner Occupied Housing Units that Are African American 2005
20% or Less
20.1% - 40%
40.1% - 60%
60.1% - 80%
Over 80%
Non Residential
Wells Fargo High Cost Refinance Loan Originations 2004-2007
1 Dot = 1 Loan: Not Actual Address
Indicates Majority African-American Neighborhood
Indicates Majority White Neighborhood

90. The fact that high-cost loans involving all of Wells Fargo's loan products are more heavily concentrated in Baltimore's African-American neighborhoods is consistent with the practice of reverse redlining and, upon information and belief, has contributed significantly to the disproportionately high rate of foreclosures in Baltimore's African-American communities. Within the subset of high-cost loans, however, the fact that a disproportionately large percentage of Wells Fargo's high-cost loans in African-American neighborhoods are refinance loans is particularly significant, for it is both consistent with and indicative of a deceptive and predatory subprime practice that involves encouraging minority borrowers who already have loans to refinance at excessive cost with little benefit. This increases the likelihood of foreclosure and, upon information and belief, has contributed to the disproportionately high rate of foreclosures in Baltimore's African-American communities.

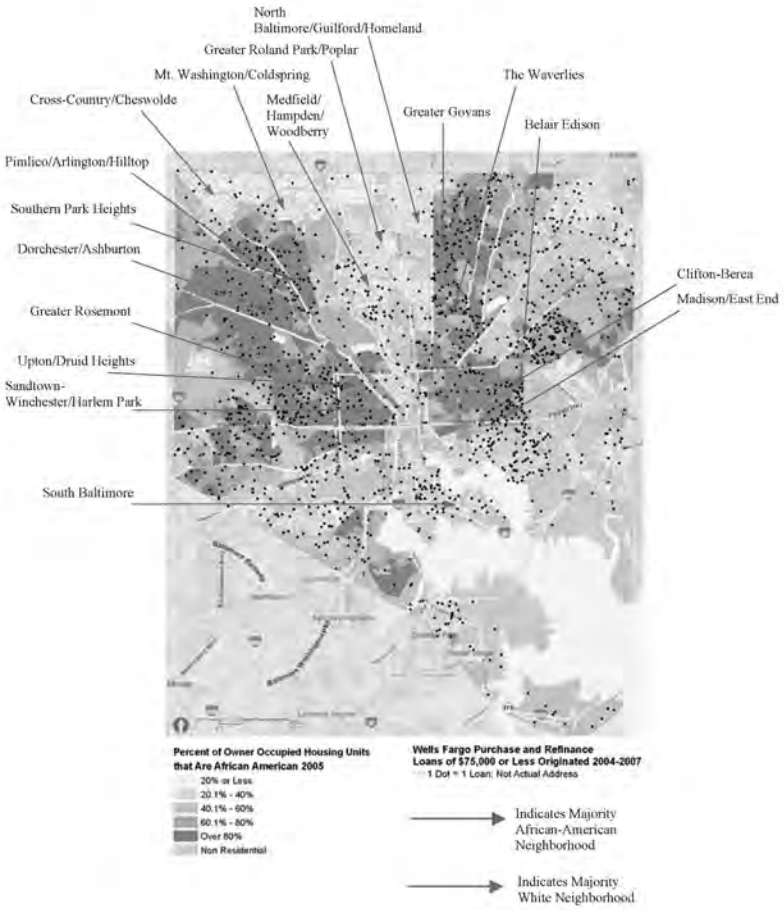
3. Wells Fargo's Pricing Sheets Show that it Targets Homes that are More Likely to be Located in African-American Neighborhoods for Interest Rate Increases, and Lowers Rates for Homes that are Disproportionately Located in White Neighborhoods

91. One reason that residents of Baltimore's African-American neighborhoods are more likely to pay higher prices for Wells Fargo loans than residents of Baltimore's white neighborhoods is the discriminatory pricing found on its pricing sheets. As set forth explicitly on the Wells Fargo Home Mortgage 2005 pricing sheet, attached as Attachment A, Wells Fargo requires a 50 basis point increase in the loan rate for loans of $75,000 or less, a 12.5 basis point decrease for loans of $150,000 to $400,000, and a 25 basis point decrease for loans larger than $400,000. This means that a borrower with a $75,000 thirty-year fixed rate loan who qualifies for an 8% interest rate instead receives an 8.5% interest rate, which costs an extra $9,493 over the life of the loan. An equally creditworthy borrower with a $150,000 loan receives a 7.875% interest rate, which costs

$4,698 less than an 8% loan. A similarly qualified borrower with a $400,001 loan would receive a 7.75% interest rate, which costs $24,987 less than an 8% loan.

92. The Fannie Mae Foundation has likewise documented how modest interest rate disparities can cause dramatic financial consequences for borrowers steered into higher-cost loans. James H. Carr and Jenny Schuetz, Fannie Mae Foundation, *Financial Services in Distressed Communities: Framing the Issue, Finding Solutions* (2001) at 12-13 (available at http://www.cra-nc.org/financial.pdf) (attached as Attachment C) (1% increase in interest rate on 30-year $81,000 mortgage translates into loss of over $78,000 in wealth due to increased payments and lost investment opportunity).

93. Wells Fargo's pricing rules have a clear and foreseeable disproportionate adverse impact on African-American borrowers. As demonstrated by the maps that follow, loans originated by Wells Fargo in Baltimore from 2004 through 2007 in the amount of $75,000 and less were almost three times as likely to be in census tracts where the population is predominantly African-American than in tracts where the population is predominantly white. By contrast, loans originated by Wells Fargo in Baltimore of more than $150,000 were 3.25 times as likely to be in tracts that are predominantly white than in tracts that are predominantly African-American.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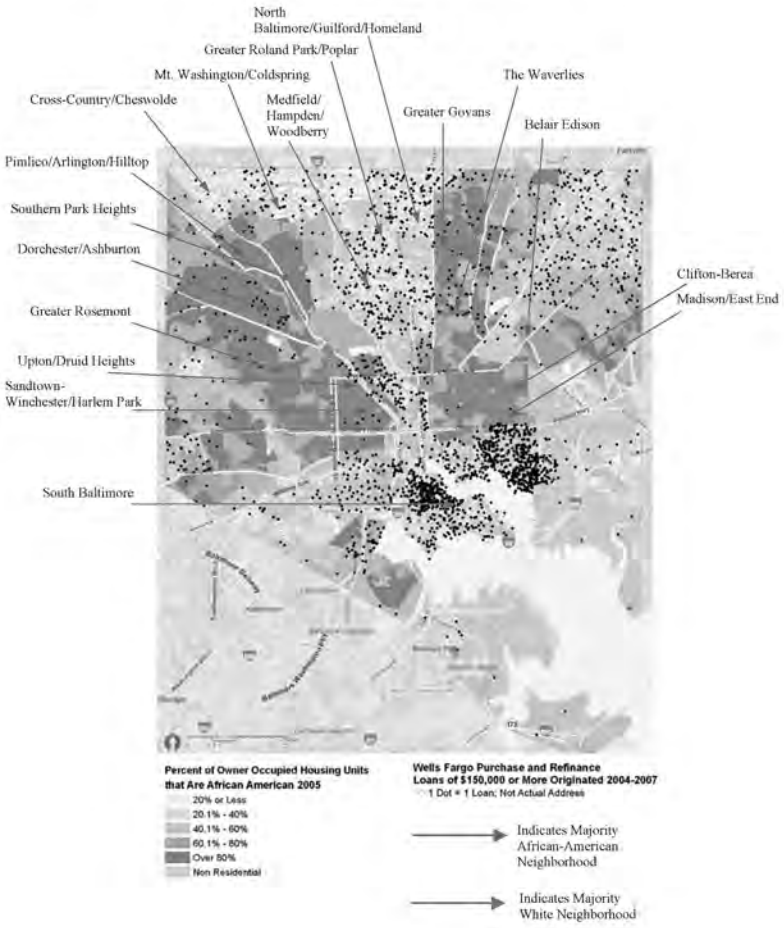
South Baltimore
Percent of Owner Occupied Housing Units that Are African American 2005
20% or Less
20.1% - 40%
40.1% - 60%
60.1% - 80%
Over 80%
Non Residential
Wells Fargo Purchase and Refinance Loans of $75,000 or Less Originated 2004-2007
1 Dot = 1 Loan; Not Actual Address
Indicates Majority African-American Neighborhood
Indicates Majority White Neighborhood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Non Residential
Wells Fargo Purchase and Refinance Loans of $150,000 or More Originated 2004-2007
1 Dot = 1 Loan; Not Actual Address
Indicates Majority African-American Neighborhood
Indicates Majority White Neighborhood

94. Upon information and belief, the discriminatory pricing reflected in Wells Fargo's pricing sheets is consistent with unfair practices associated with reverse redlining and has contributed significantly to the disproportionately large number of foreclosures found in Baltimore's African-American communities.

4. Investigation of Wells Fargo's Pricing Practices in Philadelphia Further Demonstrates the Company is Targeting the African-American Community for Unfair and Improper Lending Practices

95. Discriminatory pricing observed in Wells Fargo's loan data in Baltimore is consistent with findings drawn from data obtained in litigation brought against Wells Fargo in Philadelphia. An expert report in a pending lawsuit based on Wells Fargo's Philadelphia loans concluded that "African American borrowers, and borrowers residing in African American neighborhoods (i.e., census tracts), pay more than comparable non-African Americans and residents of communities in which White people predominate." Aff. of I. Goldstein, *Walker v. Wells Fargo Bank, N.A.*, No. 05-cv-6666 (E.D. Pa. July 20, 2007) at ¶ 7 (Docket No. 24, Attach. 1).

96. Upon information and belief, Wells Fargo's pricing practices in Philadelphia are consistent with its practices in Baltimore, and provide further evidence that the company is engaged in a pattern or practice of unfair lending that contributes significantly to the disproportionately high rate of foreclosure found in Baltimore's African-American neighborhoods.

5. Wells Fargo Underwrites Adjustable Rate Loans in Baltimore's African-American Neighborhoods That Borrowers Cannot Afford

97. Wells Fargo frequently originates "3/27" adjustable rate mortgages, and frequently originated "2/28" adjustable rate mortgages until mid-2007, to borrowers from predominantly African-American neighborhoods in Baltimore. Thirty-four percent of

Wells Fargo's foreclosures from 2000 to 2008 involved such loans. Unless properly underwritten, such loans are destined to fail.

98. Wells Fargo does not properly underwrite these loans when made to African Americans and in African-American neighborhoods. Wells Fargo does not adequately consider the borrowers' ability to repay these loans, especially after the teaser rate expires and the interest rate increases. The fact that these loans would result in delinquency, default and foreclosure for many borrowers was, or should have been, clearly foreseeable to Wells Fargo at the time the loans were made.

99. Most of the loans that Elizabeth Jacobson made were adjustable rate mortgages. Jacobson Decl. ¶ 13. Jacobson confirms in her declaration that Wells Fargo underwrites these loans as if the teaser rate will apply for the full life of the loan instead of considering the borrowers' ability to repay the loan after the teaser rate expires in two or three years. *Id.* ¶ 16.

100. The use of "2/28" and "3/27" adjustable rate mortgages in the manner described above is consistent with the practice of reverse redlining, has subjected African-American borrowers to unfair and deceptive loan terms, and has contributed significantly to the high rate of foreclosure found in Baltimore's African-American neighborhoods.

6. The Caps on Wells Fargo's Adjustable Rate Loans are Higher in African-American Neighborhoods

101. Upon information and belief, Wells Fargo has discretion to apply different caps on adjustable rate loans. The cap is the maximum rate that a borrower can be charged during the life of an adjustable rate loan.

102. The average cap on a Wells Fargo adjustable rate loan that was subject to foreclosure in 2005 or 2006 in predominantly African-American neighborhoods was 14.13%. The cap on such loans in predominantly white neighborhoods was only 13.61%.

103. The disparity observed in caps imposed on adjustable rate loans in predominantly African-American neighborhoods and predominantly white neighborhoods further demonstrates that Well Fargo is engaged in a pattern or practice of unfair and improper lending in Baltimore's African-American communities that contributes significantly to the high rate of foreclosure in these neighborhoods.

7. Wells Fargo's Loans to African Americans Result in Especially Quick Foreclosures

104. A comparison of the time from origination to foreclosure of Wells Fargo's loans in Baltimore shows a marked disparity with respect to the speed with which loans to African Americans and whites move into foreclosure. The average time to foreclosure on African-American borrowers is 1.27 years. With white borrowers it is 1.45 years, or 14% longer.

105. This disparity in time to foreclosure is further evidence that Wells Fargo is engaged in lending practices consistent with reverse redlining. As with all of the practices identified in paragraphs 61-103 above, and like the abusive practices identified in paragraphs 26 and 55 above, the disparity in time to foreclosure demonstrates that Wells Fargo is engaged in irresponsible underwriting in African-American communities that does not serve the best interests of borrowers. If Wells Fargo were applying the same underwriting practices in Baltimore's African-American and white neighborhoods, there would not be a significant difference in time to foreclosure. Were Wells Fargo underwriting borrowers in both communities with equal care and attention to proper underwriting practices, borrowers in African-American communities would not find

themselves in financial straits significantly sooner during the life of their loans than borrowers in white communities. The faster time to foreclosure in African-American neighborhoods is consistent with underwriting practices in the African-American community that are less concerned with determining a borrower's ability to pay and qualifications for the loan than they are in maximizing short-term profit.

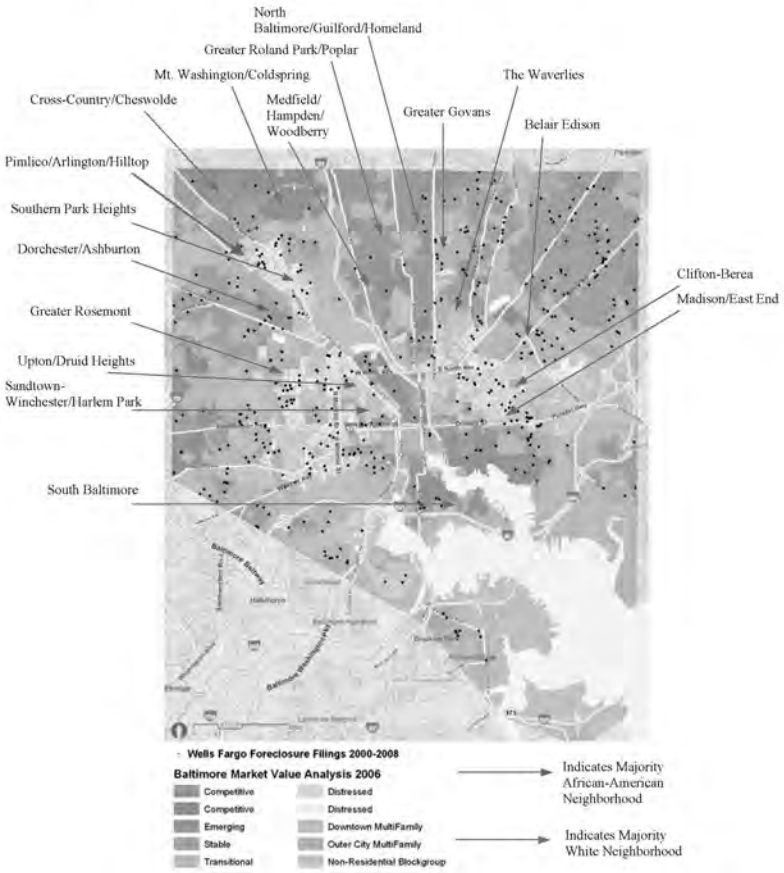
106. The HUD/Treasury Report confirms that time to foreclosure is an important indicator of predatory practices. Citing Baltimore specifically, HUD and Treasury stated that "[t]he speed with which the subprime loans in these communities have gone to foreclosure suggests that some lenders may be making mortgage loans to borrowers who did not have the ability to repay those loans at the time of origination," and that "lenders should not lend to borrowers that do not have the capacity to repay the loans that the lender offers." HUD/Treasury Report at 25 (attached as Attachment B).

107. The difference in time to foreclosure in Baltimore's African-American and white neighborhoods is especially important because foreclosures occur more quickly in Baltimore than in neighboring jurisdictions, including Philadelphia and New Castle County, Delaware (which includes Wilmington). This means that the injuries that result from foreclosures in Baltimore are compounded, and therefore grow, at a faster pace.

INJURY TO BALTIMORE CAUSED BY
WELLS FARGO'S DISCRIMINATION IN MORTGAGE LENDING

108. Wells Fargo has engaged in a pattern or practice of reverse redlining that has resulted in a disproportionately high rate of foreclosure on loans to African Americans and in Baltimore's majority African-American neighborhoods. Wells Fargo continues to engage in this discriminatory pattern or practice with similar and continuing deleterious consequences for Baltimore's African-American neighborhoods.

109. The foreclosures caused by Defendants' discriminatory lending practices are particularly injurious because they are concentrated in distressed and transitional neighborhoods, as reflected on the following map. These neighborhoods include, among others, Greater Rosemont, Upton/Druid Heights, Clifton-Berea, and Madison/East End, all with African-American populations over 90%. These neighborhoods have high vacancy rates, low rates of owner occupancy, substantial housing code violations, and low property values. These characteristics make these neighborhoods most vulnerable to the deleterious effects of foreclosures.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Dorchester/Ashburton
Clifton-Berea
Madison/East End
Greater Rosemont
Upton/Druid Heights
Sandtown-Winchester/Harlem Park
South Baltimore
Wells Fargo Foreclosure Filings 2000-2008
Baltimore Market Value Analysis 2006
Competitive
Competitive
Emerging
Stable
Transitional
Distressed
Distressed
Downtown MultiFamily
Outer City MultiFamily
Non-Residential Blockgroup
Indicates Majority African-American Neighborhood
Indicates Majority White Neighborhood

110. The foreclosures caused by Defendants' discriminatory reverse redlining practices have caused, and continue to cause, multiple types of injuries to Baltimore, including:

a. A significant decline in the value of nearby homes, resulting in a decrease in property tax revenue;

b. An increase in the number of abandoned and vacant homes;

c. An increase in criminal and gang activity as abandoned and vacant homes become centers for squatting, drug use, drug distribution, prostitution, and other unlawful activities;

d. Increased expenditures for police and fire protection;

e. Increased expenditures to secure abandoned and vacant homes;

f. Additional expenditures to acquire and rehabilitate vacant properties; and

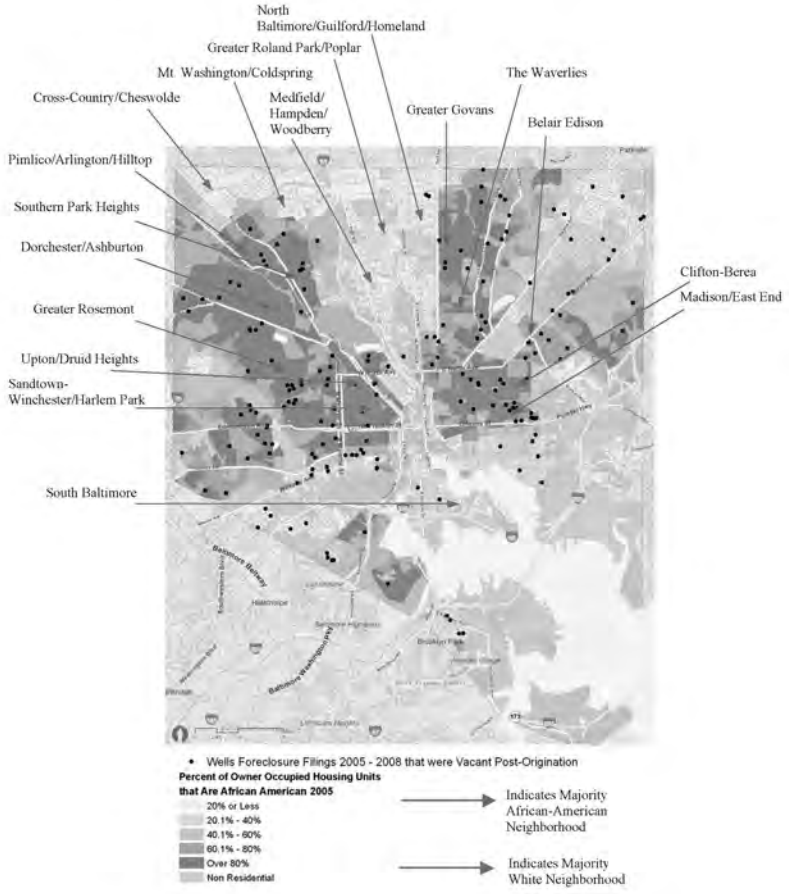
g. Additional expenditures for administrative, legal, and social services.

111. Vacancies caused by Wells Fargo foreclosures result in injuries to the City that are especially costly. Vacancies cause, among other harms, squatters, increased risk of crime and fire, and infrastructure damage such as burst water pipes and broken windows. Expensive responses by the City are required to address these harms. Vacancies likewise cause especially significant declines in property values and, therefore, in property tax revenues collected by the City.

112. Vacancies caused by Wells Fargo foreclosures are concentrated in distressed and transitional neighborhoods and in predominantly African-American neighborhoods. More than half of the 379 properties subject to a Wells Fargo foreclosure

between 2005 and 2008 were vacant after the loan was originated. Seventy-one percent of these properties are located in neighborhoods that are predominantly African-American, as shown on the map following paragraph 113. Moreover, 107 of the properties are currently vacant. Sixty-nine percent of these 107 properties are in neighborhoods that are predominantly African-American but only 16% are in neighborhoods that are predominantly white. *See* Attachment O ("Goldstein Decl.") ¶ 10.

113. These vacancies have a disproportionate and adverse impact on African-American neighborhoods. The harm from the vacancies is felt in African-American neighborhoods much more acutely than in white neighborhoods. The vacancies require Baltimore to devote substantial resources to combating their effects in African-American neighborhoods than would otherwise be required.



• Wells Foreclosure Filings 2005 - 2008 that were Vacant Post-Origination

Percent of Owner Occupied Housing Units that Are African American 2005

- 20% or Less
- 20.1% - 40%
- 40.1% - 60%
- 60.1% - 80%
- Over 80%
- Non Residential

Indicates Majority African-American Neighborhood

Indicates Majority White Neighborhood

114. Declarations from Baltimore residents who live very close to some of the properties that Wells Fargo has foreclosed on confirm that the City suffers particularly significant direct injuries as a result of Wells Fargo foreclosures that cause vacancies. Richard and Stephen Faison, Lisa Porter, and Bridget Ross all live next door or a few doors down from Wells Fargo foreclosure properties that are now vacant and that are in neighborhoods that are over 80% African-American. *See* Attachment P ("R. Faison Decl."); Attachment Q ("S. Faison Decl."); Attachment R ("Porter Decl."); Attachment S ("Ross Decl."); Goldstein Decl. ¶ 15. These residents highlight, in graphic terms, some of the ways in which vacancies cause the kind of harm that the City must spend substantial resources to address. This includes costs resulting from crime, squatting, loitering, trash, burst pipes, and more. Their declarations likewise confirm that foreclosures and vacancies cause neighborhoods to deteriorate, which erodes Baltimore's property tax base.

115. Richard Faison has had to call the police several times because of loiterers who hang out and drink at the vacant Wells Fargo foreclosed property next door to him, which was recently boarded up. R. Faison Decl. ¶¶ 3, 5. He also had to call the City to turn off the water and cap a pipe at the vacant house when the pipe burst. *Id.* ¶ 7. Richard and Stephen Faison both confirm that the vacant house is in serious disrepair and that it has created a rat infestation because loiterers and squatters let trash accumulate. R. Faison Decl. ¶ 4, 6, 8, 9; S. Faison Decl. ¶¶ 5-8.

116. The vacant Wells Fargo foreclosed property a few houses from Lisa Porter's home is also in disrepair. Porter Decl. ¶ 4, 6. Trash is scattered in the yard, the grass is not cut, and rats have become an increasing problem since it became vacant. *Id.* ¶¶ 4-5.

117. Bridget Ross and her neighbors had to call the City to come and board up the vacant Wells Fargo foreclosure property two doors down from her home. Ross Decl. ¶ 5. Vagrants stayed at the house until it was boarded. *Id.* ¶ 3. It is in disrepair, with a broken door and broken windows and large amounts of trash in the yard, and has also become a source of many rats. *Id.* ¶¶ 3, 6, 7. People have stolen plumbing from the vacant property. *Id.* ¶ 4. Ross has been trying unsuccessfully to sell her house for two years but the nearby vacant Wells Fargo foreclosure property has made her home lose value and has made it less desirable to potential purchasers. *Id.* ¶ 9.

118. The problems described by the Faisons, Porter and Ross impose direct costs on City. The City must, for example, send police officers in response to calls for assistance and send other municipal workers to cap burst pipes and board up these vacant properties. The problems and the costs incurred by the City to address them are the direct results of the foreclosures on Wells Fargo loans in these predominantly African-American neighborhoods.

119. The problems also cause these African-American neighborhoods to become less desirable and the homes in the neighborhoods to decline in value. R. Faison Decl. ¶ 10; Porter Decl. ¶ 6; Ross Decl. ¶ 9. As Richard Faison states, "[p]eople do not want to live in my neighborhood because of the condition of the" vacant Wells Fargo foreclosure property. R. Faison Decl. ¶ 10.

120. Damages suffered by the City of Baltimore as a result of Wells Fargo's foreclosures are fully capable of empirical quantification. Recent studies demonstrate that the precise financial impacts of the different types of injuries caused by foreclosures are quantifiable. A study published by the Fannie Mae Foundation, using Chicago as an example, determined that each foreclosure is responsible for an average decline of

approximately 1% in the value of each single-family home within a quarter of a mile. *See* D. Immergluck & G. Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 Housing Policy Debate 57 (2006).

121. Other studies have focused on the impact of abandoned homes on surrounding property values. A recent study in Philadelphia, for example, found that each home within 150 feet of an abandoned home declined in value by an average of $7,627; homes within 150 to 299 feet declined in value by $6,810; and homes within 300 to 449 feet declined in value by $3,542. Anne B. Shlay & Gordon Whitman, *Research for Democracy: Linking Community Organizing and Research to Leverage Blight Policy*, at 161-162 (2004).

122. The costs of increased municipal services that are necessary because of foreclosures have also been analyzed empirically. A study commissioned by the Homeownership Preservation Foundation isolated twenty-six types of costs incurred by fifteen government agencies in response to foreclosures in Chicago. *See* W. Apgar, M. Duda & R. Gorey, *The Municipal Costs of Foreclosures: A Chicago Case Study* (Feb. 27, 2005) at 24-26 (available at http://www.nw.org/network/neighborworksProgs/foreclosuresolutions/documents/2005Apgar-DudaStudy-FullVersion.pdf). It then analyzed the amount of each cost based on different foreclosure scenarios, such as whether the home is left vacant, whether and to what degree criminal activity ensues, and whether the home must be demolished. The study found that the total costs ran as high as $34,199 per foreclosure.

123. Application of methodologies like the ones employed by Immergluck, Shlay, Apgar and their colleagues can be used to quantify precisely the injury to the City

caused by Defendants' discriminatory lending practices, including but not limited to those described above, and the Wells Fargo foreclosures that are the direct result of those practices. This includes the costs to the City of addressing the types of problems described by Richard and Stephen Faison, Lisa Porter, and Bridget Ross. It also includes property tax revenue that the City has lost as result of the decline in property values in the Faisons's, Porter's, and Ross's neighborhoods and in other African-American neighborhoods where Wells Fargo's discriminatory practices have caused foreclosures.

124. The damages and costs to Baltimore of the foreclosures caused by Defendant' discriminatory lending practices are in the tens of millions of dollars. These are direct damages and costs incurred by the City because of Wells Fargo's foreclosures that are the result of the reverse redlining practices that are described in this First Amended Complaint and that violate the Fair Housing Act.

125. Defendants' actions set forth herein constitute a pattern or practice of discriminatory lending and a continuing violation of federal law. Unless enjoined, Wells Fargo will continue to engage in the unlawful pattern or practice described above.

126. Baltimore has been, and continues to be, adversely affected by the acts, policies, and practices of Defendants, their employees, and/or their agents.

127. The extent of Baltimore's injuries will increase unless and until Wells Fargo ceases to discriminate against African Americans and borrowers in majority African-American neighborhoods.

128. Defendants' unlawful actions described above were, and are, intentional and willful, and/or have been, and are, implemented with callous and reckless disregard for Baltimore's federally protected rights.

CAUSE OF ACTION
(Federal Fair Housing Act)

129. Plaintiff repeats and incorporates by reference all allegations contained in Paragraphs 1 through 128 as if fully set forth herein.

130. Defendants' acts, policies, and practices as documented above and discussed in particular by Jacobson and Paschal constitute intentional discrimination on the basis of race. Defendants have intentionally targeted residents of predominantly African-American neighborhoods in Baltimore for different treatment than residents of predominantly white neighborhoods in Baltimore with respect to mortgage lending. Defendants have intentionally targeted residents of these neighborhoods for subprime loans without regard to their credit qualifications and without regard to whether they qualify for more advantageous loans, including prime loans. Defendants have intentionally targeted residents of these neighborhoods for increased interest rates, points, and fees, and for other disadvantageous loan terms including but not limited to prepayment penalties. Defendants have intentionally targeted residents of these neighborhoods for unfair and deceptive lending practices in connection with marketing and underwriting subprime mortgage loans.

131. Defendants' acts, policies, and practices have had an adverse and disproportionate impact on African Americans and residents of predominantly African-American neighborhoods in Baltimore as compared to similarly situated whites and residents of predominantly white neighborhoods in Baltimore. This adverse and disproportionate impact is the direct result of Defendants' policies of giving substantial discretion to loan officers and others responsible for mortgage lending; giving loan officers and others responsible for mortgage lending large financial incentives to give borrowers loans that are costlier than loans for which they qualify; otherwise encouraging

and directing loan officers and others responsible for mortgage lending to steer people into subprime loans without regard for whether they qualify for better loans, including but not limited to prime loans; increasing the interest rate on loans of $75,000 or less and decreasing the interest rate on loans of $150,000 or more; and setting interest rate caps. *See, e.g.*, *Miller v. Countrywide Bank, N.A.*, 571 F. Supp. 251 (D. Mass. 2008). These policies have caused African Americans and residents of predominantly African-American neighborhoods in Baltimore to receive mortgage loans from Wells Fargo that have materially less favorable terms than mortgage loans given by Wells Fargo to similarly situated whites and residents of predominantly white neighborhoods in Baltimore, and that are materially more likely to result in foreclosure.

132. Defendants' acts, policies, and practices constitute reverse redlining and violate the Fair Housing Act, as amended, 42 U.S.C. §§ 3604 and 3605:

(a) Defendants' acts, policies, and practices have made and continue to make housing unavailable on the basis of race and/or color, in violation of 42 U.S.C. § 3604(a);

(b) Defendants' acts, policies, and practices have provided and continue to provide different terms, conditions, and privileges of sale of housing, as well as different services and facilities in connection therewith, on the basis of race, and/or color, in violation of 42 U.S.C. § 3604(b);

(c) Defendants' published policies and statements have expressed and continue to express a preference on the basis of race and/or color, in violation of 42 U.S.C. § 3604(c); and

(d) Defendants' acts, policies, and practices have provided and continue to provide different terms, conditions and privileges on the basis of race and/or color in connection with the making of residential real estate-related transactions, in violation of 42 U.S.C. § 3605.

DEMAND FOR JURY TRIAL

133. Pursuant to Fed. R. Civ. P. 38(b), Plaintiff demands a trial by jury on all issues triable as of right.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff respectfully prays that the Court grant it the following relief:

(1) enter a declaratory judgment that the foregoing acts, policies, and practices of Defendants violate 42 U.S.C. §§ 3604 and 3605;

(2) enter a permanent injunction enjoining Defendants and their directors, officers, agents and employees from continuing to publish, implement, and enforce the illegal, discriminatory conduct described herein and directing Defendants and their directors, officers, agents and employees to take all affirmative steps necessary to remedy the effects of the illegal, discriminatory conduct described herein and to prevent additional instances of such conduct or similar conduct from occurring in the future;

(3) award compensatory damages to Plaintiff in an amount to be determined by the jury that would fully compensate Plaintiff for its injuries caused by the conduct of Defendants alleged herein;

(4) award punitive damages to Plaintiff in an amount to be determined by the jury that would punish Defendants for the willful, wanton and reckless conduct alleged herein and that would effectively deter similar conduct in the future;

(5) award Plaintiff its reasonable attorneys' fees and costs pursuant to 42 U.S.C. § 3613(c)(2); and

(6) order such other relief as this Court deems just and equitable.

June 1, 2009

/s/ John P. Relman
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Attorneys for Plaintiff

ATTACHMENT M

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND
BALTIMORE DIVISION

MAYOR AND CITY COUNCIL OF BALTIMORE, Plaintiff, v. WELLS FARGO BANK, N.A. and WELLS FARGO FINANCIAL LEASING, INC., Defendants.	No. 1:08-cv-00062-BEL

DECLARATION OF ELIZABETH M. JACOBSON

1. I, Elizabeth M. Jacobson, hereby attest that I am over the age of eighteen and I am competent to testify with respect to the matter below.

2. In 1998, I was hired by Wells Fargo Home Mortgage as a "Home Mortgage Consultant" or loan officer. I worked for Wells Fargo Home Mortgage ("Wells Fargo") until December, 2007. After a period of time, I was promoted to Sales Manager.

3. For much of the time that I worked for Wells Fargo my office was located in Federalsburg, Maryland. I worked directly with loan applicants to make subprime loans. The geographic area that I covered was known as Region 12. This area included Northern Virginia, Baltimore, and Prince George's County, among other places. Much of my business came from referrals from Wells Fargo loan officers who were on the prime

side of the business. That means that they dealt with prime loan customers. These loan officers were known as "A reps." Many of these referrals came to me over the telephone from the A reps. Once I got the referrals, I would work directly with the loan customer to get them a subprime loan.

4. I was very successful in making subprime loans. I received many awards from Wells Fargo for originating a very high volume of subprime loans. For several years I was the top subprime loan officer at the company. In 2004 I made more subprime loans than any other loan officer at Wells Fargo anywhere in the country. I was always one of the top three Wells Fargo subprime loan producers in the country.

5. Between 2003 and 2007 I completed approximately $50 million in subprime loans per year. This translated to about 180 loans per year.

6. My pay was based on commissions and fees I got from making these loans. Fees and commissions were based on the size of the loan and the interest rate. In 2004, I grossed more than $700,000 in sales commissions. In 2005 I grossed more than $550,000 in commissions and pay. I was happy to remain a sales manager and not move any higher up at Wells Fargo because I could make more money working directly with customers to originate loans.

7. Because of the high volume of subprime loans that I made and the length of time that I worked at Wells Fargo, I learned all of the "ins and outs" of the subprime loan process at the company. I used this knowledge to find ways to qualify customers for subprime loans.

8. The commission and referral system at Wells Fargo was set up in a way that made it more profitable for a loan officer to refer a prime customer for a subprime

loan than make the prime loan directly to the customer. The commission and fee structure gave the A rep a financial incentive to refer the loan to a subprime loan officer. Initially, subprime loan officers had to give 40% of the commission to the A rep who made the referral; later on A reps received 50 basis points of the available commission. Because commissions were higher on the more expensive subprime loans, in most situations the A rep made more money if he or she referred or steered the loan to a successful subprime loan officer like me. A reps knew about my success in qualifying customers for subprime loans; as a result, I received hundreds of referrals.

9. When I got the referrals, it was my job to figure out how to get the customer into a subprime loan. I knew that many of the referrals I received could qualify for a prime loan. If I had access to Wells Fargo's loan files right now and could review these files, I could point out exactly which of these customers who got a subprime loan could have qualified for a prime loan.

10. Because I worked on the subprime side of the business, once I got the referral the only loan products that I could offer the customer were subprime loans. My pay was based on the volume of loans that I completed. It was in my financial interest to figure out how to qualify referrals for subprime loans. Moreover, in order to keep my job, I had to make a set number of subprime loans per month.

11. Wells Fargo, like any other mortgage company, had written underwriting guidelines and pricing rules for prime and subprime loans. There was, however, more than enough discretion to allow A reps to steer prime loan customers to subprime loan officers like me. Likewise, the guidelines gave me enough discretion to figure out how to qualify most of the referrals for a subprime loan once I received the referral.

12. In many cases A reps used their discretion to steer prime loan customers to subprime loan officers by telling the customer, for example, that this was the only way for the loan to be processed quickly; that there would be less paperwork or documentation requirements; or that they would not have to put any money down. Customers were not told about the added costs, or advised about what was in their best interest.

13. Once I received a referral from an A rep, I had discretion to decide which subprime loan products to offer the applicant. Most of the subprime loans I made were 2/28s. A 2/28 loan allowed the borrower to pay a lower fixed rate of interest for the first two years of the loan (the "teaser rate") and then the interest would reset periodically with the market for the remaining 28 years of the loan. These loans typically included a prepayment penalty for two or three years which ultimately made it more difficult for the borrower to refinance later out of the loan. For those loans where the prepayment penalty extended beyond the teaser rate period, the borrower would be unable to refinance her loan even after her interest rate re-set because she could not afford to pay the prepayment penalty. I know that some loan officers encouraged customers to apply for these loans by telling them that they should not worry about the pre-payment penalty because it could be waived. This was not true – the pre-payment penalty could not be waived.

14. According to company policy, we were not supposed to solicit 2/28 customers for re-finance loans for two years after we made a 2/28 subprime loan. Wells Fargo reneged on that promise; my area manager told his subprime loan officers to ignore this rule and go ahead and solicit 2/28 customers within the two year period, even though this violated our agreement with secondary market investors. The result was that Wells

Fargo was able to cash in on the pre-payment penalty by convincing the subprime customer to re-finance his or her 2/28 loan within the initial two year period. I complained to senior managers about this practice. I am not aware of any corrective action that was taken.

15. In addition to 2/28 loans, we had at least three types of low or no document subprime loan products that we marketed to customers: (1) "stated income" loans; (2) no income, no asset loans; and (3) no ratio loans. Stated income loans were ones in which the customer did not have to show what his or her income was with verifying documentation, but could merely say he or she made a certain amount of money. No income, no asset loans did not require the customer to list any employment. For a no ratio loan, the loan officer only had to put down the borrower's job title and did not have to list any income or debt-to-income ratio. Although the underwriting guidelines with respect to these products changed from time to time, loan officers always had discretion to use different compensating factors to get the customer into one of these subprime loan products. If, for example, a customer had a high credit score that would make them a good candidate for a prime loan, it was a simple matter to get them qualified for a subprime loan by telling the underwriting department that the customer did not want to provide documentation for the loan, had no source or seasoned assets, or needed to get the loan closed quickly.

16. Wells Fargo loan officers encouraged loan applicants to apply for stated income loans, no income – no asset loans, and no ratio loans because these loans had higher interest rates and fees and would allow the loan officer to receive a higher commission. Wells Fargo qualified borrowers for subprime loans by underwriting all

adjustable rate mortgage (ARM) loans, including 2/28 loans, with the assumption that the borrower would pay the teaser rate for the full life of the loan even though this lower rate only applied during the first two or three years of the loan. Wells Fargo also did not require subprime borrowers to escrow for taxes and insurance and most subprime borrowers did not.

17. There were various techniques that were used to qualify the A rep referrals for subprime loans. Each of the techniques involved taking advantage of the discretion we had in applying the underwriting guidelines. One way was to tell customers not to put any money down on the loan and borrow the entire amount, even if they could afford a big enough down payment to qualify for a prime loan. As soon as the loan was submitted without a down payment, it would "flip" from prime to subprime and a subprime loan officer would be able to get the loan qualified as a subprime loan. Another technique would be to tell the customer that the only way to get the loan closed quickly would be to submit it as a subprime loan. A third technique would be to put a person into a "stated income" loan, even if they had a W-2 statement that verified their income. By doing this, the loan was flipped from a prime to a subprime loan. I know that through some of these techniques borrowers with credit scores as high as 780 were steered into expensive subprime loans with as many as four points, even though they could have qualified for a prime loan.

18. I also know that there were some loan officers who did more than just use the discretion that the system allowed to get customers into subprime loans. Some A reps actually falsified the loan applications in order to steer prime borrowers to subprime loan officers. These were loan applicants who either should not have been given loans or who

qualified for a prime loan. One means of falsifying loan applications that I learned of involved cutting and pasting credit reports from one applicant to another. I was aware of A reps who would "cut and paste" the credit report of a borrower who had already qualified for a loan into the file of an applicant who would not have qualified for a Wells Fargo subprime loan because of his or her credit history. I was also aware of subprime loan officers who would cut and paste W-2 forms. This deception by the subprime loan officer would artificially increase the creditworthiness of the applicant so that Wells Fargo's underwriters would approve the loan. I reported this conduct to management and was not aware of any action that was taken to correct the problem.

19. Prior to 2004, Wells Fargo did not make any effort to determine if subprime loans were being made to customers who qualified for prime loans. In 2004 a "filter" was put in place that was supposedly to help keep subprime loans from being made to prime customers. The filter did not work, and everyone knew it. There were lots of ways for loan officers to get around the filter because of the discretion that we had. If a subprime loan was flagged by the filter as one that had gone to a customer who qualified for a prime loan, the loan officer would simply give the underwriting department one of a set of stock responses, such as "the customer has no assets," or the customer's assets were not "sourced and seasoned." ("Sourced and seasoned" refers to verification of where the money comes from for the down payment and whether it has been in the customer's bank account long enough). These responses were widely used, and as soon as they were given to the underwriter, he or she would just override the filter and approve the subprime loan.

20. High ranking Wells Fargo managers knew that this practice was going on, because after about a year of these standby explanations being given, underwriters in the underwriting department were told to call the customers directly rather than contact the loan officer who was working with the customer. The loan officers quickly figured out how to work around this by warning customers that underwriters might call them and then coaching the customers about what to say. For example, customers were told that they should just tell the underwriter that they did not have much in the way of assets or documentation for their income, because otherwise the underwriter would deny their loan or force them to fill out additional paperwork to document their financials. The point was to get the customer to say whatever would allow them to qualify for a subprime loan, even if it was not true. The customers went along with this because they thought it would expedite the process of getting them the loan that they had been told was the right one for them.

21. Underwriters, like loan officers, had a financial incentive to approve subprime loans than, even if the customer could qualify for a prime loan, because they too got paid more if a subprime loan went through.

22. Wells Fargo charged higher interest rates and fees not only on its 2/28 and 3/27 subprime loans, but also on its subprime fixed-rate loans, than it did for prime loans. Subprime loan officers had discretion to decide what interest, points and fees to charge a borrower. For example, for approximately the first five years that I worked at Wells Fargo, I could charge as many points on a loan as I decided. Pricing sheets included different "add-ons" or fees that might be added to the price of the loan depending on the circumstances of the loan.

23. Federal Housing Administration (FHA) loans, like other government-insured loans, offered lower interest rates that are closer to prime rates. Subprime loan officers were required to have a subprime borrower sign a "Benefit to Borrower" Statement that stated that the borrower may qualify for a government-insured loan, but did not want it because it was too much paperwork. In fact, subprime loan officers were never trained in how to make FHA or government-insured loans. We asked for this training, but Wells Fargo refused to provide it.

24. For most of my employment, Wells Fargo did not restrict or regulate the fees that loan officers could charge. Only in 2007 did Wells Fargo begin to regulate and set the amount of fees such as processing fees and underwriting fees. Despite this regulation, subprime loan officers still had discretion to determine which fees to include as costs to the borrower and had a financial incentive to add fees because doing so increased their commission. There was always a big financial incentive to make a subprime loan wherever one could.

25. Once the subprime loan transaction with the customer was closed and we and Wells Fargo received our fees, closing costs and commissions, the loans were sold on the secondary market. This meant that Wells Fargo was no longer exposed to any risk of default or delinquency in payment on these subprime loans. In many cases, Wells Fargo continued to service these same subprime loans, and was paid a fee for doing that, but to my knowledge that did not expose the company to any risk beyond the first three months if the loans went bad. The risk of default rested with the companies that bought the loans from Wells Fargo, such as Fannie, Freddie, and Wall Street investment banks.

26. Many of the customers who were referred to me by A reps came from Prince George's County. Some came from Baltimore. I would estimate that a large majority of my customers were African American. Subprime managers joked that Prince George's County was the "subprime capitol of Maryland." I remember managers saying that they felt "so lucky to have P.G. County because it is the subprime capitol of Maryland."

27. I know that Wells Fargo Home Mortgage tried to market subprime loans to African Americans in Baltimore. I am aware from my own personal experience that one strategy used to target African-American customers was to focus on African-American churches. The Emerging Markets unit specifically targeted black churches. Wells Fargo had a program that provided a donation of $350 to the non-profit of the borrower's choice for every loan the borrower took out with Wells Fargo. Wells Fargo hoped to sell the African American pastor or church leader on the program because Wells Fargo believed that African American church leaders had a lot of influence over their ministry, and in this way would convince the congregation to take out subprime loans with Wells Fargo.

28. I remember being part of a conference call that took place in 2005 where Wells Fargo sales managers discussed the idea of going into black churches in Baltimore to do presentations about our subprime products. Everybody on that call was a subprime loan officer. Two of the individuals on the call were branch managers. On that call we were told that we "have to be of color" to come to the presentation. The idea was that since the churchgoers were black Wells Fargo wanted the loan officers to be black. I was

told that I could attend only if I "carried someone's bag." The point was clear to me: Wells Fargo wanted black potential borrowers talking to black loan officers.

29. Wells Fargo also targeted African Americans through special events in African-American communities called "wealth building" seminars. At some point in 2005 before the conference call discussed above, I remember preparing to participate in a wealth building seminar that was to be held in Greenbelt, Maryland. It was understood that the audience would be virtually all black. The point of the seminar was to get people to buy houses using Wells Fargo loans. At the seminar, the plan was to talk to attendees about "alternative lending." This was code language for subprime lending, but we were not supposed to use the word "subprime." I was supposed to be a speaker at this seminar, but was told by the Emerging Markets manager that I was "too white" to appear before the audience. I was offended by these statements and complained to several higher ranking managers about what had been said. The company did not respond to my complaints and no action was taken.

30. Subprime loan officers did not market or target white churches for subprime loans. When it came to marketing, any reference to "church" or "churches" was understood as a code for African-American or black churches.

31. I complained many times about what I thought were unethical or possibly predatory loan practices that Wells Fargo was engaged in. Managers never took any action to respond to my concerns. In my office we morbidly joked that we were "riding the stagecoach to Hell."

32. The culture at Wells Fargo was focused solely on making as much money as possible. Even as foreclosures were increasing in recent years, the company continued

to lavish expensive trips and gifts on successful subprime loan officers. I attended all expense paid trips to Cancun, Orlando, Palm Springs, Vancouver and the Bahamas where we were entertained by Aerosmith, the Beach Boys, the Eagles, Cheryl Crow, Elton John, Jimmy Buffett and James Taylor. When we would return to our rooms at night we would find gifts of artwork, crystal platters, steak of the month club memberships and IPODs left for us.

33. Although I did not work in the part of the company known as Wells Fargo Financial ("Financial"), I am aware that Financial did mainly re-finances, not home purchase loans. Many of Financial's loans were extremely high priced with lots of points and fees. Wells Fargo management did not allow loan officers to solicit customers with high-priced Wells Fargo Financial loans for purposes of refinancing, even though this would have been in the borrower's best interest.

34. I left Wells Fargo in December 2007 because at that time the subprime market was contracting and I was getting fewer referrals. I wanted to move from Federalsburg to Easton, Maryland, but Wells Fargo said it wasn't opening any new offices. I gave my notice to the company at that point.

35. There are many other current and former Wells Fargo employees who have knowledge of the practices that I have discussed in this Declaration and, if compelled to testify, would, I believe, agree with what I have said. Many current and former Wells Fargo employees may well be reluctant to come forward voluntarily to tell what they know for fear of retaliation, reprisal or other actions that could adversely affect their future careers in the lending industry.

I hereby declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge, information, and belief.

EXECUTED WITHIN THE UNITED STATES ON: April 20, 2009

BY:_____
Elizabeth M. Jacobson

ATTACHMENT N

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND
BALTIMORE DIVISION

MAYOR AND CITY COUNCIL OF BALTIMORE, Plaintiff,	)	
v.	)	No. 1:08-cv-00062-BEL
WELLS FARGO BANK, N.A. and WELLS FARGO FINANCIAL LEASING, INC., Defendants.	)	

1. I, Tony Paschal, hereby attest that I am over the age of 18 years and that I am competent to testify with respect to the matter below.

2. Between September, 1997 and September, 2007, during two separate periods of employment and for a total of eight years, I worked as a home mortgage consultant, or loan officer, in the Annandale, Virginia office of Wells Fargo Home Mortgage ("Wells Fargo").

3. My first period of employment with Wells Fargo was from September, 1997 to June, 1999. I was initially hired by Norwest Mortgage which merged with Wells Fargo in the middle of 1998. As a loan officer in Wells Fargo's Sales and Marketing section, my duties included contacting existing Wells Fargo borrowers in forty-eight (48) states to solicit them to refinance their home mortgage loan. Other Wells Fargo loan

officers also referred to me mortgage loan applicants that they were unable to qualify for "prime" loans because the applicants had blemished credit. I worked with these applicants to see if they would qualify for a prime conventional loan or a Federal Housing Administration ("FHA") loan. As loans insured by the federal government, FHA loans have interest rates that are a little higher than the prime rate, but are significantly less expensive than subprime loans.

4. I also worked during much of this period as a Community Development Representative. In this capacity, I contacted and worked with community groups with the goal of expanding Wells Fargo's business, particularly in minority communities. I am African American.

5. In June, 1999, I left Wells Fargo to take a position with Ardent Communication, a telecommunications business. I left Wells Fargo for two reasons. First, I was uncomfortable with how Wells Fargo treated its minority employees and customers. Wells Fargo's managers were almost entirely White and there was little to no opportunity for advancement for minorities. Wells Fargo also discriminated against minority loan applicants by advising them that the interest rate on their loan was "locked", when in fact, Wells Fargo had the ability to lower the interest rate for the applicant if the market rates dropped prior to the loan closing. I believe this was deceptive and discriminatory, particularly since Wells Fargo loan officers lowered interest rates for White loan applicants when market rates dropped after the application but prior to a loan closing. Even though I complained about this differential treatment of minorities to the branch manager, Jennifer Bowman, Wells Fargo did nothing to change

the practice. I also left Wells Fargo because Ardent Communications offered me a higher salary and more opportunities as a minority employee for advancement.

6. After Ardent Communications went out of business, in November 2001, I returned to work as a loan officer in the Sales and Marketing section of Wells Fargo's Annandale, Virginia office. Although I still had concerns about Wells Fargo's treatment of minority employees and customers, I thought that because there was a new branch manager, Dave Margeson, in the Annandale office, the working environment may have improved.

7. By the time I returned to Wells Fargo, the company was targeting existing customers for refinance loans to a much greater extent than it had during my first period of employment. As during my first period of employment, I contacted existing Wells Fargo borrowers nationally to solicit them to refinance their loans into a prime or FHA loan. When the borrower did not qualify for those loans, I would refer the borrower to the Mortgage Resource division, which is known by the acronym MORE and exclusively originates higher interest rate subprime loans. The employees working for MORE were located on the same floor as I was and I communicated with them every day.

8. In addition to taking referrals from other loan officers, MORE employees in the Annandale office targeted minority consumers for both purchase and refinance subprime loans. The MORE division targeted zip codes in Washington, D.C. east of the Anacostia River, Prince George's County, Maryland and the City of Baltimore with predominantly African-American populations. I heard employees in the MORE division comment that Howard County was not good for subprime loans because it has a predominantly White population. I also heard MORE employees on several occasions

mimic and make fun of their minority customers by using racial slurs. They referred to subprime loans made in minority communities as "ghetto loans" and minority customers as "those people have bad credit," "those people don't pay their bills," and "mud people."

9. In 2002, Dave Johnson, a former colleague with whom I had worked at Wells Fargo in 1997 and 1998, asked me if I could help him return to Wells Fargo. Mr. Johnson left Wells Fargo in 1998 to work at another mortgage lender. I spoke with Dave Margeson, my branch manager, and suggested that he hire Dave Johnson. Wells Fargo hired Mr. Johnson as a manager in the MORE division. Although I had also applied for a management position, Wells Fargo hired Mr. Johnson, who is White, instead of promoting me. I believe that Wells Fargo did not promote me for two reasons. First, Wells Fargo's management culture was White. Mr. Margeson is White and so is his immediate supervisor, area manager John Goulding. Indeed, I know of only one Wells Fargo African-American manager. Second, Wells Fargo management knew that I treated Wells Fargo customers well by offering to refinance them to prime and FHA loans when they qualified for those products. Wells Fargo management did not believe that I was doing enough to promote the subprime business, which was far more profitable because of the higher interest rates and fees. John Goulding told me that I was not doing enough to promote subprime loans and managers told me and others in the Sales and Marketing section that if we could not initially qualify a borrower for an FHA loan, we should refer them to the MORE division for a subprime loan even if with additional time or assistance the borrower would qualify a prime or an FHA loan.

10. Wells Fargo promoted its subprime business by targeting subprime loans to minorities. It did so in two ways, first, by sending marketing materials to minority

communities; second, by using minority subprime loan officers to solicit loans in those same communities. Wells Fargo targeted marketing materials to zip codes with predominantly minority populations. Wells Fargo's Annandale office targeted African American zip codes in Washington, D.C., Prince George's Country and Baltimore.

11. Wells Fargo even had software to generate marketing materials to minorities. For example, if a Wells Fargo loan officer anywhere in the United States wanted to send a flyer to consumers in an African-American neighborhood soliciting subprime loans, he could access software on his computer that would print out a flyer to persons speaking the language of "African American." I discovered this practice and attach a screen shot from my computer as an illustration of how a Wells Fargo employee could generate a flyer targeting African Americans. The document attached as Exhibit A is a true and accurate copy of the screen shot I printed on January 17, 2006. Only after I complained about this practice, did Wells Fargo agree to remove the African American option from the menu of languages.

12. Wells Fargo also marketed subprime loans to minorities by hiring minority employees to solicit these higher cost loans. Wells Fargo hired African-American loan officers exclusively from other subprime lenders. In the Annandale office, all the MORE loan officers were African-American, even though their two managers were White. In Silver Spring, Maryland, Wells Fargo had an "Affinity Group Marketing" section which consisted entirely of African-American employees. The Affinity Group targeted African-American churches and their members for loans. The Affinity Group Marketing section also hired an African-American employee specifically for the purpose of targeting African-American churches. Because the MORE group only had authority to make

subprime loans, they regularly originated subprime loans to African Americans and other minority borrowers who could have qualified for a lower cost prime loan or FHA loan. I had access to Wells Fargo customers' loan records and application files for my work in the Sales and Marketing division and regularly saw minority customers who had good credit scores and credit characteristics in subprime loans who should have qualified for prime or FHA loans.

13. Because Wells Fargo made a higher profit on subprime loans, the company put "bounties" on minority borrowers. By this I mean that loan officers received cash incentives to aggressively market subprime loans in minority communities. If a loan officer referred a borrower who should have qualified for a prime loan to a subprime loan, the loan officer would receive a bonus. Loan officers were able to do this because they had the discretion to decide which loan products to offer and to determine the interest rate and fees charged to the borrower. Since loan officers made more money when they charged higher interest rates and fees to borrowers, there was a great financial incentive to put as many minority borrowers as possible into subprime loans and to charge these borrowers higher rates and fees. I knew many loan officers who made more than $600,000 a year and a few who made more than $ 1 million.

14. Wells Fargo discriminated against minority loan applicants by not offering them its better or newer products which had lower fixed interest rates and fees. Instead, Wells Fargo offered its higher cost loan products, including its adjustable rate mortgage (ARM) loans to minority applicants. Wells Fargo's loan officers also discriminated against minority refinance applicants by encouraging them to take out more cash from their home equity. By taking out more cash, the borrower would unwittingly increase the

commission the loan officer received on the loan, while at the same time eliminating his ability to qualify for a prime or FHA loan. By encouraging the borrower to take out more cash, the loan officer knowingly increased the borrower's risk of foreclosure because of the higher loan amount.

15. In trainings, Wells Fargo loan officers were encouraged to omit pertinent information about a subprime loan in talks with applicants because discussing loan terms could cost a loan officer a sale. For example, it was implied in trainings that Wells Fargo loan officers should not mention that subprime loans included a prepayment penalty if the borrower paid off or refinanced his loan before the prepayment penalty period ended or that the monthly payments on ARM loans would substantially increase. When an applicant asked a loan officer about prepayment penalties or monthly payment increases, the loan officer would tell the applicant not to worry because Wells Fargo would later be able to refinance him into a prime or an FHA loan.

16. Wells Fargo's management also tolerated a culture of discrimination. In addition to being almost entirely White, the company promoted at least one manager who used racial slurs. Dave Zoldak, who succeeded Dave Margeson as my branch manager in 2005, used the word "nigger" at the office. Although Wells Fargo knew Mr. Zoldak used racial slurs, it promoted him to area manager after I complained about his discriminatory comments. On October 21, 2005, I complained by email to Mr. Zoldak directly about his use of the word "nigger" and speaking about how African Americans lived in "'hoods" and "slums." Mr. Zoldak replied that he had used the slurs in a humorous way, just as the African-American comedian Dave Chapelle did on television and thought that I would find the use of these terms humorous. I attach as Exhibit B a true and accurate

copy of my October 21, 2005 email to Mr. Zoldak and his response later the same day. On December 9, 2005, I complained by email to Joe Rogers, an Executive Vice President, and two Human relations employees at Wells Fargo about the use of the word "nigger" and other slurs by Wells Fargo employees. I also verbally informed Mr. Rogers's of Mr. Zoldak's racial slurs, including the use of the word "nigger." Although Mr. Rogers agreed with me by email that racial epithets were unacceptable, he questioned why I was raising the issue with him. I attach as Exhibit C a true and accurate copy of my December 9, 2005 email to Mr. Rogers and others, and his December 12, 2005 response. Despite these complaints, Wells Fargo promoted Mr. Zoldak.

17. Even the underwriting of subprime loans fostered their discriminatory impact on minorities. The subprime underwriting group was located in a different city than the prime underwriting group. The subprime underwriters were located initially in Baton Rouge, Louisiana and later Ft. Mill, South Carolina. Subprime loan officers with MORE and elsewhere within Wells Fargo pressured underwriters to approve subprime loans.

18. In late 2004 and early 2005, in response to the complaints of discrimination by such groups as ACORN (the Association of Community Organizations for Reform Now) and the Center for Responsible Lending, Wells Fargo implemented so-called "filters" in their lending programs that purportedly would discourage loan officers from steering minorities to subprime loans. Wells Fargo implemented these filters for public consumption only and not to actually restrict discriminatory practices. The filters were ineffective because they did not have any "teeth" (no punishment for violating) and because they were easy for loan officers to circumvent. I do not believe these filters had

any impact on steering because subprime loan officers continued to receive large financial incentives for making subprime loans to minority borrowers and were enconraged by their managers to do so because these loans were profitable. These filters also did not have an impact on steering because, notwithstanding any written rules, loan officers had discretion to make decisions about products and pricing.

19. Wells Fargo ultimately fired me in September, 2007 asserting that my loan production was low. My loan production was lower than many other loan officers because I tried to do the right thing by Wells Fargo customers by putting them in loans they could afford. If a customer did not qualify for a loan or could not afford an estimated monthly payment, I did not originate the loan. I was verbally reprimanded by John Goulding, my indirect supervisor, for placing too many customers in FHA loans, when the company wanted me to refer them to a subprime loan officer, for example in the MORE group, so that the company could make a greater profit on the loan.

I hereby declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge and belief.

EXECUTED WITHIN THE UNITED STATES ON: April 9, 2009

BY: _____
Tony Paschal

Exhibit A

Search for Items

Standard Search (* You must at least select a Type of Item or enter a Subject)

* What Type Of Item Are You Looking For?	Fast Flyer
* What Subject Are You Looking For?	
Personalized	Yes, Personalized
Strategy	Special Programs
Language	African American
Item Size	--Select One--
Item Color	--Select One--
Audience	--Select One--
Product / Program / Feature	--Select One--
High Trust Sales and Marketing	--Select One--
SALE ITEMS	--Select One--

Search

Searching Hints

Here are some helpful searching hints t
you find the items you're looking for.

> For the fastest results, if you know the
number, enter it in the Quick Search sect

> For best results using Standard Searc
minimum, select a Type of Item AND a St
such as "FAST Flyer - Consumer" and "F
Homebuyer".

> For more targeted results, also include
search criteria as appropriate, such as a
language, etc. At a minimum, you must
either a Type of Item or enter a Subject.

Quick Search (Use This When You Know the Item ID)

Item ID (do not include NMFL#, etc.)

Search

Custom Requests

For custom design requests, click on the button below. Please note that custom requests are not tracked as orders through Easy O
should contact Ad Services directly at 515-213-4000 or by email at adservices@wellsfargo.com for questions regarding custom req

Custom Requests/Reviews

Exhibit B

Paschal, Tony

From: Zoldak, David
Sent: Friday, October 21, 2005 8:47 AM
To: Paschal, Tony
Subject: RE: Workflow

I'm only trying to provide you options to help lessen an obviously frustrating situation. I would rather suggest as many resources I know of to help you be proactive with your loans instead of making excuses to let these loans go to the wayside. As far as the rest of your comments are concerned, I believe you are referring to our many rehashings of the Dave Sheppel(spelling) show...which, I assumed you enjoyed. If something I said had ever offended you, I'm sorry. They next time I say something that you feel is offensive to you or anyone, I would encourage you to address it at that time. I would like you to focus on working with me and our team in Ohio to resolve your loan problems instead of wasting your time and energy in some other direction.

David J. Zoldak
Branch Manager
Wells Fargo Home Mortgage
MAC M8602-031
7620 Little River Turnpike, Ste. 300
Annandale, VA 22003
703.333.5555 Tel
866.333.5540 ext. 5555 Toll Free
703.333.5590 Fax
david.zoldak@wellsfargo.com

For your protection, we remind you that this is an unsecured email service, which is not intended for sending confidential or sensitive information. Please do not include your social security number, account number, or any other personal or financial information in the content of the email. To see our privacy policy regarding how we use and protect customer information, please select the following link: http://www.wellsfargo.com/privacy/privacy.jhtml. To discontinue receiving all emails containing solicitation materials from Wells Fargo Bank N.A., including Wells Fargo Home Mortgage, please send an email to NoEmailRequest@wellsfargo.com with your name and email address.

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Wells Fargo Home Mortgage-2701 Wells Fargo Way-Minneapolis, MN 55467-8009

From: Paschal, Tony
Sent: Friday, October 21, 2005 6:49 AM
To: Zoldak, David
Subject: Workflow
Importance: High

As soon as my email functionality is restored I will forward the email I sent to Ms. Noble over a week ago informing her about my computer situation. If I were able to access the information she has been requesting in her email, (cell phone numbers, work numbers, etc) I would have used loan status not LIS to get that information. Since neither of those systems has been available on a consistent basis for the past two weeks, and since loans in appraiser are reciprocally linked to loan status, getting back to Ms. Noble has been difficult at best. I feel her emails have been returned in a timely fashion, however if this situation is being approached as Shirley Temple and Bill (Bojangles) Robinson we have a problem. Speaking of problems, since you were comfortable enough to use a quote in front of me several months ago using the word "nigger" you'll understand when I say that I am nobody's "nigger" and I do not live in anyone's "hood" and I am not from anyone's slums. If you have any questions feel free to contact me. Thank's

Tony **Paschal**
Home Mortgage Consultant
Wells Fargo Home Mortgage
M8602-031
7620 Little River Turnpike Suite 300
Annandale, Virginia 22003
703.333.5549 Office
866.333.5540 ext.5549 Toll Free

Exhibit C

Paschal, Tony
From: Rogers, Joe
Sent: Monday, December 12, 2005 10:34 AM
To: Paschal, Tony
Cc: White, Julie M. - HR; Williams, Mark S (HR)
Subject: RE:

Tony,

I believe all on this chain would agree with you. My question is one of context. What prompts you to ask that question at this time. While I would want to send an across the board agreement, questions like yours below, could be an example of the use of this word. In other words, indicating a totally unacceptable practice.

Joe Rogers
Ph: (410) 872-1935

-----Original Message-----
From: Paschal, Tony
Sent: Friday, December 09, 2005 4:03 PM
To: Rogers, Joe
Cc: White, Julie M. - HR; Williams, Mark S (HR)
Subject:
Importance: High

Is there any time when it is appropriate to use the word "Nigger" in the workplace? Is it ever appropriate to reference where an African American employee and his family live as the "slums" or the "hood"? This word is so vile and filthy that our email system will not allow it to leave our own network. After reading every employee handbook since Wells Fargo Home Mortgage was Norwest Mortgage, I cannot find any instance where any racial epithet is allowed at Wells Fargo. At least that what the handbook says.

Tony Paschal
Home Mortgage Consultant
Wells Fargo Home Mortgage
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For your protection, we remind you that this is an unsecured email service, which is not intended for sending confidential or sensitive information. Please do not include your social security number, account number, or any other personal or financial information in the content of the email. To see our privacy policy regarding how we use and protect customer information, please select the following link: http://www.wellsfargo.com/privacy/privacy.html. To discontinue receiving all emails containing solicitation materials from Wells Fargo Bank N.A., including Wells Fargo Home Mortgage, please send an email to NoEmailRequest@wellsfargo.com with your name and email address.

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Wells Fargo Home Mortgage-2701 Wells Fargo Way-Minneapolis, MN 55467-8000

ATTACHMENT O

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND
BALTIMORE DIVISION

MAYOR AND CITY COUNCIL OF BALTIMORE,	)	
Plaintiff,	)	
v.	)	No. 1:08-cv-00062-BEL
WELLS FARGO BANK, N.A.	)	
and	)	
WELLS FARGO FINANCIAL LEASING, INC.,	)	
Defendants.	)	

DECLARATION OF IRA J. GOLDSTEIN

I, Ira J. Goldstein, hereby state as follows:

I am over the age of eighteen and am competent to make this Declaration. I have personal knowledge of the matters set forth below.

1. I hold a Ph.D. in Sociology from Temple University granted in 1986. My current position is that of Director of Policy and Information Services ("Policy") at an organization called The Reinvestment Fund ("TRF").

2. TRF is a Philadelphia-based community development financial institution whose mission is to alleviate poverty by building assets, wealth and opportunity for low- and moderate-

income communities and persons. TRF accomplishes its mission through the strategic use of capital, knowledge and market innovation.[1]

3. I am also a Guest Lecturer at the University of Pennsylvania where, for the last 20 years, I have taught an undergraduate course in statistics and research methods for the Urban Studies Program. For the last 5 years, I also have taught a graduate seminar in the uses of data and research methods to study issues related to urban redevelopment and blight; this course is offered in both the Urban Studies Program and the Department of City and Regional Planning.

4. In my position as Director of Policy for TRF, I am responsible for a number of grant and contract-related research projects. Among those projects have heen a study of mortgage foreclosures in Baltimore for the Goldseker Foundation and other studies of mortgage foreclosures and predatory lending, including predatory lending in the City of Philadelphia under a grant funded by the Ford Foundation.

5. I also provided litigation support to the U.S. Attorney for the Eastern District of Pennsylvania on his predatory lending initiative and currently provide support to the Pennsylvania Human Relations Commission.

6. Prior to holding my position at TRF, I served at the United States Department of Housing and Urban Development ("HUD") as Director of Fair Housing and Equal Opportunity for the federal Mid-Atlantic Region, which includes Maryland. Among other duties, I was responsible for directing enforcement of the federal Fair Housing Act. At HUD, I developed analytical tools to measure racial disparities in mortgage lending. My publications include a number of articles, book chapters, and a book. In 2004, I wrote a paper presented at the Harvard University Joint Center for Housing Studies entitled "Bringing Subprime Mortgages to Market

[1] A complete description of TRF can be found at its website: www.trfund.com.

and the Effects on Lower-Income Borrowers."[2] I also coauthored a book, released in 2008 by Temple University Press, titled Restructuring the Philadelphia Region: Metropolitan Divisions and Inequality with Carolyn Adams, David Bartelt and David Elesh. I was recently appointed to a three-year term on the Federal Reserve Board's Consumer Advisory Council. My complete resume is attached as Attachment 1.

7. I have reviewed the data submitted by Mayor and City Council of Baltimore ("Baltimore") to the Court on April 6, 2009, and the data submitted by Wells Fargo Bank, N.A. and Wells Fargo Financial Leasing, Inc. (collectively, "Wells Fargo") to Baltimore on that date. I have been informed that, pursuant to the Court's Order, both sets of data concern properties that have been the subject of a foreclosure on a Wells Fargo loan between January 1, 2005, and December 31, 2008.

8. Based on my review of the data I have determined that the parties identified 379 properties subject to a Wells Fargo foreclosure filing. My colleague at TRF, Al Parker, precisely geocoded 374 to the census tract and block group. Geocoding is a process by which an address is translated into a set of spatial coordinates, which can then be identified with standard Census geographies. In the case where an address is incomplete or inaccurate, geocoding fails to occur; that was the case in five properties subject to a Wells Fargo foreclosure filing. Of those 374 geocoded properties, 203 (54.3%) are located in census tracts that are more than 80% African-American and 34 (9.1%) are located in census tracts that are between 60% and 80% African-American. Forty-five (12.0%) are located in tracts that are less than 20% African-American. The map attached as Attachment 2 reflects the locations of the 374 properties and the percentage of the population of each census tract in Baltimore that is African-American. The map

[2] A copy of the paper can be found at http://www.jchs.harvard.edu/publications/finance/babc/babc_04-7.pdf.

demonstrates that the foreclosures are disproportionately located in census tracts with high African-American concentrations.

9. There is sufficient data on 375 of the 379 properties to determine whether they were vacant after the Wells Fargo loan was originated. The determination of vacancy was set forth in the data that I received, and described in paragraph 7 above. After reviewing data provided by Wells Fargo on the date of origination of the loans subject to the foreclosure filing along with data from other publicly available data sources referencing loan origination information, I determined that 222 of the 375 properties (59.2%) were in fact vacant after the Wells Fargo loan was originated. Mr. Parker then geocoded these 222 addresses and we determined that 132 (59.5%) are located in census tracts that are more than 80% African-American and 25 (11.3%) are located in census tracts that are between 60% and 80% African-American. The map attached as Attachment 3 reflects the locations of the 222 properties and the percentage of the population of each census tract in Baltimore that is African-American. The map demonstrates that the vacancies are disproportionately located in census tracts with high African-American concentrations.

10. The data I reviewed identified 107 of the properties as currently vacant. I determined that 69% of these are in neighborhoods that are at least 60% African-American while 16% are in neighborhoods that are at least 60% white.

11. I have also reviewed the data on the 379 properties in conjunction with data on Wells Fargo loan originations made public pursuant to the Home Mortgage Disclosure Act (HMDA) to determine the likelihood that a Wells Fargo loan in Baltimore has resulted in foreclosure. I have determined that 4.82% of Wells Fargo loans in neighborhoods that are more

than 60% African American have resulted in foreclosure, while 1.63% of its loans in neighborhoods that are over 60% White have resulted in foreclosure.

12. By analyzing HMDA data for the period 2004 through 2007 (the last year for which HMDA is available), I have also determined that Wells Fargo's high-cost loans in Baltimore are disproportionately located in neighborhoods that are more than 60% African American. The disparity is reflected on the map attached hereto as Attachment 4.

13. I have also determined based on my review of the data indicating the presence and amount of a tax lien, that 127 of the 379 Wells Fargo foreclosure properties (33.5%) were the subject of a tax lien sale between 2005 and 2008 after origination of the Wells Fargo loan, and that the median value of the tax lien for these 127 properties was $925.14. I have reviewed data released by Wells Fargo pursuant to the HMDA and determined that the median Wells Fargo mortgage loan in Baltimore between 2005 and 2007 (the 2008 HMDA data file is not yet available) was $112,000. Based on my years of experience working with municipalities, real estate attorneys and housing counselors, I do not believe that tax liens of the size at issue here are likely to play a significant role in causing borrowers to default on mortgages of this size.

14. Based on my review of HMDA data covering the years 2004 through 2007 reported by Wells Fargo, Wells Fargo made 38.7% of its mortgage loans in Baltimore in neighborhoods that are more than 60% African-American and 32.2% of its mortgage loans in neighborhoods that are less than 20% African-American.

15. I have been asked to identify the location and racial composition of the census tract/block group within which the following three properties are located:

500 N. Clinton Street, Baltimore, MD: Census tract/block group 2610.01
81.25% Black (2007 Claritas estimate)

2520 Shirley Avenue, Baltimore, MD: Census tract/block group 1513.02
95.14% Black (2007 Claritas estimate)

801 Arnold Court, Baltimore, MD: Census tract/block group 704.03
97.37% Black (2007 Claritas estimate)

I hereby declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge and belief.

EXECUTED WITHIN THE UNITED STATES ON: May 14, 2009

BY:_____
Ira J. Goldstein

Attachment #1

Resume: Ira J. Goldstein

Resume

Name: Ira J. Goldstein

Address: 7203 Lincoln Drive
Philadelphia, PA 19119

Telephone: (215) 242-4824 (H) (215) 574-5827 (O)

E:Mail: Iralin@verizon.net (H)
Ira.goldstein@trfund.com (O)

Education: Ph.D. Sociology, Temple University (1/86) The Wrong Side of the Tracts: A Study of Residential Segregation in Philadelphia, 1930-1980
M.A. Sociology, Temple University (8/82)
B.A. Sociology, Temple University (5/79)

Reports, Publications & Reviews:

"USDA's Irrational Rationale." In The Philadelphia Inquirer Op-Ed, November, 2008 (with William Yancey).

"Subprime Lending, Mortgage Foreclosures and Race: How far have we come and how far have we to go?" (with Dan Urevick-Ackelsberg). The Ohio State University Kirwan Institue for the Study of Race and Ethnicity, 2008. (http://4909e99d35cada63e7f75747fb7243be73e52e14.gripelements.com/pdfs/Goldstein_TRF_paper.pdf)

Restructuring the Philadelphia Region: metropolitan Divisions and Inequality (with Carolyn Adams, David Bartelt and David Elesh). Temple University Press, 2008.

"Estimating the Percentage of Students Income-Eligible for Free and Reduced Price Lunch." The Reinvestment Fund, 2007. A report prepared for the School District of Philadelphia. (http://www.trfund.com/resource/downloads/policypubs/SchoolLunchEligible_SDOP.pdf)

"One Industry's Risk is Another Community's Loss: The Impact of Clustered Mortgage Foreclosures on Neighborhood Property Values in Philadelphia" (with Richard Voith). Federal Reserve Bank of Philadelphia Discussion Paper, (forthcoming).

"Lost Values: A Study of Predatory Lending in Philadelphia" The Reinvestment Fund, 2007. (http://www.trfund.com/resource/downloads/policypubs/Lost_Values.pdf)

"The Economic Consequences of Predatory Lending: A Philadelphia Case Study." In Why the Poor Pay More: How to Stop Predatory Lending, Praeger Publishers, Squires, 2004.

"Bringing Subprime Mortgages to Market and the Effects on Lower Income Borrowers." The Joint Center for Housing Studies, Harvard University, Symposium on Building Assets, Building Credit. November, 2003. (http://www.jchs.harvard.edu/publications/finance/babc/babc_04-7.pdf)

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"Racial Barriers to Credit: Comment on Hula" (with Anne Shlay and David Bartelt). Urban Affairs Quarterly, 1992, Vol. 28, 1.

Mortgage Lending Patterns in Philadelphia, 1987 - 1989. A report prepared for the Philadelphia Commission on Human Relations, April, 1991. Published in Making Home Ownership a Reality - Not Just a Dream. Philadelphia Commission on Human Relations Conference Proceedings.

Philadelphia: Neighborhoods, Division and Conflict in a Post-Industrial City (with Carolyn Adams, David Bartelt, David Elesh, Nancy Kleniewski and William Yancey). Temple University Press, 1991.

"Homeless With Children: African American Women In Philadelphia" (with Phyllis Ryan and David Bartelt). In The State of Black Philadelphia, Vol. IX, The Urban League of Philadelphia, October, 1990.

"Public Education In Philadelphia: A Demographic and Social Profile." In The State of Black Philadelphia, Vol. IX, The Urban League of Philadelphia, October, 1990.

"Homelessness: A Sign of the Times." Planners Network, 1990, 81, 3.

Race Relations In Philadelphia: A 1989 Perspective - A 1990 Opportunity (with Leah Gaskin White). A report prepared jointly with the Philadelphia Commission on Human Relations, January, 1990.

The Politics of Knowledge: Activist Movements in Medicine and Planning by Lily M. Hoffman. Book review for the American Journal of Sociology, 1990, Vol. 96, 1.

Homelessness in Philadelphia: Roots, Realities and Resolutions (with David Bartelt and Phyllis Ryan). A report prepared under a grant from the Thomas Skelton Foundation, October, 1989.

"There Isn't the Housing for the Homeless." In The Philadelphia Inquirer Op-Ed, September, 1989.

"An Analysis of the Real Estate Assessment Practices of the City of Philadelphia's Board of Revision of Taxes" (with Robert Beauregard and Arthur Lyons). A report commissioned by the City Council of Philadelphia, September, 1989.

"Local Tax Reform: Is It Good For Philadelphians?" Institute for Public Policy Studies; Working Paper Series, April, 1989.

"Neighborhood Disputes and Intergroup Tension Events" (with William Yancey). In The State of Intergroup Harmony - 1988, Philadelphia Commission on Human Relations, October, 1988.

"Getting the Credit We Deserve: An Analysis of Residential Lending in New Castle County, Delaware; 1984 - 1986" (with Anne B. Shlay). A report commissioned by the Delaware Community Reinvestment Action Council.

"North Philadelphia: A Social and Demographic Profile" (with William L. Yancey). Institute for Public Policy Studies; Working Paper Series, August, 1988.

Homelessness in Pennsylvania: How Can This Be? 1988 (with Phyllis Ryan and David Bartelt). A report prepared for the Coalition on Homelessness in Pennsylvania and the Pennsylvania State Legislature.

"Islands in the Stream: Neighborhoods in the Political Economy of Urban Areas" (with David Bartelt, David Elesh, George Leon, and William Yancey). In Human Behavior and the Environment, Plenum Publishers, Altman and Wandersman, 1987.

"The Ecology of Health and Education Outcomes: An Analysis of Philadelphia Public Elementary Schools" (with William Yancey and David Webb). A report prepared for the Philadelphia School District, July, 1987.

"Rising Property Values as a Double Edged Sword: An Analysis of Residential Sales in Philadelphia, 1981-1985." Institute for Public Policy Studies; Working Paper Series, #21, December, 1986.

"Projects, Blacks and Public Policy; The Historical Ecology of Public Housing in Philadelphia" (with William Yancey). In Housing Desegregation, Race, and Federal Policies, University of North Carolina Press, ed. John Goering, 1986.

"The Flow of Housing Capital in the Philadelphia Metropolitan Area, 1982-1984." Institute for Public Policy Studies; Working Paper #20, September, 1986.

"Suddenly, Racism Has Reawakened in the Delaware Valley." In Philadelphia Daily News Guest Opinion Column, August, 1986.

"The Ecology of Educational Outcomes: A Preliminary Report" (with William Yancey and Leo Rigsby). A report prepared for the Philadelphia School District, July, 1986.

"The Energy of Racism is Misdirected." In Philadelphia Tribune, Editorial Column, May, 1987.

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"Residential Segregation and Color Stratification Among Hispanics in Philadelphia: A Comment on Massey and Mullan" (with Clark White). American Journal of Sociology, 1985, Vol. 91, 2.

The Jewish Population of the Greater Philadelphia SMSA (with William Yancey). A report prepared for the Federation of Jewish Agencies, November 1984.

Paper Presentations and Speeches:

"Next Steps in Fair Housing: Where is "Affirmatively Furthering Fair Housing" in HUD's Neighborhood Stabilization Program?" Presented at the National Housing Law Project / Housing Justice Network Conference, Washington, DC, 2008.

"Subprime Lending, Mortgage Foreclosures and Race: How far have we come and how far have we to go?" Presented at The Ohio State University's Kirwan Institute for the Study of Race and Ethnicity Conference. Columbus, OH, 2008.

"CDFI Financing of Supermarkets in Underserved Communities: a case study." (with Lance Loethen, Cathy Califano and Edward Kako). Presented at The Community Development Financial Institutions Fund Research Conference. Washington, 2008.

"Mortgage Foreclosures and Subprime Lending: An Assessment of the Issues and Proposed Policy Solutions." Presented at the 29th Annual Research Conference of the Association for Public Policy Analysis and Management. November, 2007.

"Update On Philadelphia Market Value Analysis." Presented at the City of Philadelphia's Annual Developer's Breakfast. May, 2007.

"Trends In Homeownership Across the Commonwealth of Pennsylvania." Presented at the Commonwealth Housing Forum of the Pennsylvania Housing Finance Agency. April, 2007.

"Market Value Analysis: Understanding Where and How To Invest Limited Financial Resources." Federal Reserve Bank of St. Louis' Series on Neighborhood Revitalization. December, 2006.

"Mortgage Foreclosures In Baltimore, MD." Presented at the Baltimore Homeownership Preservation Conference. October, 2006.

"Mortgage Foreclosures and Predatory Lending In Philadelphia." Presented at the American Bar Association's National Legal Aid and Defender Association Conference. July, 2006.

"One Industry's Risk is Another Community's Loss: The Impact of Clustered Mortgage Foreclosures on Neighborhood Property Values in Philadelphia." Presented at the Federal Reserve Bank of Philadelphia's Reinventing Older Communities: People, Places, Markets. March, 2006.

"Approaches Used By Non-Auditors To Investigate and Report Complex Public Issues." Presented at the National Conference of State Legislators – National Legislative Program Evaluation Society. October, 2005.

"A Study of Mortgage Foreclosure Activity in Pennsylvania, 2000-2003." Presented at the Federal Reserve Board's Consumer Advisory Council. March, 2005.

"Reflections on the American Dream; Experiences in Pennsylvania." Presented at the FNMA Annual Conference on Fair Lending." September, 2004.

"Maintaining Economic Gains: Partnerships To Protect Low Income Families From Predatory Lending." Presented at the American Public Human Services Association Family and Economic Success Forum. May, 2004.

"Recent Subprime Analyses; Foreclosures and Race." Presented at the National Fair Housing and Fair Lending Research and Policy Forum. March, 2004.

"Does Predatory Lending Disproportionately Affect Protected Classes Under the Fair Housing Act: The Latest Research." Presented at the John Marshall Law School Fair Housing Legal Support Center Symposium on Fair Housing and Predatory Lending Law. September, 2003.

"The Disproportional Incidence of Subprime and Predatory Lending on Protected Classes: New Data." Presented at the National Consumer Law Center Symposium on Market Failures & Predatory Lending. May, 2003.

"Predatory Lending: Overview and Policy Implications for Human Rights Agencies." Presented at the 54th Annual Conference of the International Association of Human Rights Agencies. July, 2002.

"Leveraging Change: Gauging the Impacts of Neighborhood Investment" with David Bartelt. Presented at the Annual Meeting of the American Sociological Association, 2002.

"Predatory Lending: From the Kitchen Table to Wall Street." Presented at regional forums of Freddie Mac's Don't Borrow Trouble in TX, NY, and CA, 2002-2003.

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"Proving Disinvestment: The CRA Experience" (with Anne Shlay). Presented at the Annual Meetings of the American Sociological Association, Pittsburgh, 1992.

"Mortgage Lending Patterns in Philadelphia, 1987 - 1989." A speech delivered to the Philadelphia Commission on Human Relations' "Making Home Ownership a Reality - Not Just A Dream" Conference, Philadelphia, 1991.

"Mortgage Redlining in Philadelphia - An Empirical Analysis." A speech delivered to the Philadelphia Finance Association, Philadelphia, 1990.

"An Overview of Mortgage Redlining; Background, Data, Research Methods and Conclusions." A speech delivered at the HUD Region III FHAP Training Conference, Philadelphia, 1990.

"The Role of Statistics In the Proof of Housing Discrimination." A Speech delivered at the HUD Region III FHAP Training Conference, Philadelphia, 1990.

"Homelessness in Philadelphia." Public testimony delivered at the Affordable Housing Forum, University of Pennsylvania, Philadelphia, 1989.

"Homelessness in Philadelphia: Roots, Realities and Resolutions" (with Phyllis Ryan and David Bartelt). Presented at the Annual Meetings of the Society for the Study of Social Problems, Berkeley, 1989.

"Philadelphia's Ignored Homeless - Unemployed Minority Males." A speech delivered at the Annual Meeting of Philadelphia Committee for the Homeless, Philadelphia, 1989.

"Why Should There Be Intergroup Harmony?" A speech delivered at the Bi-annual Meeting of the Alliance for Intergroup Harmony, Philadelphia, 1989.

"The Role of Academics in CRA." A speech delivered at the U.S. Department of Housing and Urban Development Region III Fair Housing and Equal Opportunity Conference, Baltimore, 1989.

"GDI: A Gentrification/Displacement Detection System." Presented at the Annual Meetings of the American Sociological Association, Chicago, 1987.

"The Persistent Significance of Race; A City/Suburb Comparison of Mortgage Lending in the Philadelphia Metropolitan Area." Presented at the Annual Meetings of the Eastern Sociological Society, Boston, 1987.

"The Ecology of Health and Education Outcomes: An Analysis of Philadelphia Public Elementary Schools." Presented at the Brown II Commemorative Program, School District of Philadelphia, 1987.

"The Ecology of Educational Outcomes" (with William Yancey and Leo Rigsby). Presented at the Brown II Commemorative Program, School District of Philadelphia, 1986.

"Political Integration and Residential Segregation; A Case Study of Philadelphia Voter Turnout" (with Patrick Feeney). Presented at the Annual Meetings of the American Sociological Association, Washington, 1985.

"Neighborhoods and Schools: 30 Years of Urban Change" (with William Yancey). Presented at the Brown II Commemorative Program, School District of Philadelphia, Philadelphia, 1985.

"The Political Economy of Residential Segregation: A Study of Philadelphia Neighborhoods." Presented at the 15th Annual Meetings of the Urban Affairs Association, Norfolk, 1985.

"See No Evil, Speak No Evil: The New Right, The Civil Rights Commission and 1984" (with Patrick Feeney). Presented at the Annual Meetings of the American Sociological Association, San Antonio, 1984.

"Projects, Blacks, and Public Policy: The Historical Ecology of Public Housing in Philadelphia" (with William Yancey). Presented at the Annual Meetings of the American Sociological Association, Detroit, 1983.

"Social Indicators of Four Types of Homicide" (with Margaret Zahn). Presented at the 8th Annual World Congress of Social Psychiatry, Paris, 1982.

Teaching Experience:

University of Pennsylvania:

Introduction to Urban Research
Information, Public Policy and Distressed Cities
City Limits: The Impact of Urban Public Policy

Temple University:

Introduction to Sociology
Undergraduate Statistics
Society and Personality
Urban Affairs – Discrimination in Housing

Research/Employment Experience:

June 1999 to present:
Director, Policy and Information Services, The Reinvestment Fund

The Reinvestment Fund (TRF) is a regional community development financial institution that uses capital and technical expertise to build wealth and create economic opportunity for low wealth communities and low and moderate income individuals. TRF accomplishes its mission through its financial support of affordable housing development, charter schools, community facilities, commercial real estate, small businesses, and workforce development programs. Policy and Information Services ("Policy") is an office within TRF that designs and conducts research that evaluates TRF's progress toward meeting its goals with regard to the social impact of its investments. Policy also conducts research that relates to public policy issues that impact upon our core market constituency. This research supports the development of new policy to be introduced into the public forum for debate and implementation. Policy is also responsible for obtaining and administering grant-funded and contract research that relates to the Fund's core mission. A sampling of TRF's Policy government past and preset clients includes, but is not limited to: Pennsylvania Department of Banking, Pennsylvania Housing Finance Agency, City of Philadelphia, New Jersey Housing and Mortgage Finance Agency, New Jersey Department of Community Affairs, Federal Reserve Bank of Philadelphia, City of Baltimore, Delaware Department of Banking, School District of Philadelphia.

January 1998 to June 1999:
Director, Mid-Atlantic Hub, Office of Fair Housing and Equal Opportunity, U.S. Department of Housing and Urban Development, Pennsylvania State Office

The Hub Director is the highest ranking fair housing position in HUD's Mid-Atlantic area. My jurisdiction included the states of Pennsylvania, Delaware, Maryland, Virginia, West Virginia and the District of Columbia. I was responsible for directing the investigation and resolution of fair housing cases under several statutes, including the Federal Fair Housing Act. Where state or local agencies exist that offer rights and remedies that are "substantially equivalent" to the those afforded by HUD and the Fair Housing Act, I was responsible for insuring that these agencies processed cases of discrimination in a manner that is consistent with the dictates of the law. Under current delegations of authority, with the concurrence of Regional Counsel, I was responsible for deciding whether there was factual evidence sufficient to render a determination that one (or more) statutes have been violated. I managed a staff of approximately 30 people in

the PA State Office; another 20 people around the Mid-Atlantic reported to me as well. I reported directly to the Assistant Secretary and General Deputy Assistant Secretary. This position required frequent travel and public appearances. I spoke publicly before trade groups (e.g., Mortgage Bankers Association, Maryland Multi-Family Housing Organization) fair housing organizations, and had frequent contact with elected and appointed public officials (e.g., mayors, senators, governors, council members, solicitors). Finally, Congress makes available a pool of funds that are subject of an annual competition among groups involved in fair housing advocacy and enforcement. On several occasions, I was called upon by the Assistant Secretary to contribute to the decisions on granting these funds.

The management portion of this job entailed working with the union and staff to insure a working environment that is free of social and/or structural impediments to productivity. From February 1995 until January of 1998, the official date for position changes resulting from HUD's *Management 2020*, the position I held was that of Fair Housing Enforcement Center (FHEC) Director. The responsibility of the position as Hub Director completely subsumed that of the: (a) FHEC Director; (b) what was formerly known as the Program Operations and Compliance Center (POCC) Director; (c) all of the Directors of the HUD/FHEO Offices within the Mid-Atlantic.

June 1991 to January 1998:
Chief, Systemic Investigations Branch, U.S. Department of Housing and Urban Development, Philadelphia Regional Office

In this position I was responsible for enforcing the federal Fair Housing Act through investigation of housing discrimination complaints. The Systemic Investigations Branch investigates complaints of housing discrimination which have many victims, or the nature of the discrimination is such that it is reflective of a pattern or practice of institutional discrimination. As Chief, I was also responsible for conducting Secretary Initiated complaints, an enforcement tool new to the 1988 Amendments of the Fair Housing Act. This position required that I introduce to HUD's Fair Housing and Equal Opportunity Office the science of data and statistical analysis to the investigation of housing discrimination complaints. I developed and was the first in the country to receive Assistant Secretary approval to initiate a Secretary Initiated investigation of discrimination in mortgage lending in Philadelphia. The position included a full complement of administrative responsibilities. I supervised a staff of eight professional investigators and "outstanding scholar" interns.

For the last year that I held this position, I was detailed to the headquarters office in Washington, D.C. There, I worked in the Office of Regulatory Initiatives and Federal Coordination on a Task Force on Fair Lending that was constituted with representatives of all of the financial regulatory agencies as well as the Departments of Housing and Urban Development and Justice. Also, I was involved in developing a regulation to support the Fair Housing Act's prohibitions against mortgage lending discrimination. While on detail, together with a colleague, we developed a computer based system that produced reports using Home Mortgage Disclosure Act and Census data to be used by investigators across the country in the investigation of mortgage lending discrimination complaints.

August 1988 to June 1991:
Associate Director, Institute for Public Policy Studies (IPPS)

This position requires full administrative responsibility for departmental functions including staffing and budget. The acquisition and administration of departmental research and grants/contracts is an essential component. In this capacity, the Associate Director acts as liaison between funding sources, researchers, and university officials. The Associate Director is also responsible for carrying out empirically based policy research, and creating a forum in which policy researchers from a variety of backgrounds may meet and exchange ideas on issues of contemporary public policy importance. In 1989, IPPS became a Research Affiliate of the Pennsylvania State Data Center; the Associate Director is responsible for coordination of all related activities.

Professional Activities and Awards:
Recipient of the Consumer Credit Counseling Service of Delaware Valley's Peter F. Iacovini Credit to Greater Philadelphia Community Award
Committee Member, Pennsylvania Housing Advisory Committee (Gubernatorial Appointment)
Member, Federal Reserve Board Consumer Advisory Council (2009-2011)
Member, Research Advisory Group, Center for Responsible Lending
Referee, Urban Affairs Quarterly
Referee, Journal of Urban Affairs
Referee, Law and Social Policy

References Available Upon Request

Attachment #2

- Wells Foreclosure Filings 2005 - 2008

Percent of Owner Occupied Housing Units that Are African American 2005

- 20% or Less
- 20.1% - 40%
- 40.1% - 60%
- 60.1% - 80%
- Over 80%
- Non Residential

Attachment #3

• Wells Foreclosure Filings 2005 - 2008 that were Vacant Post-Origination

Percent of Owner Occupied Housing Units that Are African American 2005

- 20% or Less
- 20.1% - 40%
- 40.1% - 60%
- 60.1% - 80%
- Over 80%
- Non Residential

Attachment #4

Percent of Owner Occupied Housing Units that Are African American 2008

- 20% or Less
- 20.1% - 40%
- 40.1% - 60%
- 60.1% - 80%
- Over 80%
- Non Residential

Wells Fargo High Cost Purchase and Refinance Loan Originations 2004-2007

1 Dot = 1 Loan; Not Actual Address

ATTACHMENT P

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND
BALTIMORE DIVISION

MAYOR AND CITY COUNCIL OF BALTIMORE,	)	
Plaintiff,	)	
v.	)	No. 1:08-cv-00062-BEL
WELLS FARGO BANK, N.A.	)	
and	)	
WELLS FARGO FINANCIAL LEASING, INC.,	)	
Defendants.	)	

1. I, Richard Faison, hereby attest that I am over the age of 18 years and that I am competent to testify with respect to the matter below.

2. I reside at 2522 Shirley Avenue, Baltimore, MD 21215. I own my home, which is a row house located in northwestern Baltimore. I have lived in my home for more than 24 years.

3. My home is adjacent to another row house located at 2520 Shirley Avenue, Baltimore, Maryland 21215 ("the Property"), which is vacant and was recently boarded up in February, 2009.

4. The Property has caused problems for me and my family. For example, because the Property is rat infested, rats from the Property have come into our home and chewed holes in the walls. We have had to make repairs to those walls to try to keep the

rats out. Rats have come into both our basement and our kitchen from the Property. I had to put down one of my dogs because it got rabies from the rats.

5. Strangers go into the Property at all hours. I have called 911 on a few occasions because strangers are hanging out at the Property drinking. I also believe that people use the Property as a place to take drugs. Police have come to the Property at least twice because of the strangers who loiter there.

6. The Property has not been very well cared for. There is often trash on the front porch which attracts rats. A neighbor of mine who lives at 2518 Shirley Avenue, Brian Jefferson, has cut the grass in front of the Property on numerous occasions because it is so high and makes the whole block look bad.

7. There was also water buildup at the Property because the pipes burst. To prevent damage to my house, we had to call the City of Baltimore to come turn off the water and cap the pipes.

8. I know from viewing the inside of the Property that it is in bad structural condition because the floor and supports appear to be rotten. I am concerned that there may be additional damage to my home because of the condition of the Property. I am also concerned that the Property is a fire hazard. The Property has deteriorated even more over the last year.

9. The Property also has termite damage and I have to make repairs to my house to replace boards that have been damaged by termites.

10. The Property has hurt our neighborhood. People do not want to live in

my neighborhood because of the condition of the Property. I do not know who to get in touch with about the Property. I would like somebody responsible for the Property to repair it so that my neighbors and I no longer suffer from the problems described above.

I hereby declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge, information, and belief.

EXECUTED WITHIN THE UNITED STATES ON: May 15, 2009

BY: Richard Faison
Richard Faison

ATTACHMENT R

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND
BALTIMORE DIVISION

MAYOR AND CITY COUNCIL OF BALTIMORE,	)	
Plaintiff,	)	
v.	)	No. 1:08-cv-00062-BEL
WELLS FARGO BANK, N.A.	)	
and	)	
WELLS FARGO FINANCIAL LEASING, INC.,	)	
Defendants.	)	

1. I, Lisa Porter, hereby attest that I am over the age of 18 years and that I am competent to testify with respect to the matter below.

2. I reside at 807 Arnold Court, Baltimore, MD 21205. I own my home, which is a row house located in East Baltimore. I have lived here since 1974.

3. My home is a few doors down from another row house located at 801 Arnold Court, Baltimore, Maryland 21205 ("the Property"), which has been vacant for at least a year.

4. Since becoming vacant, the Property has not been well maintained. It is a dumping ground for trash. There is usually trash scattered in both the front and back yard of the Property. The grass is also high around the Property. I would like the person who owns the Property to maintain it until someone can move in and take care of it.

5. Since the Property became vacant, I have also had an increased problem with rats in and around my home. Part of the inside of the Property' was "gutted" after it became vacant and this drove the rats to other homes nearby, including mine. When my grandchildren come to play in my front yard, they have to be careful not to step on or be bitten by the rats. I worry about their safety because of the rat infestation.

6. The Property also detracts from the appearance of my block. It has made my neighborhood a less attractive place to live.

I hereby declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge, information, and belief.

EXECUTED WITHIN THE UNITED STATES ON: May 18, 2009

BY: _____
Lisa Porter

ATTACHMENT S

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND
BALTIMORE DIVISION

MAYOR AND CITY COUNCIL OF BALTIMORE,	)	
Plaintiff,	)	
v.	)	No. 1:08-cv-00062-BEL
WELLS FARGO BANK, N.A.	)	
and	)	
WELLS FARGO FINANCIAL LEASING, INC.,	)	
Defendants.	)	

1. I, Bridget Ross, hereby attest that I am over the age of 18 years and that I am competent to testify with respect to the matter below.

2. I reside at 504 North Clinton, Baltimore, MD 21205. I own my home, which is a row house located in East Baltimore. I have lived in my home since 1995.

3. My home is two doors down from another row house located at 500 North Clinton, Baltimore, Maryland 21205 ("the Property"), which has been vacant for at least two years. After the Property became vacant, it was not boarded up for some time. During this period, people broke into the Property and vagrants stayed there. I noticed that the door was broken as well as some windows.

4. After becoming vacant, people stole plumbing from the Property. My neighbor Randy Taylor, who lives in a row house at 502 North Clinton, which is located

between the Property and my home, told me that he looked inside the Property after it became vacant and found that pipes were missing from the home and water was running from broken pipes inside the Property towards his home. Since the Property became vacant, my basement has flooded on more than one occasion on the side closest to the Property. Mr. Taylor told me that his basement has been flooded as well by water coming from the Property.

5. I called the City of Baltimore to complain about the Property. My neighbors told me they called the City as well to complain and within a few weeks the City boarded up the Property.

6. The Property has not been well maintained since becoming vacant. There is usually a large pile of garbage in the backyard and garbage scattered around the front yard. My neighbors and I sometimes clean up the front yard. The City has also come by to collect trash dumped in both the front and back yard of the Property.

7. I have noticed an increase in the rats around my home since the Property became vacant. There are rat holes in my backyard. I called the City to complain about the rats. In response to my call, the City took steps to exterminate the rats in and around my home, but there is still a rat problem on my block because of the garbage people dump in and around the Property.

8. I am concerned that the Property will become a drug house and increase crime in my neighborhood. I am also worried that children in the neighborhood could be injured if they play in or near the Property. The Property is already a hazard to the neighborhood.

9. The value of my home has gone down because of the Property. I have been unsuccessfully trying to sell my home for two years. I believe that having the vacant Property located so close to my home has made it difficult, if not impossible, for me to sell my home.

I hereby declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge, information, and belief.

EXECUTED WITHIN THE UNITED STATES ON: May 25, 2009

BY: Bridgette J Ross
Bridget Ross

Mr. COHEN. Thank you so much. You are the two best witnesses we have had during the whole time that I have been Chair. But we do only have 4 minutes to run and vote. We have got about, I think I have been told, four votes. And so that theoretically is give or take 30 minutes. And so in the interim you are relieved of any responsibilities to improve the world. And we are in recess.

[Recess.]

Mr. COHEN. The Committee will now come back into session. I want to thank the witnesses for their continued attendance.

Our third witness is Professor James Mason. Joseph, yes, that's right. Somehow it got diverted into acting. Professor Mason is Associate Professor of Finance at LSU's Department of Finance and a senior fellow at the Wharton School. Dr. Mason's research spans the fields of corporate finance, financial intermediation, financial history, monetary economics focusing on issues related both to theory and public policy. And do you know where the deduct box is.

Mr. MASON. The what box?

Mr. COHEN. The deduct box.

Mr. MASON. The beat up box.

Mr. COHEN. You don't know the deduct box?

Judge MAGNER. He hasn't lived in the State long enough.

Mr. COHEN. One of Huey Long's last requests made of him is, Huey, where is the deduct box? That is the D. Would you deduct it from your salary, your State job, to give to the political organization. They never found the deduct box. Huey would not tell them on his death bed. So with that recognized, always looking for the deduct box, thank you for being here Professor Mason. We now recognize you for your testimony.

Mr. MASON. Thank you. I will add that to my palette of Huey Long stories, of which I have several, but that is a new one.

TESTIMONY OF JOSEPH R. MASON, Ph.D., LOUISIANA STATE UNIVERSITY

Mr. MASON. Thank you, Chairman Cohen, Ranking Member Franks, and Members of the Subcommittee, for allowing me to testify today.

The reasons for the limited success of private modifications to date lie in the realities of the mortgage crisis, the same realities that could hinder the relevance of judicial modifications. First, many residents of homes today could never afford an amortizing loan and still cannot do so today. Second, a significant proportion of Chapter 13 repayment plans have historically failed. And third, allowing bankruptcy judges to modify mortgage debt may cause other perverse incentives among both lenders and borrowers.

The sad fact is a significant number of borrowers can't afford any amortizing mortgage. In the last several years substantial numbers of consumers borrowed money they could not afford to repay. The extent to which those loans were outside any reasonable bounds of affordability, however, is still not widely understood. The problem is that while the industry created the loans in a process that labeled them, quote, unquote, prime or Alt-A, many loans were nothing of the sort. Within the industry many of the loans that are distressed today were known as, quote, unquote, stealth prime or stealth Alt-A, acknowledging that the loans qualified for their monikers only on the basis of copious quantities of scissors, Wite-Out, and adhesive tape all in the name of the democratization of credit and expanding home ownership pursuant to Federal policy.

The question then becomes what can reasonably be expected of modification, judicial or otherwise. Prior to the crisis I reported that some 40 to 50 percent of modified loans redefaulted within 2 years of modification. And for further background on that I urge you to see the accompanying working papers that I have included to be entered into the record. Of course those results are from the

benign economic period prior to the crisis. We are already seeing evidence of far worse performance in the crisis with 1 year redefaults pushing above 70 percent.

A similar dynamic is common in Chapter 13 repayment plans. The 2008 report of statistics required by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, reported that of 113,289 Chapter 13 cases dismissed in 2008, 48,081 of those, or just over 42 percent, were dismissed for, quote, unquote, failure to make repayments under plan.

Moreover, Chapter 13 plan failures are related to economic difficulty just like private modifications. The Ninth Circuit of Eastern California Federal Court District experienced a 51 percent failure rate in making payment under plans in 2008 while the Eleventh Circuit of Northern Florida experienced a 59 percent rate, and the Eleventh Circuit of Central Florida experienced a 62 percent rate. When economic conditions are known to dominate judicial and legal arrangements in determining foreclosure outcomes we shouldn't rely centrally upon modification policy, judicial or private, to alleviate economic difficulties or declining home prices.

That being said, private modifications are proceeding apace. Treasury recently reported that servicers initiated 230,000 trial modifications in the month of July alone, more than the total of 118,000 Chapter 13 bankruptcy cases reported for the whole of 2008. Hence, it seems that private modifications are extracting the lion's share of policy effects from the market already and judicial modification can contribute relatively little to the mortgage market and economic recoveries.

Regarding the subject of cramdown, since it was introduced in opening remarks, there is a substantial threat that changes to the Bankruptcy Code can create perverse incentives. Recent bankruptcy reforms produced unanticipated effects that are only now being felt in mortgage defaults. It is now widely understood that the 2005 bankruptcy reform made escaping debts through bankruptcy less attractive by increasing the cost of filing and forcing some high income debtors to repay bankruptcy income. But because many consumers are hyperbolic discounters, making bankruptcy law less debtor friendly did not solve the problem of consumers borrowing too much. The reason is that when less debt is discharged in bankruptcy lending becomes more profitable and lenders increase the supply of credit. Along with low interest rates therefore the increased credit supply became a powerful incentive to lend and borrow, but one that had predictable and predicted results in the credit crisis.

Now, more perverse incentives can reasonably be expected to arise from judicial modification. The reason is that bifurcation of debt secured by real assets can be exploited in ways that bifurcation of debts secured by other assets cannot. If a court bifurcates a claim on an automobile loan, for instance, the automobile is not expected to ever be worth more than the current market value established by the courts. For real estate though, even in today's market conditions, perhaps especially in today's market conditions, the value of the collateral can be expected to grow in the future. Hence, judicial modifications, if allowed, perhaps should be limited

to a shared appreciation mortgage paradigm that can reduce the opportunity for bankrupt borrower arbitrage.

In summary, from an economic perspective, reducing the supply of loans while maintaining consumer demand will lead to credit rationing in which lenders refuse to lend to borrowers for reasons other than credit quality. Credit supply shortfalls, along with an estimated $30 billion price tag of additional costs of mortgage lending in the industry from cramdown, will then drag out financial sector recovery beyond that which can otherwise be reasonably be expected. Major changes to property rights, like any changes to legal precedent, are inherently economically destabilizing.

There exists a substantial body of literature on the economic inefficiency of discretionary policy relative to well-designed and well-articulated rules. Hence, without clear public policy objectives or compelling economic initiative, I find it hard to advocate judicial modification.

Thank you.

[The prepared statement of Mr. Mason follows:]

PREPARED STATEMENT OF JOSEPH MASON

Testimony of Joseph R. Mason

Hermann Moyse, Jr./Louisiana Bankers Association Professor of Finance,
Louisiana State University and Senior Fellow, the Wharton School

Before the Committee on the Judiciary,
Subcommittee on Commercial and Administrative Law

September 9, 2009

"Role of the Lending Industry in the Home Foreclosure Crisis"

While the mortgage crisis continues to churn, policymakers continue to ponder whether judicial powers can help avoid unnecessary foreclosures and help families with adequate resources save their homes. While my testimony last year to the Senate Judiciary Committee focused on the economics of why judicial modification of mortgages in bankruptcy may be untoward, my present testimony will focus more on why the modification policies enacted to date may be expected to yield little in the way of relief for the mortgage crisis and why judicial remedies of allowing bankruptcy judges to determine property values in bankruptcy may have similar results.

The reasons for limited success of private modification to date lie in the realities of the mortgage crisis, the same realities that will hinder the relevance of judicial modifications. First, many residents of single-family homes today could never afford an amortizing loan that could enable them to economically own a home in the first place, and still cannot do so today. Second, most Chapter 13 bankruptcy repayment plans have always failed so that allowing bankruptcy judges to modify mortgage debt under Chapter 13 may simply add complexity to the inevitable at the lending industry's expense. Third, if Congress allows the judiciary to allow bankruptcy judges to modify mortgage debt the change may cause other perverse incentives among both lenders and borrowers, as the Bankruptcy Reform Act of 2005 did previously.

I. A Significant Number of Borrowers Can't Afford any Amortizing Mortgage

In the last several years, substantial numbers of consumers borrowed money they could not afford to repay. That they did so should come as no surprise by now. The extent to which those loans were outside any reasonable bounds of affordability, however, is still not widely understood. The problem is that while the industry created the loans in a process that labeled

them "prime" or "Alt-A", many loans were nothing of the sort. Hence, many today are talking of a "prime" mortgage crisis.

But the loans at issue are really anything but "prime." Within the industry, many of the loans that are distressed today were known as "stealth prime," and "stealth Alt-A," acknowledging that the loans qualified for their monikers only on the basis of copious quantities of scissors, white out, and adhesive tape, all in the name of the "democratization of credit" and expanding "homeownership" pursuant to Federal policy.

The limits of consumer borrowing capacities are most clearly illustrated with an example of a typical pay-option ARM loan amortization schedule. The Pay-Option ARM (POA) contract has two interest rates, the teaser and the fully-indexed note rate. The spread between the teaser rate and the fully indexed rate is important because the teaser rate is used to calculate the minimum allowable payment on the POA loan. Suppose a borrower takes out a 30-year POA loan for $325,000 with a teaser rate of 1.5% and a fully indexed interest rate (the actual lending rate) of 8% (all chosen to be about average for the industry). The minimum monthly payment (computed using the 1.5% teaser rate) is $1,121.64, compared to an amortizing payment (computed using the 8% note rate) of $2,384.73. The difference between the two payments, $1,263.09, is the negative amortization in the *first period* of the loan. Because the $1,263.09 negative amortization is added to the loan principal next period, the negative amortization in the second and each subsequent period is greater than that in each preceding period until the loan reaches the end of its (typically) 5-year negative amortization period (or the maximum allowable – typically 115% – LTV limit) the compounding effect is working against the borrower during the negative amortization period. The point is that, using the example above and assuming home prices

remain constant, the worst (best?)-case scenario brought about by negative amortization is 100.98%.

The spread, however, also affects the payment shock to the borrower at the end of the five-year negative amortization period. Limiting the spread to, say, 300 basis points (typically viewed as a reasonable limit) results in a payment increase of roughly 31%, but at 650 basis points the payment shock is over 111%, largely due to the more than $55,000 greater loan balance that accumulated due to the higher negative amortization by the fifth year in our example.

Note further, that the borrower who can only afford to make a payment of $1,121.64 can only afford a fully-amortizing 30-year loan at 8% of $152,861, roughly 47% of the $325,000 they borrowed using the POA. Moreover, many POA borrowers today are unable to make their teaser payments (the $1,121.64) even without the threat of going to the payment shock, having used their homes repeatedly as a source of income to maintain their ability to afford the payment.

The reason some borrowers cannot even afford those artificially low payments is that many of the failed mortgage underwriting operations were plagued by operational difficulties, failing to adequately supervise underwriting operations both in-house and at brokers. The result was a quantity of loans that met no realistic or even intended underwriting criteria, having been given to people who represented (or were said to have represented) that the earned far more than they actually did.

As the industry adjusted for such underwriting defects in 2007, mortgage lending fell precipitously. In some cases, as much as 90% of originated loans were below any reasonable underwriting standards due to both borrower and lender problems, and often combinations of the two. There is little that modification policy – private or judicial – can do to realign markets faced with such severe imbalances.

II. What Can Reasonably be Expected of Modification, Judicial or Otherwise?

Modification, by judicial or private means, can be expected to help both borrowers and lenders achieve incrementally better outcomes in the face of temporary economic difficulties. For instance, a borrower with a low CLTV (below 80%) and a debt-to-income ratio of less than 40% can be relied upon to continue making payments even if the lender allows them to move a few payments to the back end of the loan or reduces principal owned in order to preserve the value already built up in the home. Less well-situated borrowers, however, are less likely to try to keep up with payments after modification relief.

Moreover, while a lender may save 10% of the home's value from legal costs of foreclosure via modification little more savings can be generated through such strategies. In the current environment, if the lender is able to wait out the upturn in market values, the savings may be much greater foreclosing than modifying.

The perspective from the borrower's side is not any better. Prior to the crisis, I reported that some 40-50% of modified loans redefaulted within two years of modification (see accompanying working paper to be entered into the record). Of course, those results are from the period prior to the crisis. The question since the time of writing that white paper, therefore, has been how bad can redefaults get? We are already seeing some hints at the answer, with one-year redefaults already pushing above 70%.

Private modification is like a targeted Chapter 13 repayment plan, and most Chapter 13 repayment plans also fail. The 2008 Report of Statistics Required by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 reported that of 113,289 Chapter 13 cases dismissed in 2008, 48,081 – or just over 42% -- were dismissed for "failure to make payments under plan."

Moreover, Chapter 13 plan failures are positively related to overall economic difficulties, just like their private modification counterparts. The 2008 Report revealed that the 9th Circuit of Eastern California Federal Court District experienced a 51% failure rate in payment plans in 2008, while the 11th Circuit of Northern Florida experienced a 59% rate and the 11th Circuit of Central Florida experienced a 62% rate.

Simple statistical analysis illustrates the relationship, as well. Regressing foreclosure rates on judicial variables like whether deficiency judgments and other foreclosure procedures are allowed in the state and comparing those effects to unemployment and economic growth reveals that economic growth effects vastly dominate judicial and other institutional arrangements. In all cases tested, institutional foreclosure arrangements were statistically insignificantly related to foreclosure outcomes.

Such results are similar to those produced by Charles Calomiris, Stanley Longhofer, and William Miles, who show in recent research that, "The impact of foreclosures on prices, while negative and [statistically] significant, is quite small in magnitude. " Simulating house price changes in response to extreme foreclosure shocks reveals that, "[e]ven under extremely pessimistic scenarios for foreclosure shocks, average U.S. house prices, as measured by the comprehensive OFHEO house price index… likely would decline only slightly or remain essentially flat in response to foreclosures. This suggests that home prices are quite sticky, and that fears of a major fall in house prices, with all of its attendant negative macroeconomic consequences, typically are not warranted even in extreme foreclosure circumstances."[1]

[1] "The Foreclosure-House Price Nexus: Lessons from the 2007-2008 Housing Turmoil," Charles W. Calomiris, Stanley D. Longhofer, and William Miles, Columbia University Working Paper, July 4, 2008

The above evidence suggests that we should not rely centrally upon modification policy – judicial or private – to alleviate economic difficulties or declining home prices, since so little can reasonably be expected of such policy and any follow-on economic effects.

That being said, private modifications are proceeding apace. Treasury recently reported that servicers initiated 230,000 trial modifications in the month of July, alone – more than the total of 118,400 Chapter 13 bankruptcy cases reported by the Report of Statistics for the Bankruptcy Abuse Prevention and Consumer Protection Act for the whole of 2008. Hence, it seems that private modifications are extracting the lion's share of policy effects from the market already, and that judicial modification can contribute relatively little to the mortgage, market, and economic recovery.

III. Perverse Incentives from Changes to the Bankruptcy Code

Recent bankruptcy reforms produced unanticipated effects that are now being felt in mortgage defaults. Before the 2005 bankruptcy reform, debtors could file for bankruptcy and have their unsecured debt discharged in Chapter 7 without losing their homes as long as their home equity was less than their state's homestead exemption. But the 2005 bankruptcy reform made filing for bankruptcy less attractive and made it more difficult for borrowers to keep their homes. The reforms had four key effects: first, debtors' cost of filing for bankruptcy increased sharply after the reform; second, a new means test prevented higher-income debtors from filing under Chapter 7; third, the homestead exemption in Chapter 7 bankruptcy was capped at $125,000 for debtors who live in high-exemption states, and; fourth, debtors who have both high income and high home equity were usually forced to repay more of their unsecured debt in bankruptcy.

The perverse incentives established by the bankruptcy reform of 2005 are clearly presented by Michelle White in "Bankruptcy Reform and Credit Cards," (NBER Working Paper No. 13265). According to White, because many consumers are hyperbolic discounters, making bankruptcy law less debtor-friendly did not solve the problem of consumers borrowing too much. This effect arises because when less debt could be discharged in bankruptcy, lending became more profitable and lenders increased supply of credit. Along with low interest rates, this dynamic became a powerful incentive to lend and borrow, but one that had predictable (and predicted) results.

According to recent research by Michelle White, Wenli Li, and Ning Zhu (Did Bankruptcy Reform Contribute to the Mortgage Crisis?), the effects of the reforms have been clearly demonstrated in the recent mortgage crisis. According to those authors, because the 2005 reform reduced consumers' gains from filing for bankruptcy it also reduced consumers' likelihood of defaulting on their unsecured debt. But because consumers' ability-to-pay is fixed in the short-run, the reform perversely increased debtors' likelihood of defaulting on their *secured* debt, particularly mortgages.

White, Li and Zhu's main results are, first, that bankruptcy reform caused mortgage default rates to rise 45% for prime mortgage-holders and 22% for subprime mortgage-holders. Second the new means test in bankruptcy caused mortgage default rates to increase more for higher-income debtors: default rates of prime and subprime mortgage-holders who are subject to the means test increased by 26% and 22%, respectively, relative to the increase for lower-income debtors not subject to the means test. Third, the new provision requiring debtors who have both non-exempt income and non-exempt home equity to repay more caused default rates to rise differentially for this other group of debtors, as well.

Intriguingly, rather than reducing lenders' incentives to supply too much credit to debtors who are likely to become financially distressed, reformers seek to maintain the incentives for consumers to borrow but penalize lenders for meeting consumer demand. In other research Michelle White and Ning Zhu ("Saving Your Home in Chapter 13 Bankruptcy," NBER Working Paper No. 14179) estimate that judicial modification will claw back a little less than 10% of the defaults[2], at an average cost of roughly $264,000 per home saved, or about $30 billion in total. The policy still, therefore, leaves a net increase in borrower defaults over those prior to the 2005 reform.

But yet more perverse incentives can reasonably be expected to arise from judicial modification. The reason is that bifurcation of debts secured by real assets can be exploited in ways that bifurcation of debts secured by other assets cannot. Bifurcation, commonly referred to as "cramdown," has long been applicable to non-real estate collateral as well as some second and vacation homes. But, while the concept is sensible for non-real fully-depreciable collateral like automobiles, the idea is fundamentally flawed for assets like real estate. The reason a bifurcation makes sense for fully-depreciable collateral is that the value of the collateral is decreasing throughout the life of the loan. If a court bifurcates a claim on an automobile loan, the automobile is not expected to ever be worth more than the current market value established by the courts.

For real estate, even in today's market conditions, the value of the collateral can be expected to grow in the future so that bifurcating the claim is akin to taking away real value from

[2] Remember, this is 10% of *bankrupt* homeowners, about 11,000 borrowers out of roughly 118,000 Chapter 13 cases, a relatively miniscule portion of the total population. Mortgage modification applied across non-bankrupt borrowers would never be expected to impact this anywhere near 10% of that much larger population. White and Zhu estimate that even *with* cramdown some 42% of bankrupt borrowers would keep their homes anyway, and that the rest – some 48% of homeowners – are too liquidity constrained to afford the home.

the lender now that will accrue to the borrower in the future. Whether that value growth is two years ahead or twenty is irrelevant, given the typical 30-year term of the mortgage contract.

The concept is especially egregious in real estate markets that are highly sensitive to economic or market conditions. Boom and bust Houston and New England real estate markets of the early 1980s returned handsome profits for investors after the relatively brief market disruptions of the late 1980s and the recession of 1991. The Case-Shiller mortgage price index, which begins in January 1987, shows that Boston home prices hit a high of 75.53 in July 1988 and retreated thereafter, only to reach and exceed that level in May 1997. Boston now stands at 170.73, providing a 127% total return, or 4.2% annually, since 1987. Los Angeles peaked at 100.00 in June 1990 and, after a similar hiatus, breached that level again in January 2000. Los Angeles now stands at 254.79, providing a 155% total return, or 5.7% annually since 1990.

It is important to note that these are worst case returns, obtained from buying at the top of the market and holding, and the cases do not account for the fact that the investment made by a home buyer is leveraged, so that an investment of 20% down, along with periodic payments, is enough to obtain the full gain on the property value.

Today, while California and Florida markets are expected to decline in value the most in the short-term, they are also expected to rebound sharply in the expansion that follows. In fact, it is not those markets that should be the source of concern, but markets like those of Ohio and Michigan, whose economic growth will not support timely rebounds from even mild home price depreciation, although they will rebound, nonetheless.

The point, therefore, is that real estate gains will resume and even if they are not on par with recent growth, the gains will restore value for true homeowners in the long term even if speculators lose in the short term. Hence, it may make sense to limit judicial modification relief

to a set of shared appreciation contracts, so that the gain on the judicially modified loan is shared with the lender and the private solution remains generally more favorable in the eyes of the consumer.

IV. Summary and Conclusions

From an economic perspective, reducing the supply of loans while maintaining consumer demand will lead to credit rationing, in which lenders refuse to lend to borrowers for reasons other than credit conditions. Credit supply shortfalls, along with an estimated $30 billion of additional costs of mortgage lending in the industry, will drag out financial sector recovery beyond that which can reasonably otherwise be expected.

Moreover, forced judicial modification offers consumers a "one-sided" contract, one with a clear option to attempt to capture value at the market minimum as part of a rational investment strategy to gain from strategic bankruptcy behavior. But, potentially of more concern to members of this committee, the attempt to capture value is given only one opportunity and – unlike private modification which can be repeated – if the borrower gets it wrong they may pay dire consequences.

Last, major changes to bankruptcy law – just like altering any judicial precedent – are inherently economically destabilizing. Without clear information about the winners and losers in the policy mash-up, lenders will charge higher loan rates merely upon the uncertain outcome. In light of the substantial body of economic literature on the economic inefficiency of discretionary policy relative to well-designed and well-articulated rules (see, for instance, Kydland and Prescott, 1977, Journal of Political Economy), therefore, I find it discouraging that the Administration remains wedded to its current agenda of "change at all costs."

While additional changes to bankruptcy law will be unavoidably disruptive, changes so soon after a major reform (in 2005) and in the midst of an economic crisis may be expected to be more disruptive, still. Hence, because of the complexity of bankruptcy law and the lender and consumer incentives intertwined with such policy it is doubtful that proposed changes to judicial modification will result in a net *gain* in economic efficiency. Without clear public policy objectives or an economic imperative beyond the need to "do something," therefore, I find it hard to advocate changes to bankruptcy law that enable judicial modification.

ATTACHMENT

Mortgage Loan Modification: Promises and Pitfalls

JOSEPH R. MASON†

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I. INTRODUCTION

Problems in the US mortgage industry have led many disparate authorities to consider numerous ways to insulate borrowers from the effects of their loan paments, and therefore ameliorate the short-term economic impact of the current market crisis.

Clearly the problem is large. Leaving the alt-A and jumbo sectors aside, subprime mortgages alone currently amount to about 13% of total mortgage loans outstanding, or about $1.2 trillion. It is estimated that in 2007 alone, about $400 million in subprime loans will face adjustable-rate interest increases, which in some cases can result in payment increases of 150 percent or more and borrower pre-tax debt-to-income ratios of up to 65 percent (it is common to consider a debt-to-income ratio of 40 percent or below as prudent). As Figure 1 shows, 2008 is expected to be worse.

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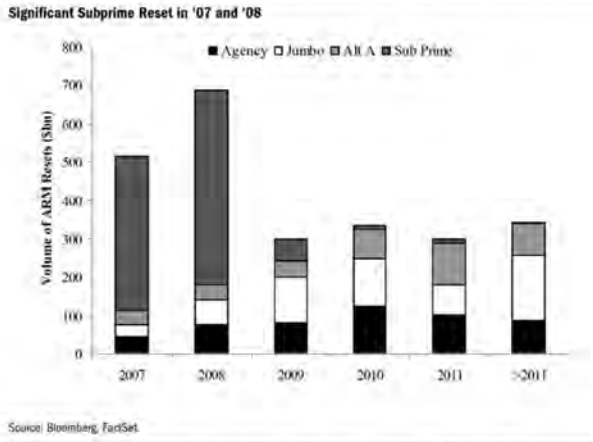
FIGURE 1: SUBPRIME MORTGAGE RESETS IN 2007 AND THE FUTURE



Source: Bank of America, "Subprime Mortgage Finance Weekly: Subprime Loan Modifications – not a Panacea," May 25, 2007.

The current subprime delinquency ratio is about 15 percent ($180 billion) of outstanding subprime mortgages, a 14-year high. Even if all subprime mortgage loans currently in delinquency do not go into foreclosure, it is easy to imagine the ratio rising further to create a crisis on par with the thrift crisis of the late 1980s, which is equal to about $150 billion in inflation-adjusted terms.[1]

Each delinquency and foreclosure is costly to administer. The cost of a typical foreclosure has been estimated to be about $60,000, or about 20-25 percent of the loan balance (legal fees alone can cost $4,000), and those costs are expected to be higher in times of home price depreciation.[2] Hence, it is logical for lenders to try to avoid foreclosures through loan modification.

Fitch Ratings recently suggested that as many as two-thirds of existing delinquencies can be expected to be modified over the next 12-18 months. Among such loans, modification might be the *only* viable alternative to foreclosure for as many as 50% of the loans in default or facing a default scenario.[3]

There are three major problems with this strategy. First, a modification effort of this magnitude is far beyond the existing modification capacity of the industry. Most servicers currently modify less than 1 percent of their loans, so increasing to 10 or 20 percent represents growth of 1,000- 2,000 percent. Second, while

1. Bank of America, *Subprime Loan Modifications – not a Panacea*, SUBPRIME MORTGAGE FINANCE WEEKLY, May 25, 2007. I derive this figure using $100 billion and adjusting for inflation from 1991-2006 with CPI.

2. *Id.*

3. Gabrielle Stein, *Loan Modifications Pick Up Pace Despite Speed Bumps*, ASSET SECURITIZATION REPORT, Jun. 18, 2007.

modification may be less costly than foreclosure (although this is far from certain), the difference could well be negligible. Third, the authorities calling for massive modification efforts must realize that, "Payment deferral will not help people who inflated incomes or recklessly bought properties they could not afford." Since, by some estimates, borrowers inflated their stated income by 50 percent or more in 70 percent of loans, it could be that few of the loans currently experiencing difficulties can benefit from modifications that would preserve any reasonably economic lending arrangement for borrower and lender alike.[4]

If modifications are given to borrowers that are not well suited for homeownership in the long term the loan modification only serves to delay the inevitable while keeping the borrower in a (somewhat milder) state of financial distress. In such cases, the borrower may be better off moving to more affordable housing today rather than continuing to pressure their finances chasing the unobtainable chimera of "homeownership." Furthermore, modifications granted to unsuitable borrowers may be considered predatory. On top of all this, thin preliminary data (provided by those with successful modification programs) suggest that modified loans experience a 35-40 percent redefault rate over the following two years. Hence, predatory or not, relatively few loan modifications "work," that is, help the borrower ultimately afford the home.

It appears, therefore, that the main purpose of loan modification is to skew financial reporting of delinquencies. In other words, modifying loans helps borrowers to make a few payments, allowing lenders to aggressively reage the accounts and classify them as "current," instead of "delinquent." Such practices appear to have been a key mechanism in supporting paper earnings of many failed subprime lenders prior to bankruptcy. Hence, without regulatory oversight or increased transparency, it is hard to imagine that borrowers will benefit from modification in the long run.

The report that follows looks at the promises and pitfalls of loan modification. Section II illustrates the costs and benefits of modification. As stated above, while delinquencies and foreclosures are long and costly to the servicer, industry inexperience with modification, the potential lack of suitable loans for modification efforts, and the sheer cost of the efforts may limit the usefulness of the approach to a level far below that which can cushion the harmful economic effects precipitated by the current crisis. Section III shows that predatory servicing has been a problem in the recent past and modification, too, can be predatory if it does not truly help borrowers afford homes in any meaningful sense. Redefault rates from modifications are high, and modification has been misused in the past, in conjunction with reaging, to skew financial performance. With no regulatory authority to oversee modification and reaging policies and little transparency with respect to those arrangements, it is quite possible that extensive modification will hurt consumers and investors alike. Again.

4. Bank of America, *Subprime Loan Modifications – not a Panacea*, SUBPRIME MORTGAGE FINANCE WEEKLY, May 25, 2007 at 4.

II. THE COSTS AND BENEFITS OF MODIFICATION ARE NOT CLEAR

Loan modification is used to avoid defaults, which are costly to servicers. Mortgage loan servicers are typically remunerated on the basis of a servicing fee of between 12.5 and 50 basis points of the outstanding principal balance. The flat servicing fee can be augmented with equity incentives, residual first-loss investment stakes that give the servicer an incentive to maximize cash flow from the loans. The total value of the direct fees and equity incentives are included on servicers' balance sheets as mortgage servicing rights (MSRs). MSRs are the net present value of the series of uncertain direct service fee payments. MSRs are difficult to value with any degree of certainty and the valuations that result can be very volatile to actual conditions realized in the servicing pool.[5]

Default costs create not only large direct costs – in terms of increased telephone call, mailing, legal, and administrative costs – but also substantial cash flow difficulties. Cash flow difficulties arise because the legal and other costs related to foreclosing upon and selling repossessed real estate, while ultimately reimbursable from the trust, are only reimbursed when the collateral is sold. "Advancing" funds in such circumstances can substantially disrupt the cash flows of the servicing entity. If the servicer does not have cash on hand to cover the cash flows those advances must be funded in the interim through borrowings, and while the direct costs of the disposition are reimbursed, the funding costs are not. Advances can remain outstanding for a long time because the foreclosure process itself is lengthy, *averaging* almost a year-and-a-half from missed payment to sale of the property in a healthy market.[6]

Servicers, therefore, engage a variety of different strategies to avoid the costs of default, but modification incurs other, new, costs. Modification strategies in the most general sense include a wide range of proactive loss mitigation tools like payment plans[7] and loan modifications.[8] Loan modifications may include a permanent reduction in rates, extending the term of the loan to reduce monthly payments, deferring prior missed payments and adding them to the principal balance, and reset shock modification where the terms of the loan are adjusted to mitigate the payment shock.[9]

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5. The vast majority of bank failures since 1992 have involved substantial issues of MSR and residual valuations. Nonetheless, many of the top mortgage servicers derive a great deal of their value from equity incentives and MSRs. WaMu's MSRs amount to 23 percent of their capital, IndyMac's amount to 90 percent of their capital, and Countrywide's amount to 115 percent of their capital. Having MSRs worth more than the value of capital creates a high risk that valuation difficulties can wipe out a substantial portion of a firm's underlying capital with the stroke of a pen.

6. Moody's, *2004 Review and 2005 Outlook: US Servicer Ratings*, Jan. 12, 2005.

7. In the case of temporary financial hardship, servicers often put borrowers on repayment or forbearance plans to make up missed payments over a short period of time. These plans do not change the contractual obligations of the original loan terms.

8. Loan modifications are designed to assist borrowers in financial distress who are unable to meet their mortgage obligation under the existing contractual terms of the loan by providing more favorable terms which will enable the borrower to make monthly payments to stay current or cure the loan.

9. Merrill Lynch, *Mortgage Credit Losses: How Much, Where, and When?*, Jul. 20, 2007. *See also* Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007.

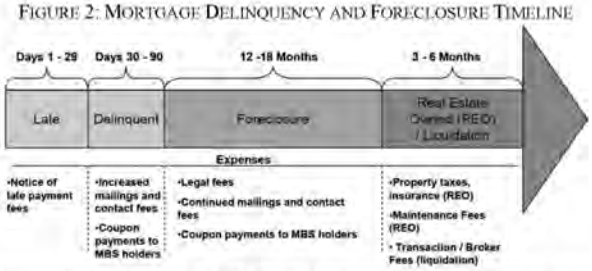
Each of those choices effectively reduces the borrower's loan payment, but not necessarily the total price paid by the borrower over the life of the loan. From the servicer's perspective, therefore, each alters cash flow expectations arising from the loan, therefore altering MSR and residual valuations.

The present section examines the magnitude of the cash flow disruptions that occur from default management and relate those to the potential for loan modification programs.

A. Servicers are Using Modification in Attempts to Avoid Costly Defaults, Foreclosures, and Advances

Figure 2 illustrates the default, foreclosure, and disposition process whose costs servicers attempt to avoid through modification. Note first that the process is lengthy, as mentioned above, taking an average year-and-a-half to complete in a healthy economic and real estate market environment. Note further that the servicer must not only advance legal fees, property taxes, maintenance fees (12 percent of principal balance), and transaction and broker fees during the process, but also maintain coupon payments to mortgage-backed securities investors until the process is complete, the losses can be properly accounted for.

FIGURE 2: MORTGAGE DELINQUENCY AND FORECLOSURE TIMELINE



Source: Bank of America, *The Hidden Credit Costs of Mortgage Servicers*, Specialty and Mortgage Finance Weekly Mar. 23, 2007.

Adding just the cost of temporarily *funding* those reimbursable default costs into Bank of America's servicing costs estimate raises the annual cost of servicing delinquent loans to over 2,000 percent the cost of servicing current loans and the cost of servicing foreclosed loans to 4,000 percent the level for current loans, or 20 to 40 times normal servicing costs. Bank of America gives the example of a $144,000 mortgage with a fixed interest rate of 7.5 percent. The servicer earns a fixed servicing fee of 35 basis points. The results of the exercise are illustrated in Figure 3.

FIGURE 3: TOTAL ANNUALIZED SERVICING COST PER MORTGAGE LOAN

	Delinquent	Foreclosure	Performing Loan
Servicing Costs	$51	$51	$51
Non-reimbursable	$316	$316	
Funding Costs for reimbursable expenses	$659	$1,086	
Reduction to MSR Fair Value		$662	
Total Annualized Cost Per Loan	$1,026	$2,115	$51

Source: Bank of America, *The Hidden Credit Costs of Mortgage Servicers*, Specialty and Mortgage Finance Weekly Mar. 23, 2007 at 7-8.

When the loan goes into default, the servicer has to advance coupon payments of $10,798 per annum to investors and does not earn the annual servicing fee of $504. Both will be reimbursed when (if) the loans becomes current, but in the meantime the servicer incurs $659 annual funding costs at LIBOR plus 50 basis points. In foreclosure, the servicer also pays taxes and legal fees of $5,759 annually and a 12 percent standard annual maintenance fee (to keep the house in marketable condition) of $17,277. Funding those fees in addition to the coupon and servicing fee amounts to $1,086 per annum at a rate of LIBOR plus 50 basis points.

Matters are further exacerbated by the effect of defaulted and foreclosed loans on MSR values, a significant source of servicer enterprise value. In each case, a loan did not remain in the performing pool, so the servicing fee revenue ended. If the servicing fee cash flow ends before originally expected, the MSR must be written down to reflect the decreased value of the servicing contract. Assuming that the average life of the loan in the previous example is six years, if the loan goes immediately into delinquency followed by default two years later, that represents roughly 4 years of foregone servicing fees. Bank of America calculates the average annual cost for a simulated sample of foreclosed loans as a function of the MSR portfolio to be 0.46 percent (based on an assumed fair value as percentage of MSR portfolio of 1.38 percent). That equates to a cost of $662 per loan in foreclosure based on the example loan's unpaid balance of $144,000. The results are also presented in Figure 3.

In summary, servicers' contractual funding needs can cause the cash costs for defaulted loans to swell significantly for about a year-and-a-half, until the servicer can complete the foreclosure and recovery process and obtain reimbursement. Since those costs can be expected to be higher and the process longer in poor economic and real estate market conditions, servicers should expect to endure substantial earnings pressure as they are squeezed between market conditions and funding needs.

B. ...but Modification, itself, is Expensive and the Benefits, for both Servicers and Borrowers, are Highly Uncertain

While most servicers claim that a well-managed loan modification program can save money over servicing through what has been illustrated above as an extremely costly delinquency and foreclosure process, loan modification is a relatively new function and, like the subprime mortgages that necessitate it, is untested in an economic downturn.

At Fitch's RMBS Servicer Workshop, held in May 2007, almost all servicers said that they "had not used modifications extensively as a loss mitigation tool in the past." And while "most indicated that they are preparing for significant increases in modification volume," the volume of modification necessary to address current market difficulties is unprecedented. Later Fitch Ratings reports that subprime servicers plan to resolve as many as 50-75 percent of defaults using various modification tools.[10]

Furthermore, not all borrowers will qualify for loan modifications. While the decision to modify a loan is not subject to oversight as is the decision to make the initial loan, modifications only make sense for a certain set of re-underwriting criteria. Moody's explains that servicers will have to, "...review the borrower's current financial situation and re-qualify the loan. It is not advantageous to modify a loan without knowing if the borrower can afford the modified obligations." Moody's also states that, "This will be particularly important for the large number of loans originated in recent years that were made to borrowers who merely stated their income and asset information instead of providing documented proof (so called "limited documentation" loans)."[11]

Even with income and qualifications, loan modifications will not be applicable to all problematic borrowers. Loans originated with little documentation of income, where borrowers still cannot document sufficient income to qualify under today's tighter credit standards are poor candidates for modification. Borrowers with no equity in their home are also poor candidates for modification, as decreasing home values may lead them to default notwithstanding the level of their loan payment. Interest only and other extremely low payment loan borrowers probably cannot support an amortizing obligation regardless of interest rate, and are, again, poor candidates for modification, as are borrowers who have 40- and 50-year mortgages that are already stretching out payments for a longer period of time.[12]

As Mark Adelson, formerly of Nomura, stated, "...modifying loans for distressed borrowers is a labor-intensive process because the servicer must carefully evaluate each borrower's capacity to pay. The full cost of processing a loan modification can be in the range of $500 to $600. It is often necessary to visit the subject property and to interact with the borrower face-to-face."[13] Because of the high cost involved, Litton Loan Servicing Vice President Shane Ross equates modification to "doubling-down" your bet: a highly risky proposition that you should not undertake without a full understanding of the risks. Ross points out that dramatic increases in loan modification work necessitate increasing, "your loss mitigation staff, your collections staff, your customer service staff,...your foreclosure staff," all at a time when servicing

10. Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007; Bank of America, *Subprime Loan Modifications – not a Panacea*, SUBPRIME MORTGAGE FINANCE WEEKLY, May 25, 2007; Fitch Ratings, *Changing Loss Mitigation Strategies for U.S. RMBS*, Jun. 4, 2007.

11. Moody's, *US Subprime Mortgage Market Update*, Apr. 2007.

12. Moody's, *Challenging Times for the US Subprime Mortgage Market*, Mar. 7, 2007.

13. Nomura, *Securitization & Real Estate Update*, May 18, 2007.

costs are skyrocketing and cash advance and funding needs are spiking. A highly risky business proposition.[14]

Legislative or regulatory intervention can easily upset the balance of discretion in loan modifications, imposing high costs on that already risky proposition. According to Chris Flanagan, managing director and head of global research at JPMorgan Securities, the whole premise of loan modifications is to allow the servicer to exercise independent discretion and evaluate borrowers individually to determine appropriate options available to them. If legislators or regulators require modifications to some group of borrowers regardless of their fundamental ability to make the loan payments successfully well into the future, that balance will be upset.[15]

At the end of the day, however, even a successful loan modification is harmful to lenders. Loan modifications reduce yields and the yield reduction will negatively impact residual valuations due to lower cash flow accrued to the trust. Since the servicer often owns an equity stake in the trust, the servicer is bound to lose.[16]

III. SINCE MODIFICATION IN AN UNREGULATED ENVIRONMENT CAUSED THE PRESENT DIFFICULTIES, IT DOES NOT MAKE SENSE TO ENCOURAGE MORE

The servicing industry has experienced problems in the past that should make those pressing for greater use of loan modifications generally wary. First, not too long ago, the industry was battling allegations of predatory servicing, or foreclosing on one class of borrowers more aggressively than others. If some classes of borrowers are more likely to receive loan modifications than others with equal credit characteristics, loan modifications may contain a predatory component as well.

Second, a sizeable proportion of modification agreements fail, in the sense that the borrower redefaults within 24 months. In such cases, the servicer spends the greater costs of default and foreclosure on top of the costs of earlier modification. Furthermore, the servicer may recover far less from the collateral due the extended period of borrower difficulties. On net, therefore, even existing modification efforts may not ;provide servicer cost savings. Extending a losing business proposition will require massive government subsidies now and in the future.

Third, in the late 1990s many segments of the consumer credit industry were found to be reaging loans aggressively to mask delinquencies. It seems that many failed non-bank subprime mortgage lenders have similarly used modification in conjunction with aggressive reaging to support portfolio performance more recently.

Last, it is important for proponents of widespread modification to understand that the practice lies outside fair lending laws, and there are no regulatory monitoring or enforcement authorities prepared to guard against predatory

14. Amilda Dymi, *Need for Loan Mods Will Persist*, NATIONAL MORTGAGE NEWS, May 28, 2007.

15. Karen Sibayan, *Panelists Reject Mandatory Loan Modifications*, ASSET SECURITIZATION REPORT, May 21, 2007.

16. Bank of America, *Subprime Loan Modifications – not a Panacea*, SUBPRIME MORTGAGE FINANCE WEEKLY, May 25, 2007.

modification, ensure prudent redefault rates, and impose reporting rules promoting transparency on reaging policy. Given that none of these risks are new, advocates would be wise to propose a more prudent measured expansion, and only after thorough and thoughtful consideration of the promises and the risks of widespread loan modification.

A. Predatory Servicing can be Extended to Modification

Predatory servicing was a common concern among regulatory officials and servicers in 2003 and 2004. In November 2003, Select Portfolio Servicing, Inc. (formerly Fairbanks Capital Corp.) signed a consent order with the Federal Trade Commission and the Department of Housing and Urban Development due to predatory servicing concerns. In April 2004, Ocwen Federal Bank FSB reached a supervisory agreement with the Office of Thrift Supervision (OTS) based on similar concerns. Soon after that, Ocwen Financial Corporation, Ocwen Federal Bank FSB's parent company, filed an Application for Voluntary Dissolution with the OTS in November 2004 to explore the possibility of the bank terminating its status as a federal savings bank under OTS and Federal Deposit Insurance Corporation supervision.[17]

Following those regulatory actions, many servicers re-evaluated their operations to identify potential exposure to predatory servicing concerns. Servicers implemented 100 percent call recording, itemized monthly statements, and issued paper notification to borrowers when fees are charged. Servicers added transparency to force-placed insurance programs (hazard insurance coverage that is assigned to mortgaged property when the borrower fails to maintain his or her own coverage) and reduced or eliminated ancillary fees.

One big concern of consumer advocates with respect to predatory servicing was quick foreclosure, particularly for lenders that refer loans to foreclosure in a 60 to 75 day timeframe following delinquency. In response to concerns that early foreclosures were not warranted, servicers added pre-foreclosure activities to ensure that collection and loss mitigation attempts on a loan were thorough and that proper notices were provided to the borrower. Loans were also reviewed pre-foreclosure for potential legal issues and headline risk that could be associated with a foreclosure action. Foreclosure referrals are now more common beginning after the 90th day of delinquency. But the new pre-foreclosure activities also paved the way for servicers to make more detailed loan-level decisions, including using more loan modifications.[18]

The fact that the opportunities for more loan modification originated from attempts to more thoroughly investigate loans prior to foreclosure to avoid predatory servicing concerns should not be a source of comfort. Rather, that means the processes surrounding modification are still new enough that they can be mis-applied to consumers' detriment.

The decision to modify a loan is identical to a decision to refinance a loan, but the modification decision is not currently treated as a new loan decision. That means that the modification proposal and acceptance by the consumer are not required to generate any of the records, disclosures, and restrictions placed upon

17. Moody's, *2004 Review and 2005 Outlook: US Servicer Ratings*, Jan. 12, 2005.
18. Moody's, *2004 Review and 2005 Outlook: US Servicer Ratings*, Jan. 12, 2005.

the new loan process. Therefore modifications can impose exorbitant fees or back-end payments or other conditions upon consumers without adequate record-keeping to pursue even a legal remedy.

The reason for concern lies in the fact that major industry groups and regulatory officials, having characterized the conditions for a successful modification as raising the net present value of the loan, have effectively advocated maximizing income to the lender as the primary goal of modification. Fitch Ratings reports that servicers express, "the belief that that ultimate loss to the transaction should be the only consideration in determining the execution of the best loss mitigation strategy."[19]

Even Moody's recognizes, however, that if borrowers cannot meaningfully qualify for a modified loan under transparent and duly reported and defensible underwriting guidelines, the modification may, "simply serve to postpone an eventual foreclosure and increase, rather than decrease, the ultimate loss on the loan."[20] Work by JP Morgan prior to the present market difficulties illustrates that the kinds of flags that can indicate predatory modification are, "...liberal repayment terms with extended amortizations, moving accounts from one workout program to another, multiple re-aging and poor monitoring of performance. *Principal reduction should be the main goal of workout programs, not maximizing income recognition* [emphasis added]." Servicing that does not promote principal reduction can therefore be considered predatory.[21]

B. Significant Borrower Redefaults Hurt both Lenders and Homeowners

Modification does not always work. Fitch Ratings reports that a good modification program has only a 60-65 percent success rate. That means that some 35-40 percent of borrowers redefault on their loans within 12-24 months. Furthermore, as of June 2007, many servicers reported to Fitch Ratings that repayment and forbearance plan effectiveness is decreasing and that modification is not, "...expected to work for borrowers facing ARM resets, as many of the borrowers are expected to default upon reset because they will not be able to afford the new monthly payments."[22]

Figure 4 shows that the type of success illustrated by respondents to Fitch Ratings may be optimistic or unrepresentative. Moody's reports that strong servicers can achieve success rates of 52 percent or more following modification, but that average servicers only achieved a 31-40 percent success rate. Participants at a May 2007 American Securitization Forum panel on servicing opined that, "It seems reasonable to expect that a company of merely average abilities and operating during stressful times would experience a somewhat higher rate of re-defaults. Also, ... a typical servicer does not have the incentive of first-loss credit exposure on the loans (i.e., no "skin in the game") and gets paid the same fee regardless of the effort and expense of servicing a loan. The $64,000 question is

19. Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007.

20. Moody's, *US Subprime Mortgage Market Update*, Apr. 2007.

21. JP Morgan, *ABS Monitor 2003 Year Ahead Outlook*, Dec. 23, 2003.

22. Fitch Ratings, *Changing Loss Mitigation Strategies for U.S. RMBS*, Jun. 4, 2007.

whether the higher re-default rate would be just a little higher than 35 percent (e.g. 40 percent) or much, much higher (e.g., 65 percent). Only time will tell."[23]

FIGURE 4: 12-MONTH LOAN RESOLUTION PERFORMANCE INDICATORS FOR SUBPRIME LOANS

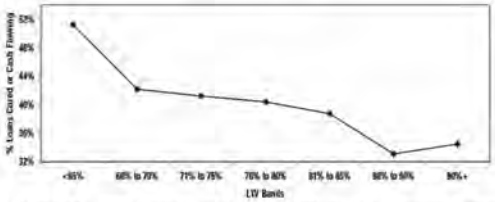
	Total Cure and Cash Flowing	Losses with Loss Mitigation
Strong	> 52%	> 23%
Above Average	41% - 51%	19% - 22%
Average	31% - 40%	9% - 18%

Note 1: The proportion of loans was censored between two and five years.
Note 2: "Total Cure and Cash Flowing" includes the percentage of loans that began a 12-month static pool analysis as 90+ days delinquent, in foreclosure, or in bankruptcy which eventually performed, current, performing on a repayment plan, modified, 30 days delinquent, 60 days delinquent, or current on a bankruptcy plan at the end of the static pool period.
Note 3: "Losses With Loss Mitigation" includes the percentage of loans that were resolved from a short sale, short payoff, deed-in-lieu, or third party sale as a percentage of total losses.

Source: Moody's, *2004 Review and 2005 Outlook: US Servicer Ratings*, Jan. 12, 2005.

Figure 5 shows that success varies significantly with the type of loan modified. Figure 5 shows that the highest success rates lie with loans below 66 percent LTV, hardly the borrowers most in need. Hence, the modification decision, like the original loan underwriting decision, is a complex multidimensional decision that needs to be made according to a set of transparent consistently-applied underwriting criteria.

FIGURE 5: AVERAGE 12-MONTH TOTAL CURE AND CASH FLOW RATES, BY LTV BAND



Source: Moody's, *2005 Review and 2006 Outlook: US Servicer Ratings*, Jan. 24, 2006.

One significant risk with respect to redefaults is that the eventual recovery rates of redefaulted modified loans will be far less than loans foreclosed immediately, without modification attempts. Figure 6 reflects the accepted wisdom that it is wisest to seize the collateral as soon as possible so that the collateral does not deteriorate unduly in the hands of a borrower who foresees the inevitable foreclosure. Hence, typical industry research like that by Moody's presented in Figure 6 shows that loss severity rises with time in distress.

23. Nomura, *Securitization & Real Estate Update*, May 18, 2007.

FIGURE 6: LOSS SEVERITY INCREASES WITH TIME: EXAMPLE WITH AN 80% LTV LOAN

Source: Moody's, Special Servicing and Default Management in the Subprime Mortgage Market: The Loan Doctors, April 1999.

Modification willingly gives up that extra time. If the redefault rate is 50 percent, but ultimate losses are twice as large, the financial effects of modification to the servicer are moot. Hence, the logic of modification flies in the face of traditional banking thought. It is not surprising that some servicers participating in Fitch's RMBS Servicer Workshop remain unconvinced by contemporary claims about modification, expressing concerns that, "redefaults for modified loans, …could result in higher ultimate losses to the trust."[24]

C. *Modification and Reaging Work together to Skew Reported Delinquencies*

Reaging policy has to do with when it is prudent to consider a once-delinquent borrower current again. Reage is defined to mean "returning a delinquent, open-end account to current status without collecting the total amount of principal, interest, and fees that are contractually due."[25] In prime loan portfolios with few delinquencies reaging policy has little effect on reported financial performance. But in subprime loan portfolios with large delinquencies reaging is a powerful tool to skew reported financial performance.

Before the advent of subprime lending, servicers typically had wide discretion to set and disclose aggressive or conservative reaging policies. Reaging is problematic because a lender that requires three consecutive on-time payments in order to reclassify borrowers as current will carry a lot more delinquencies on its books than a lender that requires only one on-time payment in order to reclassify borrowers as current. Modification policies can help pull delinquencies down even further by assisting the borrower in making that one on-time payment necessary to reclassify the loan under the aggressive reaging policy. Hence, it is not surprising that reaging policy remains of great concern to investors throughout the mortgage industry, including mortgage lenders, servicers, and MBS.

24. Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007.
25. *Notices*, 65 FEDERAL REGISTER 113, Jun. 12, 2000 at 36905-6.

Reaging policy was once an arcane backwater concern of a small segment of the industry that dealt with applying special servicing policies to defaulted loans. But that sector of the industry began to grow fast with the evolution of subprime home equity lending in the late 1990s and subprime first-lien lending more recently. According to Nomura, in 1998, there was already about $1 billion of RMBS issuance backed by "scratch and dent" mortgage loans (including re-performing, non-performing, sub-performing, out of guideline, and document deficient loans). By 2002, the sector had grown to about $9 billion of issuance, or about 5 percent of the subprime universe. Spreads on triple-A tranches can be from 10 bp to 50 bp wider than spreads on regular sub-prime RMBS, reflecting the greater risk involved.[26]

Early on in the development of subprime lending, it was commonly known that one way to spruce up scratch and dent pools was through aggressive reaging, which can skew financial ratios and mask true pool performance. After much regulatory wrangling with the problem, in 2000, regulators established reaging standards for federally-supervised financial institutions.[27]

Those regulations, however, did not affect non-bank mortgage lenders, non-bank servicers, or securitization trusts, which all lay outside federal regulatory authority and, we have recently learned, have underwritten the majority of recent subprime mortgages. They also did not alleviate the problem of interpreting delinquency levels among *federally-regulated* institutions, leading to a December 2005 rulemaking announcement that stipulated, "Policy exceptions made by servicing and collections personnel should be carefully monitored to confirm that practices such as re-aging, payment deferrals, and loan modifications are not inadvertently increasing risk."[28]

Re-Aging, Extensions, Deferrals, Renewals, and Rewrites [3]

Re-aging of open-end accounts, and extensions, deferrals, renewals, and rewrites of closed-end loans can be used to help borrowers overcome temporary financial difficulties, such as loss of job, medical emergency, or change in family circumstances like loss of a family member. A permissive policy on re-agings, extensions, deferrals, renewals, or rewrites can cloud the true performance and delinquency status of the portfolio. However, prudent use is acceptable when it is based on a renewed willingness and ability to repay the loan, and when it is structured and controlled in accordance with sound internal policies.

Management should ensure that comprehensive and effective risk management and internal controls are established and maintained so that re-ages, extensions, deferrals, renewals, and rewrites can be adequately controlled and monitored by management and verified by examiners. The decision to re-age, extend, defer, renew, or rewrite a loan, like any other modification of contractual terms, should be supported in the institution's management information systems. Adequate management information systems usually identify and document any loan that is re-aged, extended, deferred, renewed, or rewritten, including the number of times such action has been taken. Documentation normally shows that the institution's personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower has the ability to repay the loan. To be effective, management information systems should also monitor and track the volume and performance of loans that have been re-aged, extended, deferred, renewed, or rewritten and/or placed in a workout program.

Closed-End Loans

Institutions should adopt and adhere to explicit standards that control the use of extensions, deferrals, renewals, and rewrites of closed-end loans. The standards should exhibit the following:

- The borrower should show a renewed willingness and ability to repay the loan.
- The standards should limit the number and frequency of extensions, deferrals, renewals, and rewrites.
- Additional advances to finance unpaid interest and fees should be prohibited.

Management should ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained

26. Nomura Fixed Income *Research, Report from Arizona: Coverage of Selected Sessions of the February 2003 Securitization Conferences*, Feb, 18, 2003.

27. *Notices*, 65 FEDERAL REGISTER 113, Jun. 12, 2000 at 36905-6.

28. *Notices*, 70 FEDERAL REGISTER 249, Dec. 29, 2005 at 77257.

The problem is still a widespread industry concern, among both federally-regulated and non-federally regulated institutions. In 2003, well after the Federal regulatory rules, Nomura wrote that a key, "…problem for the sub-prime mortgage sector in general is that some servicers and special servicers characterize loans as 30-days delinquent when in fact they should be classified in more severe delinquency categories. The problem stems from lenders "re-aging" loans in forbearance and loans subject to payment plans or bankruptcy plans."[29]

Little has changed since 2003. In May 2007, Bank of America recently wrote, "…even in the case of successful workouts… true credit exposure will be masked because worked out loans are considered performing and will no longer be disclosed once they are disseminated into the performing loan pools. The credit ratios going forward should be distorted and are no longer reflecting the real credit exposure. For these reasons, going forward, we believe investors should focus on static pool yield changes, instead of credit ratios, as a credit performance indicator of the existing loan portfolios and static securitization pools."[30]

Nomura expressed similar concerns as early as 1997, in particular noting the incentive problems for servicers who may hold residual equity incentives. Nomura points out that, "…modifications favor the interests of subordinate and residual classes by delaying the recognition of losses and the writedown of those classes." Nomura notes further that, "…the treatment of modified loans under performance covenants (trigger tests) that allow the release of principal to subordinate and residual classes. If modified loans are treated as 'current,' a substantial amount of cash flow may be released to subordinate and residual classes while the risk to the senior classes rises. We think that the better approach is to treat modified loans as delinquent for purposes of trigger tests. We also think that this is the area that is most likely to spawn litigation, both between investors and servicers and among competing classes of investors."[31]

In summary, "The shortcomings of ABS/MBS disclosure have long been recognized. For example, in January 1996, Moody's emphasized the issue of ABS disclosure as a key challenge for the market."[32] In the eleven years since Moody's published that opinion, few of those concerns have been addressed. Modification has already been used in conjunction with reaging to mask financial condition and it is already an active concern for market participants, notwithstanding the small amount of modifications being used in today's marketplace. Hence, expanding modification efforts to ten or twenty times their existing level runs the risk of confusing MBS and mortgage lender investors even more, which will cause them to pull back from the marketplace even more dramatically than has already occurred.

29. Nomura Fixed Income *Research, Report from Arizona: Coverage of Selected Sessions of the February 2003 Securitization Conferences*, Feb. 18, 2003.

30. Bank of America, *Subprime Loan Modifications – not a Panacea*, SUBPRIME MORTGAGE FINANCE WEEKLY, May 25, 2007. See also Moody's, *Alternative Financial Ratios for the Effects of Securitization: Tools for Analysis*, Sep. 19, 1997..

31. Nomura, *Securitization & Real Estate Update*, May 18, 1997.

32. Moody's, *Challenges to the Asset-Backed Market in 1996…A Call for More Transparency*, Jan. 19, 1996.

D. There is No Monitoring or Enforcement to Guard against Adverse use of Modification

Like securitization, modification has evolved in a regulatory vacuum. Like securitization, the problem is not the lack of existing strictures that can be brought to bear on the practices, but that new business practices have evolved out of sight of regulatory and legislative authorities. Hence, little thought has been given to what can go wrong and how that can be most effectively dealt with (for example, transparency, functional regulation, or some other means). The servicing industry and, therefore modification practices, are touched by at least three existing monitoring authorities: the ratings agencies; the Securities and Exchange Commission's Regulation AB; and the Sarbanes-Oxley Act of 2002. None of those systematically monitors modification efforts on behalf of consumers, creating potentially big problems if modification efforts are rapidly expanded to ten to twenty times current industry levels.

Credit ratings agencies currently rate servicing quality for major mortgage servicers. Historically, credit rating agencies typically monitored operational cash flow considerations of servicers to better ensure remittances to investors over other factors. More recently, servicers have expanded their considerations to, "how effective a servicer is at preventing defaults and maximizing recoveries to a transaction when defaults occur."[33] Such monitoring, however, is still akin to judging modifications on the basis of maximizing cash flow to the servicer, rather than ability to reduce principal on behalf of the borrower, as explained above, and therefore is a poor means of addressing whether modification programs are built upon safe and sound business practices and satisfy potential predatory concerns.

In 2004, the Securities and Exchange Commission introduced Regulation AB, which includes enhanced reporting requirements for ABS issuers and servicers. In particular, Reg AB sets forth a new set of "best practices" servicing criteria, improving on the Uniform Single Attestation Program for Mortgage Bankers (USAP).[34] Like early ratings agency surveillance, however, that portion of Regulation AB focused primarily on investor remittance and reporting, rather than safe and sound business practices and potential predatory concerns.[35]

Regulation AB also imposed rules that, in the eyes of many investors, "represent historic steps in the evolution of financial regulation in the U.S. Under the new rules, investors will receive static pool data similar to what the rating agencies have received for years." The problem is that the new rules only went into effect in 2006, and markets will not see even the beginnings of their full impact until several years later, when static pool data will count as part of registration statements for liability purposes. In the mean time, the SEC still needs to improve its electronic filing system to replace "incorporation by reference to issuer web sites" as the vehicle for disclosure of static pool performance data. Even with improved SEC reporting, collateral-level data required under Regulation AB may still be available only at exorbitant expense from Loan Performance Corporation, which refuses to sell access to the "public"

33. Moody's, *Housing Research*, Sep. 1, 2007.
34. *See* http://www.campusmba.org/pdf/usap.pdf.
35. Moody's, *2005 Review and 2006 Outlook: US Servicer Ratings*, Jan. 24, 2006.

data to academic researchers or even bank regulatory authorities. Hence, although Regulation AB showed great promise, it has not been extended to modification issues and does not adequately provide for public reporting.[36]

The Sarbanes-Oxley Act of 2002, "...requires the management of publicly-owned companies to assess the effectiveness of internal controls over financial reporting. Because of the increased focus on maintaining strong internal controls, Moody's believes that Sarbanes-Oxley should have a meaningful impact on servicing stability. This will be true both for publicly-owned servicers as well private servicers that voluntarily take similar steps." Originators and servicers are very concerned about material disclosure provisions being applied to reaging and modification programs that may not have been properly disclosed in recent years.[37] Nonetheless, Sarbanes-Oxley has yet to be applied to reporting modification and reaging, which have certainly been material concerns.

FIGURE 7: FITCH'S SAMPLE OF NECESSARY STATISTICS TO BE REQUESTED FROM SERVICERS USING MODIFICATION AS A LOSS MITIGATION TOOL

Performing Modifications

Months Since Mod	Loan Count	Principal Balance at Mod	Projected Loss without Mod	Cost to Trust of Mod	Cash Collected at/after Mod	Net Value to Trust after Mod
< 3						
3–6						
6–12						
> 12						
Totals						

Redefaulted Modifications

Months Since Mod	Loan Count	Principal Balance at Mod	Projected Loss without Mod	Cost to Trust of Mod	Cash Collected at/after Mod	Value of Lost Time to Liquidate	Net Value to Trust after Mod
< 3							
3–6							
6–12							
> 12							
Totals							

Note: Statistics should indicate all mods since program began for RMBS. Tables should be developed by product and transaction

Source: Fitch Ratings, *Changing Loss Mitigation Strategies for U.S. RMBS*, Jun 4, 2007

In summary, since relatively few loan modifications took place prior to 2007, "...typical transaction documentation does not include standard or robust reporting language regarding loan modifications." Therefore, reporting varies significantly from transaction to transaction, even for the same issuer or servicer. Sometimes a loan being modified will continue to be reported as delinquent, based on its pre-modification terms. Other times, a delinquent loan that is modified will be reported immediately as "current." In addition, reporting mechanisms for modifications may or may not track the cumulative level of modifications. Industry participants like Moody's Investors Service advocate "...enhanced transparency in both loan-level reporting of modifications as well

36. Nomura, *ABS/MBS Disclosure Update #6: 24 Steps to Tighter ABS Regulation AB*, Dec. 27, 2006)

37. Moody's, *2004 Review and 2005 Outlook: US Servicer Ratings*, Jan. 12, 2005.

as the cumulative impact of modifications on securitizations."[38] Fitch suggests a reporting format like that in Figure 7. Unfortunately, contemporary advocates from both the industry and politics, alike, are ignoring the practical realities of modification and pushing for the expansion of highly risky practices in an environment of little consumer protection and opaque financial reporting, precisely the conditions that are causing the current market crisis.

IV. CONCLUSIONS AND POLICY RECOMMENDATIONS

Servicing is costly, and increasing loan modifications increases the costs of servicing. While the practice of modifying loans shows promise, the practice is highly risky, both to the consumer and the lender, and substantially unproven. Moreover, there are currently no industry standards for modification and financial reporting, and no consumer safeguards to monitor or prohibit predatory practices.

Modification will not be suited to helping avoid the massive defaults expected as a result of ARM interest rate resets, which account for the majority of the industries problems into 2008. Legislative pushes to mis-apply the practice to those ends will substantially worsen industry performance.

One of the key reasons loan modification has grown has been to skew financial reporting of delinquencies, modifying loans to help borrowers make a few payments and then aggressively reaging the accounts to classify them as "current," instead of "delinquent." Such practices appear to have been a key mechanism in supporting the paper earnings of many failed subprime lenders prior to bankruptcy.

Regulators can already require modified loans to be reported as material considerations under Sarbanes-Oxley with standardized reporting practices promulgated by the Financial Accounting Standards Board and Regulation AB. Without applying even existing regulations toward regulatory oversight or transparency in loan modification practices, however, it is hard to imagine long-term positive benefits for borrowers.

It does not make sense, therefore, to push a broad unmonitored application of loan modification onto the industry or the public without serious consideration. Doing so runs a substantial risk of consumers being used to prop up the mortgage industry in the short term by keeping financially-strapped consumers in homes they cannot hope to afford.

It does make sense, however, to apply limited modification programs to appropriately-selected consumers while helping to smooth the transition to smaller homes or rentals for others. Regulators need to be aware that appropriately selecting borrowers for modification is an underwriting decision, which needs to be monitored for safe and sound underwriting practices. Regulators can monitor modification programs for predatory behavior and abuse by simply classifying a modification as a new loan, which subjects the practice to all the disclosure and record-collection requirements for other new loans. Hence, regulators can use existing regulations to monitor modification outcomes so that

38. Moody's Investors Service, *Loan Modifications in U.S. RMBS: Frequently Asked Questions*, Jun. 6, 2007.

lenders who use modification for short-term gain solely at the expense of consumers can be identified and censured.

With no regulatory authority to oversee modification and reaging policies and little transparency with respect to those arrangements, however, there is a distinct possibility that extensive modification will hurt consumers and investors alike. Again.

APPENDIX: THE BUSINESS OF LOAN SERVICING

Servicing is often viewed as the key element to loan value.[39] Poor servicing can result in uncollected payments from borrowers and missed payments to investors. Poor servicing may also result in unpaid property taxes and mortgage insurance premia, placing collateral at risk. Figure A1 lists the largest mortgage services as of 2006. These servicers are the companies that will be most affected by modification policy.

FIGURE A1: TOP 15 MORTGAGE SERVICERS, 2006

Top 15 Servicers - ($ in millions)				
Rank	2006	YoY Change		2005
1 Wells Fargo Home Mortgage	$1,341,670	33.5%	**1 Countrywide Financial Corp.**	**$1,111,690**
2 Countrywide Financial Corp.	**$1,298,394**	**16.9%**	2 Wells Fargo Home Mortgage	$1,005,410
3 Washington Mutual	**$710,797**	**-4.8%**	**3 Washington Mutual**	**$746,759**
4 JPM	$674,057	11.6%	4 JPM	$604,170
5 Citi	$521,589	17.6%	5 Citi	$443,510
6 GMAC	$456,150	16.1%	6 GMAC	$392,929
7 Bank of America	$419,497	13.9%	7 Bank of America	$368,352
8 ABN Amro Mortgage	$229,889	11.6%	8 ABN Amro Mortgage	$205,953
9 Wachovia	$175,244	10.8%	9 National City Mortgage	$169,557
10 National City Mortgage	$171,006	0.8%	10 Wachovia	$158,110
11 PHH Mortgage	$160,288	1.9%	11 PHH Mortgage	$157,302
12 IndyMac Bancorp, Inc.	**$147,994**	**63.1%**	12 SunTrust Mortgage, Inc.	$105,561
13 SunTrust Mortgage, Inc.	$129,974	23.1%	13 First Horizon Home Loans	$95,284
14 First Horizon Home Loans	$101,755	6.8%	**14 IndyMac Bancorp, Inc.**	**$90,721**
15 U.S. Bank Home Mortgage	$99,789	19.7%	15 U.S. Bank Home Mortgage	$83,403
Total	**$6,638,233**	**15.7%**	**Total**	**$5,738,111**

Source: National Mortgage News

Figure A2 illustrates the main functions of mortgage servicers. For the most part, those functions can be broken down into those relating to periodically collecting and remitting mortgage principal and interest payments, as well as tax, insurance, and mortgage insurance premium escrow payments (the bottom row in Figure A2) and those relating to dealing with delinquencies and foreclosures.

FIGURE A2: TYPICAL LOAN SERVICING ACTIVITIES

Source: Fitch Ratings, *Mortgage and Housing Products Origination and Servicing Guidelines*, Jun. 3, 1997

[39] Moody's Investors Service, *Deal Sponsor and Credit Risk of U.S. ABS and MBS Securities*, December 2006.

There are three classes of mortgage servicers: master servicers, primary servicers, and special servicers. Master servicers oversee all the servicing processes and work directly for the trust that manages the loans on behalf of investors. Primary servicers manage the routine tasks on the bottom row of Figure 3 and sometimes the tasks related to delinquency and foreclosure on the top row. Special servicers specialize in delinquency and foreclosure-related tasks. Many transactions have all three types of servicers present, while others may only have one or two.[40] According to Fitch Ratings' "Ratings Definitions," some of the reasons for the various structures are age of the transaction, complexity of the loans, strength of the primary servicer, current or anticipated delinquency, and need for advancing funds on behalf of borrowers.

The sections that follow illustrate that even though servicers do not bear direct credit risk from the loans they service, credit deterioration can impose high costs and cash flow difficulties on servicers.

A. Loan Servicers are Paid Fees to Perform Routine Tasks Related to Loan Administration and Act on Investors' Behalf

Mortgage loan servicers are typically remunerated on the basis of a servicing fee of between 12.5 and 50 basis points of the outstanding principal balance, down substantially from 25-100 basis points in 1999. Direct servicing fees, however, do not always adequately compensate the servicer for costly services that are sometimes necessitated by the types of borrowers involved.

Over the years, therefore, loan servicers have attempted to charge directly for higher-cost servicing activities. One way to do this is through ancillary fees charged directly to the borrower. Such fees typically included escrow account maintenance fees, loan history fees, phone payment fees, loan document service fees, payoff statement fees, demand letter fees, and forbearance agreement fees. In recent times, however, servicers have moved away from those ancillary fees "due to concerns that this practice has been abused and the relationship between servicers and borrowers has been unfairly leveraged."[41]

The industry has now largely replaced ancillary fees with various incentive arrangements for personnel. The typical incentive arrangements, however, have distinct shortcomings. For instance, incentives based on loss severity can be affected by changes in property values, skewed initial appraisals, the LTV distribution of the loans, and other factors. Incentives to pursue more difficult long cases of delinquency can help pay for the greater costs involved, but can also be an incentive to draw out difficulties to generate revenue. Incentives based on resolution type can encourage loan reinstatements and modifications, but can affect the property disposition (the choice of short sale, foreclosure, or other variant, in different ways depending upon other terms in the loan).

The generally accepted solution to the flaws of these various incentive arrangements (on the level of the servicing entity as a whole) has been equity incentives. Generally, equity incentives take the form of residual first-loss investment stakes that are worth more in the event of solid servicing. The

40. Fitch Ratings, *Residential Mortgage Services Ratings*, Feb. 21, 2003.
41. Moody's, *Trends in Residential Mortgage Servicing Practices*, Aug. 9, 2004.

problem is that the value of equity incentives is murky, as is the total value of the mortgage servicing enterprise.

The total value of a mortgage servicing enterprise is the sum of the value of its contracts. The values of those contracts, called mortgage servicing rights (MSRs) is the present value of the series of uncertain direct service fee payments. The reason the fees are uncertain is that they rely crucially on how many mortgages remain with the servicer after prepayments and defaults. Since prepayments and defaults are not well understood,[42] MSRs are difficult to value with any degree of certainty and the valuations that result can be very volatile to actual conditions realized in the servicing pool. Residual first-loss investment stake valuations rely crucially upon the same conjectures about prepayment speeds and default rates, and are therefore similarly difficult to value.

It should not be surprising, therefore, that the vast majority of bank failures since 1992 have involved substantial issues of MSR and residual valuations. Nonetheless, many of the mortgage servicers listed in Figure A1 derive a great deal of their value from equity incentives and MSRs. WaMu's MSRs amount to 23 percent of their capital, IndyMac's amount to 90 percent of their capital, and Countrywide's amount to 115 percent of their capital. Clearly, having MSRs worth more than the value of capital creates a high risk that valuation difficulties can wipe out a firm's underlying capital with the stroke of a pen.

B. Loan Servicer's Costs Depend on how Much Work is Involved in Servicing

The two main types of operating costs associated with servicing mortgages are maintenance costs and mortgage default-related costs. Maintenance costs consist of basic elements of customer service (payment collection, mailings, systems, etc). These types of maintenance costs can be reduced on a per unit basis through scale economics and off-shoring. Mortgage-default related costs are all additional costs imposed on the servicer due to late payments and subsequent activities, including everything from additional calls and the human capital required to make those calls, to the legal and physical costs of foreclosure and sale.

Bank of America recently analyzed servicing costs per loan, starting with the Mortgage Bankers Association's (MBA) 2006 Servicing Operations Study and Forum and consulting with various servicing industry representatives. Because costs vary significantly by product with more complex and riskier products such as Option ARMs and subprime mortgages costing more to service, Bank of America used the MBA's "Mega" category, which essentially represents large, diversified mortgage servicers, as a rough guideline for mortgage servicing operating cost per loan estimates. The Bank of America study estimates that average annual operating costs per loan for performing loans range between $49 and $53 per loan. Average costs for loans in default and foreclosure may be reasonably expected to increase by over 700 percent.[43] Those costs can be

42. *See* Joseph Mason & Joshua Rosner, How Resilient are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions, Hudson Institute Working Paper, Feb. 14, 2007.

43. Bank of America, *The Hidden Credit Costs of Mortgage Servicers*, SPECIALTY AND MORTGAGE FINANCE WEEKLY, Mar. 23, 2007.

expected to rise significantly in the current market environment with far greater defaults and rising home inventories making it difficult to sell foreclosed collateral.[44]

Servicers are already beginning to restructure their operations to achieve cost savings wherever possible, including consolidating operations, rather than outsourcing. As the American Banker explains, "In an effort to cut the costs associated with foreclosure, Wells Fargo & Co., JPMorgan Chase & Co., and Bank of America Corp. have all in recent months brought in-house certain default management and loss-mitigation work.... The moves by three of the top 10 home lenders to what is called a "direct sourcing" model are a blow to the major title companies and others whose default-management outsourcing units had handled their work (and still do for many other lenders)."[45]

The reason for such drastic measures is that default costs can also create substantial cash flow difficulties. Cash flow difficulties arise because the legal and other costs related to foreclosing upon and selling repossessed real estate, while ultimately reimbursable from the trust, are only reimbursed when the collateral is sold. "Advancing" funds in such circumstances can substantially disrupt the cash flows of the servicing entity. If the servicer does not have cash on hand to cover the cash flows those advances must be funded in the interim through borrowings, and while the direct costs of the disposition are reimbursed, the funding costs are not.

While servicers generally believe that the current level of servicing fees in transactions, particularly subprime deals, is currently "adequate to cover the increasing cost to service subprime loans,... unanticipated costs that could come from mandatory actions or moratoriums on actions like foreclosure, which are being discussed by regulators or legislative factions... may cause extensions or delays in processes and make it very difficult for servicers to accurately project actual costs."[46] If servicers fail because servicing fees cannot cover costs, there may be no buyer for those servicing contracts in the event of servicer bankruptcy. Several such difficulties were experienced in the late 1990s, and led to protracted bankruptcies and high losses.

44. Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007.

45. Kate Berry, *Default Servicing Comes Back In-House*, AMERICAN BANKER, Jun. 1, 2007.

46. Fitch Ratings, *U.S. RMBS Servicer Workshop*, May 18, 2007.

Mr. COHEN. Thank you, sir. How long have you been at LSU?

Mr. MASON. LSU, now a year and a half.

Mr. COHEN. Year and a half. Well, that deduct box might have been too difficult. Chinese bandits?

Mr. MASON. No. But the reason for the bank holiday, that stems the New Orleans banking panic.

Mr. COHEN. More relevant.

Mr. MASON. Well, they needed a holiday, something they could point to to close the banking system just for a day to alleviate depositor panic. They couldn't think of anything that happened on the day, so Huey told them to look back in the history books and find something, anything, they could commemorate. So they found that this was the day that the U.S. broke economic—I am sorry—diplomatic ties with Germany prior to World War I. Boom, you had your holiday. It wasn't especially attractive from the perspective of the German immigrants, but it closed the banking sector and the bank run subsided.

Mr. COHEN. That was good work on Huey's part, wasn't it?

Mr. MASON. Yes.

Mr. COHEN. Thank you. The Chinese bandits were back in the early 1960's. The go team, the white team, the Chinese bandits, Billy Cannon, Halloween, 1959. You need to learn all that. Thank you, Professor Mason.

Our final witness is Mr. Lewis Wrobel. Mr. Wrobel has been in practice for 32 years in Poughkeepsie, NY, with a concentration of bankruptcy law. He has represented consumers and businesses in Chapters 7, 13 and 11 and has also represented creditors.

Mr. Wrobel, thank you, and you are recognized.

TESTIMONY OF LEWIS D. WROBEL, ATTORNEY AT LAW

Mr. WROBEL. Thank you. Chairman Conyers, Ranking Member Franks, thank you for allowing me to speak with you today about this issue which is now affecting so many Americans.

Although in our area of upstate New York we do not have the numbers, thankfully, of Memphis or Detroit, still there are record numbers of foreclosures in our area, and I think to look at this problem one must take an historical perspective. Prior to the 1990's the great majority of loans to purchase homes were made by local banks and credit unions. The officers of these institutions usually served for many years, were knowledgeable about the community and often about the borrower who was seeking the home mortgage. If the borrower faced financial distress, he could contact that bank officer who certainly knew the property and the community and often knew the borrower. A workout of the loan may be accomplished by deferring payments, lowering the interest rate, or entering into a forbearance agreement.

If that was not feasible, the bank might arrange a deed in lieu of foreclosure which would allow the borrower to surrender the property in full satisfaction of the debt and not suffer the damaging effect of a foreclosure on his credit record.

Beginning in the 1990's and continuing to the present, the mortgage lender and/or mortgage assignees are not the local banks or credit unions for the most part but rather large commercial institutions such as Wells Fargo, Wachovia, Bank of America, GMAC,

Citimortgage, et cetera. At these lenders, for better or ill, there is often a high turnover of personnel. At times no loan officer is present, as the mortgage loan is obtained through a broker, and there is no contact with the representative of the lender. Usually the lender does not have an office in the locality, hence communication is primarily over the phone and occasionally over the Internet.

My clients have often complained that there is no one to listen to their problem. It is common for the borrower to provide copious financial information to the lender in trying to do workout only to wait weeks or months for a response for a loan modification request. During this time, however, the lender may very well be proceeding with a foreclosure action. A responsible person who foresees a job loss or oncoming financial crisis and who has never missed a payment will receive no response on a loan modification request from a lender. It is the policy of nearly every major lender that I have been involved with not to discuss loan modification until the borrower is at least three payments in arrears.

I would like to illustrate these frustrations for the borrowers with a particular case. A retired woman in her seventies with a solid pension from her work in municipal government requested a loan modification. The home had been in her family for many years, practically her entire life. She filed and confirmed a Chapter 13 bankruptcy case but soon realized that she would need mortgage relief. To make her request for modification, Litton Loan Servicing requested the usual, pay stubs, bank statements, a financial statement. After reviewing the information an offer was made to reduce the interest rate from 7½ percent to 6½ with a missed payments being added to the principal. The principal therefore was increased by $23,000 and the maturity date was extended. The monthly payment, including escrow, however, remained $2,229.05. Therefore she received no relief. She is a senior citizen with a fixed income. She tried to enter into further dialogue but her telephone calls are not returned. She enlisted the assistance of a local housing agency, Neighborhood Works, but the agency has received no response.

In the district where I do practice we do have a program which has been instituted rather recently and it shows some signs of success. That is the program instituted in the Southern District of New York bankruptcy courts for loss mitigation. Judge Cecelia Morris has championed this program, and it applies only to individuals, only to their residences. It is of a voluntary nature, but it does push both parties to sit down and talk. Either the debtor or creditor may make a request for loss mitigation. The judge may then enter the order for loss mitigation which will then require the parties to talk. It would require the debtor to provide the information requested by the lender and on the other side of the table it would require the lender to announce a contact person, someone who the debtor or debtor's attorney can speak with.

Also the court holds status conferences to see if there is going to be some progress in this negotiation. I have seen where some of these have succeeded, at least certainly in the short term where lenders have agreed to reduce interest rates or extend out pay periods, one even reducing to 2 percent. Since the program began in February of 2009, there have been 252 requests for loss mitigation,

192 orders approving the loss mitigation. So there appears to be something that this may very well work. It is probably a little too early to tell because we do not know how it is going to work long-term. But it does relieve the frustration of the borrower in that the borrower now has somebody to speak with and someone who will respond.

Thank you.

[The prepared statement of Mr. Wrobel follows:]

PREPARED STATEMENT OF LEWIS D. WROBEL

Statement of Lewis D. Wrobel

Congress of the United States
House of Representatives
Committee of the Judiciary
Subcommittee on Commercial and
Administrative Law

Role of the Lending Industry in the Home Foreclosure Crisis

To appreciate the current actions and attitudes of the lending industry in the foreclosure crisis, it is necessary to take an historical perspective. Prior to the 1990's the great majority of loans to purchase homes were made by local banks and credit unions. The officers of these institutions usually served for many years and were knowledgeable about the community and often about the borrower who was seeking the home mortgage. If the borrower faced financial distress, he could contact the bank officer who certainly knew the property and the community and often knew the borrower. A workout of the loan might be accomplished by deferring payments, lowering the interest rate, or entering into a forebearance agreement. If that was not feasible, the bank might arrange a deed in lieu of foreclosure which would allow the borrower to surrender the property in full satisfaction of the debt and not suffer the damaging effect of a foreclosure on his credit record.

Beginning in the 1990's, and continuing to the present, the mortgage lender and/or mortgage assignees are not the local banks or credit unions but rather commercial institutions such as Wells Fargo, Wachovia, GMAC, Citimortgage, Chase Home Finance, to name a few. At these lenders, for better or ill, there is often a high turnover of personnel. At times no loan officer is present as the mortgage loan is obtained through a broker and there is no contact with a representative of the lender. Usually the lender does not have an office in the locality, hence communication is primarily over the phone and occasionally over the internet.

My clients have often complained of the frustration over not having a contact person, or

anyone who would listen to their problem. It is common for the borrower to provide copious financial information to the lender only to wait weeks or months for a response for a loan modification request. During this time, the lender may very well be proceeding with a foreclosure action.

A responsible person who foresees a job loss or an oncoming financial crisis and who has never missed a payment, will receive no response to a loan modification request from a lender. It is the policy of nearly every major lender not to discuss a loan modification until the borrower is at least three (3) payments in arrears.

I may illustrate these problems with three (3) case studies from my practice:

I. A retired woman in her 70's with a solid pension from her work in municipal government requested a loan modification. The home has been in her family for her entire life. She filed and confirmed a Chapter 13 Bankruptcy case but soon realized that she would need mortgage relief. To make her request for modification, Litton Loan Servicing requested pay stubs, bank statements and a financial statement. After review of her information, an offer was made to reduce the interest rate from 7.5% to 6.5% with the missed payments being added to the principal. The principal therefore was increased by $23,000.00 and the maturity date was extended. The monthly payment, including escrow, however, remained at $2,229.05. Therefore, she received no relief. She is a senior citizen with a fixed income. She has tried to enter into a further dialogue, but her telephone calls are not returned. She enlisted the assistance of a local housing agency, Neighborhood Works, but the agency has received no response.

II. A mortgage broker in his late 40's suffered a precipitous decline in his earnings with the housing crisis. He is the sole support of his wife and five (5) children, two (2) of whom have special needs. He is currently under the protection of Chapter 11, but the mortgagee of his home received Relief from Stay and he will need Loss Mitigation to save the residence for his family. Pursuant to the request of Wells Fargo Home Mortgage, he timely provided a financial statement, pay records, bank statements and a hardship letter for their evaluation.. He, like others, would wait weeks into months for an answer. On August 19, 2009, the borrower received a letter demanding a payment of $9,048.59 on or before September 10, 2009. At the time this offer was being made, the lender served the borrower with a foreclosure Summons and Complaint on September 2, 2009, eight (8) days prior to the date for the partial reinstatement payment. The modification offer that was made would increase his monthly payment from $4,413.18 per month to approximately $7,900.00.

III. A family of six (6) filed a Chapter 13 case to save their home. The husband worked as a mechanic in private industry and the wife worked for a local college. Their youngest child and has a severe gastro-intestinal problem. The wife left her job to care for the child. Although the Chapter 13 plan was confirmed, they would not be able to make the payments. The case was converted to Chapter 7. Ocwen, the mortgage servicer, received relief from the Automatic Stay, and proceeded with its foreclosure action. Approximately two weeks prior to the foreclosure sale date, the debtor husband received a $60,000.00 loan from his employer; more than enough funds to bring the mortgage current. After numerous requests, Ocwen finally

> provided my office with reinstatement figures. Their numbers, however, were far in excess of the amounts due and owing as evidenced by its proof of claim in the Bankruptcy case. When I spoke with the Ocwen representative, who was an outsourced contractor in another nation, and pointed out the discrepancy, Ocwen still refused to postpone the foreclosure sale unless an amount of approximately $32,000.00 was paid to Ocwen with no guarantee that the sale would be postponed. Fortunately, the Bankruptcy case was still open and we did obtain a Temporary Restraining Order to stop the sale. Also, the threat of Bankruptcy Court sanctions allowed us to obtain a very favorable settlement wherein the debtors were able to save their home.

Other abuses have been a failure by Chase Home Finance in one case to apply an escrow balance of $11,815.43 in 2007 to the missed payments. Chase Home Finance, however, allowed the escrow surplus to grow to $40,215.99, but still refuses to apply the surplus to mortgage arrears or to pay it over to the borrower. In that same case, Chase Home Finance failed to recognize online payments made by the borrower from his Chase bank account.

In a confirmed Chapter 13 case unsophisticated debtors were ready to sell their home. The lender, through its servicer had filed a proof of claim. Prior to the closing a payoff letter was sent to the borrowers with an amount nearly $19,000.00 greater than the proof of claim. Fortunately, the debtors' case was still open and there was a forum to address this discrepancy. The lender had a few thousand dollars of legitimate charges, but was forced to reduce its payoff amount by approximately $12,000.00 to the correct amount.

A program has been instituted in the Bankruptcy Courts for the Southern District of New

York to encourage Loss Mitigation negotiation. The program has been spearheaded by the Hon. Cecelia G. Morris, the Bankruptcy Judge at the Poughkeepsie Court. The program is open to individual debtors in Chapters 7, 11, 12, and 13 who are seeking to save their homes. The program only applies to residences. The debtor may request Loss Mitigation and the Court will enter an order requiring the parties to exchange information. Pursuant to the terms of the Order, the creditor must announce a contact person for the debtor. The Court shall hold status conferences to monitor the progress of the negotiations. Although the Court cannot compel the creditor to alter the terms of the loan, the program has achieved numerous agreements. It has certainly made lenders more responsive to the debtor's plea for relief. In one recent case, the lender even reduced its interest rate to 2%.

I most often appear in Judge Morris' Court. I believe that her persuasive leadership has been instrumental in getting the parties to talk seriously about modifying the loan. The Loss Mitigation Program is one that other Courts, both federal and state, may wish to adopt. Attached as an exhibit to this statement is the form for a Loss Mitigation Request by the Debtor and the form of the Loss Mitigation Order.

/s/ Lewis D. Wrobel
Lewis D. Wrobel

Mr. COHEN. Thank you, sir. Now we will begin our series of questions, and I will start. First, I would like to ask the Honorable Judge Magner here on your fourth anniversary, after 4 years on the Federal bench and a career as a litigator, I guess a practicing lawyer and a graduate, do you think you would be capable of modifying mortgages to the benefit of society if such a bill was passed giving you that authority?

Judge MAGNER. Yes. As a litigator before I took the bench, I did commercial lending, loans, reorganizations for companies. Very typically cramdowns are used for commercial lending purposes where often million, even billions of dollars are reduced or otherwise reworked in loans. So that is something I did on a regular basis in private practice.

What I suspect would happen in the bankruptcy context if a cramdown were allowed to judges is that just as in the commercial context the bar would take a view of their judges and how they ruled after two or three times and there would be a paradigm that would establish what the value of the real estate was and what the acceptable terms of the market might be. Lawyers tend to look at precedent when making decisions in negotiating, so I suspect you would not see wholesale litigation on the issue if you really want to know the truth of the matter.

I do, however, agree with Professor Mason and also with Congressman Franks that the benefits of cramdown may be fairly limited in bankruptcy. I have had the opportunity to view about 20,000 cases in the last 4 years. I was not a consumer practitioner before I got on the bench. In most instances the values of the property in Louisiana were not tremendously different than they were when the loans were taken out. I know there are other parts of the country where that may be the case, but Louisiana isn't one of them.

The interest rates are also not tremendously high, usually in the 8 percent range. You might save a percent on a cramdown maybe. So I agree with Professor Mason that the reason why for example the voluntary reworks or the cramdowns might not work are really coming from the same place. The borrower simply can't afford the loan. There are people who don't have income or have too little income to pay for their debt. I actually think that what I chose to talk about and why I chose to talk about it, which is the accounting method, would have a greater impact on both borrowers in and outside the bankruptcies, because it would allow borrowers to quickly determine where their default might lie, to give it to either their counsel or some other community organization to help them figure out what could be done. And that would have a greater impact on more loans, reduce cost to lenders and also help borrowers.

Now I have to tell you, Congressman Cohen, these thoughts are coming just from what I see, you know, on the bench. I have not statistically studied this particular issue. I certainly can do a cramdown, I have no problems with doing cramdowns and let me add on the flip side.

Mr. COHEN. Just call them judicial modifications.

Judge MAGNER. All right. I will agree with you as well that judicial modifications are generally just good business as well from the lender's perspective. When the lender is in a situation where they are about to foreclose, all they are going to get is the value of the collateral. That is what you are doing in a bankruptcy. You are valuing the collateral and you are saying that is what you will pay back. And frankly the value in a bankruptcy will be higher than in foreclosure because with a foreclosure you have considerable fees, remarketing expenses and management that occurs before the foreclosure. So most lenders would normally rework a loan or agree

to a reduction through a judicial modification, because it makes good economic sense. It is the same paradigm that works in commercial lending.

The problem that I see with the voluntary programs and the reason they don't do that in bankruptcy is that most of the loans are owned by trusts, and the trusts are held by investors that are far flung all over the globe. What happens were when the servicers or trustee tries to get permission to modify the loan, they can't get it. They cannot get the vote from the owners, so they are caught. So the one thing that would help is if judges could modify the loans, they could in essence give that lender permission, if you will, cover to make the business deal that makes sense.

I have lenders stand in front of me and say, I can't agree to it, sort of like, would you make me do it. That happens, I mean, it happens. So if you gave judges the right to make it happen, I suspect most lenders would be doing it willingly anyway, because it doesn't make a lot of sense for them to go to foreclosure.

Mr. COHEN. If they were willing to do it willingly, wouldn't the voluntary provisions that we encourage be successful and they are not?

Judge MAGNER. They are not typically successful, you are right. The voluntary modifications are reviewed in my experience again based on creditworthiness. Let's face it, people in bankruptcy are not creditworthy. It doesn't take a rocket scientist to understand that. So they don't meet the paradigms of the voluntary reorganization or refinancing.

Anecdotally, I checked with the lending community before I came up here, their counsel as well as the major debtor counsel, to see what their experiences were with the voluntary program and to a person they said basically they see very few loans going through. And they all said it is because the borrowers in bankruptcy are not creditworthy. This goes back to my statement. They can't afford the loan in the first place. Or Chapter 13 affords them the kind of relief that they need.

As an aside, the reduction of the loan if there is a significant value drop or if you can extend the loan's terms, a lot of the loans—Congressman Franks, I don't know if you are aware of this—some of the loans were made with 5-year balloons. And when a debtor is facing a balloon in 5 years and they can't refinance, that is a huge problem. If a judge could judicially modify a mortgage by extending the term to a normal 15-year or 20-year loan, that would have a positive impact on borrowers. Lenders can't get that permission oftentimes because they don't have owners who can give it to them. So that is something to consider when you are looking at judicial modifications.

Mr. COHEN. Thank you, the red light is on for me.

Judge MAGNER. I am sorry.

Mr. COHEN. No problem. I now recognize the Ranking Member, Mr. Franks.

Mr. FRANKS. Thank you, Mr. Chairman. Mr. Chairman, I know that these are challenging issues to discuss, because I especially wanted to tell the Chairman of this Committee, of the full Committee, that I appreciate so many of the remarks that he made, because I want him to know, and I think he does, I know he is com-

ing from a heart of wanting to do the best that he can for those who are having a hard time. And I identify with this in every way that I know somehow. I truly believe that is the goal here to try to make it work for everyone. The challenge that divides us is that I have come to a sincere conclusion that to force mortgagors, those who loan money for houses to be uncertain as to what will happen to the mortgage in the future if there is a foreclosure or if there is, say, a breach in the loan agreement, that the overall impact will cause many of those who otherwise could get a loan not to be able to get one. I think it will hurt the poor in the long run.

Now I want so say, even though there is some fundamental disparity between Judge Magner's position and mine, I was very touched by her testimony just now, because she may come to some different conclusion, but sincerity just exudes. And she said something that I was completely unaware of and that is one of the dynamics in all of this, is that sometimes when maybe an agreement could be reached between a lender and a borrower they can't get ahold the people that, quote, own the loan to be able to make that agreement. And that is something this Committee ought to be able to address, because that may be one of the most effective things that we could do here in the big picture. It is something that, you know, I am sure it doesn't shock all of you that I didn't know that, but it was something that this Committee Member was completely unaware of as it being a major dynamic. Because it makes sense, because most banks, as she said so eloquently, don't want to go through the expense—even if they don't care about the lender at all, they don't want to go through the expense of the full foreclosure if they can find a viable alternative for both people. It is difficult to weigh the best interest of the lender and the borrower. And unfortunately sometimes we have to do that based on whether the numbers add up for both the lender and the borrower, and there is a tremendous incentive in the existing system for them to try to reach that. And we need to take out some of those roadblocks that the judge told us about here to facilitate that more. Because I am convinced the more that government forces a change in contract law, and that is what a mortgage is, that in the long run it causes people to lose confidence in these things and that that has some ramifications that are hard for us to really fully appreciate in a setting like this.

So I am through philosophizing here, but I hope that the Committee will take a look at that. I wanted to ask Professor Mason, maybe just a general question first, and I am back on my original point that I think government is a big culprit in all of this. I think that we tried to in a genuine interest of trying to promote home ownership, we pressured a lot of the lenders to make loans that weren't sound. And I would like Professor Mason to give—would you give me some idea of what you think in terms of the genesis of this problem, the subprime loan, what part is government to blame in that, the beginning of all of that. What did we do to help catalyze this?

Mr. MASON. Well, in my opinion the government expected too much out of the home ownership policy. Is it enough to have the highest home ownership rates in the world? Possibly. But we kept pushing against homeowner rates. We do not know what the goal

was. Was it 100 percent home ownership rate? Well, we know in economics from the 1970's—I don't know how many of you are well trained in economics or remember these lessons from macro in your undergrad. Before the 1970's we did not teach stagflation or the natural rate of unemployment we didn't know existed. In the 1970's part of what caused stagflation was trying to reduce unemployment for what we thought was a social good. But when we pushed unemployment down too far, all we got out of it was more inflation, because we had to come to a realization that there is a natural rate of unemployment. There are some people that just are not working for whatever reason and to try to push them into jobs through economic policies merely fueled inflation for those who were working because for whatever reason these people, whether because of frictions between jobs or other reasons, were just unemployed. There wasn't a lot we could do about it.

In the same vein, we are never going to have 100 percent home ownership. So what is the natural rate of home ownership? Is it 65 percent or 62 percent? I don't know exactly what that is, but I would say that we probably shot way above that with origination practices and national home ownership policy. There is a particular quote I will try to get as accurate as I can from the 1996 version of the National Home Ownership Initiative. It sticks in my mind, that sought to get people into homes by relieving the historical constraints on home ownership of having enough money to make a down payment or even having enough income to make the monthly payments. To me that sounds like that policy is really only going one direction and that is the direction it went.

But there is an important aspect I want to draw out of your comments and also Judge Magner's comments about the investors who own the loans. And it draws upon something you said, Mr. Franks, that incentives are aligned all the way from the owner of the loans, who does want to realize value for modification and maximize the value of those loans, all the way through to the homeowner. But what is missing is actually in the middle of that relationship. Between the investor and the homeowner is a servicer, and Federal policy to date has embedded a friction in the servicer relationship on both sides with respect to the investor and the homeowner that is maintaining an inefficiency in today's market. The investor has the contractual right to replace the servicer with someone who can do a really good job at modification, but since modification is new and there is no data collected on it and no data given to the investor to see if the servicer is doing a good job, the investor can't tell if the servicer is actually doing a good job at modifying or if they are trying to maximize their own stake in the deal through some conflict of interest, and so you have typical terms of securitizations that require the servicer to buy the loan back from the investor in order to modify.

It seems to me in this space some simple rules for investor reporting can solve a big, big problem and get these loans to servicers who can modify in the best interest of the borrowers and the best interest of the investors.

Mr. FRANKS. Mr. Chairman, the full Chairman of the Committee suggested that he might be able to get my vote on a bill and I would suggest to you that if a bill that dealt with some of the prob-

lems of Professor Mason's and also Judge Magner said related to making sure that lenders were able to give a borrower an immediate accounting and clarify, those are the kinds of things that a right wing nut like me can support.

So I thank you.

Mr. COHEN. Let me add before I recognize the distinguished Chairman, the Ranking Member has hit upon what is probably the real issue here on the issue of judicial modifications, that if you allow judicial modifications will it hurt the poor in that it will take away the incentive for the lending industry to make money available to them because their contracts could be changed in a bankruptcy court. And so Professor Mason, I would like to ask you, since we allow for the courts to modify the terms on the purchase of secondary homes, vacation homes, yachts, airplanes and things like that, what has happened to the lending industry's willingness to loan money to people to buy yachts and airplanes and secondary homes since they can be modified? Has there been a big change in industry's desire to loan money?

Mr. MASON. Well, there has been but not necessarily recently. I have to say I am not an expert in the deeper history of bankruptcy reforms and bankruptcy law has changed across time and the economic effects of those reforms, although there is research into that that could be pointed to. I would be happy to look into that later if you would like.

I would like to correct one possible misconception from Judge Magner's perspective just based upon my view of the lending space though. She made a point that borrowers in bankruptcy are not creditworthy. I think it is very important to introduce that from the industry perspective they are very creditworthy. In fact this is part of what drove the subprime lending revolution because they can't declare bankruptcy again. And so if you get a substantial amount of their debt reduced in bankruptcy which realigns their finances and then you can give them a very high interest rate loan, they are very creditworthy and they can't go bankrupt on you again.

This is an impediment that I urge you to think about from the borrower's perspective with respect to judicial modification, that judicial modification only gives the borrower one shot. And if the borrower has, let's say, strategically misjudged and let's say declared bankruptcy when home values are down 20 percent and they are now going to drop another 30 percent, then they have their judicial modification locked in at the 20 percent and they don't have a chance to go back.

Mr. COHEN. I didn't intend to open Pandora's box, but since it is open, Judge, would you like 1 minute for rebuttal?

Judge MAGNER. Thank you. I guess this is where Professor Mason and I are going to disagree. When I say creditworthy, I mean worthy of getting a loan, not creditworthy, in other words, go out and you don't owe anybody else anything so we can charge you more interest. Creditworthy means could you get a new loan to me. I don't believe debtors are creditworthy in any real sense of the word. I don't think that is a novel or radical view. Debtors also don't arbitrage their debts and. They come in and bet home prices are going to go up and down more or less, so maybe this is the time

to file to get the better deal. That really is beyond their ability to understand. They can't pay their mortgage, they are in foreclosure. That is why they file. They do not file before they are in foreclosure and after the house is gone they don't file. It is a very—it is almost a process that is really in the are lender's hands, not theirs.

I don't think that what the professor is saying about the creditworthiness or the effect on the poor is really correct. From my perspective, and it is really from my perspective is correct. For the most part lenders have to always assume that a borrower is going to go into default. There is a certain percentage that they count on, and based on a borrower's credit scores and their income when they make the loan, they make that determination at the time the loan is made. The fact that a loan might be crammed down in the future again——

Mr. COHEN. Judicially modified.

Judge MAGNER. Judicially modified. I am sorry, I am a bankruptcy practitioner. I do use the terms of art.

The fact it might be modified by a judge down the road is not something that I think would affect the credit markets, because what happens is they figure that is all they are going to get in foreclosure anyway. If the loan defaults and they have to go to foreclosure, they are going to get the value of the collateral, and probably a lot less because of the cost of the foreclosure and, as we discussed, the administrative expenses. So I don't see the fact that there would be a judicial modification as something that the lending community when it looks at the macro level would say would make credit unavailable. They are already experiencing that, they are just experiencing it in a different way.

Mr. COHEN. Thank you.

Now the distinguished Chairman, Mr. Conyers, is recognized for 5 minutes or longer.

Mr. CONYERS. Thanks so much to all the panelists.

Ms. Sangree, you have listened to the colloquy between the judge and the professor. Would you want to make an observation?

Ms. SANGREE. The observation I would like to make is actually on a comment that Congressman Franks made earlier that he believes or he suspects that the Community Reinvestment Act may have been part of the fuel for the subprime meltdown, and I would disagree with that thought. I think the Community Reinvestment Act did put pressure on lenders to loan in underserved communities. And it was in response to this practice of redlining that we had been experiencing in this country for decades at that point. And the pressure was to properly underwrite loans in these communities. And I think it is because of the economic incentives, the huge profits to be made through these newly available subprime products through the new software that was developed in the late 1990's in which borrowers without prime credit ratings could now be able to assess what their ability to repay loans would be with much more accuracy. And that then made it possible for lenders to lend to borrowers without perfect credit ratings, without prime credit ratings. And so then we saw this profusion of subprime products. And that was all good, I think. It made it possible for people to own homes who couldn't own homes if loans were only available to people with prime credit ratings.

But where the problem came in was in abuses of those products, and that is what we are seeing in the Wells Fargo suit. We have two high level ex-employees of Wells Fargo who have come forward and said that they worked on commission and you made more money putting a borrower into a subprime loan than you did putting them into a prime loan and there was no oversight on the practice. And so loan officers routinely put unsophisticated borrowers into subprime products at much higher interest rates and paying initiation fees and points up front which were very profitable to the company, but really just disadvantageous to the borrower. And yes, there were borrowers who never should have been given loans at all and you have the underwriting mechanisms to figure that out. But they didn't really care whether the borrower could pay or not because they would be selling the loans on the secondary market and not face the risk.

I would say the problem was in a failure of oversight, not in encouraging or requiring lenders to lend in underserved communities.

Mr. CONYERS. Would the judge generally agree with those comments?

Judge MAGNER. I would, Congressman Conyers. I think that the real problem with the subprime industry was what Ms. Sangree has indicated, is the disconnects between those that originate and those that hold the loans. So you really get shoddy underwriting when you don't care what happens to a loan. If you put in some sort of mechanism, maybe not necessarily for financial institutions that originate but for these other lenders who are not financial institutions, many of them were not, so that they have to originate and hold for some period of time, you might force the type of underwriting that would avoid these problems. I really think it is an underwriting issue.

Mr. CONYERS. I thank you. We were all impressed with your opening statement because it came out of an experience of being a judge and it really gave us a new window on this.

This is the seventh hearing, and I am pleased with Trent Franks' comments about improving communication between the borrowers and the lenders and the other subsequent people that intervene, all taking profit out of this. And frequently when the mortgagor tries to contact somebody, they are closed, they are out of business, you can't find them anymore.

And so I would like to ask unanimous consent to put in the *New York Times*, October 15, 2007, Study Finds Disparities in Mortgages By Race; October 17, 2007, Subprime in Black and White, *New York Times;* and then May 16, 2009, Minorities Affected Most As New York Foreclosures Rise.

Mr. COHEN. Without objection, they will be entered into the record.

[The information referred to follows:]

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October 15, 2007

Study Finds Disparities in Mortgages by Race

By MANNY FERNANDEZ

Home buyers in predominantly black and Hispanic neighborhoods in New York City were more likely to get their mortgages last year from a subprime lender than home buyers in white neighborhoods with similar income levels, according to a new analysis of home loan data by researchers at New York University.

The analysis, by N.Y.U.'s Furman Center for Real Estate and Urban Policy, illustrates stark racial differences between the New York City neighborhoods where subprime mortgages — which can come with higher interest rates, fees and penalties — were common and those where they were rare. The 10 neighborhoods with the highest rates of mortgages from subprime lenders had black and Hispanic majorities, and the 10 areas with the lowest rates were mainly non-Hispanic white.

The analysis showed that even when median income levels were comparable, home buyers in minority neighborhoods were more likely to get a loan from a subprime lender.

In Jamaica, Queens, for example, where the majority is black and the median household income was $45,000 in 2005, 46 percent of the mortgages were issued by lenders who specialize in subprime loans, the second highest rate in the city. In Bay Ridge, Brooklyn, which had a median income of $50,000 and is mostly white, the rate was among the lowest in the city, with 3.6 percent of home loans coming from subprime lenders.

The analysis provides only a limited picture of subprime borrowing in New York City. The data does not include details on borrowers' assets, down payments or debt loads, all key factors in mortgage lending. And comparing neighborhoods is inexact; the typical borrower in one may differ from a typical borrower in another.

Jay Brinkmann, an economist with the Mortgage Bankers Association, said there was not enough information in the Furman Center analysis and other studies on the issue to draw conclusions about whether subprime lenders were discriminating against minority home buyers. One of the crucial missing pieces is the credit histories of individual borrowers, he said.

But the Furman Center study, a summary of which is being released today, still raises questions about the role of race in lending practices. A separate analysis of mortgage data by The New York Times shows that even at higher income levels, black borrowers in New York City were far more likely than white borrowers with similar incomes and mortgage amounts to receive a subprime loan.

"It's almost as if subprime lenders put a circle around neighborhoods of color and say, 'This is where we're going to do our thing,'" said Robert Stroup, a lawyer and the director of the economic justice program at the NAACP Legal Defense and Educational Fund Inc.

The New York State Division of Human Rights is investigating whether subprime lenders have been engaging in discriminatory practices by singling out minority communities.

The Furman Center analysis is based on 2006 data that lenders disclosed under the federal Home Mortgage Disclosure Act.

The study focused on mortgages issued by lenders identified by federal housing officials as subprime specialists in 2005. The list is made up of 210 companies, including major mortgage lenders like HSBC Mortgage Services and CitiFinancial, the consumer finance unit of Citigroup. But some lenders not included in the list may issue subprime loans, and not every loan made by the specialized lenders is subprime.

Even so, housing and civil rights advocates said the findings highlight lending patterns that have long troubled them.

They say minority communities whose financing needs were starved decades ago because of redlining — banks' refusal to offer loans or other services in minority areas — are now singled out for high-cost, high-risk mortgages in a kind of reverse redlining.

Any loan that carried an interest rate more than 3 percentage points above the prevailing rate for long-term Treasury bonds was considered a subprime mortgage. In 2006, Treasury rates ranged from 4.5 to 5.3 percent. Prime mortgage interest rates averaged 6.1 to 6.8 percent, according to the Federal Home Loan Mortgage Corporation.

Subprime loans are typically made to borrowers with credit histories that the mortgage industry considers less than prime. They can carry higher interest rates than traditional loans or adjustable rates that can make the mortgage difficult to repay once the interest rate resets. They can also carry higher fees and prepayment penalties and thus are at a high risk for foreclosure.

Kumiki Gibson, the commissioner of the State Division of Human Rights, acknowledged last week that her agency was investigating subprime lenders, but she said she could not discuss the details. "There was enough data to compel us to look into this," Ms. Gibson said.

She said a variety of lending practices and patterns could be considered unlawful discrimination, like a mortgage broker who works only in certain neighborhoods or who offers white borrowers better rates than similarly qualified black or Hispanic customers. Many mortgages are handled by brokers who work as a liaison between borrowers and lenders and earn a fee

The N.A.A.C.P. filed a lawsuit in federal court in Los Angeles this year against 12 mortgage lenders. The lawsuit accuses the companies of steering black borrowers into subprime loans.

An analysis by The Times of the 2006 data that lenders disclosed under the federal Home Mortgage Disclosure Act shows that in New York City, the rate of subprime lending is far higher for minorities than for whites even at higher income levels. For example, 24 percent of non-Hispanic white borrowers earning $125,000 to $150,000 took out a subprime mortgage in 2006, compared with 52 percent of Hispanics and 63 percent of non-Hispanic blacks in the same income range.

For borrowers earning $150,000 to $250,000, the rate of subprime loans was 20 percent for whites, 50 percent for Hispanics and 62 percent for blacks. That analysis looked at all mortgages reported to the

federal government, not just those issued by companies identified as subprime lenders.

The city's Department of Housing Preservation and Development also analyzed the federal mortgage data and found that last year, 58.5 percent of home loans to non-Hispanic black borrowers were high cost, compared to 15.9 percent for non-Hispanic whites. The percentage of loans to Hispanics that were high cost was 45.5.

Subprime lending, which has grown at a rapid pace in recent years, has made it possible for many New Yorkers with modest incomes and poor credit histories to buy homes. At the same time, those loans have brought some borrowers to the brink of financial ruin or cost them their homes.

Some economists and analysts said examining subprime lending by geography and race could be misleading because of the many variables not represented in the data, including the lack of banking services in some minority communities and historical differences in wealth and income among racial and ethnic groups.

"There certainly is a disgraceful element here, but how big it is, we don't know," said Julia Vitullo-Martin, a senior fellow at the Manhattan Institute, a conservative research group, who looked at a portion of the Furman Center analysis. "Is it a few rogue lenders, or is it an extensive problem that requires a regulatory response? We don't know yet."

The Furman Center's findings appear to echo recent studies from a number of local and national housing and fair-lending organizations that found racial disparities in subprime lending, high-cost mortgages and foreclosures.

A study by the Center for Responsible Lending, a nonprofit research group based in North Carolina, examined 50,000 subprime loans nationwide and found that blacks and Hispanics were 30 percent more likely than whites to be charged higher interest rates, even among borrowers with similar credit ratings. A report released in March by the Neighborhood Economic Development Advocacy Project and other groups found that in New York, blacks were five times and Hispanics almost four times more likely to pay higher interest rates for home loans than whites.

"There's no question that if you live in a predominantly African-American and Latino neighborhood you're going to be paying more for your mortgage," said Sarah Ludwig, executive director of the nonprofit Advocacy Project, which is based in New York.

The Furman Center analysis showed that subprime lending remained widespread in New York. Last year, 19.8 percent of home purchase loans in the city were from subprime lenders, a higher percentage than in San Francisco (8.4 percent), Boston (14.2 percent) and Chicago (15.9 percent). Los Angeles had a rate higher than New York's, at 25 percent.

New York City's subprime lending rate decreased by 3 percentage points between 2005 and 2006, but the rate was far higher than it was in 2002, when only 7 percent of loans were subprime, according to the Furman Center.

None of the predominantly white neighborhoods in the Furman Center analysis had a lending rate from subprime companies higher than the overall city rate of 19.8 percent, while numerous black and Hispanic areas did.

In the Middle Village and Ridgewood sections of Queens, both of which have white majorities and had a median income of $47,820 in 2005, 16.7 percent of the loans were issued by subprime lenders. In the Sheepshead Bay and Gravesend areas of Brooklyn, which also are mostly white and had a median income of $40,000, 10.8 percent of the mortgages were from subprime companies. Majority black and Hispanic neighborhoods with median incomes of $40,000 to $50,000 had far higher rates, including East Flatbush, where 44 percent of the loans were from subprime companies, and Queens Village (34.6 percent).

Ford Fessenden contributed reporting

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October 17, 2007

EDITORIAL

Subprime in Black and White

Evidence is mounting that during the housing boom, black and Hispanic borrowers were far more likely to be steered into high-cost subprime loans than other borrowers, even after controlling for factors such as income, loan size and property location.

The Furman Center for Real Estate and Urban Policy at New York University released a study this week highlighting a disturbing pattern of racial disparities. Using data gathered by the federal government, the study showed that the 10 New York City neighborhoods with the highest rates of subprime lending in 2005 had black and Hispanic majorities, while the 10 areas with the lowest rates were mainly non-Hispanic white. The higher incidence of subprime lending to borrowers of color held up even when the median income levels of the neighborhoods were comparable.

And as The Times's Manny Fernandez reported this week, the Furman findings are consistent with a separate analysis of mortgage data by this paper, which found that high-income blacks and Hispanics in New York City were two to three times more likely than comparable non-Hispanic white borrowers to have subprime loans.

Other studies have shown similar racial disparities in Boston, Washington, Philadelphia and other cities.

The bad news doesn't end there. Neighborhoods where subprime borrowers are concentrated are the same neighborhoods that are now experiencing high rates of default and foreclosure. That's because many subprime loans were not designed to be affordable over the long term, but rather to be refinanced before their initial teaser rates rose. That often hasn't been possible as home values have dropped and credit standards have tightened, leaving borrowers stuck in loans that have become unmanageable.

The mortgage lending industry says it's impossible to say that such patterns are the result of discrimination because the federal data do not include so-called risk characteristics like borrowers' credit scores, other debts or how much of a down payment they were able to make.

But the burden of proof has to be on the lenders to show that no discrimination has occurred. They have data on the risk characteristics of their borrowers. When the Federal Reserve began in 2004 to require lenders to provide specific data on subprime loans, the industry fought successfully to keep the risk profile of borrowers, including credit scores, under wraps. Now, with indications of discrimination rife, Congress must demand that data be fully disclosed.

The crisis in subprime lending is already threatening to be a socioeconomic disaster with hundreds of thousands of Americans at risk of losing their homes. Whether there has also been widespread racial discrimination by lenders is a question that lawmakers must confront fully, without delay.

The New York Times

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May 16, 2009

Minorities Affected Most as New York Foreclosures Rise

By MICHAEL POWELL and JANET ROBERTS

Turn the corner on 145th Street in Jamaica, Queens, and it is as though a cyclone has wheeled through.

One resident, Lakisha Brown, a hospital worker and mother of two, snatched her house back from foreclosure last month, if only temporarily. "We need to sell fast," she says. "I'm just trying to save what's left of my credit." Across the street in this black middle-class neighborhood, Patrick Nicholas, a surgical technician in blue scrubs, shakes his dreadlocks and shrugs. He rents but is moving out. "The owner got foreclosed and told us to leave," he says.

Six doors away, past two foreclosed and boarded-up homes, a burly man in a blue union jacket declines to give his name but his problem is evident. A foreclosure notice is pasted to the door of his house. His tone is mournful. "Tough times, man," he says. "Tough, tough times."

Late to arrive in the Northeast, the foreclosure crisis has swept through the New York region at an explosive pace in the past two years, destroying billions of dollars in housing wealth, according to a New York Times analysis of foreclosures filed since 2005 and federal mortgage data.

It now touches every corner of the region, from estates along the Connecticut Gold Coast to the suburban tracts of Long Island, where 6 percent of all mortgages are at least 90 days delinquent, the point at which foreclosure proceedings usually begin.

But the storm has fallen with a special ferocity on black and Latino homeowners, the analysis shows. Defaults occur three times as often in mostly minority census tracts as in mostly white ones. Eighty-five percent of the worst-hit neighborhoods — where the default rate is at least double the regional average — have a majority of black and Latino homeowners.

And the hardest blows rain down on the backbone of minority neighborhoods: the black middle class. In New York City, for example, black households making more than $68,000 a year are almost five times as likely to hold high-interest subprime mortgages as are whites of similar — or even lower — incomes.

This holds a special poignancy. Just four or five years ago, black homeownership was rising sharply, after decades in which discriminatory lending and zoning practices discouraged many blacks from buying. Now, as damage ripples outward, black families in foreclosure lose savings and credit, neighbors see the value of their homes decline, and renters are evicted.

That pattern plays out across the nation. A study released this week by the Pew Research Center also shows foreclosure taking the heaviest toll on counties that have black and Latino majorities, with the New York region among the badly hit.

On 145th Street in southeast Queens, just south of Linden Boulevard, attached brick homes with tidy, fenced-in gardens stretch into the distance. Children play tag under blooming oaks. But 8 of these roughly 50 homes face foreclosure; 4 are vacant; 2 have plywood boards nailed over punched-out windows.

"My district feels like ground zero," said City Councilman James Sanders Jr., an African-American who represents hundreds of blocks in Queens like this one. "In military terms, we are being pillaged."

Years ago many banks drew red lines on maps around black neighborhoods and refused to lend; more recently, some banks began taking aim at those neighborhoods for the marketing of subprime loans, say consumer advocates.

Black buyers often enter a separate lending universe: A dozen banks and mortgage companies, almost all of which turned big profits making subprime loans, accounted for half the loans given to the region's black middle-income borrowers in 2005 and 2006, according to The Times's analysis. The N.A.A.C.P. has filed a class-action suit against many of the nation's largest banks, charging that such lending practices amount to reverse redlining.

"This was not only a problem of regulation on the mortgage front, but also a targeted scourge on minority communities," said Shaun Donovan, the secretary of Housing and Urban Development, in a speech this year at New York University. Roughly 33 percent of the subprime mortgages given out in New York City in 2007, Mr. Donovan said, went to borrowers with credit scores that should have qualified them for conventional prevailing-rate loans.

For anyone taking out a $350,000 mortgage, a difference of three percentage points — a typical spread between conventional and subprime loans — tacks on $272,000 in additional interest over the life of a 30-year loan.

"There's a huge worry that this will exacerbate historic disparities between the wealth of black and white families," said Ingrid Ellen, co-director of the Furman Center for Real Estate and Urban Policy at New York University. Not that white neighborhoods and towns in the New York region stand immune. During the past decade, buyers of all colors scrimped to buy homes in one of the nation's most expensive housing markets.

Now mortgage delinquencies are rising sharply even in high-income, predominantly white enclaves, from Nirvana Avenue in Great Neck, N.Y., to Otter Rock Drive on a peninsula off Greenwich, Conn.

In the wealthiest ZIP codes, the median delinquency rate — although much lower than the regional rate, 5.3 percent — more than tripled from March 2005 to March 2008, then doubled again in the year since.

As a whole the region has fared better than stretches of Florida and California, where about one in every five borrowers is at least 90 days behind on payments.

Yet the pain in the New York region is considerable. The delinquency rate in Essex County, N.J., stood at 11 percent in March, more than two percentage points higher than in Genesee County, Mich., home to the battered city of Flint, which stands as a national symbol of this recession.

A World of Damage

Sitting on Long Island close by the Atlantic Ocean — salt air flares the nostrils on many days — Roosevelt is

79 percent black and has suffered grievously from segregation over the years. (Long Island, as measured by school and housing patterns, is among the most racially segregated suburban areas in the nation.) Still, as young black families sought bargains, home ownership rose.

Now subprime loans and a crippled economy have laid many of those families low. Olive M. Thompson, a 45-year-old nursing assistant, lost her $215,000, four-bedroom Cape in January, but not before she drained her 401(k) and declared bankruptcy.

A single mother of four, she recalled arriving in 2003 and seeing a home across the street with a garden so beautiful she fantasized about matching it. That house went into foreclosure.

"Next thing I know, it's boarded up," she said.

Foreclosure represents catastrophe on several levels. As families move to cheaper quarters, they often move their children to different schools. A rising number of foreclosures in a neighborhood is a singularly reliable predictor of an increase in violent crime, according to a recent academic study.

All these ills are magnified for black families, whose median net worth is far smaller than that of white families, and far more tied up in housing.

On Bainbridge Street in the predominantly black Bedford-Stuyvesant section of Brooklyn, 130-year-old brownstone homes loom like grand sailing ships, seemingly impervious to the ravages of time. That solidity is illusory. Looking closer, a visitor can identify homes in jeopardy by the cracked stoops, broken windowsills and tilting chimneys.

Alexia Billiart, 33, who is black, and her husband, who is white, moved a year ago from an expensive neighborhood into a handsome row house in Bedford-Stuyvesant, where they can manage their payments. Across the street, two foreclosed homes have fallen vacant, and a nearby apartment building stands broken and padlocked. At night, young men cluster on the stoops of the vacant homes.

"We figured we'd move here and participate in the rebirth of this block," said Ms. Billiart, who works for a financial planning firm. "It seems to be going backward; it's a little scary."

Several black homeowners along these blocks, including well-paid professionals, confide that they pay strikingly high mortgage rates — 9, 10 or 11 percent annually. How that came to happen is a complicated story.

Over the last decade, many commercial banks, from Wells Fargo to Bank of America to HSBC, acquired subprime lenders that thrived by offering loose lending standards and high interest rates. Court records show that brokers sometimes received bonuses for steering borrowers into high-interest loans laden with extra costs.

Even many blacks and Latinos who say they sought conventional loans ended up with subprime mortgages from these lenders. One reason, many say, was a mistrust of conventional banks.

Colvin Grannum grew up in a black neighborhood in Brooklyn and became president of the Bedford-Stuyvesant Restoration Corporation, a nonprofit organization that builds and renovates housing. His father bought several properties in the 1950s and '60s, often without turning to banks.

"I don't want to say it's in the cultural DNA, but a lot of us who are older than 30 have some memory of disappointment or humiliation related to banks," Mr. Grannum said. "The white guy in the suit with the same income gets a loan and you don't?"

"So you turn to local brokers, even if they don't offer the best rates."

This may help explain an unusual phenomenon: Upper-income black borrowers in the region are more likely to hold subprime mortgages than even blacks with lower incomes, who often benefit from homeownership classes and lending assistance offered by goverument and nonprofits.

Help for Lost Causes

The foreclosure storm shows few signs of abating. Scam artists and deed thieves prey on the desperate as complaints flood the offices of local prosecutors. In a church meeting room in the Guyanese neighborhood of Flatlands, Brooklyn, 200 homeowners tell of paying $3,000 or $4,000 to firms to "fix" their mortgage troubles. Often, these firms disappear with the money.

In southeast Queens, politicians have asked homeowner advocacy groups to set up shop in their offices. "My office is St. Jude, the patron saint of lost causes," Councilman Sanders said.

A few step clear of the rubble. Antoinette Coffi, 45, saw an ad on the subway, a photo of a black couple gazing at a gleaming home. She walked into that company's office two years ago, and six weeks later she, her two children, her mother and cousin had a home in Queens. She ended up with not one but two mortgages, including a variable-rate loan that started at 11 percent.

Last year her work hours were cut and she fell behind. "The stress, oh my God," she said, her voice thick with the juicy vowels of her native West Africa.

With the help of Changer, an advocacy group, she has kept the house. But her neighbors may not be as lucky. "Everywhere, everyone talks about being put in the street," she said.

Foreclosure is cutting so deep as to reshape the geography. If enough homes go vacant in Queens and Newark and Roosevelt, a cycle of disinvestment could beckon.

"Some home-owning neighborhoods may turn back to rentals and some might not survive," said Jay Brinkman, chief economist for the Mortgage Bankers Association in Washington. "They might end up bulldozed."

That sounds a touch apocalyptic. The Obama administration has set aside $50 billion to persuade banks to reduce monthly payments to help borrowers avoid foreclosure. Immigrants continue to flock here, and New York City officials have spent tens of billions of dollars since the 1980s to rebuild and shore up hard-pressed neighborhoods.

But few in 1965 would have predicted the South Bronx devastation of 1979. At the very least, tens of thousands of people will lose their homes, their savings and their dreams.

"Rather than helping to narrow the wealth and home ownership gap between black and white," Mr. Grannum said, "we've managed in the last few years to strip a lot of equity out of black neighborhoods."

Mr. CONYERS. And if I may be granted just a few more minutes, Mr. Chairman.

I wanted everyone to know that we are going to get copies not only to you, Chairman Cohen, but to Trent Franks and Steve King, who has a very deep interest in this subject as well. Now there is an attorney, Vanessa Flucker, in Detroit that does the same work Mr. Wrobel, Attorney Wrobel does. And she was talking to one of our staff members about a lady she represented who was two payments behind. She got foreclosed on, I don't know if she was evicted first and then foreclosed on or what, but the house was fore-

closed by Countrywide. Countrywide then sold—this hurts—to Fannie Mae, and Fannie Mae sold the property to an investor for $800. We are getting more detail about that and there were other cases. And I know that between the judge and the counsel there and this Detroit lawyer, we could do case by case. I mean, I don't know how and you have a very obvious stamina for this sort of thing, but to get up and to go in to work every day in either a law office or a courtroom and hear these incredible tales of exploitation, frequently minority purchasers who of course have read a mortgage contract, is really something.

Now Professor Mason, I am happy to come to agreement with you because I was one of the ones who voted against the credit card, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. You know the story I think, that the credit card companies for about 10 years had been trying to tighten up bankruptcies, make it harder for people to get into bankruptcies. Maybe my colleagues on the other side voted in the negative on that bill, too. I am not sure. But I did for the simple reason that it was adverse to the interest of people who were in financial difficulty. It made bankruptcy tougher on individuals. And the credit card companies had been lobbying on this for years and they finally were able to put together a majority. And I remember one part of the hearings, Chairman Cohen, when they were talking about single mothers or people that had a divorce situation. They were tough on—I mean, you couldn't get any relief for the mother and 2 kids, there was nothing there for them. It was just a mean-spirited bill all the way around. And I had—oh, here it is—I had all these reasons that tilted—the bill tilted the playing field in favor of credit card companies at the expense of struggling families. It was tough on small businesses for sure. Many of us were very concerned about that. It increased the cost of bankruptcy, and it did nothing to hold irresponsible lenders accountable for their actions.

So in my way of taking hearing number seven is that this bankruptcy judge has shown a new light on this unregulated part of the financial world that we keep going over. And it is very hard, these are exotic instruments and there are some practices that there aren't even any laws, were never written for them. We hadn't even known about them. And I would invite your comments as I conclude, Professor Mason.

Mr. MASON. Thank you, Chairman Conyers. I agree and I am humbled to the magnitude of the task before your Committee in dealing with this very difficult set of circumstances and a very difficult body of law. My comments are to be taken really in the spirit of trying to get to the important aspects or most powerful aspects of the law, and I do take into consideration Judge Magner's comments about the ability to time bankruptcy, and that is just extremely important and that is part of what I was alluding to both in terms of what was characterized as the ability to arbitrage bankruptcy, choosing your time to file. But Judge Magner is correct, you often can't choose. The time to file is when you get shocked by divorce or medical debt or something like that. But I also don't want people to get hurt either, because bankruptcy as currently constructed is something you get one shot at. And if things get worse,

then you could lock yourself out. And so I think both sides deserve to be considered here.

But in the sense of going back to some of the securitization arrangements and where the meat is, so to speak, it is important for me to point out that it is overly simplistic to think of the problem as just one where the originator doesn't care so much about the loan or the performance of the loan because they will be selling it on. It is actually worse than that.

Think of it this way. Chairman Conyers, you get to sell something to me and I promise that I'll pay you—well perhaps I should take the other side of this—neither side is very good, quite honestly. Perhaps I should take both sides. I agree to sell something to my right hand. And my left hand will pay for that say $50 a month for the next 30 years. So my right hand gets to value that $50 a month for the next 30 years. It doesn't obviously have the money yet, but just like we teach in Finance 101 it can effect that valuation by choosing a different discount rate or really it might not go the whole 30 years of monthly payments, it may go 20 or 25 or 10 or 5. And my right hand gets to choose that time period too, how many months I pay $50 a month in order to effect this valuation. Worse yet, my right-hand gets to report this as a corporate entity as income today. And the CEOs of my right hand get to use that calculation in calculating their bonuses this year. Again no cash has come here. This is called gain on sale accounting. This has been a plague of the securitization industry well acknowledged since the mid-1990's. But FASB accounting standards won't let the industry get rid of this even though certain well-managed companies have wanted to. In fact we have gone the other direction with policy, requiring other companies to do the same kind of valuation, calling it mark-to-market accounting and expanding it across the financial marketplace. It is the wrong direction to go. We are adding insult to injury here. So not only do you get to sell the loan, you get to call it whatever value you want and record that as income today. That is really bad. We have a very perverse set the incentives in the system that could use some realignment. I am convinced that some very targeted legislation can fix many of the deep problems that we have today without broad strokes. But it does take expertise in the area to get those few touch points that can have the most dramatic effect. I think probably the same can be said of consideration for judicial abilities to modify loans as well.

Mr. CONYERS. Well, I hope we can continue this discussion after today. I thank the Chair for his indulgence.

Mr. COHEN. Thank you, sir. I appreciate your questions. Now I recognize the gentleman from Iowa, the State that launched the presidential ambitions and successes of our great President Barack Obama, State of Iowa, Mr. King.

Mr. KING. I thank the Chairman and I hope he is as delighted when we launch the next President as well.

Mr. COHEN. Mr. Biden is waiting until 2016, and he thanks you.

Mr. KING. This testimony has been quite interesting, and like many Members we are trying to do a number of things at once, but all of it that I have heard has been engaging and I appreciate you all coming here to testify. I run some things across random thoughts that accumulate as I am listening to the testimony. One

of them is in some data that has been handed to me by staff that says mortgage delinquency rates are at 9.12 percent, and unemployment now is 9.7 percent. I think if you count the real unemployed in America it probably approaches 20 million. If you add the unemployed along with those who no longer qualify as unemployed, it probably actually exceeds 20 million. Loan modifications are up 172 percent from last year. That is an interesting piece of data that doesn't necessarily correlate with some of the things we have talked about here. I inject that into the dialogue as a level of optimism that the lenders really are working I think to try to avoid going before the Honorable Judge Magner. And so that would be one of those observations.

Another one as I listen to Ms. Sangree's testimony, racially segregated patterns of housing, and I want to come back to this, I just lay that out there. Racially predatory lending, another phrase, four times higher foreclosure rates in minority communities I believe is the phrase compared to White communities. That is quite arresting to hear that data.

Then the testimony that I am convinced does exist among probably more lenders than I am aware that there is misinformation there, that appears to be a pattern in the lending community.

So I lay this out so you know that at least I was listening to parts of this. I would like to go back first to Ms. Sangree, I don't know how long you have been involved in this particular trade, but do you recall when redlining first became an issue? You couldn't be old enough, but I ask if you do recall that.

Ms. SANGREE. I read about it. Yes, I recall reading about it.

Mr. KING. And so then when the Community Reinvestment Act was passed, it essentially outlawed redlining or at least with the language the effect was to try to eliminate redlining, and I reject—the idea of drawing lines around neighborhoods, declaring them to be minorities and refusing to loan money in those neighborhoods. But I reject the concept.

I am wondering what are the root causes of how we got here for this testimony today, how we got here economically. So we had the Community Reinvestment Act that was designed to reduce or hopefully eliminate redlining, bad loans in neighborhoods where the asset value wasn't sustained. Then we had a number of other things, but the secondary markets got stronger. Fannie Mae and Freddie Mac began taking on these mortgages. And people began taking their margins out of these mortgages on the front end so they weren't invested in the long-term performance of that mortgage loan.

Then we have the situation that has come up with us within the last year this phrase too big to fail, banks that are too big to be allowed to fail, to be more precise, and now we have boards of directors that are so remote that borrowers can't identify who they owe the money to in order to negotiate some terms. So it has to happen with blocks of mortgages and large boards of directors making huge decisions in places like New York, et cetera.

So then I look back and I think okay, there are other subsets of these kind of negotiations that took place. Rewards for those who could broker these subprime loans sometimes, but the loans that were misrepresented other times. And I am thinking in particular

of ACORN, and I am wondering, Ms. Sangree, do you have an engagement or involvement with ACORN? And what would be your view of how ACORN might have been involved in these problems that I have strung out? Do they fit into that chain somewhere that I need to understand?

Ms. SANGREE. I don't really know that much about ACORN. They are real activists, they are sort of plagues at city hall, they hold demonstrations there pretty frequently.

Mr. KING. Okay. I am just looking back somebody needed to broker these loans going into these neighborhoods that were redlined in order for the banks to qualify, and I think we are pretty confident here that ACORN was involved in negotiating or setting that up. I just remember reading news articles on it. So I just take you back to the racially segregated housing, the racial predatory lending that is going on. The four times higher foreclosure rates. That data, and can you tell me has that been adjusted for income and jobs or is race the only factor involved here or has it been corrected for the other factors?

Ms. SANGREE. There are several studies that have been done that had access to FICO scores and credit rating agency data that have concluded that correcting for credit risk, race, there are racial disparities in who gets prepayment penalties, who is put into subprime products, and that they are high and extremely high was one of the conclusions. AFT Associates did a study for the Casey Foundation, including Baltimore City, I think it was 12 cities across the country and Baltimore was one of the cities studied. And the conclusion for Baltimore was the refinance racially disparities were extremely high and origination loans, there were high racial disparities in quality of product.

Mr. KING. Okay. Would you want this Committee to accept the statement they are four times higher after they are corrected for other factors or before?

Ms. SANGREE. Before. We survived the motion to dismiss in the Wells Fargo litigation and now we are commencing discovery. So we have not had access to the Wells Fargo's loan documents, which would include risk credit ratings.

Mr. KING. So we don't know what it would be after it is corrected. It is an alarming figure, but it probably isn't that stark if one corrected it for the other factors involved.

Ms. SANGREE. That is probably true, we are basing that four times rate based on Home Mortgage Disclosure Act data which is publicly available and does not include credit risk. That is one of the measures that the GAO report that just came out in July of this year recommends, is HMDA should require credit risk.

Mr. KING. Thank you, Ms. Sangree. I just want to tell you why I asked one of these questions and now I will make a statement. I know the clock is red but we have been a little loose today, and I hope the Chairman indulges me. One of the reasons I asked you about ACORN, and I don't ask you to follow up on it, I have got an article here in front of me that is a press account, it is actually dated June 8, 2006. It says, ACORN has been waging a national campaign for more than 3 years against Wells Fargo's predatory lending. And that is how they have described it.

There are a number of articles like that that has taken place in Des Moines, too. I want to make this point, just suppose there had never been a Community Reinvestment Act, just suppose we found another way to put competition into those cities that needed to have a better practice of mortgage lending. What if we had small community banks that were investing in those communities, even though the real estate wasn't worth as much as the neighboring real estate. What if they were loaning a percentage on the asset value, what if they were evaluating the ability of people that were getting the mortgage to pay back the loan, wouldn't the real estate values have dropped down to a point where the people that were ready to buy those houses could actually afford them, and then when we have got banks that have gotten too big to fail, I mean too big to be allowed to fail and they are getting bigger and bigger, and we bailed out big banks and we have fewer banks. Now we lost 3,000 banks in America in the 80's during what we call the farm crisis where I come from. If we lost 3,000 banks in America today, it truly would be a financial crisis because the banks have gotten so much bigger with all the mergers, they have gotten more impersonal, and they are not serving the inner city the way they did, and they are not serving the small communities as well as they did either. I would suggest that we have tried to fix things at the national level and write rules because we had a moral abhorrence to redlining. And we want everybody to own a home as much as we can but I take the testimony of Professor Mason that probably there is a limit to the number of people just like there is to unemployment. So I am going to suggest that we take a look at how to create competition in the free market and how we let these values go to where they can actually be sustained by the people that will buy the homes and that can, that have the ability to perform on those loans and those mortgages. And I will suggest that maybe we got our hands in here too much from the Federal level and I think it has diminished the free market component of this and I think it has hurt a lot of people in the inner city and across the country. And if we keep going in the direction we are going we will end up with just a few great big banks that are ever more personal that we have to give more regulation to. If we believe in Adam Smith's invisible hand, we ought to inject more free market into this and probably less regulation so that lenders can go into those communities and make a profit, but do so at a level that is going to be useful for the people that are living there and then they can build themselves up on the American dream and go out and build a mansion and then I can buy the house that they live in.

Mr. Chairman, I yield back, and I thank you for your indulgence.

Mr. COHEN. Thank you. The gentleman's time has expired.

I would now like to recognize the Ranking Member for a special extraordinary, super owed request.

Mr. FRANKS. Thank you, Mr. Chairman. In addition to seconding Mr. King's comments, I would like with your permission and the committee to place into the record four different articles, one being the Housing Policy Council, September 9, 2009; one being an article called Spreading the Virus, it was in the *New York Post* on October 13, 2008; and one being the Committee on Oversight and Government Reform report of July 7, 2009; and one called the Inde-

pendent Policy Report: Causes of the Mortgage Meltdown by Stan Lebowitz October 3, 2008.

Mr. COHEN. Without objection, they will be admitted into the record.

Mr. FRANKS. Thank you, Mr. Chairman.

[The information referred to follows:]

ROUTING

INDEPENDENT POLICY REPORT

Anatomy of a Train Wreck

Causes of the Mortgage Meltdown

Stan J. Liebowitz

October 3, 2008

Executive Summary

Why did the mortgage market melt down so badly? Why were there so many defaults when the economy was not particularly weak? Why were the securities based upon these mortgages not considered anywhere as risky as they actually turned out to be? This report concludes that, in an attempt to increase home ownership, particularly by minorities and the less affluent, virtually every branch of the government undertook an attack on underwriting standards starting in the early 1990s. Regulators, academic specialists, GSEs, and housing activists universally praised the decline in mortgage-underwriting standards as an "innovation" in mortgage lending. This weakening of underwriting standards succeeded in increasing home ownership and also the price of housing, helping to lead to a housing price bubble. The price bubble, along with relaxed lending standards, allowed speculators to purchase homes without putting their own money at risk. The recent rise in foreclosures is not related empirically to the distinction between subprime and prime loans since both sustained the same percentage increase of foreclosures and at the same time. Not is it consistent with the "nasty subprime lender" hypothesis currently considered to be the cause of the mortgage meltdown. Instead, the important factor is the distinction between adjustable-rate and fixed-rate mortgages. This evidence is consistent with speculators turning and running when housing prices stopped rising.

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*Stan J. Liebowitz is Research Fellow at the Independent Institute and the Ashbel Smith Distinguished Professor of Managerial Economics at the University of Texas at Dallas. *Anatomy of a Train Wreck* is included in the forthcoming Independent Institute book, *Housing America, Building out of a Crisis*, edited by Randall G. Holcombe and Benjamin W. Powell (http://www.independent.org/store/book_detail.asp?bookID=76).

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Anatomy of a Train Wreck

Causes of the Mortgage Meltdown

Stan J. Liebowitz

THE MORTGAGE MELTDOWN has been the largest economic story, perhaps the largest story of any kind, since mid 2007. In the coming years, many books will be written about how and why the mortgage mess came to pass.

The basic outlines of the event are uncontroversial and fairly easy to state. Through the early years of the twenty-first century, the housing market experienced a pricing boom—with prices soaring—of almost unprecedented scale. That came to an abrupt end in the second quarter of 2006, at which time a steep decline in home prices began. Not coincidentally, in the third quarter of 2006, mortgage defaults began to rise to what would be, in modern times, unprecedented levels, although it was not until mid 2007 that the mortgage stories began to make front-page news because the financial system, which had invested heavily in securitized mortgages, began to experience signs of possible collapse. The stock market swooned, GDP (gross domestic product) growth groaned to a halt, and politicians stepped in to propose various "fixes" to the problem.

The financial difficulties are continuing through the summer of 2008 as this report is being written. Drastic actions taken by the Federal Reserve in the spring of 2008—including its bartered fire sale of Bear Stearns, a global investment bank, to JPMorgan Chase, a financial services firm; its willingness to open its discount window to investment banks; and its acceptance of new types of securities as collateral—are all indicative of a massive effort to preempt a possible financial calamity. More recently, the political classes, led by the Treasury Department, have agreed that they would, if necessary, bail out Fannie Mae (the Federal National Mortgage Association, or FNMA) and Freddie Mac (the Federal Home Loan Mortgage Corporation), which guaranteed about half of the country's mortgages. Finally, Congress and the president have enacted legislation to put a potential bailout of those two organizations in statutory language, allowing the now-saved Fannie Mae and Freddie Mac to act as "saviors," a strange position for two essentially bankrupt organizations that wholeheartedly helped engineer the financial calamity they are now supposed to fix.

As we will see, a record-breaking level of mortgage foreclosures occurred when the economy was still robust and before housing prices had fallen very

far. These increased foreclosures occurred at the same time and with virtually the same intensity for both the prime and the subprime mortgage markets, although this has not been commonly understood. The very steep home-price decline that followed has greatly exacerbated the foreclosure problems.

The increase in foreclosures caught the banking and finance industries by surprise and greatly lowered the value of securities based on these mortgages. The declining value of these securities, in turn, decimated the mortgage specialists such as Countrywide Financial and IndyMac Federal Bank, badly damaged major finance and banking firms such as Citicorp and Merrill Lynch, and brought the behemoth government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac to the brink of bankruptcy.

The point of this report is to help provide some understanding of how it is that the mortgage market melted down so badly. A seismic economic fracture, such as this one, does not have but a single cause. Nevertheless, a precondition for the market to self-destruct due to a record level of mortgage foreclosures is that a great many mortgage recipients must have been unable or unwilling to continue to pay their mortgages.

How did this come about? Why were there so many defaults when the economy was not particularly weak? Why were the securities based upon these mortgages not considered anywhere as risky as they actually turned out to be?

It is the thesis of this report that this large increase in defaults had been a potential problem waiting to happen for some time. The reason is that mortgage-underwriting standards had been undermined by virtually every branch of the government since the early 1990s. The government had been attempting to increase home ownership in the U.S., which had been stagnant for several decades. In particular, the government had tried to increase home ownership among poor and minority Americans. Although a seemingly noble goal, the tool chosen to achieve this goal was one that endangered the entire mortgage enterprise: intentional weakening of the traditional mortgage-lending standards.

After the government succeeded in weakening underwriting standards, mortgages seemed to require virtually no down payment, which is the main key to the problem, but few restrictions on the size of monthly payments relative to income, little examination of credit scores, little examination of employment history, and so forth also contributed. This was exactly the government's goal.

The weakening of mortgage-lending standards did succeed in increasing home ownership (discussed in more detail later). As home ownership rates increased there was self-congratulation all around. The community of regulators, academic specialists, and housing activists all reveled in the increase in home ownership and the increase in wealth brought about by home ownership. The decline in mortgage-underwriting standards was universally praised as an "innovation" in mortgage lending.

The increase in home ownership increased the price of housing, helping to create a housing "bubble." The bubble brought in a large number of speculators in the form of individuals owning one or two houses who hoped to quickly resell them at a profit. Estimates are that one quarter of all home sales were speculative sales of this nature.

Speculators wanted mortgages with the smallest down payment and the lowest interest rate. These would be adjustable-rate mortgages (ARMs), option ARMs, and so forth. Once housing prices stopped rising, these speculators tried to get out from under their investments made largely with other peoples' money, which is why foreclosures increased mainly for adjustable-rate mortgages and not for fixed-rate mortgages, regardless of whether mortgages were prime or subprime. The rest, as they say, is history.

In good times, strict underwriting standards seem unnecessary. But like levees against a flood, they serve a useful purpose. When markets turn sour, these standards help ensure that homeowners will not bail out of homes at the first sign of price declines, that

they will have the financial wherewithal to survive economic downturns, and that even if homeowners can't make their payments, mortgage owners will be covered by the equity remaining in the home. Removing these protections greatly increased the risk in this market when a storm did approach.

Unfortunately, it seems likely that our governing bodies have learned little or nothing from this series of events. If the proper lessons are not learned, we are likely to have a reprise sometime in the future.

1. The Birth of "Flexible Underwriting Standards"

> After the warm and fuzzy glow of "flexible underwriting standards" has worn off, we may discover that they are nothing more than standards that led to bad loans. Certainly, a careful investigation of these underwriting standards is in order. If the "traditional" bank lending processes were rational, we are likely to find, with the adoption of flexible underwriting standards, that we are merely encouraging banks to make unsound loans. If this is the case, current policy will not have helped its intended beneficiaries if in future years they are dispossessed from their homes due to an inability to make their mortgage payments. It will be ironic and unfortunate if minority applicants wind up paying a very heavy price for a misguided policy based on badly mangled data. (Day and Liebowitz, 1998)

Home mortgages have been a political piñata for many decades. All politicians at all times seem to be in favor of home ownership. What could be more apple pie than owning a home? Indeed, there can be many positive effects on behavior brought about by home ownership.

But home ownership wouldn't seem to require much help from the federal government. If you let builders build, developers develop, and lenders lend, you will soon have people living in private homes, assuming that local governments adequately perform their function of enforcing private contracts. This view is verified by the fact that at the turn of the twentieth century, before the federal government became involved in the housing industry, home ownership in the U.S., according to the Census Bureau, stood at 47 percent (compared to 66 percent in 2000). That was before the enormous wealth increase of the twentieth century and before mortgage deductibility was enacted as a form of home-ownership subsidy, both factors that would be expected to increase the ownership of homes. Clearly, home ownership rates would have increased even without flexible underwriting policies.

Nevertheless, during the great depression of the 1930s, home building, like many other industries, experienced a profound decline. Mortgages were generally of a short duration, often only good for a year or two. Because banks were cash strapped and nervous about being paid, when a mortgage came due, instead of offering to refinance it, the banks often asked for payment in full. It was difficult or impossible for homeowners, even those with the financial ability to handle a mortgage, to pay the full amount of the mortgage all at once.

To help alleviate such problems, in 1934 the federal government created the Federal Housing Administration (FHA), which guaranteed mortgages against default, thus removing the risk from the bank. This was the first major intrusion in the mortgage market. In 1938 Fannie Mae was created to purchase FHA mortgages. Its purpose was later widened, and it now purchases and repackages a large share of all private mortgages in the country. In more recent decades, FHA mortgages have generally been used by lower-income home buyers since income and mortgage-size limitations have been built into the program.

The government became heavily involved in the mortgage market in a new way after concerns about mortgage discrimination arose in the 1970s. The government passed the Community Reinvestment

Act (CRA) in 1977, requiring banks to conduct business across the entirety of the geographic areas in which they operated, thus preventing them from doing business in a suburb, say, while neglecting a downtown area. Congress also passed the Home Mortgage Disclosure Act (HMDA) in 1975, which required that mortgage lenders provide detailed information about mortgage applications. Every year banks receive a score on their CRA compliance just as they receive a score on their financial viability, and banks strive to do well on both parts of their examination.

In 1991 the HMDA data was expanded, allowing for comparison of rejection rates by race. Various news organizations started publicizing simple examinations of HMDA data, showing that minorities were denied home mortgages at a rate far higher than that for whites. It was and still is common for newspapers in large cities, shortly after the yearly HMDA data are made public, to do exposés examining the differences by race in rejection rates on mortgage applications. There are even turnkey kits for newspaper reporters aspiring to demonsttate such results. Although such comparisons are completely unable to distinguish between the possibility of discrimination or differences in credit worthiness as explanations and are therefore fairly meaningless, these results were and are trumpeted far and wide in the media.

The last defense of banks trying to defend themselves against charges of engaging in biased mortgage lending appeared to fall when the Federal Reserve Bank of Boston (Boston Fed) conducted an apparently careful statistical analysis in 1992, which purported to demonstrate that even after controlling for important variables associated with creditworthiness, minorities were found to be denied mortgages at higher rates than whites.

In fact, the study was based on such horribly mangled data that the study's authors apparently never bothered to examine them. Every later article of which I am aware accepted that the data were badly mangled, even those authored by individuals who ultimately agreed with the conclusions of the Boston Fed study. The authors of the Boston Fed study, however, stuck to their guns even in the face of overwhelming evidence that the data used in their study was riddled with errors. Ex post, this was a wise decision for them, even if a less than honorable one.

The winds were behind the sails of the study.[1] Most politicians jumped to support the study. "This study is definitive," and "it changes the landscape," said a spokeswoman for the Office of the Comptroller of the Currency. "This comports completely with common sense," and "I don't think you need a lot more studies like this," said Richard F. Syron, president of the Boston Fed (and former head of Freddie Mac). One of the study's authors, Alicia Munnell, said, without any apparent concern for academic modesty, "The study eliminates all the other possible factors that could be influencing [mortgage] decisions."[2] When important functionaries make quotes like these, you know that the fix is in and that scientific enquiry is out.

My colleague, Ted Day, and I only decided to investigate the Boston Fed study because we knew that no single study, particularly a first study, should ever be considered definitive and that something smelled funny about the whole endeavor. Nevertheless, we were shocked at the poor quality of the data created by the Boston Fed. The Boston Fed collected data on approximately three thousand mortgages. Data problems were obvious to anyone who bothered to examine the numbers. Here is a quick summary of the data problems: (a) the loan data that Boston Fed created had information that implied, if it were to be believed, that hundreds of loans had interest rates that were much too high or much too low (about fifty loans had negative interest rates according to the data); (b) over five hundred applications could not be matched to the original HMDA data upon which the Boston Fed data was supposedly based; (c) forty-four loans were supposedly rejected by the

lender but then sold in the secondary market, which is impossible; (d) two separate measures of income differed by more than 50 percent for over fifty observations; (e) over five hundred loans that should have needed mortgage insurance to be approved were approved even though there was no record of mortgage insurance; and (f) several mortgages were supposedly approved to individuals with a net worth in the negative millions of dollars.

When we attempted to conduct a statistical analysis removing the impact of these obvious data errors, we found that the evidence of discrimination vanished. Without discrimination there would be no reason to try to "fix" the mortgage market.

Nevertheless, our work largely evaporated down the memory hole as government regulators got busy putting the results of the Boston Fed study to use in creating policy. That policy, simply put, was to weaken underwriting standards. What happened next is nicely summed up in an enthusiastic Fannie Mae report authored by some leading academics (Listokin et al., 2002):

> Attempts to eliminate discrimination involve strengthened enforcement of existing laws . . . There have also been efforts to expand the availability of more affordable and flexible mortgages. The Community Reinvestment Act (CRA) provides a major incentive . . . Fannie Mae and Freddie Mac . . . have also been called upon to broaden access to mortgage credit and home ownership. The 1992 Federal Housing Enterprises Financial Safety and Soundness Act (FHEFSSA) mandated that the GSEs increase their acquisition of primary-market loans made to lower income borrowers . . . Spurred in part by the FHEFSSA mandate, Fannie Mae announced a trillion-dollar commitment.
>
> The result has been a wider variety of innovative mortgage products. The GSEs have introduced a *new generation of affordable, flexible, and targeted mortgages, thereby fundamentally altering the terms upon which mortgage credit was offered in the United States from the 1960s through the 1980s.* Moreover, these secondary-market innovations have proceeded in tandem with shifts in the primary markets: depository institutions, spurred by the threat of CRA challenges and the lure of significant profit potential in underserved markets, have pioneered flexible mortgage products. For years, depositories held these products in portfolios when their underwriting guidelines exceeded benchmarks set by the GSEs. Current shifts in government policy, GSE acquisition criteria, and the primary market have fostered greater integration of capital and lending markets.
>
> These changes in lending herald what we refer to as *mortgage innovation.* (My emphasis)

One man's innovation can be another man's poison, in this case a poison that infected the entire industry. What you will not find, if you read the housing literature from 1990 until 2006, is any fear that perhaps these weaker lending standards that *every government agency* involved with housing tried to advance, that congress tried to advance, that the presidency tried to advance, that the GSEs tried to advance—and with which the penitent banks initially went along and eventually enthusiastically supported—might lead to high defaults, particularly if housing prices should stop rising.

2. Relaxed Lending Standards—Everyone's Doin' It

Within a few months of the appearance of the Boston Fed study, a new manual appeared from the Boston Fed. It was in the nature of a "Nondiscriminatory Mortgage Lending for Dummies"[3] booklet. The president of the Boston Fed wrote in the foreword:

> The Federal Reserve Bank of Boston wants to be helpful to lenders as they work to close the mortgage gap [higher rejection rate for minorities]. For this publication, we have gathered

> recommendations on "best practice" from lending institutions and consumer groups. With their help, we have developed a comprehensive program for lenders who seek to ensure that all loan applicants are treated fairly and to expand their markets to reach a more diverse customer base.

Early in the document, the Boston Fed gracefully reminds its readers of a few possible consequences of not paying attention:

> *Did You Know?* Failure to comply with the Equal Credit Opportunity Act or Regulation B can subject a financial institution to civil liability for actual and punitive damages in individual or class actions. Liability for punitive damages can be as much as $10,000 in individual actions and the lesser of $500,000 or 1 percent of the creditor's net worth in class actions.

The part of this document that is of greatest interest to us is the section on *underwriting standards.* This is where we find the seeds of today's mortgage meltdown. It starts out:

> Even the most determined lending institution will have difficulty cultivating business from minority customers if its underwriting standards contain arbitrary or unreasonable measures of creditworthiness.

You might think that it would be difficult for a bank to cultivate business with *any* mortgage applicants, or merely to stay in business, if it had arbitrary and unreasonable measures of creditworthiness. But then you would be failing to understand the doublespeak that is actually the point of this quote. What the quote is really saying is that if a bank's underwriting standards do not allow a sufficiently high percentage of minority mortgage approvals, they must be arbitrary or unreasonable. "Arbitrary and unreasonable" include the standards that prevailed in the several decades prior to the 1990s.

The document continues:

> Management should be directed to review existing underwriting standards and practices to ensure that they are valid predictors of risk. Special care should be taken to ensure that standards are appropriate to the economic culture of urban, lower–income, and nontraditional consumers.

You might have thought that financial standards that indicate a high probability of success in making mortgage payments, such as steady employment, a record of savings, and keeping the loan payment small relative to income, might have been prudent standards for borrowers of all incomes and all races. In fact, you would be correct. But in the world of mortgage discrimination the goal is to increase mortgages for certain "nontraditional" customers, and in this case financial standards are to be twisted or discarded if necessary.

We can go through the document's critique of underwriting standards one at a time.

> *Credit History:* Lack of credit history should not be seen as a negative factor. Certain cultures encourage people to "pay as you go" and avoid debt. Willingness to pay debt promptly can be determined through review of utility, rent, telephone, insurance, and medical bill payments. In reviewing past credit problems, lenders should be willing to consider extenuating circumstances. For lower–income applicants in particular, unforeseen expenses can have a disproportionate effect on an otherwise positive credit record. In these instances, paying off past bad debts or establishing a regular repayment schedule with creditors may demonstrate a willingness and ability to resolve debts. Successful participation in credit counseling or buyer education programs is another way that applicants can demonstrate an ability to manage their debts responsibly.

The first few sentences, to the extent that they just imply that paying bills in cash should not hurt loan applicants, are largely unobjectionable. But then banks are told that extenuating circumstances should be taken into account when evaluating prior credit problems. Although this does not appear unreasonable on its face, the fact is that people with credit problems invariably have excuses for their problems, and whether those are legitimate extenuating circumstances or not is the key question. The way this is worded, a bank with an applicant who provides an "extenuating" circumstance faces the charge of "discrimination" if the application is denied. Past bad debt, the document continues, if eventually made good, should be ignored, which sounds like a recipe for inviting, well, bad debt.

More troubling is the claim that "credit counseling" is a demonstration that applicants can manage debts successfully. This is an example of the most naive form of wishful thinking being used in place of actual thought (although one might claim that relaxing underwriting standards was also an instance). There is no evidence whatsoever that "credit counseling" helps applicants avoid mortgage defaults.[4] The focus on consumer education, which is a constant and persistent theme in this literature, seems to have more to do to with political payoffs to "community activists" who help provide the "education" than with providing any benefits to homeowners or lenders.

> *Obligation Ratios:* Special consideration could be given to applicants with relatively high obligation ratios who have demonstrated an ability to cover high housing expenses in the past. Many lower–income households are accustomed to allocating a large percentage of their income toward rent. While it is important to ensure that the borrower is not assuming an unreasonable level of debt, it should be noted that the secondary market is willing to consider ratios above the standard 28/36.

Again, the first sentence seems reasonable enough. But then the tone shifts, and the document suggests that many lower-income households can handle high obligation ratios, not just those applicants who have demonstrated an ability to handle high housing expenses in the past. Clearly, the Boston Fed is suggesting that the 28/36 ratio (share of income that can be devoted to mortgage payments, gross or net) that had been historically used for most homeowners shouldn't apply to poor individuals even though logic would say that poor individuals, who are less likely to have savings (see the next paragraph) or other forms of discretionary income, are more likely, not less, to have trouble handling housing expense ratios above normal. The secondary market obliquely referred to in the last sentence of the quote is basically Fannie Mae, and that organization was willing to stretch the obligation ratios since it was an enthusiastic advocate of relaxed lending standards.

> *Down Payment and Closing Costs:* Accumulating enough savings to cover the various costs associated with a mortgage loan is often a significant barrier to home ownership by lower–income applicants. Lenders may wish to allow gifts, grants, or loans from relatives, nonprofit organizations, or municipal agencies to cover part of these costs. Cash–on–hand could also be an acceptable means of payment if borrowers can document its source and demonstrate that they normally pay their bills in cash.

This quote mixes legitimate and illegitimate sources of extra income in a dangerous way. Cash and gifts from relatives seem unobjectionable. But what this paragraph opens the door to is the "gift" from a builder wishing to sell his housing. Since these guidelines went into effect, it has become commonplace for builders of low-income homes to "gift" the down payment to the mortgage applicant, often using a nonprofit front organization to channel the funds. Since home builders are not charities, the price of the home is raised by an amount equal

to the cash gift, with appraisers apparently willing to go along (shades of Tony Soprano).

> *Sources of Income*: In addition to primary employment income, Fannie Mae and Freddie Mac will accept the following as valid income sources: overtime and part-time work, second jobs (including seasonal work), retirement and Social Security income, alimony, child support, Veterans Administration (VA) benefits, welfare payments, and unemployment benefits.

As with the other proposals, this one is a mixture of the reasonable and the outrageous. Second jobs, for example, can be held indefinitely and thus are reasonable sources of income. Unemployment benefits, on the other hand, are time limited, and it is a mistake to include temporary sources of income when the mortgage is not temporary. The fact that Fannie Mae and Freddie Mac accept these sources says more about these agencies' attempts to water down underwriting standards than it does to prove that such watered-down standards make sense.

What was the impact of this attack on traditional underwriting standards? As you might guess, when government regulators bark, banks jump. Banks began to loosen lending standards. And loosen and loosen and loosen, to the cheers of the politicians, regulators, and GSEs.

One of the banks that jumped most completely on to this bandwagon was Countrywide, which used its efforts to lower underwriting standards "on behalf" of minorities (and everyone else) to catapult itself to become the leading mortgage lender in the nation. Countrywide not only made more loans to minorities than any other lender, it also had the highest consumer satisfaction among large mortgage lenders, according to J.D. Power and Associates.[5]

Testimonials to Countrywide's virtue abound. In 2000, *La Opinión* (the nation's leading Spanish-language newspaper) named Countrywide "Corporation of the Year" for their outstanding work in the Latino community. Additionally, the chair of national housing at LULAC (League of United Latin American Citizens) said, "Through the generosity of ethical businesses like Countrywide, we can make significant strides towards bringing the pride of home ownership to our communities and enhancing the quality of life for more Latinos."[6]

According to a flattering report by the Fannie Mae foundation, Countrywide was a paragon of lending virtue.[7] Countrywide was nothing if not flexible, I mean innovative, in its underwriting practices. The report stated:

> Countrywide tends to follow the most flexible underwriting criteria permitted under GSE and FHA guidelines. Because Fannie Mae and Freddie Mac tend to give their best lenders access to the most flexible underwriting criteria, Countrywide benefits from its status as one of the largest originators of mortgage loans and one of the largest participants in the GSE programs.
>
> When necessary—in cases where applicants have no established credit history, for example—Countrywide uses nontraditional credit, a practice now accepted by the GSEs.

Countrywide had even outdone itself with respect to consumer education.

> In an interesting departure from local counseling assistance, Countrywide provides centralized home ownership counseling through the House America Counseling Center. Counseling staff members who are located in California field calls on a toll-free line. Bilingual (Spanish and English) counselors are available . . . the Counseling Center distributes materials to help potential homeowners achieve and maintain homeownership. These materials include the *Guide to Homeownership* and *A Feeling Called Home*, a video that is narrated by James Earl Jones.

Apparently, even the voice of Darth Vader couldn't keep defaults at bay. The document also reports on Countrywide's other great videos.

> Countrywide has developed a video titled *Living the Dream: A New Homeowner's Survival Guide*, which covers the basics of loan closing, mortgage insurance, budgeting, and home maintenance, as well as how to use credit wisely, make mortgage payments on time, cope with financial crises, and reap the rewards of building equity . . . The video was originally created for use in the House America program. However, following praise by industry leaders, including officials at Fannie Mae, Freddie Mac, GE Mortgage Insurance Corporation, and HUD, copies of the video have been provided to city and county libraries nationwide as an educational tool.

This hasn't stopped critics who are looking for villains in the mortgage meltdown from fingering Countrywide. Of course, Countrywide is really the poster child for flexible underwriting standards, but none of the usual critics want to criticize the standards themselves.

There is one part of the story that has not yet been discussed. We know where the idea of flexible underwriting standards came from and we know how relentlessly it was pushed by almost every government organization or quasi-government organization associated with the industry. But how did investors, who are supposed to be cool and rational, misperceive the risk so badly? One of the questions about the current crisis is, why were purchasers of mortgages (i.e., mortgage-backed securities) willing to treat them as AAA and, perhaps more surprisingly, why were the rating agencies willing to give them AAA ratings?

Although it is not clear that any answer to this question can be completely satisfactory, I believe that if we understand how universal the idea of "flexible underwriting standards" had become, how dangerous it was to suggest anything else (and risk being labeled a racist), and how strong this force is, even now, it becomes possible to understand how investors—who, just like other human beings, are prone to mistakes (the dot-com bubble is another recent example)—might be led by the same arguments that were being repeated by so many others.

To understand this, it is useful to examine the sales pitches that were made. I was able to find a 1998 sales pitch from Bear Stearns, a major underwriter of mortgage-backed securities, for loans that banks undertook to fulfill their CRA obligations, which means mortgages to low- and moderate-income individuals.[8]

This sales pitch is important because it shows us the thinking being used to sell these products in secondary markets. Underwriters of the mortgage-backed securities also likely made this pitch to the security-rating organizations. As will become apparent, this sales pitch for loans based on relaxed lending standards generally follows the script laid out by the Boston Fed and followed by the entire regulatory apparatus surrounding the housing industry. Faced with overwhelming acceptance of these facts by presumably knowledgeable experts, why wouldn't an investor believe it?

Further, the housing-price bubble that was caused in part by these relaxed underwriting standards tended to reduce defaults and obscure the impact of the standards while prices were rising because almost no one would default when they could, instead, easily sell the house at a profit. Rating agencies could suggest that these loans were no more risky than the old antiquated loans and provide empirical support for that conclusion, given the still-low default rates at the time, although to do so was shortsighted to the point of incompetence.

In fact, the rating agencies seemed overly concerned with the trees and lost sight of the forest. For example, a *Wall Street Journal* article (which

is the basis for the following three quotes) reports on rating agencies' benign treatment of piggyback mortgages (taking out a second mortgage to cover the down payment required by the first mortgage).[9] In previous decades, mortgage applicants unable to come up with the full down payment, and therefore thought to be more at risk of default, were required to pay "mortgage insurance," which raised the interest rate on the loan. Piggyback loans allowed borrowers to avoid this mechanism, thus presumably making the loan riskier. Nevertheless, the article reports that rating agencies did not consider these loans more risky:

> Data provided by lenders showed that loans with piggybacks performed like standard mortgages. The finding was unexpected, wrote S&P credit analyst Michael Stock in a 2000 research note. He nonetheless concluded the loans weren't necessarily very risky.

The finding was unexpected because it contradicted what had generally been known about mortgages by a prior generation of mortgage lenders—that when applicants made smaller down payments, increasing the loan-to-value ratio, the probability of default increased. This new finding contradicted common sense. Further, these measurements were being made at the front end of a housing price bubble (figure 1 (Yearly Real [1983 Dollars] Home Prices, 1987–2008), later in this report shows that prices were rising smartly in 2000), likely biasing downward any default statistics. Relaxed lending standards also had a short enough track record that rating agencies could not know how they would perform in the long run or in adverse conditions, meaning that it isn't clear that sufficient information existed to even rate these securities. So how did the rating agencies defend their counterintuitive ratings?

> One money manager, James Kragenbring, says he had five to ten conversations with S&P and Moody's in late 2005 and 2006, discussing whether they should be tougher because of looser lending standards . . . Other analysts recall being told that ratings could also be revised if the market deteriorated. Said an S&P spokesman: "The market can go with its gut; we have to go with the facts."

Whether such a myopic view of the "facts" was responsible for all or most of the excessively high ratings I cannot say, but these ratings were consistent with the views of the relaxed lending standards crowd. The real facts, of course, eventually soured the view of the rating agencies:

> By 2006, S&P was making its own study of such loans' performance. It singled out 639,981 loans made in 2002 to see if its benign assumptions had held up. They hadn't. Loans with piggybacks were 43% more likely to default than other loans, S&P found.

In spite of their inaccurate ratings, the rating agencies, nevertheless, were making great profits from rating mortgage-backed securities, a quasi-sinecure created by the government that required many financial organizations (e.g., insurance companies and money market funds) to invest only in highly rated securities as certified by government-approved rating agencies (Nationally Recognized Statistical Rating Organizations, NRSROs, approved by the Securities and Exchange Commission). There were only three such approved rating agencies for most of the last decade (Standard & Poor's [S&P], Moody's, and Fitch). Given that government-approved rating agencies were protected from free competition, it might be expected that these agencies would not want to create political waves by rocking the mortgage boat, endangering a potential loss of their protected profits.

Seemingly everyone went along. And most felt morally upright doing so since they were helping increase home ownership, especially among the poor and minorities.

Returning to the sales pitch made by Bear Sterns in 1998 and quoted below, Bear Stearns claimed that LTV (the size of a *loan* relative *to* the *value* of the home) *had been* the key consideration for predicting defaults but suggested that it was not appropriate for affordable loans (an opinion seconded by the rating agencies a few years later, as we have seen).[10] The traditional logic was sound: if someone puts 20 percent down on a house, the traditional down payment level, they would be unlikely to default. Even if the homeowner has trouble making the payments, as long as prices do not fall by 20 percent the homeowner would prefer to sell the house and get some of their down payment back. Yet in the sales pitch we encounter a feeble attempt to explain why this should not be true for low-income borrowers.

> *Traditionally rating agencies view LTV as the single most important determinant of default* . . . While we do not dispute these assumptions, LTVs have to be analyzed within the context of the affordable-loan situation. Three or 4 percent equity on a $50,000 house is significant to a family of limited financial resources. In relative terms, $1,500 to $2,000 could easily mean three to four months of advance rent payments in their previous housing situation.
>
> Obviously, there are more delinquencies with the higher LTV loans than the lower, but there is no tight linear correlation between the LTV levels. Delinquency rates increase along with the LTV levels, but not proportionately. As a result, the use of default models traditionally used for conforming loans have to be adjusted for CRA affordable loans.

Let's take a look at this logic. LTV has been the most important predictor of default. But when it comes to "affordable" housing, LTV is not to be taken as seriously. Why? The real reason is that if traditional LTVs were imposed on applicants for "affordable" loans, most of these applicants would be unable to come up with anything like a 20 percent down payment and the loan would be rejected. That is a politically unacceptable result. The logic being put forward by Bear Stearns appears to be that 3–4 percent (as a down payment) of a small mortgage is more important to poor people than 3–4 percent of a bigger mortgage for wealthier applicants. This is a mere assertion, although to question it (or most of the other claims being made at the time) was to run the risk of being called a racist. But more important, as we know from the Boston Fed guidebook, the down payment is most likely going to come from someone other than the applicants themselves anyway ("accumulating enough savings to cover the various costs associated with a mortgage loan is often a significant barrier to home ownership by lower-income applicants"), so there is little reason poor applicants should treat it with particular extra care.

Also, as we will see later, mortgages from the poorer portion of the income distribution, for the last thirty years at least, have had much higher default rates than traditional mortgages, a result that is conveniently ignored in so much of this literature. Subprime mortgages have tended historically to be foreclosed at ten times the rate of prime mortgages, and FHA loans (limited to low- and moderate-income individuals) are foreclosed at about four times the rate of prime mortgages.

Continuing with the 4 percent down example, if the price of the affordable house goes down by more than 4 percent, then the homeowner would be underwater or upside down, depending on your preferred metaphor. If this is due to an overall decline in housing prices, it means that the homeowner could turn around and purchase a similar house for a lower price and lower monthly payments. There is no reason to think that poor people are less likely to be swayed by this logic than middle-class people (although, as we will see, Bear Stearns considers poor homeowners to be too ignorant to figure this out).

What other nuggets of wisdom are found in this Bear Stearns pitch?

> *Credit scores.* While credit scores can be an analytical tool with conforming loans, their effectiveness is limited with CRA loans. Unfortunately, CRA loans do not fit neatly into the standard credit score framework . . . Do we automatically exclude or severely discount . . . loans [with poor credit scores]? Absolutely not.

They agree with the Boston Fed manual that traditional credit scores are not useful for poor and moderate-income households. They don't really provide any reason for this belief except to say that credit scores are complicated constructs.

> *Payment history.* While some credit-score purists might take issue with our comments in the preceding section, payment history for CRA loans tracks consistently close to the risk curves of conforming loans . . . In many cases, purchasing a home puts the borrower in a more favorable financial position than renting. It is quite common for a first-time homebuyer using a CRA loan to have been shouldering a rent payment that consumed 40 percent to 50 percent of his or her gross income.
>
> When considering the credit score, LTV, and payment history, we put the greatest weight by far on the last variable . . . Payment history speaks for itself. To many lower-income homeowners and CRA borrowers, being able to own a home is a near-sacred obligation. A family will do almost anything to meet that monthly mortgage payment.

Although the above quote might bring tears to your eyes, the tears should be from contemplating to the point of parody the poor economic logic being used by a leading financial firm. First, the claim that lower-income homeowners are somehow different in their devotion ("near sacred") to their home is a purely emotional claim with no evidence to support it. It also completely ignores the fact that foreclosure rates for loans to low-income individuals (FHA or subprime) are much higher than for ordinary mortgages, sacred obligation or not. Also, whether apartments or houses are better deals depends on the ratio of housing prices to apartment prices, which varies over time and by location. At the peak of the housing bubble, for example, apartment prices were much less expensive than amortized home payments, and the claims about the savings from home ownership made above would have been false in almost all locations.

Finally we have the "education" canard repeated again:

> Where do most payment problems occur? Usually, the problems stem from poor upfront planning and counseling. Hence, one of the key factors we look for in a CRA portfolio is whether the borrower completed a GSE-accredited homebuyer education program. The best of these programs help the individual plan for emergencies that can arise with homeownership.

Ironically, although education programs do not impact defaults, they do impact prepayments (meaning that the loan is paid off early). The Bear Stearns pitch is highly focused on prepayments. Lenders do not like prepayments because increased prepayments often means that interest rates have dropped, allowing homeowners to refinance at a lower rate. In that case the lender fails to lock in the gain from the original higher interest mortgage, which is paid off (prepaid) when it is refinanced.

> CRA-backed securities are attractive to mortgage investors because of their very stable prepayment behavior. Because pre-payments are unlikely to accelerate if interest rates decline, these securities consistently outperform their traditional mortgage-backed counterparts on a total-rate-of-return basis.

Why are affordable loans thought less likely to have prepayments? Bear Stearns suggests two reasons. First, they state that many such loans are heavily subsidized (usually by taxpayers unaware of their largesse), so the applicants would have no incentive to renegotiate. Second, such borrowers are considered too unworldly to take advantage of the lower rates ("The low-income borrower population is much more likely to have limited access to funds and/or have limited desire or ability to pay the out-of-pocket expenses associated with a refinancing transaction").

The Bear Stearns document goes on at great length about the prepayment advantages of affordable mortgages. And in a world where default is of no relevance, small disadvantages to the lender, like getting paid in full *early*, could appear to be a major problem. But to ignore the possibility of defaults, to ignore the possibility that housing prices might someday fall, and to not weigh these possibilities against the minor problem of getting paid in full early, is nothing short of gross incompetence. Getting paid early is nowhere as serious a problem as not getting paid at all, and you should not need a Ph.D. to figure that out.

Here is a final pearl from Bear Stearns: "If you are setting aside inordinately high loan loss reserves against your balance sheet, you should consider freeing up the capital for more productive purposes." They apparently took their own, deficient, advice. RIP Bear Stearns.

In closing this section, a word about mortgage innovations and the current crisis is in order. Much of the evidence related to mortgage innovation that was just presented has been focused on poor and middle-class borrowers. Indeed, the strongest incentive for eliminating traditional underwriting standards, as we have seen, came from attempts to help poor and minority borrowers. Nevertheless, newspapers tell us that upper-income individuals are being foreclosed in large numbers as well.

There are two points that need to be kept in mind. First, preliminary evidence (Mian and Sufi, 2008) indicates that the recent increase in defaults has been dominated by those areas populated by poor and moderate-income borrowers. Further, figure 9 (Share of Speculative and Subprime Loans by Census Tract Income), which will be seen later in this report, and the discussion surrounding it show that poor and moderate-income areas had the largest share of speculative home buying, and speculative home buying will be seen, later in this report, to be the leading explanation for home foreclosures. Thus the evidence is that the foreclosures are disproportionately a problem of the poor and moderate-income areas, which is entirely consistent with the weakened underwriting standards discussed above. The fact that foreclosures among poor and moderate homeowners are not receiving the greatest amount of newspaper attention doesn't mean that they are not at the epicenter of the foreclosure problem.

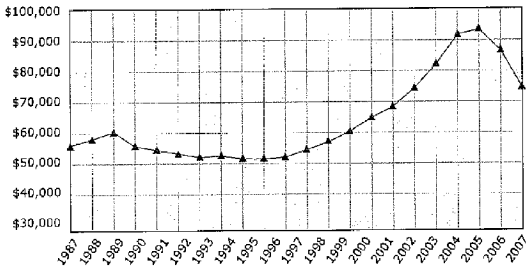
Second, although the original mortgage innovations were rationalized for low- and middle-income buyers, once this sloppy thinking had taken hold it is naive to believe that this decade-long attack on traditional underwriting standards would not also lead to more relaxed standards for higher-income borrowers as well. When everyone cheers for relaxed underwriting standards, the relaxation is not likely to be kept in narrow confines.

3. Empirics of the Current Crisis

The immediate cause of the rise in mortgage defaults is fairly obvious—it was the reversal in the remarkable price appreciation of homes that occurred from 1998 until the second quarter of 2006. Since then prices have sharply declined. The housing price bubble can be easily seen in figure 1, which shows inflation-adjusted housing prices since 1987.

Prices in the second quarter of 2008 are not yet available, but they appear likely to drop by more than 5 percent compared to the first quarter (since

Figure 1: Yearly Real (1983$) Home Prices
(Case Shiller National)



we have two months of data in the quarter), which would make the average real price in the second quarter of 2008 approximately $70,000 in 1983 dollars.

It is difficult to determine why bubbles come into existence. There are often many elements, including economic, psychological, reglatory, and political ones. One element in this case was an extremely large increase in the number of families qualifying for mortgages under the relaxed lending standards which then translated in higher ownership rates.

Figure 2 illustrates changes in home ownership rates beginning with 1970. Except for a small but temporary increase in the late 1970s, these rates had been basically flat until 1995, whereupon they began a steep ascent. Why did home ownership increase in the mid 1990s? it is almost certainly due to the relaxing of lending standards whose machinery, as we have seen, was starting to be put in place in 1993. This was also the conclusion of the Federal Reserve Bank of San Francisco in 2006:[11]

Figure 2: Yearly Home Ownership Rates (U.S. Census)

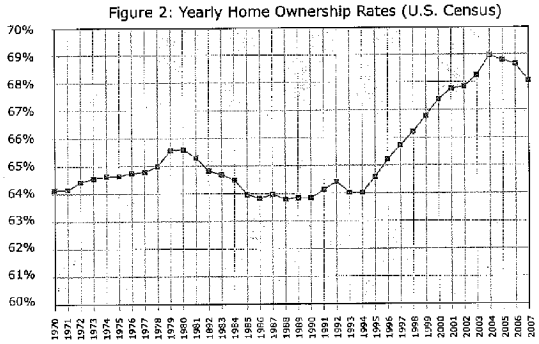
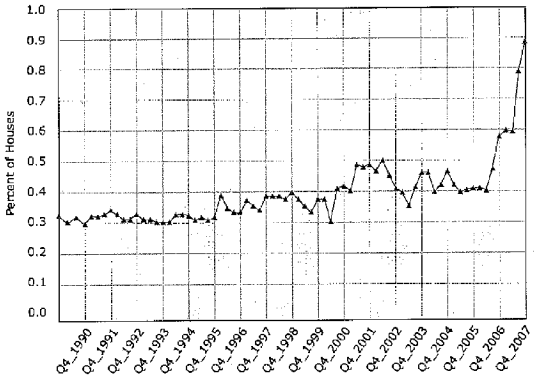


Figure 3: Foreclosures Started



> We examine several potential reasons for this surge in the homeeownership rate. We find that, while demographic changes have some role to play, it is likely that much of the increase is due to innovations in the mortgage inddustry that may have helped a large number of households buy homes more easily than they could have a decade ago. (My emphasis).

Those "innovations" are the same ones discussed at length above.

If relaxed lending standards allowed more households to qualify for financing, basic economics also says that housing prices would have risen as the demand for homes increased. Some portion of the housing price bubble, perhaps a large portion, must have been caused by the relaxed lending standards.

Of course it is not the rising portion of the bubble that causes unhappiness. In fact inflating bubbles are usually associated with joy, and the robust housing market was generally looked at benignly and considered good for the economy. The rising home prices would also keep the dark underbelly of relaxed lending standards from view since any homeowners having difficulties handling their mortgages, and there must have been many who would have run into trouble relatively quickly, could easily refinance or sell their home at a profit. Defaults would remain a rarity even for loans that should never have been made.

When housing prices started to fall, however, all the joy and happiness came to an end. The increase in home prices peaked in the second quarter of 2006 according to Case-Shiller statistics. It is probably not a total coincidence that foreclosures began to rise in the very next quarter, the third quarter of 2006, as can be seen in figure 3.[12]

The increase in foreclosures began rising virtually the minute housing prices stopped rising. It did not take much of a nominal decline in home prices to have a very large impact on foreclosures, which is important to note. Nominal housing prices dropped a mere 1.4 percent in the six months from the second quarter of 2006 to the fourth quarter of 2006. Yet foreclosure start rates (rates of loans entering the foreclosure process) increased by 43 percent, from

0.40 percent of homes to 0.57 percent of homes. At that moment in time, with virtually no price decline yet in evidence, foreclosure start rates were already at a record high, some 21 percent higher than they had ever been in the modern (post 1978) period. This increase in foreclosures was not due to an economic recession, since the economy was still humming along. This increase in foreclosures was not due to a large price drop in homes, because virtually none had yet occurred.

It is hard not to surmise that this sudden jump in foreclosure starts (from 170,000 to 248,000) came from homeowners who, having been able to purchase their home without putting any money down, intended to flip or refinance their home at a profit within a relatively short period of time. Once the home appreciation stopped, and these homeowners could no longer quickly flip or refinance their home at a profit, it is likely that some of them would have walked away, particularly in states like California, where lenders have no recourse and cannot go after an individual's assets. We know, from the several television shows on the subject (such as *Flip That House*), that there was considerable interest in short-term home ownership. Nevertheless, this is only a conjecture, although one that seems to explain the data, including more detailed data discussed later in this report, quite well.

Through 2007 and 2008, prices have continued to fall and foreclosures have continued to rise. It is generally agreed that the enormous increase in foreclosures was due in large part to the absurdly loose mortgage underwriting that had been allowed on many approved mortgages prior to the financial panic and the stricter underwriting standards that have since been put temporarily into place. Reporters have had a field day describing the various loans that had become popular: liar loans, where the applicant made up a figure for income without verification; zero-down loans, where the applicant did not have to provide any money in order to purchase a home; option ARMs, where the borrower was able to choose the payments they would make each month even if the size of the outstanding mortgage kept increasing; and other variations of these types of loans.[13]

Of course, relaxed lending standards, or underwriting innovations as it is euphemistically put, were so successful that standards were loosened across the board so that even a prime loan applicant could avoid making virtually any down payment by taking out a piggyback second mortgage to cover the down payment required by the first mortgage (often both mortgages were made by the same lender).

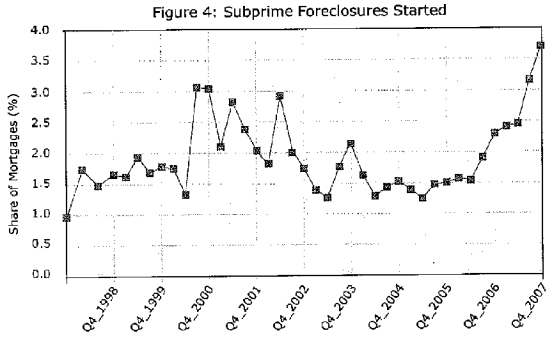
In spite of the abundant evidence of all the various successful attempts to relax underwriting standards, almost no one wants to blame those relaxed standards for what has happened. Instead, almost all the blame is focused on subprime lenders who happen to specialize in loans that use relaxed lending standards. Unscrupulous subprime lenders, we are told, are the guilty parties responsible for financial calamity at both the macro level and the personal level. They are financial vampires, sucking the life-blood from hypnotized mortgage applicants who have signed forms giving away their souls.[14] I refer to this as the subprime bogeyman story.

Forgotten in this story is the fact that the increase in subprime lenders helped to fuel the increase in home ownership, which was largely made up of poor and minority applicants. This is exactly what the purpose of the relaxed lending standards was supposed to be.

4. Problems with the Subprime Bogeyman Hypothesis

The bogeyman in the mortgage story is the unethical subprime mortgage broker who seduced unwary applicants out of their hard-earned, sacredly treated assets. This subprime bogeyman charged usurious rates for his mortgages and bamboozled his clients with artificially low teaser rates that allowed them to purchase homes that were unaffordable at realistic interest rates. This character has been pilloried by all manner of politician and pundit. Although a

Figure 4: Subprime Foreclosures Started



convenient scapegoat, this character does not actually appear to be responsible for the main part of the mortgage meltdown. This is not to say that there are not lying and cheating mortgage brokers—there are. But every profession, including economics, has its share of liars and cheaters.

There is an important problem with the hypothesis that evil subprime lenders caused the mortgage meltdown. That problem is the fact that *subprime loans did not perform any worse than prime loans.* Let's take a look.

Figure 4 shows Foreclosures Started for subprime loans. Just as for overall mortgages, the increase began in the third quarter of 2006. But this wouldn't be surprising since subprime foreclosures are a large share of all foreclosures. However, while the overall

Figure 5: Prime Foreclosures Started

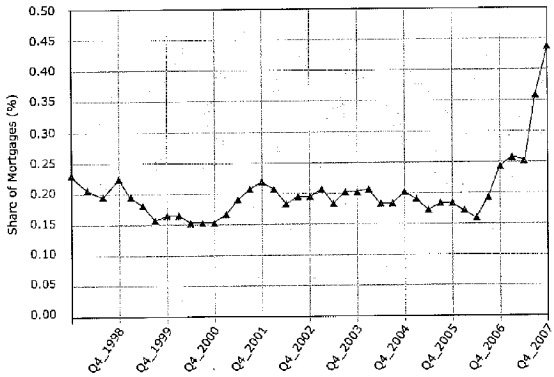


Figure 6: Fixed and Adjustable Subprime Foreclosures Started

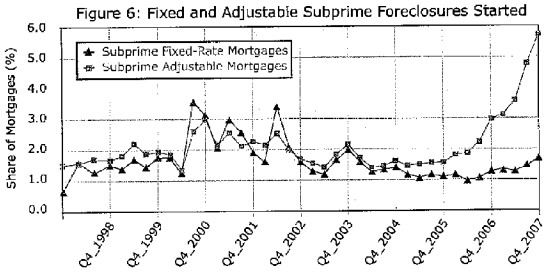
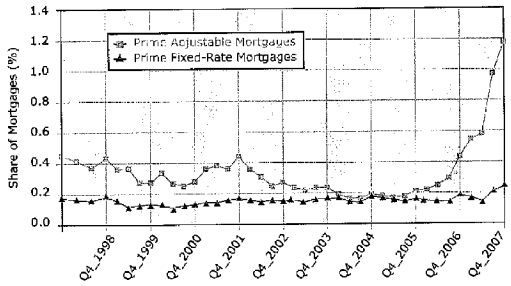


Figure 7: Fixed and Adjustable Prime Foreclosures Started



foreclosure rate was clearly in uncharted territory by the end of 2007, the foreclosure rate of subprime loans, by contrast, is only somewhat above the level that occurred in late 2000 and mid 2002.

It is interesting to compare this to the performance of prime loans, which the media claimed only started suffering from defaults after the problems in the subprime market "seeped" into the prime market.

Prime foreclosures began their increase at the same moment (third quarter of 2006) as subprime foreclosures, as can be seen in figure 5. Further, the prime foreclosure rate went into territory that was far above where it had been in the prior ten years, much more so than was the case for subprime loans. In percentage terms, the increase in foreclosures started from the second quarter of 2006 until the end of 2007 was 39 percent for subprime loans and 69 percent for prime loans.

There is no evidence to support a claim that somehow the subprime market had this unprecedented increase in foreclosures and that later the prime loans accidentally caught the contagion. Both markets were hit at the same time, and the force was at least as strong in the prime market. But this is not to say that foreclosures were not higher in the subprime market. They were. Historically, subprime default rates have been ten times as large as the default rates for prime loans, and that has largely continued

through the mortgage meltdown (just compare the numbers on the vertical axes of the figures 4 and 5). That is one reason that subprime loans carry much higher interest rates than prime loans.

It has also been claimed that *adjustable-rate* subprime loans have been hit harder by foreclosures even than fixed-rate subprime loans. This is true. Figure 6 illustrates this fact.

The foreclosures on subprime adjustable-rate mortgages track closely with the foreclosures on subprime fixed-rate mortgages until 2005, at which point they begin to sharply diverge. Foreclosures on subprime *adjustable* loans began to increase in late 2005 and had increased by almost 300 percent by the end of 2007 (almost 200 percent from the second quarter of 2006). Fixed subprime loans, by contrast, also had defaults rise from mid 2006 until mid 2007 (by almost 80 percent), but the foreclosure rate at the end of 2007 was considerably lower than it had been in previous years, such as 2000–2002 or the end of 2003.

The prime adjustable-rate mortgage foreclosures, pre 2005, do not track quite as closely with the prime fixed-rate mortgage foreclosures, unlike the close tracking of the two types of subprime loans. Figure 7 shows the two series. Prime adjustable-rate mortgages routinely had higher default rates than prime fixed-rate mortgages for the first six years of data, and then the two briefly coalesce from 2004 through 2005 before diverging sharply again in 2006. As was the case for subprime loans, however, when prime foreclosure rates diverge, the *adjustable* prime foreclosure rate skyrockets.

Prime fixed-rate mortgage foreclosures went up by 54 percent from the second quarter of 2006 until the end of 2007, which is not a small number, but visually the increase doesn't appear to be much because it is so dwarfed by the adjustable-rate mortgages. Fixed-rate prime defaults are also at all-time highs by the end of 2007, but not by much. This result is completely overshadowed, however, by the increased default rates of adjustable-rate prime loans, which increase by almost 400 percent over the same period and which reached levels unlike anything in the previous decade. Again, adjustable-rate prime mortgages are hit as hard or harder than the adjustable-rate subprime mortgages.

The main facts standing in the way of the subprime bogeyman theory is that adjustable-rate prime mortgages had a larger percentage increase in default rates than did the subprime market and that overall there was very little difference between the prime market and the subprime market.

Since the subprime bogeyman, by definition, does not inhabit the prime mortgage territory, this theory is then at odds with the performance that has actually taken place in the mortgage markets. Why would mortgage defaults increase so greatly in the prime adjustable-rate market where there was no bogeyman at work? Prime mortgage brokers do not charge usurious rates. They presumably do not face witless clients across the desk that can be easily bamboozled.

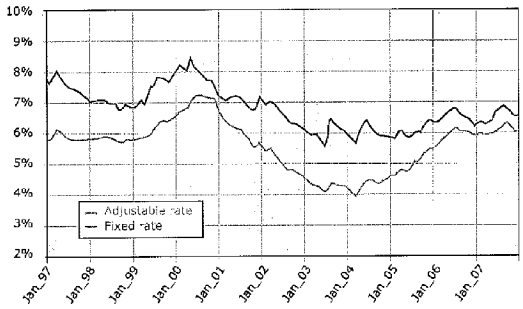
The subprime bogeyman story requires that only subprime mortgages perform badly relative to prime mortgages. They did not. Nevertheless, this story was so strongly believed that it probably explains why most news stories failed to properly note that the rise in prime defaults was occurring at exactly the same time as in the subprime market and instead intoned that the subprime market problem was "leaking" into the prime market.

5. Interpreting These Results

So, if there is no subprime bogeyman on whom the mortgage meltdown can be blamed, what's a politician to do?

Before answering that, it is worthwhile to think about why it might be that adjustable-rate mortgages performed so much worse than fixed-rate mortgages. The story that is popular about poor performing adjustable-rate subprime mortgages was that bogeyman mortgage brokers led the subprime customers to purchase homes they could not afford because

Figure 8: Fixed and Adjustable Mortgage Rates



their initial lower rates would help them qualify for such a house. What adjustable-rate mortgages do, of course, is to provide lower interest rates initially, at the risk of rates rising later, although they also may fall later.

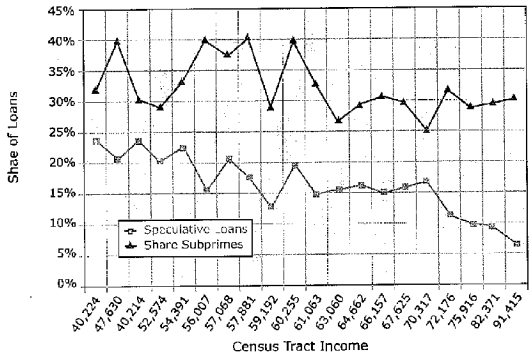
Figure 6 (Fixed-Rate and Adjustable-Rate Subprime Foreclosures Started) makes it clear, however, that adjustable-rate subprime mortgages did not have higher defaults in prior years than did fixed-rate subprime mortgages. This then shows another weakness in the bogeyman theory. Why would subprime customers be less susceptible to being bamboozled prior to 2005?

Actually, customers should have been more likely to be bamboozled prior to 2005. Figure 2 (Yearly Home Ownership Rates, 1970–2007) shows that new homeowners entered the market in great numbers from 1994 until 2005. Because this increase had come to an end by 2006, applicants truly unfamiliar with the mortgage process should have been less common in 2006 than had been the case in prior years. If these naïfs were steered to adjustable-rate mortgages, we should have seen the higher defaults for adjustable-rate mortgages prior to 2005.

Left out of the story so far is the impact of interest rates. After all, if interest rates increased then adjustable-rate mortgage (ARM) payments would ratchet up when they adjusted and some defaults would be likely to ensue. The timing of when the original rate adjusts in an ARM varies from one loan to another. The adjustment period for common adjustable-rate mortgages can change within a year, or after three or five years, or at any time for option-adjustable mortgages.

Figure 8 provides a short history of both adjustable and fixed rates for mortgages.[15] The first notable feature is that adjustable mortgages always have lower interest rates than fixed mortgages. This is for the simple reason that otherwise no borrower would ever prefer an adjustable-rate mortgage. Banks can offer adjustable mortgages at lower rates since such mortgages reduce their risk. Thirty-year mortgages are commitments to receive a fixed payment for thirty years. If high inflation (and high short-term interest rates) occurs in the intervening years, the bank would take a loss since the payments they receive from these mortgages do not rise with inflation. If interest rates fall, you might think that the bank would benefit in a symmetrical way, thus evening things out, but that is not the case since the mortgagee can refinance at a lower rate, depriving the bank of the gain. Since adjustable-rate mort-

Figure 9: Share of Speculative and Subprime Loans by Census Tract Income



gages change with the market, the bank is not stuck on the wrong side of an asymmetrical contract, and thus banks are willing to accept lower interest rates in return.

The other major feature of figure 8 is the drop in mortgage rates from mid 2000 until the beginning of 2004 followed by an increase in adjustable mortgage rates until mid 2006 (rates on fixed-rate mortgages remained relatively constant).

There is some evidence here that is consistent with a claim that higher interest rates in 2006 and 2007 might have led to defaults for mortgages adjusting in those years since the new interest rates would be higher than the old if the original rate were set in 2003 or 2004. Note, however, that a somewhat smaller but still substantial increase in interest rates occurred during 1999 and through mid 2000, yet it had a very unclear impact on defaults. For subprime loans, defaults on adjustable-rate mortgages rose substantially in 1999 and remained high in 2000. The problem with attributing this to the increase in interest rates is that defaults for fixed-rate subprime mortgages exhibited virtually identical behavior, indicating that something other than the higher interest rates was responsible for the increase in mortgage defaults. For prime mortgages in 1999 and 2000, defaults reached a nadir in 1999, and although they did increase in 2000, this just brought them back to 1998 levels when the interest rates were not increasing. Since increases in interest rates at that time did not lead to much of an increase in foreclosures, it seems unlikely that the very large recent increase in defaults is due to increased interest rates.

It is also worthwhile to remember that much of the world, such as Canada, operates with only adjustable-rate mortgages and you do not see massive defaults every time interest rates rise.

Which brings us back to the question: why did default rates rise so rapidly for adjustable-rate mortgages but nowhere as quickly for fixed-rate mortgages? Higher interest rates seem unlikely to account for more than a small part of the increase in defaults. Declines in house prices, or more precisely, the ending of the price rise should have impacted both fixed-rate and adjustable-rate mortgages equally, if the population of homeowners was similar for the

two types of loans since either group is as likely as the other to be underwater when home prices fall.

One possibility for the remarkable increase in defaults on adjustable-rate mortgages is that adjustable-rate mortgages drew a very different type of home buyer than did fixed-rate mortgages. Fixed-rate mortgages, since they charge higher interest rates, make sense for people who plan to stay in their homes for several years and who do not want to risk the possibility of rates increasing. Adjustable-rate mortgages, on the other hand, are most attractive for people who intend to stay in a home for only a short period of time if at all. Such buyers get the lower interest rate without the worry about interest rates rising in the future, since they do not intend to own the home long enough for the rates to reset.

One type of home purchaser that would be particularly attracted to adjustable-rate mortgages is the speculative buyer. These would be people not expecting to stay in their house very long. One subtype in this genre is a *flipper*, as seen on several television shows. House flippers are people who intend to make some alterations to a house and then sell it at a profit. Another type of person looking for a short-term gain can be called an *ATMer*. These are individuals or families who like to use the appreciation of a house as a personal ATM. Often, members of this latter group try to move up to larger houses so that the appreciation would be greater (assuming there would be appreciation). Sometimes someone in this latter group will purchase a second house to rent out as they wait for it to appreciate. Because of the unprecedented rise in house prices on the upside of the housing bubble, house speculation was a very successful activity drawing many new individuals into it.

Flippers never intend to hold the houses that they work on for very long and do not live in the house. ATMers often do not plan to stay in a house very long and sometimes do not live in the house. Such buyers would prefer a mortgage with the lowest possible rate, even just a teaser rate, since they plan to be out of the house before the rate resets. Since it would never make sense for these types of house buyers to get fixed-rate loans, their foreclosures will show up in the adjustable mortgages, whether prime or subprime. That is consistent with the fact that prime and subprime adjustable-rate mortgages each experienced enormous increases in defaults the minute that housing prices stopped rising. The foreclosures could easily be due to speculators being unable to profit from the property and thus just defaulting instead.

How many such speculative home buyers are there? According to the National Association of Realtors, speculative home purchases amounted to 28 percent of all sales in 2005 and 22 percent in 2006.[16] These numbers are large enough that if only a minority of speculators defaulted when housing prices stopped increasing, it could have explained all or most of the entire increase in foreclosures started. Although it is unlikely that speculators are responsible for the entire increase in foreclosures, the fact that foreclosures are very high where speculation was rampant (Florida, Las Vegas, and California) further strengthens this hypothesis. The alternative bogeyman explanation does not seem to explain why foreclosures are so high in these locations.

The type of speculation described here might sound like a middle- or upper-class activity. In fact, the areas where this type of speculation seems most common are lower-income areas. The lower line in figure 9 reveals that areas with low incomes have a larger share of homes bought speculatively. The measure of speculation is the share of mortgages made to people not planning to make the house being purchased their primary residence. The data come from the 2006 HMDA. This particular measure of speculation is actually biased against such a finding because it includes vacation homes as short-term speculative purchases (which they are not since people buying vacation homes plan to own them a long time), and vacation homes tend to be in higher priced neighborhoods.

Indeed, speculation is more strongly negatively related to income in a census tract than is subprime mortgage origination (where subprime is defined as mortgages with above-normal interest rates), which is the upper line in figure 9. The point of this comparison is to show that speculation is more strongly related to an area's income than is subprime lending. Indeed, speculation occurs at more than twice the rate in low-income areas than in wealthier areas.

Although this evidence supports a view that the increase in foreclosures is mainly due to speculators, it is not a direct test. Whether speculators are responsible for most of the dramatic increase in defaults can be, in principle, more directly tested. Since speculators are less likely to live in the homes they purchase than are ordinary purchasers, a direct test would be to examine whether homes that are defaulting also have lower occupancy-by-owner rates than typical homes. In particular, how much of the increase in foreclosures would seem to be due to owners who did not occupy the house? This, unfortunately, would require data of finer granularity than found in typical data sets, and whether such data even exist is unknown to me.

A second and weaker approach would be to examine the share of homes that are purchased to be lived in for both fixed- and adjustable-rate mortgages and see whether the population of homes that are not occupied by the owner has a higher percentage of adjustable-rate mortgages than owner-occupied homes. This would be less definitive as a test, but it would at least examine whether my suggestion that speculative purchasers take primarily adjustable-rate mortgages is correct. Such data probably exist, but I do not have access to it.

6. Conclusions

We are experiencing one of the worst financial panics in the post-WWII era. Everyone knows that the increase in mortgage defaults has been the primary driver for these financial difficulties. The mortgages with outrageously lax underwriting standards that have been justifiably ridiculed in the press are not unusual outliers but unfortunately are representative of a great many mortgages that have been made in the last few years.

The question that is being asked is the correct question: how did it come about that our financial system allowed such loans to be made, condoned such loans, and even celebrated such loans? The answers that are being given are not yet the correct ones, however. The main answer that is being given, that unscrupulous lenders were taking advantage of poorly informed borrowers, does not fit the evidence nor does it dig deep enough.

The "mortgage innovations" that are largely the federal government's responsibility are almost completely ignored. These "innovations," heralded as such by regulators, politicians, GSEs, and academics, are the true culprits responsible for the mortgage meltdown. Without these innovations we would not have seen prime mortgages made with zero down payments, which is what happens when individuals use a second mortgage to cover the down payment of their first. Nor would we have seen "liar loans" where the applicant was allowed to make up an income number, unless the applicant was putting up an enormous down payment, which was the perfectly reasonable historical usage of no-doc loans (which require minimal financial documentation).

The political housing establishment, by which I mean the federal government and all the agencies involved with regulating housing and mortgages, is proud of its mortgage innovations because they increased home ownership. The housing establishment refuses, however, to take the blame for the flip side of its focus on increasing home ownership—first, the bubble in home prices caused by lowering underwriting standards and then the bursting of the bubble with the almost catastrophic consequences to the economy as a whole and the financial difficulties being faced by some of the very homeowners the housing establishment claims to be trying to benefit.

The evidence on foreclosures is consistent with an overall loosening of underwriting standards, as I described earlier, not with the subprime bogeyman story being put forward by the housing establishment and its pliant political supporters.

The key facts are that both subprime and prime loans had large increases in foreclosures at the same time. The subprime vulture hypothesis just does not fit the evidence. The main driver of foreclosures was adjustable-rate loans, both prime and subprime. Therefore, any understanding of the current crisis must account for this fact. The subprime bogeyman theory does not.

The hypothesis that currently seems to best fit with the evidence suggests that housing speculators were taking out many loans with the hope of a quick and profitable turnover. These housing speculators did not much care about the terms of their mortgages because they didn't expect to be making payments for very long. But it is clear why they would prefer adjustable-rate mortgages. The hypothesis also is consistent with speculators often lying about their income on their loan applications and taking out teaser rates so they would qualify for larger loans, so they could make a bigger bet on housing. Under this hypothesis borrowers are adults, not witless pawns.

When the housing bubble stopped growing, according to this hypothesis, these speculators turned and ran. The investors who lent money to these speculators are left holding the mortgage-debt bag. The size of the mortgage-debt bag was so massive that fear of being left holding it brought the financial system to its knees.

But let's not blame the speculators here. There is nothing wrong with speculation or speculators. At fault is a mortgage system run by flexible underwriting standards, which allowed these speculators to make bets on the housing market with other people's money. It was a system that invited the applicant to lie about income. It was a system that induced applicants to watch a video instead of providing solid evidence about their financial condition.

Even that would not be so bad if the people making the money available were aware of its use and knew that they would have recourse to getting their money back. But the money for the speculation was made available by lenders who believed the housing and regulatory establishment when this housing and regulatory establishment said that such loans were safe. Since the housing and regulatory establishment consisted of mighty government agencies and highly educated academics, it was not unreasonable for the lenders to assume that the claims made for flexible underwriting standards were correct. Unfortunately, the claims were not correct although most of the housing and regulatory establishment continue to argue otherwise.

Hindsight is the best sight, they say. Unfortunately, the housing establishment and our political leaders seem intent on not learning from the past. Hopefully this report can help move the debate in a direction that will allow for more productive learning.

Notes

1. Including academic winds. The article (Munnell et al. 1996) was published in the *American Economic Review*, and the editor presumably felt strongly enough about the political conclusions that he refused to run any comments on the article. Further, he allowed the Boston Fed authors to malign the work of one of their critics, David Horne, by alleging that he could not reproduce certain of his results, which Horne denied. I believe Horne.
2. All quotes were taken from Paulette Thomas, "Boston Fed Finds Racial Discrimination in Mortgage Lending Is Still Widespread," *Wall Street Journal* (October 9, 1992): A3.
3. It was actually called "[Closing the Gap:] A Guide to Equal Opportunity Lending." There were no authors listed, but Susan E. Rodburg and Richard C. Walker III were listed as project coordinators. Available at http://www.bos.frb.org/commdev/commaff/closingg.pdf.
4. This is true regardless of whether the counseling is at the individual level, based on classroom "education" or conducted over the telephone. See Spader and Quercia (2008).
5. Both of these stories are reported at http://www.minorityprofessionalnetwork.com/News/Countrywide.htm.
6. See http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/06-08-2005/0003824590&EDATE=.
7. "Case Study: Countrywide Home Loans, Inc." Fannie Mae Foundation (2000). http://www.fanniemaefoundation.org/programs/pdf/rep_newmortmkts_countrywide.pdf.
8. Dale Westhoff. "Packaging CRA Loans into Securities." Mortgage Banking (May 1 1998). http://www.allbusiness.com/personal-finance/real-estate-mortgage-loans/677967-1.html.
9. Lucchetti, Aaron, and Serena Ng. "Credit and Blame: How Rating Firms' Calls Fueled Subprime Mess—Benign View of Loans Helped Create Bonds, Led to More Lending." *Wall Street Journal* (August 15, 2007).
10. For a recent and careful analysis showing that LTV is the key factor leading to foreclosures, see Gerardi et al. (2007).
11. "The Rise in Homeownership." *Federal Reserve Bank of San Francisco Economic Letter Number 2006-30* (November 3, 2006). http://www.frbsf.org/publications/economics/letter/2006/el2006-30.html.
12. All statistics on foreclosures come from the Mortgage Banker Association. There are several measures of delinquency and default. The measure chosen for the charts here is "foreclosures started," which differs from foreclosure inventory, which was not chosen since the latter depends on more than just what is happening in the most recent quarter, meaning that how quickly or how slowly homes leave foreclosure also impacts the inventory.
13. An exquisite personal story illustrating these points involves one Dien Truong from Richmond, California, a thirty-five-year-old water deliveryman who refinanced his home with an option adjustable-rate mortgage for $628,000, from which he promptly removed $156,000 to purchase a second house. On his loan application he and his wife claimed to make more than twice as much income as they actually earned. His loan balance on the first mortgage, since he had opted to pay less than the interest payment on the mortgage, is now $690,000, and he cannot make his monthly payments. Says Mr. Truong, "I've been a good customer . . . This time my credit will be screwed up for good." See Simon, Ruth, "FirstFed Grapples with Payment-Option Mortgages." *Wall Street Journal* (August 6, 2008).
14. I apologize for mixing metaphors.
15. These data come from HSH Associates. It is a quite imperfect measure since it is an amalgam of slightly different mortgages (points and so forth) mixed together to come up with an average rate. The data can be found at http://www.hsh.com/mtghist.html.
16. See "Vacation-Home Sales Rise to Record, Investment Sales Plummet in 2006." National Association of Realtors. (April 30, 2007). http://www.realtor.org/press_room/news_releases/2007/phsi_apr07_vacation_home_sales_rise.

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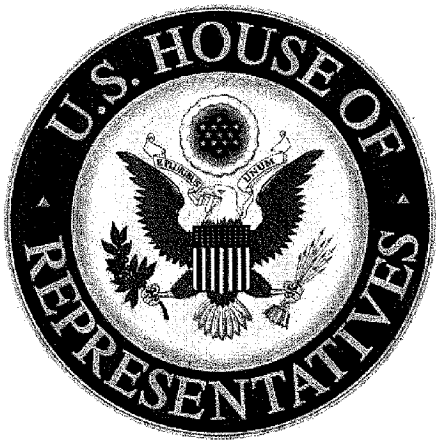

The Role of Government Affordable Housing Policy in Creating the Global Financial Crisis of 2008

STAFF REPORT
U.S. HOUSE OF REPRESENTATIVES
111TH CONGRESS
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
JULY 7, 2009

INTRODUCTION

The housing bubble that burst in 2007 and led to a financial crisis can be traced back to federal government intervention in the U.S. housing market intended to help provide homeownership opportunities for more Americans. This intervention began with two government-backed corporations, Fannie Mae and Freddie Mac, which privatized their profits but socialized their risks, creating powerful incentives for them to act recklessly and exposing taxpayers to tremendous losses. Government intervention also created "affordable" but dangerous lending policies which encouraged lower down payments, looser underwriting standards and higher leverage. Finally, government intervention created a nexus of vested interests – politicians, lenders and lobbyists – who profited from the "affordable" housing market and acted to kill reforms. In the short run, this government intervention was successful in its stated goal – raising the national homeownership rate. However, the ultimate effect was to create a mortgage tsunami that wrought devastation on the American people and economy. While government intervention was not the sole cause of the financial crisis, its role was significant and has received too little attention.

In recent months it has been impossible to watch a television news program without seeing a Member of Congress or an Administration official put forward a new recovery proposal or engage in the public flogging of a financial company official whose poor decisions, and perhaps greed, resulted in huge losses and great suffering. Ironically, some of these same Washington officials were, all too recently, advocates of the very mortgage lending policies that led to economic turmoil. In a number of cases, political officials even engaged in unethical conduct, helping their political allies, family members and even themselves obtain lucrative positions in the mortgage lending industry and other benefits. At a time when government intervention in private markets has become alarmingly common, government "affordable housing" initiatives offer important lessons about the dangers of government efforts to manipulate or conjure outcomes in the market.

EARLY HISTORY OF FANNIE MAE AND FREDDIE MAC

Prior to the creation of Fannie Mae, there was no national mortgage market in the United States. Instead, the mortgage industry was concentrated primarily in urban banking centers, making affordable home financing difficult to come by for many rural residents. The widespread banking failures of the Great Depression exacerbated this problem. In response, Congress passed the National Housing Act of 1934, creating the Federal National Mortgage Association, or Fannie Mae, as a purely governmental agency. Fannie Mae purchased home loans from mortgage lenders and financed these purchases by issuing government bonds. Fannie, and its congressionally-chartered competitor Freddie Mac, removed the burden of these liabilities from bank balance sheets, freeing up capital that otherwise would have been tied down to protect the banks from the risk of loan default. As policymakers intended, this service increased the amount of money local banks could lend to homebuyers – it increased the liquidity of the mortgage market.

In 1968, President Lyndon Johnson, facing mounting budget deficits and criticism over American involvement in Vietnam, contrived a scheme to reduce government debt by privatizing Fannie Mae. Enacted as part of the Housing and Urban Development Act of 1968, this maneuver amounted to an accounting sleight-of-hand that removed Fannie Mae's large liabilities from the Federal balance sheet in a single stroke. In reality, however, the markets never truly believed that the newly-designated government-sponsored enterprise ("GSE") was in fact a private company.

FANNIE AND FREDDIE: WHY THEY DOMINATED THE MORTGAGE MARKET

Fannie Mae's and Freddie Mac's dominance in the secondary mortgage market was made possible by numerous competitive advantages stemming from their unique relationship with the federal government. These advantages for the two GSEs were justified by the government as an implicit subsidy to American homeowners in the form of reduced mortgage rates. With the help of these subsidies, Fannie and Freddie were able to squeeze out their competition and corner the secondary mortgage market. At their height, they controlled over three-quarters of the secondary market for prime mortgages in the United States. Wall Street and others were left with the nonprime, non-conforming market, mainly risky subprime and Alt-A loans.[1]

Their chief advantage began with their government sponsored mission: Fannie and Freddie were charged by Congress with keeping the secondary mortgage market liquid and increasing the availability of affordable housing. They enjoyed a $2.25 billion line of credit from the U.S. Treasury. Because of this mission and their special connection to the Federal government, the market viewed them as extensions of the U.S. government and therefore "too big to fail." No other private companies could borrow money at such an affordable rate. Private debt markets were willing to lend the GSEs money at an interest rate not much greater than the "risk-free" rate they charged the U.S. government itself.

As a business model, Fannie and Freddie would sell bonds in the debt markets at a relatively low cost and use the borrowed money to turn around and purchase mortgages from primary lenders like Countrywide Financial that dealt directly with customers seeking home loans. Oftentimes, they would then bundle many of these mortgages into securities and either sell them to investors, who paid Fannie and Freddie a fee to guarantee payment in the event the mortgages defaulted. The GSEs could also hold the securities in their own portfolios, making profits off the difference between their low cost of debt and the higher rates borrowers paid on their mortgages.

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[1] Federal bank regulators have defined subprime borrowers as those with multiple recent mortgage delinquencies, foreclosures or bankruptcies, a high probability of default as indicated by a credit score below 660, and/or a debt service-to-income ratio of 50 percent or greater. *See* http://www.federalreserve.gov/Boarddocs/SRletters/2001/sr0104a1.pdf. Investopedia.com defines Alt-A mortgages as "types of loans [that] are attractive to lenders because the rates are higher than rates on prime classified mortgages, but they are still backed by borrowers with stronger credit ratings than subprime borrowers. However, with the higher rates comes additional risk for lenders because there is a lack of documentation - including limited proof of the borrower's income."

Another advantage Fannie and Freddie enjoyed was that Congress, by statute, allowed them to operate with much lower capital requirements than their private sector competitors. Federally-regulated banks are required to hold 4 percent capital against their mortgages. By federal law, however, Fannie Mae and Freddie Mac were only required to hold 2.5 percent capital against their on-balance sheet mortgages, and only 0.45 percent against mortgages they guaranteed.[2] According to one witness who testified before the Committee on the role of the GSEs in the financial crisis, "the capital requirements were an anomaly that artificially restrained depository institutions from competing effectively with the GSEs."[3] Much like the borrowers who took advantage of government efforts to lower down payments on mortgages, low capital requirements allowed Fannie Mae and Freddie Mac to use huge amounts of leverage. During hearings on the collapse of Wall Street investment bank Lehman Brothers, Members of the Committee were outraged to learn that Lehman Brothers was leveraged at a ratio in excess of 30-to-1. However, Fannie and Freddie used their congressionally-granted advantages to leverage themselves in excess of 70-to-1, and even did so in an undiversified market – housing. Furthermore, because their abnormally low capital requirements were set by U.S. law, the GSEs' weak regulator, the Office of Federal Housing Enterprise Oversight ("OFHEO") that was supposed to regulate the safety and soundness of the companies, could not raise the GSEs' capital requirements or limit their borrowing to address their overleveraging without congressional action. This exposed the GSEs and – ultimately, the taxpayers – to tremendous latent risks in the event of a housing market collapse.

Fannie Mae and Freddie Mac were also allowed to sell debt to banks in the guise of "preferred shares," and the government even encouraged banks to hold this debt, which exposed them to catastrophic consequences in the event of a GSE collapse. Only about 50 percent of the capital the GSEs held consisted of equity raised from the sale of common stock and retained earnings. The other 50 percent was raised through the sale of preferred stock to banks at below-market rates.[4] Fannie and Freddie were able to do this because federal bank regulators allowed federally-regulated national banks to apply a risk-weighting of just 20 percent against GSE preferred stock.[5] This stands in stark contrast to their holdings of other preferred stock, which required risk weighting of 100 percent. In other words, the federal government encouraged regulated banks to purchase GSE preferred stock by allowing them to hold 80 percent less capital against it compared to similar assets, providing a major subsidy to their purchase of what amounted to cheap borrowing by Fannie and Freddie.

Fannie Mae and Freddie Mac were also exempt from key regulatory and market oversight. For example, their congressional charters exempted them from oversight by

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[2] *See* P.L. 102-550, Sec. 1362.
[3] See Arnold Kling, testimony before the House Oversight and Government Reform Committee, (December 9, 2008).
[4] *See* Edward Pinto, testimony before the House Oversight and Government Reform Committee, (December 9, 2008).
[5] *See* Office of the Comptroller of the Currency, Interpretive Letter #964, (May 2003), *accessed at* http://www.occ.treas.gov/interp/may03/int964.pdf.

the Securities and Exchange Commission ("SEC"): the GSEs are the only publicly-traded corporations exempt from SEC oversight. It was not until scandals in 2003 and 2004 revealed that the companies had used non-approved accounting practices to manipulate earnings that they agreed to "voluntary" SEC filings. The GSEs were also exempt from market oversight of the quality of their mortgage-backed security issuances. The GSEs packaged much of their $5 trillion in mortgages into mortgage-backed securities. These securities were sold to investors, who received the interest and principal payments associated with the underlying mortgages much like a bond. Fannie and Freddie also guaranteed investors that they would take the loss if the security went bust due to defaults among the underlying mortgages. Mortgage securitization is a useful financial tool that can be used to increase liquidity and spread risk. However, as with most tools, securitization can become dangerous when not used with the proper safety precautions.

One critical safety precaution is a credit rating derived from a risk analysis of the mortgages that underlie a mortgage-backed security. During the Committee's investigation of the root causes of the financial crisis, it became evident that the so-called "Big Three" credit rating agencies had become hopelessly compromised, issuing top-line "AAA" ratings on the mortgage-backed securities and collateralized debt obligations of many Wall Street firms.[6] However, Fannie Mae and Freddie Mac securities were exempt from even this flawed process. Instead, all GSE securities carry an implicit "AAA" rating because of the federal government's backing. As the quality of the mortgages the GSEs were willing to buy declined, this exemption became increasingly dangerous to taxpayers.

These competitive advantages and exemptions from regulatory oversight allowed Fannie Mae and Freddie Mac to muscle out their competition and grow to dominate over three-quarters of the secondary market for prime mortgages in the United States. The GSEs entered the 1990s as financial giants that, by most accounts, had successfully helped usher in affordable housing opportunities for Americans while practicing sound lending principles: a requirement for a substantial down payment and reasonable assurances that a borrower could repay a home mortgage.

THE POLITICIZATION OF MORTGAGE LENDING

As publicly traded corporations, the GSEs faced the obligation of all corporations – to maximize the value of shareholders' equity. This meant seeking out profitable opportunities to invest in housing and, to the maximum extent possible, pushing the envelope of innovation in mortgage finance to compete for market share. However, unlike any other publicly traded corporation, Fannie Mae and Freddie Mac also answered in a very direct way to the federal government and elected officials in a manner reminiscent of the "crony capitalism" of countries such as Russia or China, which preserve a large state-owned enterprise sector. Fannie and Freddie answered to the Department of Housing and Urban Development ("HUD"), which set quotas for GSE investment in affordable housing, as well as to Congress and the White House, which

[6] The "Big Three" are Moody's Investors Service, Standard & Poor's, and Fitch Ratings.

sought to use them as vehicles to advance the politically popular goal of increasing the national homeownership rate. This was done directly through legislation and regulation which mandated affordable housing lending and indirectly through political pressure from politicians and advocacy groups. This created incentives for Fannie and Freddie to curry political favor with Congress and necessitated a massive lobbying effort which GSE executives termed "political risk management." As the New York Times summarized it:

> Fannie Mae, the nation's biggest underwriter of home mortgages, has been under increasing pressure from the Clinton Administration to expand mortgage loans among low and moderate income people and felt pressure from stock holders to maintain its phenomenal growth in profits.[7]

In the early 1990s, Fannie and Freddie began to come under considerable pressure to lower their underwriting standards, particularly on the size of down payments and the credit quality of borrowers. A deeply flawed 1992 study published by the Federal Reserve Bank of Boston, purporting that minorities faced discrimination in mortgage lending, was particularly influential at the time. This study has since been shown to have been based on inaccurate data, including loans which were supposedly made to borrowers with a negative net worth. When researchers ran the models again after correcting the flawed data, the discrimination that had been the study's central finding disappeared.[8] Yet the damage had been done and Congress seized on the study as part of a major legislative reorganization of the GSEs' function.

In 1992, Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act, which created an "affordable housing mission" for Fannie Mae and Freddie Mac. This legislation directed HUD to establish three separate quotas requiring the GSEs to set aside a certain percentage of their yearly mortgage purchases to loans with affordable characteristics. These quotas were expressed as the minimum share of mortgages that Fannie and Freddie purchased every year which had to be made to "low- and moderate-income families ... low-income families in low-income areas and very low-income families," as well as borrowers in "central cities, rural areas, and other underserved areas."[9] Congress granted HUD the authority to adjust these three affordable housing quotas for the GSEs over time, allowing both Democratic and Republican Administrations to consistently make campaign promises to boost homeownership through government intervention in the market. Consequently, under both the Clinton and Bush Administrations, HUD dramatically increased these quotas, which reached their zenith when the Bush Administration raised them to 56 percent, 27 percent and 39 percent, respectively.

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[7] *See* Steven A. Holmes, "Fannie Mae Eases Credit to Aid Mortgage Lending," *The New York Times*, (September 30, 1999) *accessed at http://www.nytimes.com/1999/09/30/business/fannie-mae-eases-credit-to-aid-mortgage-lending.html*.

[8] *See* Stan J. Liebowitz, "Anatomy of a Train Wreck: Causes of the Mortgage Meltdown," *Independent Policy Report*, (October 3, 2008), *accessed at* http://www.independent.org/pdf/policy_reports/2008-10-03-trainwreck.pdf.

[9] *See* note 2 at Title XIII.

HUD's affordable housing quotas represented major departures from the GSEs' prior commitment to underwriting only sustainable mortgages. Fannie Mae's original congressional charter acknowledged the risks involved in low down payment loans because it allowed Fannie to purchase loans with less than a 20 percent down payment only in concert with certain mitigating factors such as private mortgage insurance or a repurchase agreement with the mortgage originator.[10] The establishment of the HUD quotas broke this convention and set the stage for the dramatic politicization of mortgage lending.

In 1994, Fannie Mae CEO Jim Johnson announced the company's first affordable housing initiative, the $1 trillion "Opening the Doors to Affordable Housing" program. Johnson, a long-time friend of both President Clinton and Treasury Secretary Robert Rubin, took the helm of Fannie in 1991 after a stint at Lehman Brothers. In an article entitled "Fannie Mae's Trillion-Dollar Giveaway," written about this initial affordable housing initiative, the Los Angeles-based Family Savings Bank criticized Fannie Mae's past practices for relying too heavily on borrowers' income and debt levels when underwriting loans. Although some would consider using such metrics to be prudent, the article stated that these guidelines "must have been written sometime in the 1800s." It praised Mr. Johnson's $1 trillion commitment because it would introduce "qualifying flexibility," for low-income borrowers, allowing them to reduce their down payments to as little as 3 percent. The article cited "pressure from President Clinton's administration," as the primary influence on Fannie Mae's decision to lower its lending standards.[11]

The GSEs also allowed politicians to claim credit for earmark-like affordable housing initiatives in their districts without having to appropriate the money in Congress. In 1994, Johnson opened Fannie Mae's first "partnership office" in a congressional district. These partnership offices "issued thousands of press releases" featuring Members of Congress assisting Fannie Mae with affordable housing initiatives.[12] They also had a reputation for hiring relatives of Members of Congress as employees.[13] This political strategy won Fannie and Freddie allies on Capitol Hill who would prove invaluable in fending off calls to rein in their risky borrowing and lending practices.

In 1995, Johnson seeded the Fannie Mae Foundation with $350 million of Fannie stock. The company used this foundation to spread millions of dollars around to politically-connected organizations like the Congressional Hispanic Caucus Institute.[14] It also hired well-known academics to write papers that gave an aura of academic rigor to policy positions favorable to Fannie Mae. For example, one paper coauthored by now-Director of the Office of Management and Budget Peter Orszag, concluded that the chance was

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[10] *See* Federal National Mortgage Association Charter Act, *accessed at* http://www.fhfa.gov/GetFile.aspx?FileID=29.
[11] *See* Valencia Roner, "Fannie Mae's Trillion-Dollar Giveaway," *Black Enterprise*, (November 1, 1994).
[12] *See* Bethany McLean, "Fannie Mae's Last Stand," *Vanity Fair*, (February 2009).
[13] *See* Peter J. Wallison and Charles W. Calomiris, "The Last Trillion-Dollar Commitment," *American Enterprise Institute Financial Services Outlook*, (September 2008), *accessed at* http://www.aei.org/docLib/20080930_Binder1.pdf.
[14] *See* note 12, *supra*.

minimal that the GSEs were not holding sufficient capital to cover their losses in the event of a severe economic shock. The authors suggested that "the risk to the government from a potential default on GSE debt is effectively zero," and that "the expected cost to the government of providing an explicit government guarantee on $1 trillion in GSE debt is just $2 million."[15] As of May 14, 2009, the taxpayers had already been exposed to $700 billion of GSE bailouts, including $59.8 billion of capital injections by the U.S. Treasury, $73 billion of GSE debt purchases by the Federal Reserve, and $567.3 billion of direct purchases of GSE mortgage-backed securities by both the Fed and Treasury.[16]

CLINTON ADMINISTRATION REFORMS – CRA AND THE NATIONAL HOMEOWNERSHIP STRATEGY

1995 was a pivotal year in the politicization of mortgage lending. In that year, the Clinton Administration implemented a major reform of the Community Reinvestment Act ("CRA") and issued its National Homeownership Strategy ("the Clinton Strategy"), both of which increased pressure on Fannie and Freddie to loosen their lending standards.

The CRA was originally passed in 1977 to prevent banks from engaging in "redlining" – refusing to lend to otherwise credit-worthy borrowers in lower-income neighborhoods. Until 1995, the legislation was largely ineffective because it was very broad in its directives to both banks and regulators. For example, while the legislation called for federally-regulated banks to meet "the credit needs of [their] entire community, including low- and moderate-income neighborhoods," it also directed the regulators to "encourage" banks to achieve this goal. It went on to require regulators to "consider" any failure when banks seek approval from the government for actions such as mergers and acquisitions.[17] It was not surprising that this expansive language was not effective in achieving compliance, as demonstrated by the relative infrequency of CRA enforcement actions against banks.

However, in 1995, the Clinton Administration implemented a major regulatory reform of CRA which emphasized "performance-based evaluation." The impact of this reform was that regulators would no longer rate banks based on their efforts to lend to customers using equitable procedures but rather on the volume of their lending. According to one academic study of CRA, this regulatory change marked "a shift of emphasis from procedural equity to equity in outcome." Furthermore, the "lending test" component of the regulatory review process, which was the "most heavily weighted component of CRA

[15] *See* Joseph E. Stiglitz, Jonathan M. Orszag and Peter R. Orszag, "Implications of the New Fannie Mae and Freddie Mac Risk-based Capital Standard," *Fannie Mae Papers*, (March 2002).
[16] *See* U.S. Department of the Treasury, "Monthly Treasury Statement of Receipts and Outlays of the United States Government," (April 30, 2009), *accessed at* http://fms.treas.gov/mts/mts0409.pdf.
See also, Board of Governors of the Federal Reserve System, "Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks," (May 14, 2009), *accessed at* http://www.federalreserve.gov/releases/h41/Current/h41.pdf.
[17] *See* AKM Rezaul Hossain, "The Past, Present and Future of Community Reinvestment Act (CRA): A Historical Perspective," (October 2004) at 13.

examination," included criteria for the "use of innovative or flexible lending practices." As demonstrated time and again by congressional advocates of affordable mortgage lending, "innovative and flexible" means reduced down payments and riskier, unsustainable lending.[18] This shift of regulatory emphasis from ensuring equitable lending procedures to ensuring equitable lending outcomes regardless of borrowers' ability to repay was subtle but significant. When combined with the endorsement of "flexible and innovative" mortgage underwriting, this change in the CRA represented a troubling move away from prudent and sustainable mortgage lending towards government endorsement of lower quality lending to those of modest means.

Although the annual value of CRA home mortgage lending increased some 250 percent between 1996 and 2008, CRA lending never exceeded about 3 percent of total originations.[19] While CRA cannot be directly blamed for the huge volumes of risky nonprime mortgages that were eventually purchased by Fannie, Freddie and Wall Street investment houses, CRA continued a pattern of behavior of lowering mortgage underwriting standards in order to drive up the national homeownership rate.

The other important event of 1995 was the release of the Clinton Administration's *National Homeownership Strategy*. The document's foreword, penned by HUD Secretary Henry Cisneros, cited President Clinton's directive to "lift America's homeownership rate to an all-time high by the end of the century." Among the methods the Strategy proposed to achieve this bump in the homeownership rate was lower down payments. It observed that, "low- and moderate-income families often cannot become homeowners because they are unable to come up with the required downpayment." It goes on to direct that, "lending institutions, secondary market investors [Fannie Mae and Freddie Mac are the dominant players in the secondary market], and other[s]...should work collaboratively to reduce homebuyer downpayment requirements." The Clinton *Strategy* also called for increased use of "flexible underwriting criteria," which it said could be achieved in concert with "liberalized affordable housing underwriting criteria established by...Fannie Mae and Freddie Mac." It also called for "financing strategies, fueled by the creativity and resources of the private and public sectors to help homeowners that lack cash to buy a home or to make the payments."[20]

The Clinton *National Homeownership Strategy* made only a passing acknowledgement of the risks associated with reducing borrowers' equity in their mortgages and instituting "flexible underwriting standards:"

> The amount of borrower equity is an important factor in assessing mortgage loan quality. However, many low-income families do not have access to sufficient funds for a downpayment.

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[18] *Id.* at 54-57.
[19] CRA volume data *accessed at* http://www.ffiec.gov/craadweb/national.aspx, total subprime mortgage originations *accessed at* www.mortgagedaily.com.
[20] *See* U.S. Department of Housing and Urban Development, *The National Homeownership Strategy: Partners in the American Dream*, (May 1995).

Instead it praised lenders for their efforts thus far toward reducing this "barrier to home purchase" but urged that "more must be done." The report noted that in 1989 only 7 percent of mortgages had less than a 10 percent down payment but that by 1994 this had increased to 29 percent. The *Strategy* praised lenders for developing "innovative low-down payment programs" and applauded Fannie Mae for announcing 3 percent-down payment mortgages. HUD also issued new rules that allowed the GSEs to count subprime mortgages made to low-income borrowers toward their affordable housing goals.

In retrospect, President Clinton's rebranding of prudent down payments of 10 to 20 percent as "barrier[s] to home purchase" takes on great significance. As with the 1995 CRA reform and the Clinton Administration's decision to allow the GSEs to count subprime loans toward their affordable housing goals, this represented a shift in government policy from one that emphasized equity of procedure to equity of outcome. This emphasis on equity of outcome inevitably created tremendous pressure on regulated institutions to make more loans to low-income borrowers. It also created pressure for secondary market investors such as Fannie Mae and Freddie Mac to buy these loans. The correspondingly lower emphasis on how the loans were being made inevitably meant less attention would be paid to their quality and sustainability.

A Freddie Mac spokeswoman later acknowledged that the Clinton HUD's decision on subprime loans "forced us to go into that market to serve the targeted populations that HUD wanted us to serve." Clinton's HUD Assistant Secretary William C. Apgar, Jr. has since called the decision a "mistake," while his former advisor Allen Fishbein called the loans that the GSEs started buying to meet their affordable housing goals "contrary to good lending practices," and examples of "dangerous lending."[21] President Clinton himself acknowledged his role in efforts to loosen mortgage lending standards when he admitted that "there was possible danger in his administration's policy of pressuring Fannie Mae...to lower its credit standards for lower- and middle-income families seeking homes."[22] These accumulated government affordable housing policies, including the Clinton *Strategy*, trapped millions of Americans in mortgages they could not afford.

LOWER LENDING STANDARDS SPREAD AND CAUSE THE HOUSING BUBBLE

Risky mortgage lending, particularly loans with very low down payments, contributed directly to the rise of a housing bubble. Had this risky lending been contained within the low-income segment of the market targeted by politicians advocating more "innovation" in "affordable lending," the damage to the wider economy might have been minimal. However, these "innovations" in "flexible" loans products spread beyond just affordable lending into the entire U.S. mortgage market. The lure of reduced underwriting standards

[21] *See* Carol D. Leonnig, "How HUD Mortgage Policy Fed the Crisis," *The Washington Post*, (June 10, 2008).
[22] *See* Walter Alarkon, "Clinton Rejects Blame for Financial Crisis," *The Hill*, Sept. 9, 2008, *accessed at* http://thehill.com/leading-the-news/clinton-rejects-blame-for-financial-crisis-2008-09-25.html.

held true not just for borrowers of modest income but for those at all income levels. Although the erosion of mortgage underwriting standards began in Washington with initiatives like the CRA as a way to reduce "barriers to homeownership," this trend inevitably spread to the wider mortgage market. One observer noted:

> Bank regulators, who were in charge of enforcing CRA standards, could hardly disapprove of similar loans made to better qualified borrowers. This is exactly what occurred.[23]

Borrowers – regardless of income level – took advantage of the erosion of underwriting standards that started with government affordable housing policy. As one study observed,"[o]ver the past decade, most, if not all, the products offered to subprime borrowers have also been offered to prime borrowers."[24] For example, Alt-A and adjustable-rate mortgages became incredibly popular with borrowers – who were generally not low-income – engaging in housing speculation. As home prices continued their dizzying rise, many people decided to cash in by buying a house with an adjustable-rate mortgage featuring a low introductory teaser rate set to increase after a few years. These borrowers, confident in the oft-cited assertion that U.S. home values had never before fallen in the aggregate, planned to sell or refinance their investment before the mortgage rate adjusted upward, pocketing the difference between the initial purchase price and the subsequent appreciation in value. However, buyers failed to grasp the effect of a government policy that had quietly eroded the prudential limits on mortgage leverage, creating a dangerous speculative bubble.

As the size of down payments for mortgages fell, so too did borrowers' equity stake in the homes they purchased. This had two important effects. First, it eliminated the borrower's "skin in the game," increasing the likelihood that he or she would walk away from the mortgage if times got tough. It also increased the borrower's leverage (debt) as measured by the Loan-to-Value ratio.[25] This leverage allows borrowers to purchase more expensive houses than they would otherwise be able to afford at a given level of income.

It was this process of steadily increasing leverage that drove the complete decoupling of home prices from Americans' income and fed the growth of the housing bubble. As the average down payment shrank and leverage correspondingly increased, the amount of mortgage debt relative to borrowers' income increased. This increasing leverage in turn eroded the power of supply and demand to restrain irrational price increases. In a normal housing market, free of government intervention, an increase in home prices would have been restrained when the marginal, or next, home seller tried to charge a price too high

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[23] *See* Peter J. Wallison, "Cause and Effect: Government Policies and the Financial Crisis," , *American Enterprise Institute Financial Services Outlook*, (November 2008), *accessed at http://www.aei.org/docLib/20081203_1123724NovFSOg.pdf*.

[24] *See* James R. Barth, Tong Li, Triphon Phumiwasana, and Glenn Yago, "Surprise: Subprime Mortgage Products Are Not The Problem!" (December 2007), *accessed at* http://www.milkeninstitute.org/pdf/Subprime-Mortgage-Products.pdf.

[25] According to Investopedia.com, "leverage" is, "the amount of debt used to finance a firm's assets. A firm with significantly more debt than equity is considered to be highly leveraged. Leverage is most commonly used in real estate transactions through the use of mortgages to purchase a home."

for prospective borrowers to afford. This home seller would have been forced to cut his or her unreasonable price.

Once government-sponsored efforts to decrease down payments spread to the wider market, home prices became increasingly untethered from any kind of demand limited by borrowers' ability to pay. Instead, borrowers could just make smaller down payments and take on higher debt, allowing home prices to continue their unrestrained rise. Some statistics help illustrate how this occurred. Between 2001 and 2006, median home prices increased by an inflation-adjusted 50 percent, yet at the same time Americans' income failed to keep up. For the 30 years prior to 2000, the ratio of U.S. home prices to income averaged only about 4-to-1 – in other words, the average American lived in a home costing four times his annual income. In just five years, from 2000 to 2005, that ratio doubled to 8-to-1. As a result of homes becoming more expansive and seemingly less affordable, the only way for many Americans to buy a home during the housing bubble was to dramatically increase their leverage. It is not surprising, then, that between 2000 and 2006 mortgage debt in the U.S. increased by 80 percent. According to one early warning in 2006, the odds against such an increase in the price-to-income ratio occurring naturally were greater than 300-to-1.[26]

Government actions distorted the housing market, yet advocates of affordable housing policies, such as Congressman Barney Frank (D-MA), have asserted that those who criticize these policies seek to place blame for the financial crisis solely on borrowers of modest means.[27] This misses the mark entirely. In fact, responsibility for the erosion of mortgage lending standards, which began with government affordable housing policy, rests squarely on the policy makers who advocated these ill-conceived policies in the first place. Borrowers quite naturally responded to the incentives they were given, irrespective of their socioeconomic status, and risky lending spread to the wider mortgage market.

SPECIAL INTERESTS: THE RISE OF THE "AFFORDABLE" HOUSING COALITION

Under continuing political and economic pressure, the trend toward lowering mortgage lending standards continued apace throughout the 1990s. The GSEs altered their automated mortgage underwriting criteria to encourage banks to make loans to borrowers with damaged credit, in large part to satisfy the Clinton Administration's demand that the GSEs do more to increase homeownership among low-income and minority borrowers as laid out in the Administration's affordable housing strategy.[28] In this vein, Johnson's

[26] *See* Andrew LaPerriere, "Housing Bubble Trouble: Have we been living beyond our means?" *The Weekly Standard*, (April 10, 2006).
[27] *See* Glen Johnson, "Frank Says GOP Housing Attacks Racially Motivated," *Associated Press*, (October 6, 2008).
[28] According to Investopedia.com, "automated underwriting" is "a computer-generated loan underwriting decision. Using completed loan application information, an automated underwriting system retrieves relevant data, such as a borrower's credit history, and arrives at a logic-based loan decision. Automated underwriting engines can provide near-instantaneous loan approval or denial decisions;

successor, Fannie Mae CEO Franklin Raines said that the company had "expanded home ownership for millions of families in the 1990's by reducing down payment requirements."[29] Raines told the Mortgage Bankers Association that he and Freddie Mac CEO Richard Syron "made no bones about their interest in buying loans made to borrowers formerly considered the province of nonprime and other niche lenders." Raines said his goal was, "to push products and opportunities to people who have lesser credit quality."[30]

Fannie Mae and Freddie Mac would ultimately announce over $5 trillion in affordable housing initiatives. Many of these loans came increasingly from large non-bank mortgage lenders like Countrywide Financial Corporation, the country's largest mortgage lender and a major innovator in pushing subprime loans. These non-bank lenders rose to fill the void in mortgage lending left in the wake of the savings and loan crisis, and they grew rapidly in response to government policies that encouraged lower lending standards. A symbiotic relationship developed between these non-bank lenders and the GSEs. For example, Fannie Mae under CEO Jim Johnson reached a "strategic agreement" with Countrywide CEO Angelo Mozilo, under which "Countrywide agreed to deliver a large portion of Fannie's annual loan volume in exchange for special financing terms."[31] In fact, Countrywide regularly accounted for 10 to 30 percent of all the loans purchased by Fannie Mae in a given year. In the words of Mozilo: "If Fannie and Freddie catch a cold, I catch the fucking flu."[32]

Freddie Mac also joined in the subprime action, according to internal documents obtained by the Committee. For example, Freddie developed a plan to partner with non-bank mortgage lender Ameriquest by installing its automated underwriting software on-site.[33] Fannie and Freddie both used their automated underwriting software to divert subprime and Alt-A loans from private label securitizers on Wall Street, driving up demand for risky junk mortgages. By 1997, Fannie Mae was offering to buy loans with only a 3-percent down payment, and by 2001 was offering to buy zero-down payment loans.[34]

Not only could these loans be used to satisfy the government's demand for more low-down payment affordable mortgages, they turned out to be highly profitable as well. Combined with the value of their government subsidies and their ability to operate without far-flung retail operations, the GSEs were phenomenally profitable. Fannie Mae enjoyed perhaps the highest level of net income per employee in the world – about

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therefore, implementing automated underwriting systems can save a considerable amount of time, as manual underwriting can take as long as 60 days to complete. In addition to the time savings, automated underwriting is preferred because it is based on algorithms, eliminating human bias. Freddie Mac maintains and markets a large automated underwriting engine known as Loan Prospector, and Fannie Mae has an automated underwriting engine known as Desktop Underwriter."

[29] *See* note 7, *supra*.

[30] *See* Neil Morse, "Looking for New Customers," *Mortgage Banking*, (December 1, 2004), *in* note 13, *supra*.

[31] *See* Glenn R. Simpson, "Countrywide Made Home Loans to Gorelick, Mudd," *The Wall Street Journal*, (September 25, 2008).

[32] *See* Paul Muolo and Matthew Padilla, *Chain of Blame*, New York: John Wiley & Sons, (2008), at 112.

[33] *See* Freddie Mac, document produced to the Committee, Bates FMAC0013683-FMAC0013692.

[34] *See* note 23, *supra*.

$900,000 per employee according to one estimate.[35] The GSEs paid their executives handsomely as well. Fannie CEO Franklin Raines earned over $90 million in compensation during his six-year tenure.[36] Fannie and Freddie paid billions more to their shareholders every year in dividends. Thus, government subsidization of GSE operations amounted to little more than corporate welfare. Indeed, both the Congressional Budget Office and the Federal Reserve found that only about half of this taxpayer subsidy ever came back to the taxpayers in the form of lower mortgage rates.[37]

Similarly, Wall Street investment houses like Lehman Brothers, Bear Stearns, and Merrill Lynch, which came to specialize in packaging and investing in the lowest-quality tranches of mortgage-backed securities, profited hugely from the increased volume that government affordable lending policies sparked. Private-label securitization of subprime mortgages grew from $60 billion-a-year in 1997 to nearly $500 billion-a-year by 2006.[38] These firms could not compete in any segment of the market Fannie and Freddie chose to close off to them because the GSEs could always undercut Wall Street's costs by virtue of their government-granted competitive advantages. However, as with the GSEs' relationship to non-bank lenders such as Countrywide, Wall Street formed its own symbiotic relationship with Fannie and Freddie. Wall Street firms profited from buying and selling GSE mortgage-backed securities, which because of the government backing were deemed to be as safe as Treasury bonds – but with a higher yield. For their part, the GSEs became the largest purchasers of the "AAA"-rated tranches of Wall Street's private-label securities, while Wall Street invested in the lower-quality portions. However, without the GSEs' participation, it is unlikely that Wall Street could have formed these pools of toxic mortgages, making Fannie and Freddie the indispensable actors in the subprime market.[39] This resulted in consistent downward pressure on down payments and on the credit quality of borrowers, fueling the housing bubble.

The nexus of political advocates of affordable housing, non-bank mortgage lenders like Countrywide, the homebuilding industry, and Wall Street firms came together to create a powerful affordable housing coalition led by Fannie Mae and Freddie Mac and their congressional allies. This group of vested interests used its money, power and influence to protect its political prerogatives and profits, blocking repeated attempts at reform and distorting the relationship between government and business. Between 1998 and 2008, Fannie Mae and Freddie Mac spent over $176 million on lobbyists.[40] They paid lobbyists to influence Members of Congress to block legislative proposals that would have stripped

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[35] *See* Owen Ullmann, "Crony Capitalism: American Style," *The International Economy*, (July/August 1999).

[36] *See* OFHEO, "Report of the Special Examination of Fannie Mae," (May 2006), *accessed at* *http://www.fhfa.gov/webfiles/747/FNMSPECIALEXAM.pdf*.

[37] *See* Congressional Budget Office, "Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac," (May 1996), at xiv, *accessed at* http://www.cbo.gov/ftpdocs/0xx/doc13/Fanfred.pdf. *See also*, Wayne Passmore, Board of Governors of the Federal Reserve System, "The GSE Implicit Subsidy and the Value of Government Ambiguity," (2005), at 3, *accessed at* http://www.federalreserve.gov/Pubs/feds/2005/200505/200505pap.pdf.

[38] Data from Standard & Poor's and Moody's, *accessed at* www.mortgagedaily.com.

[39] *See* note 13, *supra*.

[40] *See* www.opensecrets.org.

them of their preferential advantages. The GSEs even paid lobbyists just so they would not lobby against them. As one person who was offered money not to lobby against the GSEs noted, Fannie and Freddie could rely on a simple and politically powerful message touting their commitment to homeownership to blunt any efforts to rein them in.[41] If that failed, according to one congressional staffer who preferred anonymity, the GSEs could take a tougher line:

> Fannie has this grandmotherly image, but they'll castrate you, decapitate you, tie you up and throw you in the Potomac. They're absolutely ruthless.[42]

When Congressman Jim Leach (R-IA) proposed assessing a fee on the GSEs to offset the federal subsidy they receive on their cost of borrowing, "it took just twelve hours for Fannie to blow the idea out of the water." Fannie Mae also forced then-Treasury Secretary Larry Summers to "tone down" a report that was originally going to criticize the cozy relationship between the federal government and the GSEs.[43] When Congressman Paul Ryan (R-WI) sought to increase regulation of the GSEs, Fannie Mae sent lobbyists to harass him in his Wisconsin congressional district, going so far as to call his constituents and accuse him of seeking to increase mortgage rates, generating 6,000 angry responses to his office. When Ryan transferred to a committee without direct oversight of the GSEs, Fannie CEO Raines sent him a "congratulatory" note. "He meant good riddance," said Ryan.[44] When Congressman Christopher Shays (R-CT) introduced legislation to end the GSEs' unique exemption from SEC registration, he "had lobbyists literally barging into my room," while Fannie CEO Raines reportedly called the lawmaker to ask, "What the hell have [you] done?" The GSEs retaliated by ending their home-buying forums in Shays' congressional district in an attempt to hurt him politically.[45] Congressman Cliff Stearns (R-FL), who scheduled hearings on Freddie Mac's use of improper accounting procedures in 2004, had his jurisdiction over the GSEs stripped by House Speaker Dennis Hastert (R-IL), who assigned the task to Michael Oxley (R-OH), who was the most frequent featured guest at 19 of the fund-raisers Freddie Mac held for members of his committee.[46]

Just as the perils of opposing the vested interests of the affordable lending coalition were rife, so the rewards for supporting them were lucrative. From 2000 to 2008, the GSEs and their employees contributed nearly $15 million to the campaigns of dozens of Members of Congress on key committees responsible for oversight of Fannie and Freddie.[47] At the time federal regulators seized the insolvent companies, sitting Members of Congress had received over $4.8 million in political contributions since 1989, with over $3 million of that coming from the GSEs' political action committees. Of that total,

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[41] *See* Bara Vaida, "Battling Fannie and Freddie," *National Journal*, (October 18, 2008).
[42] *See* note 35, *supra*.
[43] *Id.*
[44] *See* Paul A. Gigot, "The Fannie Mae Gang," *The Wall Street Journal*, (July 23, 2008).
[45] *See* Matthew Murray, "A $90 Million Package Gets Lambasted Again," *Roll Call*, (December 10, 2008).
[46] *See* note 44, *supra*. *See also* Pete Yost, "Freddie Mac Lobbyist Staged 50 GOP Fund-Raisers as Congress Let Legislation Die," *The Associated Press*, (July 18, 2003).
[47] *See* Common Cause, "Ask Yourself Why…They Didn't See This Coming," (September 24, 2008), *in* note 13, *supra*.

57 percent went to Democrats, and 43 percent to Republicans.[48] Not all of this fundraising was in compliance with federal law. In 2006, Freddie Mac paid the largest fine in Federal Election Commission history – $3.8 million – for improperly using corporate resources to hold 85 fundraisers for Members of Congress, raising a total of $1.7 million.[49]

Fannie Mae and Freddie Mac regional partnership offices provided millions in additional contributions to politicians who supported them by funding affordable housing projects in congressional districts. For example, one press release from the office of Senator Charles Schumer (D-NY) read, "Schumer Announces up to $100 Million Freddie Mac Commitment to Address Fort Drum and Watertown Housing Crunch." The release touted that, "Schumer has frequently partnered with Freddie Mac on creative, affordable housing initiatives around the state," and that Freddie had committed to purchase $100 million of loans originated by HSBC bank, including "low-down payment loans."[50] These politicians could then claim credit with their constituents for bringing home these earmark-like subsidies which didn't have to go through the scrutiny of the normal appropriations process.

Fannie and Freddie also served as a revolving door for powerful former politicians, their aides and even their family members. Jim Johnson managed Walter Mondale's 1984 presidential campaign, chaired the vice presidential selection committee for presidential candidate John Kerry, and was involved in President Barack Obama's vice presidential selection process. Franklin Raines had been President Clinton's Director of the Office of Management and Budget. Former Clinton Deputy Attorney General Jamie Gorelick served as Vice-Chairman of Fannie Mae and earned over $26 million in compensation.[51] Former Fannie Senior Vice President John Buckley had served as a Republican Congressional staffer and senior advisor to the presidential campaigns of Ronald Reagan in 1984 and Bob Dole in 1996. Another former Fannie Senior Vice President, Arne Christenson, had been a senior advisor to Republican House Speaker Newt Gingrich.[52] The son of Republican Senator Bob Bennett worked for Fannie Mae's Utah regional office, while Democratic Representative Barney Frank's partner, Herb Moses, worked at Fannie Mae from 1991 to 1998 as Assistant Director for Product Initiatives while Frank sat on the House Banking Committee with responsibility for oversight of the GSEs.[53]

Until President George W. Bush ended the practice, the President of the United States appointed five members to the GSEs' boards. This was a unique arrangement among

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[48] *See* Open Secrets, "Update: Fannie Mae and Freddie Mac Invest in Lawmakers," *accessed at* http://www.opensecrets.org/news/2008/09/update-fannie-mae-and-freddie.html.
[49] *See* Federal Election Commission press release, "Federal Home Loan Mortgage Corporation ("Freddie Mac") Pays Largest Fine in FEC History," (April 18, 2006), *accessed at* http://www.fec.gov/press/press2006/20060418mur.html.
[50] *See* Senator Charles Schumer press release, (November 20, 2006), *accessed at* http://schumer.senate.gov/SchumerWebsite/pressroom/record.cfm?id=266131.
[51] *See* note 36, *supra*.
[52] *See* note 35, *supra*.
[53] *See* note 12, *supra*. *See also* Bill Sammon, "Lawmaker Accused of Fannie Mae Conflict of Interest," *Fox News*, (October 3, 2008), *accessed at* http://www.foxnews.com/story/0,2933,432501,00.html.

publicly-trade companies and solely a function of their hybrid public-private nature. These board positions were highly lucrative sinecures with which Presidents could reward their political allies. Typically, those appointed to the board by the President served for very short periods of time and contributed very little to the day-to-day operations of the company, yet were paid handsomely. For example, current White House Chief of Staff Rahm Emanuel was appointed to the board of Freddie Mac by President Clinton in February 2000, where he served for only 14 months and in return received $320,000 in compensation. He also sold Freddie Mac stock worth between $100,001 and $250,000. He did not serve on any of the board's working committees and the board itself met no more than six times a year. Clinton also appointed lobbyist and golfing partner James Free and former aide Harold Ickes to the Freddie Mac board.[54]

Other members of the affordable lending coalition also were involved in buying influence among Washington figures. One of the most notable examples was Countrywide's use of preferential mortgages to curry favor with so-called "VIPs." Countrywide CEO Angelo Mozilo styled this the "Friends of Angelo" program. Officials with direct responsibility for overseeing GSE operations, including Senators Christopher Dodd and Kent Conrad and HUD Secretary Alphonso Jackson (responsible for setting the GSEs' affordable housing quotas), received sweetheart mortgages from Countrywide. Key congressional staffers with responsibility for oversight of Fannie and Freddie also received sweetheart mortgages, including Clinton Jones III, Republican Chief Counsel of the House Financial Services Committee, which oversees the GSEs. Jones eventually left his job in Congress to join Fannie Mae as a vice president.[55] Another staffer who received a sweetheart mortgage from Countrywide was Joyce Brayboy, Chief of Staff to Congressman Mel Watt. Watt is a member of the House Financial Services Committee and the Congressional Black Caucus, a group noted for its strong support of the GSEs' affordable housing "mission." High-level GSE executives were also beneficiaries of Mozilo's largesse, including Fannie Mae CEO Jim Johnson, who also was a key conduit for referring other "VIPs" to the program, Franklin Raines, and Fannie Vice Chair and former Clinton Justice Department official Jaime Gorelick.[56]

SCANDALS AT FANNIE AND FREDDIE

In 2003, Fannie Mae and Freddie Mac were at the height of their power. They dominated the secondary mortgage market, including a combined exposure of $372 billion to subprime mortgages made to borrowers with FICO scores below 660, 81 percent of the total market.[57] Wall Street firms were responsible for a mere 19 percent of this market. However, accounting scandals were about to hammer the GSEs' share prices, threaten

[54] *See* Bob Secter and Andrew Zajac, "Rahm Emanuel's Profitable Stint at Mortgage Giant," *The Chicago Tribune*, (March 26, 2009).
[55] *See* Dan Golden, "Angelo's Fannie Pack," *Conde Nast Portfolio*, (July 17, 2008).
[56] *See* House Oversight and Government Reform Committee, "Friends of Angelo: Countrywide's Systematic and Successful Effort to Buy Influence and Block Reform," (March 19, 2009) *accessed at* http://republicans.oversight.house.gov/media/pdfs/20090319FriendsofAngelo.pdf. *See also* note 31, *supra*.
[57] *See* Edward Pinto, information provided to the Committee on Oversight and Government Reform, based on an analysis of securities filings and mortgage market data.

their market share, and create an urgent need for a pro-active political influence strategy to blunt calls for reform.

In 2003 and 2004, it became known that GSE executives had manipulated accounting rules to maximize profits and executive compensation, breathing new life into efforts by the Bush Administration and some in Congress to properly regulate them. This in turn forced the GSEs to seek shelter with their congressional benefactors, the advocates of affordable housing policy.

As part of their highly profitable business model, Fannie Mae and Freddie Mac both built up huge investment portfolios of mortgages and mortgage-backed securities, from which they earned the principal and interest payments. This was both the most profitable and the riskiest part of their business model. Part of the risk was that the companies had to use complex hedging operations to compensate for the inherent volatility of an undiversified portfolio of home mortgages in order to maintain the illusion of smooth and steady earnings growth. If Congress became aware of the risks they were taking, the GSEs feared it would have greatly strengthened calls to rein in the companies' over-leveraging by increasing their capital requirements. While this would have protected taxpayers by increasing the regulatory capital cushion beneath the GSEs' investments, the companies opposed it because it threatened their profitability.

Conducting the necessary hedging of the GSEs' portfolio perfectly was impossible, particularly with prices rising so rapidly during the growth of the housing bubble. Officials at Fannie and Freddie decided to cheat by manipulating the companies' earnings with improper accounting practices in order to hide volatility from their investors and the government. An internal Freddie Mac investigation revealed this improper behavior, forcing the board to promptly oust the company's top leadership in June 2003 and announce that it would restate earnings. It turned out that Freddie Mac had been underreporting earnings on derivatives and bonds that had dramatically increased in value due to falling interest rates between 2000 and 2003 by $5 billion. Freddie did so to maintain the illusion of the steadily increasing returns its investors had come to expect, disguising the increasingly volatile nature of its undiversified investments in the housing market.

The fact that Freddie's Board of Directors had been briefed on management's plan to massage earnings yet did not question it raised serious doubts about the board's motivations and effectiveness. In its report on the scandal, OFHEO singled out the presidentially-appointed board members such as Rahm Emanuel, who sat on the Board at the time it was apprised of the improper accounting scheme, as an "anachronism" which should be "repealed so shareholders can elect all Directors."[58] This was a stinging indictment of the crony capitalism that led directly to lax oversight and perverse incentives for the GSEs to behave improperly.

[58] *See* OFHEO, "Report of the Special Examination of Freddie Mac," (December 2003), at vi, *accessed at* http://www.fhfa.gov/Preview-FHFAWWW/webfiles/749/specialreport122003.pdf.

To its credit, OFHEO responded to revelations of fraud at Freddie Mac, and launched an investigation of Fannie Mae as well. In 2004, OFHEO announced that Fannie Mae had also "deviated from generally accepted accounting principles in order to conceal losses, reduce volatility in reported earnings, present investors with an artificial picture of steadily growing profits, and to meet financial performance targets that triggered the payment of large bonuses" to its executives.[59] The SEC conducted an independent review that confirmed OFHEO's findings of improper behavior, and within weeks the leadership team led by Mr. Raines resigned from Fannie Mae. Fannie was forced to revise its earnings downward by $6.3 billion. OFHEO found that "Fannie Mae's executives were precisely managing earnings to the one-hundredth of a penny to maximize their bonuses while neglecting investments in systems internal controls and risk management."[60] The regulator found that earnings management, "made a significant contribution to the compensation of [CEO] Franklin Raines."[61] Raines ultimately earned over $50 million at Fannie Mae while Freddie Mac CEO Leland Brendsel earned almost $20 million in salary, bonuses and dividends at Freddie Mac.[62]

The accounting scandals caused outrage on Capitol Hill and prompted Members of Congress and the Bush Administration, including Federal Reserve Chairman Alan Greenspan, to seek reform legislation that would have limited the GSEs' risky mortgage portfolios and high-leverage debt issuance by empowering their regulator to require them to hold additional capital. In response, Fannie Mae and Freddie Mac sought protection from their strongest political protectors, the advocates of high-risk affordable lending. The GSEs essentially doubled down on risky low down payment lending to shore up support on Capitol Hill and fend off attempted regulation. GSE congressional supporters, many of whom sat on key committees charged with oversight of the housing and mortgage industries, made repeated public statements in support of the push to reduce the quality of underwriting at the GSEs and to block congressional efforts at better regulation.

For example, at a hearing of the House Financial Services Committee on the GSE accounting scandals, Congresswoman Maxine Waters (D-CA) publicly praised the GSEs for implementing their "affordable housing mission, a mission that has seen innovation flourish, from desktop underwriting to 100 percent [zero-down payment] loans."[63] And in a speech delivered at the swearing-in ceremony of the Congressional Black Caucus in 2005, Franklin Raines' successor, Fannie Mae CEO Daniel Mudd, sent a clear signal to congressional advocates of loosened lending standards that his company sought political cover in order to blunt efforts to address the serious structural problems posed by the GSEs. Mudd told the assembled Members that he was "humbled…to reaffirm the friendship and the partnership between Fannie Mae and the Congressional Black

[59] *See* Mark Jickling, Congressional Research Service, "Accounting Problems at Fannie Mae," (December 7, 2006).
[60] *See* OFHEO press release, "Fannie Mae Façade," (May 23, 2006), *accessed at* http://www.fhfa.gov/webfiles/2095/52306fnmsecrelease.pdf.
[61] *Id.*
[62] *See* Fannie Mae document produced to the Committee, Bates FM-COMP-COGR-00009. *See also* Freddie Mac document produced to the Committee.
[63] *See* House Financial Services Committee hearing, (September 25, 2003).

Caucus," and noted that "[s]o many of you have been good friends to Fannie Mae and our [affordable housing] mission…You've been friends through thick and thin." In reference to the accounting scandal, Mudd noted:

> We have indeed come upon a difficult time for Fannie Mae. There is much to be done inside my company and I humbly ask you to help us and to help me. If there are areas where we are missing, if there are areas where we could do better, we'd like to hear it from our friends and I'd be so bold as to say, our family first.

He noted pointedly that "Fannie Mae has lent more money to more minorities and more underserved individuals than any single company in history," and reassured Members that "you will see Fannie Mae reaching out and listening to the [Congressional Black] Caucus" and opined that "you are also the conscience of Fannie Mae, keeping us on course to serve those who need serving most."[64]

This speech by Fannie Mae's CEO reveals much about the unique relationship between the GSEs and congressional advocates of lower mortgage lending standards. The company was desperate to maintain its unfair competitive advantages granted by Congress in the wake of the accounting scandals and increased calls to strip it of some of those privileges. Its leadership clearly decided that the best strategy was to play up the politically popular albeit short-sighted goal of lowering their standards in order to increase the national homeownership rate and please their political benefactors. That the effect of this strategy was to trap Americans in unsustainable mortgages and feed the growth of a housing bubble merely heaped insult upon injury.

REFORM OF FANNIE AND FREDDIE THWARTED: FOR A PRICE

The GSEs' political risk management succeeded in thwarting congressional and Bush Administration attempts at reform. In 2004, Senators Hagel, Sununu, Dole, and McCain, took up Fed Chairman Alan Greenspan's call to create stronger regulatory oversight of the GSEs and limit the amount of leverage GSEs could use to invest in risky mortgage lending. While this would not have interfered with the GSEs' role in providing a secondary mortgage market, it would have reduced their ability to fund high-risk lending with borrowed money and cut into the companies' fabled profit margins and executive compensation. However, when the Senate Banking Committee took up the legislation, S.1508, Democrats and some Republicans opposed it as originally drafted. For example, the legislation was approved by the Committee only after Senator Robert Bennett, whose son was employed by the Fannie Mae partnership office in Utah, attached an amendment that stripped the provision which would have allowed a new regulator to limit the GSEs' leverage.[65] This led the Bush Administration to withdraw its support from the weakened legislation, which ultimately failed to pass the full Senate.

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[64] *See* Daniel Mudd speech, (January 4, 2005), *accessed at* rtsp://video.c-span.org/project/c04/c04010405_cbc.rm.

[65] *See* note 12, *supra*. *See also* Leslie Paige, Citizens Against Government Waste, "GSE Reform in Critical Stage," (May 1, 2004), *accessed at* http://www.cagw.org/site/News2?page=NewsArticle&id=7769.

A similar scenario unfolded in 2005 when the Senators reintroduced their GSE reform language. Once again the bill, S.190, failed to get a single Democratic vote in the Banking Committee. Among the Democrats who voted against the bill were Senator Christopher Dodd, who received a sweetheart mortgage from Countrywide, and Senator Charles Schumer, who had so prominently advertised a $100 million Freddie Mac affordable housing program in his state. Without any Democratic support, the legislation failed to garner sufficient support for a vote on the Senate floor and was never enacted.

The House of Representatives also took up GSE reform in 2005 with the passage of H.R. 1461. However, the legislation did not allow the new federal regulator it would have created to limit the size of the GSEs' portfolio. As a result, the Bush Administration, citing Fed Chairman Alan Greenspan's insistence on the need for such a measure, once again withdrew its support and the bill died.

In return for political protection from oversight and reform, however, Fannie Mae and Freddie Mac were forced to placate their congressional protectors with an ever-increasing commitment to high-risk lending. That Fannie and Freddie felt such political pressure is made clear in an email exchange at Freddie Mac regarding the company's decision to not place an upper limit on the number of defaulting affordable loans the company was underwriting. Freddie Mac's senior vice president in charge of its affordable housing mission admitted that the higher default rates typical of lower-quality affordable mortgages could do serious "[h]arm to households and neighborhoods." This grim reality notwithstanding, "[t]ipping the scale in favor of no cap [on defaults] at this time was the pragmatic consideration that [it] would be interpreted by external critics as additional proof that we are not really committed to affordable lending."[66] Clearly the GSEs feared a backlash from powerful advocates of looser mortgage standards so much that they could not even agree to place limits on how many defaults they would tolerate for one of their more risky loan products, irrespective of the obvious damage this lending was doing to families and neighborhoods.

Politicians who favored reduced lending standards in the name of increasing the homeownership rate among their constituents cheered on these efforts. For example, members of the Hispanic Caucus in the U.S. House of Representatives formed a special housing initiative called *Hogar* to encourage increased lending to Latino borrowers in their districts through reduced standards. These lawmakers received financial and policy support from the subprime lending industry as well as from Fannie Mae and Freddie Mac, which in return received congressional support for their drive to make low-quality loans. According to one report, for $150,000 in campaign contributions a year, subprime lenders could supply a research fellow to produce studies for *Hogar* that would in turn be used by industry lobbyists to push low-quality mortgage lending among Latino borrowers. For $100,000 a year in donations, the congressional group "offered to provide news releases from the Hispanic Caucus promoting a lender's commercial products for the Latino market." Freddie Mac partnered with *Hogar* to produce a study of Latino homeownership in 63 congressional districts which found that Latino homeownership

[66] *See* Freddie Mac document produced to the Committee, Bates FMAC0013801-FMAC0013802.

had increased thanks to "new flexible mortgage loan products" and recommended "further easing of down-payment and underwriting standards."[67] Indeed, according to the U.S. Census Bureau, Latino homeownership increased by 47 percent during the housing bubble, from 4.1 million to 6.1 million between 2000 and 2007. This was an astonishing rate of increase at a time when the national homeownership rate rose by just 8 percent.

Along with political pressure from Congress for more low-quality affordable housing loans, Fannie Mae and Freddie Mac also caved in to the temptation to lower their standards in an attempt to take market share away from Wall Street. This pressure amplified the effect of the push by politicians to lower their underwriting standards in order to do more risky affordable lending. These dual pressures were noted in an email from Freddie Mac's chief risk officer:

> [T]he push to do more affordable business and increase share means more borderline and unprofitable business will come in. The best credit enhancement is a profit margin and ours is likely to get squeezed as we respond to these market pressures.[68]

But even as Fannie and Freddie acted to placate political allies who they needed to help thwart reforms, some GSE employees were beginning to develop a new fear. A Fannie Mae presentation obtained by the Committee explicitly acknowledged conditions indicative of a housing bubble, including an overheated market and the proliferation of increasingly risky mortgages. Yet when faced with the choice of "staying the course" or "meeting the market where it is," the presenters recommended developing "underground" efforts to delve into subprime and "alternative" markets in order to avoid becoming "less of a market leader."[69]

One case study that illustrates the dual pressures of the politicization of mortgage lending and the push for market share is the internal debate at Freddie Mac over its purchase of No-Income, No-Asset ("NINA") mortgages, a type of Alt-A loan. These risky loans did not verify a borrower's income or assets. The company's chief risk officer warned his fellow executives in 2004 that the mortgages in question would prove to be dangerously risky and that Freddie Mac would likely give in to the temptation to continue lowering its standards to attract market share. "In 1990 we called this product 'dangerous' and eliminated it from the marketplace," he wrote to his colleagues.[70] He also warned that these mortgages were "disproportionately targeted towards Hispanics," making "[t]he potential for the perception and the reality of predatory lending with this product…great".[71] He also predicted that these loans were going to "borrowers who would have trouble qualifying for a mortgage if their financial position were adequately

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[67] *See* Susan Schmidt and Maurice Tamman, "Housing Push for Hispanics Spawns Wave of Foreclosures," *The Wall Street Journal*, (January 5, 2009).
[68] *See* Freddie Mac document produced to the Committee, Bates FMAC0013756.
[69] *See* Fannie Mac document produced to the Committee, Bates FM-COGR_00177162 – FM-COGR_0177172.
[70] *See* Freddie Mac document produced to the Committee, Bates FMAC0013672.
[71] *See* Freddie Mac document produced to the Committee, Bates FMAC0013739.

disclosed," with first-year delinquency rates ranging from 8 percent to 13 percent.[72] However, according to another executive, the company pushed ahead, buying billions of dollars worth of these loans "to ensure we hit share objectives and continue to diversify our customer base."[73]

Freddie Mac executives sought to control the risk of these junk mortgages by implementing certain minimum parameters such as only buying loans made to borrowers with at least a 680 credit score. However, in a nod to the competitive pressures of the market, the chief risk officer warned that "we have already had requests from [J.P. Morgan] Chase and Wells [Fargo] to allow this offering to go to 660 [credit scores]," and that competition between Fannie and Freddie "will likely compete the borrower profile [down] to a level where understanding income and assets really does matter. I don't know how to put the genie back in the bottle."[74] He continued:

> I know this is where the market is evolving…Having said that, we did no-doc lending [in the late 1980s and early 1990s], took inordinate losses and generated significant fraud cases. I'm not sure what makes us think we're so much smarter this time around.[75]

Another Freddie Mac executive admitted that pressure to reduce underwriting quality and purchase these loans was "largely driven by a need to allow lenders to compete" with reduced documentation mortgages at Countrywide and Bank of America.[76] At the same time, the chief risk officer also acknowledged that, "the push to do more affordable business and increase share means more borderline and unprofitable business will come in."[77]

FALLOUT: TAXPAYERS PAY FOR FANNIE'S AND FREDDIE'S BINGE ON RISKY MORTGAGES

As long as housing prices continued to rise, the GSEs' exposure to risky nonprime loans remained manageable. With the bursting of the bubble, however, the underlying weaknesses of Fannie Mae and Freddie Mac, caused by years of purchasing low-quality loans and dangerously high levels of leverage, began to show. In 2007, the GSEs reported combined losses of over $5 billion, the first full-year loss for Fannie Mae since 1985 and the first ever for Freddie Mac. These losses were dwarfed in 2008, however, when the GSEs reported combined year-end losses in excess of $108 billion. The companies' share prices plummeted by 60% between July 2007 and July 2008.[78]

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[72] *Id.*
[73] *See* Freddie Mac document produced to the Committee, Bates FMAC0013673.
[74] *See* Freddie Mac document produced to the Committee, Bates FMAC0013675.
[75] *See* Freddie Mac document produced to the Committee, Bates FMAC0013676.
[76] *See* Freddie Mac document produced to the Committee, Bates FMAC0013757.
[77] *See* note 68, *supra*.
[78] *See* Mark Jickling, Congressional Research Service, "Fannie Mae and Freddie Mac in Conservatorship," (September 15, 2008).

In response to these mounting losses, Congress finally passed much-needed reform legislation, the Housing and Economic Recovery Act of 2008 ("HERA"), which was signed into law on July 30. HERA created a new regulator, the Federal Housing Finance Authority ("FHFA") to replace OFHEO. Congress gave the new agency the power to review and approve new types of mortgages, set capital requirements, limit the GSEs' portfolio sizes, and force them to sell assets. FHFA was also granted the power to place Fannie and Freddie into conservatorship and reorganize them in order to prevent their insolvency.[79]

These reforms came too late to protect taxpayers from a huge government bailout. On September 7, 2008, FHFA, in consultation with Treasury Secretary Henry Paulson, exercised its new authority and placed Fannie Mae and Freddie Mac into conservatorship, wiping out common shareholders and taking on the responsibility for running the companies. In addition to the collapse of the GSEs' share price and their mounting losses, one of the factors in this decision appears to have been Treasury's discovery that the GSEs had overstated their capital reserves by $64 billion by relying on government-granted tax credits which they would probably never be able to use and were therefore worthless. Treasury also discovered that the GSEs were not marking losses on their subprime and Alt-A loans to market and were carefully managing their public reporting of these losses.[80] Finally, the full extent of the GSEs' involvement in risky lending had started coming to light. For example, in its 2007 10-K, filed in February 2008, Fannie Mae finally disclosed its large exposure to first mortgages with so-called "silent seconds" – second loans made to cover down payment and closing costs. Freddie Mac divulged its own exposure to such risky mortgages in its second quarter 10-Q filed in August 2008.

During the House Oversight and Government Reform Committee's investigation starting, in the fall of 2008, it became clear that Fannie Mae and Freddie Mac were in fact leaders in risky mortgage lending. According to an analysis presented to the Committee, between 2002 and 2007, Fannie and Freddie purchased $1.9 trillion of mortgages made to borrowers with credit scores below 660, one of the definitions of "subprime" used by federal banking regulators.[81] This represents over 54% of all such mortgages purchased during those years. If one factors in Alt-A and adjustable-rate mortgages, this analysis found that, at the end of 2008, Fannie and Freddie were still exposed to $1.6 trillion of risky default-prone loans. Thus, at year-end 2008, Fannie Mae and Freddie Mac were responsible for 34 percent of all outstanding subprime mortgages and 60 percent of all outstanding Alt-A mortgages in the United States.[82]

Fannie and Freddie were not only enabling a huge amount of subprime and Alt-A lending – the extremely high delinquency and default rates on these mortgages demonstrate that the GSEs were directly damaging both themselves and their borrowers. At year-end

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[79] *See* Congressional Research Service, "Housing and Economic Recovery Act of 2008," (December 5, 2008).
[80] *See* Gretchen Morgenson and Charles Duhigg, "Mortgage Giant Overstated the Size of Its Capital Base," *The New York Times*, (September 7, 2008).
[81] *See* note 57, *supra*.
[82] *See* Edward Pinto, presentation to the American Enterprise Institute, "How Serious is the Mortgage Problem That Will Confront President Obama?" (January 16, 2009).

2008, Fannie's and Freddie's main line of business by volume continued to be backing safe mortgage lending, with 66 percent of their exposure consisting of prime loans. As of December 31, 2008, this 66 percent exposure to prime mortgages, even with the deterioration in the housing market, was only suffering a serious delinquency rate of about 0.5 percent, accounting for only 10% of the GSEs' total losses. On the other hand, nonprime loans, which accounted for only 34% of the GSEs' risk exposure at the end of 2008, were suffering a 6% delinquency rate, accounting for 90% of the GSEs' losses.[83] Put another way, the GSEs'nonprime loans were 14 times more likely to be in serious delinquency than their prime loans. In the end, failures on nonprime GSE mortgages may account for the failure of roughly 1 in 6 home mortgages in the U.S., or 8.8 million foreclosures.[84]

The continuing losses caused by Fannie and Freddie's binge on junk mortgages have already cost the taxpayers dearly. Under the terms of their conservatorship, the U.S. Treasury is committed to inject up to $400 billion of capital into Fannie and Freddie to offset their losses and maintain solvency. These capital injections take the form of Treasury purchases of preferred stock in the companies. As of April 30, 2009, the Treasury had spent $59.8 billion on such purchases.[85] In addition, the Federal Reserve has also pledged to purchase GSE debt issuances, of which the Fed had bought nearly $77 billion worth as of May 20, 2009.[86] Finally, both Treasury and the Fed continue to purchase massive amounts of GSE mortgage-backed securities directly – over $567 billion-worth as of May 20, 2009.[87] The sum of these federal aid packages brings the total current taxpayer exposure to GSE liabilities to over $700 billion.

Even more than Wall Street firms, Fannie and Freddie used high leverage to borrow money and gamble on low-down payment affordable and speculative mortgages. Unlike Wall Street, however, the GSEs did this with the mandate and the blessing of Congress and successive Administrations, which encouraged them to use their government-granted competitive advantages to engage in a race to the bottom, boosting the national homeownership rate for political gain.

All told, the government experiment in unsustainable affordable mortgage lending based on low down payments and "flexible" credit criteria has sucked the equity out of the U.S. housing market, trapped millions of Americans under crushing debt, and seriously damaged global financial markets. In 2006, the value of U.S. housing was estimated at $22 trillion. By October 31, 2008 this had fallen to $18.5 trillion. As of the end of 2008, there was about $12 trillion in mortgage debt, of which 42 percent consisted of default-prone loans, with 70 percent of all mortgage debt guaranteed by the federal government. This means that at the end of 2008, the U.S. housing market had a loan-to-value ratio of

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[83] *Id.*
[84] *Id.*
[85] *See* U.S. Department of the Treasury, "Monthly Treasury Statement of Receipts and Outlays of the United States Government," (April 30, 2009), *accessed at* http://fms.treas.gov/mts/mts0409.pdf.
[86] *See* Board of Governors of the Federal Reserve System, "Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks," (May 20, 2009), *accessed at*, http://www.federalreserve.gov/releases/h41/Current/h41.pdf.
[87] *See* notes 85 *and* 86, *supra*.

66 percent. If U.S. housing prices fall an additional 15 percent to $11 trillion by the end of 2009, the U.S. housing market will be leveraged at a ratio of 110 percent, meaning the market on average will be in negative equity, or "under water."

These statistics are alarming enough on their own, but the real tragedy of the government's affordable housing policy is the impact on average Americans, particularly those of modest means. Millions of these borrowers, who were supposed to have been helped by federal affordable housing policy, have now been forced into delinquency and foreclosure, destroying their asset base, their credit, and in some cases their families. For example, Latino homeowners, who once appeared to be among the most frequent beneficiaries of affordable housing policies, are now the victims of the policies that their political representatives in Washington once championed. According to the Pew Hispanic Center, nearly one-in-ten Latino homeowners said they had missed a mortgage payment or were unable to make a full payment, while 3 percent said they have received a foreclosure notice in the past year. At the same time, 62 percent of Latino homeowners said there have been foreclosures in their neighborhoods and 36 percent say they are worried about their own homes going into foreclosure.[88]

The consequences of these policies have also brought the entire global financial system to the brink of collapse, destroying trillions in equity and untold numbers of lives. It is essential to reexamine the borrow-and-spend, high-leverage policies that became prevalent in the mortgage market as a result of well-intentioned-but-reckless decisions made by elected officials on behalf of the American people. Without such a return to fiscal discipline and responsibility, we will continue making the same mistakes that led us to the current financial crisis.

LEARNING THE RIGHT LESSONS

Washington must reexamine its politically expedient but irresponsible approach to encouraging higher levels of homeownership based on imprudently small down payments and too little emphasis on borrowers' creditworthiness and ability to repay their loans. Unfortunately, very few elected officials would be comfortable echoing Yale University economist and housing expert Robert Shiller, who writes: "[T]he subprime housing dilemma in the United States points up the problems with over-promoting homeownership. Homeownership, for all its advantages, is not the ideal housing arrangement for all people in all circumstances."[89] However, failing to learn the mistakes of our overleveraged binge on mortgage debt will almost certainly doom the country to repeating the same mistakes again and again.

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[88] *See* Mark Hugo Lopez, Gretchen Livingston and Rakesh Kochhar, Pew Hispanic Center, "Hispanics and the Economic Downturn: Housing Woes and Remittance Cuts," (January 8, 2009) at i.
[89] *See* Robert J. Shiller, *The Subprime Solution*, Princeton, NJ: Princeton University Press, (2008), at 6.

Spreading the Virus

How ACORN and its Dem allies built the mortgage disaster.

By Stanley Kurtz
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TO discover the roots of to day's economic crisis, consider a tale from 1995.

That March, House Speaker Newt Gingrich was scheduled to address a meeting of county commissioners at the Washington Hilton. But, first, some 500 protesters from the Association of Community Organizations for Reform Now (ACORN) poured into the ballroom from both the kitchen and the main entrance.

Hotel staffers who tried to block them were quickly overwhelmed by demonstrators chanting, "Nuke Newt!" and "We want Newt!" Jamming the aisles, carrying bullhorns and taunting the assembled county commissioners, demonstrators swiftly took over the head table and commandeered the microphone, sending two members of Congress scurrying.

The demonstrators' target, Gingrich, hadn't yet arrived - and his speech was cancelled. When the cancellation was announced, ACORN's foot soldiers cheered.

Editorial writers from Little Rock to Buffalo condemned ACORN's action as an affront to both civility and freedom of speech. Editorialists also pointed out that the "spending cuts" the protesters railed against were imaginary - Gingrich proposed merely to slow the growth in some welfare programs and turn control back to the states.

Yet ACORN had only just begun. Two days later, 50 to 100 of the same protesters hit their main target - a House Banking subcommittee considering changes to the Community Reinvestment Act, a law that allows groups like ACORN to force banks into making high-risk loans to low-credit customers.

The CRA's ostensible purpose is to prevent banks from discriminating against minorities. But Rep. Marge Roukema (R-NJ), who chaired the subcommittee, was worried that charges of discrimination had become an excuse for lowering credit standards. She warned that new, Democrat-proposed CRA regulations could amount to an illegal quota system.

FOR years, ACORN had combined manipulation of the CRA with intimidation-protest tactics to force banks to lower credit standards. Its crusade, with help from Democrats in Congress, to push these high-risk "subprime" loans on banks is at the root of today's economic meltdown.

When the role of ACORN and congressional Democrats in the mortgage crisis is pointed out, Democrats reply that banks subject to the CRA represent only about a quarter of the loans that led to our current troubles. In fact, the problem goes way beyond the CRA.

As ACORN ran its campaigns against local banks, it quickly hit a roadblock. Banks would tell ACORN they could afford to reduce their credit standards by only a little - since Fannie Mae and Freddie Mac, the federal mortgage giants, refused to buy up those risky loans for sale on the "secondary market."

That is, the CRA wasn't enough. Unless Fannie and Freddie were willing to relax their credit standards as well, local banks would never make home loans to customers with bad credit histories or with too little money for a downpayment.

So ACORN's Democratic friends in Congress moved to force Fannie Mae and Freddie Mac to dispense with normal credit standards. Throughout the early '90s, they imposed ever-increasing subprime-lending quotas on Fannie and Freddie.

But then the Republicans won control of Congress - and Rep. Roukema scheduled her hearing. ACORN went into action to protect its golden goose.

IT struck as Roukema aired her concerns at that hearing. Pro testers, led by ACORN President Maud Hurd, stood up and began chanting, "CRA has got to stay!" and "Banks for greed, not for need!" The protesters then demanded the microphone.

With the hearing interrupted and the demonstrators refusing to leave, Roukema called the Capital Police, who arrested Hurd and four others for "disorderly conduct in a Capital building" - a charge carrying a penalty of a $500 fine, six months in prison or both. As the police arrived, two of the protesters menacingly approached Roukema's desk, still demanding the hearing microphone.

Requests to the Capital Police to release the activists from Sen. Ted Kennedy (D-Mass.) and Rep. Joe Kennedy (D-Mass.) failed. Then Rep. Maxine Waters (D-Calif.) showed up at the jail and refused to leave until the protesters were released; the Capital Police relented.

Meanwhile, instead of repudiating ACORN's intimidation tactics, Rep. Kennedy berated Roukema for arresting one of his constituents and accused the Republicans of preparing for "an all-out attack on CRA." He also promised to introduce legislation to expand the CRA's coverage to mortgage bankers and large credit unions.

THIS little slice of political life from 1995 had a variety of ripple effects. Above all, ACORN's intimidation tactics, and its alliance with Democrats in Congress, triumphed. Despite their 1994 takeover of Congress, Republicans' attempts to pare back the CRA were stymied.

Instead, Democrats like Rep. Barney Frank (D-Mass.) and Reps. Kennedy and Waters allied with the Clinton administration to *broaden* the acceptability of risky subprime loans throughout the financial system, thus precipitating our current crisis.

ACORN had come to Congress not only to protect the CRA from GOP reforms but also to expand the reach of quota-based lending to Fannie, Freddie and beyond. By steamrolling the GOP that March, it had crushed the last potential barrier to "change."

Three months later, the Clinton administration announced a comprehensive strategy to push homeownership in America to new heights - regardless of the compromise in credit standards that the task would require. Fannie and Freddie were assigned massive subprime lending quotas, which would rise to about half of their total business by the end of the decade.

WHEN the ACORN-Democrat alliance finally succeeded in blocking Republicans from restoring fiscal sanity in 1995, the way was open to virtually unlimited lending quotas - and to a whole new way of thinking about credit standards.

Urged on by ACORN, congressional Democrats and the Clinton administration helped push tolerance for high-risk loans through every sector of the banking system - far beyond the sort of banks originally subject to the CRA.

So it was the efforts of ACORN and its Democratic allies that first spread the subprime virus from the CRA to Fannie and Freddie and thence to the entire financial system.

Soon, Democratic politicians and regulators actually began to take pride in lowered credit standards as a sign of "fairness" - and the contagion spread.

And when financial institutions across the board saw that they could make money by trading what would once have been considered junk loans, the profit motive kicked in. But the bad seed that started it all was ACORN.

HOW does Barack Obama fit into all of this? Obama has been a key ally of Chicago ACORN going back to his days as a community organizer.

Later, as a young lawyer, he offered leadership training to the activists who were forcing Chicago banks into high-risk subprime loans. And when he made it on to the boards of Chicago's Woods Fund and the Chicago Annenberg Challenge, he channeled money ACORN's way.

Obama was perfectly aware of ACORN's intimidation tactics - indeed, he oversaw a Woods Fund report that *boasted* of managing to fund the radical group despite its shocking behavior.

And as a lawmaker, in Illinois and in Washington, he has continued to back ACORN's legislative agenda.

ACORN's high-pressure tactics live on. And congressional Democrats are still covering for ACORN, funneling it money and doing its legislative bidding. ACORN also continues its shady ways, using a vast network of technically separate but in fact quite interconnected organizations to evade federal laws on the politicized use of government money.

Perhaps most disturbing of all, the Obama campaign appears to have little more regard for freedom of speech than Reps. Kennedy or Waters did when they backed up ACORN's thugs in 1995. The campaign actually practices ACORN-style tactics, sending out "action wires" that call on supporters to block Obama critics from radio appearances (a tactic once applied to me) and demanding legal actions against unfriendly political advertisers.

As a presidential candidate, Obama promises a massive national-service program closely allied with the nonprofit sector. He wants to remove "barriers for smaller nonprofits to participate in government programs."

In other words, he plans a massive effort to funnel America's youth into volunteer work alongside the likes of ACORN. So Obama's favorite community organizers may soon be training your child.

ACORN's alliance with the Democratic Party is at the root of the current financial meltdown. And Barack Obama has stayed true to ACORN's ways.

Pretty soon, the folks who poured into the Washington Hilton to shut down Speaker Gingrich in 1995 may no longer need to take over the microphone. They'll be in charge of it.

Stanley Kurtz is a senior fellow with the Ethics and Public Policy Center in Washington.

HOUSING POLICY COUNCIL
THE FINANCIAL SERVICES ROUNDTABLE

Statement for the Record

John H. Dalton

President, Housing Policy Council

Subcommittee on the Commercial and Administrative Law

Committee on the Judiciary

United States House of Representatives

September 9, 2009, 2:00 p.m.

Hearing on

The Role of the Lending Industry in the Home Foreclosure Crisis

2141 Rayburn House Office Building

Introduction

Chairman Cohen, Ranking Member Franks and Members of the Subcommittee, thank you for the opportunity to present the views of the Housing Policy Council (HPC) on the home foreclosure crisis and the actions the mortgage lending industry are taking to assist homeowners in distress and prevent foreclosures. The members of the Housing Policy Council are working hard to implement the Administration's Home Affordable Modification Program (HAMP), and are continuing other comprehensive efforts to contact and provide loan modifications and other workout solutions to their mortgage customers who are experiencing difficulty. In addition, many members of HPC are also members of the HOPE NOW Alliance which is a coalition of investors, servicers, and housing counselors, working together to prevent foreclosures and keep people in their homes.

OVERALL INDUSTRY EFFORTS

The member companies of the Housing Policy Council (HPC) are committed to working with their customers to find solutions that preserve homeownership and avoid foreclosure whenever possible. We have been working hard in this area for a number of years and mortgage servicers have voluntarily reported their results since 2007 through the HOPE NOW Alliance.

The latest HOPE NOW data shows:

- Since January 2009, servicers have provided 1.77 million workout solutions to homeowners to avoid foreclosure.
- Since July 2007, servicers have provided more than 4.9 million workout solutions to homeowners.
- HPC companies and other HOPE NOW servicers work with every at-risk homeowners they can reach. There is a wide-variety of solutions available including, but not limited to, the new Government supported Home Affordable Modification Program (HAMP).

ADMINISTRATION'S HOME AFFORDABLE MODIFICATION PROGRAM

The Housing Policy Council supports the Administration's efforts to help at-risk homeowners through the Making Home Affordable Program ("HAMP"). As you know, in its first report on HAMP on August 4, the Administration reported that the Program was having a positive impact. In the initial stages of HAMP, participating servicers offered more than 400,000 trial modifications to homeowners and more than 230,000 trial modifications were underway as of early August. These new modifications under HAMP are in addition to the non-HAMP workouts that continue to be offered to troubled homeowners by the industry. HAMP is a major new program and while it was announced on March 4, the actual requirements needed to implement the Program were developed and communicated to the industry over the next several months from April through June. Servicers had to determine if they could meet the requirements for HAMP for their non-GSE loans and have signed up for HAMP at different times during the initial period. The first report on August 4 was a positive snapshot, but as HAMP becomes more

fully implemented, we believe its impact will continue to grow. We agree that more can be done, and our members will continue to increase their efforts to assist at-risk homeowners.

All servicers for Fannie Mae and Freddie Mac must participate in the Program for GSE-owned loans. Servicers for private label securities must examine their ability to apply HAMP to loans in private mortgage-backed securities. Those servicers have been making those decisions and more continue to join the Program. In evaluating the Treasury Department's August 4 and subsequent reports on the trial modifications initiated by servicers in HAMP, it is important to keep in mind that servicers have different loan servicing portfolios and joined the Program at different times. The types of loans being serviced and the date a servicer enters the Program can affect the reported number of trial modifications they have offered and initiated. We appreciate the Administration's willingness to work with servicers in the implementation of this Program and we hope the reporting on the Program will fully reflect the variety of issues facing servicers as they join and administer HAMP.

It is the responsibility of our industry to continue to provide solutions for our consumers who are facing difficulty. We continue to work hard to provide solutions to homeowners who have a desire and an ability to pay their mortgage but who need some assistance. HAMP will be an effective option for a growing number of homeowners. For those who do not qualify for HAMP, servicers are actively offering other workouts to their customers with the goal of avoiding foreclosures whenever possible.

The industry is committed to making the Home Affordable Modification Program as effective as possible. Mortgage servicers are in regular communication with Treasury and other Administration officials about the Program, companies communicate individually and we also work on issues that affect all servicers through the HPC and through the very effective working groups established through the HOPE NOW Alliance.

In a meeting hosted by Treasury at the end of July, HPC mortgage servicers and other servicers in the HOPE NOW Alliance offered Treasury a list of recommended improvements to HAMP to help streamline the mortgage modification process and make the Program more effective. Our members will continue to work cooperatively with the Administration and through HOPE NOW to strengthen the implementation of HAMP and to reach as many at-risk borrowers as possible. We support the Program and believe the Administration is on the right track by focusing on making loans affordable for at-risk homeowners. However, HAMP will continue to need to be refined to maximize its impact.

INDUSTRY EFFORTS TO ASSIST HOMEOWNERS ARE CONTINUING AND INCREASING

HPC member companies continue to work to keep as many people in their homes as possible. They are implementing HAMP and also offering other loan modifications and workouts to homeowners who do not qualify for HAMP, but need help to stay in their home. Servicers are also working hard to increase their capacity to respond to homeowners and offer aid.

HPC companies are taking individual steps that include:

- Hiring and training thousands of new staff in servicing and loss mitigation;
- Creating special offices and retail locations dedicated to homeowners in difficulty;
- Phone and mail campaigns to reach at-risk homeowners.
- Company outreach events with non-profits in select markets.

In addition, HPC member companies are engaged in cooperative efforts, such as participating in the HOPE NOW Alliance. The HOPE NOW Alliance is a broad-based voluntary collaboration between lenders, HUD-approved housing counselors, investors, mortgage market participants and trade associations. Activities of the HOPE NOW Alliance include:

- HOPE NOW mailings. The members of the Alliance have mailed over 4.1 million letters, averaging 200,000 per month, to at-risk homeowners offering assistance and urging them to call their servicer or the Homeowners HOPE hotline.
- Supporting the Homeowner's HOPE Hotline, 888-995-HOPE, by funding independent non-profit counseling for their customers, at no cost to the consumer.
- HOPE NOW is educating borrowers on HAMP through the HOPE Hotline and homeownership preservation events.
- HOPE NOW Homeowner Outreach Events. From March 2008 thru August 2009, HOPE NOW has held more than forty-five events across the country; reaching nearly 40,000 homeowners and providing them free counseling and an opportunity to meet with their servicer. Outreach partners include, NeighborWorks America, Fannie Mae, Freddie Mac, the Federal Reserve Banks and the US Treasury.
- In July and August, HOPE NOW assisted 2,000 homeowners in the Washington DC, MD and VA area; 1,500 in Las Vegas; 2,800 in Phoenix; in June, 1,153 in Fresno and Bakersfield, California, and 741 in St. Paul, MN; In April and May 3,300 homeowners in Atlanta, GA.; and, 3,900 in Orlando and Miami, FL. There are thirty HOPE NOW in-person homeowner outreach events planned for 2009. The next is September 17 in Boston, MA.
- The Homeowner's HOPE Hotline, 888-995 HOPE, is receiving thousands of calls per day from homeowners who are connected to a network of HUD-certified non-profit agencies for free counseling and can be connected to their servicer.

In addition to the actions listed above, servicers will continue to work through the HOPE NOW Alliance on these issues:

- Technology: HOPE NOW operates a website that provides homeowners with another option to contact their servicer or a certified counselor. HOPE NOW Servicers are exploring upgrading this to a "one-stop" web portal to provide improved communication with borrowers on loan workout options and applications.
- Best Practices: HOPE NOW serves as a work center and clearing house for servicers as they work toward best practices in servicing and assisting homeowners.

- Coordination with Government: HOPE NOW coordinates and shares information between the government, the GSEs and servicers as they implement HAMP and other solutions to assist homeowners.
- Cooperation with Non-Profits: HOPE NOW serves as a contact and facilitator between counseling agencies and servicers.
- Reporting on Results: HOPE NOW will continue to collect data on actual loan workouts and modifications and voluntarily publish these results.

CHALLENGES FOR HOMEOWNERS AND SERVICERS:

Unemployment: Unemployment continues to be a troubling issue. With unemployment approaching 10 percent, it is affecting an increasing number of homeowners, particularly those who have prime mortgages. The crisis facing homeowners is now most directly related to problems in the economy, rather than types of mortgages. If a homeowner is unemployed or has lost income, it makes it difficult to pay any debt. Regardless of why a homeowner is in trouble, they should contact their servicer or a non-profit counselor. In addition, the HOPE NOW Alliance is working closely with the U.S. Department of Labor to find solutions for the growing number of unemployed borrowers.

Homeowners with High Debt: Homeowners with high levels of non-mortgage debt face greater challenges in staying in their home. HAMP is the first wide scale program for uniform modifications that provides an affordability ratio of 31% housing debt to income for homeowners who need to have their payments reduced to be able to stay in their homes. Under HAMP, servicers are required to make changes to reduce the borrowers' housing debt ratio to 38% and then the government will share the cost of reducing it to a more affordable 31%.

For homeowners with significant other household debt - debts greater than 55% of income- counseling is required under HAMP. This is a positive requirement. Servicers are encountering a large number of homeowners who may already have a housing debt ratio or 31% or less, but excessive other debt that makes a loan modification or other workout difficult to achieve.

DELINQUENCIES, FORECLOSURE STARTS AND SALES:

HOPE NOW data indicates that there are roughly 2.9 million borrowers who are 60 days past due on their mortgages. This is a real challenge, but there are some encouraging signs as well. While foreclosure starts increased slightly from 251,340 in June to 283,682, in July, completed foreclosure sales decreased from 92,661 to 89,173. The 60-day plus delinquencies show a slight increase of 5.9% or 3.1 million homeowners in July. As HOPE NOW reported on its July data, more than 253,000 borrowers were helped through loan work out solutions, while foreclosure sales dropped. This data reflects the industry's on-going efforts to assist homeowners and shows real progress that HAMP will continue to contribute to. At the same time, the economy continues to show weakness; unemployment has increased; and certain markets in California, Las Vegas, Phoenix Arizona and Florida face continued challenges in the

number of properties at risk of foreclosure. The government and industry must continue to work together to address these issues.

A NOTE ON MORTGAGE HELP SCAMS

It is imperative that at-risk homeowners get assistance from reputable companies and HUD-certified non-profit agencies. They should be wary of paying third parties for services they can obtain directly from their mortgage servicer or a non-profit counselor. The HOPE NOW Alliance has been working with the Federal Trade Commission, the FBI and states' attorneys general to eliminate mortgage scams that hurt vulnerable consumers. HOPE NOW educates borrowers on how to recognize these scams through the Homeownership Preservation Foundation's Hotline (888-995-HOPE), its website (www.hopenow.com) and at consumer outreach events.

HOMEOWNERS IN DIFFICULTY SHOULD:

It is critical to repeat this basic message. Homeowners in difficulty should:

- Write to their lender/servicer
- Respond to letters and calls from their servicer
- Call: 888-995-HOPE
- Visit: www.hopenow.com
- Visit: www.makinghomeaffordable.gov

CONCLUSION

The member companies of the Housing Policy Council are working to assist their at-risk mortgage customers whenever possible. HPC member companies are working to implement the Administration's Home Affordable Modification Program (HAMP). In addition, mortgage servicers provide a range of workout solutions in addition to the HAMP program. A homeowner who does not qualify for HAMP may still be able to obtain another type of workout to avoid foreclosure. The industry will continue to work to assist at-risk homeowners utilizing the government HAMP program and other options to prevent foreclosures. Thank you for considering our views.

Mr. COHEN. Is there any other request for admission of extraordinary requests? If not, I would like to thank all the legislative days to submit any additional questions to the witnesses, which we will forward thereto. Then we would ask the witnesses to answer those questions as quickly as possible. The record will remain open for 5 legislative days for the submission of any other materials that you might have.

Again, I thank everybody for their time and patience, and I declare that the hearing of the Subcommittee on Commercial and Administrative Law adjourned.

[Whereupon, at 5:05 p.m., the Subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

RESPONSE TO POST-HEARING QUESTIONS FROM THE HONORABLE ELIZABETH W. MAGNER, UNITED STATES BANKRUPTCY COURT FOR THE EASTERN DISTRICT OF LOUISIANA

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing the Role of the Lending Industry in the Home Foreclosure Crisis
September 9, 2009

The Honorable Elizabeth W. Magner, United States Bankruptcy Court for the Eastern District of Louisiana

Questions from the Honorable Steve Cohen, Chairman

1. In some of your written opinions, you have raised concerns about the poor underwriting and inaccurate accounting practices of mortgage lenders and servicers. Do you have similar concerns about underwriting and accounting practices with respect to other types of consumer loans, like credit card loans or private student loans? If so, please explain why.

I do not have sufficient experience with the underwriting or accounting practices of lenders in other consumer credit transactions. As a result, I do not have an opinion on their underwriting or the accuracy of their accounting practices.

2. What is your view of the loss mitigation program instituted in the Southern District of New York that Lewis Wrobel described in his testimony?

Judge Morris' program is innovative and I have been following its progress since she implemented mandatory mediation some time ago. I have requested that she keep me up to date on its results so that I can evaluate its effectiveness. I assume it provides a forum for settlement that is cheaper and more efficient than a trial on the merits. For pro se filers, access to a skilled mediator could be particularly helpful in navigating the bankruptcy process. With the multitude of loans in default nationally, both lenders and servicers often have difficulty focusing on the resolution of any particular problem loan. Pushing a problem loan to the top of the priority list by requiring those with settlement authority attend mediation is one way of getting a lender/servicer to focus.

However, in my experience, mandatory mediation programs are generally less successful than those instigated by the parties. If parties to a suit want to settle and perceive it to be in their interest to compromise, mediation is often a quick and efficient way to resolve issues standing in the way of resolution. Conversely, if one or more parties to a dispute do not want to settle, forcing mediation is often a waste of time and money.

For these reasons, I do not pressure litigants to mediate or attend settlement conferences prior to trial. The attorneys who appear before me are both specialists and very good lawyers. I respect their decision to try a case on the merits rather than settle and assume they have good reasons to litigate. For example, trial on the merits is often cheaper for the parties than mediation, particularly if private mediators are utilized. These observations have made me a

strong advocate of a party's right to trial on the merits and have not found this to be a deterrent to the fair resolution of consumer cases.

In most districts, the consumer bankruptcy bar is relatively small. Debtor and creditor counsel routinely engage with each other and most disputes are resolved consensually. Although creditors generally have greater resources, they are also cost conscious. When a mortgage balance is disputed, the lender may be required to produce significant numbers of documents and records in order to substantiate the claim. This can be an expensive and time consuming process and often no amount of time or money can explain discrepancies.

As I indicated in my previous testimony, mortgage loan records many become unavailable because the note has been transferred from holder to holder. In the transfer, documents, records, even accountings are lost. Even if the records are transferred with the note, many times they cannot be accessed. Because each servicer utilizes its own proprietary software, as servicers are changed, the computer records of one often cannot be read by the new servicer's computer system. Disputed amounts tend to be relatively small, so often it is not worth the cost to a lender to defend. In that case, settlement is a viable option.

The difficulty in resolving mortgage lending disputes is due in large measure to a lack of attention or authority on behalf of mortgage lenders or servicers. Due to rising default rates and increasing costs of administration, lenders and servicers are not providing the kind of attention to loan administration necessary to resolve questions, inquires, or disputes quickly and to the satisfaction of the borrower. Judge Morris' program has the distinct advantage of forcing a lender to focus on a loan, evaluate the costs or benefits of settlement, and resolve the case before trial.

Perhaps because I have conducted extensive trials on many of the issues raised in lending disputes, I find it unnecessary to follow this approach. In my district, counsel for both lenders and borrowers understand that the court is open and available to decide issues should the need arise. Published opinions provide direction on the law. Local procedures designed to isolate accounting issues and simplify discovery help reduce costs. As a result, I find that the lenders quickly focus on the issues raised by the debtor's bar and regularly resolve any discrepancies by consent order.

3. If there are any additional points you wish to make—by way of elaborating upon your hearing testimony or responding to the testimony of other witnesses—please do so.

I strongly encourage this committee to consider implementing uniform reporting for loan transactions with consumers. A simple "Excel" type spread sheet reflecting the amount, date and description for each charge applied to a loan account, as well as, the date of payments, amount and application would assist consumers, lenders, counsel and courts in isolating any disputes. This would simplify research into problems, lower the costs of and speed resolution.

I also suggest that this accounting be delivered annually to a consumer during the life of the loan. An annual statement with the information outlined above would provide consumers with the status of their obligation and the transactional history. If discrepancies exist between

the consumer's personal records and that of the lender, they could be addressed quickly and before a serious problem occurs. Consumers would also understand the cost to them of credit as interest and other loan charges would be evident on their loan statements. This could encourage more responsible borrowing practices as well as allow a borrower to shop for better terms.

Given that the free transfer of mortgage loan notes is both beneficial to the economy and consumers, the historical data associated with a loan needs to be protected and preserved. Loan transaction histories and documentary support (copies of loan payments or cost invoices on charges) should be preserved in a national database accessible to the holder or servicer of the note. This would enable holders to account and provide support for any disputes arising on a loan even if that dispute relates to a period when another held the instrument.

A national database would protect consumers from mistakes that have been all too common in the industry in a cost efficient manner. A loan's history could be quickly researched and provided. Once the information was obtained, both lender and consumer would have the facts necessary to resolve a question or dispute without significant additional time or effort.

A national database would facilitate the free transfer of negotiable instruments because it would provide a loan's accounting data and support documentation in a central location. Should a consumer question arise or enforcement of a note become necessary, the tools to resolve both would be readily available and accessible. This is turn would satisfy concerns in the market over the quality and reliability of loan accounts potentially raising the value of marketed securities.

RESPONSE TO POST-HEARING QUESTIONS FROM SUZANNE SANGREE,
CITY OF BALTIMORE LAW DEPARTMENT

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing the Role of the Lending Industry in the Home Foreclosure Crisis
September 9, 2009

Suzanne Sangree, City of Baltimore Law Department

Questions from the Honorable Steve Cohen, Chairman

1. To your knowledge, how many other local governments have filed or are exploring the possibility of filing a lawsuit similar to Baltimore's fair housing lawsuit against Wells Fargo?

Two local governments have filed Fair Housing Act claims:

a) Illinois: On August 4, 2009, the State of Illinois filed suit against Wells Fargo on a Fair Housing Act claim in addition to claims under Illinois state law-- Human Rights Act, Fairness in Lending Act, Consumer Fraud Act, and the Uniform Deceptive Trade Practices Act. Wells Fargo's Motion to Dismiss is pending. (Complaint and Motion follow in subsequent email.)

b) Birmingham, Alabama: Birmingham filed an FHA claim along with several state negligence claims, against 14 Defendants first on November 17, 2008, and then again on February 5, 2009. The suit was dismissed without prejudice on August 19, 2009 because the City had failed to sufficiently allege that the Defendants, which include Citigroup and Countrywide, had caused the injuries the City alleged it had suffered. As a result, the Court found the City lacked standing as an aggrieved party under the FHA. Birmingham's complaint reproduced the first few paragraphs of Baltimore's complaint concerning the subprime meltdown nationally and did not provide the court with specific facts relating to Birmingham. In addition, some of the named Defendants have never made loans within that City. (Complaint and Decision follow in subsequent email.)

In addition, Cleveland filed a state law nuisance claim against 27 Defendants for their role in bundling loans to sell on the secondary market. The suit was dismissed as preempted by state and federal law, *inter alia*, on May 15, 2009. Appeal is pending in the 6th Circuit. Also noteworthy in Cleveland, Housing Court Judge Raymond Pianka issued a preliminary injunction prohibiting Wells Fargo from selling any property for more than $40,000 without first demonstrating to the Court that it is in good repair and compliant with City Building Code. (Nuisance Complaint and cited Decisions follow in subsequent email.)

Buffalo also filed a state nuisance claim to recover demolition and other abatement costs from 36 lender defendants who own 57 vacant properties following foreclosure. This suit, filed on February 20, 2008 is pending. (Complaint to follow.)

St. Paul and Minneapolis have followed a demand letter approach and announced November 7, 2009 a quasi-settlement with Wells Fargo, in which the lender will invest in various neighborhood recovery initiatives. (Letter from Wells Fargo to Mayor Coleman follows in separate email.)

In *NAACP v. Ameriquest et. al*, SACV-07-0794 AG (C.D. Ca.), the NAACP filed a nation-wide class action in federal district court, against 18 lenders alleging violations of the Fair Housing Act, the Equal Credit Opportunity Act and the Civil Rights Act, 42 U.S.C. Sec. 1981. On January 12, 2009 the Defendants Motion to Dismiss was denied. Several defendants have been terminated, and the remaining parties are engaged in motions practice before Judge Andrew Guilford.

Many cities are monitoring Baltimore's suit against Wells Fargo and considering similar suits. Numerous municipalities are pursuing legal strategies to aggressively enforce building codes and vacant building registry requirements against REO properties post foreclosure. In addition numerous states and some cities (i.e. Philadelphia) are pursuing some version of mandatory mediation in foreclosure proceedings. (Mandatory Mediation Study to follow.)

2. Please describe any efforts that local governments have undertaken to coordinate their responses to possible reverse redlining by mortgage lenders.

In September 2008, the City Solicitor of Baltimore and the City Attorney of St. Paul co-founded (as Co-Chairs) the International Municipal Lawyers Association ("IMLA") Foreclosure Litigation Workgroup. Currently 19 cities have signed a common interest agreement and conduct monthly member-only conference calls discussing developments and strategies in litigation and alternatives to litigation concerning the foreclosure crisis.

The cities which are signatories to the common interest agreement include, Arlington, TX; Atlanta; Baltimore; Buffalo; Chicago; Cleveland; Denver; Detroit; Duluth, MN; Memphis; Miami; Minneapolis; New York; Oakland; Sacramento; St. Louis; St. Paul; San Francisco; Shelby County, TN. The Workgroup presented a panel on Foreclosure Litigation at IMLA's Annual meeting in Miami in October, and it held a closed meeting for common interest participants there as well.

IMLA also conducts monthly conference calls, open to any municipality, concerning Code Enforcement. To date, 135 municipalities participate in those calls.

3. If there are any additional points you wish to make—by way of elaborating upon your hearing testimony or responding to the testimony of other witnesses—please do so.

It would vastly simplify oversight of lenders for racially discriminatory lending if they were required to report FICO credit scores as part of their Home Mortgage Disclosure Act reporting. Without credit data, municipalities evaluating the validity of claims against lenders, or for that matter, the federal enforcement agencies charged with enforcing Fair Housing and Fair Lending laws, must engage in costly investigation, discovery and/or litigation. The lenders already collect this information so it would not be unduly burdensome to require public reporting. The increased accountability alone would likely improve legal compliance, as we well know that sunshine is the best disinfectant. This measure was recommended by the GAO July 2009 report.

RESPONSE TO POST-HEARING QUESTIONS FROM JOSEPH R. MASON, PH.D., LOUISIANA STATE UNIVERSITY

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing the Role of the Lending Industry in the Home Foreclosure Crisis
September 9, 2009

Jospeh Mason, Ph.D., Louisiana State University

Questions from the Honorable Steve Cohen, Chairman

1. You stated that by changing bankruptcy law in 2005 to make it more difficult for consumers to discharge debt, Congress may have inadvertently encouraged lenders to engage in risky mortgage lending practices. Do you have a similar concern with respect to other types of consumer credit?

Michelle White at University of California Can Diego has written extensively on this topic. I defer to her for more specifics, however, her own work has shown that the credit card industry responded to those same incentives, as well. The results for credit cards are well accepted in the industry. I know of no evidence regarding automobile loans or other consumer credit, however, although only for lack of research in the topic as those sectors are far smaller and receive less attention than mortgages and credit cards.

2. Should Congress revisit some of the 2005 bankruptcy amendments that you identified – including the means test and higher filing fees - that made it more difficult for consumers to obtain bankruptcy relief?

In my opinion, it may be appropriate for Congress to revisit bankruptcy reform to attempt to strike a better balance of incentives between the old and new systems. While it is laudable to attempt to hold consumers responsible for amounts they can repay in bankruptcy and avoid overuse of the bankruptcy safety valve, we must also acknowledge that the safety valve is there to release pressure that can build to an economic crisis like that we have in place today.

As a caveat, however, I also am of the opinion that because of the complex incentives involved, it may not be wise to attempt such reform in the near term as credit markets and consumers right now need a stable set of incentives to make financial decisions in an uncertain economic environment. So unless such changes are clearly stimulative to borrowers and lenders alike, legislative changes are best left until well after the crisis has passed.

RESPONSE TO POST-HEARING QUESTIONS FROM LEWIS D. WROBEL, ATTORNEY AT LAW

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing the Role of the Lending Industry in the Home Foreclosure Crisis
September 9, 2009

Lewis Wrobel

Questions from the Honorable Steve Cohen, Chairman

1. Would the availability of judicial mortgage modification authority for principal residences enhance the successes of the loss mitigation program developed by Judge Cecelia Morris in the Southern District of New York? Please explain.

It is my belief that the availability of judicial mortgage modification authority for principal residences would enhance the success of the loss mitigation program developed by Judge Cecelia G. Morris. As the program is currently constituted, a number of lenders are offering mortgage loan modification to debtors. The voluntary participation of banks would only be increased if the lender knew that the Bankruptcy Judge had the ultimate authority to alter the terms of the loan. The lender would have greater incentive to negotiate a meaningful loan modification with the debtor/borrower if the lender knew that the Court had the power to modify the loan. A negotiated settlement is always preferable to a judicial decree.

2. If there are any additional points you wish to make—by way of elaborating upon your hearing testimony or responding to the testimony of other witnesses—please do so.

The frustration of borrowers with the slowness of the loan modification process continues. I believe that banking regulations, which set up specific time frames for the lender response to a loan modification request, would be very helpful.

PREPARED STATEMENT OF THE HONORABLE CECELIA G. MORRIS, UNITED STATES BANKRUPTCY COURT FOR THE SOUTHERN DISTRICT OF NEW YORK—POUGHKEEPSIE DIVISION

Statement of Hon. Cecelia G. Morris

United States Bankruptcy Judge

Southern District of New York

Poughkeepsie Division

The Bankruptcy Court for the Southern District of New York has attracted national attention for its timeliness and success in its loss mitigation program. The program is remarkable for its uniformity, fairness, and efficiency.

The Bankruptcy Code does not allow a bankruptcy judge to rewrite residential mortgages. But it does not prevent the judge from forcing both sides to talk, in the hopes that they will avert either the loss of the debtor's property to foreclosure, increased costs to the lender, or both.

The court's program allows any party in the case to seek loss mitigation. Most lenders have their own in-house loss mitigation procedures, and borrowers have complained about not being able to speak to a live person when they call to inquire about utilizing the lenders' procedures. Lenders often are concerned about violating the injunction federal bankruptcy law imposes on efforts to collect debts from anyone under its protection.

In today's economy, the secured creditor is often better served in salvaging the mortgage and continuing to get payments, albeit at a lower interest rate.

As long as it is court authorized, loss mitigation in the Southern District of New York is available to any individual debtor under any chapter of the Bankruptcy Code who is trying to save the home. To qualify as a good-faith effort, each of the parties participating in the program needs to be accessible to the other and have settlement authority. All parties benefit from clear and established lines of communication and an enforceable deadline – the debtor knows that their questions and goals are under review, and the creditor has the opportunity to make the official statement that a debtor is not cooperating or does not have income to support a loan modification.

The loss mitigation order is an order from a federal judge, with the same weight as any other order issuing from bankruptcy court, including the power to hold a recalcitrant party in contempt.

The creditor has the opportunity to object to a debtor's request for loss mitigation, and to show the court it made a good-faith effort to resolve the issues related to a loan modification. If the debtor is using the program to stall, or does not supply the information needed to complete a loan modification, the creditor has the opportunity to build a record in support of its denial of loan modification. The creditor has the chance to make the official statement that debtor is not cooperating or does not have income to support a loan modification.

The genius of a court-supervised loss mitigation program is that it gives all parties involved the opportunity to say they did the best they could. The results of the program range from reduction of the principal balance to acceptance of reality that the home cannot be saved despite all efforts.

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