

EXAMINING LENDING DISCRIMINATION PRACTICES AND FORECLOSURE ABUSES

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WEDNESDAY, MARCH 7, 2012

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The Committee met, pursuant to notice, at 10:07 a.m., in room SD-226, Dirksen Senate Office Building, Hon. Patrick J. Leahy, Chairman of the Committee, presiding.

Present: Senators Leahy, Whitehouse, Klobuchar, Franken, and Grassley.

OPENING STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM THE STATE OF VERMONT

Chairman LEAHY. Today we welcome Assistant Attorney General Tom Perez, who has hobbled in here. And for the record, so that in case somebody reads this, he has just had knee surgery, so that is why I appreciate him taking the time to be here to discuss the Justice Department's efforts to combat discrimination in mortgage lending and foreclosure abuse. This Committee has tried to do its part in connection with the housing crisis, including our consideration of important legislation introduced by Senator Whitehouse after a series of hearings both here and in Rhode Island. Our exploration of the civil rights component of the housing crisis and foreclosure abuse is part of that effort.

The Obama administration has been aggressively responding to the foreclosure crisis. Yesterday the administration announced a new initiative which could benefit millions of homeowners by reducing their fees and providing an average savings of \$1,000 a year through refinancing. The administration reiterated its commitment to our men and women in uniform by outlining the steps it is taking to provide relief to those who have been harmed by lending abuses.

A few weeks ago, Attorney General Holder, Housing and Urban Development Secretary Donovan, and 49 State attorneys general, announced a historic \$25 billion settlement with the Nation's five largest mortgage servicers, and I commend them for that. Key actors were Associate Attorney General Tom Perrelli, Vermont Attorney General Bill Sorrell, and Iowa Attorney General Tom Miller, who helped lead the effort to investigate and expose the abuses and misconduct that have hurt so many. It will provide relief not just in my State of Vermont but in every other State.

I should recognize the Civil Rights Division for its role in obtaining compensation, above the \$25 billion settlement, to provide relief

to our men and women in uniform who have lost their homes to wrongful foreclosures. It is inexcusable that in some cases, under the Servicemembers Civil Relief Act, mortgage servicers failed to meet their responsibilities to our men and women in uniform who risk their lives in the service of our country. It is not only inexcusable; it is disgusting to see some of the news accounts in total violation of the law, foreclosing on men and women in uniform.

Just a few months ago, the Civil Rights Division fought on behalf of hundreds of thousands of African-Americans and Hispanics victimized by Countrywide Financial Corporation and received a landmark \$355 million compensation there.

Historically, lending discrimination has manifested itself in redlining, the refusal to lend to qualified minority borrowers in certain neighborhoods. We would like to think that those days are behind us, but apparently the Justice Department has identified a new and disturbing trend in lending discrimination, so-called reverse redlining, targeting minority neighborhoods and borrowers to push subprime and other riskier mortgages to individuals in certain communities who might otherwise have been qualified for safer and more traditional loan products. I hope that these recent settlements put banks and others on notice that our laws will be enforced and that those abuses for profit will not be tolerated.

The unsound practices of our Nation's biggest banks crept into the bankruptcy process, where Americans turn as a last resort. Last year, Senators Whitehouse, Blumenthal, and I introduced the Fighting Fraud in Bankruptcy Act to strengthen the Justice Department's efforts to protect American homeowners and our servicemen and servicewomen. Struggling homeowners, and in particular our service families, have to be treated fairly.

So I do welcome Assistant Attorney General Perez back before the Committee today. He knows this Committee very, very well. But before we hear from him, I will recognize first our Ranking Member, and then we will have the pleasure of welcoming back to the Committee Senator Ben Cardin, one of the best Senators I have served with, a man with a well-deserved reputation in Maryland. He has been a leader in these matters in the Maryland Legislature, in the House of Representatives, and in the Senate. He was a hard-working member of this Committee until his recent transfer to the Finance Committee, but he has never stopped his activity in matters of fairness and civil rights, and it is a pleasure to have him here.

I will yield first, speaking of the Finance Committee, to the Ranking Member.

Senator GRASSLEY. Because I have a longer statement than what you had, I would like to not hold up Senator Cardin. So let him go ahead and then call on me right after he is done. Is that OK?

Chairman LEAHY. I appreciate the courtesy.

Senator Cardin, go ahead, sir.

STATEMENT OF HON. BEN CARDIN, A U.S. SENATOR FROM THE STATE OF MARYLAND

Senator CARDIN. Well, Senator Leahy and Senator Grassley, thank you for the courtesy, and Senator Whitehouse. Senator Leahy, it is nice to be back to the Judiciary Committee. I must tell

you, on the other committees I serve the Chairman does not recognize me in the same way that you just did. So I thank you very much for those very nice comments. But it is good to be back, and I thank you for that. And I thank you for holding this hearing because I think this is an extremely important subject, and I applaud your leadership and the leadership of the members of this Committee.

I know from my own State of Maryland that families and communities are still hurting from the effects of lending discrimination and foreclosure abuses. The wounds are raw and real. There is still so much more that we can do. My own State of Maryland has become a model for the Nation in strategies for combating foreclosures. Working across agencies, the State has developed a comprehensive strategy that includes legal and regulatory reforms, as well as housing counseling and legal assistance networks. They are making a difference. Here is just one example.

A few weeks ago, I was proud to partner with the Maryland Department of Housing and Community Development to hold a foreclosure prevention workshop. That was not the first that I have held, and it certainly will not be the last. And there was very strong community turnout. In fact, Mr. Chairman, there were over 600 people who showed up for this mortgage foreclosure prevention workshop. It took place maybe 8 or 9 miles from here, in the Washington suburbs.

Viola Williams was one the hundreds of Marylanders that attended the event. Three years ago, she began to fall behind on her mortgage, mainly due to factors that were beyond her control. She was responsible and immediately got in touch with her bank about modifying her loan. For 3 years, she went back and forth with her bank. She became convinced that her bank was trying to wear her down. But she did not give up. She was persistent. She was proactive because she knew that her home was her biggest investment and she could not walk away. At my event, she met with a housing counselor who gave her honest opinions as to what she could do and what resources were available to her and how to deal with her bank.

Most importantly, she was able to meet directly with a representative from her bank who was able to directly submit her modification papers. After waiting for 3 years, a few days after this event Ms. Williams received her modification papers. Her story is a common one. But her happy ending is all too rare. We need to do more to help these people. There is no magic wand or silver bullet for fixing our housing problems. In the end, our success will be the result of a patchwork of policies and the hard work of government officials, housing counselors, and individuals. The path ahead is unknown, but we owe it to Viola Williams and others like her to keep trying and to provide them with the tools to stay in their homes.

Mr. Chairman, we can make a difference. Our policies can save people's homes, can save families, and can save communities. The height of the irresponsible lending practices was from 2004 to 2008. According to the Justice Department, the greater Washington area, including suburbs in my home State of Maryland, ranked among Countrywide's top 10 targets. In Prince George's County, the most

affluent majority-black county in the United States, these types of loans have had a devastating effect. At the beginning of the housing crisis in 2007, a State task force identified it as the epicenter of Maryland's foreclosure crisis, and the county's residents continue to struggle to stay in their homes. Mortgages for roughly one in four single-family residences there have been in default or some stage of the foreclosure process since 2006. And average property values have declined by 35 to 40 percent, and homeowners will continue to struggle with underwater mortgages.

The banks protected themselves by shifting the risks of non-payment to investors and made a profit in the process. These practices triggered the worst financial crisis since the Great Depression. And today many economists blame the anemic housing market as the biggest drag on our economy.

Many of the victims are honest, hardworking, responsible people that bought homes to raise their families, to pursue their dreams, and to make memories. And now they are trapped in a nightmare where they cannot refinance their homes to make them more affordable, or worse, are in serious risk of foreclosure.

I want to personally thank Assistant Attorney General Perez and the Department of Justice for the important steps they have taken and continue to take to protect families across the Nation. In December, the Department of Justice announced a historic settlement of a lawsuit involving Countrywide. Countrywide charged over 200,000 African-American and Latino victims more for their loans because of their race or ethnicity. Countrywide put more than 10,000 of those families who had qualified for safe loans in the less expensive prime market into risky, subprime mortgages, while at the same time white borrowers with similar credit histories were steered into safer, prime loans.

Traditional civil rights laws took aim at the practice of redlining, which in the housing context meant that banks and mortgage companies would favor lending to whites and disfavor lending to minorities. Congress passed the Fair Housing Act of 1968 and the Equal Credit Opportunity Act of 1974 specifically to prohibit discrimination based on race, color, or ethnicity in terms of selling, buying, renting, or financing a house. But today, in 2012, we are seeing a new type of housing discrimination. This is the practice of reverse redlining. While traditional civil rights cases dealt with being denied a benefit based on race—such as lack of access to public accommodations, employment, or the election booth—today's discrimination makes the victims believe that they are actually lucky and have finally achieved the American dream. I commend Mr. Perez for aggressively enforcing our civil rights laws to meet today's challenges.

This new type of discrimination results from the steering of Hispanic and African-American borrowers into less favorable loan rates, including subprime loans. According to the Department of Justice, these loans were often much more expensive and were subject to possible prepayment penalties, exploding adjustable interest rates, sudden rate increases after a few years, and increased risk of credit problems, default, and, ultimately, foreclosure.

Every family has paid a very steep price for the irresponsibility and recklessness on Wall Street over the last decade. But no group

has experienced the pain of this crisis more than African-American and Latino families. According to the Department of Housing and Urban Development, “between 2005 and 2009, fully two-thirds of median household wealth in Hispanic families was wiped out. At the same time, middle class African-American saw nearly two decades of gains reversed in a matter of months.”

Any way you look at it, it is an absolute tragedy. As my staff and I work with borrowers, banks, and housing counselors to keep hardworking families in their homes, I am grateful for the efforts taken by the State of Maryland and the Federal Government to stabilize our neighborhoods. At the same time, I look to Mr. Perez, the Department of Justice, and this Committee to continue our work in making sure that deceptive and discriminatory lending practices never happen again.

The Countrywide consent order and \$335 million settlement are but a first step. I commend the President for forming a Financial Fraud Enforcement Task Force to investigate and prosecute housing fraud and discrimination. Last month, Attorney General Eric Holder announced a multi-State settlement with five of the Nation’s largest mortgage servicers for origination and servicing fraud and wrongful foreclosures. As part of this settlement, these market leaders will implement new standards designed to ensure that borrowers are protected as they enter into mortgages.

In Maryland, this settlement will also bring \$1 billion to help homeowners. Forty thousand borrowers will be able to modify their mortgages to make them more affordable or receive restitution for the loss of their homes. The State will have more funds to increase mortgage counseling and legal services available to homeowners. The settlement is a positive step forward and is part of ongoing efforts by the States and on the national level to investigate previous practices, improve them going forward, and hold bad actors responsible.

Mr. Chairman, I am reminded of what Senator Ted Kennedy, a former member of this Committee, used to say when he discussed civil rights as the “great unfinished business of the Nation.” Let us keep working to fulfill the promise of the American dream for all our citizens.

Thank you.

[The prepared statement of Senator Cardin appears as a submission for the record.]

Chairman LEAHY. Senator Cardin, I thank you. I thank you for your hearings and your persistence on this. I know you well enough to know you will keep right on it. We would like to think that redlining has become a matter of the past, but I think one of our witnesses here today knows that it is not completely obliterated, but this reverse redlining is just as wrong and just as perfidious and just as damaging to the moral core of our country. So thank you very much for doing that.

Senator CARDIN. Thank you.

Chairman LEAHY. I realize you have to go to another hearing, so we will let you be excused. And I will yield to Senator Grassley.

**STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR
FROM THE STATE OF IOWA**

Senator GRASSLEY. Thank you, Senator Cardin.

I thank you for holding this hearing, and I fully support pursuing justice for victims of the mortgage crisis, and I would remind listeners that I took the lead in the Clinton administration, the Bush administration, and finally completing the job in this administration in bringing justice to black farmers who were discriminated against on Government programs. So I appreciate very much people fighting to make sure that justice comes to those who are discriminated against.

But the settlement that the Civil Rights Division of the Justice Department obtained—and I do not belittle that, the one against Countrywide, but I hope that it will not divert us from the real issues surrounding the mortgage crisis.

Recently, Barry Ritholtz wrote a column in the Washington Post concerning the larger robo-signing mortgage settlement. Many of the points that he made about that settlement also apply to the Countrywide settlement. The economic impact of the Countrywide settlement is minimal.

Now, remember, the complaint asked for the victims to be put in the same position they would have been absent the discrimination for civil penalties and, of course, for consequential damages. But the consent decree provided only \$1,700 per victim.

For those who still have these mortgages, perhaps this would cover a mortgage payment. Many of these individuals will still hold mortgages that exceed the value of their homes. The likelihood that they will default is essentially unchanged.

For other people, bear in mind that one-third of all Countrywide mortgages ended up in default. For these victims who are alleged to have paid higher costs and interest rates, the default rate is almost certainly higher. Since you no longer live at your most recent address, good luck for receiving the settlement. If you do, here is my advice: Do not spend it all in one place.

Like the larger settlement that State attorneys general obtained, this settlement is for Bank of America a mere cost of doing business. One, we still do not know what individuals took the unlawful action; two, they face no punishment; three, they can keep their jobs; four, Countrywide admits nothing, and the Government has proved nothing to the courts.

The problem is not limited to civil litigation. The Justice Department has brought no criminal cases against any of the major Wall Street banks or executives who are responsible for the financial crisis. In the greatest speech ever made concerning prosecution, then-Attorney General Robert Jackson said, "Law enforcement is not automatic. It isn't blind. What every prosecutor is practically required to do is select the cases for prosecution in which the offense is the most flagrant, the public harm the greatest, and the proof the most certain." And that has not happened in these cases.

I have already called for the resignation of the head of the Criminal Division, Lanny Breuer, for his false denials to Congress that ATF ever walked guns in Operation Fast and Furious, but that does not take away from the terrible job being done by him in pros-

ecuting financial crimes. So let us consider once again Countrywide.

The former CEO was accused of lying about the risk of Countrywide loans. He made more than half a billion dollars as CEO of Countrywide. The SEC let him settle for less than 5 percent of that amount given that Countrywide reimbursed him for most of the costs. Something is seriously wrong if the allegations, including discrimination, against the former CEO are true but he keeps 95 percent of his salary.

Even worse, Mr. Breuer's Justice Department decided not to bring any criminal charges against him. Mr. Breuer recently stated that it was important not to "completely discount the deterrent effects when we investigate cases, even if we do not bring them." Now, this is a preposterous statement. The Department's message is that crime does pay. Light settlements and no prosecution not only do not deter, they also invite crimes of this sort to occur against similar future victims. How are the Department's enormous resources being used? I think that is a question that we can beg.

The error in failing to prosecute Countrywide's former CEO is further compounded by the unwillingness of the Department to contact a former Countrywide vice president whose job was to fight fraud. And people know that I pay a lot of attention to what whistleblowers say, not meaning that they are always right, but most often you get valuable information from them. CBS interviewed this whistleblower, Eileen Foster. In her "60 Minutes" appearance, she discussed Countrywide's, in her words, "systemic fraud." She said they concealed evidence of fraud. She also had evidence of Countrywide's unlawful act of retaliation for reporting bank fraud and mail fraud to Federal regulators. Based on her statements, "60 Minutes" wondered why no charges of violating the certification requirements of Sarbanes-Oxley had been brought. Ms. Foster was fired but eventually recovered more than \$1 million for whistleblower complaints.

As the co-author, along with Chairman Leahy, of the whistleblower protection provisions Ms. Foster utilized, I am glad that she was made whole for her unlawful termination. However, I am appalled that the Justice Department turned a blind eye and refused to reach out to her.

When recently asked about the Department's failure to contact Ms. Foster, Mr. Breuer responded that she should not have waited for the Government. "There are telephones. You can Tweet. You can let the Government know." I think that is an insulting comment. Mr. Breuer obviously lacks comprehension of the enormous obstacles facing whistleblowers.

Other administration officials in this area are equally questionable. The administration is about to use taxpayer dollars through the HAMP program to bail out speculators who drove up housing prices during the bubble. Landlord will be able to qualify for up to four federally subsidized loan workouts. The benefits they will receive include lower interest rates, longer terms, and forgiveness of principal. We know for sure that Countrywide victims did not receive those benefits. I am glad that we see the National Council of La Raza here and the NAACP having representatives testifying be-

fore us today because they have a story to tell that we all ought to listen to.

Finally, I note that there have been multiple previous financial crime task forces announced by this administration, including a new one this year, but no major responsible party has ever been prosecuted. All the previous task forces did was issue press releases. They have added nothing to the existing entities that have also taken no meaningful criminal action. We should not expect anything more from the announcement of yet another task force. We should not confuse packaging with packages. All that matters is results—in other words, prosecutions and convictions. The American people are waiting. I ask consent to include that “60 Minutes” referral into the record.

Chairman LEAHY. Without objection.

[The information referred to appears as a submission for the record.]

Chairman LEAHY. Our first witness is Thomas Perez. He was nominated by President Obama to serve as the Assistant Attorney General for the Civil Rights Division. He was sworn in on October 8, 2009. Prior to his nomination, he served as Secretary of Maryland’s Department of Labor, Licensing, and Regulation. He also served as special counsel to the late Senator and former Chairman of this Committee, our good friend Ted Kennedy, acting as Senator Kennedy’s principal adviser on civil rights, criminal justice, and constitutional issues. He and I have known each other from that time, and he received his law degree from Harvard University in 1987.

I know it is not the easiest thing being here today, Mr. Perez, having recently had your knee surgery, but it means a lot to us that you are here, and I am going to turn it over to you. I would also note that at some point I am going to have to go to another Committee that I serve on.

Senator GRASSLEY. Mr. Chairman, I may have to go also to Finance.

Chairman LEAHY. No, you have to stay here if I go.

[Laughter.]

Senator GRASSLEY. Well, I will try to——

Chairman LEAHY. No, no, I am just kidding you. But Senator Franken is going to take over the chair when that happens. Please go ahead, Mr. Perez.

STATEMENT OF HON. THOMAS E. PEREZ, ASSISTANT ATTORNEY GENERAL, CIVIL RIGHTS DIVISION, U.S. DEPARTMENT OF JUSTICE, WASHINGTON, D.C.

Mr. PEREZ. Thank you, Mr. Chairman. It is an honor to be back here before the Committee. You inspired me over many years to purchase, among other things, many Jerry Garcia ties, and I want to thank you for that.

And, Senator Grassley, you always treated me with great respect when I was on Senator Kennedy’s staff, so there is a lot of wonderful ghosts in this room as I sit here today, 3 weeks removed from knee replacement surgery, which I am told is going to be helpful, but I have not yet seen it, so hopefully it will.

Chairman LEAHY. Or felt it.

Mr. PEREZ. Or felt it, yes, exactly.

As we all know, the housing crisis has touched so many communities across the country, and I have seen in my work as a civil rights lawyer at a State, Federal, and local level that communities of color, in particular African-Americans and Latinos, have been hit particularly hard. I have seen all too frequently that Latinos and African-Americans seeking equal credit opportunity were all too frequently judged by the color of their skin rather than the content of their creditworthiness. And for all too many years, accountability was lacking and enforcement was spotty, at best.

That is why, in the wake of the housing and foreclosure crisis, the Federal Government under the leadership of President Obama has indeed responded forcefully. To address the lending discrimination, Attorney General Holder created a Fair Lending Unit in the Civil Rights Division's Housing Section. Since the establishment of that unit, thanks to the dedicated career staff in the Division, we have brought record numbers of enforcement actions. In the approximately 2 years since the unit was established, we have filed or resolved 16 lending matters, and by way of comparison, from 1993 to 2008 the Department filed or resolved 37 matters. So 16 in 2 years and 37 in the 15 previous years.

The Division produced an unprecedented set of results in 2011 alone. We filed a record eight lending-related Federal lawsuits and obtained eight settlements, providing for more than \$350 million in relief. I will talk shortly about our Countrywide case. I also look forward to talking about the record relief we have gotten on behalf of servicemembers.

No one case can rectify the multitude of unlawful practices, but as our enforcement record illustrates, we use every possible tool to combat the range of abuses seen in the market, both mortgage and non-mortgage lending.

Collaboration is key to what we have accomplished. We have been working very carefully and closely with the regulatory agencies, and they have picked up the pace of their work, and let me give you a data point there: From 2009 to 2011, the regulatory agencies, the FTC, and HUD referred a total of 109 matters involving a potential pattern or practice of lending discrimination to the Justice Department. Fifty-five of those matters involved race or national origin discrimination, a combined total that is far higher than the 30 race and national origin matters that we were referred 2001 to 2008. So we got 30 race and national origin matters in 8 years, and we got 55 over the course of the last 3 years. They have definitely picked up the pace of our work.

Let me talk about Countrywide because that is the largest settlement—in fact, more than 50 times larger than the next largest fair lending settlement—in our history. Our complaint against Countrywide alleges that the systematic discrimination over a 4-year period violated the Fair Housing Act and the Equal Credit Opportunity Act and impacted more than 200,000 African-American and Latino families, and at the core of the case was a very simple story. If you are African-American or Latino and you were qualified, you likely paid much more for a loan than a similarly qualified white borrower simply because of the color of your skin.

So, for instance, a qualified non-subprime customer in Chicago seeking a \$200,000 loan in essence paid a racial surtax of about \$1,100, unnecessary fees. A Latino paid \$1,235 racial surtax simply because of the color of your skin.

In addition, if you are African-American or Latino and you qualified for a prime loan, you were far more likely to be steered into subprime loans, and the impact of this is literally tens of thousands of dollars in increased costs, not to mention the corrosive features such as prepayment penalties and the increased risk of default.

This was what this case was about, remedying discrimination, and we reviewed 2.5 million loans, including data loan terms and information on creditworthiness. It was the most Countrywide investigation in our history, and I was proud to be part of it, and I appreciate the work of the career staff as well as the regulatory agencies that referred it.

We have also done four other pattern or practice pricing discrimination cases since the unit was established, and we have also continued the regrettably time-honored cases involving redlining, which is the practice where a red line is literally drawn around certain elements of a city that are predominantly minority and lending does not occur there. That practice has been around, regrettably, since seemingly the beginning of time. Our settlements also have gone to expand opportunities for minority communities and others to access credit in areas where a lender had previously denied those services.

Let me turn very briefly to our work in the SCRA context because we have had a robust array of work on behalf of our servicemembers. Last year, we settled a case with the Bank of America, the largest SCRA settlement. These are our Nation's finest serving our Nation, and while they were serving our Nation abroad, they were having their homes foreclosed at home illegally. And we had a \$20 million settlement fund in the Bank of America case.

We also had another case involving Saxon Mortgage, and then most recently as part of the \$25 billion mortgage servicer agreement, we were able to reach agreement with the other servicers. And so there will be a minimum of \$116,785 in compensation, and that is a floor. That is not the ceiling. And this compensation is in addition to the \$25 billion settlement fund. So we continue to aggressively enforce the Servicemembers Civil Relief Act on behalf of our servicemembers and their families.

I have spoken about our litigation experience, but we also have an active program of education, outreach, and prevention. We reach out regularly to those in the industry. We share our lessons. I do not understand why the redlining cases continue to occur, and we share what happens. An ounce of prevention is worth a pound of cure, and so many of the discriminatory practices that we see could be prevented if there were adequate internal controls. I spend a lot of time working with police departments to develop adequate internal controls, and similarly, we spend a lot of time working with lenders so that they can develop adequate internal controls, because I would far rather prevent the train wreck from occurring than pick up the pieces. And, regrettably, there are too many pieces to pick up. And as such, we will continue to use every tool

in our arsenal to ensure that there is equal credit opportunity across America.

I look forward to answering any questions that you may have today, and once again, it is an honor to be here, and thank you for your leadership in all of these matters.

[The prepared statement of Mr. Perez appears as a submission for the record.]

Chairman LEAHY. Thank you very much, Mr. Perez. As I noted, when I first got into this, finding out about this reverse redlining, you just wonder what decade or even what century you are living in.

Now, some have actually criticized the Obama administration for protecting borrowers who are targeted because of the color of their skin. Some have argued the Justice Department is interfering between a lender's ability and willingness to make credit available and a borrower's right to freely enter into a contract. I think you know from my earlier statement I do not buy that argument, but how do you respond to it? And is your work with reverse redlining a part of the core responsibilities of your Division?

Mr. PEREZ. The answer to your second question is absolutely. Redlining referred to the practice of drawing a red line around communities and failing to offer prime loan products. Reverse redlining is the flip side: targeting minority communities and offering the toxic products that are incredibly destructive.

There is often a false choice that I have heard, Senator Leahy, Mr. Chairman, and that is the choice between common-sense consumer protection and fair lending and preserving a sound lending climate for business. I think if there is one lesson we have learned from the meltdown, it is that the absence of common-sense consumer protections not only undermines communities, but it put a lot of lenders out of business. I know in Maryland we worked on a lot of consumer protection work, and all of those bills passed unanimously between the industry recognized that it was important to put the stops on no-doc loans and other abusive practices that were undermining the industry.

And so I think it is a false choice, and that is what I say when I have the outreach to lenders, is that we can have common-sense fair lending enforcement and consumer protection and preserve that sound lending climate for businesses. We can and must do both.

Chairman LEAHY. Well, as you know, in the current litigation, we saw some of the documents. In one case bank employees state that subprime loans were referred to internally as "ghetto loans," and that African-Americans are targeted because "they were not savvy enough to know they were getting a bad loan, and the bank would have a better chance of convincing them to apply for a high-cost subprime loan."

Frankly, as far as I am concerned, those who would do that, you should be cracking down on them every way you can, both civilly and I believe in some instances criminally.

Mr. PEREZ. I agree, and we see these practices. I am holding up a photograph of—this is Detroit, Michigan, and in this particular case the bank is required under the Community Reinvestment Act to establish its catchment area, and there is a red dot here. This

red concentration is the African-American concentration, and their catchment area that they established was a horseshoe all around the African-American communities.

A picture tells a thousand words, and when I look at this, I cannot help but wonder why aren't there internal systems of control, because you do not need to be a rocket scientist to see that you have established in all of the white areas where you are going to do business, and you have deliberately ignored African-American areas. And we do peer analysis, so other banks are in the African-American areas; they are doing well and they are doing good. And so this is not a case of there is no business there. That is a stereotypical judgment. But we see this all too frequently. There are emerging abusive practices, and then there are some time-honored practices, and we are going to root out all of them to the best of our abilities.

Chairman LEAHY. I appreciate that. You also had a role in reaching an agreement to compensate servicemembers for wrongful disclosures. I introduced legislation to require creditors in a bankruptcy case to certify that the requirements of the Servicemembers Civil Relief Act had been met. Do you believe that legislation, the Fighting Fraud in Bankruptcy Act, would help the Justice Department ensure that military homeowners are protected?

Mr. PEREZ. Again, anything we can do to help service-members I think is very, very important. For instance, we actually prepared and disseminated to a bipartisan group of lawmakers a series of legislative proposals regarding servicemembers, and including the SCRA, and we have done a lot of work on the credit provisions that you are referring to, on the foreclosure provisions, and we are trying to expand the protections for our servicemembers, and we look forward to working with you and with Senator Grassley, because this is not a Republican or a Democratic issue. Protecting our servicemembers has always been a bipartisan issue, and I look forward to working with you.

Chairman LEAHY. I agree with that, and you have also worked on discrimination on the basis of sex and familial status when mortgage companies have refused a woman who was on paid maternity leave.

Mr. PEREZ. Yes. We have a case in Pennsylvania that we filed roughly a year ago on that issue.

Chairman LEAHY. Well, I hope you will continue it, and I will turn the gavel over to Senator Franken and turn it over to Senator Grassley.

Mr. PEREZ. Good morning, Senator. It is an honor to see you again.

Senator GRASSLEY. Thank you, General Perez, for being here. I have already stated some opinion that I have about this, so you already have some background for questions I might ask.

The complaint that the Department filed against Countrywide alleged intentional, willful, or reckless discrimination against Hispanic and African-American borrowers. Nobody argues with that. It asks that victims be restored as nearly as practical "to the position that they would have been in but for the discriminatory conduct," plus asking for civil penalties. But the consent decree provided only \$335 million, not nearly enough to do anything like restoring the

victims to the position that they should have been, and there was no civil penalty, and the bank can deduct the settlement costs from its taxes, which could take away up to one-third of the bank's sting already.

So, question—and when I use that figure \$335 million, just remember in the case of Bank of America, they earned \$9 billion last year. Won't banks that may have discriminated view settlements that are so much weaker than the relief sought in the Department's complaint as a cost of doing business rather than a deterrent to future bad acts?

Mr. PEREZ. I appreciate your question, Senator, and we certainly hear from banks that we are too hard on them. And so it is interesting that you should say that.

Our goal in this particular case when we established the settlement fund was to maximize the amount of dollars that would go directly to victims. And I should note in this case, Senator, that there are two types of victims. There are the people who are the victims of pricing discrimination, and, again, the average amount of recovery there will be in the \$700 to \$2,000 range, depending on the individual.

And then there are the steering victims. Those are people who should have been in a prime loan but were discriminatorily put into subprime loans. They will be recovering in the tens of thousands of dollars on the average, and we will have an individual case-by-case analysis of what they should recover.

This settlement is about 50 times larger than any settlement we have had. I do not think there is any home run, Senator, in the work that we do. There is no one case that is going to be the panacea to address all of the abuses of the past 10 years.

I am very proud of the work that was done in the servicer agreement. The servicer agreement does some great things, but as Secretary Donovan has correctly pointed out, that does not address the underwriting abuses. That addressed another part of the problem.

And so our approach, Senator, has been to make sure that we continue to do our level best to address every type of abuse, and we continue to hit, I believe, a series of doubles and singles and a triple here and there, and we are going to continue to do that. And I do not know of any one case that we could bring that will resolve this, but I think it is very important that the Government become a credible deterrent. And in our fair lending work—and I have outlined the cases that we have brought, both the quantity and quality, I think we have done that. And we will continue to do that because I think there is a role for common-sense fair lending enforcement, and we have to be vigilant in that area.

Senator GRASSLEY. Your testimony references the settlement that the Department obtained against lenders who violated the SCRA. That law protects the rights of servicemembers not to be foreclosed on while they are on active duty.

Now, those individuals received a minimum of \$117,000 plus lost equity.

Mr. PEREZ. Correct.

Senator GRASSLEY. That figure is 70 times larger than the average settlement at Countrywide.

Mr. PEREZ. Sure, and that figure was a function of the direct economic harm and the emotional harm, and that was a function of that—and, by the way, that figure is a floor. If there is lost equity in any servicemember's home that exceeds that, then they will get that. And another important aspect of the servicemember agreements that we just reached is that there is not a cap on the amount that the servicers will be paying. So, in other words, we will be—depending on how many—if we identify 600, then they will compensation all 600. They will not reach a cap and say, “No more.” That was a very important part of the agreement.

And, again, that reflects the damage that we found in that particular case, and so that is how we arrived at those figures.

Senator GRASSLEY. Mr. Chairman, let me ask one more question.

Senator FRANKEN [presiding]. Absolutely.

Senator GRASSLEY. Some of the settlements that you described as “innovative” worked to help banks to build relationships with new customers. Why don't some of the settlements include such innovative ideas as removing bank executives who knew of or approved of discrimination?

Mr. PEREZ. Well, it is an idea that is worth considering. When we meet with and negotiate these decrees, we have a lot of different ideas on the table, and in the course of these agreements, we also have a very active monitoring capacity. And so if we continue to see problems, we continue to have the ability to remedy those. But, again, we are trying to reflect the balance between our enforcement responsibilities and allowing the bank to make their appropriate judgments.

Senator GRASSLEY. Thank you.

Thank you, Senator.

Senator FRANKEN. Assistant Attorney General Perez, thank you for your testimony. It is clear from the Countrywide settlement and from your written testimony that the policies that Countrywide had in place between 2004 and 2008 led to widespread discrimination against racial and ethnic minorities. I am going to come to this \$335 million figure. While I commend DOJ for bringing the case, again, the settlement only comes to about \$2,000 per individual, if you can find these individuals. And these are people who may have lost their homes based on illegal lending discrimination.

Why is \$335 million adequate when there are, you know, presumably in the SCRA settlement you are talking about \$176,000 or something for a wrongful foreclosure? These are people who, because of the discrimination, went into foreclosure, may have gone into foreclosure directly because of discrimination. Why was \$335 million arrived at? I realize it is a lot larger than any other settlement you have had, but, still, Countrywide was a lot larger entity, wrote a lot more of these loans, was a lot larger defrauder of the American public. How was that figure arrived at? Was it that you had to reach this settlement and you felt that was the farthest you could go? Or how was that done?

Mr. PEREZ. First of all, let me again reiterate there are two categories of victims in the Countrywide case. There are the pricing discrimination victims who were charged, in essence, a racial surtax, and the figures that they will get, they will be compensated for that, what I call “racial surtax.” Then there are steering vic-

tims. These are, again, people who should have been in a prime loan but were steered into subprime, and we will be making case-by-case individual determinations. And it is our estimate that the average steering victim will recover tens of thousands of dollars because if you had a 7-percent loan when you should have had a 5-percent loan, you can do the math and figure out that the recovery is going to be significantly greater.

Senator FRANKEN. Well, what I am saying is that the terms of the predatory or subprime loan where they should have qualified for a better loan may have been the very thing that drove them into foreclosure. And it seems to me that the damages to them far exceed a few tens of thousands of dollars.

Mr. PEREZ. We will be doing a case-by-case evaluation, and the fact that we have this particular settlement fund, as we identify particular individuals and we see the harm that it has caused, that does not prevent us from going back and attempting to use other tools to assist them. So I think one of the major benefits of this—and there are about 2,000 victims in the Twin Cities metropolitan census area, and I think one of the real benefits of this is to be able to identify people and make that particular judgment. In some cases, you know, people—well, in most cases, people were unaware that they were victims. That is the insidiousness of this. It is discrimination with a smile.

Senator FRANKEN. Sure.

Mr. PEREZ. And in some of those cases, they continue to have their home, and in other cases they do not. And that is why we are going to be doing the individualized determinations so that we not only have the settlement fund at our disposal, but then there are other programs through the Federal Government that we may be able to use that will help people. And so—

Senator FRANKEN. What are those?

Mr. PEREZ. Well, again, the President has been very active in attempting to expand the universe of programs to help people who are underwater, and so this is a real coordination challenge and a real coordination opportunity, because we will have the names—we have the names of the victims in this case, and we are in the process, through the administrator, of reaching out to them. And that is going to present us with opportunities. This is not just—one way that Government often works is, well, here is your—we are in this narrow lane, we have got this settlement fund, if you do not qualify, you go somewhere else. That is not the approach we are taking. You may have been a victim here, and you may be entitled to \$2,000, but you may have other challenges, and what we are going to be doing is working with them to see what other opportunities we can use to avail ourselves to assist them to stay in their home.

Senator FRANKEN. And I assume that part of that will be to assist eligible borrowers to refinance their loans.

Mr. PEREZ. Again, availing them of programs of that nature, and I know that has been an interest of yours for some time.

Senator FRANKEN. Well, yes, I have introduced a bill, the Helping Homeowners Refinance Act. You know what I would like to do? I would like to go to Senator Whitehouse because I am going to be chairing this for the third panel, so I am here. I know that both Senator Klobuchar and Senator Whitehouse may have—I do not

know their schedules. I am not intimately involved with their scheduling. But in that event, I would like to allow them to ask their questions, and I might just hold you for a little bit extra, and then we will go to our next panel.

Mr. PEREZ. I would be honored to stay.

Senator FRANKEN. Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Chairman.

Mr. PEREZ. Good morning, Senator.

Senator WHITEHOUSE. Good morning. How are you?

Mr. PEREZ. Doing very well.

Senator WHITEHOUSE. We are glad to have you back here and glad that we are here on this issue because it has been a source of immense frustration to a great number of us here in Congress. Rhode Island has been hit very hard by foreclosures, and the frustration is that in many cases those foreclosures should not have happened. Some of them should not have happened as a matter of law because they befell veterans, because the documents were phony, because the foreclosure was itself illegal. Some of them should not have happened as a matter of economics. The person in the house was actually the best person to buy the house, and yet the bank insisted on throwing them out and having an empty house get scavenged in the foreclosure market with real costs to the neighbors and to the community around it. You have people who cannot refinance because they are underwater, but they could do fine if they were allowed to refinance. And it is not their fault they are underwater. That is because of the housing crash.

I have heard over and over again from the Rhode Island realtors about what a disaster the short sales are in terms of just plain mismanagement of short sales by the bank so that it becomes impossible both for buyers and realtors to deal with them. It is just not worth your trouble. And the sort of ultimate folly is banks that agree to a short sale and then turn around and foreclose on their own short sale because the right hand and the left hand do not know what they are doing. And now you have got everybody just tearing their hair out again. It is just constant frustration. And in some cases, the foreclosure, frankly, should not have happened just as a matter of decency, and it could have been solved if there had been somebody there to talk to. And one of the prevailing complaints I have heard over the years has been that folks who have their homes at risk cannot find a human being to talk to. They have to dial the 800 number. They have to go through endless push buttons. They finally find somebody name Joe or Tom or Frances or Jane, and then that person will not give their last name, and you never find them again, and the information probably is not accurate, and it is different from the papers that they have got in front of them. And the confusion and the fear is a huge cause for frustration.

So please push harder on this. I think wherever you go in that array of reasons why foreclosure would not happen, you find the banks right there at it, the banks and their lawyers failing with the documents and performing illegal foreclosures, the banks basically going against their own economic best interests and the economic best interests of their investors, fouling up the ability of homeowners to stay in their homes and forcing foreclosures that

just hurt communities. And probably the worst consumer protection problem that I come across is people with their homes at risk who simply cannot get a straight answer, who simply cannot find a human being to talk to who will talk to them a second time later and be familiar with their case. That is the single-point-of-contact problem, as referred to by the Government. And, frankly, I do not think it has been that great, the response. I think we need to do a lot better, and I think we need to press very hard to make these banks clean up their act. This is just plain bad management of these cases.

I would particularly like to focus on veterans because I have a piece of legislation that would increase the penalty for foreclosures on veterans. Could you tell me what you are doing about illegal foreclosures on veterans while they are serving overseas or during the period when they are still coming back and recovering economically as they try to get back into this tough jobs market.

Mr. PEREZ. Sure. We reached a settlement last year with Bank of America and Saxon in connection with the illegal foreclosures, and some of the stories were just shocking—servicemembers who had been deployed, sustained serious injury, including things like TBI, and they are losing their home in the process because of violations of the SCRA. And so we reached the agreement with Bank of America, and, again, the floor in terms of the recovery is \$116,000 and change, and it can go higher depending on our particularized assessment of the individual situation. So if there is other equity loss, et cetera, that number can go higher. And then in connection with the most recent servicer agreement, we were able to reach agreement with five servicers and, again, the figure I cited is the floor as we move forward.

You know, in the servicing context, I have not yet met a lender who was deliberately trying to screw servicemembers. But that is no excuse nonetheless. They should know what the rules are. The rules are very—they are transparent, and they were in violation. And so I think we are working hard on those, and—yes, absolutely.

Senator WHITEHOUSE. The fact that it is a systems failure rather than intentional is no solace to the—

Mr. PEREZ. And that is exactly right—

Senator WHITEHOUSE.—their home.

Mr. PEREZ. And I absolutely share your frustration. I worked on this issue when I was a cabinet secretary in the State of Maryland. I was one of the Governor's point people on foreclosure prevention, the communities that Senator Cardin talked about. I have spent a lot of time with Senator Cardin in those communities. We used to talk about equity stripping back in 2006 in Prince George's County. We do not talk about equity stripping anymore because there is no equity left to be stripped because of what has happened in the market.

The one thing I have learned from this is that the problems were many years in the making, and they are going to be many years in the solution. They are going to require vigilance. I am very proud of the Countrywide agreement because—again, it is not a home run. I do not think we have any home runs in our arsenal. There is not one solution that is going to solve everything. The servicer agreement that was just reached is another critical compo-

ment forward, and you mentioned, Senator, the concept of the single point of contact. That is critical. I cannot tell you the number of people that we have heard from, and I know you have heard from, who just cannot get the darn phone answered. And then if you are limited English proficient, you are in deep—you are hot water. Senator, I do not know the other word for it.

[Laughter.]

Senator WHITEHOUSE. Just as well.

Senator FRANKEN. Do not look at me.

Mr. PEREZ. I do not know why I looked at you, Senator, for guidance on that.

[Laughter.]

Mr. PEREZ. So we have seen this, and you certainly have my commitment, because we have done more than we have ever done before in fair lending, but we need to do even more, because I recognize that for all the people we have helped, there are scores more that need our help, and that is why it has been an all-hands-on-deck enterprise and will continue to be so.

Senator FRANKEN. Senator Klobuchar.

Senator KLOBUCHAR. Thank you very much.

Mr. PEREZ. Good to see you again, Senator.

Senator KLOBUCHAR. Good to see you. Thank you for—I was going to ask you about the servicemembers, and I appreciate your work in that area. It is completely unbelievable that that would happen.

I was going to first start off by asking you about—I authored an amendment with Senator Merkley during the Wall Street reform bill to help end the practice of steering, whereby loan originators are compensated for leading borrowers into non-prime loans that are not sustainable for them over the long term. And in your testimony, you discussed how in the Countrywide case minority borrowers were steered into loans that—this is your own quote—“cost them on average thousands of dollars more and caused additional harm as a result of increased risk of prepayment penalties, credit problems, default, and ultimately foreclosure.”

Could you discuss how this discriminatory practice harms not only the borrowers and their families but also damages the housing market?

Mr. PEREZ. Sure. Again, we looked at data on 2.5 million loans, so we really did an unprecedented review, and this was a comparison of qualified white applicants with similarly qualified African-American and Latino applicants, and we saw that if you were Latino, you were something like two to three times more likely to be steered into the subprime loan and similar likelihood for African-Americans. And that is unconscionable because it is not only the damage to the particular individual, but then when you have one foreclosure which leads to another foreclosure you see the damage to the community. So the collateral damage is as burdensome and destructive as the damage to the particular family. And that is why we focused a lot of effort and we do have other matters under review that involve similar issues of steering, and we will continue to see that happen.

Senator KLOBUCHAR. Thank you. I think that point is really important, that while the damage is immense to the individual fam-

ily, people have to understand it is not just, oh, it is my neighbor. It affects the whole community.

Last year, I held a hearing in my Judiciary Subcommittee on the Financial Fraud Enforcement Task Force and the important contributions it has made. In your testimony, you talked about the task force, the role that it played in the discrimination investigation. Can you talk about how that is going, the collaboration with State and local authorities in order to fulfill your mission?

Mr. PEREZ. Oh, it has been going very well. In the Countrywide, for instance, we worked very closely with the attorney general of Illinois, Lisa Madigan, who was a critical partner in this enterprise. I have traveled to the south side of Congress and the west side of Chicago with Attorney General Madigan to a number of distressed communities to hear directly from individuals.

The work we have been able to do with regulators—and I gave some data in my remarks today about the increase in the number of referrals. Virtually every case I am talking about is a referral from a regulator, and they have really picked up the pace of their activity, and without them we really cannot do our job.

Senator KLOBUCHAR. Do you see any kind of geographic patterns? Are there areas that are hurting, you know, where you see areas that are hit the hardest by foreclosures? Is there more discrimination? Is there any geographic pattern?

Mr. PEREZ. That is an interesting question. As I reflect on the geo-mapping of our cases, you know, we have had cases in urban areas, St. Louis and Detroit, that have large African-American and Latino populations. In Countrywide, 30 percent of the victims were in California. But there were 2,000 victims in the Twin Cities area. And while I have not specifically geo-mapped where they are, I am going to guess that they are probably concentrated in Minneapolis and St. Paul. And so where you have larger concentrations of minorities, you tend to have larger concentrations of our fair lending work.

Senator KLOBUCHAR. It makes sense. I was just thinking, because in the health care area where we had more disorganized health care systems, we had more fraud in those areas.

Mr. PEREZ. Correct.

Senator KLOBUCHAR. Even though those two things did not seem related, but this is a different issue.

Last, multiple agencies, I have been struck by how many different agencies are involved in overseeing mortgage lending practices and forcing our banking laws. The President has shown an interest in streamlining our Government and made a significant proposal in the trade and commerce area. The Wall Street reform law took some steps to streamline, but do you think there is any opportunity to streamline things and make it more focused and efficient?

Mr. PEREZ. Well, I think we have tried to make it more focused and efficient through the working group and the task force, and one of the things we are trying to do is marry data bases because sometimes you get your own data, you put it in your own data base, and little did you know that another regulator might be working on a similar issue.

And so one of the many value-added of the work that we have done is to make sure that information sharing is occurring as a matter of course, and that enables us, I think, to do our job better.

Senator KLOBUCHAR. Thank you.

Senator FRANKEN. I am going to just follow up a little on a couple things as quickly as I can. Then Senator Grassley, I know, before the next panel would like to say a couple things because he—and he will listen to the testimony of the next panel, but he will have to go at a certain point.

I wanted to talk about just a couple things. I want to pick up on what Senator Whitehouse was talking about, this complaint that he talked about that I have heard over and over again, that when borrowers are underwater and seek the Government's help, they sometimes fall through the bureaucratic cracks, to say the least. Often they talk to several different people and get several different answers. Servicers lose their documentation all the time, and that is why I introduced a bill—and this was actually during the Wall Street reform bill—to create an Office of the Homeowner Advocate, and this office is based on the IRS' successful Office of the Taxpayer Advocate. It would help homeowners get the loan modifications or other help they need, and it would provide what you exactly talked about, the single point of contact, because I think that is the key, that you can call someone and that you talk to the same person every time so that person knows your history and has records of your history. And this is not brain science. I am sorry.

So I was wondering if we could work together to make this office happen. I do not know if it happens under Treasury, I do not know if it happens under the Consumer Financial Protection Bureau. But somewhere we need a place where people can call and know that they are not going to get a runaround, and a runaround caused by absolute total incompetence.

Mr. PEREZ. We have been having a lot of conversations about this issue. When I first entered the Justice Department in 1990—in 1989, in the Bush I administration, one of the things I remember from one of my early supervisors, he wrote on the board, "This is one of the most important things you need to remember, three words: Return phone calls." And I have sort of kept it in my mind, and unfortunately, I do not know that they went to the same training, a lot of the servicers here, because people cannot get phone calls returned.

When automated underwriting came into play and there was a lot of money to be made, now suddenly you could get a loan approved in 48 to 72 hours. Well, we need some form of automated servicing so that we can move with similar alacrity because time is of the essence. The most important things that people in distress need are time, money, an advocate to work for them, and a Government that is working for them. And you need all of those—

Senator FRANKEN. Well, that is what I am talking about, and I know—

Mr. PEREZ. I appreciate that.

Senator FRANKEN. Senator Whitehouse articulated it beautifully, and I know that Senator Grassley has had this experience. I think now that every member of the U.S. Senate has had this conversation in somebody's living room or their office or in the Senator's of-

fice about the litany of frustrating calls. It is a universal experience, and please, would you help me with that?

Mr. PEREZ. I look forward to trying to make—we need to improve this. We need to do better. There is no doubt about it.

Senator FRANKEN. OK. Well, I need an advocate in the administration.

Last month, I introduced a bill, the Helping Homeowners Refinance Act, to assist eligible borrowers in refinancing their loans. The same week I introduced my legislation, the President announced his plan to help borrowers refinance, which included my proposal, and I understand you cannot comment on any particular piece of legislation, but it is fair to say that the administration supports the policy of reducing barriers to refinancing. Is that the case?

Mr. PEREZ. Sure. And I look forward to reviewing the text of your bill, and I know obviously the administration does indeed support removal of barriers. And so we look forward to reviewing what you have introduced.

Senator FRANKEN. And I just want to say one last thing, then I will excuse you, on the Servicemembers Civil Relief Act. I was just meeting a couple days ago with members of the VFW from Minnesota who told me that they knew recently returned servicemembers who fell into that category. What should servicemembers and veterans who think they are victims of illegal foreclosure do to benefit from the settlement? What should they do?

Mr. PEREZ. Actually, they do not need to do anything because it is incumbent on us, and we have a data base that enables us to identify victims. Having said that, we have identified and established an 800 number so that if they have questions or want to talk to a live body—and they will get a live body—they can do this.

I did two calls yesterday with advocacy groups that deal with servicemembers to talk about this precise issue, and we have been getting a lot of calls, and the number—

Senator FRANKEN. And where would they find that—

Mr. PEREZ.—is 800-896-7743. 800-896-7743. And, again, under the terms of this agreement, it is not incumbent on servicemembers to opt in. It is incumbent on us to find them, and it is incumbent—and we are working very closely with—

Senator FRANKEN. Well, just in case you do not find someone—

Mr. PEREZ. Absolutely. No, we can use the help—we can use all the help we can get, which is why we have been having these outreach meetings. And I had two of them yesterday with advocacy groups that have a wide footprint across America.

Senator FRANKEN. Thank you. Thank you for doing that.

Mr. PEREZ. Thank you for your leadership.

Senator FRANKEN. Thank you for your testimony. Thank you, Assistant Attorney General Perez. You are excused. And I would like to turn to the esteemed Ranking Member.

Mr. PEREZ. It might take me a little while to excuse myself.

Senator FRANKEN. Well, do not worry about it. He is going to talk. But I would not that that is not a Jerry Garcia tie.

Senator GRASSLEY. I will be here until the bottom of the hour, but I have an 11:35 appointment I have to go to. I will be able to listen to most of the testimony, but most importantly, I want to

thank Professor Black for answering our calls for him to come here and testify. And I will be submitting questions to the panel for answer in writing.

Thank you, Mr. Chairman.

Senator FRANKEN. Thank you to the Ranking Member.

Senator FRANKEN. Now I would like to call the third panel, and while they are taking their seats, I would just like to say, as we heard from Mr. Perez and I am sure it will be echoed in the testimony from our next distinguished panel, the lending practices of Countrywide Bank were unlawful and unconscionable. There is no doubt in my mind that these activities were also immoral and the targeting and exploitation of racial and ethnic minorities for financial gain will also have long-lasting effects.

In Minnesota and across the country, foreclosures take a toll far beyond the immediate financial losses that the families experience. In addition to short-term financial insecurity and uncertainty, many families struggle to pay for higher education and retirement when they do not have the kind of equity provided by homeownership. Studies have shown that children are more likely to move frequently when their families lose housing stability, and student mobility is a major cause of low academic achievement. So these discriminatory lending practices will have long-reaching effects on the children and the families who experience this exploitation.

The Federal Housing Administration was established in 1934 to regulate the mortgage terms and interest rates, and it had strict lending standards dictating which mortgages and properties it would support. Included in these criteria was the consideration of the racial and ethnic demographics of the neighborhood. The FHA used color-coded residential security maps to determine where mortgages could or could not be supported. Red lines on the maps showed where mortgages were less secure based in part on racial and ethnic makeup of the neighborhood.

Putting the discriminatory practices of lenders such as Countrywide into this context, the kind of targeted predatory lending that we have seen in recent years is a tragedy. While I have no information to suggest these schemes were carried out with the intent of segregating neighborhoods, there can be no doubt that this has been their effect.

In Minnesota, 56 percent of loans to black Minnesotans in 2006 were subprime, and as Mr. Rodriguez noted in his written testimony, approximately one out of four Latino and black borrowers has lost a home to foreclosure or is at serious risk of foreclosure compared to about 12 percent of white borrowers. The effect of these trends is that racial and ethnic minorities are losing their homes and are forced into lower-income neighborhoods. These flawed lending practices will have long-term repercussions not only for those families who have lost their homes, but also for our society.

This leaves me with one question: How can we work to repair the damage that has been done? Last month, as I told Mr. Perez, I introduced the Helping Homeowners Refinance Act. This legislation will keep Fannie Mae and Freddie Mac from making investments that create a financial disincentive to helping borrowers refinance their mortgages. It will also help remove artificial barriers that are

currently keeping banks from competing to refinance eligible borrowers' mortgages.

This proposal to reward competition in the marketplace, which President Obama included in his recent plan to revitalize the housing market, will be an important first step for healing the damage that we have seen in recent years. Expanded access to refinancing is the low-hanging fruit. We know that many if not most eligible borrowers have not refinanced their loans, but by doing so they could save thousands of dollars a year. I am proud that the organizations of two of our distinguished panelists, the National Council of La Raza and the NAACP, have both endorsed this legislation. I hope that my colleagues on both sides of the aisle will work with me to take this first step toward a healthier and more equitable housing market.

With that, it is my honor to introduce our panelists.

Eric Rodriguez is the vice president of the Office of Research, Advocacy, and Legislation at the National Council of La Raza. His expertise includes policy issues affecting Latino families, economic and labor issues, and homeownership issues. He has a bachelor's degree in history from Siena College and a master's degree in public administration from American University.

William Black is an associate professor of economics and law at the University of Missouri-Kansas City. From 2005 to 2007, he was the executive director of the Institute of Fraud Prevention and previously taught at the LBJ School of Public Affairs at the University of Texas at Austin. He was also the litigation director of the Federal Home Loan Bank Board and has worked with the Federal Home Loan Bank of San Francisco and the National Commission on Financial Institution Reform, Recovery, and Enforcement. Thank you for being here.

Hilary Shelton is the vice president for advocacy and the director of the NAACP's Washington Bureau. In his current capacity, he has covered a wide range of policy issues, including homeownership and consumer protection. Additionally, Director Shelton serves on the boards of directors of the Leadership Conference on Civil Rights, the Center for Democratic Renewal, and the Congressional Black Caucus. He holds degrees in political science, communications, and legal studies from Howard University, the University of Missouri, and Northeastern University.

I want to thank you all for being here today. You are good Mr. Ranking Member?

Senator GRASSLEY. Yes.

Senator FRANKEN. Why don't we start with Mr. Rodriguez.

STATEMENT OF ERIC RODRIGUEZ, VICE PRESIDENT, OFFICE OF RESEARCH, ADVOCACY, AND LEGISLATION, NATIONAL COUNCIL OF LA RAZA, WASHINGTON, D.C.

Mr. RODRIGUEZ. Well, thank you. Thank you, Senator, and I certainly want to thank the Ranking Member and the Chairman for inviting me today to provide expert testimony and for the gracious welcome this morning.

I have had an opportunity to work on civil rights and human rights issues for many, many years, and as many of you know, recent evidence of discrimination in housing is perhaps some of the

most damaging we have witnessed in recent years. So it is really important for all of us to put a spotlight on this issue in the hopes that we do not forget these lessons and understand fully the shared benefit of the remedy that we are discussing today.

I just want to make a few brief points in my time. To begin with, this is the largest fair lending settlement in our history, and it should serve as a blueprint for enforcement of the Nation's fair lending laws going forward. We know three main things at this point.

Discrimination against Latino and black borrowers was prevalent in the mortgage market, and this is really critical because the mortgage lending system in the U.S. is an advanced and innovative system, and I think it is really striking to find in a system like this, where everyone really talked about automated underwriting and the great benefits of it and how it was really going to get rid of discriminatory and discretionary behavior that we are seeing evidence and proof of race/ethnic discrimination in that system.

Second, I would say discrimination against Latino and black borrowers had widespread impact on all Americans, not just Latinos and African-Americans.

And, lastly, there is more work that needs to be done, and I think the Assistant Secretary's testimony really shows that, as well as some of the cases that were being raised and talked about in the questions.

So, first, the DOJ investigation into Countrywide documents discriminatory tactics that we have long warned against. For civil rights groups, we are oriented toward seeing discrimination everywhere, right? I can open my refrigerator and I see disparate impact in my food choices. But the fact that we have documented evidence finally of a case—and many cases—is really striking for the rest of America to really see patterns of discrimination, and I think that is really what is most notable about what we are seeing in this settlement today.

Investigations found 10,000 victims of steering—we had been talking about steering for over a decade—and a particularly egregious form of predatory lending where creditworthy borrowers were unfairly sold risky subprime products even though we know they are eligible for prime. One other study found that among borrowers with FICO's about 660, blacks and Latinos received higher interest rate loans more than 3 times as often as whites.

Second, the ramifications of predatory lending are not limited to just the immediate victims, and I think that is really crucial. It is not just about how this is impacting African-Americans and Latinos, although that is really crucial for our community. The housing bubble that eventually drove the financial crisis of 2008 was seeded by unfair lending that targeted vulnerable communities. As a result, communities of color, low-income families, and the elderly have experienced disproportionately high foreclosure rates. However, the pain has been widely felt as the housing market crashed, drove the Great Recession where millions have lost their jobs, 2.7 million families have lost their homes, 10 million are underwater right now. In a highly integrated system like the housing market, you cannot just see one or two areas of really bad behavior and not think that that is going to have a widespread im-

pact on our economy. Approximately one out of four Latino and black borrowers have lost their homes or are at serious risk of foreclosure compared to nearly 12 percent of white borrowers.

Third, DOJ must build on the investigation of Countrywide to root out other abusive lending. The Wall Street bailouts and the Great Recession have cost taxpayers untold sums. DOJ has the responsibility to hold companies that contributed to the circumstances accountable to the public. Moreover, the need for this work is only increasing. The Civil Rights Division you heard today is getting referrals. More than half of those in the last 3 years are race/ethnic based.

There is a lot of work to be done out there. The lessons of the housing bubble must be that ignoring the abuses concentrated in certain communities puts the entire market at risk.

It is equally important that DOJ deliver justice to as many individual victims as possible. We have offered some recommendations in our testimony and look forward to working with everyone on those.

So, in summary, this is a landmark settlement of importance to all Americans, not just Latinos and African-Americans. We now see that housing discrimination in one or two areas can have widespread and devastating impacts on all of us. Therefore, it should be a call to action for all that we do everything that we can to ensure equal justice and fair treatment in our economic systems.

Furthermore, solutions and remedies to injustice can have widespread positive impacts. This settlement will contribute greatly to our country's economy as we stabilize our housing market and puts ourselves on a path to recovery.

Thank you.

[The prepared statement of Mr. Rodriguez appears as a submission for the record.]

Senator FRANKEN. Thank you, Mr. Rodriguez.

Professor Black.

**STATEMENT OF WILLIAM K. BLACK, ASSOCIATE PROFESSOR
OF ECONOMICS AND LAW, UNIVERSITY OF MISSOURI-KANSAS
CITY SCHOOL OF LAW, KANSAS CITY, MISSOURI**

Mr. BLACK. Thank you for the invitation. I will go directly to substance given the timing.

I am going to build on Assistant Attorney General Perez's metaphor that he now believes that we are up to singles and doubles and that home runs are not in our arsenal.

In the different leagues, the big leagues, of criminal prosecutions, the industry is pitching a perfect game. We have no elite convictions. We have a massive fraud that has been described, massive illegality, not even really a criminal investigation, no indictments, as far as I know not a grand jury, certainly no prosecutions. And they are all K's, if you want to extend the baseball metaphor, strikeouts, and they are all strikeouts called looking. We have not gotten the bat off our shoulder.

He told you that we are up to 50 or 80 referrals now for non-crime criminal referrals. Our agency, the Office of Thrift Supervision, in 4-1/2 years in the savings and loan crisis made over 30,000 criminal referrals. The Office of Thrift Supervision in this

crisis made zero criminal referrals. The Office of the Comptroller of the Currency, depending on who you believe at the OCC, made either zero or three. The Federal Reserve made three. The FDIC is smart enough not to answer the question.

Without criminal referrals in elite white-collar crime, you cannot get any significant convictions. We have destroyed the absolute essential function. It does not even exist. People are not even there in charge of making criminal referrals anymore, where we had dozens of personnel whose job was to make the criminal referral. And this is the largest epidemic of elite fraud in the history of the world, and it has caused the most devastating consequences.

You are looking at pieces and not seeing the integration. The mortgage origination fraud, the discrimination and predatory lending, the fraudulent sales of mortgages to the street, the fraudulent sales by the street, and the foreclosure fraud are all part of the same piece. And the mystery is that the Assistant Attorney General of the United States cannot understand why internal controls were weakened. They were weakened because they got in the way of fraud. So here is the recipe for an accounting control fraud, standard criminology and economics:

One, grow like crazy.

Two, by making really crappy loans, but at a premium yield or interest rate.

Three, while employing extreme leverage that just means a lot of debt.

And, four, while putting aside virtually no reserves for the inevitable losses. In jargon, that is the Allowance for Loan and Lease Losses, the ALLL.

If you do those four things, then the Nobel Laureate in Economics George Akerlof warned in 1993, in the famous article "Looting: The Economic Underworld of Bankruptcy for Profit," that you are mathematically guaranteed to report record profits. It was, in his phrase, "a sure thing." And this produces record income, and that is the profit, of course. The bankruptcy is, as Assistant Attorney General Perez said, the firm fails because it is making the bad loans. So let us make it real.

There is testimony in front of the Financial Crisis Inquiry Commission that the typical job for a mortgage broker, prior job, was flipping burgers. So this is a guy, sometimes a gal, making roughly \$20,000. Your fee as a mortgage broker for a single California jumbo, a \$600,000 to \$800,000 mortgage, could be \$20,000. And it was a question of hitting the sweet spot, and to create the sweet spot, you had to create a unicorn—something that cannot exist in finance but was made to exist millions of times every year, and that was the liar's loan, an asset that was supposedly relatively low risk and high yield at the same time, which is impossible under efficient markets, which they purported to believe in.

So how did you do that? The first thing you want is a real premium yield. You do that by picking on the people that you can get away with. Who are the great people to pick on?

First, the elderly, particularly those with incipient Alzheimer's.

Second, Latinos, especially Latinos that do not speak or read English very well, because you handle all the negotiations in English.

Third, African-Americans, because they have less connection to the financial industry, fewer choices, and, yes, statistically less formal training in finance.

That is why you go after these groups: because you can charge them more. And that is the first thing that maximizes your fee.

The second thing has two subparts:

You have got to make the loan look less risky. How do you do that? First, you gimmick two ratios: one is the loan-to-value ratio. The loan is the loan amount, the value is the appraisal.

Senator FRANKEN. Professor, I hate to do this, but because of my time limitations, I am going to have to ask you to try to wrap this up in—

Mr. BLACK. Happy to.

Senator FRANKEN. You know, to give justice to your argument as quickly as possible.

Mr. BLACK. Absolutely. So what that meant empirically is that 90 percent of liar's loans were fraudulent, and that it was lenders overwhelmingly who put the lies in liar's loans, and that after warnings from the Government and the industry, they massively increased the amount of liar's loans they made. That produced the crisis; that destroyed the documentation. That is how you get the discrimination pattern; that is how you get the foreclosure fraud; that is how you get the largest loss of wealth to minorities in America in the history of our Nation.

Thank you.

[The prepared statement of Mr. Black appears as a submission for the record.]

Senator FRANKEN. Thank you, Professor.

Mr. Shelton.

STATEMENT OF HILARY O. SHELTON, DIRECTOR, WASHINGTON BUREAU, AND SENIOR VICE PRESIDENT FOR ADVOCACY AND POLICY, NATIONAL ASSOCIATION FOR THE ADVANCEMENT OF COLORED PEOPLE (NAACP), WASHINGTON, D.C.

Mr. SHELTON. Thank you very much, Senator Franken, Chairman Leahy, and esteemed members of this Committee. My name is Hilary Shelton. I am the director of the NAACP's Washington Bureau, the Federal legislative and national public policy arm of the Nation's oldest and largest grassroots-based civil rights organization.

Let me be clear: Abusive, predatory lending and the lack of access to basic financial services and reasonable credit continues to be a major civil rights issue in America today. In my written testimony I provide an in-depth review of the literature and data which supports the NAACP's contention that, for at least 20 years, African-Americans and other racial and ethnic minorities have been targeted by abusive predatory loans and that this targeting was exacerbated by the lack of access to reasonable and responsible credit in our communities. For brevity's sake, I will simply refer you to my written testimony for more on this particular piece of information.

While the NAACP recognizes the benefits of non-conventional credit for a constituency which includes many without a strong tra-

ditional credit history, we are offended by the notion that somehow it makes it OK to offer abusive predatory loans through a group of people based solely on their race or ethnic background. Furthermore, we find it deplorable for a potential homebuyer to be given a higher-rate mortgage than a borrower with an equivalent credit history and score based only on the borrower's race or ethnicity.

The results of decades of disparate and discriminatory predatory lending in our communities are becoming more and more evident. Borrowers of color are more than twice as likely to lose their homes to foreclosure today than white homeowners. Furthermore, neighborhoods with high concentrations of racial and ethnic minority residents have been hit especially hard by the foreclosure crisis. Nearly 20 percent of loans in high-minority neighborhoods have been foreclosed upon or are seriously delinquent, with significant implications for long-term economic viability on these communities.

The impact of these disproportionate foreclosures on our communities cannot be understated. Neighborhoods with high concentration of foreclosures lose tax revenue while at the same time incurring the financial costs of abandoned properties and neighborhood blight. In fact, it is estimated that local governments incur an average of over \$19,000 in costs for every foreclosure.

Furthermore, homeowners living in close proximity to the foreclosed home typically lose significant wealth as a result of depreciated home values. Neighbors adjacent to a foreclosure incur a loss of \$3,000 in lost property values. These revenue losses have a direct impact on the ability of local governments to provide residents with crucial services, such as high-quality schools, adequate health care, basic public safety, and infrastructure maintenance, to name just a few.

So how do we help these people, these families and these communities? By enforcing the existing laws as well as enacting new laws to help those currently struggling to keep a roof over their families' heads.

The NAACP recognizes and is deeply appreciative of the enforcement efforts by Assistant Attorney General Tom Perez, Attorney General Eric Holder, and the entire Justice Department. We are, in fact, encouraged by many of the actions coming out of DOJ and other agencies, and we are especially heartened by the fact that if and when the nascent Consumer Financial Protection Bureau becomes fully operational, there will be an even more robust enforcing of laws already on the books and fewer cases of discrimination that are allowed to fester and grow as big as Countrywide. We are also pleased that the Dodd-Frank Wall Street Reform and Consumer Protection Act prohibits many of the predatory lending practices which have decimated so many of our communities.

Legislatively, we support several initiatives which we believe will alleviate much of the pain and suffering which has been caused by the foreclosure crisis and allow millions of hardworking American families to stay in their homes and their communities.

First off, we support a yearlong moratorium on foreclosures. This would potentially allow homeowners and mortgage servicers time to find and take remedial action.

The NAACP also supports initiatives to help homeowners who are currently facing foreclosure and/or those who are underwater

on their mortgages, owing more than the value of their homes. We need to make it easier for homeowners to refinance their mortgages and get away from the abusive or high-cost loans and take advantage of today's record-low interest rates. Proposals such as Senator Franken's Helping Homeowners Refinance Act of 2012 will help make it easier for homeowners to refinance. We strongly support it.

We also support and enact proposals such as Congresswoman Maxine Waters' Project Rebuild, which would target Federal dollars and matching State and local funds into rehabilitating and redeveloping abandoned and foreclosed properties. By doing this, we are not only investing in communities which have, for too long, been ravaged by the foreclosure crisis, but we are also creating jobs.

I would again like to thank the Committee for holding this hearing and for also inviting the NAACP to share our perspective and our opinion on these matters. As such, I look forward to your questions.

[The prepared statement of Mr. Shelton appears as a submission for the record.]

Senator FRANKEN. I want to thank all the witnesses. And, by the way, your complete written testimonies will be made part of the record.

Mr. Rodriguez, as I mentioned, I introduced the Helping Homeowners Refinance Act last month to expand access for eligible homeowners to refinance their mortgages. Based on what I have heard today, it is clear that many racial and ethnic minorities were unfairly discriminated against and are now stuck in loans with high interest rates. The National Council of La Raza was one of the first endorsers of my legislation. I want to thank you for your support.

Can you explain how helping homeowners to refinance their mortgages would help to heal the damage done or some of the damage done by discriminatory lending practices of banks like Countrywide?

Mr. RODRIGUEZ. I would be happy to. Thank you. And thank you for your leadership. It is a good piece of legislation. We think it is crucial in this environment to provide all the opportunities we can to keep homeowners in their homes as much as possible. All of the families that we talk to and our housing counselors have an opportunity to talk to, they want to remain in their homes. It is just very unaffordable for them right now to be able to make their monthly payments. Any opportunities that can be provided and support that helps them do that I think is something we ought to encourage, and we hope for swift passage of that legislation.

Senator FRANKEN. Thank you. And, Mr. Shelton, thank you also for the NAACP's endorsement.

Mr. SHELTON. It is a good bill.

Senator FRANKEN. Thank you. How do you think that helping homeowners refinance their mortgages would help heal the housing market?

Mr. SHELTON. As you know, so many are locked into mortgages they cannot continue to sustain. Being able to make that transition

into an affordable, sustainable loan will make all the difference to them in the world.

When we look at the trap that so many were placed in, the subprime loan trap, one of the things many Americans were not told and disproportionate racial and ethnic minority Americans were not told is that as we move through the process of this once attractive loan, as we saw the escalating mortgage rates, that they would be able to transition into a mortgage they could actually support, they could actually sustain.

Indeed, what this bill would do is allow them to do that, make that transition, get past those early payment penalties, which in some cases far superseded anything they could afford. So it would help them move along. The idea is to sustain people in the homes and communities they are in and make sure they can continue to stay there, putting that roof over their families' heads.

Senator FRANKEN. It would have been nice if we could have done this a little earlier.

Mr. SHELTON. Absolutely.

Senator FRANKEN. Mr. Shelton and Mr. Rodriguez, even before the foreclosure crisis, geographic segregation by income among racial and ethnic minorities in our country was increasing. This trend was exacerbated by the racial and ethnic discrimination faced by Americans by mortgage lenders like those at Countrywide.

Can banks be doing more to repair the damage done by their discriminatory lending practices? And if so, what?

Mr. SHELTON. I believe that certainly a stronger outreach to the communities that they have abused, reaching out to those individuals, helping them reassess the loans that they have, and moving them as expeditiously as possible to some refis, some ability to restructure those loans, is extremely important. But as was mentioned earlier by Assistant Attorney General Tom Perez, too often not only are the banks and lending institutions not reaching out, but they are not making themselves available. So what we find is we have millions of Americans that are sitting on the brink of foreclosure and trying to figure out exactly what to do.

The banks could do so much more. They could also work very closely with community-based organizations. It stands to reason that many of the people that are struggling to maintain their loans are fearful when they get a call from their bank. If I had a call or a message left on my answering machine from the same bank that—I am trying to find a nice term for what they did to me and the mortgage they saddled me with. But I would very well find myself perhaps not even responding or knowing exactly why they are calling.

Utilizing those trusted entities within communities, whether it is organizations like La Raza or the NAACP, churches, synagogues, other religious organizations in the communities, or other trust entities, could prove to be very helpful.

Mr. RODRIGUEZ. Yes, I concur. I would just add and make three quick points.

For banks, clearly compliance and cooperation in this environment I think would be pretty crucial. You mentioned the single point of contact earlier as being a crucial piece of the remedy, and I think being responsive to that and doing so more quickly than I

think we have seen is going to be crucial going forward. Getting out more accurate information and doing their very best to root out fraud in communities. All of our communities have received letters that say—they are sort of stamped “HUD” something, that, “I can help you,” and it is really scam artists that are targeting our community. And I think there is a lot more we can all do collectively, and certainly the banks can play a role in helping to root out bad actors that are out there. And I certainly agree that partnering with community-based organizations in the way that our organizations have been able to, with HUD-certified housing counselors that are out there doing really, really good work and need the support and cooperation of local banks to fix cases that we are seeing quite often I think is a crucial part—all crucial parts of the remedy.

Senator FRANKEN. Well, thank you. I do think the single point of contact is so important because of the frustration that you see in people.

I have to go preside in a couple minutes, but, Professor Black, you came here and you testified, and I want to be able to hear more from you because you are basically saying that we need to be prosecuting people. That came through loud and clear.

Mr. BLACK. Mission accomplished then.

Senator FRANKEN. Mission accomplished. And I could not agree more. It would be nice if some of these bad actors—do you know if, for example, in Countrywide there was—there was an attempt to do some kind of criminal prosecution, was there not?

Mr. BLACK. “No” is the real answer. There was a supposed review. This is at a time when there were a total of 120 FBI agents nationwide working all mortgage fraud cases. To give you an idea of scope, in 2006 alone there were more than 2 million fraudulent mortgages originated, and they were assigned to tiny cases. So I am sure that somebody called it an investigation and assigned a couple of FBI agents maybe even for a month.

To give you an idea of scope, in the savings and loan crisis where the losses were 1/70 as large, we had 1,000 FBI agents working it. And in just our Dallas task force, we had over 100 professionals. To do a sophisticated of Countrywide would take roughly a team of 100 FBI agents and 20 prosecutors. So, no, there was no serious criminal investigation.

On that note, we now have several governmental entities put in pleadings that Countrywide committed intentional fraud.

Senator FRANKEN. Well, thank you all for your testimony. I unfortunately have to go preside, because we could go on for a lot longer more productively, but I really appreciate your testimony.

The record will be kept open, and it will be kept open for, I believe, another week. One week. That is kind of what I said. So the record will be help open for 1 week for submission of questions for witnesses and for other materials.

Thank you again, gentlemen, and this hearing is adjourned.

[Whereupon, at 11:50 a.m., the Committee was adjourned.]

[Submissions for the record follow.]

SUBMISSIONS FOR THE RECORD

Prepared Testimony of

William K. Black

Associate Professor of Economics and Law

University of Missouri-Kansas City

blackw@umkc.edu

Before a hearing of the

Senate Committee on the Judiciary

Entitled:

“Examining Lending Discrimination Practices and Foreclosure Abuses”

March 7, 2012

Introduction

Chairman Leahy, Senator Grassley, distinguished members of the Senate Committee on the Judiciary, thank you for inviting me to testify on the central role that mortgage fraud, predatory lending, and foreclosure fraud have played in driving the ongoing financial crisis and the failure of all sectors to sanction the elite criminals that grew wealthy through these frauds and abuses. The Committee will deal with no more important white-collar crime issue than the subject of this hearing.

My primary appointment at the University of Missouri-Kansas City (UMKC) is in economics. I have a joint appointment in law. I have taught previously at the University of Texas at Austin and Santa Clara University. In addition to degrees in economics and law, I have a doctorate in Criminology and my primary research focus is on financial “control fraud.” Control fraud is a term that criminologists use to refer to cases in which the persons controlling a seemingly legitimate entity use it as a “weapon” to defraud. In finance, accounting is the “weapon of choice.” Control frauds cause greater financial losses than all other forms of property crime – combined. They drive our recurrent, intensifying financial crises. They have wrought unprecedented damage in the ongoing crisis.

Background

I am also a former senior financial regulator. At the staff level, I led the reregulation of the savings and loan (S&L) industry under Federal Home Loan Bank Board Chairman Edwin Gray that contained the S&L debacle before it could cause a recession. I played a central role in the effort to close the S&L control frauds and hold their senior officers accountable through civil suits, administrative enforcement actions, and criminal prosecutions. I was also a serial

whistleblower with a special talent for making virulent enemies in high places. Charles Keating famously issued a written order that Lincoln Savings' "HIGHEST PRIORITY" should be to "GET BLACK ... KILL HIM DEAD." (Keating was an "all caps" kind of guy.) Lincoln Savings hired private detectives twice to investigate me and Keating eventually brought a *Bivens* action against me seeking \$400 million in damages. One of the charges against Speaker of the House James Wright, Jr., proposed by the independent counsel of the House ethics committee after the committee's investigation, was the Speakers' repeated efforts to get me fired. The Senate ethics investigation of the "Keating Five" revealed (when the Senate ethics committee granted immunity to one of Keating's lieutenants) that, subsequent to the April 2 and 9, 1987 meetings of the five senators with us, the Speaker met with Keating and urged him to sue me (and former Chairman Gray) and to continue the effort to get me fired. I want to thank Senator Grassley for his long record of seeking to protect whistleblowers from these forms of retaliation.

My regulatory career is the focus of three works by academic experts in public administration: Chapter 2 of Professor Riccucci's book *Unsung Heroes* (Georgetown U. Press: 1995), Chapter 4 ("The Consummate Professional: Creating Leadership") of Professor Bowman, et al's book *The Professional Edge* (M.E. Sharpe 2004), and Joseph M. Tonon's article: "The Costs of Speaking Truth to Power: How Professionalism Facilitates Credible Communication" *Journal of Public Administration Research and Theory* 2008 18(2):275-295.

My book about the S&L debacle, control fraud theory, and the regulatory and prosecutorial lessons learned is entitled *The Best Way to Rob a Bank is to Own One* (2005). My work is highly multidisciplinary. George Akerlof (Nobel Laureate in Economics in 2001) and co-author with Paul Romer of the essential 1993 economics article on control fraud ("Looting: the Economic Underworld of Bankruptcy for Profit") and Paul Volcker have praised the book.

I was one of the leading trainers of FBI special agents, AUSAs, and agency personnel in the identification, investigation, and prosecution of elite white-collar criminals during the S&L debacle and I served as a (free) expert witness in the prosecution of several high priority cases. I also served as a paid expert for OFHEO in its administrative enforcement action against Mr. Raines, Fannie Mae's former CEO.

I testified many times before Congress and the California legislature during the S&L debacle. This is my fifth presentation to Congress about the ongoing financial crisis. I provided testimony to the Senate on financial derivatives and the role of control fraud in driving the crisis and I to the House on executive compensation and Lehman's failure. My congressional invitations have come at the initiative of both parties. I have had extended meetings with senior governmental officials (financial regulators and prosecutors) responding to the Irish and Icelandic financial crises at the invitation of citizens of those nations.

I have also testified before the Financial Crisis Inquiry Commission (FCIC) on the role of fraud in the ongoing crisis and presented at the invitation of the National Research Council's Committee on Law and Justice to their "Seminar on the Future of White-Collar Crime

Research.” The Council asked me to discuss new quantitative methodologies relevant to measuring the incidence and impact of elite white-collar crimes, particularly those that played such a decisive role in the current crisis.

Overview of my testimony

I make seven major points.

1. We have decent data on the incidence of fraud in stated income loans. The incidence is 90 percent. We know from investigations that it was overwhelmingly the lenders and their agents that prompted these frauds. No governmental entity ever required any entity to make, or purchase, a stated income loan. Even at their most anti-regulatory extreme, U.S. regulators warned against stated income loans. We know roughly how many fraudulent stated income loans were made. Over two million fraudulent mortgage loans were made in 2006 alone. It was overwhelmingly fraudulent loans to borrowers who lacked any ability to repay their loans out of their income that caused the housing bubble to hyper-inflate.
2. Endemic accounting control fraud in the origination of mortgages led to creation of “echo” fraud epidemics in other contexts, including widespread appraisal fraud, endemic fraud in the sale of mortgages and mortgage derivatives, widespread predatory lending targeting Latinos, blacks and the elderly, and endemic foreclosure fraud. Fraudulent lenders use compensation to create perverse incentives that produce “Gresham’s” dynamics in which bad ethics drives good ethics out of the marketplace. Fraud begets fraud. Or in criminology jargon, accounting control fraud involving lenders is criminogenic. The federal government, California, and dozens of financial firms have sued the largest banks for fraud, yet the Justice Department refuses to even conduct a meaningful criminal investigation of the largest banks. The FBI investigates several thousand relatively minor mortgage fraud cases annually. This is equivalent to sitting on a beach in San Diego, throwing handfuls of sand in the Pacific Ocean, and wondering how soon one will be able to walk to Hawaii. The strategy must fail. Everyone involved knows it must fail. To succeed, we must fundamentally change the strategy, not tinker with it or simply reinforce defeat. The FBI and the Justice Department have fallen for one of the greatest acts of misdirection by accepting the Mortgage Banker Associations definition of “mortgage fraud” – a definition that defines accounting control fraud out of existence. (The courts have implicitly defined accounting control fraud out existence in the context of civil suits for securities fraud. Think of how insane that is. The form of fraud that economists and criminologists have shown to be the leading cause of catastrophic financial losses purportedly does not exist because judges think such frauds would be “irrational.” We are acting as if this was the first “virgin” financial crisis (conceived without sin).
3. The elite financial frauds are treating the United States of America’s criminal justice system and financial markets with utter contempt. They believe they can become

wealthy – with impunity – through frauds that cost U.S. households \$11 trillion dollars and cost seven million Americans their jobs. Not a single elite fraudster who was instrumental in making the millions of fraudulent loans that drove the crisis has even been indicted – over seven years after the FBI’s September 2004 warnings that there was an “epidemic” of mortgage fraud that would cause a financial “crisis” if it were not stopped. Here is how bad the situation has become. The firms that specialized in making huge amounts of “stated income” loans called such loans “liar’s loans.” This was publicly reported – and nothing effective was done by the markets, by self-regulation, by federal regulators, or by federal prosecutors to stop frauds that were as brazen as they were massive. Akerlof and Romer’s 1993 warning that accounting fraud is a “sure thing” – guaranteed to make even the most mediocre CEO wealthy – was ignored. Only fraudulent firms made large numbers of liar’s loans. Making liar’s loans inherently meant committing multiple frauds and making predatory loans.

4. The proposed settlement of the endemic foreclosure fraud is a profound embarrassment to the U.S. criminal justice system because it immunizes from criminal sanction endemic fraud. Had the administration gotten its preferred settlement, which was designed to block even investigations of many forms of control fraud, the result would have been the formal surrender of the U.S. to crony capitalism.
5. The newly created “working group” does not have the resources to succeed. It is more than an order of magnitude too small for the task and it has not taken the foundational steps essential to success against multiple epidemics of control fraud. Absent vigorous financial regulators that understand control fraud and make reducing and sanctioning such frauds their top priority the prosecutors cannot succeed against an epidemic of accounting control fraud. Financial regulators who make the necessary criminal referrals and provide the FBI with the expertise to identify and investigate accounting control fraud mechanisms are essential if we are to prevent or prosecute an epidemic of such frauds. Effective financial “regulatory cops on the beat” are essential to our ability to prosecute elite white-collar criminals.
6. We know how to succeed. We know how to make future crises far more unlikely and damaging. We’ve known for a quarter century. It is bad to forget the mistakes of the past, but one can remember a past mistake and still make a new mistake. It is tragic to forget past successes.

Formal Written Testimony

Neo-Classical Economic Policies are Criminogenic: They Cause Control Fraud Epidemics

Neo-classical economics failed to build on Akerlof’s work to develop a coherent theory of fraud, bubbles, or financial crises (Black 2005). It continued to rely on a single methodological approach (econometrics) that inherently produces the worst possible policy advice during the expansion phase of a bubble.

Control frauds can cause enormous losses, while minimizing the risk that controlling officers will be sanctioned because only the CEO can (Black 2005):

- Optimize the firm's operations and structures for fraud
- Set a corrupt tone at the top, and suborn controls, employees and officers into becoming allies
- Convert firm assets to the CEO's personal benefit through seemingly normal corporate compensation mechanisms
- Optimize the external environment for control fraud, e.g., by creating regulatory black holes.

These perverse factors were first identified in connection with the S&L debacle of the 1980s. The National Commission on Financial Institution Reform Recovery and Enforcement (NCFIRRE) (1993), report on the causes of the S&L debacle documented the patterns.

The typical large failure was a stockholder-owned, state-chartered institution in Texas or California where regulation and supervision were most lax.... [It] had grown at an extremely rapid rate, achieving high concentrations of assets in risky ventures.... [E]very accounting trick available was used to make the institution look profitable, safe, and solvent. Evidence of fraud was invariably present as was the ability of the operators to "milk" the organization through high dividends and salaries, bonuses, perks and other means (NCFIRRE 1993: 3-4).

[A]busive operators of S&L[s] sought out compliant and cooperative accountants. The result was a sort of "Gresham's Law" in which the bad professionals forced out the good (NCFIRRE 1993: 76).

James Pierce, NCFIRRE's Executive Director, explained:

Accounting abuses also provided the ultimate perverse incentive: it paid to seek out bad loans because only those who had no intention of repaying would be willing to offer the high loan fees and interest required for the best looting. It was rational for operators to drive their institutions ever deeper into insolvency as they looted them (1994: 10-11).

A lender optimizes accounting control fraud through a four-part recipe. Top economists, criminologists, and the savings and loan (S&L) regulators agreed that this recipe is a "sure thing" – producing guaranteed, record (fictional) near-term profits and catastrophic losses in the longer-term. Akerlof & Romer (1993) termed the strategy: *Looting: Bankruptcy for Profit*. The firm fails, but the officers become wealthy (Bebchuk, Cohen & Spamann 2010).

- Extremely rapid growth
- Lending at high (nominal) yield to borrowers that will frequently be unable to repay
- Extreme leverage
- Providing grossly inadequate reserves against the losses inherent in making bad loans

George Akerlof and Paul Romer published an article in 1993 about accounting control fraud. The title of their article captured their thesis – "Looting: the Economic Underworld of

Bankruptcy for Profit.” They chose to end their article with this paragraph because it was the message they wished to emphasize.

Neither the public nor economists foresaw that [S&L deregulation was] bound to produce looting. Nor, unaware of the concept, could they have known how serious it would be. Thus the regulators in the field who understood what was happening from the beginning found lukewarm support, at best, for their cause. Now we know better. If we learn from experience, history need not repeat itself.

In the S&L debacle, “the regulators in the field ... understood what was happening from the beginning....” Akerlof and Romer excuse the economists, because they were “unaware of the concept,” for getting the debacle wrong. They are being kind. Economists did not give “lukewarm support” to our reregulation of the S&L industry. They were our most fervid and intractable opponents. As Akerlof and Romer stressed, “now we know better.” Akerlof was made a Nobel laureate in 2001. He is one of the most respected economists in the world.

The remarkable fact is that economists dominated financial policy and despite the success of the S&L regulators, which arose from understanding how accounting control frauds worked, despite the extensive scholarship by white-collar criminologists confirming the regulators’ findings, despite the research of two of more prominent and well-respected economists in the world confirming the decisive role of accounting control fraud, and despite the pervasive role of accounting control fraud in the Enron-era frauds, neo-classical economists continues to ignore even the existence of accounting control fraud. They argued that such frauds could not exist because markets were “efficient.”

Ironically, we proved that we did not “know better” in the same year that Akerlof & Romer published their article. The Clinton administration promptly took three actions that were far more destructive than the repeal of Glass-Steagall and the passage of the Commodities Futures Modernization Act of 2000 (the Act that created a “regulatory black hole” in which credit default swaps (CDS) operated). First, it greatly reduced the prosecution of elite bank and S&L frauds by changing the priority to health care fraud. Second, it implemented the “Reinventing Government” initiative that was hostile to regulation and enforcement. We were instructed, pursuant to that initiative, to refer to (and think of) the industry as our “clients.” That is a mindset that destroys effective supervision. Third, the Office of Thrift Supervision (OTS) terminated its underwriting regulations (which essentially banned liar’s loans) and replaced them with deliberately unenforceable guidelines. This change made it significantly more difficult to prosecute “accounting control frauds” by lenders. The three “de’s” – deregulation, desupervision, and *de facto* decriminalization returned with a vengeance in 1993 and expanded over the next 15 years.

The result was that nonprime mortgage lenders were able to follow the same accounting fraud recipe employed 20 years earlier by the fraudulent S&Ls. Growth was extreme.

In summary, the bank in our analysis pursued an aggressive expansion strategy relying heavily on broker originations and low-documentation loans in particular. The strategy allowed the bank to grow at an annualized rate of over 50% from 2004 to 2006. Such a business model is typical among the major players that enjoyed the fastest growth during the housing market boom and incurred the heaviest losses during the downturn (Jiang, Aiko & Vylacil 2009: 9).

A study by a Federal Reserve Bank of St. Louis economist documented that the growth of liar's loans ("Alt-a" is one of many euphemisms for liar's loans) was so extraordinary that it hyper-inflated the bubble.

"[B]etween 2003 and 2006 ... subprime and Alt-A [loans grew] 94 and 340 percent, respectively. The higher levels of originations after 2003 were largely sustained by the growth of the nonprime (both the subprime and Alt-A) segment of the mortgage market."

The growth of liar's loans was actually far greater than 340 percent. The author made a common error, thinking that subprime and liar's loans were mutually exclusive categories. In fact, by 2006, roughly half of all loans called subprime were also liar's loans.

Loan standards collapsed. Cutter (2009), a managing partner of Warburg Pincus, explains:

In fact, by 2006 and early 2007 everyone thought we were headed to a cliff, but no one knew when or what the triggering mechanism would be. The capital market experts I was listening to all thought the banks were going crazy, and that the terms of major loans being offered by the banks were nuttiness of epic proportions.

Charles Calomiris' description is even harsher and it is remarkable because Calomiris was one of the leading proponents of financial deregulation. He called the strategy "plausible deniability" and argued that the lenders, credit rating agencies, investment banks, Fannie and Freddie, and the purchasers all knew that the fraudulent mortgages and the financial derivatives based on those fraudulent mortgages were massively overvalued. It paid to pretend that they were good assets because it made everyone's bonus far bigger.

Leverage was exceptional. Unregulated nonprime lenders had no meaningful capital rules.

Honest lenders would establish record high loss reserves pursuant to generally accepted accounting principles (GAAP). "The industry's reserves-to-loan ratio has been setting new record lows for the past four years" (A.M. Best 2006: 3). The ratio fell to 1.21 percent as of September 30, 2005 (*Id.*: 4-5). Later, "loan loss reserves are down to levels not seen since 1985" (roughly one percent) (A.M. Best 2007: 1). It noted that these inadequate loss reserves in 1985 led to banking and S&L crises. In 2009, IMF estimated losses on U.S. originated assets of \$2.7 trillion (IMF 2009: 35 Table 1.3) (roughly 30 times larger than bank loss reserves).

Fraud Warnings

The claim that no one could have foreseen the crisis is false. Unlike the S&L debacle, the FBI was far ahead of the regulators in recognizing that there was an “epidemic” of mortgage fraud and that it could cause a financial crisis. The FBI warned in September 2004 (CNN) that the “epidemic” of mortgage fraud would cause a “crisis” if it were not contained. The FBI has emphasized that 80 percent of mortgage fraud losses occur when lending industry insiders are part of the fraud scheme. The FBI deserves enormous credit for sounding such a strong, accurate, and public warning. Special praise should also go to Inman News, which put out a series of reports about mortgage fraud that culminated in a compendium in 2003 entitled: “Real Estate Fraud: The Housing Industry’s White-Collar Epidemic.” The warnings about appraisal fraud were equally stark – “Home Insecurity: How Widespread Appraisal Fraud Puts Homeowners at Risk” (Demos 2005). The remarkable fact is that the private sector, the regulators, and the prosecutors failed to take effective action despite these warnings. The failure to act is all the more troubling because the nonprime lenders followed the distinctive four-part recipe for lenders optimizing accounting control fraud that regulators, economists, and criminologists had documented and explained in the S&L debacle, during financial privatization (e.g., tunneling), and in the Enron-era control frauds.

Fraud Markers

S&L regulators (in the 1980s) and criminologists and economists (in the 1990s) had identified fraud “markers” (a term borrowed from pathology) that only fraudulent lenders would employ. Gutting underwriting is essential for lenders engaged in accounting control fraud because they have to make massive amounts of bad loans in order to grow extremely rapidly and charge premium interest rates in order to optimize near-term accounting “profits.” Banks (and economists) have known for centuries that gutting mortgage underwriting leads to “adverse selection” (lending to borrowers that will often not be able or willing repay their loans). The “expected value” of adverse selection is sharply negative, i.e., the lender will invariably lose money (once the losses become manifest).

S&L regulators looked for fraud “markers”, such as deliberately lending to uncreditworthy borrowers by inflating appraisals or by ignoring a track record of defaults that no honest lender would commit (Black, Calavita & Pontell 1985; Black 2005).

S&L regulators used these markers to identify and close the accounting control frauds while they were reporting record profits and minimal losses in the 1980s before they could cause a nationwide financial bubble, a general economic crisis, or recession. The most obvious marker is when lenders do not even take prudent steps to prevent fraud, but rather cover it up.

There is no honest reason for deliberately failing to establish adequate loss reserves, yet the typical nonprime lender slashed general loss reserves while risk was surging and GAAP required reserves to increase. That constitutes accounting and securities fraud, but it is also a marker of accounting control fraud. The officers controlling nonprime lenders, by keeping loan loss reserves at trivial levels, maximized the lenders’ fictional income – and their compensation.

Similarly, appraisal fraud is not only a fraud but a “marker” of a broader fraud scheme. An honest secured lender would never inflate, or permit others to inflate, appraisal values. The

2009 FINCEN report explains why appraisal fraud adds enormously to losses from mortgage fraud.

Lenders rely on accurate appraisals to ensure that loans are fully secured. The Appraisal Institute and the American Society of Appraisers testified that "...it is common for mortgage brokers, lenders, realty agents and others with a vested interest to seek out inflated appraisals to facilitate transactions because it pays them to do so. Higher sales prices typically generate higher fees for brokers, lenders, real estate agents, and loan settlement offices, and higher earnings for real estate investors. Appraisal fraud has a snowball effect on inflating real estate values, with fraudulent values being ... used by legitimate appraisers....

The Gresham's dynamic that the accounting control frauds deliberately induced in appraisals has been established repeatedly in surveys of appraisers.

A new survey of the national appraisal industry found that 90 percent of appraisers reported that mortgage brokers, real estate agents, lenders and even consumers have put pressure on them to raise property valuations to enable deals to go through. That percentage is up sharply from a parallel survey conducted in 2003, when 55 percent of appraisers reported attempts to influence their findings and 45 percent reported "never." Now the latter category is down to just 10 percent.

The survey found that 75 percent of appraisers reported "negative ramifications" if they refused to cooperate and come in with a higher valuation. Sixty-eight percent said they lost the client -- typically a mortgage broker or lender -- following their refusal to fudge the numbers, and 45 percent reported not receiving payment for their appraisal.

Control frauds, either directly or indirectly through the perverse incentives their compensations systems create for loan officers, loan brokers, and mortgage brokers, cause, encourage, and accede to endemic appraisal fraud.

The New York Attorney General's investigation of Washington Mutual (WaMu) (one of the largest nonprime mortgage lenders) and its appraisal practices supports this dynamic.

New York Attorney General Andrew Cuomo said [that] a major real estate appraisal company colluded with the nation's largest savings and loan companies to inflate the values of homes nationwide, contributing to the subprime mortgage crisis.

"This is a case we believe is indicative of an industrywide problem," Cuomo said in a news conference.

Cuomo announced the civil lawsuit against eAppraiseIT that accuses the First American Corp. subsidiary of caving in to pressure from Washington Mutual Inc. to use a list of "proven appraisers" who he claims inflated home appraisals.

He also released e-mails that he said show executives were aware they were violating federal regulations. The lawsuit filed in state Supreme Court in Manhattan seeks to stop the practice, recover profits and assess penalties.

"These blatant actions of First American and eAppraiseIT have contributed to the growing foreclosure crisis and turmoil in the housing market," Cuomo said in a statement. "By allowing Washington Mutual to hand-pick appraisers who inflated values, First American helped set the current mortgage crisis in motion."

"First American and eAppraiseIT violated that independence when Washington Mutual strong-armed them into a system designed to rip off homeowners and investors alike," he said (*The Seattle Times*, November 1, 2007).

Note particularly Attorney General Cuomo's claim that WaMu "rip[ped] off ... investors." That is an express claim that it operated as an accounting control fraud and inflated appraisals in order to maximize accounting "profits." A Senate investigation has found compelling evidence that WaMu acted in a manner that fits the accounting control fraud pattern.

<http://levin.senate.gov/newsroom/release.cfm?id=323765>

Pressure to inflate appraisals was endemic among nonprime lending specialists.

Appraisers complained on blogs and industry message boards of being pressured by mortgage brokers, lenders and even builders to "hit a number," in industry parlance, meaning the other party wanted them to appraise the home at a certain amount regardless of what it was actually worth. Appraisers risked being blacklisted if they stuck to their guns. "We know that it went on and we know just about everybody was involved to some extent," said Marc Savitt, the National Association of Mortgage Banker's immediate past president and chief point person during the first half of 2009 (*Washington Independent*, August 5, 2009).

These markers are pervasive in the current crisis and would have allowed effective regulatory intervention. They can be used to prosecute the senior officials that caused the current crisis and they can be used to limit future crises. Current regulators and prosecutors did not recognize the markers and act effectively on the FBI warning. Current regulators and prosecutors have been so blinded by anti-regulatory ideology that they joined the private sector in failing to act effectively even against lenders that specialized in what the trade openly called "liar's loans."

Echo Epidemics of Accounting Control Fraud

The primary epidemic of accounting control fraud by nonprime lenders produced "echo" epidemics of upstream and downstream control fraud. The primary mortgage fraud epidemic created a criminogenic environment that caused the upstream mortgage fraud epidemic. The downstream epidemic consists of those that purchased the nonprime product. The downstream epidemic could not have existed without the endemic mortgage fraud the other two fraud epidemics produced, but the downstream epidemic allowed both of the mortgage fraud epidemics to grow far larger.

In order to maximize their (fictional) accounting income, the nonprime lenders needed to induce others to send them massive quantities of relatively high yield mortgage loans with supporting appraisals, without regard to credit quality. The nonprime lenders created perverse incentives that produced a series of “Gresham’s” dynamics. This did not require any formal agreement (conspiracy), which made it far easier to create an upstream echo epidemic and far harder to prosecute. Traditional mortgage underwriting has shown the ability to detect fraud prior to lending. The senior managers that controlled nonprime mortgage lenders that were control frauds, therefore, had to eliminate competent underwriting and suborn “controls” to pervert them into fraud allies.

When the nonprime lenders gutted their underwriting standards and controls and paid brokers greater fees for referring nonprime loans they inherently created an intensely criminogenic environment for loan brokers and appraisers. The brokers’ optimization strategy was simple – refer as many relatively high yield mortgage loans as possible, as quickly as possible, with applications and made the borrower appear to qualify for the loan. The nonprime lenders, in essence, signaled their intention not to kick the tires and weed out even fraudulent loan applications and appraisals. I call this the financial version of “don’t ask; don’t tell” (a justly maligned U.S. military policy about gays serving in our armed services).

The Financial Crisis Inquiry Commission (FCIC) reported on how these perverse incentives worked in the real world.

More loan sales meant higher profits for everyone in the chain. Business boomed for Christopher Cruise, a Maryland-based corporate educator who trained loan officers for companies that were expanding mortgage originations. He crisscrossed the nation, coaching about 10,000 loan originators a year in auditoriums and classrooms.

His clients included many of the largest lenders—Countrywide, Ameriquest, and Ditech among them. Most of their new hires were young, with no mortgage experience, fresh out of school and with previous jobs “flipping burgers,” he told the FCIC. Given the right training, however, the best of them could “easily” earn millions.

“I was a sales and marketing trainer in terms of helping people to know how to sell these products to, in some cases, frankly unsophisticated and unsuspecting borrowers,” he said. He taught them the new playbook: “You had no incentive whatsoever to be concerned about the quality of the loan, whether it was suitable for the borrower or whether the loan performed. In fact, you were in a way encouraged not to worry about those macro issues.” He added, “I knew that the risk was being shunted off. I knew that we could be writing crap. But in the end it was like a game of musical chairs. Volume might go down but we were not going to be hurt.”

On Wall Street, where many of these loans were packaged into securities and sold to investors around the globe, a new term was coined: IBGYBG, “I’ll be gone, you’ll be gone.” It referred to deals that brought in big fees up front while risking much larger losses in the future. And, for a long time, IBGYBG worked at every level [FCIC: 7-8]

The downstream epidemic of accounting control fraud could not be created by the nonprime lenders because they could not create a downstream Gresham's dynamic. Indeed, the argument runs the other direction. The nonprime loan purchasers, by adopting the financial version of "don't ask; don't tell" (and ignore or hide bad results), produced a criminogenic environment that helped drive the primary mortgage fraud epidemic. While press accounts have asserted that nonprime lenders had no concern about mortgage quality because they intended to sell the nonprime loans, that claim assumes away the central problem that the lender has no power to force someone to purchase the loans. The nonprime lenders were selling mortgages that were frequently fraudulent and worth dramatically less than lender's book value. They were selling in circumstances that the economic theory of "lemon" markets predicts can only be sold at a significant discount from the original book value (Akerlof 1970). Neoclassical economic theory predicts that "private market discipline" will prevent any downstream fraud (Black 2003). Fraudulent downstream investors rationally overpay for assets in order to obtain greater short-term yield (increasing accounting income) and rationally adopt a financial "don't ask; don't tell" policy with regard to asset quality and losses. Investors overpaid massively for nonprime CDOs – by 65 to 85 cents on the dollar. This created an overwhelming incentive to avoid massive loss recognition through a downstream epidemic of accounting fraud. The bankruptcy examiner's recent report on Lehman reveals that Lehman employed two common forms of accounting fraud – it did not recognize huge losses on assets and it used REPO transactions for the purpose of hiding those losses from creditors, investors, and regulators. Note that the downstream purchasers – including Fannie and Freddie – were never required to purchase fraudulent loans. Large numbers of liar's loans, for example, would not have counted towards Fannie and Freddie's regulatory requirement to purchase set percentages of below median income mortgages precisely because income was commonly grossly inflated. The CEOs that controlled the large financial players purchased over a trillion dollars in liar's loans not because they were required to or because President Clinton and Bush gave speeches favoring broader home ownership but because purchasing such loans created increased accounting income (in the near term), which maximized their bonuses.

Mortgage Fraud became Endemic

It is commonly reported that roughly 40% of U.S. mortgage lending during 2006 were nonprime, evenly split between subprime (known credit defects) and "alt-a" (purportedly high credit quality, but lacking verification of key underwriting data). "Alt-a" loans, by definition, did not conduct traditional underwriting (Bloomberg 2007; Gimein 2008). Liar's loans were sold under the bright shining lie that the borrowers had excellent credit characteristics essentially equivalent to prime borrowers. Investment banks typically called their liar's loans "prime" loans on their financial statements.

When discussing a category known in the trade as "liar's loans", however, it is well to keep in mind the likelihood of deliberate misreporting of data. Over time, "alt-a" and "subprime" loans came to increasingly common features. Lehman, for example, had a subsidiary that specialized in liar's loans (Aurora) and one (BNC) that specialized in subprime. Aurora increasingly made liar's loans to borrowers that reported substantial credit problems and BNC increasingly made liar's loans to its subprime customers. When Lehman finally shut down BNC, Aurora continued

to make liar's loans to borrowers disclosing defective credit. That is an extraordinary fact, for these were the borrowers whose incomes were typically grossly inflated. If even after the loan broker falsified much of the information on the application (Aurora purchased 95% of its liar's loans) the application showed obvious credit defects and Aurora still purchased the loans, then these actions are only rational for an accounting control fraud.

The implications of this are critical. It became the norm for liar's loans to be made on the basis of loan applications that, while fraudulent, also showed serious credit defects.

The typical presentation states that almost half of subprime loans, by 2006, did not conduct traditional underwriting. That percentage may be seriously underestimated. Lenders appear to have lied increasingly by describing liar's loan as "prime" loans. Credit Suisse reported in March 2007 that "we believe the most pressing areas of concern should be stated income (49% of originations), high CLTV/piggyback (39%), and interest only/negative amortizing loans (23%)." This is a good example of "layered risk." The sum of the three percentages exceeds 100% because it was common to make loans that had at least two, sometimes each, of these characteristics.

A small sample review of nonprime loan files by Fitch (2007), found that underwriting had to be eviscerated to permit the endemic fraud that came to characterize nonprime mortgage lending.

Fitch's analysts conducted an independent analysis of these files with the benefit of the full origination and servicing files. The result of the analysis was disconcerting at best, as there was the appearance of fraud or misrepresentation in almost every file.

[F]raud was not only present, but, in most cases, could have been identified with adequate underwriting, quality control and fraud prevention tools prior to the loan funding. Fitch believes that this targeted sampling of files was sufficient to determine that inadequate underwriting controls and, therefore, fraud is a factor in the defaults and losses on recent vintage pools.

MARI, the Mortgage Bankers Association (MBA's) experts on fraud, warned that "low doc" lending caused endemic fraud.

Stated income and reduced documentation loans ... are open invitations to fraudsters. It appears that many members of the industry have little historical appreciation for the havoc created by low-doc/no-doc products that were the rage in the early 1990s. Those loans produced hundreds of millions of dollars in losses for their users.

One of MARI's customers recently reviewed a sample of 100 stated income loans upon which they had IRS Forms 4506. When the stated incomes were compared to the IRS figures, the resulting differences were dramatic. Ninety percent of the stated incomes were exaggerated by 5% or more. More disturbingly, almost 60% of the stated amounts were exaggerated by more than 50%. These results suggest that the stated income loan deserves the nickname used by many in the industry, the "liar's loan."

The same obvious question (which neither Fitch nor MARI asked) arises: why did lenders fail to use well understood underwriting systems that are highly successful in preventing fraud – even when they knew that fraud was endemic and would cause massive losses? The same obvious answer exists – it was in the interests of the controlling officers to optimize short-term accounting income. Turning a blind eye to endemic fraud helped optimize reported income and their executive compensation.

MARI's reference to the "early 1990s" refers to a number of S&Ls that originated or purchased "low doc" loans in the early 1990s. These loans caused "hundreds of millions of dollars in losses." Those losses were contained because the regulators promptly used their supervisory powers to halt the practice when they realized that it was growing and becoming material. We acted because we recognized that not underwriting maximized adverse selection and guaranteed high real losses (after near-term, fictional, profits). We ordered a halt to the practice even while many of the lenders were reporting that the lending was profitable. "Hundreds of millions of dollars in losses" is serious, but if the losses are contained at that level the number of lender failures will be minimal and there will be no risk of a crisis. Unfortunately, our regulatory successors had no "historical appreciation" for successful supervisory policies or the identification of accounting control fraud. They issued ineffective "cautions" to the industry that "low doc" loans could be risky, but refused to order an end to the practice and never considered the possibility that the lenders were control frauds.

Thomas J. Miller, Attorney General of Iowa, testimony at a 2007 Federal Reserve Board hearing shows why fraud losses are enormous:

Over the last several years, the subprime market has created a race to the bottom in which unethical actors have been handsomely rewarded for their misdeeds and ethical actors have lost market share.... The market incentives rewarded irresponsible lending and made it more difficult for responsible lenders to compete. Strong regulations will create an even playing field in which ethical actors are no longer punished.

Despite the well documented performance struggles of 2006 vintage loans, originators continued to use products with the same characteristics in 2007.

[M]any originators ... invent ... non-existent occupations or income sources, or simply inflat[e] income totals to support loan applications.

Importantly, our investigations have found that most stated income fraud occurs at the suggestion and direction of the loan originator, not the consumer.

Because these risks were "layered" – interacting to produce far greater risk (IMF 2008: 4-5 & n.6) – honest nonprime lenders would have responded by establishing record high general loss reserves in accordance with generally accepted accounting principles (GAAP). Instead, A.M. Best reported in February 2006 that: "the industry's reserves-to-loan ratio has been setting new record lows for the past four years" (A.M. Best 2006: 3). The ratio fell to 1.21 percent as of September 30, 2005 (*Id.*: 4-5). One year later, A.M. Best reported: "loan loss reserves are down

to levels not seen since 1985” (roughly one percent) (A.M. Best 2007: 1). A.M. Best went on to point out that these grossly inadequate loss reserves in 1985 led to a decade-long crisis in banking and S&Ls. In 2009, IMF estimated losses on U.S. originated assets of \$2.7 trillion (IMF 2009: 35 Table 1.3). Total U.S. bank and S&L general loss reserves in 2006 were under \$100 billion, so general loss reserves would have had to be roughly 30 times larger to be adequate. If the lenders had established adequate loss reserves they would have reported that they were deeply unprofitable, which was the economic reality. The banking regulatory agencies, the SEC, and “private market discipline” all failed to require even remotely adequate reserves and minimal honesty in financial reports. The current control frauds used the same optimization techniques as did the S&Ls – but they did it on steroids. The primary epidemic directly created the upstream epidemic and was a necessary, but not sufficient, cause of the upstream epidemic.

Endemic Mortgage Origination Fraud Means Endemic Predation and Foreclosure Fraud

Liar’s loans provide a superb “natural experiment” that allows us to test rival theories about what caused the U.S. crisis. As I have explained, the government did not require any entity to make or purchase a liar’s loan. Liar’s loans make no sense for honest lenders or purchasers. Liar’s loans were overwhelmingly made for the purpose of prompt resale to the secondary market at the greatest possible price. Liar’s loans were ideal for producing a “too good to be true” result that made all the controlling officers involved rich while causing massive losses to the firms. The key was the compensation system for mortgage brokers. They were paid more for producing something that would have been impossible if markets really were efficient, but was child’s play to produce in the real world. The lender paid the broker a larger fee if the broker could charge a higher price (yield) to the borrower and if the broker could make the loan appear less risky. The broker also wanted to do so without creating a paper trail that would make it easy to prosecute the broker for fraud. The liar’s loan was the optimal “ammunition” for such fraud purposes.

It is easier to charge borrowers a higher yield if they (i) have early stage Alzheimers, (ii) are not financially sophisticated, (iii) have fewer banking alternatives, and (iv) do not read or speak English. This is why the elderly, African-Americans, Latinos, and working class individuals with very limited income were the ideal candidates for liar’s loans. Predation and liar’s loans are the closest and vilest of companions.

The other key to maximizing the broker’s fee was making the loan appear safer. This could easily be accomplished through fraudulently manipulating two ratios. The “loan-to-value” (LTV) ratio is the ratio of the size of the loan to the appraised (market value) of the collateral pledged as security for the loan (your house). The goal was to inflate the appraisal to make the loan appear safer. With rare exceptions, borrowers cannot inflate appraisals. Fraudulent lenders and their agents could do so easily by using their ability to hire and fire appraisers to produce a

Gresham's dynamic in which unethical appraisers drove their honest counterparts out of the work.

The other ratio was debt-to-income. By inflating the borrower's income the broker or lender could make the loan appear less risky. Inflating a borrower's income is something that only a fraudulent lender would do. It is normally a dangerous fraud to commit. We convicted hundreds of controlling officers and borrowers of loan fraud because they filed false financial statements. Honest underwriting produces a paper trail that makes prosecution far easier. If the lender or its agents forges a document or destroys the real records juries find their task simple. Liar's loans (which typically did not verify the borrower's income) are so criminogenic because they allow fraud without creating the incriminating paper trail.

We can now connect the dots to see how the lender's perverse compensation system for brokers was designed to produce endemic fraud. If the broker inflates the appraised value of the house and the borrower's income while negotiating a premium yield the lender's controlling officers find it far easier to sell the mortgage to the secondary market and far easier to sell it at a higher price. This maximizes their executive compensation and it is a "sure thing." The most pedestrian CEOs can pull off this scam.

Now consider the matter from the broker's perspective. Your prior job (as the FCIC report explained) was often flipping burgers. If you hit the sweet spot in terms of excess yield and the most desirable ratios you can receive – for bringing one California "jumbo" (\$650,000) liar's loan to the lender a fee of \$20,000. Are you going to leave it to the unsophisticated borrower to randomly hit the magic ratios, particularly when you know that the borrower cannot qualify for the loan at his actual income? Not all people will cheat in these circumstances, but more than enough will to be able to grow liar's loans by over 500% during 2003-2006.

This analysis also takes us most of the way to understanding why foreclosure fraud is endemic. First, foreclosures have reached unprecedented levels because so many bad loans were made pursuant to the fraud recipe and because the fraudulent loans hyper-inflated the bubble. Second, foreclosure fraud was certain to grow immensely because the originations and sales of liar's loans were pervasively fraudulent. It is necessary to gut underwriting and internal controls to allow a lender to make endemic fraudulent loans. Even in honest banks, loan officers hate paperwork. It slows them down and reduced their commissions. That is one of the reasons why honest banks have multiple levels of internal and external controls staffed by tough, anal, rigorous reviewers. Accounting control frauds must undercut these controls. The inevitable result is that lots of documents never get finalized or get lost. This tendency grew far worse once one could sell a mortgage electronically without review of the individual files and hard copy documents. MERS put this problem on steroids. A fraudulent lender could now sell a fraudulent loan without the purchaser ever checking to see whether the lender had the fully executed note. Securitization then ramped up the problem by producing large numbers of electronic assignments

and sales that removed anyone with an institutional knowledge of the loan. With MERS, no one is in charge.

The mass failure of the mortgage bankers and mortgage brokers who made the great bulk of the fraudulent loans intensified this disaster. It was common for the firms to be liquidated rather than acquired (or for the acquirer to soon fail and be liquidated). Document transfers were no longer publicly recorded if they were done through MERS. (MERS is a tax evasion scheme.) No one even knew which documents still existed and which had been thrown into the dumpsters. The overwhelming norm is that the mortgage banking firms that made the majority of the fraudulent loans failed and their record keeping was destroyed.

The final two contributions to mass foreclosure fraud were that the people hired to service the loans were often hired by the most fraudulent lenders, such as Countrywide. Many employees committed fraud as their central function when they made mortgages. They simply continued business as usual when it came to foreclosure, particularly when their work load surged due to the endemic foreclosures, which in turn were due to the endemic mortgage origination fraud. Fannie and Freddie made this even worse by documenting that foreclosure fraud was endemic by its servicers – and proceeding to do nothing effective to stop the frauds or make criminal referrals. Foreclosure fraud, we now know because of the release of a GSE report, has been widespread for over five years.

If You Don't Investigate, You Won't Find

Criminologists and financial regulators have long warned that the failure to regulate the financial sphere *de facto* decriminalizes control fraud in the industry. The FBI cannot investigate effectively more than a small number of the massive accounting control frauds. Only the regulators can have the expertise, staff, and knowledge to identify on a timely basis the markers of accounting control fraud, to prepare the detailed criminal referrals essential to serve as a roadmap for the FBI, and to “detail” (second) staff to work for the FBI and serve as their “Sherpas” during the investigation.

The agency regulating S&Ls made criminal prosecution a top priority. The result was over 1000 priority felony convictions of senior insiders and their co-conspirators. That is the most successful effort against elite white-collar criminals. The agency also brought over 1000 administrative enforcement actions and hundreds of civil lawsuits against the elite frauds. One result of this was an extensive, public record of fact that fraud was “invariably present” at the “typical large failure” (NCFIRRE 1993). The Enron-era frauds were accounting control frauds and while the effort against them was too late and weaker than the effort against the S&L frauds it involved scores of prosecutions and provided substantial public documentation.

The FBI, however, after a brilliant start in identifying the epidemic of mortgage fraud, went tragically astray and its efforts to contain the epidemic failed. The FBI suffered from a horrific systems capacity problem. It did not have the agents or expertise to deal with the concurrent

control fraud epidemics it faced this decade. Its systems capacity problems became crippling when 500 white-collar specialists were transferred to national security investigations in response to the 9/11 attacks and the administration refused to allow the FBI to hire new agents to replace the lost white-collar specialists.

The most crippling limitation on the regulators', FBI's, and DOJ's efforts to contain the epidemic of mortgage fraud and the financial crisis was not understanding of the cause of the epidemic and why it would cause a catastrophic financial crisis. The mortgage banking industry controlled the framing of the issue of mortgage fraud. That industry represents the lenders that caused the epidemic of mortgage fraud. The industry's trade association is the Mortgage Bankers Association (MBA). The MBA followed the obvious strategy of portraying its members as the victims of mortgage fraud. What it never discussed was that the officers that controlled its members were the primary beneficiaries of mortgage fraud. It is the trade association of the "perps." The MBA claimed that all mortgage fraud was divided into two categories – neither of which included accounting control fraud. The FBI, driven by acute systems incapacity, formed a "partnership" with the MBA and adopted the MBA's (facially absurd) two-part classification of mortgage fraud (FBI 2007). The result is that there has not been a single arrest, indictment, or conviction of a senior official of a nonprime lender for accounting fraud.

One of the most dramatic, and unfortunate differences between the S&L debacle and the current crisis is that the financial regulatory agencies gave the FBI no help in this crisis – even after it warned of the epidemic of mortgage fraud. The FBI does not mention the agencies in its list of sources of criminal referrals for mortgage fraud. The data on criminal referrals for mortgage fraud show that regulated financial institutions, which are required to file criminal referrals when they find "suspicious activity" indicating mortgage fraud, typically fail to do so. There is no evidence that the agencies responsible for enforcing the requirement file criminal referrals have taken any action to crack down on the widespread violations.

The crippling mischaracterization of the nature of the mortgage fraud epidemic came from the top, as the *New York Times* reported in late 2008.

But Attorney General Michael B. Mukasey has rejected calls for the Justice Department to create the type of national task force that it did in 2002 to respond to the collapse of Enron.

Mr. Mukasey said in June that the mortgage crisis was a different "type of phenomena" that was a more localized problem akin to "white-collar street crime."

The U.S. Attorney in one of epicenters of mortgage fraud has an even more crippling conceptual failure because of his inability to understand the concept of looting.

<http://huffpostfund.org/stories/2010/05/too-big-jail>

Too Big to Jail?

Not everyone agrees that such a case can be successful. Benjamin Wagner, a U.S. Attorney who is actively prosecuting mortgage fraud cases in Sacramento, Calif., points out that banks lose money when a loan turns out to be fraudulent. An investor in loans who documents fraud can force a bank to buy the loan back. But convincing a jury that executives intended to make fraudulent loans, and thus should be held criminally responsible, may be too difficult of a hurdle for prosecutors.

“It doesn’t make any sense to me that they would be deliberately defrauding themselves,” Wagner said.

Wagner has confused himself with his pronouns. “They” refers to the CEO. “Themselves” refers to the bank. The CEO has a “sure thing” – he can grow wealthy very quickly by looting the bank through the accounting fraud recipe. He is not looting himself.

Wagner is far from alone in not understanding the most destructive financial fraud scheme and in making a clear error of logic. The courts routinely interpret the Private Securities Litigation Reform Act (PSLRA) to require the dismissal of complaints based on inferences the courts deem to rely on “irrational” behavior. But they mean irrational from the standpoint of the corporation. Lenders loot by making loans that are irrational from the bank’s standpoint but wholly rational from the looter’s standpoint. Indeed, it is the very irrationality of the action from the standpoint of an *honest* bank that allows juries to infer so strongly that the CEO caused the bank to operate in that suicidal manner because it optimized his looting. Indeed, the PSLRA case law on the most important inferences (e.g., about the criminogenic effects of particular forms of executive compensation) calls for inferences that white-collar criminologists, financial regulators, and forensic accountants (indeed, the accounting literature) all reject. The PSLRA has become a shield against even the most meritorious securities fraud actions, which has contributed to securities fraud becoming so common and severe.

The nation’s top law enforcement official swallowed the MBA’s mischaracterization of the mortgage fraud epidemic and economic crisis hook, line, sinker, bobber, rod, reel, and boat they rowed out into the swamp. Because Mukasey refused to investigate the elite frauds he created a self-fulfilling prophecy in which the FBI and DOJ pursued only the “white-collar street crim[inals]” (the small fry) and therefore confirmed that the problem was the small fry. The pursuit of the small fry was certain to fail.

The MBA’s success in causing the FBI to ignore the control frauds reminds me of this passage in the original *Star Wars* movie where Obi-Wan uses Jedi powers to pass through an Imperial check point with two wanted droids in plain sight:

Stormtrooper: Let me see your identification.

Obi-Wan: *[with a small wave of his hand]* You don't need to see his identification.

Stormtrooper: We don't need to see his identification.

Obi-Wan: These aren't the droids you're looking for.

Stormtrooper: These aren't the droids we're looking for.

Obi-Wan: He can go about his business.

Stormtrooper: You can go about your business.

Obi-Wan: Move along.

Stormtrooper: Move along... move along.

Luke: I don't understand how we got by those troops. I thought we were dead.

Obi-Wan: The Force can have a strong influence on the weak-minded.

The FBI isn't supposed to be "weak-minded" about elite white-collar criminals. It is not supposed to be misled by "Jedi mind tricks" by the lobbyists for the "perps." It is not supposed to fail to understand the importance of endemic markers of accounting control fraud at every nonprime specialty lender where even a preliminary investigation has been made public.

The FBI, DOJ, banking regulators, SEC, and all the purported sources of "private market discipline" failed to act against (and even praised) the *perverse incentive structures* that the accounting control frauds created to cause the small fry to act fraudulently. Those incentive structures ensured that there were always far more new small fry hatched to replace the relatively few small fry that the DOJ could imprison. Accounting control frauds deliberately produce intensely criminogenic environments to recruit (typically without any need for a formal conspiracy) the fraud allies that optimize accounting fraud. They create the perverse Gresham's dynamic that means that the cheats prosper at the expense of their honest competitors. The result can be that the unethical drive the ethical from the marketplace. Had Mukasey been aware of modern white-collar criminological research he would have been forced to ask why tens of thousands of small fry were able to cause an epidemic of mortgage fraud in an industry that had historically successfully held fraud losses to well under one percent of assets. Ignoring good theory produces bad criminal justice policies.

The Size of the Mortgage Fraud Epidemic Swamps the FBI

The size of the current financial crisis and the incidence of fraud in the current crisis vastly exceed the S&L debacle. The FBI testified that it "increased the number of agents around the country who investigate mortgage fraud cases from 120 Special Agents in FY 2007 to 180 Special Agents in FY 2008...." Its testimony noted that it employed "1000 FBI agents and forensic experts" against the S&L frauds (Pistole 2009). It received over 63,000 criminal referrals for mortgage fraud in the last year for which it has full data (a figure that has risen substantially every year). The FBI, therefore, can investigate only a tiny percentage of criminal referrals for mortgage fraud. The FBI reports that 80% of mortgage fraud losses occur when "industry insiders" are involved in the fraud (FBI 2007).

Only federally insured banks and S&Ls are required to file criminal referrals. Non-insured lenders made 80% of nonprime mortgage loans (subprime and "alt-a"), and they made the worst nonprime loans that most invited fraud. These lenders can make criminal referrals and it would be in the interests of honest lenders to do so, but they rarely do. That means that the first approximation of the true annual incidence of mortgage fraud would be to multiply 63,000 by five (315,000). That extrapolation, however, would only be sound if (A) insured lenders spotted

all mortgage fraud and (B) filed criminal referrals when they spotted likely frauds. The FBI believes that insured entities identify mortgage frauds prior to lending in about 20% on “no doc” loans (known in the trade as “liar’s loans”) (*New York Times*, April 6, 2008). Multiplying 315,000 by five produces a product of over 1.5 million.

The data on referrals show that the typical insured lender rarely files when it finds mortgage fraud. The October 2009 FinCEN report on criminal referrals for mortgage fraud (in jargon, Suspicious Activity Reports (SARs) found:

In the first half of 2009, approximately 735 financial institutions submitted SARs, or about 50 more filers compared to the same period in 2008. The top 50 filers submitted 93 percent of all [mortgage fraud] SARs, consistent with the same 2008 filing period. However, SARs submitted by the top 10 filers increased from 64 percent to 72 percent.

Only a small percentage of mortgage lenders, 75 in total (roughly 10% of federally-insured mortgage lenders), filed even a single criminal referral for mortgage fraud during a mortgage fraud epidemic. Of the 735 that make at least one filing, fewer than 200 file more than four referrals. A mere ten filers provide the FBI with almost three-quarters of all SARs mortgage fraud filings. We cannot form an appropriate estimate of the degree of under-filing of criminal referrals when insured banks find fraud, but we can infer that the failure to file is pervasive. The logical explanation for the widespread failure of lenders to file criminal referrals when they discover mortgage frauds is that they fear that if they file FBI would come to the lender and discover its complicity in the fraud.

To sum it up, in FY 2007 the FBI has had less than one-eighth of the resources it had to investigate the S&L frauds despite the fact that the current crisis inflicted losses on the household sector 70 times worse than the S&L debacle. It was facing well over a million mortgage frauds annually. It could investigate under 1000 cases per year. If every investigation was successful the FBI would be completely ineffective in preventing or even slowing materially the epidemic of mortgage fraud. Mukasey’s and Holder’s strategy of going after the small fry gave the control frauds a free pass and had to fail to deter the small fry.

What it takes to succeed against an epidemic of accounting control fraud

The Obama administration’s record of prosecuting elite financial frauds is worse than the Bush administration’s record, which is a very large statement. Syracuse University’s TRAC issued a report on November 11, 2011 entitled “Criminal Prosecutions for Financial Institution Fraud Continue to Fall.”

<http://trac.syr.edu/tracreports/crim/267/>

Neither administration has prosecuted any elite CEO for the epidemic of mortgage fraud that drove the ongoing crisis. This contrasts with over 1,000 elite felony convictions arising from the S&L debacle. The ongoing crisis caused losses more than 70 times greater than the S&L debacle and the amount of elite fraud driving this crisis is also vastly greater than during the S&L

debacle. Bank CEOs leading “accounting control frauds” now do so with impunity from the criminal laws. They become wealthy through fraud and even if they are sued civilly they almost invariably walk away wealthy with the proceeds of their frauds.

The Obama Administration Prefers Politics and Propaganda to Prosecutions

Elite financial institutions officers engaged in fraud face a dramatically reduced risk of prosecution compared to 20 years ago when financial fraud was far less common. TRAC reports that the number of financial institution fraud prosecutions under Obama is less than one-half the number 20 years ago. Bush (II) was slightly better than Obama in prosecuting non-elite financial institution frauds, but both were pathetically bad.

The *New York Times* reported on January 23, 2012 that the administration rushed to try to reach a settlement with the five largest banks that engaged in massive foreclosure fraud so that it could take credit for it in the State of the Union (SOTU) address. The headline for the article was “Political Push Moves a Deal on Mortgages Inches Closer.” The administration did not deny the statements made in the article.

“But a final agreement remained out of reach Monday despite political pressure from the White House, which had been trying to have a deal in hand that President Obama could highlight in his State of the Union address Tuesday night.

The housing secretary, Shaun Donovan, met on Monday in Chicago with Democratic attorneys general to iron out the remaining details and to persuade holdouts to agree with any eventual deal. He later held a conference call with Republican attorneys general. But as he renewed his efforts, Democrats in Congress, advocacy groups like MoveOn.org and several crucial attorneys general said the deal might be too lenient on the banks.

In a bid to win support from California officials, Mr. Donovan proposed earmarking \$8 billion in aid for beleaguered California homeowners, but that left other state attorneys general incensed, according to an official familiar with the negotiations.”

http://www.nytimes.com/2012/01/24/business/a-deal-on-foreclosures-inches-closer.html?_r=1&hpbw

The *NYT* did not make the point, but these facts represent multiple disgraces on the administration’s part that go beyond the substance of deal. First, there is the obvious impropriety of pressuring state attorney generals (AGs) who are Democrats to approve a deal so that the President can claim credit for it in the SOTU. Second, it is disgraceful that HUD Secretary Donovan met separately with Democratic AGs. Prosecutions and suits against banks must have nothing to do with political affiliation. Holding separate meetings with AGs based on their party affiliation brings the entire system into disrepute. Third, the idea of offering California a unique earmark in order to buy AG Harris’ support for a deal is as stupid as it was offensive. The administration thinks that everything is about politics. As a former Department of Justice

attorney I regret the administration's bringing the department into disgrace. I can personally assure the nation that nothing like this ever occurred during the S&L debacle in our prosecutions, civil lawsuits, and agency enforcement actions.

Here is what Obama said in his SOTU address:

"One of my proudest possessions is the flag that the SEAL Team took with them on the mission to get bin Laden. On it are each of their names. Some may be Democrats. Some may be Republicans. But that doesn't matter. Just like it didn't matter that day in the Situation Room, when I sat next to Bob Gates – a man who was George Bush's defense secretary; and Hillary Clinton, a woman who ran against me for president.

All that mattered that day was the mission. No one thought about politics. No one thought about themselves."

http://www.washingtonpost.com/politics/state-of-the-union-2012-obama-speech-full-text/2012/01/24/gIQA9D3QOO_story.html

The President was, of course, correct. The same logic applies to everything that government attorneys do. No one should think about politics or themselves. Political party "doesn't matter." Party, politics, and the pursuit of financial contributions not only matter, but are controlling for the administration in their non-pursuit of the fraudulent elite CEOs that drove the ongoing crisis.

The fact that a *NYT* story could reveal this outrage without the authors even mentioning the impropriety of the actions described, without the administration feeling any need to respond to the impropriety, and without any scandal demonstrates how badly we have fallen as a society. While the President was reviewing drafts of a major address to the nation that emphasized that politics should never have a role in government service two of his cabinet officers, Attorney General Holder and HUD Secretary Donovan, were devising a partisan lobbying strategy aimed at getting the state AGs to approve a disgraceful surrender to five of the nation's largest banks. He either did not notice the contradiction or did not feel any need to end the impropriety. Have we lost our capacity for outrage?

The failure of the article to generate a scandal reflects badly on both parties. The candidates for the Republican Party's nomination have been searching for every conceivable issue as a potential basis for attacking Obama. The administration's conduct as described by the *NYT* article provides the perfect club to the Republican candidates, yet none of them will use it. Why? The Republican candidates could not oppose a settlement that, substantively, was so exceptionally favorable to the largest banks. Finance is the largest contributor to both parties. The only criticism in the article came from liberal Democrats (Senator Brown and Representative Miller).

The administration recognized that the only threat to the disgraceful settlement came from liberal Democrats. The administration devised a sophisticated propaganda campaign to counter this opposition. It bore fruit immediately. The day after the *NYT* story ran, the Center for Responsible Lending (CRL) issued a press release entitled "AG Settlement: Not Perfect, but Significant Reform of Mortgage Servicing."

<http://www.responsiblelending.org/media-center/press-releases/archives/AG-Settlement-Not-Perfect-but-Significant-Reform-of-Mortgage-Servicing.html>

The press release was based on a friendly leak, presumably from the administration, of the terms of the settlement as of January 24, 2012. The settlement had two express, related substantive defects. The amount of money the banks would pay was grossly inadequate, relative to the claims being released by the federal and state governments. The third substantive defect is not contained in the written release, but it is one of the keys to the governmental surrender to the fraudulent financial CEOs who caused the crisis. The federal government does not intend to prosecute criminally the large financial firms and their senior officers who committed hundreds of billions of dollars in fraudulent mortgage originations. That figure only counts the fraudulent liar's loans the five large banks made. The total amount of mortgage origination fraud through liar's loans exceeds \$1 trillion. The five banks' civil liability for mortgage origination fraud is vastly larger than their civil liability for their endemic foreclosure fraud. I have explained in detail in prior articles and testimony why only fraudulent banks made material amounts of liar's loans.

Here is how the administration successfully spun the deal to CRL.

“Banks remain accountable. While the state AGs would not be able to bring additional origination or servicing claims against the participating banks, the settlement would preserve the ability of homeowners to pursue claims against banks. Moreover, the settlement would not shield banks from prosecution related to criminal activities, claims based on mortgage securities violations, fair lending suits, or claims against MERS. Finally, the settlement would be enforceable in court by an independent monitor.”

As of January 24, the deal the administration was desperate to conclude prior to the SOTU required the state and federal governments to release civil claims for mortgage origination fraud.

The administration's efforts to pressure the state AGs (all Democrats) to withdraw their opposition to this cynical deal to immunize expressly the largest banks from civil liability for their mortgage origination fraud and, implicitly, to immunize them from criminal liability for mortgage origination fraud failed. The administration responded to the failure through an elaborate symbolic creation of a new task force and a renewed propaganda campaign designed to neutralize liberal opposition to its proposed surrender to the largest banks. The maneuver, however, required an important substantive change in the proposed deal that reveals how bad for the public the administration's proposed deal of January 24 was.

The administration is good at spinning, and this effort had a clever twist and a substantive change that added to its credibility. To date, the spin has been largely successful with liberal commentators. The clever twist was adding the AG leading the opposition to the surrender, NY AG Eric Schneiderman, to the newly created working group. Schneiderman has great credibility with liberals because he blocked the administration's proposed grants of immunity to the five large banks (which were apparently far broader and included express terms raising crippling barriers even to criminal prosecutions). The administration needed Schneiderman on the task force to grant it any credibility. The need for credibility became even more intense after Scot

Paltrow's January 20 expose in Reuters (**Insight: Top Justice officials connected to mortgage banks**). The article revealed that U.S. Attorney General Holder and Lanny Breuer, head of DOJ's criminal division, had been partners at the law firm Covington & Burling, which represented many of the largest banks and had provided key legal opinions to the infamous MERS (Mortgage Electronic Registration System) that has contributed greatly to foreclosure fraud.

<http://www.reuters.com/article/2012/01/20/us-usa-holder-mortgage-idUSTRE80J0PH20120120>

Schneiderman apparently recognized the great leverage he had over the administration and insisted on the modification of the deal's release of the big banks' civil liability for their mortgage origination fraud. The administration used Schneiderman's willingness to serve on the new task force and the reduced grant of immunity for the big banks' mortgage origination fraud as the centerpiece of its effort to spin liberals. It promptly leaked a description of the new proposed deal terms to several liberals – and was immediately rewarded with praise from liberals. Given the fact that Holder and Breuer have no credibility with liberals, this was an exceptional achievement that has delighted the administration. Mike Lux, who has consistently and strongly opposed the administration's earlier proposed settlement drafts, broke the story of the substantive improvements to the deal on January 27. His story explains that two sources he trusts leaked the terms of the new deal to him. He entitled his article "Settlement Release Looks Tight." I encourage reading Lux's entire article, but here is the key excerpt.

http://www.huffingtonpost.com/mike-lux/settlement-release-looks- b_1236602.html

"Big breaking news about the long-fought over bank settlement: senior sources high up in the negotiations have outlined the terms of the legal release. Here's what I was told:

No release on the "vast majority" of origination claims.

No release on the "vast majority" of securitization claims, including all claims of state pension funds.

According to these (two) sources, the release is almost entirely confined to robo signing cases.

Now, I haven't seen the actual language, so I can't verify all this, and I don't know what the phrase "vast majority" means. I also don't know if every player in the negotiations is 100 percent signed off on it. But I have a lot of trust in my sources that this real and that they wouldn't be trying to BS me on how narrow this is. If the language is indeed as tight as my sources are telling me, this is very big news.

All along in this battle, there have been two things progressives working on this issue have been fighting hardest for: one was that we got a broad, deep, well-resourced, and serious investigation of the big financial fraud issues that have gone down in this country over the last decade; the other was that if there was a settlement, that the legal releases the banks got was drawn as narrowly as it could be drawn, as tight as a drum. That combination, in the view of New York Attorney General Eric Schneiderman and those of us fighting by his side, would create real potential of finally holding the Wall Street bankers who wrecked our economy and abused us all accountable for their actions, and for getting a serious amount of money for writing down underwater mortgages. While there are still legitimate questions in both areas, it is looking like we may be achieving both of these huge goals.

One other big question remains in all this: with a release this narrow, will the big banks actually settle? JP Morgan Chase CEO Jamie Dimon and unnamed bank lobbyists are already threatening to walk away, and are clearly really unhappy, so that isn't clear. If they walk away, though, progressives can certainly live very well knowing that they will be prosecuted aggressively by AGs like Schneiderman, Beau Biden of Delaware, Kamala Harris of California, and hopefully others, so it's a win-win for us. My view is: anything that makes Jamie Dimon and big-bank lobbyists unhappy is good for the rest of us."

Lux obviously recognizes that there are important outstanding questions about the proposed deal. I write to add several cautions.

1. There is no reason for granting any civil immunity on mortgage origination or securitization frauds and the grant of even limited immunity for such frauds can only create future problems.
2. The state AGs do not have the resources to investigate mortgage origination fraud. It isn't even close. Collectively, the 50 state AGs could investigate Countrywide's frauds if they took every investigator with expertise in financial institutions and assigned them to the case for five years.
3. The state AGs are not investigating mortgage origination fraud by major lenders.
4. The new working group will not investigate mortgage origination fraud. Obama described the task force in these words in his SOTU address.

"And tonight, I am asking my Attorney General to create a special unit of federal prosecutors and leading state attorneys general to expand our investigations into the abusive lending and packaging of risky mortgages that led to the housing crisis. This new unit will hold accountable those who broke the law, speed assistance to homeowners, and help turn the page on an era of recklessness that hurt so many Americans."

The working group will not "investigate ... abusive lending" and it will not "hold accountable those who broke the law ... [by defrauding] homeowners." It will not "speed assistance to homeowners." It will not "turn the page on an era of recklessness" – and fraud, not "recklessness" is what prosecutors should prosecute. The name of the working group makes its crippling limitations clear: the Residential Mortgage-Backed Securities Working Group. Attorney General Holder's memorandum about the working

group makes clear that the name is not misleading. The working group will deal only with mortgage backed securities (MBS) – not the fraudulent mortgage origination that drove the crisis (the only exception is federally insured mortgages).

<http://www.justice.gov/ag/residential-mortgage-backed-securities.pdf>

Fraudulent mortgage originators engaged in fraudulent sales of the mortgages, mostly to Wall Street and, eventually, Fannie and Freddie. As I stressed earlier, the administration is continuing to grant *de facto* immunity to CEOs at the large lenders whose massive mortgage origination frauds drove the crisis. The working group's mandate helps confirm the administration's continued refusal to prosecute elite mortgage origination fraud.

5. The working group is a symbolic political gesture designed to neutralize criticism of the administration's continuing failure to hold accountable the elite frauds that drove the crisis. Neither the Bush nor the Obama administration has convicted a single elite fraud that drove the crisis. This is a national disgrace and represents the triumph of crony capitalism. Remember that the FBI warned in September 2004 that there was an "epidemic" of mortgage fraud and predicted that it would cause a financial "crisis." There are no valid excuses for the Bush and Obama administrations' failures. The media have begun to pummel the Obama administration for its failure to prosecute. The administration could not answer this criticism with substance because it has nothing substantive to offer in prosecuting elite mortgage origination frauds. The ugly truth is that we are three full years into his presidency and Holder could not find a single indictment to bring that Obama could brag about in his SOTU address. Who doubts that Holder and Obama would have done so if they had anything in the prosecutorial pipeline? Why do Holder and Obama have nothing in the pipeline? There are three fundamental problems, and the working group has not even addressed, much less resolved, any of the three fundamental defects.

One, criminal prosecutions of elite financial criminals have to come from investigations initiated by those with the expertise and resources to detect and investigate "accounting control fraud" (the form of fraud that can hyper-inflate financial bubbles and cause catastrophic losses and financial crises). Only the federal banking regulators have this capability. The absolute essential to achieving broad success is superb criminal referrals from those regulators. The central difficulty with such referrals should be that roughly 75% of the fraudulent mortgage loans were made by entities not regulated by the federal (or state) banking regulators. They were primarily made by mortgage bankers. Sadly, that did not prove to be the central difficulty with federal banking regulators' criminal referrals. The federal banking regulators essentially ceased making criminal referrals last decade.

Banks will not file criminals against their CEOs – the people who run the accounting control frauds that produced the epidemics of mortgage fraud. Police and detectives do not investigate elite accounting control frauds. The FBI does not patrol a beat. Unless the regulatory cops on the beat (e.g., the banking regulators) make the criminal referrals

the DOJ and the FBI will never investigate or prosecute the fraud. Indeed, because accounting control fraud is inherently complex and requires specialized knowledge to recognize, the DOJ will rarely recognize accounting control fraud even when the facts are only consistent with accounting control fraud (as opposed to bad luck or optimism). Absent high quality criminal referrals from the banking regulatory agencies, DOJ may have episodic successes but it will fail utterly to prosecute any epidemic of elite accounting control fraud. Criminal referrals provide the road map that allows effective investigations and prosecutions.

Two, DOJ has not provided remotely enough resources to investigate the large accounting control frauds. Three, DOJ has adopted a self-serving definition of mortgage fraud that implicitly defines accounting control fraud out of existence. DOJ has violated the central rule of investigating elite white-collar crime – if you don't look; you don't find.

We have forgotten the successes of the past. During the S&L debacle, Congress responded to the S&L crisis, once the presidentially-ordered cover up of the scope of the crisis ended in 1989, by ordering and funding a dramatic increase in DOJ resources dedicated to prosecuting the S&L accounting control frauds that drove the second phase of the debacle. President Bush (II), President Obama, and Congress have each failed to emulate the policies that proved so successful in prosecuting elite frauds that caused prior crises. DOJ and the S&L regulators made the prosecution of the elite frauds a top priority by their deeds as well as their words. Contrast that with Holder's press release announcing the formation of the working group.

“Over the past three years, we have been aggressively investigating the causes of the financial crisis. And we have learned that much of the conduct that led to the crisis was – as the President has said – unethical, and, in many instances, extremely reckless. We also have learned that behavior that is unethical or reckless may not necessarily be criminal. When we find evidence of criminal wrongdoing, we bring criminal prosecutions. When we don't, we endeavor to use other tools available to us – such as civil sanctions – to seek justice.”

Holder was even more dismissive of criminality in his memorandum to the financial fraud task force officially informing it of the creation of the working group: “To the extent there was any fraud or misconduct in the RMBS market, we remain committed to discovering it...” This phrase indicates his doubt that there was any fraud – he is saying that they have not “discover[ed]” any fraud. That is a remarkable statement on three grounds. It is a statement made without any credible DOJ investigation. It is a statement contrary to all recent experience with financial crises. Accounting control frauds caused the largest losses in the Enron-era frauds and the S&L debacle. It is also extraordinary because other federal agencies have documented endemic fraud and charged many of the world's largest financial institutions with intentionally selling loans they knew to be fraudulent through false reps and warranties.

Holder consistently emphasizes the lack of criminality. Indeed, since he has prosecuted no elite CEO involved in causing this crisis, he is actually saying that he believes this is our first Virgin Crisis. Countrywide and its ilk made millions of fraudulent mortgage loans – yet Holder thinks that Countrywide’s CEO was a victim of the fraud.

I have concluded that the entire working group gambit upsets me so much because it rests on such crude propaganda. Holder decided to embellish the gambit with the illusion of concrete action. Reuters reported Holder’s claims at his press conference on the working group.

“The Justice Department issued civil subpoenas to 11 financial institutions as part of a new effort to investigate misconduct in the packaging and sale of home loans to investors, Attorney General Eric Holder said on Friday.

Holder declined to provide specifics, including the names of the firms.

“We are wasting no time in aggressively pursuing any and all leads,” Holder said at a news conference announcing details of a new working group to investigate misconduct in the residential mortgage-backed securities (RMBS) market, “you can expect more to follow.””

<http://www.reuters.com/article/2012/01/27/us-mortgages-subpoenas-idUSTRE80Q27U20120127>

One assumes that reporters were so stunned by Holder’s audacity that they failed to challenge his claim that “we are wasting no time in aggressively pursuing any and all leads.” Let us review only the most obvious reasons why this statement is preposterous. The subpoenas are civil subpoenas, not grand jury subpoenas. There is no indication that Holder is serious even now about conducting any criminal investigation of elite banks or bankers.

The question is not whether the Working Group wasted a day or two in issuing civil subpoenas. The Obama administration has wasted three years before issuing these subpoenas. (The Bush administration wasted eight years. The total waste is cumulative.) Civil subpoenas are the most preliminary form of investigation. DOJ should have been issuing grand jury subpoenas to every lender making liar’s loans and every entity packaging liar’s loans no later than September 2004 when the FBI warned that there was an “epidemic” of mortgage fraud and predicted that it would cause a financial “crisis.”

The Obama and Bush administrations have consistently failed to “pursu[e] any and all leads.” Let us count the ways DOJ has *typically* failed to pursue leads against the *elite officers whose* frauds drove this crisis: they have not used grand juries, they have not issued civil subpoenas, they have not used electronic surveillance, they have not used undercover investigators, they have not “wired” cooperating witnesses who they have “flipped”, they have not appealed for whistleblowers to come forward, they have not called elite witnesses before grand juries, they have not convened grand juries, they have not sent FBI agents to their homes or offices to conduct formal interviews, they have not

retained expert witnesses or consultants with expertise in accounting control fraud, they have not demanded that the banking regulatory agencies produce high quality criminal referrals, they have not asked those agencies to “detail” examiners and other skilled staff to the FBI to serve as internal experts, they have not trained AUSAs, special agents, and banking regulators in how to detect, investigate and prosecute accounting control frauds, they have not prosecuted where other federal agencies, after investigation, have charged that financial elites committed fraud, and they have not flipped intermediate officers and gone up the chain of command, they have not assigned remotely adequate staff to investigate and prosecute frauds, they have not assigned any meaningful number of their staff to investigate the elite frauds, and they have not made strong, consistent demands that Congress fund adequate staff to end the ability of financial elites to commit fraud with impunity. Conversely, DOJ has assigned its inadequate staff almost exclusively to non-elite mortgage fraud, has formed a “partnership” with the Mortgage Bankers Association (MBA) – the trade association of the “perps”, and has adopted the MBA’s absurd “definition” of mortgage fraud that implicitly defines accounting control fraud out of existence. How does Holder expect to get “leads” against elite frauds when he gets no criminal referrals from the banking regulatory agencies, “defines” the leading fraud perpetrators of mortgage fraud as the “victim” of mortgage fraud, conducts no credible investigation of elite frauds, takes no proactive steps to investigate (e.g., using undercover FBI investigations), makes no plea for whistleblowers to come forward with evidence on the elite frauds, and provides training for regulators, FBI agents, and AUSAs that implicitly denies the existence of accounting control fraud? I understand that he inherited a disaster and a disgrace from his predecessor, but he has made it worse.

Collectively, the Bush and Obama administration have provided *de facto* impunity from the criminal laws for our largest financial firms and their elite officers who drove our crisis. DOJ has had episodic successes against financial elites not involved in creating the crisis (e.g., Madoff and a prominent insider trader). These “successes” were bittersweet. Madoff conducted a Ponzi scheme that last for decades. DOJ only learned about the scheme because Madoff confessed to his family. He only confessed because the Ponzi scheme was about to collapse. The government learned of the insider trading through a whistleblower and found key facts through electronic surveillance and “wiring” “flipped” participants in the insider trading. The insider trading fraud went on for many years and likely would have gone on for many more years without the government learning of it but for the whistleblower. Both of these frauds were elite financial control frauds, so it is bizarre that Holder simultaneously takes credit for their successful prosecution while implicitly denying that control fraud could exist in elite financial institutions in the mortgage fraud context.

The Reuters story records Holder’s effort to claim that DOJ is vigorously prosecuting elite corporate frauds.

“[Holder] responded to criticism that federal enforcers have brought few marquee cases in the aftermath of the financial crisis. Holder said the department has brought around 2,100 mortgage-related cases.

"The notion that there has been inactivity over the course of the last three years is belied by a troublesome little thing called facts," Holder said."

It is Holder whose claims are "belied by a troublesome little thing called facts." He was responding to the factual critique that he has not indicted or prosecuted any elite banking officers of the large fraudulent lenders that drove the financial crisis. That critique is true. Holder, however, implied that it was an untrue critique by deliberately making a non-responsive response. His answer was that he has indicted 2,100 defendants in mortgage-related cases (roughly 700 annually). By 2006, lenders made roughly *two million* fraudulent liar's loans. In 2005, they made over one million fraudulent liar's loans. Prosecuting roughly 700 (or 7,000) smaller mortgage fraud cases annually is, at best, a symbolic act that cannot possibly have any material effect in slowing an epidemic of mortgage fraud, bringing to justice the elite frauds that caused the ongoing crisis, or deterring future crises. If Holder had led any elite prosecutions of the senior officers of the huge, fraudulent lenders and investment bankers that drove the crisis he would have used them to refute the criticism. Instead, he tried misdirection.

In January 1993, the GAO released a report entitled: *Bank and Thrift criminal Fraud*" prepared at the request of Senate Judiciary Committee Chairman Biden, who is now Obama's Vice-President. Here are key excerpts from that report that demonstrate how real investigations and prosecutions occur.

"In 1984, Justice, along with the federal financial regulatory agencies, formed the Interagency Bank Fraud Enforcement Working Group in an effort to facilitate interagency communication and coordination between Justice and each of the regulatory agencies.

[WKB note: the key deregulatory law that created the criminogenic environment that led to the epidemic of accounting control fraud by roughly 300 S&Ls was the Garn-St Germain Act of 1982. By 1984, DOJ and the banking regulatory agencies realized (with the aid of a vigorous kick to their rears from the House of Representatives administered by Chairman Doug Barnard (D. Georgia)) that there was a fraud crisis and had formed the working group to investigate and prosecute bank frauds.]

Renamed the National Bank Fraud Enforcement Working Group, the group included officials from Justice (including the Criminal Division's Fraud Section, the Attorney General's Advisory Committee of Attorneys, and FBI), OTS, FDIC, occ, the Fed, NCUA, the Farm Credit Administration, the Secret Service, the Department of the Treasury, and the Securities and Exchange Commission.

[WKB note: Contrast this membership with Holder's announcement of the members of his working group:

"The mission of the group — to hold accountable those who violated the law and provide relief for homeowners struggling from the collapse of the

housing market — will be furthered through the active participation of the following members:

- Executive Office for United States Attorneys
- Federal Bureau of Investigation
- Financial Crimes Enforcement Network
- Internal Revenue Service - Criminal Investigation
- Consumer Financial Protection Bureau
- Federal Housing Finance Agency's Office of Inspector General
- United States Department of Housing and Urban Development
- United States Department of Housing and Urban Developments Office of Inspector General"]

[WKB note: Notice the conspicuous (except that no one I have read mentions it) failure to include any of the banking regulatory agencies — the entities that should have the expertise and should be making the vital criminal referrals. The administration will eventually be forced to add the banking regulatory agencies to the working group to quell criticism. The administration's failure to name them originally is revealing. Any serious effort would start with the banking regulatory agencies. The more fundamental problem is, that unlike the S&L debacle, when the banking regulatory agencies led the demand for criminal prosecution of the elite frauds, the current crop of regulatory leaders under Bush and Obama have been notoriously silent and have failed to take even the most basic, essential step — reestablishing a superb criminal referral process and vigorous regulatory investigations of the largest frauds. There is no excuse for this continuing failure.]

In 1990, in testimony before the House Committee on the Judiciary, the Assistant Attorney General of the Criminal Division noted that the group had a number of accomplishments. Among other things, he noted that it produced a uniform criminal referral form....

[WKB note: this may seem a small, bureaucratic step if you have never created a system that resulted in the most successful prosecution of elite white-collar criminals. It is in fact the absolute essential place to start. The bank working groups engaged in what we would now call "continuous improvement." The banking regulators responsible for making criminal referrals got feedback from the FBI on what aspects of our referrals were most useful and what aspects failed to meet the FBI's needs. Our criminal referral specialists took that knowledge back to our staff and, through training and editing of draft referrals, continuously improved the quality of our referrals.]

The criminal financial institution fraud investigative workload in FBI has continued to grow. As of July 31, 1992, FBI had 9,669 investigations pending, an increase of about 46 percent from 1987. More than half of those investigations were classified as "major" fraud cases....

Table 2.1: [Number of criminal referrals filed by the banking regulatory agencies]
Federal Home Loan Bank Board/OTS [WKB note: the Office of Thrift
Supervision (OTS) was the successor agency to the FHLBB.]

1987: 6,100
1988: 5,114
1989: 5,014
1990: 6,393
1991: 7,861

[WKB note: these figures do not include criminal referrals made by OTS after 1991, criminal referrals by the RTC (which resolved failed S&Ls' bad assets), and criminal referrals by S&Ls placed into receiverships by OTS). Collectively, the federal agencies regulating S&Ls and dealing with S&L failures filed well over 30,000 criminal referrals during the S&L debacle.]

[WKB note: number of criminal referrals filed by OTS in the ongoing crisis: 0.]

Following enactment of FIRREA, the Attorney General designated criminal fraud in financial institutions a top enforcement priority. He announced but did not implement plans to address this "enormous and unprecedented challenge" by establishing task forces in 26 cities around the country modeled after the Dallas Bank Fraud Task Force. The Crime Control Act of 1990 authorized more than a doubling of available Justice resources and focused responsibility for the overall effort in Justice's new Office of Special Counsel for Financial Institutions Fraud.

[WKB note: the Dallas Bank Fraud Task Force was staffed with over 100 professionals plus support staff. See the 1993 GAO report for the breakdown.]

FBI has relied on the cooperation of staff from the regulatory agencies to provide information and expertise needed for investigations.

Between October 1, 1988, and June 30, 1992, Justice charged 3,270 defendants through indictments and informations [in "major cases"] and convicted 2,603 defendants (110 defendants were acquitted, establishing a conviction rate near 96 percent). The courts sentenced 1,706 of 2,205 offenders to jail (77.4 percent).

The major difference between working groups and task forces is that task forces investigate and prosecute cases, while working groups do not.

As of July 31, 1992, FBI had 9,669 financial institution fraud cases pending, an increase of 11.3 percent over the 8,678 pending at the end of fiscal year 1991 and 45.3 percent over the 6,649 pending at the end of fiscal year 1987.

In 1989 and 1990, Congress passed two major pieces of legislation that shaped the government's approach. The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 and the Crime Control Act of 1990 (Crime Control Act) provided Justice with additional powers and resources to investigate and prosecute financial institution fraud.

The House report accompanying FIRREA reflects the belief that Title IX of FIRREA was "absolutely essential to respond to a serious epidemic of financial institution insider abuse and criminal misconduct and to prevent its recurrence in the future."

Title XXV of the Crime Control Act [was] entitled the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990....

Appropriations following FIRREA and the Crime Control Act nearly tripled the investigative and prosecutive resources that had previously been available to Justice to address the mounting volume of criminal bank and thrift fraud. The Crime Control Act also authorized additional appropriations to support more IRS resources important to fraud investigations. In addition, the act appropriating funds for the Department of the Treasury in fiscal year 1991 also authorized the Secret Service to participate in financial institution fraud investigations.

Appendix III: FBI and U.S. Attorney Resource Allocations Under FIRREA
[Additional staffing resources made available to aid the prosecution of S&L and bank frauds pursuant to the Financial Institution Reform, Recovery and Enforcement Act of 1989]

FBI: Special Agents: 219; Accounting technicians: 100
U.S. Attorney office: AUSAs: 121; Auditors: 22; Support: 120

Appendix IV: FBI and U.S. Attorney Resource Allocations Under the Crime Control Act [of 1990]
FBI: Special Agents: 289
U.S. Attorney Office: AUSAs: 228; Support: 198 [WKB note: this category included paralegals and auditors]

Table 2.4: Increased Justice Authorized Staff Positions
Fiscal years 1990 to 1992 (special agent, attorney, and other support positions)

FBI (total positions):	1621
U.S. Attorneys (total positions):	772
Criminal Division (total positions):	116
Tax Division (total positions):	65
Civil Division (total positions):	46
Total [DOJ] positions	2,620

[WKB note: these figures do not include IRS, Secret Service, Postal Service, and banking regulators working on the S&L and bank fraud task cases.]

[WKB (very long) note: in FY 2007 the FBI had 120 agents assigned to mortgage fraud cases. By FY 2009 that number rose to 300.

<http://www.fbi.gov/stats-services/publications/financial-crimes-report-2009>

The ongoing crisis caused losses over 70 times greater than the S&L debacle and the number of frauds in this crisis is vastly greater than during the S&L debacle. The best estimate is that there were roughly two million new cases of mortgage fraud in 2006. (The estimate arises from two facts explained at length in my prior work. Roughly one-third of all mortgage loans originated in 2006 were liar's loans and the incidence of fraud in liar's loans is roughly 90 percent.) Worse, DOJ formed a "partnership" with the Mortgage Bankers Association (the MBA) – the trade association of the "perps" and adopted the MBA's contrary-to-fact definition of "mortgage fraud" in which the lender originating the fraudulent mortgages is always the victim of the fraud. Accounting control fraud is, implicitly, defined out of existence. The DOJ repeats this self-serving definition of mortgage fraud repeatedly, without any critical consideration. After the dominant role of accounting control fraud in the second phase of the S&L debacle and the Enron-era frauds we are faced with the conclusive assumption (unsullied by any real investigation or analytics) that the current crisis is the Virgin Crisis. Because they know that the lender is the victim, virtually every FBI agent has been assigned to investigating relatively minor mortgage frauds in which the lender is the purported victim. There has been no meaningful criminal investigation of any of the large fraudulent lenders. Given the pathetically low number of FBI agents assigned to mortgage frauds and their assignment to review staggering numbers of relatively small mortgage fraud cases there were never, remotely, adequate numbers of FBI agents to conduct a real investigation of Countrywide or Washington Mutual (WaMu). Each of these S&Ls made hundreds of thousands of fraudulent mortgage loans. Each of these S&Ls is substantially larger and more complex to investigate than Enron. Each of the S&L originated their hundreds of thousands of fraudulent mortgages by crafting perverse incentives for a vast network of mortgage brokers that induced them to commit endemic mortgage fraud. It took roughly 100 DOJ professionals several years to investigate Enron, so a comparable competent investigation of Countrywide or WaMu would require well over 100 DOJ professionals for several years. Any credible investigation of Countrywide or WaMu would have also required a group of OTS examiners to be "detailed" to work with the FBI investigation and serve as their internal experts. There is no evidence that either of these events ever occurred. Any purported FBI investigation of those massive shops was a sham.

The Working Group continues the sham and political symbolism at the expense of substance. Holder's press release explained its staffing levels.

“Attorney General Holder announced that the new Working Group will consist of at least 55 Department of Justice attorneys, analysts, agents and investigators from around the country. Currently, 15 civil and criminal attorneys are part of the Working Group, along with 10 FBI agents and analysts who will be assigned to the Working Group efforts. An additional 30 attorneys, investigators and other staff around the country will join the Working Group efforts in the coming weeks. This team will join existing state and federal resources investigating similar misconduct under those authorities.”

<http://www.justice.gov/opa/pr/2012/January/12-ag-120.html>

Compare that staffing with the staffing levels we know from experience are required to be successful against elite accounting control frauds. The Working Group does not pass even the most generous laugh test. No one who has ever been involved in a successful, complex criminal investigation of a large organization could take this Working Group seriously. It lacks the capacity to conduct a competent investigation of any of the largest financial frauds – and there are scores of huge institutions engaged in MBS frauds and hundreds of large mortgage banks engaged in MBS frauds.]

The Settlement is too good, or too bad to be true

Lux notes that Jamie Dimon (JP Morgan Chase’s CEO) has expressed skepticism about whether the five large banks will continue to support the settlement now that its substance has been changed (assuming the accuracy of the leaks) to remove the “great majority” of the grants of immunity from civil liability and all grants of criminal immunity. The banks considered the earlier drafts of the deal that offered substantial immunity for mortgage origination fraud to be worth far more than the \$25 billion they would pay in return to secure the immunity. Their civil liability exposure for mortgage origination fraud is in the hundreds of billions of dollars, so being released from both mortgage origination and foreclosure fraud for \$25 billion would have been a spectacular win for the banks. Even if they received no express immunity from criminal prosecutions, it was clear that the administration was implicitly signaling that it would prosecute their mortgage origination frauds. By eliminating civil liability for mortgage origination fraud, the banks also would have made civil suits far less likely or even impossible and that would greatly reduce the risk that civil investigations would disclose criminal conduct that DOJ could not avoid prosecuting, particularly in an election year.

If the administration’s characterization of the revised settlement as having virtually no releases from civil liability for mortgage origination fraud and none for criminal actions is accurate, then it should have been a no brainer that the deal no longer made any sense for the banks. Their civil liability for their foreclosure fraud should be far less than \$25 billion. The banks, however, are eagerly seeking to finalize the revised settlement that Dimon criticized. We can infer from their decision that the big banks realize that they have such rotten skeletons in their foreclosure fraud closets that it is imperative that they settle the suits and prevent the civil suits from going forward and bringing the skeletons to light.

Could this crisis have been prevented?

Yes. Indeed, in many ways this was an easier crisis to contain successfully than many prior financial crises. The United States had extensive experience with nonprime mortgage lending – and it always ended badly. This is the third nonprime failure in twenty years. Nonprime lending, on its face, is inherently imprudent. I quoted MARI about the nonprime losses of the early 1990s and explained how we used supervisory powers to end those losses. No expensive failures resulted and there was, of course, no crisis. Those were primarily “low doc” and (marginally) subprime loans.

Nonprime lenders suffered considerably worse losses (and many failures) in the late 1990s. These nonprime lenders were also known for their predatory lending practices, which led to serious (but not criminal) sanctions by the Federal Trade Commission. The most disturbing aspect of this series of nonprime failures was that elite commercial banks rushed to acquire the predatory lenders even as they were failing and sued by the FTC. President Bush even appointed the most infamous predatory subprime lender (and his largest political contributor), as our ambassador to the Netherlands.

The nonprime loans of the current crisis were an order of magnitude worse than in the early 1990s. They were subprime loans with severe credit defects and “no doc” (“liar’s loans”). I’ve explained why that produces severe adverse selection. Adverse selection is criminogenic. It can produce fraud epidemics.

I noted the how the “layered” nature of the risk of nonprime loans surged during the crisis. These risks interact, the whole is far riskier than the sum of the parts – and the sum of the parts would have been terrifying to any honest lender. By 2006 and 2007, it was common for nonprime loans to include each of these characteristics:

- A trivial, or even no, downpayment
- The minimal downpayment was funded by another loan
- The purported loan-to-value (LTV) ratio was substantial
- The actual LTV was far higher, often >100%, because the appraisal was inflated
- The loan was occurring during the worst financial bubble in history, so the LTV once the bubble burst would greatly exceed 100%
- The loans were increasingly secured by junior liens
- The loan was “no doc” and the representations were not verified
- The information on the loan application was false
- The lender “qualified” the borrower for the loan on the basis of whether he could pay the initial, far lower (“teaser”) interest rate rather than the fully indexed rate
- The borrower could not afford to pay the fully indexed interest rate (even if the borrowers “stated income” was accurate – it was typically inflated)
- The loan payments were less than the interest due (negative amortization)

- The home was not being purchased by someone who would occupy the home (despite a contrary representation on the application)
- While it was never typical, it became common for the mortgage term to be 40 years

Any experienced lender, investment banker, accountant, regulator, or rating agency official would recognize that this was a formula for disaster. They would also understand that packaging a thousand of these toxic mortgages together in a collateralized debt obligation (CDO) in which 80 percent of the derivative was structured as top “tranche” and was supposedly worthy of a “AAA” rating was too good to be true. CDOs are no better than the underlying mortgages (the various “credit enhancements” proved ephemeral). I learned by reading here in Reykjavik a recently released governmental report on Iceland’s banking crisis, that large amounts of worthless debt instruments of Iceland’s “Big 3” banks were put into CDOs because their debt carried relatively high credit ratings. It should not be necessary to add that the ratings for the (deeply insolvent and massively fraudulent Icelandic banks) bore no relationship to reality and that this debt did not adequately “enhance” CDO credit quality.

I’ve discussed the warnings of an “epidemic” of mortgage fraud, which began in 2003, were embraced by the FBI in 2004, and were supplemented by warnings of endemic appraisal fraud in 2005. “Stated income” loans became known throughout the industry as “liar’s loans” and grew to roughly 30% of total new mortgages by early 2007. Many lenders made liar’s loans their primary product. How difficult was it for a regulator (or purchaser of nonprime mortgages or CDOs) to figure out that a business strategy of making “liar’s loans” was imprudent?

The nonprime market also made no sense on other dimensions. As I’ve just explained, the risk of loss rose spectacularly during the decade as loan quality collapsed, fraud became endemic in nonprime loans, and the bubble hyper-inflated. Logically, this should have caused a dramatic increase in loss reserves and should have caused nonprime “spreads” to widen substantially. Instead, the officers controlling the lenders reduced loan loss reserves to ridiculous levels – and spreads narrowed. The first dimension demonstrates endemic accounting and securities fraud. The second dimension demonstrates that markets were not only “inefficient”, but also became increasingly inefficient throughout the growing crisis.

While Greenspan and other failed regulators have claimed that no one warned of the coming crisis; that was truer of the S&L debacle than the current crisis. I’ve shown that there were strong, early warnings of endemic fraud and predictions that it would cause a crisis. Nonprime loans, as I’ve explained, had a consistently bad track record and their problems were sufficiently recent that they should have been well known to both private and public sector leaders. The Enron-era control frauds and New York Attorney General Spitzer’s investigations were fresh in Americans’ minds. Those frauds made clear that:

- The most elite corporations engaged in fraud
- Those frauds were led from the top
- Accounting fraud produced exceptional deception – firms such as Enron that were grossly insolvent and unprofitable purported to be immensely profitable

- The large frauds were able to get “clear opinions from top tier audit firms
- Executive compensation was a major driver of the frauds
- Banks funded the accounting control frauds rather than exerting effective “private market discipline” against them
- Effective regulation was essential to limit such frauds

During the S&L debacle, by contrast, only one economist (Ed Kane) warned publicly of a coming crisis arising from bad assets – and he did not warn about the wave of control fraud. Economists virtually unanimously opposed our reregulation of the industry (Paul Volcker was the leading exception). Economists, including Alan Greenspan, were leading allies of the worst S&L accounting control frauds.

The most difficult aspect of the current crisis to contain was that roughly 80% of nonprime loans were made by entities not subject to direct federal regulation (primarily mortgage bankers). (Note that this also meant they were not subject to the Community Reinvestment Act (CRA) and to requirements to file criminal referrals.) The Federal Reserve (Fed), however, had unique statutory authority to regulate all mortgage lenders under the Home Ownership and Equity Protection Act of 1994 (HOEPA), but Greenspan and Bernanke refused to use it. Finally, over a year after the secondary market in nonprime loans (CDOs) collapsed, and after Congressional pressure to act, the Fed used its HOEPA authority to order an end to some of the most abusive nonprime lending practices. Prior to that time, the federal regulatory agencies acted aggressively throughout the decade to assert federal “pre-emption” of state regulation as a means of attempting to prevent the states from protecting their citizens from predatory nonprime lenders.

All the regulators needed to do to prevent the crisis was ban lending practices that were rational only for control frauds engaged in looting. The regulators consistently refused to do so because of their anti-regulatory ideology. Traditional mortgage underwriting practices are highly effective against fraud. The regulators knew what reforms would work, but refused to mandate the reforms.

By the time this crisis began economists (Akerlof & Romer 1993), regulators (Black 1993); and criminologists (Calavita, Pontell & Tillman 1997; Black 2003; Black 2005) had developed effective theories explaining why combining financial nonregulation and modern executive and professional compensation produced criminogenic environments that led to epidemics of accounting control fraud. We also explained why these were near perfect frauds and explained how control frauds used their compensation and hiring and firing powers to create a “Gresham’s” dynamic that allowed them to suborn the “independent” professionals that were supposed to serve as “controls” and transform them into allies. (This is similar to HIV’s ability to infect the immune system.)

One of the important practical aspects of control fraud research findings is the existence of fraud “markers.” These can be used to identify the frauds even while they are reporting record profits

and minimal losses. The fraud markers also make it possible to prosecute successfully complex frauds because jurors can understand that it makes no sense for honest firms to engage in such practices but makes perfect sense for frauds.

Equally importantly, our research showed how to contain a spreading epidemic of accounting control fraud. These policies were exceptionally effective in containing the S&L debacle. The existence of these research findings and our regulatory record of successful efforts against the accounting control fraud should have made it far easier for our regulatory successors (and any honest bankers) to identify the frauds at an early date and take effective action against them.

What if We Had Looked?

Within the last month, facts have been revealed about three massive nonprime players that show the strong evidence of elite criminality that would have been revealed – in some cases, five years ago – had there been real investigations.

WaMu

Readers interested in reading the Senate Permanent Subcommittee on Investigations' report and the underlying documents can find them through this link:
<http://levin.senate.gov/newsroom/release.cfm?id=323765>

WaMu was an obvious disaster. Its advertising campaign mocked prudent bankers and made it clear that WaMu's answer to potential borrowers would be "yes." Here are the high points picked up by the *New York Times* and the *Huffington Post* in two recent columns:

<http://www.nytimes.com/2010/04/13/business/13wamu.html?hpw>

April 12, 2010

Memos Show Risky Lending at WaMu

By SEWELL CHAN

WASHINGTON — New documents released by a Senate panel show how entrenched Washington Mutual was in fraudulent and risky lending, and highlighted how its top executives received rewards as their institution was hurtling toward disaster.

The problems at WaMu, whose collapse was the largest in American banking history, were well known to company executives, excerpts of e-mail messages and other internal documents show.

The documents were released on Monday by the Senate Permanent Subcommittee on Investigations, which began an inquiry into the financial crisis in November 2008. The

panel has summoned seven former WaMu executives to testify at a hearing on Tuesday, including the former chief executive Kerry K. Killinger.

The panel called WaMu illustrative of problems in the origination, sale and securitization of high-risk mortgages by any number of financial institutions from 2004 to 2008.

“Using a toxic mix of high-risk lending, lax controls and compensation policies which rewarded quantity over quality, Washington Mutual flooded the market with shoddy loans that went bad,” the panel’s chairman, Senator Carl Levin, Democrat of Michigan, said.

Mr. Killinger was paid \$103.2 million from 2003 to 2008. In WaMu’s final year of existence, he received \$25.1 million, including a \$15.3 million severance payment.

In fairness to the reporter, I note that reporters rarely write their headlines. The headline, however, exemplifies the weak analysis and lack of candor that dominates coverage of this crisis. WaMu’s failure was caused by fraudulent lending practices, not “risky lending.” “Risk”, as we conventionally use that word in economics and finance, had nothing to do with any of the three epidemics of accounting control fraud. WaMu’s senior managers deliberately put in place incentive structures that produce massive fraud – then gutted the protections (underwriting and controls) that honest lenders use (successfully) to limit fraud. In combination with providing trivial loss reserves and an executive compensation system based largely on short-term accounting “income”, this produced a “sure thing.” It was certain that the strategy would produce record (albeit fictional) short-term profits. If other lenders followed similar practices (as was extremely likely), it was also certain hyper-inflate the bubble. That meant WaMu’s bad loans could be masked for years through refinancings (WaMu also delayed the recognition of losses by making primarily option ARM loans that allowed extremely low mortgage payments for up to a decade – payments so low that they produced serious negative amortization.) By masking the inevitable defaults for many years the senior executives were able to become exceptionally wealthy. It was also certain that this would lead to disaster for the firm. But the failure of the firm does not represent a failure of the fraud scheme.


Criminologists view WaMu as a “vector” spreading the fraud epidemic through the financial system. But one should have limited sympathy for the purchasers of WaMu’s fraudulent loans for the reasons the Fitch study demonstrated. The fraudulent mortgages were typically obvious on the face of the document. Had the purchasers of WaMu’s mortgages, typically (allegedly) sophisticated parties, engaged in due diligence they would have found widespread fraud. Indeed, that is one of the weaknesses of endemic mortgage fraud – it is relatively easy to spot. The purchasers, however, engaged in “don’t ask; don’t tell” because their senior officers knew that

purchasing relatively high yield nonprime loans would produce record short-term accounting income (and extraordinary compensation).

Killinger was made rich by the lending policies that destroyed WaMu. The fact that he is complaining in his Congressional testimony that it was “unfair” that the taxpayers didn’t bail out WaMu after he trashed it epitomizes the demise of elite accountability and its replacement with a sickening sense of absolute entitlement of the group that Simon Johnson and Peter Kwak aptly refer to as the financial “oligarchs” (2010).

http://www.huffingtonpost.com/2010/04/13/kerry-killinger-exwamu-ce_n_535749.html

Kerry Killinger, Ex-WaMu CEO, It's 'Unfair' Bank Didn't Get Bailed-Out

MARCY GORDON | 04/13/10 11:35 AM | 

WaMu was one of the biggest makers of so-called "option ARM" mortgages. They allowed borrowers to make payments so low that loan debt actually increased every month.

The Senate subcommittee investigated the Washington Mutual failure for a year and a half. It focused on the thrift as a case study on the financial crisis.

Senior executives of the bank were aware of the prevalence of fraud, the Senate investigators found.

The investors who bought the mortgage securities from Washington Mutual weren't informed of the fraudulent practices, the Senate investigators found. WaMu "dumped the polluted water" of toxic mortgage securities into the stream of the U.S. financial system, Levin said.

In some cases, sales associates in WaMu offices in California fabricated loan documents, cutting and pasting false names on borrowers' bank statements. The company's own probe in 2005, three years before the bank collapsed, found that two top producing offices – in Downey and Montebello, Calif. – had levels of fraud exceeding 58 percent and 83 percent of the loans. Employees violated the bank's policies on verifying borrowers' qualifications and reviewing loans.

Citicorp

The full prepared statement of Mr. Richard Bowen, Former Senior Vice President and Business Chief Underwriter of CitiMortgage Inc. before the Financial Crisis Inquiry Commission on April 7, 2010 can be found here:

<http://www.fcic.gov/hearings/04-07-2010.php>

Mr. Bowen's testimony received far less attention because he testified on the same day as Alan Greenspan and Citi's former top officials. This is unfortunate because he was far more candid about Citi's operations than were its former senior officials. Mr. Bowen disclosed that Citi was also a massive vector, selling roughly \$50 billion annually in mostly bad mortgages (primarily to Fannie and Freddie).

The delegated flow channel purchased approximately \$50 billion of prime mortgages annually. These mortgages were not underwritten by us before they were purchased. My Quality Assurance area was responsible for underwriting a small sample of the files post-purchase to ensure credit quality was maintained.

These mortgages were sold to Fannie Mac, Freddie Mac and other investors. Although we did not underwrite these mortgages, Citi did rep and warrant to the investors that the mortgages were underwritten to Citi credit guidelines.

In mid-2006 I discovered that over 60% of these mortgages purchased and sold were defective. Because Citi had given reps and warrants to the investors that the mortgages were not defective, the investors could force Citi to repurchase many billions of dollars of these defective assets. This situation represented a large potential risk to the shareholders of Citigroup.

I started issuing warnings in June of 2006 and attempted to get management to address these critical risk issues. These warnings continued through 2007 and went to all levels of the Consumer Lending Group.

We continued to purchase and sell to investors even larger volumes of mortgages through 2007. And defective mortgages increased during 2007 to over 80% of production.

Lehman Brothers

The bankruptcy examiner conducted an investigation of Lehman Brothers. The report reveals that Lehman Brothers was engaged in large scale accounting and securities fraud by failing to recognize losses so large that it had failed as an enterprise. Lehman's senior executives sought to cover up its failure with a series of very large (\$50 billion) quarter end REPO transactions. Curiously, the report puts no emphasis on the underlying fraud that drove the fraud concentrates on the second-stage REPO cover up.

Here is a link to the full series of the bankruptcy examiner's reports:

<http://lehmanreport.jenner.com/>

My oral and written testimony before House Financial Services on April 20, 2010 provides a detailed description of the evidence indicating accounting control fraud at Lehman. Lehman was one of the principal vectors of liar's loans in the world. The links are:

<http://c-spanvideo.org/program/id/222787>

http://www.house.gov/apps/list/hearing/financialsvcs_dem/black_4.20.10.pdf

Goldman Sachs

Now, we learn that the SEC charges that Goldman Sachs should be added to the list of elite financial frauds. It is a tale of two (unrelated) Paulsons. Hank Paulson, while Goldman's CEO, had Goldman buy large amounts of collateralized debt obligations (CDOs) backed by largely fraudulent "liar's loans." He then became U.S. Treasury Secretary and launched a successful war against securities and banking regulation. His successors at Goldman realized the disaster and began to "short" CDOs. Mr. Blankfein, Goldman's CEO, recently said Goldman was doing "God's work." If true, then we know that God wanted Goldman to blow up its customers.

Goldman designed a rigged trifecta: (1) it secured additional shorting pressure from John Paulson (CEO of a hedge fund that Goldman would love to have as an ally) that aided Goldman's overall strategy of using "the big short" to turned a massive loss caused by Hank Paulson's investment decisions into a material profit, (2) helped make John Paulson a massive profit – in a "profession" where reciprocal favors are key, and (3) blew up its customers that purchased the CDOs. Paulson and Goldman were shorting because they believed that the liar's loans were greatly overrated by the rating agencies. Goldman let John Paulson design a CDO in which he was able to help pick the nonprime packages that were most badly overrated (and, therefore, overpriced). Paulson created a CDO "most likely to fail." Goldman constructed, at John Paulson's request, a "synthetic" CDO that had a credit default component (CDS). The CDS allowed John Paulson to bet that the CDO he had constructed (with Goldman) to be "most likely to fail" would in fact fail – in which case John Paulson would be become even wealthier because of the profit he would make on the CDS.

Now, any purchaser of the "most likely to fail" CDO would obviously consider it "material information" that the investment was structured for the sole purpose of increasing the risk of failure (and helping Goldman "big short" strategy designed to offset losses on Hank Paulson's worst investments). The SEC complaint says that Goldman therefore defrauded its own customers by representing to them that the CDO was "selected by ACA Management." ACA was supposed to be an independent group of experts that would "select" nonprime loans "most likely to succeed" rather than "most likely to fail." The SEC complaint alleges that the representations about ACA were false.

The obvious question is: did John Paulson and ACA know that Goldman was making these false disclosures to the CDO purchasers? Did they “aid and abet” what the SEC alleges was Goldman’s fraud? Why have there been no criminal charges? Why did the SEC only name a relatively low-level Goldman officer in its complaint? Where are the prosecutors?

The Rating Agencies

The Senate has released documents from the rating agencies that demonstrate that they were willingly manipulated by perverse compensation arrangements to give grotesquely inflated ratings to liar’s loans. At the barest minimum, the rating agencies were leading enablers of the downstream epidemic of accounting control frauds.

Fannie and Freddie

The SEC found accounting control fraud at Fannie and Freddie and forced large restatements of their financial statements. If they won their bet on interest rates they gained. When Fannie lost on its interest rate risk gambles it used fraudulent “hedge” accounting to avoid recognizing its losses. When Freddie won on its interest rate gambles it used fraudulent “hedge” accounting to defer recognizing the gain until it had a bad quarter that would lead the executives to fail to obtain their maximum bonus. Freddie’s managers could then make the gain magically appear so that they would receive their maximum bonus. (This is a variant on “cookie jar reserves.”)

When the SEC found that Fannie and Freddie had engaged in accounting fraud their financial regulator, which was then OFHEO, forced CEO changes. OFHEO also (finally) limited what had been the rapid growth of their portfolio (which they used primarily to take interest rate risk prior to the SEC action.)

Because Fannie and Freddie were privatized, their officers designed their compensation system in the same perverse manner as most firms (Bebchuk & Fried 2004), they stood to gain enormous compensation if they inflated short-term accounting income. As Mr. Raines explained in response to a media question as to what was causing the repeated scandals at elite financial institutions:

We’ve had a terrible scandal on Wall Street. What is your view?

Investment banking is a business that’s so denominated in dollars that the temptations are great, so you have to have very strong rules. My experience is where there is a one-to-one relation between if I do X, money will hit my pocket, you tend to see people doing X a lot. You’ve got to be very careful about that. Don’t just say: “If you hit this revenue number, your bonus is going to be this.” It sets up an incentive that’s overwhelming. You wave enough money in front of people, and good people will do bad things.

http://msnbc.businessweek.com/magazine/content/03_20/b3833125_mz020.htm¹

Raines learned that the unit that should have been most resistant to this “overwhelming” financial incentive, Internal Audit, had succumbed to the perverse incentive. Mr. Rajappa,

¹ Raines’ observation about the perverse impact of such compensation systems has been confirmed by statistical tests. As Bebchuk & Fried, the leading experts on compensation systems, observed in their study of Fannie Mae’s compensation system:

As we noted at the outset, we do not know whether Rames and Howard were in any way influenced by the incentives to inflate earnings created by their compensation packages. There is a growing body of evidence, however, that in the aggregate, the structure of executive pay affects the incentive to inflate earnings.¹⁰ For example, pay arrangements that enable executives to time the unwinding of equity incentives have been correlated with attempts to increase short-term stock prices by inflating earnings. Thus, the problem of rewards for short-term results is of general concern.

n. 10 See, e.g., Scott L. Summers & John T. Sweeney, **Fraudulently Misstated Financial Statements and Insider Trading: An Empirical Analysis**, 73 *Acct. Rev.* 131 (1998). For further discussion of this problem, see [Lucian Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (2004);] at 183-85.

Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage. Lucian A. Bebchuk and Jesse M. Fried. *Journal of Corporation Law*, 2005, Vol. 30, pp. 807-822 (at p. 811).

Even scholars opposed to many aspects of financial regulation have noted the endemic nature of these perverse incentives and their close ties to accounting and securities fraud. Markham, Jerry W. **Regulating Excessive Executive Compensation – Why Bother?** (available on SSRN: See, e.g., pp. 20- 21). The depth of consensus on this issue is shown by the strong concurrence of the intellectual father of executive bonus systems, Michael Jensen, who has concluded that (as implemented) they have caused pervasive perverse incentives and led to endemic accounting and securities fraud. Jensen concludes:

- When managers make any decisions other than those that maximize value in order to affect reporting to the capital markets they are lying
- And for too long we in finance have implicitly condoned or even collaborated in this lying. Specifically I am referring to “managing earnings”, “income smoothing”, etc.
- When we use terms other than lying to describe earnings management behavior we inadvertently encourage the sacrifice of integrity in corporations and in board rooms and elsewhere

Recent Evidence from Survey of 401 CFO’s Reveals Fundamental Lack of Integrity

- Graham, Harvey & Rajgopal survey (“Economic Implications of Corp. Fin. Reporting” <http://ssrn.com/abstract=491627>) of 401 CFOs find:
- 78% of surveyed executives willing to knowingly sacrifice value to smooth earnings
- Recent scandals have made CFOs less willing to use accounting manipulations to manage earnings, but
- Perfectly willing to change the real operating decisions of the firm to destroy long run value to support short run earnings targets

Jensen, Michael. **Putting Integrity Into Finance Theory and Practice: A Positive Approach** (June 9, 2007) (available on SSRN).

Senior Vice President for Operations Risk and Internal Audit instructed his internal auditors in a formal address in 2000 (and provided the text of the speech to Raines). (\$6.46 refers to the earnings per share (EPS) number that will trigger maximum bonuses.)

By now every one of you must have 6.46 branded in your brains. You must be able to say it in your sleep, you must be able to recite it forwards and backwards, you must have a raging fire in your belly that burns away all doubts, you must live, breath and dream 6.46, you must be obsessed on 6.46. ... After all, thanks to Frank [Raines], we all have a lot of money riding on it. ... We must do this with a fiery determination, not on some days, not on most days but day in and day out, give it your best, not 50%, not 75%, not 100%, but 150%. Remember, Frank has given us an opportunity to earn not just our salaries, benefits, raises, ESPP, but substantially over and above if we make 6.46. So it is our moral obligation to give well above our 100% and if we do this, we would have made tangible contributions to Frank's goals (emphasis in original).

In addition to allowing the CEO to convert firm assets to his personal benefit through seemingly normal corporate means, executive compensation has two additional advantages to accounting control frauds. The CEO of a large corporation cannot send a memorandum to 5000 employees instructing them to commit accounting fraud – but he can send the same message with near impunity through the compensation system. The CEO ensures that the compensation system creates a criminogenic environment that produces powerful incentives for subordinated to engage in accounting fraud in order to maximize their bonuses (which will maximize the CEO's bonus and the value of his stock) – all with complete deniability from the CEO. Generous bonuses for even lower level managers also provide a powerful social pressure against whistle blowers coming forward and leading all their peers to lose their bonuses.

Fannie and Freddie CEOs caused them to purchase huge amounts of nonprime assets because, with their growth restricted the way to create fictional accounting income and maximize their bonuses was to purchase for their portfolio the highest yield assets. This is the same strategy that most of the investment banker CEOs followed. OFHEO had ample regulatory power to order that an end to this strategy. It failed to do so because it did not believe that regulating assets purchases was an appropriate regulatory policy prior to those assets causing serious losses. The bubble masked those losses by allowing refinancing. The CEOs of Fannie, Freddie, Bear Stearns, Citi, Wachovia, Merrill Lynch, and Lehman followed similar strategies for the same perverse reasons (and that list is not exhaustive).

Other Nations Suffering from Control Fraud during this Crisis

Very recent reports by governmental authorities in Ireland, Afghanistan, and Iceland provide strong support for concerns that control fraud played a role in their bank failures.

Specific Proposals to Reduce and Deter Accounting Control Fraud

1. Eliot Spitzer, Frank Partnoy and I proposed in our December 19, 2009 op ed in the *New York Times* – that AIG's emails and key deal documents be made public so that we can

investigate the elite control frauds. (I have called for the same disclosures of Fannie and Freddie's key documents.) Goldman used AIG to provide the CDS on these synthetic CDO deals and Hank Paulson used our money to bail out Goldman when AIG's CDS deals drove it to failure. Treasury also used AIG to secretly bail out UBS – a massive Swiss bank engaged in a conspiracy with wealthy Americans to commit tax evasion/fraud. In essence, Americans paid UBS' fine – and gave it over \$4 billion is walking away money. AIG was not federally insured. The U.S. had no responsibility to bear its losses. AIG's managers, directors, and trustees have failed to make any response to our requests that they assist these vital investigations by releasing the documents. (I have received no response to my similar open requests to Fannie and Freddie.)

2. Clarify that investors and creditors may pursue a private right of action against those that "aid and abet" relevant frauds under the securities laws.
3. Enact Representative Kaptur's bill to authorize, fund and direct the FBI to hire 1000 additional white-collar crime specialists as FBI agents to replace those transferred to national security and add resources necessary to take on the backlog of control frauds.
4. The regulators, FBI, and DOJ should follow a successful strategy used during the S&L debacle and create a "Top 100" priority list of the most significant criminal cases arising from the Great Recession.
5. All home lenders should be required to file criminal referrals (SARs) when they discover a reasonable suspicion of a federal crime.
6. The regulatory agencies should revitalize their criminal referral processes (which effectively ceased to exist with regard to control frauds).
7. The regulatory agencies should "detail" experienced examiners and supervisors to the FBI and DOJ so that they can serve as "Sherpas" to aid the investigations and prosecutions and have access to "6e" grand jury materials.
8. DOJ/FBI should create a national task force to investigate the systemically dangerous institutions (SDIs) and other major originators, sellers, and purchasers of nonprime paper and financial derivatives.
9. Where appropriate, the FBI should use undercover investigators and electronic surveillance in investigating control frauds.
10. The FBI should terminate immediately its "partnership" with the MBA.
11. The regulatory agencies should reinstate requirements for full underwriting of income, assets, liabilities, credit ratings, and appraised values for all mortgage lenders. They should, by rule, require that this underwriting be evidenced contemporaneously in writing

and be maintained on site for at least five years (and off site for ten years from the date of the loan being made). While violating such rules is not a crime, this requirement is one of the most effective means of establishing the necessary intent of those that seek to evade the requirement.

12. The agencies should immediately review every significant nonprime lender under their jurisdiction to determine whether they have made roughly the number of criminal referrals that would be expected given the epidemic of mortgage fraud. Where lenders have filed far too few referrals they should be priorities for special purpose examinations to determine whether their failure to file referrals is an indicator that they are a control fraud.
13. The regulatory agencies, including the CFTC, SEC, FBI, and DOJ, should create a position of the “Chief Criminologist” staffed by someone tasked with remaining current with white-collar criminological findings and ensuring that such findings, where relevant, be provided as input to senior decision-makers.
14. Create minimum federal requirements for fiduciary duties, which have been badly eroded by state “competition in laxity.” Delaware corporations, for example, have generally eliminated the duty of care.
15. Take conflicts of interest exceptionally seriously. Forbid financial institutions to make any loans to their employees, officers, boards, and professionals (e.g., senior personnel of their outside auditors and rating agencies).
16. Remove the perverse incentive caused by compensation not tied to demonstrated, long-term performance. This is one of the leading criminogenic environments globally.
17. Reform professional compensation to remove the perverse incentives and “Gresham’s dynamic” now common.

Biography of William K. Black

Bill Black is an Associate Professor of Economics and Law at the University of Missouri – Kansas City (UMKC). He is a white-collar criminologist. He was the Executive Director of the Institute for Fraud Prevention from 2005-2007. He has taught previously at the LBJ School of Public Affairs at the University of Texas at Austin and at Santa Clara University, where he was also the distinguished scholar in residence for insurance law and a visiting scholar at the Markkula Center for Applied Ethics.

He was litigation director of the Federal Home Loan Bank Board, deputy director of the FSLIC, SVP and General Counsel of the Federal Home Loan Bank of San Francisco, and Senior Deputy Chief Counsel, Office of Thrift Supervision. He was deputy director of the National Commission on Financial Institution Reform, Recovery and Enforcement. His regulatory career is profiled in Chapter 2 of Professor Riccucci's book *Unsung Heroes* (Georgetown U. Press: 1995),

Chapter 4 (“The Consummate Professional: Creating Leadership”) of Professor Bowman, et al’s book *The Professional Edge* (M.E. Sharpe 2004), and Joseph M. Tonon’s article: “The Costs of Speaking Truth to Power: How Professionalism Facilitates Credible Communication” *Journal of Public Administration Research and Theory* 2008 18(2):275-295.

George Akerlof called his book, *The Best Way to Rob a Bank is to Own One* (University of Texas Press 2005), “a classic.” Paul Volcker praised its analysis of the critical role of Bank Board Chairman Gray’s leadership in reregulating and resupervising the industry:

Bill Black has detailed an alarming story about financial - and political - corruption. The specifics go back twenty years, but the lessons are as fresh as the morning newspaper. One of those lessons really sticks out: one brave man with a conscience could stand up for us all.

Robert Kuttner, in his *Business Week* column, proclaimed:

Black’s book is partly the definitive history of the savings-and-loan industry scandals of the early 1980s. More important, it is a general theory of how dishonest CEOs, crony directors, and corrupt middlemen can systematically defeat market discipline and conceal deliberate fraud for a long time -- enough to create massive damage.

Black developed the concept of “control fraud” – frauds in which the CEO or head of state uses the entity as a “weapon.” Control frauds cause greater financial losses than all other forms of property crime combined and kill and maim thousands. He helped the World Bank develop anti-corruption initiatives and served as an expert for OFHEO in its enforcement action against Fannie Mae’s former senior management.

He teaches White-Collar Crime, Public Finance, Antitrust, Law & Economics (all joint, multidisciplinary classes for economics and law students), and Latin American Development (co-taught with Professor Grieco, UMKC – History).

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**HEARING TESTIMONY FOR
“EXAMINING LENDING DISCRIMINATION PRACTICES
AND FORECLOSURE ABUSES”**

SENATE JUDICIARY COMMITTEE

SENATOR BENJAMIN L. CARDIN

March 7, 2012

Thank you Senator Grassley for the courtesy, and Senator Whitehouse. Senator Leahy, it's nice to be back before the Judiciary Committee. I must tell you, on the other committees that I serve the Chairman does not recognize me in the same way you just did. So I thank you very much for those very nice comments. It's good to be back. Thank you for that; and I thank you for holding this hearing. I think this is an extremely important subject and I applaud your leadership and the leadership of this Committee.

Let me begin by telling the Committee that I know from my own state of Maryland that families and communities are still hurting from the effects of lending discrimination and foreclosure abuses. The wounds are raw and real. There is still so much more that we can do. My own state of Maryland has become a model for the nation in strategies for combating foreclosures. Working across agencies, the state has developed a comprehensive strategy that includes legal and regulatory reforms, as well as housing counseling and legal assistance networks. They are making a difference. Here is just one example.

A few weeks ago, I was proud to partner with the Maryland Department of Housing and Community Development to hold a foreclosure prevention workshop. This was not the first workshop I sponsored and it certainly will not be the last. There was very strong

community turnout for this event. In fact, Mr. Chairman, there were over 600 people who showed up for this mortgage foreclosure prevention workshop. It took place 8 or 9 miles from here, in the Washington suburbs.

Viola Williams was one the hundreds of Marylanders that attended the event. Three years ago, she began to fall behind on her mortgage, mainly due to factors that were beyond her control. She was responsible and immediately got in touch with her bank about modifying her loan. For three years, she went back and forth with her bank. She became convinced that her bank was trying to wear her down. But she did not give up. She was persistent. She was proactive because she knew that her home was her biggest investment and she could not walk away. At my event, she met with housing counselors, who were honest with her about her options, what resources were available to her, and what to expect when dealing with her bank.

Most importantly, she was able to meet directly with a representative from her bank who was able to directly submit her modification papers. After waiting for three years, a few days after this event Ms. Williams received her modification papers. Her story is a common one. But her happy ending is all too rare. We need to do more to help these people. There is no magic wand or silver bullet for fixing our housing problems. In the end, our success will be the result of a patchwork of policies and the hard work of government officials, housing counselors, and individuals. The path ahead is unknown, but we owe it to Viola Williams and others like her to keep trying and to provide them with the tools to stay in their homes.

Mr. Chairman, we can make a difference. Our policies can save people's homes, can save families, and communities. The height of the irresponsible lending practices was from 2004 to 2008. According to the Justice Department, the greater Washington area, including suburbs in my home state of Maryland, ranked among Countrywide's top 10 targets. In Prince George's County, the most affluent majority-black county in the United States, these types of loans have had a devastating effect. At the beginning of the housing crisis in 2007, a state task force identified it as the epicenter of Maryland's foreclosure crisis and the County's residents continue to struggle to stay in their homes. Mortgages for roughly one in four single-family residences there have been in default or some stage of the foreclosure process since 2006. Average property values have declined by 35 to 40 percent and homeowners will continue to struggle with underwater mortgages.

The banks protected themselves by shifting the risks of nonpayment to investors, and make a profit in the process. These practices triggered the worst financial crisis since the Great Depression. And today, many economists blame the anemic housing market as the biggest drag on our economy.

No state has been spared. Nationally, average home prices have fallen by 25 percent since prices peaked in 2006. In the same period, prices fell 30 percent in Maryland. Across the nation, more than 10 million homeowners now owe more on their mortgages than their homes are worth and 4 million more have been foreclosed upon since 2007.

Many of the victims are honest, hardworking, responsible people that bought homes to raise their families, to pursue their dreams, and make memories. And now they are trapped in a nightmare where they

can't refinance their homes to make them more affordable, or worse, are in serious risk of foreclosure.

I want to personally thank Assistant Attorney General Perez and the Department of Justice for the important steps they have taken and continue to take to protect families across the nation. In December, the DOJ announced a historic settlement of a lawsuit with Countrywide. Countrywide charged over 200,000 African-American and Latino victims more for their loans because of their race or ethnicity. Further, Countrywide put more than 10,000 of those families who had qualified for safe loans in the less expensive prime market into risky, subprime mortgages – while at the same time white borrowers with similar credit histories were steered into safer, prime loans.

Traditional civil rights laws took aim at the practice of “redlining,” which in the housing context meant that banks and mortgage companies would favor lending to whites and disfavor lending to minorities. Congress passed the Fair Housing Act of 1968 and Equal Credit Opportunity Act of 1974 specifically to prohibit discrimination based on race, color, or ethnicity in terms of selling, buying, renting, or financing a house. But today, in 2012, we are seeing a new type of housing discrimination. This is the practice of “reverse redlining.” While traditional civil rights cases dealt with being denied a benefit based on race – such as lack of access to public accommodations, employment or the election booth – today’s discrimination makes the victim believe that they are actually lucky and have finally achieved the American dream. I commend Mr. Perez for aggressively enforcing our civil rights laws to meet today’s challenges.

This new type of discrimination results from the “steering” of Hispanic and African-American borrowers into less favorable loan rates, including subprime loans. According to DOJ these loans were often much more expensive, and were subject to: possible prepayment penalties, exploding adjustable interest rates, sudden rate increases after a few years, and increased risk of credit problems, default, and, ultimately, foreclosure.

Every family has paid a very steep price for the irresponsibility and recklessness on Wall Street over the last decade. But no group has experienced the pain of this crisis more than African-American and Latino families. According to the Department of Housing and Urban Development, “between 2005 and 2009, fully two-thirds of median household wealth in Hispanic families was wiped out. At the same time, middle class African-American neighborhoods saw nearly two decades of gains reversed in a matter of months.”

Any way you look at it, it’s an absolute tragedy. As my staff and I work with borrowers, banks, and housing counselors to keep hard-working Marylanders in their homes, I am grateful for the efforts taken by the state of Maryland and the federal government to stabilize our neighborhoods. At the same time, I look to Mr. Perez, the Department of Justice, and this Committee to continue our work in making sure that deceptive and discriminatory lending practices never happen again.

The Countrywide consent order and \$335 million settlement are but a first step. I commend the President for forming a Financial Fraud Enforcement Task Force to investigate and prosecute housing fraud and discrimination. Last month, Attorney General Eric Holder announced a multi-state settlement with 5 of the nation’s largest mortgage servicers

for origination and servicing fraud and wrongful foreclosures. As part of this settlement, these market leaders will implement more new standards designed to ensure that borrowers are protected as they enter into mortgages.

In Maryland, this settlement will also bring almost \$1 billion to help homeowners. 40,000 borrowers will be able to modify their mortgages to make them more affordable or receive restitution for the loss of their homes. The state will have more funds to increase the mortgage counseling and legal services available to homeowners. The settlement is a positive step forward and is part of ongoing efforts by the states and on the national level to investigate previous practices, improve them going forward, and hold bad actors responsible.

Mr. Chairman, I am reminded what Senator Ted Kennedy, a former member of this Committee, used to say when he discussed civil rights as the “great unfinished business of the nation.” Let’s keep working to fulfill the promise of the American dream for all our citizens, regardless of their race or ethnicity.

Senator Dianne Feinstein
Opening statement at Senate Judiciary Hearing on the Due Process Guarantee Act
February 29, 2012

>>**Senator Feinstein:** Thank you very much, Mr. Chairman. Let me thank you for holding the hearing and for co-sponsorship of this bill. I would also like to thank Senator Lee; I am delighted that he is here today and a major Republican cosponsor, member of this committee and, if you wish to make a brief statement while I am presiding, before we go to the witnesses – [Senator Lee responds off-mic]. Well, if you change your mind, let me know.

I'd also like to thank Senators Durbin, Klobuchar, Franken, who is here as well, Coons and Blumenthal who are members of this committee and six of the twenty three cosponsors of this bipartisan legislation. And I also want to thank the witnesses for being here today, as well.

Let me take a moment to describe why this is such an important issue for me. I was very young during World War II and one Sunday—my dad was a doctor and the only time I ever saw very much of him was on Sunday—he said I want to show you something. And he took me down the peninsula, south of San Francisco, to a race track known as Tanforan. And it had been converted into an internment camp and processing center for Japanese Americans, who, on a certain day, were told throughout the United States to report, to be held in confinement for no reason other than we were at war with Japan. And so every Japanese American citizen essentially was interned. And, Tanforan was a transition camp. I'll always remember seeing the infield of the racetrack all filled with little tiny shacks, the barbed wire around the exterior. And, I think I didn't really realize the impact of that until many years later. And it remains, in my view, a dark stain on our history and our values and also something we should never repeat.

It took a long time, but in 1971, Congress passed and President Nixon signed into law something called the Non-Detention Act of 1971. And subsequently, Ronald Reagan made an official apology when he was President of the United States. The Non-Detention Act clearly states this, and I quote, it's very brief, "No citizen shall be imprisoned, or otherwise detained by the United States, except pursuant to an Act of Congress," end quote.

Now, what happened was, in the Armed Services Committee, an amendment was put in the Defense Authorization Bill, which essentially used the resolution to authorize force to apply the laws of war also to the United States. And in the laws of war, a suspect on the battlefield can be held, detained, without charge until the end of hostilities. This had never been the case in the United States. So, on the floor that day, there was considerable debate. The Judiciary staff, Senator Lee, Senator Paul, we spent a lot of time discussing this. The Intelligence staff came down. And there was a very, very good discussion on what was meant and what was not meant. I think we spent, Senator Lee, virtually the whole day on it. I remember being in the Republican Cloakroom sitting with you and Senator Paul and trying to work this out.

Others on the floor, including myself and Senator Durbin argued that this was prohibited by the Non-Detention Act and that the *Hamdi* decision by the Supreme Court was, by its own terms, limited to the circumstances of an American picked up on the battlefield in Afghanistan. The four justice plurality in *Hamdi* clearly stated, and I quote, “If the government has made clear, however, that for purposes of this case, the enemy combatant that it is seeking to detain is an individual, who it alleges was part of, or supporting forces hostile to the United States or coalition partners in Afghanistan, and who engaged in an armed conflict against the United States there. We therefore answer only the narrow question before us: whether the detention of citizens falling within that definition is authorized”. So, *Hamdi*, in itself, was very narrow and really related to the battlefield in Afghanistan only.

In the end, as the Chairman said, the Senate adopted a compromise that was worked out with Senators Graham, Durbin, Levin, McCain, Chambliss, and others, which passed by a 99-1 vote. I don’t think any one of us thought that was really the solution. On that given day, it was the best we could do. And it provided that the Defense Authorization Bill did not change current law. In effect, what this did was leave it up to the courts to resolve at a later time.

There was widespread outrage at the notion that the Defense Authorization Bill or the AUMF would authorize the military to indefinitely detain U.S. citizens without charge or trial. I believe that message clearly got out there and was reflected in the number of calls and letters that came in. So, the time is really now to end the legal ambiguity and state clearly once and for all that the AUMF, or other authorities, do not authorize such indefinite detention of Americans in America.

To accomplish this, a number of us joined to introduce the bill we are considering today, the Due Process Guarantee Act. This picks up right where the Non-Detention Act of ‘71 leaves off. It amends that act to provide clearly that no military authorization will allow for the indefinite detention of United States citizens or Green Card holders who are apprehended inside the United States. It does not change current law for terrorist detainees captured outside the United States. The bill also codifies a clear statement rule that requires any Congress in the future to expressly state when it wants to put United States citizens and Green Card holders into an indefinite detention. In other words, they have to explicitly authorize that. We lack the power to pass a statute that would prevent future Congresses from passing a statute to authorize such detention, although the Constitution may well prohibit it. However, we can at least provide that if a future Congress decides to take such action to override the protection of the Non-Detention Act, it must say so clearly and explicitly that Congress wants to authorize indefinite detention of United States persons.

As I understand it, under the Supreme Court precedent of *Yick Wo v. Hopkins* in 19—excuse me—1886, and other cases, individuals residing in the United States both legally and illegally have the same Due Process protections as citizens under the Constitution. Therefore, some argue that this legislation should provide coterminous protection to all persons in the United States, whether lawfully, or unlawfully present.

But, candidly, the question is whether we can pass such a bill to cover others beside United States citizens and Green Card holders. If there would be, I am all for it. We have explored this with our Republican cosponsors and at the present time, we do not believe that there is support to go beyond this. Whenever we draw the line or wherever we draw the line on who should be covered by the legislation, it is unclear to me why anyone apprehended on United States soil should be detained by the military. The criminal justice system has at least the following four options at its disposal to detain suspected terrorists who may be in the United States illegally. One, they can be charged with a crime and held. Two, they can be held for violating immigration laws. Three, they can be held as material witnesses as part of federal grand jury proceedings. And four, they can be held under the PATRIOT ACT for six months.

As we know, the Bush Administration tried to expand the circumstances under which United States citizens could be held in indefinite detention. United States citizen Jose Padilla was detained without charge in a military prison for three years, even though he was arrested inside the United States. Amid considerable controversy regarding the legality of his detention, Padilla was ultimately transferred out of military custody and tried and convicted in a civilian federal court. I very much agree with the Second Circuit Court of Appeals, which ordered Padilla to be released in the case of *Padilla v. Rumsfeld*, 2003 and held. And here is the quote “we conclude that clear, Congressional authorization is required for detentions of American citizens on American soil because 18 U.S.C. § 4001a, the Non-Detention Act, prohibits such detentions absent specific Congressional authorization” end quote.

The Second Circuit went on to say that the 2001 authorization to use military force passed after 9/11, quote, “is not such an authorization and no exception to the Non-Detention Act otherwise exists,” end of quote. That is the Second Circuit. The Fourth Circuit came to a different conclusion—and I think all of this is important or I wouldn’t bother with it—came to a different conclusion when it took up Padilla’s case. But its analysis turned entirely on disputed claims that quote, “Padilla associated with forces hostile to the United States government in Afghanistan,” end quote. And, quote, “like Hamdi,” end quote, and this is a quote “Padilla took up arms against United States forces in that country in the same way and to the extent as did Hamdi,” end of quote.

The Due Process Guarantee Act would help resolve this apparent dispute between the circuits and adopt the Second Circuit’s clear statement rule. The bill—our bill—states, quote “An authorization to use military force, a declaration of war, or any similar authority shall not authorize the detention without charge or trial of a citizen, or lawful permanent resident of the United States apprehended in the United States, unless an act of Congress expressly authorizes such detention” end quote. That’s the clear statement rule that this bill will enact into law.

I want to be very clear about what this bill is and what it is not about. It is not about whether citizens such as Hamdi and Padilla, or others who would do us harm should be captured, interrogated, incarcerated and severely punished. They should be. But what about an innocent American, like Fred Korematsu, or other Japanese Americans during World War II? What about someone in the wrong place at the wrong time that gets picked up, held without charge or trial until the end of hostilities, and who knows when these hostilities end.

The federal government experimented with indefinite detention of United States citizens during World War II, a mistake that we now recognize as a betrayal of our core values. Experiences over the last decade prove the country is safer now than before the 9/11 attacks. Terrorists are behind bars, dangerous plots have been thwarted. In the Worldwide Threat Hearing, FBI Director Muller testified that there have been twenty arrests just this past year of people who would do harm in the United States. The system is working. Now is the time to clarify United States law to state unequivocally that the government cannot indefinitely detain American citizens and Green Card holders captured inside this country without trial or charge.

I am sorry this is so long, Mr. Chairman, but I thought it was really important to point out what this is and what it is not.

**Statement Of Senator Patrick Leahy (D-Vt.),
Chairman, Senate Committee On The Judiciary,
Hearing On "Examining Lending Discrimination Practices And Foreclosure Abuses"
March 7, 2012**

Today we welcome Assistant Attorney General Tom Perez to discuss the Justice Department's efforts to combat discrimination in mortgage lending and foreclosure abuse. This Committee has tried to do its part in connection with the housing crisis, including our consideration of important legislation introduced by Senator Whitehouse after a series of hearings both here and in Rhode Island. Our exploration of the civil rights component of the housing crisis and foreclosure abuse is part of that effort.

The Obama administration has been aggressively responding to the foreclosure crisis. Yesterday, the administration announced a new initiative which could benefit millions of homeowners by reducing their fees and providing an average savings of \$1,000 a year through refinancing. And the administration reiterated its commitment to our men and women in uniform by outlining the steps it is taking to provide relief to those who have been harmed by lending abuses.

Just a few weeks ago, Attorney General Holder, Housing and Urban Development Secretary Donovan, and 49 state attorneys general, announced an historic \$25 billion settlement with the Nation's five largest mortgage servicers. I commend them for their persistence in reaching this landmark settlement to hold the Nation's biggest mortgage servicers accountable. Key actors were Associate Attorney General Tom Perrelli, Vermont Attorney General Bill Sorrell, and Iowa Attorney General Tom Miller, who helped lead the effort to investigate and expose the abuses and misconduct that have hurt so many hardworking Americans. This settlement points in the right direction and will provide relief for homeowners in Vermont and across the country.

I also want to recognize the Civil Rights Division for its role in obtaining compensation, above the \$25 billion settlement amount, to provide relief to our men and women in uniform who have lost their homes to wrongful foreclosures. It is inexcusable that in some cases, under the Servicemembers Civil Relief Act, mortgage servicers failed to meet their responsibilities to our men and women in uniform who risk their lives in the service of our country.

In addition, just a few months ago, the Civil Rights Division fought on behalf of hundreds of thousands of African-Americans and Hispanics victimized by Countrywide Financial Corporation, and reached a landmark \$355 million settlement in compensation for a pattern and practice of discrimination in mortgage lending.

Historically, lending discrimination has manifested itself in redlining, which is the refusal to lend to qualified minority borrowers in certain neighborhoods. The Justice Department has identified a new and disturbing trend in lending discrimination, so-called "reverse redlining." This approach targets minority neighborhoods and borrowers to push subprime and other riskier mortgages to individuals in certain communities who may have been otherwise qualified for safer and more traditional loan products. The recent settlement puts banks and others on notice that our laws will be enforced and that those abuses for profit will not be tolerated.

The unsound practices of our Nation's biggest banks have also crept into the bankruptcy process, where Americans turn as a last resort. Last year, Senators Whitehouse, Blumenthal and I introduced the Fighting Fraud in Bankruptcy Act to strengthen the Justice Department's efforts to protect American homeowners from creditor misconduct in the bankruptcy process, and to protect our servicemen and servicewomen in accordance with the Servicemembers Civil Relief Act. Struggling homeowners, and in particular our service families, must be treated fairly.

So I welcome Assistant Attorney General Perez back before the Committee today. Before we hear from him, I will recognize our ranking member for his opening statement and then have the pleasure of welcoming back to the Committee Senator Ben Cardin of Maryland. Senator Cardin has been a leader on these matters throughout his service in the Maryland legislature, the House of Representatives and the Senate. He was a hardworking member of this Committee until his recent transfer to the Finance Committee and continues to be active on matters of fairness and civil rights.

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Department of Justice

**STATEMENT OF
THOMAS E. PEREZ
ASSISTANT ATTORNEY GENERAL
CIVIL RIGHTS DIVISION**

**BEFORE THE
COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE**

**ENTITLED
"EXAMINING LENDING DISCRIMINATION PRACTICES
AND FORECLOSURE ABUSES"**

**PRESENTED
MARCH 7, 2012**

**Statement of
Thomas E. Perez
Assistant Attorney General
Department of Justice**

**Before the
Committee on the Judiciary
United States Senate**

**At a Hearing Entitled
“Examining Lending Discrimination Practices
And Foreclosure Abuses”
March 7, 2012**

Good morning, Chairman Leahy, Ranking Member Grassley, and members of the Committee. Thank you for calling this hearing on discrimination in lending. It is a great privilege to appear before you today to tell you about what the Civil Rights Division is doing to address this critical issue.

The promise of equal opportunity represents the foundation of the American dream – from the opportunity to learn, to the opportunity to earn, to the opportunity to gain fair access to credit, to live where one chooses and move up the economic ladder – and homeownership has been its most basic building block. Our job as an Administration is to enforce the law so that every eligible person has access to equal credit opportunity free from discrimination.

While many communities nationwide have been devastated during the housing crisis, African-American and Hispanic families and their communities have been hit especially hard. Through our enforcement actions we have found that all too often African-American and Hispanic families paid more for loans because of their race or national origin, not based on their credit qualifications. All too often African-American and Hispanic families were steered to more expensive and risky subprime loans based on race or national origin, not based on their credit qualifications. And regrettably, some lenders have refused to lend in minority communities, making assumptions and reaching conclusions about communities based on the race of the residents rather than their individual credit qualifications.

If all of America's working families are to have a fair chance to realize the American dream, fair lending laws must be vigorously enforced. That is why, in the wake of the housing and foreclosure crisis, the President and the Attorney General have made fair lending enforcement a top priority. The Civil Rights Division plays a critical role in ensuring a level playing field through our enforcement of three fair lending laws: the Equal Credit Opportunity Act (ECOA), the Fair Housing Act (FHA), and the Servicemembers Civil Relief Act (SCRA).

To ensure that the Division is in the best position to enforce these laws, in early 2010, the Attorney General established a dedicated Fair Lending Unit in the Civil Rights Division's Housing and Civil Enforcement Section.

The Division's Fair Lending Unit has achieved extraordinary results. In the approximately 24 months since the Unit was established, the Division has either filed or resolved 16 lending matters.¹ In contrast, in the 16 year period from 1993 through 2008, the Division filed or resolved 37 lending matters (25 in the period from 1993-2000² and 12 from 2001-2008) or a little over 2 cases per year.

In 2011, the Civil Rights Division produced unprecedented results, filing a record eight lending-related federal lawsuits and obtaining eight settlements providing for more than \$350 million in relief to the victims of illegal lending practices. This includes the Department's settlement with Countrywide Financial Corporation, the largest lending discrimination case ever brought by the U.S. Department of Justice, as well as a record settlement under the SCRA.

The vast majority of lending institutions comply with our fair lending laws. However, it is the stubborn persistence of race or national origin as a factor in the lending process, even after accounting for relevant creditworthiness factors, that we seek to address through our enforcement actions. According to the Center for Responsible Lending, even after accounting for credit score, African-American and Hispanic borrowers with credit scores over 660, which are those borrowers considered to have good credit scores, received risky, high-cost loans three times as often as white borrowers. And the disparity grows as you move up the credit score ladder, with the largest disparities for African-American and Hispanic borrowers who have the highest credit scores. All too frequently, equal credit opportunity remains elusive for minorities, even upper income minorities who are the most creditworthy.

My testimony today highlights the accomplishments of the dedicated career staff of the Civil Rights Division in combating unlawful lending discrimination over the past two years in several key areas.

COORDINATION WITH STATE AND FEDERAL PARTNERS

The Division's ability to bring a record number of enforcement actions is a direct result of close collaboration with our federal and state partners. Much of our enforcement is done through the President's Financial Fraud Enforcement Task Force, particularly its Non-Discrimination Working Group, which I co-chair. The Task Force, led by Attorney General Holder, was

¹ The Department also settled two lending cases in 2009 before the Fair Lending Unit was established.

² This includes four FHA cases referred by HUD and filed on behalf of individual complainants.

established to wage an aggressive, coordinated, and proactive effort to investigate and prosecute illegal financial activity. The Task Force includes representatives from the highest levels at the U.S. Department of Justice, federal law enforcement agencies, regulatory authorities, and inspectors general, state attorneys general, and local law enforcement who, working together, constitute a powerful force of criminal and civil enforcement personnel.

Among the federal agencies with fair lending enforcement authority, the Justice Department's role is unique. Under the FHA and the Equal Credit Opportunity Act (ECOA), the Department is the agency charged with broad authority to bring pattern or practice lawsuits against any lender that has engaged in illegal discrimination.

Under ECOA or FHA, for example, the bank regulatory agencies – Federal Deposit Insurance Corporation, Federal Reserve Board, Office of Thrift Supervision, Office of the Comptroller of the Currency, Federal Trade Commission (FTC), Department of Housing and Urban Development (HUD), National Credit Union Administration, and the Consumer Finance Protection Bureau – refer matters to the Department when they have reason to believe a lender has engaged in a pattern or practice of discrimination. In the past three years, the Division has received an unprecedented number of referrals from our federal partners. From 2009 through 2011, the bank regulatory agencies, the FTC and HUD referred a total of 109 matters involving a potential pattern or practice of lending discrimination to the Justice Department. Fifty-five of the 109 matters involved race or national origin discrimination, a combined total that is far higher than the 30 race and national origin discrimination referrals the Division received from 2001 through 2008.

Almost all of the Division's lending cases in 2011 involved collaborative work with other government agencies and other offices within the Department of Justice. And the government-wide fair lending enforcement efforts were bolstered in 2011 by the Consumer Financial Protection Bureau (CFPB), a new and critical partner for the Division that has its own strong enforcement authority under ECOA.

The Division has also worked closely with state attorneys general. The *Countrywide* case was done in coordination with the Illinois Attorney General's office and two of our current active investigations are collaborations with state attorneys general. In addition, in 2011 the Division demonstrated the value it places on state fair lending enforcement by filing a statement of interest as amicus arguing that federal banking law does not preempt state agencies enforcing state fair housing laws from investigating a complaint of lending discrimination by a federally chartered bank.

LENDING DISCRIMINATION ENFORCEMENT

No one case can rectify the multitude of unlawful practices in the housing and lending market that contributed to the foreclosure crisis, but the Civil Rights Division's fair lending work represents an important piece of the Administration's comprehensive efforts to address the nationwide housing crisis. As the 2011 enforcement record illustrates, the Division's Fair Lending Unit focuses on the entire range of discriminatory abuses seen in the market, from traditional access to credit issues -- such as redlining -- to pricing, steering, reverse redlining, mortgage insurance discrimination, denial of credit-related rights to servicemembers and other areas. While most of our recent cases involve mortgage lending, the Fair Lending Unit addresses discrimination in all areas of lending, including unsecured consumer lending, auto lending, and credit card products.

The *Countrywide* case, with its landmark product steering claim, and its pricing discrimination claims that involved an unprecedented number of victims, marks a major step forward in the Department's efforts to address a wide range of discriminatory practices by lenders, brokers, and other players in the mortgage market that contributed to our nation's housing crisis. During 2011, the Department filed two additional pricing discrimination cases, two cases alleging redlining, and one case involving discrimination by a mortgage insurance company against women on paid maternity leave.

United States v. Countrywide Financial Corp.

The Division's complaint against Countrywide alleged that its systemic discrimination from 2004 to 2008 violated both ECOA and the Fair Housing Act and affected more than 200,000 African-American and Hispanic families. The \$335 million settlement was more than 50 times larger than the Division's next largest lending discrimination settlement. The *Countrywide* case resulted from referrals by the Board of Governors of the Federal Reserve System and the Office of Thrift Supervision (OTS), and the Division worked collaboratively with the Illinois Attorney General's office on this matter.

At the core of the allegations in the complaint was a simple story: If you were African-American or Hispanic and you went to Countrywide for a loan, and qualified for a Countrywide loan, you likely paid more simply because of the color of your skin. You likely paid more than a similarly-qualified white borrower if you were African-American or Hispanic and received your loan from a Countrywide loan officer, or from Countrywide's mortgage brokers. And if you were African-American and Hispanic you were far more likely to be steered into an expensive and risky subprime loan than a similarly-qualified white borrower. More than 200,000 African-American and Hispanic victims were identified in the complaint, which alleged that they were charged higher prices or steered into more risky products because of the color of their skin rather

than the content of their creditworthiness.

Countrywide built a business based, in large part, on the trust they earned from families as they guided them through the most important financial transaction of their lives. They understood marketing and how to build trust. But, as our complaint outlines, they exploited that trust. It was Countrywide's business strategy to target local African-American and Hispanic markets in order to expand its mortgage lending business and ultimately gain market dominance in making residential loans in those communities.

But once those borrowers walked into Countrywide's door, they did not receive fair and equal provisions; they received discriminatory terms. And the victims had no idea they were being victimized. They were thrilled to have gotten a loan and realize the American dream. They had no idea that they could have, and should have, gotten a better deal. That was discrimination with a smile.

This was one of the most extensive investigations in our history. We reviewed data on over 2.5 million loans, including data on loan terms and information on each borrower's creditworthiness.

The Countrywide lawsuit marks the first time the Department has obtained relief for borrowers who were steered into subprime loans based on race or national origin. The complaint alleged that from 2004 to 2008, Countrywide discriminated against more than 12,000 Hispanic and African-American wholesale borrowers across the country by systematically placing those borrowers into subprime loans while placing non-Hispanic white borrowers with similar creditworthiness into prime loans. Minority borrowers who were steered into these loans paid, on average, thousands of dollars more and experienced additional harm as a result of increased risk of prepayment penalties, credit problems, default and ultimately foreclosure.

The complaint also alleged that Countrywide discriminated against more than 200,000 Hispanic and African-American borrowers by systematically charging higher discretionary fees and markups to those borrowers than to white borrowers. This was by far the most pervasive pattern of lending discrimination ever alleged by the Department. The complaint further alleged that the defendants discriminated on the basis of marital status by encouraging non-applicant spouses to forfeit their property rights as part of their spouse obtaining a Countrywide loan.

There were more than 200,000 victims identified in our complaint. Two thirds were Hispanic and one third were African Americans. While the complaint spans virtually every corner of the country, California, which was the corporate headquarters for Countrywide, was clearly the epicenter of discriminatory activity in this area. Roughly 30 percent of the victims were in California. The 200,000 borrowers represent families – many of whom may not know they were victims of discrimination. Especially in the case of steering, this discrimination harms not only borrowers and their families but also communities as well.

Nothing can undo the damage that hard-working, responsible families suffered as a result of these outrageous practices. However, the \$335 million in relief for victims of discrimination will not only address their financial loss, it will make it abundantly clear that this kind of behavior will not be tolerated. As such, the *Countrywide* case, with its landmark product steering claims and its price discrimination claims on an unprecedented scale, marks a major step forward in the Justice Department's efforts to tackle a wide range of discriminatory practices that are harming families and devastating our communities.

Pricing Discrimination: Charging Borrowers More Because Of Their Race Or National Origin

In addition to the *Countrywide* case, the Division has brought four other pattern or practice pricing discrimination cases since the Fair Lending Unit was established.

These cases include multi-million dollar settlements with AIG Federal Savings Bank and PrimeLending, as well as the first unsecured consumer lending pricing case brought by the Division in at least a decade. The cases involved discrimination against African-Americans and Hispanics and covered lending through brokers, as well as lending by the banks' own employees. These cases were brought as the result of referrals from the FDIC, the Federal Reserve, and the Office of Thrift Supervision.

There are certain common elements that underlie most of these cases: discretion to a loan originator coupled with a lack of guidelines for how to set fees or interest rates, inadequate documentation explaining differences in prices, and a lack of fair lending compliance policies and monitoring. The predictable result was that minorities paid more for the same loan product than similarly qualified white borrowers.

Many of the Division's pricing cases have relied, in part, on disparate impact analysis to show a violation of law. This approach has been unanimously accepted by the courts, and I have made clear that, under my leadership, the Civil Rights Division is using all of the tools in our arsenal to root out discrimination and ensure a level playing field, including utilizing both disparate treatment and disparate impact analysis when supported by the facts.

Redlining: Failing to Provide Services to Residents of Minority Neighborhoods On An Equal Basis As White Neighborhoods

In a redlining case, a lender does not provide its lending services on an equal basis in a neighborhood because of the race, color, or national origin of the people who live there. In 2011, the Fair Lending Unit settled two cases of redlining in mortgage lending, which is a significant issue in the current tightened credit market. The Unit also currently has multiple ongoing investigations.

Redlining is a regrettably long-standing practice that is discriminatory and illegal. Its destructive impact is exacerbated by the fact that many of the communities that were “redlined” had seen considerable investment in the years leading up to the boom but those investments have all too often been lost in the crisis – collateral community damage wrought by discrimination. Access to credit is a fundamental building block for healthy communities. When qualified homebuyers are denied the opportunity to access credit on the same basis as other qualified homebuyers simply because of their race or national origin, or because they live in a minority neighborhood, they are denied the opportunity to build wealth and create stable communities.

In 2011, the Civil Rights Division settled two redlining cases, one against Citizens Bank of Flint, Michigan and the other against Midwest Bankcentre of St. Louis. In both cases, the pattern of redlining was easily recognized because the Detroit metro area and the St. Louis metro area have long histories of highly-segregated residential housing patterns. The Citizens Bank of Flint case was a referral from the Federal Reserve and the Midwest Bankcentre was a referral from the Metropolitan St. Louis Equal Housing Opportunity Council, a HUD Fair Housing Initiatives Program grantee. Both banks, when compared to peer banks, trailed their peer lenders by a statistically significant amount in serving majority black census tracts. And, in both cases, we alleged that the banks’ Community Reinvestment Act assessment area was drawn to avoid African-American communities. In short, the evidence showed that the banks were judging communities and individuals in those communities by the color of their skin rather than their creditworthiness.

Under the settlement, Citizens agreed to open a loan production office in an African-American neighborhood in Detroit, to engage in affirmative marketing, and to invest approximately \$3.6 million in Wayne County and the City of Detroit. Midwest agreed to similar provisions including opening a branch and investing approximately \$1.45 million in African-American neighborhoods in St. Louis.

The Civil Rights Division has worked to include in recent settlements several innovative provisions to address the full scope of damage experienced by communities. For example, in the Citizens settlement there is a provision to help stabilize neighborhoods by providing home improvement grants to current homeowners living in neighborhoods hard hit by foreclosures. This measure is an acknowledgement that the failure of a bank to fully provide its services to a community impacts not only those denied credit to purchase homes in the community, but its current residents as well. In Midwest, the consent decree includes several provisions to help residents repair their credit and provide access to low-cost checking accounts. This will not only help remedy the harm resulting from the bank’s failure to serve the community, but is also good for the bank’s business by helping to build relationships with new customers in an untapped market.

While our settlements seek to expand opportunities for minority communities and individuals to access credit in areas where a lender had previously denied such services,

our settlements never require a lender to make a loan to unqualified borrowers. The Department's settlement agreements repeatedly refer to the extension of credit to "qualified applicants" only. Further, the Department makes clear that no provision in any redlining settlement agreement, including the special loan program or loan subsidy fund commitment, requires the bank to make any unsafe or unsound loan.

The Justice Department, through its settlements, simply ensures that all qualified home buyers have equal access to sustainable credit without being subject to illegal discrimination, as is required by law. And our redlining settlements have been very successful in achieving this goal of equal access. The consent orders in our redlining cases have consistently resulted in increased lending in previously redlined majority-minority areas. For example, as a result of the consent order in *United States v. First American Bank* (N.D. Ill. 2004), the proportion of the bank's lending in the majority-minority areas of the Chicago and Kankakee metropolitan areas more than quadrupled and the bank performed as well or better than other similar banks in making residential loans in those majority-minority areas.

Fair and equal access to credit is a critical issue for small businesses as well. Although many of our recent cases have involved discrimination in home mortgage lending, lending discrimination also affects minority entrepreneurs. The Department has brought suit against banks where it has found statistically significant evidence of discrimination in the banks' business lending in majority minority communities and among minority businesses.³

Discrimination Against Women On Paid Maternity Leave

Another area of our fair lending work involves discrimination against women on paid maternity leave. In 2011, the Department brought its first Fair Housing Act case alleging discrimination on the basis of sex and familial status in mortgage insurance against the nation's largest mortgage insurance company and two of its underwriters. The complaint against Mortgage Guaranty Insurance Corp. alleges that the defendants discriminated by requiring women on paid maternity leave to return to work before the company would agree to insure their mortgages. The case was referred by the Department of Housing and Urban Development (HUD). The case is currently in litigation.

³ *United States v. First United Security Bank* (S.D. Ala. 2009) included a redlining claim regarding the bank's home mortgage lending and small business lending services. The complaint alleged that the bank engaged in a race-based pattern of locating or acquiring branch offices, by aiming to serve fully the banking and credit needs of the residents of, and small businesses located in, majority-white counties and census tracts, but not those of residents of or businesses located in majority-black counties or census tracts. As part of its settlement, First United agreed to invest \$500,000 in a special financing program for small business and residential loans. See also *United States v. Centier Bank* (N.D. Ind. 2006); *United States v. First American Bank* (N.D. Ill. 2004); *United States v. Old Kent financial Corporation and Old Kent Bank* (E.D. Mich. 2004).

ENFORCEMENT TO PROTECT THE RIGHTS OF OUR SERVICEMEMBERS

In addition to our traditional fair lending work, we have stepped up efforts to protect the rights of our servicemembers through enforcement of the Servicemembers Civil Relief Act (SCRA). The SCRA provides additional, critical consumer and other protections to the men and women serving our nation in the military; it reflects a recognition that those who are making great sacrifices to protect us deserve to know they have our full support at home.

The law postpones, suspends, terminates or reduces the amount of certain consumer debt obligations so that members of the armed forces can focus their full attention on their military duties without adverse consequences for themselves or their families. It allows our servicemembers to focus on the critical role they play in protecting our nation.

Among these protections is a prohibition on foreclosure of a servicemember's property without first getting approval from the court, if the servicemember purchased the property prior to entering military service. And if a foreclosure is filed in court, it requires the servicer to notify the court that a servicemember is on active duty. Finally, the SCRA provides that a servicemember can have his or her interest rate lowered to six percent on debt that was acquired before entering military service.

Wrongful Foreclosures

The Civil Rights Division has moved aggressively to protect servicemembers whose homes were foreclosed on in violation of the SCRA. As a result of our six settlements with national servicers, the vast majority of all foreclosures against servicemembers will be under court ordered review.

Last year, the Division announced two multi-million dollar settlements under SCRA, including a \$20 million settlement with Bank of America.⁴ As a result of the consent order, Bank of America is in the process of paying \$20 million to 156 servicemembers who were illegally foreclosed on between 2006 and the middle of 2009, with each servicemember receiving a minimum of \$116,785 plus compensation for any equity lost due to the bank's alleged violation of the SCRA. The consent order also requires Bank of America to compensate any additional victims through December 31, 2010 at the same level as the already-identified victims. As a result, the total settlement in the Bank of America case will be well in excess of \$20 million. This is the Department's largest SCRA settlement ever reached.

⁴ The SCRA settlement negotiated with Bank of America in 2011 was with BAC Home Loans Servicing, LP f/k/a Countrywide Home Loans, LP.

The Division initiated the investigation in this case based on a referral from the United States Marine Corps on behalf of a servicemember whose home Bank of America was scheduled to sell at a trustee's sale in three days despite having received a copy of his military orders. The servicemember was deployed to Iraq at the time. The Department of Defense provided critical assistance in identifying the servicemembers whose rights were violated and has been a critical partner in our SCRA enforcement efforts.

In 2011, the Division also reached a similar settlement with Saxon Mortgage Services. Under that consent order, Saxon agreed to pay \$2.35 million to 18 servicemembers who were illegally foreclosed on and to compensate any additional servicemembers foreclosed on from middle of 2009 through December 31, 2010. Both Saxon and Countrywide/Bank of America agreed not to pursue any remaining amounts owing under the mortgages, take steps to remedy negative credit reporting directly resulting from the foreclosures of affected servicemembers' loans, and implement enhanced measures including monitoring, training, and checking loans against the Defense Manpower Data Center's SCRA database during the foreclosure process.

The 2011 Bank of America and Saxon consent orders, which resolved claims of non-judicial foreclosures that violated the SCRA, provided the template for agreements the Department reached in February 2012 with Bank of America, JPMorgan Chase & Co., Wells Fargo & Company, Citigroup Inc. and Ally Financial Inc. (formerly GMAC). The Department's 2012 SCRA agreements were incorporated into the Department's broader mortgage servicer consent order between the federal and state attorneys general and these five servicers. The mortgage servicer settlement provides for \$25 billion in relief based on the servicers' illegal mortgage loan servicing practices. The financial compensation to servicemembers for SCRA violations is in addition to the \$25 billion settlement.

Under the SCRA settlements, the nation's five largest mortgage loan servicers will conduct full reviews to determine whether any servicemembers were foreclosed on either judicially or non-judicially in violation of the SCRA since 2006. Any foreclosure victims identified through these SCRA reviews will be compensated a minimum of \$116,785 each plus any lost equity with interest.⁵ All five servicers agreed to numerous other measures, including SCRA training for employees and agents and developing SCRA policies and procedures to ensure compliance with the law. The servicers will also repair any negative credit report entries related to the allegedly wrongful foreclosures and will not pursue any remaining amounts owed under the mortgages.

⁵ To ensure consistency with an earlier private settlement, JPMorgan Chase will provide any servicemember who was a victim of a wrongful foreclosure either his or her home free and clear of any debt or the cash equivalent of the full value of the home at the time of the sale. In addition, servicemembers will receive compensation for any additional harm suffered.

Charging Interest in Excess of 6%⁶

In the SCRA agreements filed with the mortgage servicer settlement, Bank of America, Citigroup, Wells Fargo, and Ally Financial also agreed to conduct a thorough review, overseen by the Division, to determine whether any servicemember – from January 1, 2008, to the present – was charged interest in excess of 6 percent on his or her mortgage in violation of the SCRA. Servicers will be required to provide any servicemember who was wrongfully charged interest in excess of 6 percent a refund of the amount charged in error plus triple the amount refunded or \$500, whichever is larger.

We will continue to aggressively enforce the law to protect all homeowners from unlawful lending practices, including servicemembers who put their lives on the line on our behalf.

LOOKING FORWARD

Based on the groundwork laid in 2009 and 2010, the Fair Lending Unit produced a banner year of fair lending enforcement in 2011. Enhanced collaborative relationships with our federal, state and community partners produced a record number of cases filed, including landmark cases in the areas of mortgage lending discrimination and servicemembers' rights.

A few days ago, we submitted to Congress our annual report on our lending enforcement efforts. That report includes detailed information about the broad range of possible discriminatory conduct under investigation by the Division. In the coming year, we will continue our efforts to provide justice to those families who were harmed by discriminatory conduct during the mortgage boom and to hold lenders responsible for their actions. We also will focus on the challenges in the current market, including access to mortgage credit on fair and non-discriminatory terms, discrimination in auto lending, and discrimination in student lending. In short, we will continue to enforce the laws that seek to ensure that all Americans have equal access to credit and to the opportunity to achieve the American dream.

Congress can also improve our existing fair lending laws. On September 20, 2011, the Department transmitted to Congress a package of legislative proposals that would significantly strengthen the protections afforded to servicemembers and their families under existing civil rights laws, including the SCRA, the FHA, and ECOA. We propose to strengthen enforcement of the SCRA by, among other things, doubling the civil penalties currently available and authorizing the Attorney General to issue civil investigative demands to obtain documents in SCRA investigations. We also recommend parallel changes to the Fair Housing Amendments Act and the Equal Credit Opportunity Act. Safeguarding the civil rights of all Americans is a top

⁶ JP Morgan Chase had already agreed to compensate servicemembers charged interest in excess of 6% on their mortgage through the earlier private settlement approved by the District of South Carolina on January 10, 2012, in *Rowles v. Chase Home Finance, LLC*.

priority for this Administration. I urge Congress to enact these proposed improvements and would welcome the opportunity to discuss these proposals with members of this Committee.

Thank you for the opportunity to testify before you today about the fair lending work of the Division. I look forward to answering your questions.

Prosecuting Wall Street

Two whistleblowers offer a rare window into the root causes of the subprime mortgage meltdown. Eileen Foster, a former senior executive at Countrywide Financial, and Richard Bowen, a former vice president at Citigroup, tell Steve Kroft the companies ignored their repeated warnings about defective, even fraudulent mortgages. The result, experts say, was a cascading wave of mortgage defaults for which virtually no high-ranking Wall Street executives have been prosecuted.

The following is a script of "Prosecuting Wall Street" which aired on Dec. 4, 2011. Steve Kroft is correspondent, James Jacoby, producer.

It's been three years since the financial crisis crippled the American economy, and much to the consternation of the general public and the demonstrators on Wall Street, there has not been a single prosecution of a high-ranking Wall Street executive or major financial firm even though fraud and financial misrepresentations played a significant role in the meltdown. We wanted to know why, so nine months ago we began looking for cases that might have prosecutorial merit. Tonight you'll hear about two of them. We begin with a woman named Eileen Foster, a senior executive at Countrywide Financial, one of the epicenters of the crisis.

Behind the financial crisis: A fraud investigator talks

Steve Kroft: Do you believe that there are people at Countrywide who belong behind bars?

Eileen Foster: Yes.

Kroft: Do you want to give me their names?

Foster: No.

Kroft: Would you give their names to a grand jury if you were asked?

Foster: Yes.

But Eileen Foster has never been asked - and never spoken to the Justice Department - even though she was Countrywide's executive vice president in charge of fraud investigations. At the height of the housing bubble, Countrywide Financial was the largest mortgage lender in the country and the loans it made were among the worst, a third ending up in foreclosure or default, many because of mortgage fraud.

It was Foster's job to monitor and investigate allegations of fraud against Countrywide employees and make sure they were reported to the board of directors and the Treasury Department.

Kroft: How much fraud was there at Countrywide?

Foster: From what I saw, the types of things I saw, it was-- it appeared systemic. It, it wasn't just one individual or two or three individuals, it was branches of individuals, it was regions of individuals.

Kroft: What you seem to be saying was it was just a way of doing business?

Foster: Yes.

In 2007, Foster sent a team to the Boston area to search several branch offices of Countrywide's subprime division - the division that lent to borrowers with poor credit. The investigators rummaged through the office's recycling bins and found evidence that Countrywide loan officers were forging and manipulating borrowers' income and asset statements to help them get loans they weren't qualified for and couldn't afford.

Foster: All of the-- the recycle bins, whenever we looked through those they were full of, you know, signatures that had been cut off of one document and put onto another and then photocopied, you know, or faxed and then the-- you know, the creation thrown-- thrown in the recycle bin.

Kroft: And the incentive for the people at Countrywide to do that was what?

Foster: The loan officers received bonuses, commissions. They were compensated regardless of the quality of the loan. There's no incentive for quality. The incentive was to fund the loan. And that's-- that's gonna drive that type of behavior.

Kroft: They were committing a crime?

Foster: Yes.

After Foster's investigation, Countrywide closed six of its eight branches in the Boston region and 44 out of 60 employees were fired or quit.

Kroft: Do you think that this was just the Boston office?

Foster: No. No, I know it wasn't just the Boston office. What was going on in Boston was also going on in Chicago, and Miami, and Detroit, and Las Vegas and, you know-- Phoenix and in all of the big markets all over Florida.

After the Boston investigation, Foster says Countrywide's subprime division began systematically concealing evidence of fraud from her in violation of company policy, and Countrywide's internal financial controls system. Someone high up in the top levels of

management - she won't say who - told employees to circumvent her office and instead report suspicious activity to the personnel department, which Foster says routinely punished other whistleblowers and protected Countrywide's highest earning loan officers.

Foster: I came to find out that there were-- that there was many, many, many reports of fraud as I had suspected. And those were never-- they were never reported through my group, never reported to the board, never reported to the government while I was there.

Kroft: And you believe this was intentional?

Foster: Yes. Yes, absolutely.

Foster, with the support of her boss, took the information up the corporate chain of command and to the audit department, which confirmed many of her suspicions, but no action was taken. In late 2008, with Countrywide sinking under the weight of its bad loans, it merged with Bank of America. Foster was promoted and not long afterwards was asked to speak with government regulators to discuss Countrywide's fraud reports. But she was fired before the meeting could take place.

Kroft: What would you have told 'em?

Foster: I would have told 'em exactly-- exactly what I've told you.

Kroft: Did you have any discussions with anybody at Countrywide or Bank of America about what you should say to the federal regulators when they came?

Foster: I got a call from an individual who, you know, suggested how-- how I should handle the questions that would be coming from the regulators, made some suggestions that downplayed the severity of the situation.

Kroft: They wanted you to spin it and you said you wouldn't?

Foster: Uh-huh (affirm).

Kroft: And the next day you were terminated?

Foster: Uh-huh (affirm).

Kroft: I mean, it seems like somebody at Countrywide or Bank of America did not want you to talk to federal regulators.

Foster: No, that was part of it, no, they absolutely did not.

Kroft: Do you feel like you were a victim of criminal activity?

Foster: It's a crime to retaliate against someone for making reports of mail fraud, bank fraud, wire fraud, mortgage fraud, things that would harm stockholders and investors. And that's what I did and that's why I was terminated.

Kroft: Were you offered a settlement?

Foster: They asked me to sign a 14-page document that basically would buy my silence in exchange for a large amount of money.

Kroft: But you didn't sign it?

Foster: No.

Kroft: Why not?

Foster: How many people can they-- can they buy off? They just pay for it. They commit the crime and they buy their way out of it. And just do it over and over and over again. I wanted them to have some sleepless nights thinkin' about what they would say to a federal investigator and worry about being exposed and being held accountable for committing a crime.

Eileen Foster spent three years trying to clear her name. This fall she finally won a federal whistleblower complaint against Bank of America for wrongful termination and was awarded nearly a million dollars in back pay and benefits.

All of this raises several questions. Why has the Justice Department failed to go after mortgage fraud inside Countrywide? There has not been a single prosecution. Even more puzzling is the Justice Department's reluctance to employ one of its most powerful legal weapons against Countrywide's top executives. It's called the Sarbanes Oxley Act of 2002.

It was overwhelmingly passed by Congress and signed by President Bush following the last big round of corporate scandals involving Enron, Tyco and Worldcom. It was supposed to restore confidence in American corporations and financial markets.

The Sarbanes Oxley Act imposed strict rules for corporate governance, requiring chief executive officers and chief financial officers to certify under oath that their financial statements are accurate and that they have established an effective set of internal controls to insure that all relevant information reaches investors. Knowingly signing a false statement is a criminal offense punishable with up to five years in prison.

Frank Partnoy is a highly regarded securities lawyer, a professor at the University of San Diego Law School and an expert on Sarbanes Oxley.

Frank Partnoy: The idea was to have a criminal statute in place that would make CEOs and CFOs think twice, think three times before they signed their names attesting to the accuracy of financial statements or the viability of internal controls.

Kroft: And this law has not been used at all in the financial crisis.

Partnoy: It hasn't been used to go after Wall Street. It hasn't been used for these kinds of cases at all.

Kroft: Why not?

Partnoy: I don't know. I don't have a good answer to that question. I hope that it will be used. I think there clearly are instances where CEOs and CFOs-- signed financial statements that said there were adequate controls and there weren't adequate controls. But I can't explain why it hasn't been used yet.

We told Partnoy about Eileen Foster's allegations of widespread mortgage fraud at Countrywide and efforts to prevent the information from reaching her, the federal government and the board of directors in violation of the company's internal controls.

Kroft: I mean, that's a deliberate circumvention, right?

Partnoy: It certainly sounds like it. And it certainly sounds like a good place to start a criminal investigation. Usually when the federal government hears about facts like this, they would start an investigation and they would try to move up the organization to try to figure out whether this information got up to senior officers, and why it wasn't disclosed to the public.

In fact, according to a civil suit filed by the Securities and Exchange Commission, Countrywide's chief executive officer, Angelo Mozilo, knew as early as 2006 that a significant percentage of its subprime borrowers were engaged in mortgage fraud and that it hid this and other negative information about the quality of its loans from investors.

When the case was settled out of court a year ago October, the SEC's director of enforcement, Robert Khuzami, called Mozilo "a corporate executive who deliberately disregarded his duty to investors by concealing what he saw from inside the executive suite -- a looming disaster in which Countrywide was buckling under the weight of increasing risky mortgage underwriting, mounting defaults and delinquencies, and a deteriorating business model."

Mozilo, who admitted no wrongdoing, accepted a lifetime ban from ever serving as an officer or director of a publicly traded company, and agreed to pay a record \$22 million fine, less than five percent of the compensation he received between 2000 and 2008.

Kroft: What did you think of the settlement with Countrywide?

Partnoy: I'd think a lot of it if I were Angelo Mozilo. I'd think I did pretty well for myself. No jail, a relatively small fine compared to the hundreds of millions of dollars I was able to take out of this company.

Kroft: Slap on the wrist.

Partnoy: Clearly a slap on the wrist. And part of the problem is the dual nature of how we prosecute these kinds of violations. We have the Department of Justice, which can put people in jail and the Securities and Exchange Commission, which can't. And its sort of like we have this two-headed monster - one head has some teeth. The other head has no teeth. And it was the head with no teeth that went after Angelo Mozilo. So the greatest danger he was in from the beginning was maybe he'd be gummed to death, but not even that happened.

Three months after the SEC settled the civil suit, federal prosecutors in Los Angeles dropped their criminal investigation of Countrywide and its CEO, Angelo Mozilo. We wanted to know why the Justice Department has been unable to bring a single criminal case against Countrywide or any of the major Wall Street banks and Lanny Breuer, the head of the criminal division at the Justice Department, agreed to talk to us.

Kroft: A year ago, in September of 2010, you told the congressional hearing that you seek to prosecute people who make materially false statements. People who told the investors one thing and did something different.

Lanny Breuer: That's absolutely right. And we're-- we're doing exactly that.

Kroft: We spoke to a woman at Countrywide, who was a senior vice president for investigating fraud. And she said that the fraud inside Countrywide was systemic. That it was basically a way of doing business.

Breuer: Well, it's hard for me to talk about a particular case. Of course, in the Countrywide case, Steve, as you know, terrific office, U.S. attorney's office in Los Angeles investigated that, interviewed many, many people, hundreds of people perhaps, and reviewed millions of documents.

Kroft: They never talked to the senior vice president inside Countrywide, who is charged with investigating fraud.

Breuer: Well, I-- we-- look, I-- I can't speak about that, because I actually don't know about that particular case. But if the senior vice president of any company believes they know about fraud, I want them to contact us.

Breuer says the department has brought major financial prosecutions involving hedge funds, insider trading, Ponzi schemes and a huge bank fraud case in Florida but he acknowledged there have been no prosecutions against major players in the financial crisis.

Breuer: In our criminal justice system, we have to prove beyond a reasonable doubt that you intended to commit a fraud. But when you can't or when we think we can't, there's still many, many important resolutions and options we have.

And that's why there have been civil lawsuits and regulatory action.

Kroft: Do you lack confidence in bringing cases under Sarbanes Oxley?

Breuer: Steve, no-- no one is-- really has accused this Department of Justice or this division or me of lacking confidence. If you look at the prosecutors all over the country, they are bringing record cases, with respect to all kinds of criminal laws. Sarbanes Oxley is a tool, but it's only one tool. We're confident. We follow the facts and the law wherever they take us. And we're bringing every case that we believe can be made.

Lanny Breuer says this Justice Department has been as aggressive as any in history. But a recent report on federal prosecutions from a research center at Syracuse University, says the number of cases brought against financial institutions for fraud is at a 20-year low. When we come back, we talk to a whistleblower who was inside Citigroup during the financial meltdown.

If you had looked at the financial statements of the major banks on Wall Street in the weeks leading up to the financial crisis of 2008, you wouldn't have guessed that most of them were about to crumble and require a trillion dollar bailout from the taxpayers. It begs the question did the CEO's of these banks and their chief financial officers withhold critical information from their investors. If they did they can be subject to criminal prosecution under the Sarbanes Oxley Act for knowingly certifying false financial reports and statements about the effectiveness of their internal controls. The Justice Department has not brought a single case against Wall Street executives for violating Sarbanes Oxley, in spite of some compelling evidence. Tonight we take a look at Citigroup beginning with a former vice president, Richard Bowen.

Richard Bowen: There are things that obviously went on in this crisis, and decisions that were made, that people need to be accountable for.

Kroft: Why do you think nothing's been done?

Bowen: I don't know.

Until 2008, Richard Bowen was a senior vice president and chief underwriter in the consumer lending division of Citigroup. He was responsible for evaluating the quality of thousands of mortgages that Citigroup was buying from Countrywide and other mortgage lenders, many of which were bundled into mortgage-backed securities and sold to investors around the world. Bowen's job was to make sure that these mortgages met Citigroup's own standards - no missing paperwork, no signs of fraud, no unqualified borrowers. But in 2006, he discovered that 60 percent of the mortgages he evaluated were defective.

Kroft: Were you surprised at the 60 percent figure?

Bowen: Yes. I was absolutely blown away. This-- this cannot be happening. But it was.

Kroft: And you thought that it was important that the people above you in management knew this?

Bowen: Yes. I did.

Kroft: You told people.

Bowen: I did everything I could, from the way-- in the way of e-mail, weekly reports, meetings, presentations, individual conversations, yes.

Kroft: How high up in the company?

Bowen: My warnings, which were echoed by my manager, went to the highest levels of the Consumer Lending Group.

Bowen also asked for a formal investigation to be conducted by the division in charge of Citigroup's internal controls. That study not only confirmed Bowen's findings but found that his division had been out of compliance with company policy since at least 2005.

Kroft: Did the situation improve?

Bowen: I started raising those warnings in June of 2006. The volumes increased through 2007 and the rate of defective mortgages increased to an excess of 80 percent.

Kroft: So the answer is no?

Bowen: The answer is no, things did not improve. They got worse.

Not only was Citigroup on the hook for massive potential losses, Bowen says it was misleading investors about the quality of the mortgages and the mortgage securities it was selling to its customers. We managed to get our hands on a prospectus for a mortgage-backed security that was made up of home loans that Bowen had tested.

Kroft: It says, "These loans were originated under guidelines that are substantially, in accordance with Citi Mortgage's guidelines, for its own originations, its own mortgages." Is that a true statement?

Bowen: No.

Kroft: This is not some insignificant statement. This is-- speaks to the quality of the-- of the mortgages that-- that investors are putting their money in.

Bowen: Yes.

Kroft: And it's wrong?

Bowen: Yes.

Kroft: And people at Citigroup knew it was wrong. Had been warned that it was wrong, had been told that it was wrong.

Bowen: Yes.

In early November of 2007, with Citi's mortgage losses mounting, Bowen decided to notify top corporate officers directly. He emailed an urgent letter to the bank's chief financial officer, chief risk officer, and chief auditor as well as Robert Rubin, the chairman of Citigroup's executive committee and a former U.S. treasury secretary. The letter informed them of "breakdowns of internal controls" in his division and possibly "unrecognized financial losses existing within our organization."

Kroft: Why did you send that letter?

Bowen: I knew that there existed in my area extreme risks. And one, I had to warn executive management. And two, I felt like I had to warn the Board of Directors.

Kroft: You're saying there's a serious problem here, you've got a big breakdown in internal controls. You need to pay attention. This could cost you a lot of money.

Bowen: Yes. Somebody needed to pay attention. Somebody needed to take some action.

The next day Citigroup's CEO Charles Prince, in his last official act before stepping down, signed the Sarbanes Oxley certification endorsing a financial statement that later proved to be unrealistic and swore that the bank's internal controls over its financial reporting were effective.

Bowen: I know that there were internal controls that were broken. I served notice in that e-mail that they were broken. And the certification indicates that they are not broken.

Kroft: It would seem the chief financial officer and the people that signed the Sarbanes Oxley certification disregarded those warnings.

Bowen: It would appear.

We received a letter from Citigroup saying the bank had acted promptly to address Richard Bowen's concerns and that the issues he raised were limited to his division and had little bearing on the bank's overall financial health. Citigroup also told us that it did not retaliate against Bowen for sending the email. But not long after he sent it, Bowen's duties were radically changed.

Bowen: I was relieved of most of my responsibility and I no longer was physically with the organization.

Kroft: You were told not to come into the office?

Bowen: Yes.

[Phil Angelides: Mr. Bowen.

Bowen: I am very grateful to the commission to be able to give my testimony today.]

The Financial Crisis Inquiry Commission thought enough of Bowen's story to call him as one of its first witnesses and he turned over more than a thousand pages of documents to the Securities and Exchange Commission. Nothing ever came of it. But Bowen wasn't the only one to warn Citigroup's top officials about its financial weaknesses and breakdowns in the company's internal controls.

Three months after Bowen's email Citigroup's new CEO Vikram Pandit received a blistering letter from the office of the comptroller of the currency, its chief regulator. It questioned the valuations that Citi had placed on its mortgage securities and found internal controls deeply flawed. The letter stated, among other things, that risk management had insufficient authority and risk was insufficiently evaluated and that the Citibank board had no effective oversight.

Yet eight days later, CEO Vikram Pandit and Chief Financial Officer Gary Crittenden personally signed the Sarbanes Oxley certification. They attested to the bank's financial viability and the effectiveness of its internal controls. The deficiencies cited by the comptroller of the currency were never mentioned. Citi said it didn't consider the problems serious enough that they had to be disclosed to investors and says the certifications were entirely appropriate. But nine months later, Citigroup would need a \$45 billion bailout and \$300 billion more in federal guarantees just to stay in business.

Frank Partnoy: I don't think Wall Street senior people really think they'll ever end up in jail and they've been right.

Frank Partnoy, the securities lawyer and expert on Sarbanes Oxley law, says the facts about Citigroup raise some troubling questions.

Partnoy: They certainly knew the internal controls were inadequate and that the company was out of control from a reporting perspective.

Kroft: And yet they signed the Sarbanes Oxley letter saying that everything was fine.

Partnoy: I'm very surprised that the CEO and CFO would sign those letters. I wouldn't have signed them under those conditions. You're signing them under penalties of potentially 10 years in prison. You're certifying that you designed and implemented effective internal controls in the aftermath of all this news about the company's problems.

Kroft: How is that not a violation of Sarbanes Oxley?

Partnoy: I don't know. I think that it might be hard to establish knowledge. That might be what prosecutors are thinking in not bringing the cases.

Kroft: The letter was addressed to Vikram Pandit, the new CEO of Citigroup.

Partnoy: And he had eight days to think about it, from February 14th, Valentine's Day, he gets the letter. And then February 22nd, he sits down and signs his name, certifying that financial statements are accurate and that he had designed and evaluated and reported any problems with internal controls. Eight days is a long time on Wall Street. I can't get inside his head, but I would certainly think, as a prosecutor, that this would be something I'd be interested in asking some questions about.

We wanted to know what Assistant Attorney General Lanny Breuer, thought about that, and why no prosecutions have been directed at Wall Street. We also wanted to know why Sarbanes Oxley has not been used against big banks like Citigroup.

Lanny Breuer: When you talk about Sarbanes Oxley we have to know that you intended-- had the specific intent to make a false statement.

Kroft: They knew there was a problem. Not only had they been told that there was a problem by one of their chief underwriters, that the loans that they were buying were not what they claimed, and that the federal government, that the comptroller of the currency didn't think their internal controls were adequate either.

Breuer: If a company is intentionally misrepresenting on its financial statements what it understands to be the financial condition of its company and makes very real representations that are false, we want to know about it. And we're gonna prosecute it.

Kroft: Do you have cases now that you think that will result in prosecution against major Wall Street banks?

Breuer: We have investigations going on. I won't predict how they're gonna turn out.

Kroft: Has anybody at Treasury or-- or the Federal Reserve or the White House come to you and said, 'Look, we need to go easy on the banks. That-- there are collateral consequences if you bring prosecutions. Some of these organizations are still very fragile and we don't want to push them over the edge?'

Breuer: Steve, this Department of Justice is acting absolutely independently. Every decision that's being made by our prosecutors around the country is being made 100 percent based on the facts of that particular case and the law that we can apply it. And there's been absolutely no interference whatsoever.

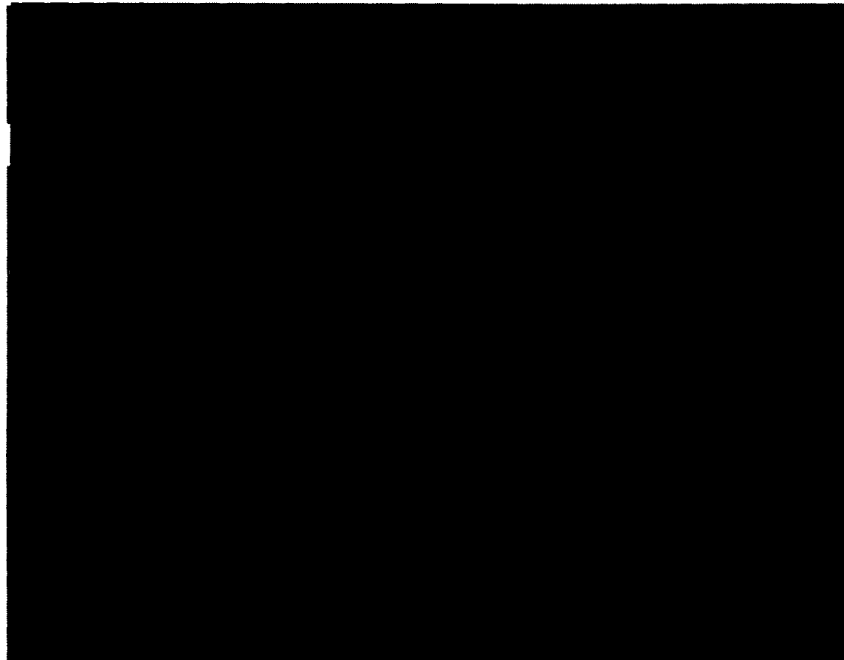
Kroft: The perception. I mean, it doesn't seem like you're trying. It doesn't seem like you're making an effort. That the Justice Department does not have the will to take on these big Wall Street banks.

Breuer: Steve, I get it. I find the excessive risk taking to be offensive. I find the greed that was manifested by certain people to be very upsetting. But because I may have an emotional reaction and I may personally share the same frustration that American people all over the country are feeling, that in and of itself doesn't mean we bring a criminal case.

Kroft: If you had said two years ago that nobody was gonna be prosecuted on Wall Street for the subprime mortgage scandal, I think people would think, "It's not possible."

Breuer: Sometimes it takes a number of years to bring these cases. So I'd say to the American people, they should have confidence that this is a department that's working hard and we're gonna keep working hard, so stay tuned.

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**ASSESSING THE DAMAGE OF PREDATORY LENDING BY COUNTRYWIDE:
THE FALLOUT FOR LATINO FAMILIES**

Presented at

“Examining Lending Discrimination Practices and Foreclosure Abuses”

Submitted to

**United State Senate
Committee on the Judiciary**

Submitted by

**Eric Rodriguez
Vice President of the Office of Research, Advocacy, and Legislation
National Council of La Raza**

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Raul Yzaguirre Building
1126 16th Street, NW, Suite 600
Washington, DC 20036

www.nclr.org

Good morning. My name is Eric Rodriguez and I am Vice President of the Office of Research, Advocacy, and Legislation at the National Council of La Raza (NCLR)—the largest national Hispanic¹ civil rights and advocacy organization in the United States. For the last four decades, NCLR has been committed to improving opportunities for the nation's 50.5 million Latinos. To this end, NCLR conducts research, policy analysis, and advocacy on a variety of financial services issues that affect the ability of Latinos to build and maintain assets and wealth. I would like to thank Chairman Patrick Leahy and Ranking Member Chuck Grassley for inviting me to participate in today's hearing.

NCLR works to improve the financial security of Latino families by promoting fair and responsible housing and financial markets that serve Hispanic families well and allow them to build assets that they can share with the next generation. This goal has led us to engage in critical public policy issues such as strengthening fair housing and lending laws, improving access to financial services for low-income families, and promoting sustainable homeownership in the Latino community. In addition, the NCLR Homeownership Network (NHN)—a network of 50 community-based counseling providers—has provided first-time homebuyers with the advice and guidance they need to navigate the mortgage process for more than a decade. NCLR serves 65,000 families annually through this network, and has produced more than 25,000 first-time homebuyers since its inception. By working closely with housing practitioners serving our community, we are able to represent the real-time experiences of Hispanic families and recommend practical policy solutions. We are focused on results for families, which is why we supported the elimination of the Department of Treasury's Home Affordable Modification Program (HAMP) to make room for a more robust solution to the foreclosure crisis.²

Reviews of publicly reported mortgage data have long shown that Black and Hispanic borrowers were more likely than their White peers to receive high-cost and high-risk loans even after controlling for key risk factors.³ NCLR's analysis pointed to the mechanisms built into our national home lending system that made it more likely that Latino borrowers would be steered toward such loans.⁴ The Department of Justice (DOJ) settlement with Bank of America regarding the past discriminatory practices of Countrywide uncovers one of the most egregious practices common during the housing bubble years—steering a creditworthy family into a subprime loan even though they were qualified to receive a prime loan. DOJ is to be

¹ The terms "Hispanic" and "Latino" are used interchangeably by the U.S. Census Bureau and throughout this document to identify persons of Mexican, Puerto Rican, Cuban, Central and South American, Dominican, Spanish, and other Hispanic descent; they may be of any race.

² Janis Bowdler, "Time to Move On: Families Facing Foreclosure Need Better Solutions than HAMP," *NCLR Blog*, http://www.nclr.org/index.php/about_us/news/blog/time_to_move_on_families_facing_foreclosure_need_better_solutions_than_hamp/ (accessed March 5, 2012).

³ Debbie Gruenstein Bocian, Keith S. Ernst, and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on Price of Subprime Mortgages* (Durham, NC: Center for Responsible Lending, 2006), and Debbie Gruenstein Bocian, Wei Li, Carolina Reid, and Roberto G. Quercia, *Lost Ground, 2011: Disparities in Mortgage Lending and Foreclosures* (Center for Responsible Lending and UNC Center for Community Capital, 2011).

⁴ NCLR has published several reports, public statements, and testimony on this issue, available at www.nclr.org. Key publications include: Janis Bowdler, *Jeopardizing Hispanic Homeownership: Predatory Practices in the Mortgage Market* (Washington, DC: NCLR, 2005); Janis Bowdler, *Challenges to Building Sustainable Homeownership in Latino Communities* (Washington, DC: NCLR, 2007); Graciela Aponte, *Putting an End to Predatory Lending in Minority and Latino Communities* (Washington, DC: NCLR, 2009).

congratulated for this landmark victory for Hispanic and Black borrowers, while Bank of America deserves credit for not standing in the way of justice for the Countrywide clients that have come under its care.

In my testimony today I will review the evidence of lending abuse that makes this settlement so critical and explain how the consequences stretch far beyond its 200,000 victims. I will also offer recommendations on how Congress and the claims administrator can ensure that justice reaches as many families as possible.

Background

Like all Americans, Latino families rely on the equity in their homes to support their retirement, finance their children's education, buoy them in times of financial emergencies, or start a small business. Those fortunate enough to own their homes or land are able to pass this wealth to their children, a practice that has historically fueled the upward mobility of millions into the middle class. Unfortunately, the benefits of homeownership have not been equally available to all. Historical discrimination has contributed to a stubborn disparity in homeownership rates and a legacy of disparity between the assets owned by White families versus those owned by families of color—a figure known as the racial wealth gap. The racial wealth gap—18-to-one for Latinos and 20-to-one for Blacks—currently has been exasperated by deceptive lending practices that stripped homeowners of equity and contributed to record foreclosure rates.⁵ Nevertheless, homeownership is still vital to all Americans, and policies should not abandon the concept of climbing up the economic ladder via homeownership.

Predatory lending in communities of color was not a random occurrence. Deceptive lenders targeted our communities while a breakdown in state and federal oversight allowed for these signs to go unnoticed. Below are four of the most prominent reasons that Hispanic families became targets for dishonest lenders and brokers:

- **Latinos have unique mortgage borrower profiles.** Mortgage lenders have become highly dependent on automated underwriting systems whereas Latino and other immigrant borrowers would benefit from a manual underwriting process for a true evaluation of their credit and income profiles. For example, 22% of Latinos, compared to only 4% of Whites, have a thin credit file, or no credit history, which usually results in a zero credit score.⁶ Multiple wage earners, additional co-borrowers, and small business and cash income are also common among Latino borrowers. Mainstream and prime lenders had little incentive to process these applications through manual underwriting systems where other reliable underwriting criteria such as rent and utility payment history could have been evaluated. In some cases, lenders referred borrowers to their subprime affiliates that used no-documentation loans to avoid sound underwriting. Others simply avoided such borrowers despite the demand for credit, leaving a vacuum that subprime and predatory lenders were quick to fill.

⁵ Rakesh Kochhar, Richard Fry, and Paul Taylor, *Wealth Gaps Rise to Record Highs Between Whites, Blacks, Hispanics: Twenty-to-One* (Washington, DC: Pew Research Center, 2011).

⁶ Michael Stegman et al., "Automated Underwriting: Getting to Yes for More Low-Income Applicants," Presented before the 2001 Conference on Housing Opportunity, Research Institute for Housing America Center for Community Capitalism (Chapel Hill: University of North Carolina, April 2001).

- **Profit incentives fueled predatory lending in minority and vulnerable communities.** Commission-based loan officers have less of an incentive to serve low-to-moderate-income borrowers and a greater incentive to steer borrowers to loans that would earn higher profits, which was exactly the case for subprime and high-risk loans. Loan officer and mortgage brokers' compensation was based on the size of the mortgage, interest rate, and points and fees charged. Therefore, lenders had little motivation to assist families financing modestly sized mortgages, who had applications that took extra time, or who received down payment assistance. The evidence bears out this trend: Research shows that nontraditional mortgage products such as Option Adjustable Rate Mortgages (Option ARMs) and interest-only mortgages are disproportionately concentrated among minority borrowers; Latinos are more than twice as likely as Whites to receive an Option ARM. In addition, Latinos and Blacks were much more likely to receive subprime loans that included high interest rates, prepayment penalties, and hybrid or Option ARMs. These disparities were evident even comparing borrowers within the same credit score ranges. For example, among borrowers with a FICO (Fair Isaac Corporation) credit score of over 660, Blacks and Latinos received a high interest rate loan more than three times as often as White borrowers.⁷
- **Commonsense standards for sustainable lending were abandoned.** The long-standing best practices of matching borrowers to sustainable and well-underwritten mortgages were abandoned in exchange for an underwrite-to-distribute model where profits were earned upfront and the long-term performance of a loan was of little concern. Originators and securitizers of mortgages received instantaneous profits and faced little or no risk of loss if the loans defaulted. As underwriting standards continued to decline in order to facilitate an increased volume of loans, more borrowers received loans that responsible lenders should have known they would be unable to repay.⁸ Moreover, most lenders—including Fannie Mae, Freddie Mac, and the Federal Housing Administration mortgage insurance program—lifted their requirement that first-time homebuyers or others with less-than-ideal credit profiles receive homebuyer counseling prior to their purchases. Borrowers who attended housing counseling sessions were more likely to avoid predatory loans and much less likely to default on their mortgage payments.⁹
- **Strong federal rules and enforcement were not in place to protect borrowers.** Federal regulators did not act to prevent or prohibit even the worst of the deceptive lending practices despite constant warnings from community advocates. Congress finally passed anti-predatory legislation in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010; however, by then the damage had been done.

⁷ Debbie Gruenstein Bocian, *Lost Ground*, 2011.

⁸ Michael H. Krimminger for the Federal Deposit Insurance Corporation, *Understanding the Implications and Consequences of the Proposed Rule on Risk Retention*, 112 Cong., 1st sess., 2011, available at <http://www.fdic.gov/news/news/speeches/chairman/spapr1311.html>.

⁹ Neil S. Mayer, Peter A. Tatian, Kenneth Temkin, and Charles A. Calhoun, *National Foreclosure Mitigation Counseling Program Evaluation: Preliminary Analysis of Program Effects* (Washington, DC: Urban Institute, 2009).

Consequences of Predatory Lending

Unfair and discriminatory lending may have hit communities of color and low-income families particularly hard, but such tactics have widespread consequences for all homeowners. When regulators turned their backs on the predatory practices festering in the subprime and so-called “Alt-A” lending markets, they laid the groundwork for the housing bubble and the collapse of our financial markets. To date, 2.7 million families have lost their homes to foreclosure¹⁰ and nearly \$371 billion in equity has been lost through home value declines in communities of color.¹¹ The disproportionate impact on minority borrowers will make their recovery even more challenging. Approximately one out of four Latino and Black borrowers has lost a home to foreclosure or is at serious risk of foreclosure, compared to nearly 12% of White borrowers.¹² As a result, the wealth of Hispanic households has declined by a startling 66%.¹³

While the financial impact of the foreclosure crisis is staggering, the lasting effects of foreclosures on children and families have only begun to surface. NCLR and the University of North Carolina (UNC) Center for Community Capital conducted interviews with families that had recently experienced a foreclosure in five regions of the country (southeastern Texas, southeastern Michigan, the west coast of Florida, northwestern Georgia, and the Central Valley of California).¹⁴ Following the foreclosure, signs of depression, increased anxiety and tension, and feelings of guilt and resentment were commonplace. Several participants were forced to forego medical care for themselves or their children in failed attempts to keep their home. Multiple moves contributed to family instability. Parents reported that their children’s academic performance declined while problematic behavior at school increased. With their safety nets eroded and their credit scores in ruins, the families found themselves in a hole from which it will be difficult to recover. The Nuñez family from northwestern Georgia, an interview participant, summed up their frustration:

[W]e invested the money we had [in the house] thinking that the money that we were investing would be for our children to study, hoping that they didn’t have to be moving here and there, that they would have a home and be stable. We had dreams and plans. For them to study, go to college. We had plans, with the money that we gave as down payment, that we could use it for them to have a career or study something good. But now, there’s no house, there’s no money, and there’s no dreams. There’s only our good intention of doing all that for them.

Given the demographic shifts of our nation, efforts to hold discriminatory lenders responsible and restore opportunity in minority neighborhoods are a critical step to the nation’s economic improvement. Private industry, Fannie Mae, Freddie Mac, federal regulators, and community

¹⁰ Debbie Gruenstein Bocian, *Lost Ground*, 2011.

¹¹ Debbie Gruenstein Bocian, Wei Li, and Keith S. Ernst, *Foreclosures by Race and Ethnicity: The Demographics of a Crisis* (Washington DC: Center for Responsible Lending, 2010).

¹² Debbie Gruenstein Bocian, *Lost Ground*, 2011

¹³ Rakesh Kochhar, Richard Fry, and Paul Taylor, *Wealth Gaps Rise to Record Highs Between Whites, Blacks, Hispanics: Twenty-to-One* (Washington, DC: Pew Research Center, 2011).

¹⁴ Janis Bowdler, Roberto Quercia, and David Andrew Smith, *The Foreclosure Generation: The Long-Term Impact of the Housing Crisis on Latino Children and Families* (NCLR and University of North Carolina, Center for Community Capital, 2010).

service providers must work together to create bold solutions to our housing challenges. In addition to tangible, direct support such as loan modifications and principal reduction, public accountability is critical to the healing of the market. The Department of Justice's settlement with Bank of America on behalf of Countrywide is critical in this respect. The breakthrough case sends a strong signal to the market that discriminatory practices will not be tolerated and to families that justice is possible.

Delivering Justice to Harmed Families

The DOJ investigations into Countrywide uncovered widespread discrimination that harmed more than 200,000 Latino and Black borrowers between 2004 and 2008. Approximately 10,000 Countrywide borrowers were steered into risky subprime loans, many of which are likely to have ended in foreclosure, even though the borrowers qualified for a prime loan. Two-thirds of the victims are Latino and one-third are Black borrowers. These abusive practices occurred with Countrywide loans across the country, but more than 30% of the victims were in California, where one out of two foreclosures in the state are against Latino homeowners.¹⁵ This is the largest residential fair-lending settlement in history and provides \$335 million to compensate victims.

The settlement was negotiated by DOJ's Fair Lending Unit, which was recently created to improve efforts to combat lending discrimination. The Unit works closely with the banking regulatory agencies, the Federal Trade Commission, and the Department of Housing and Urban Development (HUD), by investigating referrals where the agency suspects there is a pattern or practice of discrimination. In 2010, the division received 49 referrals from partner agencies, more than it had received in a single year in at least 20 years.¹⁶ The improved coordination between federal agencies and heightened vigilance are critical to ensuring that fair housing and lending laws are honored and enforced as the majority of fair housing violations do not get reported. Victims often do not know their rights have been violated, many do not know where to report violations, and others fear the consequences of reporting. HUD estimates that only 1% of fair housing violations committed are ever reported, but even this number is conservative. Yet over four million fair housing violations are committed every year against members of protected classes under the Fair Housing Act.¹⁷

Given the importance of this settlement, it is critical that DOJ—and Congress as its overseer—make every effort to locate homeowners harmed by Countrywide. The settlement has two categories of victims: prime borrowers that were charged thousands of dollars in excessive fees and those unfairly and unnecessarily steered from prime to subprime loans. The first set of borrowers should be easier to locate. However, homeowners that were steered and therefore experienced a foreclosure will be difficult to find and may be hesitant to respond to unsolicited outreach.

¹⁵ Debbie Gruenstein Bocian, Peter Smith, Ginna Green and Paul Leonard, *Dreams Deferred: Impacts and Characteristics of the California Foreclosure Crisis* (Durham, NC: Center for Responsible Lending, 2010).

¹⁶ Tracy Russo, "Fair Lending," *The Justice Blog*, September 1, 2011, <http://blogs.usdoj.gov/blog/archives/1537> (accessed February 2, 2012).

¹⁷ National Fair Housing Alliance, *The Big Picture: How Fair Housing Organizations Challenge Systemic and Institutionalized Discrimination, 2011 Fair Housing Trends Report* (Washington, DC: National Fair Housing Alliance, 2011).

To ensure that as many victims receive their due justice as possible, NCLR makes the following recommendations to the Department of Justice, the settlement claims administrator, and Congress:

- **Streamline and maximize outreach efforts.** A number of efforts are underway to deliver relief or compensation to millions of families affected by discriminatory lending, servicer abuse, and wrongful foreclosure. Unclear or confusing outreach efforts will only make room for scammers to insert themselves into the process and exploit families once again. The federal agencies charged with administering compensation to victims must streamline their approach and integrate applications for the two major federal foreclosure prevention programs—HAMP and Home Affordable Refinance Program (HARP). Moreover, their efforts will be maximized by including public service announcements (PSAs) and paid advertisements featuring recognized and trusted officials from the administration, a toll-free phone line with Spanish-language capability that can provide information about each of the initiatives, coordinating with the nonprofit sector, and a system to monitor and enforce rules that prevent scams.
- **Partner with qualified community-based organizations.** The power, reach, and capacity of the nonprofit sector has been consistently overlooked and underused in the rollout of federal foreclosure initiatives. Not surprisingly, borrower contact, satisfaction, and success have been lackluster in many cases. HUD-approved housing counseling agencies have worked with more than 11 million households since 2006. Objective, trusted counseling organizations support borrower contact efforts and work with local news outlets to place PSAs and paid advertisements to draw out victims. In addition, the claims administrator can contract with qualified nonprofits to reach unresponsive households. NCLR employs this model with Bank of America, Wells Fargo, and Ocwen, and has been successful at connecting hard-to-serve clients to the loss mitigation process. We also urge Congress and the administration to fully fund the HUD Housing Counseling Program at \$88 million.
- **Ensure sustainable homeownership opportunities for victims of lending discrimination.** Congress and the administration must require servicers to provide settlement victims still in their homes an expedited review to determine their eligibility for a loan modification and principal reduction. For those who have already lost their homes, the road back to homeownership may be a long one. In addition to cash compensation, the settlement should provide for a financial advisor or housing counselor to work with families to begin repairing their financial circumstances. The three credit bureaus should consider credit amnesty policies for victims of lending discrimination. Ultimately, if and when these families are ready to purchase another home, affordable financing should be made available through Fannie, Freddie, or FHA.

Conclusion

The Department of Justice's investigation of Countrywide should serve as a blueprint for further enforcement of our fair lending laws. The evidence uncovered during this probe into Countrywide dealings serves as affirmation of the analysis offered by civil rights organizations for the past decade regarding the unequal homeownership opportunities available to communities of color. Moreover, it is now clear that the unequal treatment of certain borrowers can lead to widespread harm for nearly all homeowners. Our housing market and economy will be stronger when all lenders play by the rules and every borrower has a fair shot at homeownership.

WASHINGTON BUREAU · NATIONAL ASSOCIATION FOR THE ADVANCEMENT OF COLORED PEOPLE
1156 15TH STREET, NW SUITE 915 · WASHINGTON, DC 20005 · P (202) 463-2940 · F (202) 463-2953
E-MAIL: WASHINGTONBUREAU@NAACPNET.ORG · WEB ADDRESS WWW.NAACP.ORG



**TESTIMONY OF HILARY O. SHELTON
DIRECTOR, NAACP WASHINGTON BUREAU AND
SENIOR VICE PRESIDENT FOR ADVOCACY AND POLICY**

before the

SENATE JUDICIARY COMMITTEE

on

"Lending Discrimination and Foreclosure Abuse"

March 7, 2012

Good morning Chairman Leahy, Senator Franken, Ranking Member Grassley and esteemed members of this Committee. Thank you so much for calling this important hearing and for asking me here today to share with you the NAACP's position on this crucial issue.

My name is Hilary Shelton, and I am the Director of the NAACP Washington Bureau, the federal legislative and national public policy advocacy arm of the NAACP. As many of you know, with more than 2,200 membership units in every state in the country, the NAACP is our Nation's oldest, largest and most widely recognized grassroots-based civil rights organization. I am also pleased to say that just last month we celebrated our 103rd anniversary.

Since our founding, a basic goal of the NAACP has been, and continues to be, to ensure that every American, regardless of race, ethnicity, place of national origin or background should have an equal opportunity to achieve economic success, sustainability and financial security. Sadly, more than 103 years later, we are still struggling to achieve that goal.

Let me be clear: abusive, predatory lending and the lack of access to basic financial services and reasonable credit continues to be a major civil rights issue in America.

Abusive Lending and the lack of available credit in racial and ethnic minority communities

The targeting of racial and ethnic minority Americans by predatory lenders is not a new phenomenon. In mortgage lending, numerous studies have shown that since at least the early 1990's select groups, including racial and ethnic minorities, women, and senior citizens were targeted by predatory mortgage lenders with subprime loans, regardless

of the borrowers' past history or existing credit score. I should hasten to say at this point that not all subprime loans are predatory, but we have found that all predatory or abusive loans are subprime. Indeed the NAACP recognizes the benefits of non-abusive, non-predatory subprime loans to a constituency which includes many without a strong traditional credit history.

As early as 1996, a study by Fannie Mae and Freddie Mac reported that as many as a third of the families who receive subprime loans actually qualify for prime loans¹. A seminal report by Allen Fishbein and Harold Bunce for the U.S. Department of Housing and Urban Development (HUD) issued in 2000 demonstrated definitively the "rapid growth of subprime lending in minority neighborhoods."² Ensuing reports and evaluations of HMDA data bore this out: African Americans, Latinos, and seniors, among others, were consistently being targeted by predatory lenders peddling their nefarious mortgage loans.

A 2006 study by the Center for Responsible Lending demonstrated that for most types of subprime home loans, African American and Latino borrowers are more than 30% more likely to have higher rate loans than Caucasian borrowers, even after accounting for differences in risk³. They have since followed this up with a number of other studies, most recently *Lost Ground, 2011: Disparities in Mortgage Lending and Foreclosures*⁴. All of their reports have reached similar conclusions when it comes to race and predatory mortgages: that African Americans and Latinos were much more likely to receive high interest rate loans than their white counterparts, even when credit scores and credit history are taken into account.

In addition to predatory mortgages, racial and ethnic minority Americans have been and continue to be disproportionately impacted by other types of abusive loans. One of the most obvious examples of this would be short term, or "payday" loans, which like predatory mortgage loans really took hold in our communities beginning in the early 1990's. Virtually no payday loan outlets existed in 1990, but a study released in 2005 found that in 2004, there were 22,000 payday loan stores extending about \$40 billion in

¹ Freddie Mac. September 1996. *Automated Underwriting: Making Mortgages Lending Simpler and Fairer for America's Families*. Washington DC

² Fishbein, Allen and Bunce, Harold, Subprime Market Growth and Predatory Lending, U.S. Department of Housing and Urban Affairs, 2000. In Susan M. Wachter and R. Leo Penne, eds. *Housing Policy in the New Millennium*. Washington, DC: U.S. Department of Housing and Urban Development.

³ Center for Responsible Lending. May 31, 2006. "Unfair Lending: The effect of Race and Ethnicity on the Price of Subprime Mortgages" Debbie Gruenstein Bocian, Keith Ernst and Wei Li.

⁴ Center for Responsible Lending, November 2011. *Lost Ground, 2011: Disparities in Mortgage Lending and Foreclosures*. Debbie Gruenstein Bocian, Wei Li and Roberto G. Quercia,

loans⁵. Today, there are more payday loan and check cashing stores nation-wide than there are McDonald's, Burger King, Sears, J.C. Penney, and Target stores combined⁶.

Payday lenders offer small, short-term loans while charging the equivalent of annual interest rates of up to 900% for a one-week loan, 450% for a two-week loan and more than 200% for a one-month loan⁷. Most of the loans (more than 40%, according to the FDIC) are for between \$200 and \$300; less than 10% are for more than \$500.

One of the biggest problems with payday loans is that consumers who use payday lenders are often in desperate debt, and the high interest rate makes it so hard to pay back the loan that they quickly find themselves on the perpetual debt treadmill. When they cannot pay back the original loan, they extend it, often paying the fees and interest several times over. The end result is that many consumers end up paying far more in fees than what they originally borrowed. This is so common that 99% of all payday loans go to repeat borrowers; the typical payday borrower pays almost \$800 on a \$325 loan⁸. In total, payday lending earns the financial institutions \$4.2 billion in fees annually⁹. It is currently estimated that 12 million Americans are trapped every year in a payday debt loan cycle¹⁰.

What is even more disturbing is that these stores are concentrated in low-income and racial and ethnic minority communities. As Julian Bond, the Chairman Emeritus of the NAACP Board of Directors once stated, "Visits to payday lending stores – which open their doors in low-income neighborhoods at a rate equal to Starbucks openings in affluent ones – are threatening the livelihoods of hard-working families and stripping equity from entire communities."¹¹

One study found that African American neighborhoods have three times as many payday lending stores per capita as white neighborhoods in North Carolina, even when the average income of the neighborhood is taken into account. Another study showed that in Texas, where 11% of the population is African American, 43% of the payday loans were taken out by blacks. Seven states in the nation have five or more payday stores per 10,000 households: Alabama, Louisiana, Mississippi, Missouri, Nevada,

⁵ Bair, Sheila. 2005. *Low-Cost Payday Loan: Opportunities and Obstacles*. The Annie E. Casey Foundation, June.

⁶ Karger, Howard. 2005. *Shortchanged: Life and Debt in the Fringe Economy*, San Francisco: Berrett-Koehler.

⁷ Consumer's Union. November 1999. Fact Sheet on Payday loans. Found at <http://www.consumersunion.org/finance/paydayfact.htm>

⁸ Center for Responsible Lending, "Fast Fact on Payday Loans", found at <http://www.responsiblelending.org/payday-lending/tools-resources/fast-facts.html>

⁹ Ibid

¹⁰ Ibid

¹¹ Bond, Julian. December, 2003.

South Carolina and Tennessee¹². It should come as no surprise that these seven states have some of the highest percentages of African American residents in the nation: the 2010 Census reports that the population of four of these seven states is at least, or in some cases more than, one third black¹³.

I should also mention that abusive predatory lenders have also targeted the men and women of the armed services who serve and protect our country by also concentrating themselves around military installations. In response, in 2006, Congress passed the NAACP-supported Military Lending Act, aimed at ending predatory lending practices, such as 400%-interest payday loans and auto title loans, to military men and women and their families. The Act found that abusive high-cost loans were creating significant financial distress for soldiers, leading to failed security clearances and ultimately harming military readiness. Military relief societies report that this law has had a significant impact in curbing some abusive products, but that predatory practices continue to cause significant harm to members of the military and their families. In some cases, this is because lenders have become adept at evading key protections of the original Act.

While I realize that the focus of this hearing is abusive, discriminatory lending, I would be remiss if I didn't also briefly discuss some of the forces behind the conditions which have made our communities so receptive to the targeted abusive lending practices which I have outlined above.

There has always been, and sadly there continues to be, a definitive lack of access to reasonable, responsible credit in racial and ethnic minority neighborhoods. A 1995 Federal Reserve Survey of Consumer Finances found that among lower income families, one-third of African-American households and 29 percent of Hispanic households were unbanked. Furthermore, while specific state studies are abundant, one particularly striking statistic comes from California, where a 1999 *Harvard Business Review* article, cites extreme disparity in financial services options available to residents of two neighborhoods in Los Angeles—one in South Central and the other in Pacific Palisades. South Central, which has a high African American population, has one depository institution for every 36,000 people, while Pacific Palisades, a majority white community, has one for every 1,250 people.

Unfortunately, the situation has not improved for our communities. The 1977 Community Reinvestment Act (CRA) requires banks to make loans in all the areas they serve, not just the wealthy ones. Yet one analysis has found the percentage of banks

¹² Ibid

¹³ U.S. Department of the Census, The Black Population, 2010. September 2011. Found at <http://www.census.gov/prod/cen2010/briefs/c2010br-06.pdf>

earning negative ratings from regulators on CRA exams has risen from 1.45 percent in 2007 to more than 6 percent in the first quarter of 2011¹⁴.

Given the sustained and continued dearth to reasonable credit, when coupled with the targeting of racial and ethnic minorities by predatory mortgage lenders, the disproportionately devastating impact of the foreclosure crisis on racial and ethnic minority families, neighborhoods and communities is of no surprise.

The disparate impact of the foreclosure crisis on communities of color

In November, 2011, the Center for Responsible Lending (CRL) issued a seminal report, *Lost Ground, 2011: Disparities in Mortgage Lending and Foreclosures*. The results of this report were sobering, and confirmed what NAACP members and branches throughout the United States have been witnessing for years: Foreclosure patterns are strongly linked with patterns of risky lending, and as a result of the continued targeting of racial and ethnic minorities by predatory mortgage lenders, borrowers of color are more than twice as likely to lose their home as white households¹⁵.

Perhaps more disturbing, and frightening, is their conclusion that our nation is not even halfway through the foreclosure crisis: among mortgages made between 2004 and 2008, 6.4 percent have ended in foreclosure, and an additional 8.3 percent are at immediate, serious risk.

Foreclosures take a financial and physical toll on a former homeowner and his or her family. Homeownership has long been the primary asset for most Americans. Steadily building modest wealth can leverage education, entrepreneurship, or retirement opportunities. When nurtured over a lifecycle, home equity can be shared with the next generation and further their financial security. Communities of color do not own homes at rates comparable to their White peers, which contributes heavily to the racial wealth gap. In fact, recent research by the Pew Research Center shows that wealth in White households exceeds that of Hispanic households by a staggering 18-to-one ratio and by 20-to-one for African American households.¹⁶ The foreclosure crisis has only served to exacerbate this gap.

Further, the CRL report began to quantify the suffering which many of our neighborhoods have endured: "...neighborhoods with high concentrations of minority residents have been hit especially hard by the foreclosure crisis. Nearly 20 percent of

¹⁴ Benson, Clea "A Renewed Crackdown on Redlining" Bloomberg Businessweek, May 5, 2011, found at http://www.businessweek.com/magazine/content/11_20/b4228031594062.htm

¹⁵ Center for Responsible Lending, November 2011. *Lost Ground, 2011: Disparities in Mortgage Lending and Foreclosures* Debbie Gruenstein Bocian, Wei Li and Roberto G. Quercia, p.3

¹⁶ Paul Taylor et al., *Twenty to One: Wealth Gaps Rise to Record Highs Between Whites, Blacks and Hispanics* (Washington, DC. Pew Research Center Social and Demographic Trends, 2011)

loans in high-minority neighborhoods have been foreclosed upon or are seriously delinquent, with significant implications for the long-term economic viability of these communities¹⁷.

The CRL study went on to show that there is strong evidence that low-income and minority neighborhoods are being hit hardest, not only by foreclosures, but by the attendant spillover effects of higher crime, lower property values, and fractured social cohesion.¹⁸

The impact of these disproportionate foreclosures on our neighborhoods cannot be understated: the high concentration of foreclosures in racial and ethnic minority communities make it impossible for these areas to remain viable, let alone grow or prosper. Neighborhoods with high concentrations of foreclosures lose tax revenue while at the same time incurring the financial costs of abandoned properties and neighborhood blight. According to a 2009 report by the Urban Institute, local governments incur, on average, over \$19,000 in costs for every foreclosure¹⁹. These revenue losses have a direct impact on the ability of the local government to provide residents with crucial services such as high quality schools, adequate health care, basic public safety and infrastructure maintenance, to name just a few services.

Furthermore, homeowners living in close proximity to foreclosures typically lose significant wealth as a result of depreciated home values. The 2009 Urban Institute study also found that neighbors adjacent to a foreclosure incur a loss of \$3,000 in lost property values²⁰.

How do we help these communities?

Several things must be done to help those now fearing foreclosure who were targeted by unscrupulous predatory mortgage lenders. Perhaps it is most simple to break it down into two categories: Enforcement and legislative initiatives.

On the enforcement side, the NAACP recognizes and is deeply appreciative of the efforts by the current U.S. Department of Justice (DoJ) to bring to justice some of the more egregious marketers of discriminatory mortgage products. We are, in fact, encouraged by many of the actions coming out of the DoJ and other agencies, and we are especially heartened by the fact that if and when the nascent Consumer Financial Protection Bureau (CFPB) becomes fully operational, there will be an even more robust

¹⁷ Center for Responsible Lending, November 2011. *Lost Ground, 2011: Disparities in Mortgage Lending and Foreclosures*, p.4

¹⁸ *Ibid*, p.10

¹⁹ G. T. Kingsley, R. Smith, and D. Price (2009). *The Impacts of Foreclosure on Families and Communities*. Washington, DC: The Urban Institute.

²⁰ *Ibid*

enforcing of laws already on the books and fewer cases of discrimination that are allowed to fester and grow as big as Countrywide. We are also pleased that the *Dodd-Frank Wall Street Reform and Consumer Protection Act* prohibits many of the predatory lending practices, such as yield spread premiums and steering, which have decimated so many of our communities. Currently, under President Obama, Attorney General Holder and Assistant Attorney General for Civil Rights Perez, of the U.S. DoJ has led the effort to apply existing laws to ensure that discrimination is not tolerated.

The Countrywide settlement, for example, is a welcomed demonstration of DoJ using the law and its resources to go after a company with a long and well-established record of discrimination when it comes to mortgage lending. As I am sure Assistant Attorney General Perez noted in his remarks earlier today, the settlement asserts that between 2004 and 2008, Countrywide discriminated by charging more than 200,000 African-American and Hispanic borrowers higher fees and interest rates than white borrowers in both its retail and wholesale lending. The complaint alleges that these borrowers were charged higher fees and interest rates because of their race, ethnicity or national origin, and not because of the borrowers' creditworthiness or other objective criteria related to borrower risk. The Justice Department further found that Countrywide discriminated by steering thousands of African-American and Hispanic borrowers into subprime mortgages when white borrowers with similar credit profiles received prime loans.

As a result of these heinous practices and the settlement, Countrywide has paid \$335 million in compensation for the victims of their discriminatory behavior. Again, the NAACP would like to extend our sincere thanks to the US DoJ for their thorough investigation and for their willingness and ability to enforce the law, or in this case several laws, which were put into place to protect Americans from discrimination and abuse.

The DoJ Office of Civil Rights has also, in recent months, aggressively been addressing cases of redlining, or punishing financial institutions which do not serve racial and ethnic minorities. Again, the NAACP appreciates and applauds the efforts of the U.S. DoJ for their continuing efforts to end lending discrimination.

That is not to say, however, that the increase in making fair lending a priority has not been a government-wide effort. According to Assistant Secretary Perez's office, there have been a record number of referrals from other supervisory agencies of suspected civil rights violations. In fact, in the past three years, there have been 55 referrals of lending misconduct sent to the U.S. DoJ, compared to 30 referrals in the preceding 8 year. And, according to Mr. Perez's office, the majority of these referrals are suspected cases of discriminatory actions against racial or ethnic minorities.

Legislatively, we support several initiatives which we believe will alleviate much of the pain and suffering which has been caused by the foreclosure crisis and allow millions of hardworking American families to stay in their homes and communities.

First off, we support a year-long moratorium on all foreclosures. This would potentially allow homeowners time to find and take remedial action. It would also provide mortgage servicers, many of whom currently may find it easier and more time efficient to foreclose on a home than to work with the homeowner, the time they need to try to resolve cases and allow the homeowners to stay in their homes.

The NAACP also supports several initiatives to help homeowners who are currently facing foreclosure and / or those who are "underwater" on their mortgages, owing more than the value of their homes. We need to make it easier for homeowners to refinance their mortgages and get away from abusive or high cost loans and take advantage of today's record-low loan rates. Proposals such as Senator Franken's *Helping Homeowners Refinance Act of 2012*, S. 2072 will help level the playing field and make it easier for homeowners, including those who may find themselves owing more for their homes than their current value, to refinance.

In the short term, we must stop the foreclosure crisis which is disproportionately impacting racial and ethnic minority homeowners and communities. We must change not only the thinking of financial institutions, which are not taking responsibility for their role by selling abusive loans, but we must also change the incentive for mortgage servicers, who currently generally gain more by foreclosing on a home than working with a homeowner to modify their loans to a sustainable level.

We must also support and enact proposals such as Congresswoman Maxine Waters' Project Rebuild, which would target federal dollars and matching state and local funds into rehabilitating and redeveloping abandoned and foreclosed properties. By doing this, we are not only creating jobs we are investing in communities which have, for too long, been ravaged by the foreclosure crisis.

Given the continuing disparate impact of the foreclosure crisis on racial and ethnic minority communities across the nation, as well as the continuing lack of access to reasonable, responsible credit in our neighborhoods, the growing wealth gap in our Nation should come as no surprise. We clearly have our work cut out for us.

I would again like to thank the committee for holding this important hearing and for asking for the opinions of the NAACP. I would also, at this time, welcome any questions or comments you may have.