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STATEMENT OF

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before the

FINANCIAL CRISIS INQUIRY COMMISSION

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Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

INTRODUCTION

Chairman Angelides, Vice Chairman Thomas, and Commissioners, I appreciate the opportunity to appear today before the Financial Crisis Inquiry Commission ("Commission"). The Commission was created to examine the causes of both the financial crisis and the collapse of each major financial institution that failed or was likely to fail if not for the receipt of exceptional government assistance. In this context, the Commission's letter of invitation asked me to address several specific areas: the roles played in the crisis by federal preemption of state mortgage lending laws and by the Community Reinvestment Act; the impact of the activities of national banks related to subprime lending, both directly and indirectly; changes in laws and regulations governing commercial banks' authority to conduct asset-securitization activities; and aspects of supervision of Citibank and Citigroup, by the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board, respectively. My statement addresses each topic, and is followed by separate appendices discussing each area in more detail, including additional relevant material. It concludes with my thoughts regarding several key lessons learned for the future.

CAUSES OF THE CRISIS

To address the specific topics the Commission has identified, it is essential to place them in the context of key events that ignited the crisis. In particular, the Commission's questions focus on the problems caused by deep and widespread losses on residential mortgages, especially subprime mortgages. That focus is appropriate given the record foreclosures, large financial institution losses and failures, and market seizures that trace back to problem mortgages.

While the lack of adequate consumer protection contributed to the record levels of mortgage losses, I believe there was a more fundamental problem: poor underwriting practices that made credit too easy. Among the worst of these practices were the failure to verify borrower

representations about income and financial assets; the failure to require meaningful borrower equity in homes in the form of real down payments; the offering of "payment option" loans where borrowers actually increased the amount of their principal owed with each monthly payment; and the explicit or implicit reliance on future house price appreciation as the primary source of loan repayment, either through refinancing or sale.

In short, at the beginning of the 21st century, the U.S. system for mortgage finance failed fundamentally. The consequences were disastrous not just for borrowers and financial institutions in the United States, but also for investors all over the world due to the transmission mechanism of securitization.

I believe there are a number of reasons why this happened. One is that, for many years, home ownership has been a policy priority. As a result, when times are good, we as a nation have an unfortunate tendency to tolerate looser loan underwriting practices – sometimes even turning a blind eye to them – if they make it easier for more people to buy their own homes. Against that backdrop, an unhappy confluence of factors and market trends led to even greater problems.

Around the world, low interest rates and excess liquidity spurred investors to chase yields, and U.S. mortgage-backed securities offered higher yields on historically safe investments. Hungry investors tolerated increased risk in order to obtain those higher yields, especially from securities backed by subprime mortgages, where yields were highest. The resulting strong investor demand for mortgages translated into weak underwriting standards to increase supply.

Structured mortgage-backed securities, especially complex collateralized debt obligations, were poorly understood. They gave credit rating agencies and investors a false sense of security that, no matter how poor the underwriting of the underlying mortgages, the risk could

be adequately mitigated through geographic and product diversification, sufficient credit tranching, and other financial engineering.

Cheap credit and easy underwriting helped qualify more consumers for mortgages, which increased demand for houses, which increased house prices. That in turn made it easier for lenders and investors to rely more on house price appreciation and less on consumer creditworthiness as the ultimate source of repayment for the underlying loans – so long as house prices kept rising.

In addition, many mortgage brokers and originators sold mortgages directly to securitizers. They therefore had no economic risk when considering the loan applications of even very risky borrowers. Without any "skin in the game," brokers and originators had every incentive to apply the weakest underwriting standards that would produce the most mortgages that could be sold. And unlike banks, most mortgage brokers in the United States were virtually unregulated, so there was no regulatory or supervisory check on imprudent underwriting practices.

The rapid increase in market share by these unregulated brokers and originators put pressure on regulated banks to lower their underwriting standards, which they did, though not to the same extent as was true for unregulated mortgage lenders. Indeed, the OCC took a number of steps to keep the national banks we supervise from engaging in the same risky underwriting practices as their nonbank competitors. That made a difference, but not enough for the whole mortgage system.

The combination of all the factors I have just described produced, on a nationwide scale, the worst underwritten mortgages in our history. When house prices finally stopped rising, borrowers could not refinance their way out of financial difficulty. And not long after, we began to see the record levels of delinquency, default, foreclosures, and declining house prices that

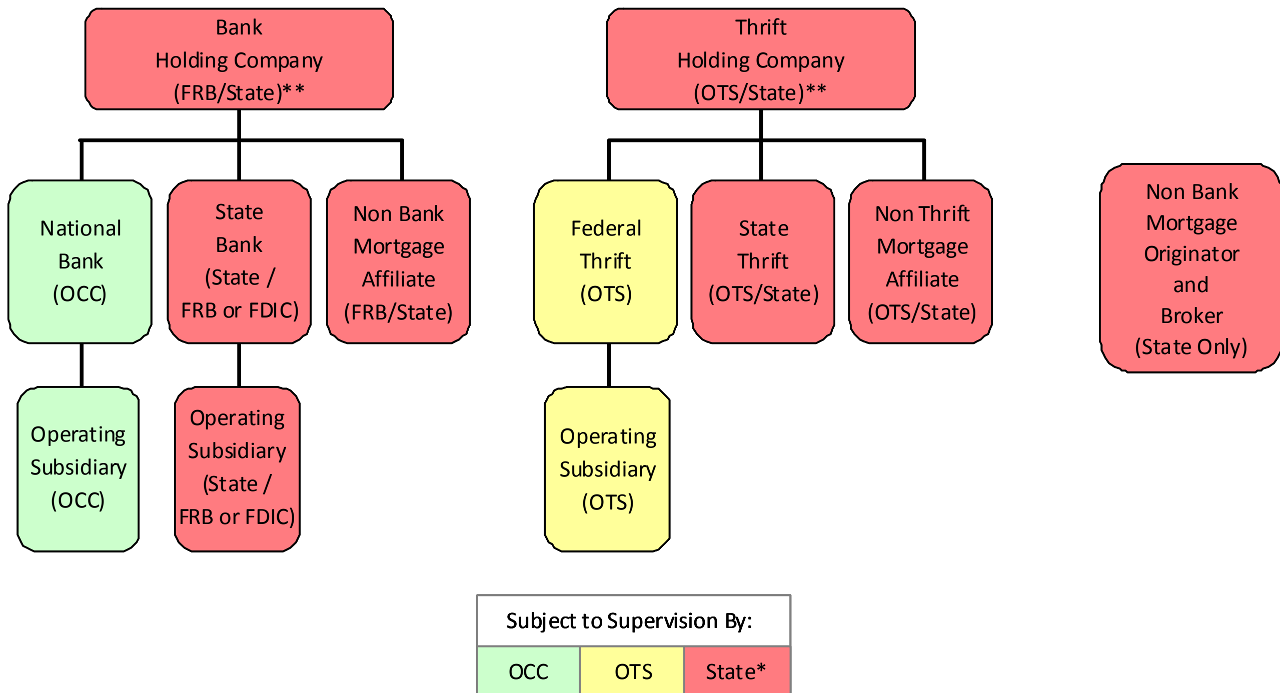
have plagued the United States for the last two years – both directly and through the spillover effects to financial institutions, financial markets, and the real economy.

REGULATORY FRAMEWORK FOR MORTGAGE ORIGINATORS

With that context, let me also briefly describe the regulatory framework governing the different types of institutions that originate residential mortgages, which is important for addressing the Commission's questions relating to both subprime lending and the role played by federal preemption.

Chart 1 shows a regulated bank holding company, a regulated thrift holding company, and the entities within those holding companies that originate mortgages. It also shows mortgage originators that are not affiliated with a bank or thrift. In addition, the chart indicates the federal regulatory agency and/or the state that has supervisory responsibility for each mortgage originator. The OCC supervises national banks and their operating subsidiaries (the green boxes); these are the only entities over which the OCC exercises supervisory authority. Only the national banks and their operating subsidiaries, and the federal thrifts and their operating subsidiaries (the yellow boxes) are subject to exclusive federal supervision and federal preemption. The red boxes indicate entities that are subject to state supervision, either solely by the state, or jointly by the state and federal agencies; these entities are not subject to federal preemption. That is, state-chartered banks and thrifts and non-bank affiliates of bank and thrift holding companies are subject to both federal and state supervision, while mortgage lenders that are not affiliated with banks or thrifts are subject only to state supervision.

CHART 1: Regulators of Mortgage Originators



* As noted, some mortgage originators are regulated by both state and federal regulators.
** Some (mostly smaller) banks and thrifts are not part of holding companies and are not represented separately here.

FEDERAL PREEMPTION OF STATE LAW AND THE CAUSES OF THE CRISIS

As discussed above, the root cause of the mortgage crisis was exceptionally weak underwriting standards. But these weak standards were not caused by federal preemption of state mortgage lending laws.

Basic elements of national bank preemption are described in Appendix A. These principles apply to national banks and their subsidiaries. Preemption is not applicable to state regulated mortgage originators, whether they are state-chartered banks or thrifts, holding company affiliates of banks or thrifts, or lenders or brokers that are unaffiliated with depository institutions (the red boxes in Chart 1). As a result, preemption has done nothing to impede the ability of states to establish and enforce sound mortgage underwriting standards for these

mortgage originators, which, as described below, were collectively the source of the overwhelming majority of subprime loans that are now performing so badly.

Indeed, if it were true that federal preemption caused the subprime mortgage crisis by preventing states from applying more rigorous lending standards to national banks, one would expect that most subprime lending would have migrated from state regulated lenders to national banks. One would also expect that all bank holding companies engaging in these activities that owned national banks would carry out the business through their national bank subsidiaries subject to federal preemption, rather than their nonbank subsidiaries that were subject to state law. But, as described below, neither of these conjectures is accurate: the overwhelming majority of subprime lending was done outside of national banks in entities that were subject to state law, and several large bank holding companies conducted all or most of their subprime mortgage lending in nonbank subsidiaries rather than their national bank subsidiaries.

The essence of federal preemption as applied to national banks is that their banking activities are governed by uniform federal standards, and a federal supervisor, the OCC, regulates national banks to ensure their compliance with these federal standards. Conversely, by express Congressional design, national banks' banking activities are not subject to multiple sets of state banking standards and multiple state regulators. The fundamental concept is that a uniform set of banking standards should apply to national banks wherever they operate in the country.

National banks are subject, however, to various state laws that govern their day-to-day operations and do not restrict their federally authorized banking powers, such as laws governing fraud, contracts, torts, etc. Notably, state anti-discrimination laws and state laws governing the foreclosure process are not preempted.

The lending activities of national banks and their subsidiaries are subject to extensive federal standards and supervision by the OCC. This has been true, for example, in the area of predatory lending, or the set of unscrupulous, unfair, and deceptive lending practices by which lenders exploit borrowers. In the mortgage area, these include such practices as loan flipping, equity stripping, and lending based solely on the liquidation value of the houses underlying the mortgages. Such predatory lending is usually a subset of subprime lending, but it is different from the type of subprime lending that was lawful but involved exceptionally weak underwriting standards.

The OCC has been clear that predatory lending – unfair, deceptive, and abusive lending practices – has no place in the national banking system. We have taken enforcement actions to address such unacceptable credit practices; alone among the federal banking agencies issued detailed guidance to national banks on avoidance of abusive mortgage lending practices; and alone among the federal banking agencies issued enforceable guidelines on abusive, predatory, unfair or deceptive residential mortgage lending practices. Predatory lending practices of the type targeted by many state mortgage lending laws simply did not take root in the national banking system.

More broadly, OCC-supervised national banks have not been especially receptive to even the lawful type of subprime mortgage lending where underwriting standards declined so significantly in the last ten years. This may have been the result of more rigorous credit supervision and reserving practices required in national banks (and indeed, all banks), as evidenced by the fact that a number of large bank holding companies owning national banks often used nonbanks for their subprime lending. For example, HSBC, Citigroup, Wells Fargo, and Countrywide (when it owned a national bank) conducted most of their subprime mortgage lending in holding company affiliates of national banks that were not subject to OCC supervision, but were subject to Federal Reserve and state supervision. It may also have been the

result of the lead the OCC took on an interagency basis to promulgate standards for sound underwriting and consumer protection for nontraditional mortgage products, particularly negatively amortizing "payment option" mortgages, which were rarely provided by national banks.

Whatever the reasons, the result was that national banks and their operating subsidiaries accounted for a disproportionately small share of the subprime mortgage market during the period when the worst subprime mortgages were provided to consumers. The same was true for the market for so-called Alt-A mortgages, the credit quality of which was better than subprime mortgages but worse than prime mortgages. In both cases, overwhelmingly, these non-prime mortgage loans were originated by nonbank lenders that were unaffected by preemption.

More specifically, as described in detail in Appendix B, national banks and their operating subsidiaries accounted for only a small portion of non-prime loans originated in the key years 2005-2007, the peak years for non-prime lending: national banks originated 10.6 percent of subprime loans, and 12.1 percent of non-prime loans overall. Moreover, this figure overstates the portion of non-prime loans originated by national banks where preemption of state law could even have been an issue. The non-prime figure includes originations of both home purchase mortgages and refinance mortgages. Yet many state mortgage lending laws only covered home refinance mortgages and not home purchase mortgages; therefore, preemption could not have been a factor for a significant share of mortgage originations – the home purchase mortgages – in those states.

As discussed in detail in Appendix B, the vast majority of non-prime loans originated during this period were made by entities clearly subject to the jurisdiction of state authorities – lenders for which preemption was not an issue. During the crucial period 2005-2007, for example, analysis of non-prime loan data and HMDA data indicates that 72 percent of non-prime loans were made by lenders subject to state authority (the red boxes in Chart 1).

Moreover, the non-prime loans originated by national banks and their subsidiaries generally have performed better than non-prime lending as a whole: 22 percent of the loans originated by national banks and their subsidiaries subsequently entered the foreclosure process at some time after origination, compared to the market average of 25.7 percent of loans. Apart from credit unions, which were not significant originators, that percentage was the lowest of any other federal regulator and was below the percentage of non-prime loans originated by entities subject to state jurisdiction. The lower foreclosure rates generally indicate that the non-prime loans originated by national banks were of relatively higher credit quality. Analysis of delinquency rates on non-prime mortgage loans also supports that conclusion.

The relatively smaller share of non-prime mortgage originations made by national banks and their subsidiaries, and the relatively better performance of these loans, are hard facts that belie the argument that national banks' federal preemption caused the mortgage crisis. Objective analysis of the data reveals that the overwhelming majority of subprime and Alt-A loans, and the worst of these loans, were made outside the national banking system.

This is not to suggest that national banks had no involvement in the subprime lending crisis. Some national banks did originate poor quality non-prime mortgage loans and have suffered substantial losses as those loans defaulted. Some national banks, like other investors, acquired securitized interests in poorly underwritten subprime mortgages, unduly relying on the investment grade ratings accorded those investments. And some national banks, as discussed below, ended up holding mortgage-related risks that they had not anticipated. Nevertheless, the relatively smaller role that national banks played in originating and purchasing these mortgages is direct evidence that federal preemption was not a principal cause of the subprime mortgage crisis.

OTHER ACTIVITIES OF NATIONAL BANKS RELATED TO SUBPRIME LENDING

The Commission's letter of invitation also asked me to address the nature and scope of the activities of national banks and their operating subsidiaries to indirectly support subprime mortgage lending. This could include activities such as providing warehouse lines of credit to subprime originators and purchasing subprime loans and interests in residential mortgage-backed securities or other structured products. Using the best information available, as discussed in Appendix B, Parts II-IV, it is clear that national banks played a relatively limited role in indirectly supporting independent subprime lenders.

Many of the state supervised subprime mortgage originators that sold mortgages directly to securitizers relied on warehouse lines of credit to finance their lending operations. Warehouse lines of credit are used to finance loans held for sale from origination to delivery into the secondary market. Relative to the overall size of the warehousing market, the warehouse lines of credit provided by national banks to subprime lenders were small. For example, as described in Appendix B, Part III, as of the fourth quarter 2006, large national banks provided approximately $33 billion of warehouse lines to 60 subprime lenders, compared with a total warehousing market in excess of over $200 billion in 2006. By the third quarter of 2007, the volume of such facilities at large national banks decreased to $14.6 billion, compared to a total warehousing market of over $200 billion in 2007.

Once originated, many of these subprime loans were bundled into residential mortgage-backed securities ("RMBS"), and these RMBS were sold to a broad range of investors, including national banks. As detailed in Appendix B, Part IV, national banks held more than $700 billion in RMBS during 2005 - 2007, but much of this consisted of securities issued by the government-sponsored enterprises ("GSEs"). National bank holdings of private-label RMBS peaked at $193 billion in 2007, representing less than 9 percent of the private-label market. But even that percentage is overstated as it relates to nonprime RMBS, because about one fourth of

outstanding private-label RMBS were backed by prime mortgages rather than subprime or Alt-A mortgages.

Another form of national bank involvement with subprime loans is through mortgage servicing. National banks service a sizeable volume of subprime mortgages. The OCC and the Office of Thrift Supervision collect data on first-lien residential mortgages serviced by most of the industry's largest mortgage servicers, the loans of which make up approximately 65 percent of all mortgages outstanding in the United States. At year-end 2009, the largest national bank servicers combined to service approximately $378 billion in subprime first mortgage loans, yet this represented only approximately 8 percent of the total servicing portfolio. Moreover, servicing of loans does not drive the origination of loans, and the servicing function is distinct from the activities and funding associated with making the loan. Once a loan is originated, it must be serviced, regardless of whether the loan was prime or subprime.

DATA DOES NOT SUPPORT ASSERTIONS THAT CRA WAS A CAUSE OF THE CRISIS

Questions also have been raised about whether the Community Reinvestment Act ("CRA") was a cause of the subprime mortgage crisis. As described in more detail in Appendix C, available data does not support that claim. The federal banking agencies have considered this question and, based on available studies, all have concluded that the mortgage crisis cannot be traced to the CRA responsibilities of insured depository institutions. Moreover, based on independent studies of comprehensive home lending data sets, the volume of subprime originations in CRA assessment areas was simply too small relative to the overall mortgage market to be a cause of the crisis.

Of course, not all single-family CRA mortgages performed well, because these loans have experienced the same stresses as most other types of consumer credit. But CRA-related loans appear to perform comparably to or better than other types of subprime loans. For

example, a study by the Federal Reserve Bank of San Francisco concluded that loans made by a CRA-covered lender within its assessment area were markedly less likely to enter foreclosure than loans made in the same area by lenders not subject to CRA. A second Federal Reserve study concluded that single-family CRA-related mortgages originated and held in portfolio under the affordable lending programs operated across the country by partners of NeighborWorks (the Congressionally chartered organization dedicated to neighborhood reinvestment and rehabilitation) have, by any measure of delinquency or foreclosure, performed better than subprime and FHA-insured loans, and they have had a lower foreclosure rate than prime loans.

Changes in Regulation and Laws Relating to Asset-Securitization Activities

The Commission's letter of invitation also asked about the impact of changes in regulations and laws over the last 25 years that have allowed commercial banking organizations to engage in the issuance and sale of asset-backed and structured investments.

Actually, national banks (and bank holding company affiliates) have long been permitted to sell evidences of debt, including mortgages, to third parties, and no significant change in law or regulation was necessary for them to use asset securitizations as a means of selling interests in pools of mortgage loans (although there were important legal interpretations that clarified this authority). National banks engaged in the first securitization of residential mortgage loans in the 1970s pursuant to statutory language unaltered since the enactment of the National Bank Act in 1864. The same statutes permit national banks to securitize their assets today.

Appendix D provides a detailed summary of the evolution of securitization activities of national banks and companies affiliated with banks. This evolution has been gradual and has taken place against the backdrop of the maturing secondary market for mortgage assets. Over the years, as securitization practices have evolved, Congress and the courts have recognized the authority of national banks to engage directly in these activities. For example, the courts have

upheld, as part of the business of banking, national banks' authority to issue and sell interests in a pool of mortgages as a mechanism for selling loans. Congress, in provisions enacted in the Gramm-Leach-Bliley Act ("GLBA"), expressly recognized and preserved this authority for national banks to engage directly in asset-backed securitization activities. GLBA also repealed key provisions of the Glass-Steagall Act to allow banks to affiliate with full service investment banks that engage extensively in, among other securities activities, asset securitizations.

The result of this evolution in law, regulation, and legal interpretation is that banking organizations, especially larger ones, have become full participants in securitization activities and securitization markets. In practice, most securitizations and structured credit activities have been conducted outside of banking subsidiaries in holding company affiliates registered as broker-dealers and regulated by the SEC and the Federal Reserve. National banks have continued to participate in these activities, however, in various ways, including through credit and liquidity support facilities, as well as through derivatives activities that are often conducted in the bank.

It is plainly true that problems in securitization markets played a key role in the crisis, including, as described above, the negative effect that the "originate to distribute" model had on loan underwriting practices; the severe liquidity problems caused by the seizure in securitizations; and the spread of severe and unanticipated losses to investors around the world. It is also true that banking organizations, as full participants in securitization markets, participated in these securitization problems. And it is certainly true, as described below, that securitization activities caused very substantial losses for some banking organizations, including for some national banks.

Nevertheless, I do not think that the increasing participation by banking organizations in securitization markets over time was a singular cause of the securitization problems described

above. These problems were not unique to bank participants, and indeed appear to have been more severe for the investment banking organizations that were unaffiliated with banks, *e.g.*, Merrill Lynch, Lehman Brothers, and Bear Stearns. The same was true of the incidence of large securitization losses.

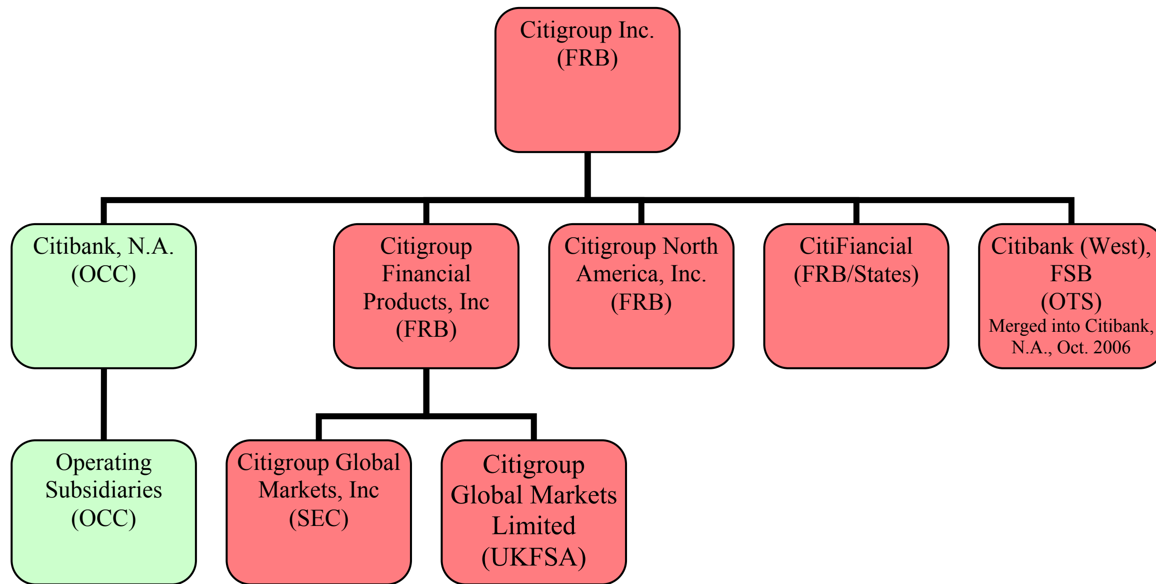
Moreover, I do not believe that restricting or curtailing bank participation in securitization activities or bank affiliation with securities companies is the right policy or regulatory response to securitization problems. Indeed, had GLBA not repealed key provisions of the Glass-Steagall Act to allow such affiliations, it would have been impossible to handle the market confidence problems associated with Bear Stearns and Merrill Lynch, where mergers with banks restored confidence and stability, and Morgan Stanley and Goldman Sachs, where conversions to regulated bank holding companies did the same.

Instead, I believe that other measures have been and continue to be necessary to address abuses in securitization markets, while preserving their benefits. These include accounting and regulatory capital changes, which have already been implemented, to address the problem of off-balance sheet assets and vehicles presenting the same risks as on-balance sheet assets. They also include changes to credit rating agency rating methodology and required disclosures to investors. And they include changes to the incentives to weaken loan underwriting, which I have argued should be addressed in the case of mortgages by the government establishing across-the-board minimum mortgage underwriting standards.

SUPERVISION OF CITIBANK AND CITIGROUP BY THE OCC AND THE FEDERAL RESERVE

Finally, the Commission asked about aspects of the supervision of Citibank and Citigroup by the OCC and the Federal Reserve. As an initial matter, it is important to be clear, as the chart below depicts, that the OCC's jurisdiction extends only to the national banks within Citigroup, and the subsidiaries of those national banks (the green boxes). The remainder of the company – including

the holding company affiliates in the chart that are referenced in the discussion below – is subject to the jurisdiction of the Federal Reserve, various other federal functional regulators, and state regulators.



As described in detail in Appendix E, some of Citigroup's exposures to subprime mortgages and securities backed by subprime mortgages arose from the bank's direct activities. However, a significant part of that exposure resulted from activities of holding company affiliates that, due to extraordinary market events, caused losses in the bank.

For example, through its broker-dealer affiliate, Citigroup warehoused and packaged subprime mortgage loans purchased from third parties (not the national bank) into collateralized debt obligations ("CDOs") that were funded through off-balance sheet special purpose vehicles ("SPVs"). The national bank provided a liquidity backstop for a segment of this business by means of a "liquidity put." If a liquidity event caused investors in short-term commercial paper issued by the CDO/SPV to refuse to renew their investments at maturity, and no replacement investors could be found, the liquidity put required the bank to step in with replacement funding. Management viewed the likelihood of such an event as extremely remote. However, long before

credit deterioration in the CDOs was officially evidenced through credit rating agency downgrades, the subprime mortgage market meltdown triggered just such a liquidity event as commercial paper investors chose not to roll commercial paper funding. As a result of the liquidity put, and as explained in Appendix E, the bank ultimately assumed a significant amount of "super-senior" credit exposure to CDOs backed ultimately by subprime mortgages. Even though such exposures had received the very highest credit agency ratings, they were subsequently downgraded and produced very large mark-to-market losses.

Citibank also assumed synthetic subprime CDO exposure through its London office. This synthetic exposure was created using credit derivatives on either asset-backed securities or related indices that were based on RMBS. When a structured synthetic CDO was packaged, the highest risk tranches were sold, and the bank retained the super senior position. As with the super-senior exposure to cash CDOs from the liquidity puts, the super senior exposures from the synthetic CDOs ultimately produced substantial losses.

Additional subprime mortgage losses resulted from a major corporate restructuring completed in October 2006. In this action, Citigroup reduced the number of insured depository institutions from twelve to five as it consolidated approximately $200 billion of assets into Citibank. Approximately 10 percent of this total consisted of subprime mortgages originated primarily by Citigroup's consumer finance company, CitiFinancial. Many of these mortgages were originated in 2005 and 2006, when underwriting standards were weakest, and Citibank has taken large losses and made substantial loan loss provisions as a result. Subprime mortgages subsequently issued by Citibank in 2007 have also produced losses.

Despite these losses, and other significant losses arising from other lending activities, Citibank and the other national banks owned by Citigroup have repeatedly performed as well or better than the remainder of the corporate family, as indicated in the chart below.

Net Income $B	2006	2007	2008	2009
National Banks	$13.1	$5.1	- $6.3	-$3.0
Non-Banks	$8.5	-$1.5	-$21.4	$1.4

The national banks reported a net income of $5.1 billion in 2007, and a loss of $6.3 billion in 2008, compared to losses of $1.5 billion in 2007 and $21.4 billion in 2008 for Citigroup, excluding its national bank subsidiaries. As a result of its performance, as well as its better funding base, Citibank has consistently maintained a stronger position than Citigroup as a whole.

LESSONS FOR THE FUTURE

There are many lessons to be learned from the crisis to prevent a recurrence of similar events in the future. Financial reform legislation and changes to regulation and supervisory practices, both here and in countries around the world, are intended to do just that, with many sweeping changes proposed in such areas as capital and liquidity requirements, consumer protection, derivatives regulation, resolution regimes for systemically important companies, systemic risk regulation, loan loss provisioning practices, and many others. I have previously testified on these issues in the context of U.S. financial reform, and strongly support moving forward with legislative and regulatory changes.

In the context of the particular questions raised by the Commission for this hearing on mortgage lending, securitization, and the problems at Citigroup, let me close with several thoughts on lessons learned and proposed changes to address them.

First, we need to do more to ensure strong minimum underwriting standards for residential mortgages that are applied across the board to all mortgage originators. I support the

current proposals to empower a federal agency to write strong consumer protection rules that apply uniformly to all providers of financial products and services. But these proposals do not address minimum mortgage underwriting standards, which is a core safety and soundness function for prudential regulators (although it certainly has a bearing on consumer protection as well). I believe the bank regulators, the regulator of government sponsored enterprises, and the Federal Housing Administration should coordinate the adoption of minimum, common sense rules in such areas as required income and financial asset verification, real cash down payments and limits on home equity extraction, and the qualification of borrowers for "teaser rate" loans. In so doing, it is critical that the new rules apply effectively to <u>all</u> mortgage originators and purchasers of mortgages, not just those subject to federal regulation.

Second, steps need to be taken to address differential regulation both among banking regulators and, critically, between regulated sectors and the "shadow financial system" of unregulated sectors. In the area of mortgages, for example, it should not be the case that regulation should differ substantially depending on whether activities are conducted in a bank, where they are most regulated today; in a holding company affiliate, where they are less regulated; or in a mortgage lender or broker unaffiliated with a bank, where they are virtually unregulated. Current proposals to consolidate bank and thrift regulation would help, as would the proposal in the current Senate legislation to ensure unified regulation and supervision of banking activities in a bank holding company, regardless of whether the activities are conducted in the bank or a holding company affiliate of the bank. But we have still not solved the problem of effectively extending comparable standards and supervision to such shadow banking entities as nonbank mortgage lenders and brokers. These unregulated originators simply cannot be allowed to "end run" federal standards to put pressure on regulated lenders to follow suit, which was the very dynamic that caused so much damage during the crisis.

Third, important steps have been taken and need to be taken in the area of securitization. Accounting and regulatory capital standards have already been changed to address the problem off-balance sheet securitization vehicles that never should have been treated as off-balance sheet. Consensus proposals are moving forward, worldwide, to increase required capital for securitized assets, especially re-securitized assets such as CDOs, and to prevent banking organizations from over-relying on credit rating agency ratings in managing the risk of these exposures. The Securities and Exchange Commission will soon propose enhanced disclosure rules for asset-backed securities that will allow investors to do more due diligence on the credit quality of underlying assets, instead of relying exclusively on credit ratings. Other proposals are also moving forward on mandatory risk retention for securitizers, often referred to as "skin in the game" requirements, to improve the incentives for purchasers of loans to insist that the loans are well underwritten. While I support the goal of these skin-in-the-game proposals, which is to improve underwriting quality, there are legitimate concerns with unintended accounting consequences that could make it considerably more difficult to securitize assets subject to such rules. If these concerns cannot be addressed, then I have argued that, at least in the area of mortgages, a better approach to improving underwriting quality would be for the government to directly establish minimum underwriting standards, as discussed above.

Fourth, banking and financial organizations need to substantially improve their ability to aggregate and manage similar risk exposures that take different forms in different parts of their businesses. The crisis showed that risk concentrations can accumulate across product, business lines, and legal entities within a firm, and that complex products containing the same types of risks under different labels can obfuscate aggregate exposures. It also revealed weaknesses in banking companies' risk identification systems, which failed to capture and aggregate these risks, and in their risk measurement models, which relied on historical correlations that did not

adequately address the risks presented by new forms of structured securities. Banking companies, and their regulators, also failed to appreciate the ramifications of different lending standards and risk tolerances in different segments of large companies, and how banks could end up bearing risks that they would not otherwise directly accept. For example, the losses on subprime CDOs proved in several cases to be a surprise to management that had consciously reduced exposure to direct subprime lending risk. In light of this issue, the OCC, working with other federal regulators, has directed bank management to take a number of steps to significantly upgrade reporting systems and risk management to address this risk aggregation issue.

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I appreciate this opportunity to appear before the Commission, and would be pleased to answer questions.

LIST OF APPENDICIES

APPENDIX A: Federal Preemption of State and Local Fair Lending and Mortgage Lending Laws

APPENDIX B: Activities of National Banks Related to Subprime Lending

APPENDIX C: Impact of the Community Reinvestment Act on Losses Incurred by National Banks

APPENDIX D: Changes in Laws and Regulations Impacting National Banks Engaging in the Issuance and Sale of Asset-Backed and Structured Investments

APPENDIX E: OCC Supervision of Citibank, N.A.

APPENDIX A: FEDERAL PREEMPTION OF STATE AND LOCAL FAIR LENDING AND MORTGAGE LENDING LAWS

I. Background of National Bank Preemption

Since its establishment in 1863 and 1864, the national banking system, operating under uniform federal standards across state lines, has fostered an open financial marketplace, the growth of national products and services in national and multi-state markets, sound operating practices and efficient product delivery to bank customers. At the core of the national banking system is the principle that national banks, in carrying on the business of banking under a Federal authorization, should be subject to uniform national standards and uniform federal supervision.[1] The legal principle that produces such a result is the "preemption" of state law.

In the years following the National Bank Act's enactment, the Supreme Court recognized the clear intent on the part of Congress to limit the authority of states over national banks precisely so that the nationwide system of banking that was created in the National Bank Act could develop and flourish. This point was highlighted by the Supreme Court in 1903 in *Easton v. Iowa.*[2] The Court stressed that the application of multiple states' standards would undermine the uniform, national character of the powers of national banks, which operate in–

> a system extending throughout the country, and independent, so far as powers conferred are concerned, of state legislation which, if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the states…. If [the states] had such power it would have to be exercised and limited by their own discretion, and confusion would necessarily result from control possessed and exercised by two independent authorities.[3]

The Supreme Court strongly reaffirmed this point in 2007 in *Watters v. Wachovia*,[4] stating:

> Diverse and duplicative superintendence [by the states] of national banks' engagement in the business of banking, we observed over a century ago, is precisely what the [National Bank Act] was designed to prevent.[5]

The Supreme Court and lower Federal courts have repeatedly made clear that state laws that conflict, impede, or interfere with national banks' powers and activities are preempted. For

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[1] In discussing the impact of the National Currency Act and National Bank Act, Senator Sumner stated that, "[c]learly, the [national] bank must not be subjected to any local government, State or municipal; it must be kept absolutely and exclusively under that Government from which it derives its functions." Cong. Globe, 38th Cong., 1st Sess., at 1893 (April 27, 1864).

[2] 188 U.S. 220 (1903).

[3] *Id.* at 229, 230-31. A similar point was made by the Court in *Talbott v. Bd. of County Commissioners of Silver Bow County,* in which the court stressed that the entire body of the Statute respecting national banks, emphasize that which the character of the system implies - an intent to create a national banking system co-extensive with the territorial limits of the United States, and with uniform operation within those limits. 139 U.S. 438, 443 (1891).

[4] 550 U.S. 1 (2007).

[5] *Id.* at 14.

example, in *Davis v. Elmira Savings Bank*,[6] the Supreme Court stated: "National banks are instrumentalities of the Federal Government, … It follows that an attempt, by a state, to define their duties or control the conduct of their affairs, is absolutely void." In *Franklin National Bank v. New York*,[7] the Supreme Court held that a state could not prohibit a national bank from using the word "savings" in its advertising, since the state law conflicts with the power of national banks to accept savings deposits. More recently, in *Barnett Bank v. Nelson*,[8] the Supreme Court affirmed the preemptive effect of Federal banking law under the Supremacy Clause and held that a state statute prohibiting banks from engaging in most insurance agency activities was preempted by Federal law that permitted national banks to engage in insurance agency activities. In reaching its conclusion, the Court explained that the history of the National Bank Act "is one of interpreting grants of both enumerated and incidental 'powers' to national banks as grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law."

However, the Supreme Court also has recognized that many types of state commercial and infrastructure laws do apply to national banks. The Supreme Court, only five years after the enactment of the National Bank Act, recognized that national banks may be subject to some state laws in the normal course of business if there is no conflict with Federal law.[9] In holding that national banks' contracts, their acquisition and transfer of property, their right to collect their debts, and their liability to be sued for debts, are based on state law, the Court noted that national banks "are subject to the laws of the State, and are governed in their daily course of business far more by the laws of the State than of the nation."[10] The OCC does not dispute this basic proposition.

The courts have continued to recognize that national banks are subject to state laws, unless those laws infringe upon the national banking laws or impose an undue burden on the performance of the banks' federally authorized activities. In *McClellan v. Chipman*,[11] the Supreme Court held that the application to national banks of a state statute forbidding certain real estate transfers by insolvent transferees was not preempted as the statute would not impede or hamper national banks' functions. In *Wichita Royalty Co. v. City Nat. Bank of Wichita Falls*,[12] the Court upheld the application of state tort law to a claim by a bank depositor against bank directors. And in *Anderson Nat. Bank v. Luckett*,[13] the Supreme Court held that a state statute administering abandoned deposit accounts did not unlawfully encroach on the rights and privileges of national banks and, as a result, was not preempted.

As these cases demonstrate, there are numerous state laws to which national banks remain subject because the laws do not significantly impede or interfere with powers granted national banks under federal law. Yet, in reaching this conclusion, these cases serve to confirm the fundamental principle of federal preemption as applied to national banks: that is, that the

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[6] 161 U.S. 275, 283 (1896).

[7] 347 U.S. 373 (1954).

[8] 517 U.S. 25, 32 (1996).

[9] *National Bank v. Commonwealth*, 76 U.S. (9 Wall.) 353 (1869).

[10] *Id.* at 362 (1869).

[11] 164 U.S. 347 (1896).

[12] 306 U.S. 103 (1939).

[13] 321 U.S. 233 (1944).

banking business of national banks is governed by federal standards. These uniform national standards and the federal supervision under which national banks operate are the defining attributes of the national bank component of our dual banking system.

II. State Fair Lending Laws

The OCC does not take the position that state laws prohibiting discrimination in lending (*e.g.*, laws that prohibit lenders from discriminating on the basis of race, religion, ethnicity, gender, sexual orientation, disability, or the like) are preempted. This position was explained in a letter dated March 9, 2004, from then-Comptroller John D. Hawke, Jr., to the Honorable Barney Frank.[14] Reflecting this, the OCC did not challenge the applicability to national banks of the New York state fair lending law underlying the Supreme Court's decision in *Cuomo v. Clearing House Ass'n, L.L.C.*[15]

In *Cuomo,* the OCC acknowledged that the state fair lending law was not preempted but challenged the state attorney general's authority to enforce it against national banks on the grounds that the National Bank Act[16] prohibits the exercise of visitorial authority except by the OCC or under other circumstances authorized by federal law.[17] The Supreme Court held that a State attorney general could enforce non-preempted State law by bringing an action in court to enforce the non-preempted state law, but that the type of administrative investigation initiated by the state attorney general in this case was precluded by the National Bank Act.

There may be some misunderstanding of the OCC's position with regard to state fair lending laws, because some state laws imposing restrictions on mortgage lending terms have "fair lending" in their titles, but do not actually address unlawful discrimination in lending. For example, the Georgia Fair Lending Act ("GFLA")[18] does not address lending discrimination but rather prohibits certain mortgage loan products and terms and imposes special restrictions when other loan terms or conditions are set. For this reason, the OCC concluded that various provisions of the GFLA were preempted.[19]

III. State Mortgage Lending Laws

The OCC's preemption rule issued in 2004 identifies and lists categories of state laws that ordinarily are, and are not, preempted.[20] The lists were drawn from existing case law and

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[14] OCC Interpretive Letter No. 998 (March 9, 2004).

[15] 129 S. Ct. 2710 (June 29, 2009).

[16] 12 U.S.C. § 484.

[17] The *Cuomo* case concerned the OCC's visitorial powers rule rather than the OCC's preemption rule. As we explained in our brief, the visitorial powers "regulation does not declare the preemptive scope of the [National Bank Act], but identifies the circumstances under which state officials may act to enforce *non-preempted* state-law provisions." Brief for the Federal Respondent at 9 (filed March 25, 2009) (emphasis added).

[18] Ga. Code. Ann. §§ 7-6A-1 *et seq*.

[19] 68 Fed. Reg. 46264 (Aug. 5. 2003).

[20] 69 Fed. Reg. 1904 (Jan. 13, 2004)(amending the OCC's real estate lending rules at 12 C.F.R. Part 34). In addition to real estate lending, the preemption rule also addressed deposit-taking, non-real estate lending, and, generally, activities authorized to national banks by Federal law. *Id*.

interpretations and are based on the preemption standards summarized in Barnett and developed by the Supreme Court.

The rule affects state law restrictions on mortgage lending terms and conditions in several respects. Examples of preempted laws include laws that restrict or prescribe the terms of credit, amortization schedules, permissible security property, permissible rates of interest, escrow accounts, disclosure and advertising, and laws that require a state license as a condition of national banks' ability to make loans.[21]

On the other hand, the regulation also gives examples of the types of state laws that are not preempted and would be applicable to national banks to the extent that they only incidentally affect the real estate lending, other lending, deposit-taking, or other operations of national banks. These include laws on contracts, rights to collect debts, acquisition and transfer of property, taxation, zoning, crimes, and torts. In addition, any other law that the OCC determines to only incidentally affect national banks' lending, deposit-taking, or other operations would not be preempted under the preemption rule.

The OCC also included in the preemption rule two new provisions to ensure that the federal standards under which national banks operate directly address abusive or predatory lending practices. First, the preemption rule prohibits national banks from making a real estate loan (or other consumer loan) based predominantly on the foreclosure or liquidation value of a borrower's collateral, rather than on the borrower's ability to repay the loan according to its terms. This underwriting standard applies uniformly to all consumer lending activities of national banks, regardless of the location from which the bank conducts those activities or where their customers live. It is comprehensive, it is nationwide, and it targets lending practices, such as relying on future house price appreciation as the primary source of repayment that contributed significantly to the mortgage meltdown that sparked the financial crisis.

Second, the preemption rule provides that national banks shall not engage in unfair and deceptive practices within the meaning of Section 5 of the Federal Trade Commission Act in connection with any type of lending. Section 5 prohibits "unfair or deceptive acts or practices" in interstate commerce. This addition to our rule is particularly appropriate in light of the fact that the OCC pioneered the use of Section 5 as a basis for enforcement actions against banks that have engaged in such conduct.[22]

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[21] In *Watters v. Wachovia Bank, N.A.*, 550 U.S. 1 (2007), the Supreme Court noted that the state licensing and registration requirements at issue in that case expressly exempted national banks from their application. As the Supreme Court explained, that exemption for national banks was "not simply a matter of the [state] legislature's grace. . . . For, as the parties recognize, the [National Bank Act] would have preemptive force, i.e., it would spare a national bank from state controls of the kind here involved."

[22] The OCC's pioneering commitment to using the FTC Act to address consumer abuses is demonstrated by a number of actions against national banks that have resulted in the payment of hundreds of millions of dollars in restitution to consumers. For example, in 2000, the OCC required Providian National Bank to set aside not less than $300 million for restitution to affected consumers; in 2005, the OCC required The Laredo National Bank and its subsidiary, Homeowners Loan Corporation, to set aside at least $14 million for restitution to affected customers; and in 2008, the OCC required Wachovia Bank, N.A., to set aside $125 million for restitution to affected consumers.

LISTING OF ATTACHMENTS TO APPENDIX A

69 Fed. Reg. 1904 (Jan. 13, 2004) (amending the OCC's real estate lending rules at 12 C.F.R. Part 34 to clarify the extent to which state laws in general apply to national banks' real-estate lending activities).

Remarks by John C. Dugan, Comptroller of the Currency, before the Women in Housing and Finance ("The Need to Preserve Uniform National Standards for National Banks"), Washington, DC (September 24, 2009).

OCC White Paper, "The Importance of Preserving A System of National Standards For National Banks" (October 2009).

enforce/enf_search.htm. Indeed, as recently observed by the Superior Court of Arizona, Maricopa County, in an action brought by Arizona against a national bank, among others, the restitution and remedial action ordered by the OCC in that matter against the bank was ''comprehensive and significantly broader in scope than that available through [the] state court proceedings.'' *State of Arizona* v. *Hispanic Air Conditioning and Heating, Inc.*, CV 2000–003625, Ruling at 27, Conclusions of Law, paragraph 50 (Aug. 25, 2003). Thus, the OCC has ample legal authority and resources to ensure that consumers are adequately protected.

List of Subjects in 12 CFR Part 7

Credit, Insurance, Investments, National banks, Reporting and recordkeeping requirements, Securities, Surety bonds.

Authority and Issuance

■ For the reasons set forth in the preamble, the OCC amends part 7 of chapter I of title 12 of the Code of Federal Regulations as follows:

PART 7—BANK ACTIVITIES AND OPERATIONS

■ 1. The authority citation for part 7 continues to read as follows:

Authority: 12 U.S.C. 1 *et seq.*, 71, 71a, 92, 92a, 93, 93a, 481, 484, 1818.

Subpart D—Preemption

■ 2. In § 7.4000:
■ a. Add a new paragraph (a)(3); and
■ b. Revise paragraph (b) to read as follows:

§ 7.4000 Visitorial powers.

(a) * * *

(3) Unless otherwise provided by Federal law, the OCC has exclusive visitorial authority with respect to the content and conduct of activities authorized for national banks under Federal law.

(b) *Exceptions to the general rule.* Under 12 U.S.C. 484, the OCC's exclusive visitorial powers are subject to the following exceptions:

(1) *Exceptions authorized by Federal law.* National banks are subject to such visitorial powers as are provided by Federal law. Examples of laws vesting visitorial power in other governmental entities include laws authorizing state or other Federal officials to:

(i) Inspect the list of shareholders, provided that the official is authorized to assess taxes under state authority (12 U.S.C. 62; this section also authorizes inspection of the shareholder list by shareholders and creditors of a national bank);

(ii) Review, at reasonable times and upon reasonable notice to a bank, the bank's records solely to ensure compliance with applicable state unclaimed property or escheat laws upon reasonable cause to believe that the bank has failed to comply with those laws (12 U.S.C. 484(b));

(iii) Verify payroll records for unemployment compensation purposes (26 U.S.C. 3305(c));

(iv) Ascertain the correctness of Federal tax returns (26 U.S.C. 7602);

(v) Enforce the Fair Labor Standards Act (29 U.S.C. 211); and

(vi) Functionally regulate certain activities, as provided under the Gramm-Leach-Bliley Act, Pub. L. 106–102, 113 Stat. 1338 (Nov. 12, 1999).

(2) *Exception for courts of justice.* National banks are subject to such visitorial powers as are vested in the courts of justice. This exception pertains to the powers inherent in the judiciary and does not grant state or other governmental authorities any right to inspect, superintend, direct, regulate or compel compliance by a national bank with respect to any law, regarding the content or conduct of activities authorized for national banks under Federal law.

(3) *Exception for Congress.* National banks are subject to such visitorial powers as shall be, or have been, exercised or directed by Congress or by either House thereof or by any committee of Congress or of either House duly authorized.

* * * * *

John D. Hawke, Jr.,

Comptroller of the Currency.

[FR Doc. 04–585 Filed 1–12–04; 8:45 am]

BILLING CODE 4810–33–P

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Parts 7 and 34

[Docket No. 04–04]

RIN 1557–AC73

Bank Activities and Operations; Real Estate Lending and Appraisals

AGENCY: Office of the Comptroller of the Currency, Treasury.

ACTION: Final rule.

SUMMARY: The Office of the Comptroller of the Currency (OCC) is publishing a final rule amending parts 7 and 34 of our regulations to add provisions clarifying the applicability of state law to national banks' operations. The provisions concerning preemption identify types of state laws that are preempted, as well as the types of state laws that generally are not preempted, with respect to national banks' lending, deposit-taking, and other operations. In tandem with these preemption provisions, we are also adopting supplemental anti-predatory lending standards governing national banks' lending activities.

EFFECTIVE DATE: February 12, 2004.

FOR FURTHER INFORMATION CONTACT: For questions concerning the final rule, contact Michele Meyer, Counsel, or Mark Tenhundfeld, Assistant Director, Legislative and Regulatory Activities Division, (202) 874–5090.

SUPPLEMENTARY INFORMATION:

I. Introduction

The OCC is adopting this final rule to specify the types of state laws that do not apply to national banks' lending and deposit taking activities *and* the types of state laws that generally *do* apply to national banks. Other state laws not specifically listed in this final rule also would be preempted under principles of preemption developed by the U.S. Supreme Court, if they obstruct, impair, or condition a national bank's exercise of its lending, deposit-taking, or other powers granted to it under Federal law.

This final rule also contains a new provision prohibiting the making of any type of consumer loan based predominantly on the bank's realization of the foreclosure value of the borrower's collateral, without regard to the borrower's ability to repay the loan according to its terms. (A consumer loan for this purpose is a loan made for personal, family, or household purposes). This anti-predatory lending standard applies uniformly to all consumer lending activities conducted by national banks, wherever located. A second anti-predatory lending standard in the final rule further specifically prohibits national banks from engaging in practices that are unfair and deceptive under the Federal Trade Commission Act (FTC Act) [1] and regulations issued thereunder, in connection with all types of lending.

The provisions concerning preemption of state laws are contained in 12 CFR part 34, which governs national banks' real estate lending, and in three new sections to part 7 added by this final rule: § 7.4007 regarding deposit-taking activities; § 7.4008 regarding non-real estate lending

[1] 15 U.S.C. 45(a)(1).

activities; and § 7.4009 regarding the other Federally-authorized activities of national banks. The first anti-predatory lending standard appears both in part 34, where it applies with respect to real estate consumer lending, and in part 7, with respect to other consumer lending. The provision prohibiting a national bank from engaging in unfair or deceptive practices within the meaning of section 5 of the FTC Act and regulations promulgated thereunder [2] similarly appears in both parts 34 and 7.

II. Description of Proposal

On August 5, 2003, the OCC published a notice of proposed rulemaking (NPRM or proposal) in the **Federal Register** (68 FR 46119) to amend parts 7 and 34 of our regulations to add provisions clarifying the applicability of state law to national banks. These provisions identified the types of state laws that are preempted, as well as the types of state laws that generally are not preempted, in the context of national bank lending, deposit-taking, and other Federally-authorized activities.

A. Proposed Revisions to Part 34—Real Estate Lending

Part 34 of our regulations implements 12 U.S.C. 371, which authorizes national banks to engage in real estate lending subject to ''such restrictions and requirements as the Comptroller of the Currency may prescribe by regulation or order.'' Prior to the adoption of this final rule, subpart A of part 34 explicitly preempted state laws concerning five enumerated areas with respect to national banks and their operating subsidiaries.[3] Those are state laws concerning the loan to value ratio; the schedule for the repayment of principal and interest; the term to maturity of the loan; the aggregate amount of funds that may be loaned upon the security of real estate; and the covenants and restrictions that must be contained in a lease to qualify the leasehold as acceptable security for a real estate loan. Section 34.4(b) stated that the OCC would apply recognized principles of Federal preemption in considering whether state laws apply to other aspects of real estate lending by national banks.

Pursuant to our authority under 12 U.S.C. 93a and 371, we proposed to amend § 34.4(a) and (b) to provide a more extensive enumeration of the types of state law restrictions and requirements that do, and do not, apply to the real estate lending activities of national banks. To the five types of state laws already listed in the regulations, proposed § 34.4(a) added a fuller, but non-exhaustive, list of the types of state laws that are preempted, many of which have already been found to be preempted by the Federal courts or OCC opinions. As also explained in the preamble to the NPRM, consistent with the applicable Federal judicial precedent, other types of state laws that wholly or partially obstruct the ability of national banks to fully exercise their real estate lending powers might be identified and, if so, preemption of those laws would be addressed by the OCC on a case-by-case basis.

We also noted in the preamble that the nature and scope of the statutory authority to set ''requirements and restrictions'' on national banks' real estate lending may enable the OCC to ''occupy the field'' of the regulation of those activities. We invited comment on whether our regulations, like those of the Office of Thrift Supervision (OTS),[4] should state explicitly that Federal law occupies the field of real estate lending. We noted that such an occupation of the field necessarily would be applied in a manner consistent with other Federal laws, such as the Truth-in-Lending Act (TILA) [5] and the Equal Credit Opportunity Act (ECOA).[6]

Under proposed § 34.4(b), certain types of state laws are not preempted and would apply to national banks to the extent that they do not significantly affect the real estate lending operations of national banks or are otherwise consistent with national banks' Federal authority to engage in real estate lending.[7] These types of laws generally pertain to contracts, collection of debts, acquisition and transfer of property, taxation, zoning, crimes, torts, and homestead rights. In addition, any other law that the OCC determines to interfere to only an insignificant extent with national banks' lending authority or is otherwise consistent with national banks' authority to engage in real estate lending would not be preempted.

The proposal retained the general rule stated in § 34.3 that national banks may ''make, arrange, purchase, or sell loans or extensions of credit, or interests therein, that are secured by liens on, or interests in, real estate, subject to terms, conditions, and limitations prescribed by the Comptroller of the Currency by regulation or order.'' That provision was unchanged, other than by designating it as paragraph (a).

The proposal added a new paragraph (b), prescribing an explicit, safety and soundness-based anti-predatory lending standard to the general statement of authority concerning lending. Proposed § 34.3(b) prohibited a national bank from making a loan subject to 12 CFR part 34 based predominantly on the foreclosure value of the borrower's collateral, rather than on the borrower's repayment ability, including current and expected income, current obligations, employment status, and other relevant financial resources.

This standard augments the other standards that already apply to national bank real estate lending under Federal laws. These other standards include those contained in the OCC's Advisory Letters on predatory lending; [8] section 5 of the FTC Act,[9] which makes unlawful ''unfair or deceptive acts or practices'' in interstate commerce; and many other Federal laws that impose standards on lending practices.[10] The NPRM invited commenters to suggest other anti-predatory lending standards that would be appropriate to apply to national bank real estate lending activities.

As a matter of Federal law, national bank operating subsidiaries conduct their activities subject to the same terms and conditions as apply to the parent banks, except where Federal law provides otherwise. *See* 12 CFR 5.34(e)(3) and 7.4006. *See also* 12 CFR 34.1(b) (real estate lending activities specifically). Thus, by virtue of regulations in existence prior to the proposal, the proposed changes to part 34, including the new anti-predatory lending standard, applied to both national banks and their operating subsidiaries.

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[2] 12 CFR part 227.

[3] Prior 12 CFR 34.1(b) and 34.4(a).

[4] 12 CFR 560.2.

[5] 15 U.S.C. 1601 *et seq.*

[6] 15 U.S.C. 1691 *et seq.*

[7] Federal law may explicitly resolve the question of whether state laws apply to the activities of national banks. There are instances where Federal law specifically incorporates state law standards, such as the fiduciary powers statute at 12 U.S.C. 92a(a). The language used in this final rule ''[e]xcept where made applicable by Federal law'' refers to this type of situation.

[8] See OCC Advisory Letter 2003–2, ''Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices'' (Feb. 21, 2003) and OCC Advisory Letter 2003–3, ''Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans'' (Feb. 21, 2003). These documents are available on the OCC's Web site at *http://www.occ.treas.gov/advlst03.htm.*

[9] 15 U.S.C. 45(a)(1).

[10] There is an existing network of Federal laws applicable to national banks that protect consumers in a variety of ways. In addition to TILA and ECOA, national banks are also subject to the standards contained in the Real Estate Settlement Procedures Act, 12 U.S.C. 2601 *et seq.*, the Fair Housing Act, 42 U.S.C. 3601 *et seq.*, the Home Mortgage Disclosure Act, 12 U.S.C. 2801 *et seq.*, the Fair Credit Reporting Act, 15 U.S.C. 1681 *et seq.*, the Truth in Savings Act, 12 U.S.C. 4301 *et seq.*, the Consumer Leasing Act, 15 U.S.C. 1667, and the Fair Debt Collection Practices Act, 15 U.S.C. 1692 *et seq.*

B. Proposed Amendments to Part 7—Deposit-Taking, Other Lending, and Bank Operations

The proposal also added three new sections to part 7: § 7.4007 regarding deposit-taking activities, § 7.4008 regarding non-real estate lending activities, and § 7.4009 regarding other national bank operations. The structure of the proposed amendments was the same for §§ 7.4007 and 7.4008 and was similar for § 7.4009. For §§ 7.4007 and 7.4008, the proposal first set out a statement of the authority to engage in the activity. Second, the proposal stated that state laws that obstruct, in whole or in part, a national bank's exercise of the Federally-authorized power in question are not applicable, and listed several types of state laws that are preempted. As with the list of preempted state laws set forth in the proposed amendments to part 34, this list reflects judicial precedents and OCC interpretations concerning the types of state laws that can obstruct the exercise of national banks' deposit-taking and non-real estate lending powers. Finally, the proposal listed several types of state laws that, as a general matter, are not preempted.

As with the proposed amendments to part 34, the proposed amendment to part 7 governing non-real estate lending included a safety and soundness-based anti-predatory lending standard. As proposed, § 7.4008(b) stated that a national bank shall not make a loan described in § 7.4008 based predominantly on the foreclosure value of the borrower's collateral, rather than on the borrower's repayment ability, including current and expected income, current obligations, employment status, and other relevant financial resources. The preamble to the NPRM pointed out that non-real estate lending also is subject to section 5 of the FTC Act.

For proposed § 7.4009, as with proposed §§ 7.4007 and 7.4008, the NPRM first stated that a national bank could exercise all powers authorized to it under Federal law. To address questions about the extent to which state law may permissibly govern powers or activities that have not been addressed by Federal court precedents or OCC opinions or orders, proposed new § 7.4009(b) provided that state laws do not apply to national banks if they obstruct, in whole or in part, a national bank's exercise of powers granted to it under Federal law. Next, proposed § 7.4009(c) noted that the provisions of this section apply to any national bank power or aspect of a national bank's operation that is not otherwise covered by another OCC regulation that specifically addresses the applicability of state law. Finally, the proposal listed several types of state laws that, as a general matter, are not preempted.

As with the proposed changes to part 34, and for the same reasons, the proposal's changes to part 7 would be applicable to both national banks and their operating subsidiaries by virtue of an existing OCC regulation.

III. Overview of Comments

The OCC received approximately 2,600 comments, most of which came from the following groups:

Realtors. The vast majority—approximately 85%—of the opposing comments came from realtors and others representing the real estate industry, who expressed identical concerns about the possibility that national banks' *financial subsidiaries* would be permitted to engage in real estate brokerage activities [11] and that, if that power were authorized, the proposal would permit them to do so without complying with state real estate brokerage licensing laws. This final rule will not have that result because it does not apply to the activities of national bank financial subsidiaries. Thus, should the Department of the Treasury (Treasury) and the Board of Governors of the Federal Reserve System (Board) proposal to permit financial subsidiaries and financial holding companies to engage in real estate brokerage activities go forward, this final rule would not affect the application of state real estate licensing requirements to national bank financial subsidiaries.

Many realtor comments also raised arguments concerning the impact of this rulemaking on consumers and market competition and some argued that preemption of state licensing requirements related to real estate *lending* is inappropriate on the basis of field or conflict preemption. These issues also were raised by other commenters and are addressed in sections IV and VI of this preamble.

Community and consumer advocates. In addition to the comments from realtors, the OCC received opposing comments from community and consumer advocates. These commenters argued that the OCC should not adopt further regulations preempting state law and, in particular, should not adopt in the final rule an ''occupation of the field'' preemption standard for national banks' real estate lending activities. The community and consumer advocates also asserted that the proposed ''obstruct, in whole or in part'' preemption standard is inconsistent with, and a lowering of, the preemption standards articulated by the U.S. Supreme Court. Whatever the standard, the community and consumer advocates expressed concern that preemption would allow national banks to escape some state tort, contract, debt collection, zoning, property transfer, and criminal laws, and would expose consumers to wide-spread predatory and abusive practices by national banks. These commenters asserted that the OCC's proposed anti-predatory lending standard is insufficient and urged the OCC to further strengthen consumer protections in parts 7 and 34, including prohibiting specific practices characterized as unfair or deceptive. These issues are addressed in sections IV and VI of this preamble.

State officials and members of Congress. State banking regulators, the Conference of State Bank Supervisors (CSBS), the National Conference of State Legislators, individual state legislators, the National Association of Attorneys General (NAAG), and individual state attorneys general questioned the legal basis of the proposal and argued that the OCC lacks authority to adopt it. These commenters, like the community and consumer advocates, also challenged the OCC's authority to adopt in the final rule either a ''field occupation'' preemption standard or the proposed ''obstruct, in whole or in part'' standard. These commenters raised concerns about the effect of the proposal, if adopted, on the dual banking system, and its impact on what they assert is the states' authority to apply and enforce consumer protection laws against national banks, and particularly against operating subsidiaries. Several members of Congress submitted comments, or forwarded letters from constituents and state officials, that echoed these concerns. The arguments concerning the dual banking system are addressed in the discussion of Executive Order 13132 later in this preamble.[12] The remaining issues raised by the state commenters are addressed in sections IV and VI of this preamble.[13]

[11] Pursuant to procedures established by the Gramm-Leach-Bliley Act, Pub. L. 106–102, 113 Stat. 1338 (Nov. 12, 1999), for determining that an activity is ''financial in nature,'' and thus permissible for financial holding companies and financial subsidiaries, the Board and Treasury jointly published a proposal to determine that real estate brokerage is ''financial in nature.'' *See* 66 FR 307 (Jan. 3, 2001). No final action has been taken on the proposal.

[12] *See also* OCC publication entitled *National Banks and the Dual Banking System* (Sept. 2003).

[13] *See also* Letter from John D. Hawke, Jr., Comptroller of the Currency, to Senator Paul S. Sarbanes (Dec. 9, 2003), available on the OCC's Web site at *http://www.occ.treas.gov/foia/SarbanesPreemptionletter.pdf*; and identical letters sent to nine other Senators; and Letters from John

National banks and banking industry trade groups. National banks, other financial institutions, and industry groups supported the proposal. Many of these commenters argued that Congress has occupied the fields of deposit-taking and lending in the context of national banks and urged the OCC to adopt a final rule reflecting an extensive occupation of the field approach. These commenters concluded that various provisions of the National Bank Act establish broad statutory authority for the activities and regulation of national banks, and that these provisions suggest strongly that Congress did in fact intend to occupy the fields in question. In addition to these express grants of authority, the commenters noted that national banks may, under 12 U.S.C. 24(Seventh), ''exercise * * * all such incidental powers as shall be necessary to carry on the business of banking,'' and that this provision has been broadly construed by the Supreme Court.[14] These commenters concluded that this broad grant of Federal powers, coupled with equally broad grants of rulemaking authority to the OCC,[15] effectively occupy the field of national bank regulation.

Many of the supporting commenters also urged the adoption of the proposal for the reasons set forth in its preamble. These commenters agreed with the OCC's assertion in the preamble that banks with customers in more than one state ''face uncertain compliance risks and substantial additional compliance burdens and expense that, for practical purposes, materially impact their ability to offer particular products and services.'' [16] The commenters stated that, in effect, a national bank must often craft different products or services (with associated procedures and policies, and their attendant additional costs) for each state in which it does business, or elect not to provide all of its products or services (to the detriment of consumers) in one or more states. These commenters believe that the proposal, if adopted, would offer much-needed clarification of when state law does or does not apply to the activities of a national bank and its operating subsidiaries. Such clarity, these commenters argued, is critical to helping national banks maintain and expand provision of financial services. Without such clarity, these commenters assert, the burdens and costs, and uncertain liabilities arising under a myriad of state and local laws, are a significant diversion of the resources that national banks otherwise can use to provide services to customers nationwide, and a significant deterrent to their willingness and ability to offer certain products and services in certain markets. These issues are addressed in sections IV and VI of this preamble.

IV. Reason and Authority for the Regulations

A. The Regulations Are Issued in Furtherance of the OCC's Responsibility To Ensure That the National Banking System Is Able To Operate As Authorized by Congress

As the courts have recognized, Federal law authorizes the OCC to issue rules that preempt state law in furtherance of our responsibility to ensure that national banks are able to operate to the full extent authorized under Federal law, notwithstanding inconsistent state restrictions, and in furtherance of their safe and sound operations.

Federal law is the exclusive source of all of national banks' powers and authorities. Key to these powers is the clause set forth at 12 U.S.C. 24(Seventh) that permits national banks to exercise ''all such incidental powers as shall be necessary to carry on the business of banking.'' This flexible grant of authority furthers Congress's long-range goals in establishing the national banking system, including financing commerce, establishing private depositories, and generally supporting economic growth and development nationwide. [17] The achievement of these goals required national banks that are safe and sound and whose powers are dynamic and capable of evolving so that they can perform their intended roles. The broad grant of authority provided by 12 U.S.C. 24(Seventh), as well as the more targeted grants of authority provided by other statutes,[18] enable national banks to evolve their operations in order to meet the changing needs of our economy and individual consumers.[19]

The OCC is charged with the fundamental responsibility of ensuring that national banks operate on a safe and sound basis, and that they are able to do so, if they choose, to the full extent of their powers under Federal law. This responsibility includes enabling the national banking system to operate as authorized by Congress, consistent with the essential character of a national banking system and without undue confinement of their powers. Federal law gives the OCC broad rulemaking authority in order to fulfill these responsibilities. Under 12 U.S.C. 93a, the OCC is authorized ''to prescribe rules and regulations to carry out the responsibilities of the office'' [20] and, under 12 U.S.C. 371, to ''prescribe by regulation or order'' the ''restrictions and requirements'' on national banks'' real estate lending power without state-imposed conditions.[21]

In recent years, the financial services marketplace has undergone profound changes. Markets for credit (both consumer and commercial), deposits, and many other financial products and services are now national, if not international, in scope. These changes are the result of a combination of factors, including technological innovations, the erosion of legal barriers, and an increasingly mobile society.

Technology has expanded the potential availability of credit and made possible virtually instantaneous credit decisions. Mortgage financing that once took weeks, for example, now can take only hours. Consumer credit can be obtained at the point of sale at retailers and even when buying a major item such as a car. Consumers can shop for investment products and deposits on-line. With respect to deposits, they can compare rates and duration of a variety of deposit products offered by financial institutions located far from where the consumer resides.

Changes in applicable law also have contributed to the expansion of markets for national banks and their operating subsidiaries. These changes have affected both the type of products that may be offered and the geographic region in which banks—large and small—may conduct business. As a result of these changes, banks may branch across state lines and offer a broader array of products than ever before. An even wider range of

D. Hawke, Jr., Comptroller of the Currency, to Representatives Sue Kelly, Peter King, Carolyn B. Maloney, and Carolyn McCarthy (Dec. 23, 2003).

[14] *See, e.g., Nationsbank of North Carolina, N.A. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251, 258 n.2 (1995) (VALIC).

[15] *See, e.g.*, 12 U.S.C. 93a.

[16] 68 FR 46119, 46120.

[17] For a more detailed discussion of Congress's purposes in establishing a national banking system that would operate to achieve these goals distinctly and separately from the existing system of state banks, *see* the preamble to the proposal, 68 FR 46119, 46120, and *National Banks and the Dual Banking System, supra* note 12.

[18] *See, e.g.*, 12 U.S.C. 92a (authorizing national banks to engage in fiduciary activities) and 371 (authorizing national banks to engage in real estate lending activities).

[19] The Supreme Court expressly affirmed the dynamic, evolutionary character of national bank powers in *VALIC*, in which it held that the ''business of banking'' is not limited to the powers enumerated in 12 U.S.C. 24(Seventh) and that the OCC has the discretion to authorize activities beyond those specifically enumerated in the statute. *See* 513 U.S. at 258 n.2.

[20] 12 U.S.C. 93a.

[21] 12 U.S.C. 371(a).

customers can be reached through the use of technology, including the Internet. Community national banks, as well as the largest national banks, use new technologies to expand their reach and service to customers.

Our modern society is also highly mobile. Forty million Americans move annually, according to a recent Congressional report issued in connection with enactment of the Fair and Accurate Credit Transactions Act of 2003.[22] And when they move, they often have the desire, if not the expectation, that the financial relationships and status they have established will be portable and will remain consistent.

These developments highlight the significance of being able to conduct a banking business pursuant to consistent, national standards, regardless of the location of a customer when he or she first becomes a bank customer or the location to which the customer may move *after* becoming a bank customer. They also accentuate the costs and interference that diverse and potentially conflicting state and local laws have on the ability of national banks to operate under the powers of their Federal charter. For national banks, moreover, the ability to operate under uniform standards of operation and supervision is fundamental to the character of their national charter.[23] When national banks are unable to operate under national standards, it also implicates the role and responsibilities of the OCC.

These concerns have been exacerbated recently, by increasing efforts by states and localities to apply state and local laws to bank activities. As we have learned from our experience supervising national banks, from the inquiries received by the OCC's Law Department, by the extent of litigation in recent years over these state efforts, and by the comments we received on the proposal, national banks' ability to conduct operations to the full extent authorized by Federal law has been curtailed as a result.

Commenters noted that the variety of state and local laws that have been enacted in recent years—including laws regulating fees, disclosures, conditions on lending, and licensing—have created higher costs and increased operational challenges.[24] Other commenters noted the proliferation of state and local anti-predatory lending laws and the impact that those laws are having on lending in the affected jurisdictions. As a result, national banks must either absorb the costs, pass the costs on to consumers, or eliminate various products from jurisdictions where the costs are prohibitive. Commenters noted that this result is reached even in situations where a bank concludes that a law is preempted, simply so that the bank may avoid litigation costs or anticipated reputational injury.

As previously noted, the elimination of legal and other barriers to interstate banking and interstate financial service operations has led a number of banking organizations to operate, in multi-state metropolitan statistical areas, and on a multi-state or nationwide basis, exacerbating the impact of the overlay of state and local standards and requirements on top of the Federal standards and OCC supervisory requirements already applicable to national bank operations. When these multi-jurisdictional banking organizations are subject to regulation by each individual state or municipality in which they conduct operations, the problems noted earlier are compounded.

Even the efforts of a single state to regulate the operations of a national bank operating only within that state can have a detrimental effect on that bank's operations and consumers. As we explained in our recent preemption determination and order responding to National City Bank's inquiry concerning the Georgia Fair Lending Act (GFLA),[25] the GFLA caused secondary market participants to cease purchasing certain Georgia mortgages and many mortgage lenders to stop making mortgage loans in Georgia. National banks have also been forced to withdraw from some products and markets in other states as a result of the impact of state and local restrictions on their activities.

When national banks are unable to operate under uniform, consistent, and predictable standards, their business suffers, which negatively affects their safety and soundness. The application of multiple, often unpredictable, different state or local restrictions and requirements prevents them from operating in the manner authorized under Federal law, is costly and burdensome, interferes with their ability to plan their business and manage their risks, and subjects them to uncertain liabilities and potential exposure. In some cases, this deters them from making certain products available in certain jurisdictions.[26]

The OCC therefore is issuing this final rule in furtherance of its responsibility to enable national banks to operate to the full extent of their powers under Federal law, without interference from inconsistent state laws, consistent with the national character of the national banking system, and in furtherance of their safe and sound operations. The final rule does not entail any new powers for national banks or any expansion of their existing powers. Rather, we intend only to ensure the soundness and efficiency of national banks' operations by making clear the standards under which they do business.

B. Pursuant to 12 U.S.C. 93a and 371, the OCC May Adopt Regulations That Preempt State Law

The OCC has ample authority to provide, by regulation, that types of state laws are not applicable to national banks. As mentioned earlier, 12 U.S.C. 93a grants the OCC comprehensive rulemaking authority to further its responsibilities, stating that—

> Except to the extent that authority to issue such rules and regulations has been expressly and exclusively granted to another regulatory agency, the Comptroller of the Currency is authorized to prescribe rules and regulations to carry out the responsibilities of the office * * *.[27]

This language is significantly broader than that customarily used to convey rulemaking authority to an agency, which is typically focused on a particular statute. This was recognized, some 20 years ago, by the United States Court of Appeals for the D.C. Circuit in

[22] *See* S. Rep. No. 108–166, at 10 (2003) (quoting the hearing testimony of Secretary of the Treasury Snow).

[23] As we explained last year in the preamble to our amendments to part 7 concerning national banks' electronic activities, ''freedom from State control over a national bank's powers protects national banks from conflicting local laws unrelated to the purpose of providing the uniform, nationwide banking system that Congress intended.'' 67 FR 34992, 34997 (May 17, 2002).

[24] Illustrative of comments along these lines were those of banks who noted that various state laws would result in the following costs: (a) Approximately $44 million in start-up costs incurred by 6 banks as a result of a recently-enacted California law mandating a minimum payment warning; (b) 250 programming days required to change one of several computer systems that needed to be changed to comply with anti-predatory lending laws enacted in three states and the District of Columbia; and (c) $7.1 million in costs a bank would incur as a result of complying with mandated annual statements to credit card customers.

[25] *See* 68 FR 46264 (Aug. 5, 2003).

[26] As was recently observed by Federal Reserve Board Chairman Alan Greenspan (in the context of amendments to the Fair Credit Reporting Act), ''[l]imits on the flow of information among financial market participants, or increased costs resulting from restrictions that differ based on geography, may lead to an increase in the price or a reduction in the availability of credit, as well as a reduction in the optimal sharing of risk and reward.'' Letter of February 28, 2003, from Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, to The Honorable Ruben Hinojosa (emphasis added).

[27] 12 U.S.C. 93a.

its decision confirming that 12 U.S.C. 93a authorizes the OCC to issue regulations preempting state law. In *Conference of State Bank Supervisors* v. *Conover,*[28] the Conference of State Bank Supervisors (CSBS) sought to overturn a district court decision upholding OCC regulations that provided flexibility regarding the terms on which national banks may make or purchase adjustable rate mortgages (ARMs) and that preempted inconsistent state laws. The regulations provided generally that national banks may make or purchase ARMs without regard to state law limitations. The district court granted the OCC's motion for summary judgment on the ground that the regulations were within the scope of the OCC's rulemaking powers granted by Congress.

On appeal, the CSBS asserted that 12 U.S.C. 93a grants the OCC authority to issue only ''housekeeping'' procedural regulations. In support of this argument, the CSBS cited a remark from the legislative history of 12 U.S.C. 93a by Senator Proxmire that 12 U.S.C. 93a ''carries with it no new authority to confer on national banks powers which they do not have under existing law.'' CSBS also cited a statement in the conference report that 12 U.S.C. 93a ''carries no authority [enabling the Comptroller] to permit otherwise impermissible activities *of national banks* with specific reference to the provisions of the McFadden Act and the Glass-Steagall Act.'' [29]

The Court of Appeals rejected the CSBS's contentions concerning the proper interpretation of 12 U.S.C. 93a. The Court of Appeals explained first that the challenged regulations (like this final rule) did not confer any new powers on national banks. Moreover,

> [t]hat the Comptroller also saw fit to preempt those state laws that conflict with his responsibility to ensure the safety and soundness of the national banking system, *see* 12 U.S.C. § 481, does not constitute an expansion of the powers of national *banks.*[30]

Nor did the Court of Appeals find support for the CSBS's position in the conference report:

> As the ''specific reference'' to the McFadden and Glass-Steagall Acts indicates, the ''impermissible activities'' which the Comptroller is not empowered to permit are activities that are impermissible under federal, not state, law.[31]

The court summarized its rationale for holding that 12 U.S.C. 93a authorized the OCC to issue the challenged regulations by saying:

> It bears repeating that the entire legislative scheme is one that contemplates the operation of state law only in the absence of federal law and where such state law does not conflict with the policies of the National Banking Act. *So long as he does not authorize activities that run afoul of federal laws governing the activities of the national banks, therefore, the Comptroller has the power to preempt inconsistent state laws.*[32]

The authority under 12 U.S.C. 93a described by the court in *CSBS* v. *Conover* thus amply supports the adoption of regulations providing that specified types of state laws purporting to govern as applied to national banks' lending and deposit-taking activities are preempted.

Under 12 U.S.C. 371, the OCC has the additional and specific authority to provide that the specified types of laws relating to national banks' real estate lending activities are preempted. As we have described and as recognized in *CSBS* v. *Conover*,[33] 12 U.S.C. 371 grants the OCC unique rulemaking authority with regard to national banks' real estate lending activities. That section states:

> [a]ny national banking association may make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real estate, subject to section 1828(o) of this title and such restrictions and requirements as the Comptroller of the Currency may prescribe by regulation or order.[34]

The language and history of 12 U.S.C. 371 confirm the real estate lending powers of national banks and that only the OCC ''subject to other applicable Federal law ''and not the states may impose restrictions or requirements on national banks' exercise of those powers. The Federal powers conferred by 12 U.S.C. 371 are subject *only* ''to section 1828(o) of this title and such restrictions and requirements as the Comptroller of the Currency may prescribe by regulation or order.'' [35] Thus, the exercise of the powers granted by 12 U.S.C. 371 is not conditioned on compliance with any state requirement, and state laws that attempt to confine or restrain national banks' real estate lending activities are inconsistent with national banks' real estate lending powers under 12 U.S.C. 371.

This conclusion is consistent with the fact that national bank real estate lending authority has been extensively regulated at the *Federal* level since the power first was codified. Beginning with the enactment of the Federal Reserve Act of 1913,[36] national banks' real estate lending authority has been governed by the express terms of 12 U.S.C. 371. As originally enacted in 1913, section 371 contained a limited grant of authority to national banks to lend on the security of ''improved and unencumbered farm land, situated within its Federal reserve district.'' [37] In addition to the geographic limits inherent in this authorization, the Federal Reserve Act also imposed limits on the term and amount of each loan as well as an aggregate lending limit. Over the years, 12 U.S.C. 371 was repeatedly amended to broaden the types of real estate loans national banks were permitted to make, to expand geographic limits, and to modify loan term limits and per-loan and aggregate lending limits.

In 1982, Congress removed these ''rigid statutory limitations'' [38] in favor of a broad provision that is very similar to the current law and that authorized national banks to ''make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real estate, subject to such terms, conditions, and limitations as may be prescribed by the Comptroller of the Currency by order, rule, or regulation.'' [39] The purpose of the 1982 amendment was ''to provide national banks with the ability to engage in more creative and flexible financing, and to become stronger participants in the home financing market.'' [40] In 1991, Congress removed the term ''rule'' from this phrase and enacted an additional requirement, codified at 12 U.S.C.

[28] 710 F.2d 878 (D.C. Cir. 1983).

[29] *Id.* at 885 (emphasis in original).

[30] *Id.* (emphasis in original).

[31] *Id.*

[32] *Id.* at 878 (emphasis added).

[33] In *CSBS* v. *Conover,* the court also held that the authority conferred by 12 U.S.C. 371, as the statute read at the time relevant to the court's decision, conferred authority upon the OCC to issue the preemptive regulations challenged in that case. The version of section 371 considered by the court authorized national banks to make real estate loans ''subject to such terms, conditions, and limitations'' as prescribed by the Comptroller by order, rule or regulations. The court said that the ''restrictions and requirements'' language contained in the statute today was ''not substantially different'' from the language that it was considering in that case. *Id.* at 884.

[34] 12 U.S.C. 371(a).

[35] *Id.* As noted *supra* at note 7, Federal legislation occasionally provides that national banks shall conduct certain activities subject to state law standards. For example, national banks conduct insurance sales, solicitation, and cross-marketing activities subject to certain types of state restrictions expressly set out in the Gramm-Leach-Bliley Act. See 15 U.S.C. 6701(d)(2)(B). There is no similar Federal legislation subjecting national banks' real estate lending activities to state law standards.

[36] Federal Reserve Act, Dec. 23, 1913, ch. 6, 38 Stat. 251, as amended.

[37] *Id.* section 24, 38 Stat. 273.

[38] S. Rep. No. 97–536, at 27 (1982).

[39] Garn-St Germain Depository Institutions Act of 1982, Pub. L. 97–320, section 403, 96 Stat. 1469, 1510–11 (1982).

[40] S. Rep. No. 97–536, at 27 (1982).

1828(o), that national banks (and other insured depository institutions) conduct real estate lending pursuant to uniform standards adopted at the Federal level by regulation of the OCC and the other Federal banking agencies.[41]

Thus, the history of national banks' real estate lending activities under 12 U.S.C. 371 is one of extensive Congressional involvement gradually giving way to a streamlined approach in which Congress has delegated broad rulemaking authority to the Comptroller. The two versions of 12 U.S.C. 371—namely, the lengthy and prescriptive approach prior to 1982 and the more recent statement of broad authority qualified only by reference to Federal law —may be seen as evolving articulations of the same idea.

C. The Preemption Standard Applied in This Final Rule Is Entirely Consistent With the Standards Articulated by the Supreme Court

State laws are preempted by Federal law, and thus rendered invalid with respect to national banks, by operation of the Supremacy Clause of the U.S. Constitution.[42] The Supreme Court has identified three ways in which this may occur. First, Congress can adopt express language setting forth the existence and scope of preemption.[43] Second, Congress can adopt a framework for regulation that ''occupies the field'' and leaves no room for states to adopt supplemental laws.[44] Third, preemption may be found when state law actually conflicts with Federal law. Conflict will be found when either: (i) compliance with both laws is a ''physical impossibility;'' [45] or (ii) when the state law stands ''as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'' [46]

In *Barnett Bank of Marion County* v. *Nelson,*[47] the Supreme Court articulated preemption standards used by the Supreme Court in the national bank context to determine, under the Supremacy Clause of the U.S. Constitution, whether Federal law conflicts with state law such that the state law is preempted. As observed by the Supreme Court in *Barnett,* a state law will be preempted if it conflicts with the exercise of a national bank's Federally authorized powers.

The Supreme Court noted in *Barnett* the many formulations of the conflicts standard. The Court stated:

In defining the pre-emptive scope of statutes and regulations granting a power to national banks, these cases take the view that normally Congress would not want States to forbid, or impair significantly, the exercise of a power that Congress explicitly granted. To say this is not to deprive States of the power to regulate national banks, where (unlike here) doing so does not prevent or significantly interfere with the national bank's exercise of its powers. See, *e.g., Anderson Nat. Bank* v. *Luckett,* 321 U.S. 233, 247–252 (1944) (state statute administering abandoned deposit accounts did not ''unlawful[ly] encroac[h] on the rights and privileges of national banks''); *McClellan* v. *Chipman,* 164 U.S. 347, 358 (1896) (application to national banks of state statute forbidding certain real estate transfers by insolvent transferees would not ''destro[y] or hampe[r]'' national banks'' functions); *National Bank* v. *Commonwealth*, 76 U.S. (9 Wall.) 353, 362 (1869) (national banks subject to state law that does not ''interfere with, or impair [national banks'] efficiency in performing the functions by which they are designed to serve [the Federal] Government'').[48]

The variety of formulations quoted by the Court—''unlawfully encroach,'' ''hamper,'' ''interfere with or impair national banks' efficiency''—defeats any suggestion that any one phrase constitutes the exclusive standard for preemption. As the Supreme Court explained in *Hines* v. *Davidowitz:*[49]

There is not—and from the very nature of the problem there cannot be—any rigid formula or rule which can be used as a universal pattern to determine the meaning and purpose of every act of Congress. This Court, in considering the validity of state laws in the light of treaties or federal laws touching the same subject, has made use of the following expressions: conflicting; contrary to; occupying the field; repugnance; difference; irreconcilability; inconsistency; violation; curtailment; and interference. *But none of these expressions provides an infallible constitutional test or an exclusive constitutional yardstick. In the final analysis, there can be no one crystal clear distinctly marked formula.* Our primary function is to determine whether, under the circumstances of this particular case, [the state law at issue] stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.[50]

Thus, in *Hines*, the Court recognized that the Supremacy Clause principles of preemption can be articulated in a wide variety of formulations that do not yield substantively different legal results. The variation among formulations that carry different linguistic connotations does not produce different legal outcomes.

We have adopted in this final rule a statement of preemption principles that is consistent with the various formulations noted earlier. The phrasing used in the final rule—obstruct,[51] impair,[52] or condition [53]''—differs somewhat from what we proposed. This standard conveys the same substantive point as the proposed standard, however; that is, that state laws do not apply to national banks if they impermissibly contain a bank's exercise of a federally authorized power. The words of the final rule, which are drawn directly from applicable Supreme Court precedents, better convey the range of effects on national bank powers that the Court has found to be impermissible. The OCC intends this phrase as the distillation of the various preemption constructs articulated by the Supreme Court, as recognized in *Hines* and *Barnett,* and not as a replacement construct that is in any way inconsistent with those standards.

In describing the proposal, we invited comment on whether it would be appropriate to assert occupation of the entire field of real estate lending. Some commenters strongly urged that we do so, and that we go beyond real estate lending to cover other lending and deposit-taking activities as well. Upon further consideration of this issue and

[41] *See* section 304 of the Federal Deposit Insurance Corporation Improvement Act, codified at 12 U.S.C. 1828(o). These standards governing national banks' real estate lending are set forth in Subpart D of 12 CFR part 34.

[42] ''This Constitution, and the Laws of the United States which shall be made in Pursuance thereof * * * shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.'' U.S. Const. art. VI, cl. 2.

[43] *See Jones* v. *Rath Packing Co.,* 430 U.S. 519, 525 (1977).

[44] *See Rice* v. *Santa Fe Elevator Corp.,* 331 U.S. 218, 230 (1947).

[45] *Florida Lime & Avocado Growers, Inc.* v. *Paul,* 373 U.S. 132, 143 (1963).

[46] *Hines* v. *Davidowitz,* 312 U.S. 52, 67 (1941); *Barnett Bank of Marion County, N.A.* v. *Nelson,* 517 U.S. 25, 31 (1996) (quoting *Hines*).

[47] 517 U.S. 25 (1996).

[48] *Id.* at 33–34. Certain commenters cite *Nat'l Bank* v. *Commonwealth* for the proposition that national banks are subject to state law. These commenters, however, omit the important caveat, quoted by the *Barnett* Court, that state law applies only where it does not ''interfere with, or impair [national banks'] efficiency in performing the functions by which they are designed to serve [the Federal] Government.''

[49] 312 U.S. 52 (1941).

[50] *Id.* at 67 (emphasis added) (citations omitted).

[51] *See Hines,* 312 U.S. at 76.

[52] *See Nat'l Bank* v. *Commonwealth,* 76 U.S. at 362; *Davis* v. *Elmira Savings Bank,* 161 U.S. 275, 283 (1896); McClellan, 164 U.S. at 357.

[53] *See Barnett,* 517 U.S. at 34; *Franklin Nat'l Bank of Franklin Square* v. *New York,* 347 U.S. 373, 375–79 (1954).

careful review of comments submitted pertaining to this point, we have concluded, as the Supreme Court recognized in *Hines* and reaffirmed in *Barnett,* that the effect of labeling of this nature is largely immaterial in the present circumstances. Thus, we decline to adopt the suggestion of these commenters that we declare that these regulations ''occupy the field'' of national banks' real estate lending, other lending, and deposit-taking activities. We rely on our authority under both 12 U.S.C. 93a and 371, and to the extent that an issue arises concerning the application of a state law not specifically addressed in the final regulation, we retain the ability to address those questions through interpretation of the regulation, issuance of orders pursuant to our authority under 12 U.S.C. 371, or, if warranted by the significance of the issue, by rulemaking to amend the regulation.

V. Description of the Final Rule

A. Amendments to Part 34

1. Section 34.3(a). The final rule retains the statement of national banks' real estate lending authority, now designated as § 34.3(a), that national banks may ''make, arrange, purchase, or sell loans or extensions of credit, or interests therein, that are secured by liens on, or interests in, real estate (real estate loans), subject to 12 U.S.C. 1828(o) and such restrictions and requirements as the Comptroller of the Currency may prescribe by regulation or order.''

2. Section 34.3(b). New § 34.3(b) adds an explicit safety and soundness-derived anti-predatory lending standard to the general statement of authority concerning lending. Many bank commenters voiced concern that the proposed anti-predatory lending standard, by prohibiting a national bank from making a loan based predominantly on the foreclosure value of a borrower's collateral without regard to the borrower's repayment ability, would also prohibit a national bank from engaging in legitimate, non-predatory lending activities. These commenters noted that reverse mortgage, small business, and high net worth loans are often made based on the value of the collateral.

We have revised the anti-predatory lending standard in the final rule to clarify that it applies to consumer loans only, (*i.e.*, loans for personal, family, or household purposes), and to clarify that it is intended to prevent borrowers from being unwittingly placed in a situation where repayment is unlikely without the lender seizing the collateral. Where the bargain agreed to by a borrower and a lender involves an understanding by the borrower that it is likely or expected that the collateral will be used to repay the debt, such as with a reverse mortgage, it clearly is not objectionable that the collateral will then be used in such a manner. Moreover, the final rule's anti-predatory lending standard is not intended to apply to business lending or to situations where a borrower's net worth would support the loan under customary underwriting standards.

Thus, we have revised the anti-predatory lending standard so that it focuses on consumer loans and permits a national bank to use a variety of reasonable methods to determine a borrower's ability to repay, including, for example, the borrower's current and expected income, current and expected cash flows, net worth, other relevant financial resources, current financial obligations, employment status, credit history, or other relevant factors.

Several commenters urged the OCC to expressly affirm that a national bank's lending practices must be conducted in conformance with section 5 of the FTC Act, which makes unlawful ''unfair or deceptive acts or practices'' in interstate commerce,[54] and regulations promulgated thereunder. As discussed in more detail in section VI of this preamble, the OCC has taken actions against national banks under the FTC Act where the OCC believed they were engaged in unfair or deceptive practices. As demonstrated by these actions, the OCC recognizes the importance of national banks and their operating subsidiaries acting in conformance with the standards contained in section 5 of the FTC Act. We therefore agree that an express reference to those standards in our regulation would be appropriate and have added it to the final rules.[55]

3. *State laws that are preempted (§ 34.4(a)).* Pursuant to 12 U.S.C. 93a and 371, the final rule amends § 34.4(a) to add to the existing regulatory list of types of state law restrictions and requirements that are not applicable to national banks. This list, promulgated under our authority ''to prescribe rules and regulations to carry out the responsibilities of the office'' and to prescribe the types of restrictions and requirements to which national banks' real estate lending activities shall be subject, reflects our experience with types of state laws that can materially affect and confine—and thus are inconsistent with—the exercise of national banks' real estate lending powers.[56]

The final rule revises slightly the introductory clause used in proposed § 34.4(a) in order to conform this section more closely to the amended sections of part 7 discussed later in this preamble. Thus, the final rule provides: ''Except where made applicable by Federal law, state laws that obstruct, impair, or condition a national bank's ability to fully exercise its Federally authorized real estate lending powers do not apply to national banks.'' The final rule then expands the current list of the types of state law restrictions and requirements that are not applicable to national banks.

Many of the supporting commenters requested that the final rule clarify the extent to which particular state or local laws that were not included in the proposal are preempted. For example, these commenters suggested that the final rule address particular state laws imposing various limitations on mortgage underwriting and servicing.

We decline to address most of these suggestions with the level of specificity requested by the commenters. Identifying state laws in a more generic way avoids the impression that the regulations only cover state laws that appear on the list. The list of the types of preempted state laws is not intended to be exhaustive, and we retain the ability to address other types of state laws by order on a case-by-case basis, as appropriate, to make determinations whether they are preempted under the applicable standards.[57]

4. *State laws that are not preempted (§ 34.4(b)).* Section 34.4(b) also provides that certain types of state laws are not preempted and would apply to national banks to the extent that they are consistent with national banks' Federal authority to engage in real estate lending because their effect on the real estate

[54] 15 U.S.C. 45(a)(1).

[55] It is important to note here that we lack the authority to do what some commenters essentially urged, namely, to specify by regulation that particular practices, such as loan ''flipping'' or ''equity stripping,'' are unfair or deceptive. While we have the ability to take enforcement actions against national banks if they engage in unfair or deceptive practices under section 5 of the FTC Act, the OCC does not have rulemaking authority to define specific practices as unfair or deceptive under section 5. *See* 15 U.S.C. 57a(f).

[56] As we noted in our discussion of this list in the preamble to the proposal, the ''OCC and Federal courts have thus far concluded that a wide variety of state laws are preempted, either because the state laws fit within the express preemption provisions of an OCC regulation or because the laws conflict with a Federal power vested in national banks.'' *See* 68 FR 46119, 46122–46123. The list is also substantially identical to the types of laws specified in a comparable regulation of the OTS. See 12 CFR 560.2(b).

[57] *See, e.g.*, OCC Determination and Order concerning the Georgia Fair Lending Act, *supra* footnote 25.

lending operations of national banks is only incidental. These types of laws generally pertain to contracts, rights to collect debts, acquisition and transfer of property, taxation, zoning, crimes, torts,[58] and homestead rights. In addition, any other law the effect of which is incidental to national banks' lending authority or otherwise consistent with national banks' authority to engage in real estate lending would not be preempted.[59] In general, these would be laws that do not attempt to regulate the manner or content of national banks' real estate lending, but that instead form the legal infrastructure that makes it practicable to exercise a permissible Federal power.

One category of state law included in the proposed list of state laws generally not preempted was ''debt collection.'' Consistent with Supreme Court precedents addressing this type of state law,[60] we have revised the language of the final rule to refer to national banks' ''right to collect debts.''

B. Amendments to Part 7—Deposit-Taking, Other Consumer Lending, and National Bank Operations

The final rule adds three new sections to part 7: § 7.4007 regarding deposit-taking activities, § 7.4008 regarding non-real estate lending activities, and § 7.4009 regarding national bank operations. The structure of the amendments is the same for §§ 7.4007 and 7.4008 and is similar for § 7.4009.

For § 7.4007, the final rule first sets out a statement of the authority to engage in the activity. Second, the final rule notes that state laws that obstruct, impair, or condition a national bank's ability to fully exercise the power in question are not applicable, and lists several types of state laws that are preempted. Types of state laws that are generally preempted under § 7.4007 include state requirements concerning abandoned and dormant accounts, checking accounts, disclosure requirements, funds availability, savings account orders of withdrawal, state licensing or registration requirements, and special purpose savings services. Finally, the final rule lists types of state laws that, as a general matter, are not preempted. Examples of these laws include state laws concerning contract, rights to collect debt, tort, zoning, and property transfers. These lists are not intended to be exhaustive, and the OCC retains the ability to address other types of state laws on a case-by-case basis to make preemption determinations under the applicable standards.

For § 7.4008, the final rule also sets out a statement of the authority to engage in the activity (non-real estate lending), notes that state laws that obstruct, impair, or condition a national bank's ability to fully exercise this power are not applicable, and lists several types of state laws that are, or are not, preempted. Section 7.4008 also includes a safety and soundness-based anti-predatory lending standard. Final § 7.4008(b) states that ''[a] national bank shall not make a consumer loan subject to this § 7.4008 based predominantly on the bank's realization of the foreclosure or liquidation value of the borrower's collateral, without regard to the borrower's ability to repay the loan according to its terms. A bank may use any reasonable method to determine a borrower's ability to repay, including, for example, the borrower's current and expected income, current and expected cash flows, net worth, other relevant financial resources, current financial obligations, employment status, credit history, or other relevant factors.'' Separately, § 7.4008(c) also includes a statement that a national bank shall not engage in unfair or deceptive practices within the meaning of section 5 of the FTC Act and regulations promulgated thereunder in connection with making non-real estate related loans. The standards set forth in § 7.4008(b) and (c), plus an array of Federal consumer protection standards,[61] ensure that national banks are subject to consistent and uniform Federal standards, administered and enforced by the OCC, that provide strong and extensive customer protections and appropriate safety and soundness-based criteria for their lending activities.

In § 7.4009, the final rule first states that national banks may exercise all powers authorized to them under Federal law.[62] Second, the final rule states that except as otherwise made applicable by Federal law, state laws that obstruct, impair, or condition a national bank's ability to fully exercise its authorized powers do not apply to the national bank.[63] Finally, the final rule lists several types of state laws that, as a general matter, are *not* preempted. For the reasons outlined earlier in the discussion of the amendments to 12 CFR part 34, the reference to debt collection laws has been revised to refer to state laws concerning national banks' ''rights to collect debts.''

The OCC's regulations adopted in this final rule address the applicability of state law with respect to a number of specific types of activities. The question may persist, however, about the extent to which state law may permissibly govern powers or activities that have not been addressed by Federal court precedents or OCC opinions or orders. Accordingly, as noted earlier, new § 7.4009 provides that state laws do not apply to national banks if they obstruct, impair, or condition a national bank's ability to fully exercise the powers authorized to it under Federal law, including the content of those activities and the manner in which and standards whereby they are conducted.

As explained previously, in some circumstances, of course, Federal law directs the application of state standards to a national bank. The wording of § 7.4009 reflects that a Federal statute may require the application of state

[58] *See Bank of America* v. *City & County of San Francisco,* 309 F.3d 551, 559 (9th Cir. 2002).

[59] The label a state attaches to its laws will not affect the analysis of whether that law is preempted. For instance, laws related to the transfer of real property may contain provisions that give borrowers the right to ''cure'' a default upon acceleration of a loan if the lender has not foreclosed on the property securing the loan. Viewed one way, this could be seen as part of the state laws governing foreclosure, which historically have been within a state's purview. However, as we concluded in the OCC Determination and Order concerning the GFLA, to the extent that this type of law limits the ability of a national bank to adjust the terms of a particular class of loans once there has been a default, it would be a state law limitation ''concerning * * * (2) The schedule for the repayment of principal and interest; [or] (3) The term to maturity of the loan * * *'' 12 CFR 34.4(a). In such a situation, we would be governed by the effect of the state statute.

[60] *See, e.g., Nat'l Bank* v. *Commonwealth,* 76 U.S. at 362 (national banks ''are subject to the laws of the State, and are governed in their daily course of business far more by the laws of the State than of the nation. All their contracts are governed and construed by State laws. Their acquisition and transfer of property, *their right to collect their debts*, and their liability to be sued for debts, are all based on State law.'') (emphasis added); *see also McClellan*, 164 U.S. at 356–57 (quoting *Nat'l Bank* v. *Commonwealth).*

[61] *See supra* note 10.

[62] As noted in the proposal, the OTS has issued a regulation providing generally that state laws purporting to address the operations of Federal savings associations are preempted. *See* 12 CFR 545.2. The extent of Federal regulation and supervision of Federal savings associations under the Home Owners' Loan Act is substantially the same as for national banks under the national banking laws, a fact that warrants similar conclusions about the applicability of state laws to the conduct of the Federally authorized activities of both types of entities. *Compare, e.g.*, 12 U.S.C. 1464(a) (OTS authorities with respect to the organization, incorporation, examination, operation, regulation, and chartering of Federal savings associations) *with* 12 U.S.C. 21 (organization and formation of national banking associations), 12 U.S.C. 481 (OCC authority to examine national banks and their affiliates), 12 U.S.C. 484 (OCC's exclusive visitorial authority), and 12 U.S.C. 93a (OCC authority to issue regulations).

[63] As noted previously, the final rule makes changes to the introductory clause concerning the applicability of state law in 12 CFR 34.4(a), 7.4007(b), 7.4008(d), and 7.4009(b) to make the language of these sections more consistent with each other.

law,[64] or it may incorporate—or ''Federalize''—state standards.[65] In those circumstances, the state standard obviously applies. State law may also apply if it only incidentally affects a national bank's Federally authorized powers or if it is otherwise consistent with national banks' uniquely Federal status. Like the other provisions of this final rule, § 7.4009 recognizes the potential applicability of state law in these circumstances. This approach is consistent with the Supreme Court's observation that national banks ''are governed in their daily course of business far more by the laws of the state than of the nation.'' [66] However, as noted previously, these types of laws typically do not regulate the manner or content of the business of banking authorized for national banks, but rather establish the legal infrastructure that makes practicable the conduct of that business.

C. Application of Amendments to Operating Subsidiaries

As a matter of Federal law, national bank operating subsidiaries conduct their activities under a Federal license, subject to the same terms and conditions as apply to the parent banks, except where Federal law provides otherwise. *See* 12 CFR 5.34 and 7.4006. *See also* 12 CFR 34.1(b)(real estate activities specifically).[67] Thus, by virtue of preexisting OCC regulations, the changes to parts 7 and 34, including the new anti-predatory lending standards applicable to lending activities, apply to both national banks and their operating subsidiaries. The final rule makes no change to these existing provisions.

VI. The OCC's Commitment to Fair Treatment of National Bank Customers and High Standards of National Bank Operations

The OCC shares the view of the commenters that predatory and abusive lending practices are inconsistent with national objectives of encouraging home ownership and community revitalization, and can be devastating to individuals, families, and communities. We will not tolerate such practices by national banks and their operating subsidiaries. Our Advisory Letters on predatory lending,[68] our pioneering enforcement positions resulting in substantial restitution to affected consumers, and the anti-predatory lending standards adopted in this final rule reflect our commitment that national banks operate pursuant to high standards of integrity in all respects. The provisions of this final rule, clarifying that certain state laws are not applicable to national banks' operations, do not undermine the application of these standards to all national banks, for the protection of all national bank customers—wherever they are located.

Advisory Letters 2003–2, which addresses loan originations, and 2003–3, which addresses loan purchases and the use of third party loan brokers, contain the most comprehensive supervisory standards ever published by any Federal financial regulatory agency to address predatory and abusive lending practices and detail steps for national banks to take to ensure that they do not engage in such practices. As explained in the Advisory Letters, if the OCC has evidence that a national bank has engaged in abusive lending practices, we will review those practices not only to determine whether they violate specific provisions of law such as the Homeowners Equity Protection Act of 1994 (HOEPA), the Fair Housing Act, or the Equal Credit Opportunity Act, but also to determine whether they involve unfair or deceptive practices that violate the FTC Act. Indeed, several practices that we identify as abusive in our Advisory Letters—such as equity stripping, loan flipping, and the refinancing of special subsidized mortgage loans that originally contained terms favorable to the borrower—generally can be found to be unfair or deceptive practices that violate the FTC Act.

Moreover, our enforcement record, including the OCC's pioneering actions using the FTC Act to address consumer abuses that were not specifically prohibited by regulation, demonstrates our commitment to keeping abusive practices out of the national banking system. For example, *In the Matter of Providian Nat'l Bank, Tilton, New Hampshire,*[69] pursuant to the FTC Act, the OCC required payment by a national bank to consumers in excess of $300 million and imposed numerous conditions on the conduct of future business. Since the Providian settlement in 2000, the OCC has taken action under the FTC Act to address unfair or deceptive practices and consumer harm involving five other national banks.[70]

Most recently, on November 7, 2003, the OCC entered into a consent order with Clear Lake National Bank that requires the bank to reimburse fees and interest charged to consumers in a series of abusive home equity loans. More than $100,000 will be paid to 30 or more borrowers. This is the first case brought by a Federal regulator under the FTC Act that cites the unfair nature of the terms of the loan. The OCC also found that the loans violated HOEPA, the Truth in Lending Act, and Real Estate Settlement Procedures Act.[71]

The OCC also has moved aggressively against national banks engaged in payday lending programs that involved consumer abuses. Specifically, we concluded four enforcement actions against national banks that had entered into contracts with payday lenders for loan originations, and in each case ordered the bank to terminate the relationship with the payday lender.[72]

[64] *See, e.g.*, 15 U.S.C. 6711 (insurance activities of national banks are ''functionally regulated'' by the states, subject to the provisions on the operation of state law contained in section 104 of the Gramm-Leach-Bliley Act).

[65] *See, e.g.*, 12 U.S.C. 92a (permissible fiduciary activities for national banks determined by reference to state law).

[66] *Nat'l Bank* v. *Commonwealth,* 76 U.S. at 362 (holding that shares held by shareholders of a national bank were lawfully subject to state taxation).

[67] For a detailed discussion of this issue, *see* the OCC's visitorial powers rulemaking also published today in the **Federal Register**.

[68] *See supra* note 8.

[69] Enforcement Action 2000–53 (June 28, 2000), *available* at the OCC's Web site in the ''Popular FOIA Requests'' section at *http://www.occ.treas.gov/foia/foiadocs.htm.*

[70] *See In the Matter of First Consumers National Bank, Beaverton, Oregon,* Enforcement Action 2003–100 (required restitution of annual fees and overlimit fees for credit cards); *In the Matter of Household Bank (SB), N.A., Las Vegas, Nevada,* Enforcement Action 2003–17 (required restitution regarding private label credit cards); *In the Matter of First National Bank in Brookings, Brookings, South Dakota,* Enforcement Action 2003–1 (required restitution regarding credit cards); *In the Matter of First National Bank of Marin, Las Vegas, Nevada,* Enforcement Action 2001–97 (restitution regarding credit cards); and *In the Matter of Direct Merchants Credit Card Bank, N.A., Scottsdale, Arizona,* Enforcement Action 2001–24 (restitution regarding credit cards). These orders can be found on the OCC's Web site within the ''Popular FOIA Requests'' section at *http://www.occ.treas.gov/foia/foiadocs.htm.*

[71] *See In the Matter of Clear Lake National Bank, San Antonio, Texas,* Enforcement Action 2003–135 (Nov. 7, 2003), available at *http://www.occ.treas.gov/FTP/EAs/ea2003–135.pdf.* We believe these enforcement actions, which have generated hundreds of millions of dollars for consumers in restitution, also demonstrate that the OCC has the resources to enforce applicable laws. Indeed, as recently observed by the Superior Court of Arizona, Maricopa County, in an action brought by Arizona against a national bank, among others, the restitution and remedial action ordered by the OCC in that matter against the bank was ''comprehensive and significantly broader in scope that that available through [the] state court proceedings.'' *State of Arizona* v. *Hispanic Air Conditioning and Heating, Inc.*, CV 2000–003625, Ruling at 27, Conclusions of Law, paragraph 50 (Aug. 25, 2003).

[72] *See In the Matter of Peoples National Bank, Paris, Texas,* Enforcement Action 2003–2; *In the Matter of First National Bank in Brookings, Brookings, South Dakota,* Enforcement Action 2003–1; *In the Matter of Goleta National Bank, Goleta, California,* Enforcement Action 2002–93; and *In the Matter of Eagle National Bank, Upper Darby, Pennsylvania,* Enforcement Action 2001–

Continued

Other than these isolated incidences of abusive practices that have triggered the OCC's aggressive supervisory response, evidence that national banks are engaged in predatory lending practices is scant. Based on the absence of such information—from third parties, our consumer complaint database, and our supervisory process—we have no reason to believe that such practices are occurring in the national banking system to any significant degree. Although several of the commenters suggested this conclusion is implausible given the significant share of the lending market occupied by national banks, this observation is consistent with an extensive study of predatory lending conducted by the Department of Housing and Urban Development (HUD) and the Treasury Department,[73] and even with comments submitted in connection with an OTS rulemaking concerning preemption of state lending standards by *46* State Attorneys General.

Less than one year ago, nearly two dozen State Attorneys General signed a brief in litigation that reached the same conclusion. That case involved a revised regulation issued by the Office of Thrift Supervision to implement the Alternative Mortgage Transaction Parity Act (AMTPA). The revised regulation seeks to distinguish between Federally supervised thrift institutions and non-bank mortgage lenders and makes non-bank mortgage lenders subject to state law restrictions on prepayment penalties and late fees. In *supporting* the OTS's decision to retain preemption of state laws for supervised depository institutions and their subsidiaries but *not* for unsupervised housing creditors, the State Attorneys General stated:

Based on consumer complaints received, as well as investigations and enforcement actions undertaken by the Attorneys General, predatory lending abuses are largely confined to the subprime mortgage lending market and to *non-depository institutions. Almost all of the leading subprime lenders are mortgage companies and finance companies, not banks or direct bank subsidiaries*.[74]

It is relevant for purposes of this final rule that the preemption regulations adopted by the OCC are substantially identical to the preemption regulations of the OTS that have been applicable to Federal thrifts for a number of years. It does not appear from public commentary—nor have the state officials indicated—that OTS preemption regulations have undermined the protection of customers of Federal thrifts. In their brief in the OTS litigation described above, the State Attorneys General referenced "the burdens of federal supervision," in concluding that there "clearly is a substantial basis for OTS's distinction" [75] between its supervised institutions and state housing creditors.

These considerations are equally applicable in the context of national banks, and were recognized, *again,* by all 50 State Attorneys General, in their comment letter to the OCC on this very regulation, which stated:

It is true that most complaints and state enforcement actions involving mortgage lending practices have not been directed at banks. However, most major subprime mortgage lenders are now subsidiaries of bank holding companies, (*although not direct bank operating subsidiaries*).[76]

The OCC is firmly committed to assuring that abusive practices—whether in connection with mortgage lending or other national bank activities—continue to have no place in the national banking system.

VII. Regulatory Analysis

CDRI Act Delayed Effective Date

This final rule takes effect 30 days after the date of its publication in the **Federal Register**, consistent with the delayed effective date requirement of the Administrative Procedure Act. *See* 5. U.S.C. 553(d). Section 302 of the Riegle Community Development and Regulatory Improvement Act of 1994 (CDRI Act), 12 U.S.C. 4802(b), provides that regulations that impose additional reporting, disclosure, or other requirements on insured depository institutions may not take effect before the first day of the quarter following publication unless the agency finds that there is good cause to make the rule effective at an earlier date. The regulations in this final rule require national banks to adhere to explicit safety and soundness-based anti-predatory lending standards. These standards prohibit national banks from engaging in certain harmful lending practices, thereby benefiting consumers. The final rule imposes no additional reporting, disclosure, or other requirements on national banks. Accordingly, in order for the benefits to become available as soon as possible, the OCC finds that there is good cause to dispense with the requirements of the CDRI Act.

Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. 605(b) (RFA), the regulatory flexibility analysis otherwise required under section 604 of the RFA is not required if the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities and publishes its certification and a short, explanatory statement in the **Federal Register** along with its rule.

Pursuant to section 605(b) of the RFA, the OCC hereby certifies that this final rule will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not needed. The amendments to the regulations identify the types of state laws that are preempted, as well as the types of state laws that generally are not preempted, in the context of national bank lending, deposit-taking, and other activities. These amendments simply provide the OCC's analysis and do not impose any new requirements or burdens. As such, they will not result in any adverse economic impact.

Executive Order 12866

The OCC has determined that this final rule is not a significant regulatory action under Executive Order 12866.

Unfunded Mandates Reform Act of 1995

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104–4 (2 U.S.C. 1532) (Unfunded Mandates Act), requires that an agency prepare a budgetary impact statement

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104. These orders can also be found on the OCC's Web site within the "Popular FOIA Requests" section at *http://www.occ.treas.gov/foia/foiadocs.htm.*

[73] A Treasury-HUD joint report issued in 2000 found that predatory lending practices in the subprime market are less likely to occur in lending by—

banks, thrifts, and credit unions that are subject to extensive oversight and regulation * * *. The subprime mortgage and finance companies that dominate mortgage lending in many low-income and minority communities, while subject to the same consumer protection laws, are not subject to as much federal oversight as their prime market counterparts—who are largely federally-supervised banks, thrifts, and credit unions. The absence of such accountability may create an environment where predatory practices flourish because they are unlikely to be detected.

Departments of Housing and Urban Development and the Treasury, "Curbing Predatory Home Mortgage Lending: A Joint Report" 17–18 (June 2000), *available at http://www.treas.gov/press/releases/report3076.htm.*

In addition, the report found that a significant source of abusive lending practices is non-regulated mortgage brokers and similar intermediaries who, because they "do not actually take on the credit risk of making the loan, * * * may be less concerned about the loan's ultimate repayment, and more concerned with the fee income they earn from the transaction." *Id.* at 40.

[74] Brief for Amicus Curiae State Attorneys General, *Nat'l Home Equity Mortgage Ass'n* v. *OTS,* Civil Action No. 02–2506 (GK) (D.D.C.) at 10–11 (emphasis added).

[75] *Id.* at 10.

[76] National Association of Attorneys General comment letter on the proposal at 10 (Oct. 6, 2003) (emphasis added).

before promulgating any rule likely to result in a Federal mandate that may result in the expenditure by State, local, and tribal governments, in the aggregate, or by the private sector of $100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. The OCC has determined that this final rule will not result in expenditures by State, local, and tribal governments, or by the private sector, of $100 million or more in any one year. Accordingly, this rulemaking is not subject to section 202 of the Unfunded Mandates Act.

Executive Order 13132

Executive Order 13132, entitled ''Federalism'' (Order), requires Federal agencies, including the OCC, to certify their compliance with that Order when they transmit to the Office of Management and Budget any draft final regulation that has Federalism implications. Under the Order, a regulation has Federalism implications if it has ''substantial direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government.'' In the case of a regulation that has Federalism implications and that preempts state law, the Order imposes certain consultation requirements with state and local officials; requires publication in the preamble of a Federalism summary impact statement; and requires the OCC to make available to the Director of the Office of Management and Budget any written communications submitted by state and local officials. By the terms of the Order, these requirements apply to the extent that they are practicable and permitted by law and, to that extent, must be satisfied before the OCC promulgates a final regulation.

In the proposal, we noted that the regulation may have Federalism implications. Therefore, in formulating the proposal and the final rule, the OCC has adhered to the fundamental Federalism principles and the Federalism policymaking criteria. Moreover, the OCC has satisfied the requirements set forth in the Order for regulations that have Federalism implications and preempt state law. The steps taken to comply with these requirements are set forth below.

Consultation. The Order requires that, to the extent practicable and permitted by law, no agency shall promulgate any regulation that has Federalism implications and that preempts state law unless, prior to the formal promulgation of the regulation, the agency consults with state and local officials early in the process of developing the proposal. We have consulted with state and local officials on the issues addressed herein through the rulemaking process. Following the publication of the proposal, representatives from the Conference of State Bank Supervisors (CSBS) met with the OCC to clarify their understanding of the proposal and, subsequently, the CSBS submitted a detailed comment letter regarding the proposal. As mentioned previously, additional comments were also submitted on the proposal by other state and local officials and state banking regulators. Pursuant to the Order, we will make these comments available to the Director of the OMB. Subsequent, public statements by representatives of the CSBS have restated their concerns, and CSBS representatives have further discussed these concerns with the OCC on several additional occasions.

In addition to consultation, the Order requires a Federalism summary impact statement that addresses the following:

Nature of concerns expressed. The Order requires a summary of the nature of the concerns of the state and local officials and the agency's position supporting the need to issue the regulation. The nature of the state and local official commenters' concerns and the OCC's position supporting the need to issue the regulation are set forth in the preamble, but may be summarized as follows. Broadly speaking, the states disagree with our interpretation of the applicable law, they are concerned about the impact the rule will have on the dual banking system, and they are concerned about the ability of the OCC to protect consumers adequately.

Extent to which the concerns have been addressed. The Order requires a statement of the extent to which the concerns of state and local officials have been met.

a. There is fundamental disagreement between state and local officials and the OCC regarding preemption in the national bank context. For the reasons set forth in the materials that precede this Federalism impact statement, we believe that this final rule is necessary to enable national banks to operate to the full extent of their powers under Federal law, and without interference from inconsistent state laws; consistent with the national character of the national banks; and in furtherance of their safe and sound operations. We also believe that this final rule has ample support in statute and judicial precedent. The concerns of the state and local officials could only be fully met if the OCC were to take a position that is contrary to Federal law and judicial precedent. Nevertheless, to respond to some of the issues raised, the language in this final regulation has been refined, and this preamble further explains the standards used to determine when preemption occurs and the criteria for when state laws generally would *not* be preempted.

b. Similarly, we fundamentally disagree with the state and local officials about whether this final rule will undermine the dual banking system. As discussed in the OCC's visitorial powers rulemaking also published today in the **Federal Register**, differences in national and state bank powers and in the supervision and regulation of national and state banks are not inconsistent with the dual banking system; rather, they are the defining characteristics of it. The dual banking system is universally understood to refer to the chartering and supervision of state-chartered banks by state authorities and the chartering and supervision of national banks by Federal authority, the OCC. Thus, we believe that the final rule preserves, rather than undermines, the dual banking system.

c. Finally, we stand ready to work with the states in the enforcement of applicable laws. The OCC has extended invitations to state Attorneys General and state banking departments to enter into discussions that would lead to a memorandum of understanding about the handling of consumer complaints and the pursuit of remedies, and we remain eager to do so. Moreover, as discussed in the preamble, we believe the OCC has the resources to enforce applicable laws, as is evidenced by the enforcement actions that have generated hundreds of millions of dollars for consumers in restitution, that have required national banks to disassociate themselves from payday lenders, and that have ordered national banks to stop abusive practices. Thus, the OCC has ample legal authority and resources to ensure that consumers are adequately protected.

List of Subjects

12 CFR Part 7

Credit, Insurance, Investments, National banks, Reporting and recordkeeping requirements, Securities, Surety bonds.

12 CFR Part 34

Mortgages, National banks, Real estate appraisals, Real estate lending

standards, Reporting and recordkeeping requirements.

Authority and Issuance

■ For the reasons set forth in the preamble, parts 7 and 34 of chapter I of title 12 of the Code of Federal Regulations are amended as follows:

PART 7—BANK ACTIVITIES AND OPERATIONS

■ 1. The authority citation for part 7 is revised to read as follows:

Authority: 12 U.S.C. 1 *et seq.*, 71, 71a, 92, 92a, 93, 93a, 481, 484, and 1818.

Subpart D—Preemption

■ 2. A new § 7.4007 is added to read as follows:

§ 7.4007 Deposit-taking.

(a) *Authority of national banks.* A national bank may receive deposits and engage in any activity incidental to receiving deposits, including issuing evidence of accounts, subject to such terms, conditions, and limitations prescribed by the Comptroller of the Currency and any other applicable Federal law.

(b) *Applicability of state law.* (1) Except where made applicable by Federal law, state laws that obstruct, impair, or condition a national bank's ability to fully exercise its Federally authorized deposit-taking powers are not applicable to national banks.

(2) A national bank may exercise its deposit-taking powers without regard to state law limitations concerning:

(i) Abandoned and dormant accounts;[3]

(ii) Checking accounts;

(iii) Disclosure requirements;

(iv) Funds availability;

(v) Savings account orders of withdrawal;

(vi) State licensing or registration requirements (except for purposes of service of process); and

(vii) Special purpose savings services; [4]

(c) *State laws that are not preempted.* State laws on the following subjects are not inconsistent with the deposit-taking powers of national banks and apply to national banks to the extent that they only incidentally affect the exercise of national banks' deposit-taking powers:

(1) Contracts;

(2) Torts;

(3) Criminal law; [5]

(4) Rights to collect debts;

(5) Acquisition and transfer of property;

(6) Taxation;

(7) Zoning; and

(8) Any other law the effect of which the OCC determines to be incidental to the deposit-taking operations of national banks or otherwise consistent with the powers set out in paragraph (a) of this section.

■ 3. A new § 7.4008 is added to read as follows:

§ 7.4008 Lending.

(a) *Authority of national banks.* A national bank may make, sell, purchase, participate in, or otherwise deal in loans and interests in loans that are not secured by liens on, or interests in, real estate, subject to such terms, conditions, and limitations prescribed by the Comptroller of the Currency and any other applicable Federal law.

(b) *Standards for loans.* A national bank shall not make a consumer loan subject to this § 7.4008 based predominantly on the bank's realization of the foreclosure or liquidation value of the borrower's collateral, without regard to the borrower's ability to repay the loan according to its terms. A bank may use any reasonable method to determine a borrower's ability to repay, including, for example, the borrower's current and expected income, current and expected cash flows, net worth, other relevant financial resources, current financial obligations, employment status, credit history, or other relevant factors.

(c) *Unfair and deceptive practices.* A national bank shall not engage in unfair or deceptive practices within the meaning of section 5 of the Federal Trade Commission Act, 15 U.S.C. 45(a)(1), and regulations promulgated thereunder in connection with loans made under this § 7.4008.

(d) *Applicability of state law.* (1) Except where made applicable by Federal law, state laws that obstruct, impair, or condition a national bank's ability to fully exercise its Federally authorized non-real estate lending powers are not applicable to national banks.

(2) A national bank may make non-real estate loans without regard to state law limitations concerning:

(i) Licensing, registration (except for purposes of service of process), filings, or reports by creditors;

(ii) The ability of a creditor to require or obtain insurance for collateral or other credit enhancements or risk mitigants, in furtherance of safe and sound banking practices;

(iii) Loan-to-value ratios;

(iv) The terms of credit, including the schedule for repayment of principal and interest, amortization of loans, balance, payments due, minimum payments, or term to maturity of the loan, including the circumstances under which a loan may be called due and payable upon the passage of time or a specified event external to the loan;

(v) Escrow accounts, impound accounts, and similar accounts;

(vi) Security property, including leaseholds;

(vii) Access to, and use of, credit reports;

(viii) Disclosure and advertising, including laws requiring specific statements, information, or other content to be included in credit application forms, credit solicitations, billing statements, credit contracts, or other credit-related documents;

(ix) Disbursements and repayments; and

(x) Rates of interest on loans.[6]

(e) *State laws that are not preempted.* State laws on the following subjects are not inconsistent with the non-real estate lending powers of national banks and apply to national banks to the extent that they only incidentally affect the exercise of national banks' non-real estate lending powers:

(1) Contracts;

(2) Torts;

(3) Criminal law;[7]

(4) Rights to collect debts;

(5) Acquisition and transfer of property;

(6) Taxation;

(7) Zoning; and

[3] This does not apply to state laws of the type upheld by the United States Supreme Court in *Anderson Nat'l Bank* v. *Luckett*, 321 U.S. 233 (1944), which obligate a national bank to ''pay [deposits] to the persons entitled to demand payment according to the law of the state where it does business.'' *Id.* at 248–249.

[4] State laws purporting to regulate national bank fees and charges are addressed in 12 CFR 7.4002.

[5] *But see* the distinction drawn by the Supreme Court in *Easton* v. *Iowa*, 188 U.S. 220, 238 (1903) between ''crimes defined and punishable at common law or by the general statutes of a state and crimes and offences cognizable under the authority of the United States.'' The Court stated that ''[u]ndoubtedly a state has the legitimate power to define and punish crimes by general laws applicable to all persons within its jurisdiction * * *. But it is without lawful power to make such special laws applicable to banks organized and operating under the laws of the United States.'' *Id.* at 239 (holding that Federal law governing the operations of national banks preempted a state criminal law prohibiting insolvent banks from accepting deposits).

[6] The limitations on charges that comprise rates of interest on loans by national banks are determined under Federal law. *See* 12 U.S.C. 85; 12 CFR 7.4001. State laws purporting to regulate national bank fees and charges that do not constitute interest are addressed in 12 CFR 7.4002.

[7] *See supra* note 5 regarding the distinction drawn by the Supreme Court in *Easton* v. *Iowa,* 188 U.S. 220, 238 (1903) between ''crimes defined and punishable at common law or by the general statutes of a state and crimes and offences cognizable under the authority of the United States.''

(8) Any other law the effect of which the OCC determines to be incidental to the non-real estate lending operations of national banks or otherwise consistent with the powers set out in paragraph (a) of this section.

■ 4. A new § 7.4009 is added to read as follows:

§ 7.4009 Applicability of state law to national bank operations.

(a) *Authority of national banks.* A national bank may exercise all powers authorized to it under Federal law, including conducting any activity that is part of, or incidental to, the business of banking, subject to such terms, conditions, and limitations prescribed by the Comptroller of the Currency and any applicable Federal law.

(b) *Applicability of state law.* Except where made applicable by Federal law, state laws that obstruct, impair, or condition a national bank's ability to fully exercise its powers to conduct activities authorized under Federal law do not apply to national banks.

(c) *Applicability of state law to particular national bank activities.* (1) The provisions of this section govern with respect to any national bank power or aspect of a national bank's operations that is not covered by another OCC regulation specifically addressing the applicability of state law.

(2) State laws on the following subjects are not inconsistent with the powers of national banks and apply to national banks to the extent that they only incidentally affect the exercise of national bank powers:

(i) Contracts;

(ii) Torts;

(iii) Criminal law [8]

(iv) Rights to collect debts;

(v) Acquisition and transfer of property;

(vi) Taxation;

(vii) Zoning; and

(viii) Any other law the effect of which the OCC determines to be incidental to the exercise of national bank powers or otherwise consistent with the powers set out in paragraph (a) of this section.

PART 34—REAL ESTATE LENDING AND APPRAISALS

Subpart A—General

■ 5. The authority citation for part 34 continues to read as follows:

Authority: 12 U.S.C. 1 *et seq.*, 29, 93a, 371, 1701j–3, 1828(o), and 3331 *et seq.*

■ 6. In § 34.3, the existing text is designated as paragraph (a), and new paragraphs (b) and (c) are added to read as follows:

§ 34.3 General rule.

* * * * *

(b) A national bank shall not make a consumer loan subject to this subpart based predominantly on the bank's realization of the foreclosure or liquidation value of the borrower's collateral, without regard to the borrower's ability to repay the loan according to its terms. A bank may use any reasonable method to determine a borrower's ability to repay, including, for example, the borrower's current and expected income, current and expected cash flows, net worth, other relevant financial resources, current financial obligations, employment status, credit history, or other relevant factors.

(c) A national bank shall not engage in unfair or deceptive practices within the meaning of section 5 of the Federal Trade Commission Act, 15 U.S.C. 45(a)(1), and regulations promulgated thereunder in connection with loans made under this part.

■ 7. Section 34.4 is revised to read as follows:

§ 34.4 Applicability of state law.

(a) Except where made applicable by Federal law, state laws that obstruct, impair, or condition a national bank's ability to fully exercise its Federally authorized real estate lending powers do not apply to national banks. Specifically, a national bank may make real estate loans under 12 U.S.C. 371 and § 34.3, without regard to state law limitations concerning:

(1) Licensing, registration (except for purposes of service of process), filings, or reports by creditors;

(2) The ability of a creditor to require or obtain private mortgage insurance, insurance for other collateral, or other credit enhancements or risk mitigants, in furtherance of safe and sound banking practices;

(3) Loan-to-value ratios;

(4) The terms of credit, including schedule for repayment of principal and interest, amortization of loans, balance, payments due, minimum payments, or term to maturity of the loan, including the circumstances under which a loan may be called due and payable upon the passage of time or a specified event external to the loan;

(5) The aggregate amount of funds that may be loaned upon the security of real estate;

(6) Escrow accounts, impound accounts, and similar accounts;

(7) Security property, including leaseholds;

(8) Access to, and use of, credit reports;

(9) Disclosure and advertising, including laws requiring specific statements, information, or other content to be included in credit application forms, credit solicitations, billing statements, credit contracts, or other credit-related documents;

(10) Processing, origination, servicing, sale or purchase of, or investment or participation in, mortgages;

(11) Disbursements and repayments;

(12) Rates of interest on loans;[1]

(13) Due-on-sale clauses except to the extent provided in 12 U.S.C. 1701j–3 and 12 CFR part 591; and

(14) Covenants and restrictions that must be contained in a lease to qualify the leasehold as acceptable security for a real estate loan.

(b) State laws on the following subjects are not inconsistent with the real estate lending powers of national banks and apply to national banks to the extent that they only incidentally affect the exercise of national banks' real estate lending powers:

(1) Contracts;

(2) Torts;

(3) Criminal law; [2]

(4) Homestead laws specified in 12 U.S.C. 1462a(f);

(5) Rights to collect debts;

(6) Acquisition and transfer of real property;

(7) Taxation;

(8) Zoning; and

(9) Any other law the effect of which the OCC determines to be incidental to the real estate lending operations of national banks or otherwise consistent with the powers and purposes set out in § 34.3(a).

Dated: January 6, 2004.

John D. Hawke, Jr.,

Comptroller of the Currency.

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BILLING CODE 4810–33–P

[8] 8 *Id.*

[1] The limitations on charges that comprise rates of interest on loans by national banks are determined under Federal law. *See* 12 U.S.C. 85 and 1735f–7a; 12 CFR 7.4001. State laws purporting to regulate national bank fees and charges that do not constitute interest are addressed in 12 CFR 7.4002.

[2] *But see* the distinction drawn by the Supreme Court in *Easton* v. *Iowa*, 188 U.S. 220, 238 (1903) between "crimes defined and punishable at common law or by the general statutes of a state and crimes and offences cognizable under the authority of the United States." The Court stated that "[u]ndoubtedly a state has the legitimate power to define and punish crimes by general laws applicable to all persons within its jurisdiction * * *. But it is without lawful power to make such special laws applicable to banks organized and operating under the laws of the United States." *Id.* at 239 (holding that Federal law governing the operations of national banks preempted a state criminal law prohibiting insolvent banks from accepting deposits).

Remarks by

John C. Dugan

Comptroller of the Currency

Before

Women in Housing and Finance

Washington, DC

September 24, 2009

The Need to Preserve Uniform National Standards for National Banks

I welcome this opportunity for a return engagement before Women in Housing and Finance at this very critical time. We are, of course, in the middle of an important national debate about how best to address the gaps and weaknesses in financial regulation that were exposed by the financial events of the last two years. In this context, the Treasury Department's plan to strengthen our regulatory framework is both thoughtful and comprehensive, and I support many of its core elements.

Among these are certain parts of the plan that would enhance consumer protection. One is the establishment of a strong federal rulewriter – which Treasury proposes as a new Consumer Financial Protection Agency or "CFPA" – to issue uniform national rules for consumer protection. These rules would apply equally not just to federally regulated banks, but also – and this is critically important – to the literally hundreds of thousands of nonbank financial providers, such as finance companies and mortgage brokers, that have been unregulated or lightly regulated by the states. It is well established that this "shadow banking system" of unregulated financial providers has

been the source of the worst consumer protection and underwriting abuses, especially in the area of subprime mortgages.

For the same reason, I support providing the CFPA with supervisory and enforcement authority over these nonbank financial providers, which is crucial to ensure their compliance with CFPA rules to the same extent as banks. However, for reasons that have received a great deal of attention in congressional hearings and media accounts, I think the plan should not strip such authority from bank regulators, where I believe the current system has worked well.

Today I would like to focus my remarks on a different part of the consumer protection plan that has received less attention than I think it deserves, given its critical importance. That is the sweeping proposal to eliminate uniform national consumer protection standards by repealing key parts of the National Bank Act's preemption of state laws, which unfortunately I cannot support. This radical change is fundamentally at odds with the concept of efficient national standards for national products and services offered across state lines in national markets – a concept that has been central to the economic prosperity of the United States since the adoption of our Constitution, and one that has been critical to the flourishing of our national banking system since 1863. More importantly – and especially with the strong federal consumer protection rules envisioned by the new CFPA – truly uniform national standards that provide real benefits to consumers would be undermined by the repeal of national bank preemption.

Importance of National Standards in US History

Let me explain my strong concerns, beginning, if you will indulge me, with a brief history of the important role that national standards have played in our economic

history. After the Revolutionary War, the critical and well recognized weakness in the Articles of Confederation was that it permitted individual states to erect commercial barriers to trade with neighboring states and foreign powers.[1] The ensuing problems precipitated the adoption of our national Constitution in 1789, because the framers understood that fragmentation via differing state laws was incompatible with economic growth, efficiency, and innovation by the nation as a whole. Indeed, one of the most critical changes the Constitution made was to grant Congress plenary authority over commerce in Article I, Section 8. Aptly referred to as the "Interstate Commerce clause," this provision empowered Congress to establish uniform national standards to govern economic activities that span state boundaries, clearing the way for the emergence of a truly national economy.[2]

How these principles should apply to banking, and whether the national interest was served by a federal role in the banking system, was one of the earliest policy debates addressed by the new government. Creation of the First Bank of the United States in 1791 and the Second Bank of the United States in 1816 substantially benefited the nation's finances, but proved hugely controversial. Beyond attracting charges of excessive concentration of power, these federal banks were seen as threats to state-chartered institutions. Maryland's attempt to prevent effective operation of the Second Bank through state taxation resulted in a landmark Supreme Court decision – *McCulloch v. Maryland* – that confirmed the national government's power to establish a bank and the supremacy of federal over state law.

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[1] For example, some states with ports exacted a price from producers in landlocked states to move goods to market; states adopted bankruptcy laws that advantaged local creditors and debtors at the expense of others; and states sought to tax and regulate the United States mails.

[2] "To regulate Commerce with foreign Nations, and among the Several States, and with the Indian Tribes[.]"

The controversy came to a head in 1836, when Andrew Jackson vetoed the renewal of the Second Bank. His principal political opponent, Henry Clay, articulated a very different vision, rooted in the ideas of Alexander Hamilton, of a truly American system based on national standards and institutions. Clay proposed to extend the life of the national bank, protect American industry, and establish a national network of roads and rails. And it was one of Clay's most enthusiastic followers, Abraham Lincoln, who was to ensure that Clay's national vision ultimately prevailed.

In 1861, the departure of secessionist legislators from Washington marked a critical step on the path to Civil War. But it also ushered in a period of unprecedented legislative productivity that advanced national economic goals. This included the construction of a transcontinental railroad, expansion of the national telegraph network, improvements in roads and canals, and of course, establishment of our national banking system through the National Currency Act of 1863 and the National Bank Act of 1864, which Lincoln helped shape into law.

In adopting these measures, Congress did not abolish state banking. But it did include explicit protections in the new framework so that national banks would be governed by federal standards administered by a new federal agency – the Office of the Comptroller of the Currency. The OCC has successfully carried out those duties for nearly 150 years, and over that same period, a series of Supreme Court decisions have confirmed the fundamental principle of federal preemption as applied to national banks: that is, that the banking activities of national banks are governed by national standards established by Congress, subject to supervision and oversight by the OCC.

With this design, the state and national banking systems have grown up around one another, creating the "dual banking system" we know today. Encompassing both large institutions that market products and services nationally and very small institutions that do business exclusively in their immediate communities, it is a diverse system with complex linkages and interdependencies. In this context and over time, a crucial benefit has been clear: the "national" part of the dual banking system, the part that has allowed large and small national banks to operate under uniform national rules across state lines, has strongly fostered the growth of national products and services in national and multi-state markets.

Repeal of National Bank Preemption

Returning to the Treasury plan, it's important to recognize that key parts of it promote and endorse the concept of uniform national standards. Indeed, as previously discussed, one of its critical intended benefits is that strong federal rules issued by the new CFPA would apply equally to all financial providers, whether bank or nonbank. Another of its goals is to raise the level of compliance with such rules by nonbanks, which today are unregulated or very lightly regulated, to the same level as currently applies to federally regulated banks. Both of these aspects of the plan are fully consistent with the principle of uniform national standards, uniformly applied – as are other aspects of the plan.[3]

[3] *See*, *e.g.,* Proposal, *supra* note 1, at 69 (discussing the proposed CFPA, observing that "[f]airness, effective competition, and efficient markets require consistent regulatory treatment for similar products," and noting that consistent regulation facilitates consumers' comparison shopping); and at 39 (discussing the history of insurance regulation by the states, which "has led to a lack of uniformity and reduced competition across state and international boundaries, resulting in inefficiency, reduced product innovation, and higher costs to consumers.").

Unfortunately, however, the very principle of uniform national standards is expressly undermined by the plan's specific grant of authority to individual states to adopt different rules; by the repeal of uniform standards for national banks; and by the empowerment of individual states, with their very differing points of view, to enforce federal consumer protection rules – under all federal statutes – in ways that might vary from state to state. In effect, the resulting patchwork of federal-plus-differing-state standards would distort and displace the CFPA's federal rulemaking. This is true even though the CFPA's federal rules would be the product of an open public comment process and the behavioral research and evaluative functions that the plan highlights.

In particular, for the first time in the 146-year history of the national banking system, federally chartered banks would be subject to multiple state operating standards, because the plan would sweepingly repeal the ability of national banks to conduct retail banking business under uniform national standards. This rejection and reversal of such standards is an extreme change that is, in my view, both unwise and unjustified.

Given the CFPA's enhanced authority and mandate to write stronger consumer protection rules, and the thorough and expert processes described as integral to its rulemaking, there should no longer be any issue as to whether sufficiently strong federal consumer protection standards would be in place and apply to national banks. In this context there is no need to authorize states to adopt different standards for such banks. Likewise, there is no need to authorize states to enforce federal rules against national banks – which would inevitably result in differing state interpretations of federal rules – because federal regulators already have broad enforcement authority over such institutions and the resources to exercise that authority fully.

More fundamentally, we live in an era where the market for financial products and services is often national in scope. Advances in technology, including the Internet and the increased functionality of phones, enable banks to do business with customers in many states. Our population is increasingly mobile, and many people live in one state and work in another – as is true for many of us in the Washington, D.C. area.

In this context, regressing to a regulatory regime that fails to recognize the way retail financial services are now provided, and the need for a single set of rules for banks with customers in multiple states, would discard many of the benefits consumers reap from our modern financial product delivery system. Such a balkanized approach could give rise to significant uncertainty about which sets of standards apply to institutions conducting a multistate business. That in turn would generate major legal and compliance costs, and major impediments to interstate product delivery.

Moreover, this issue is very real for all banks operating across state lines – not just national banks. Recognizing the importance of preserving uniform interstate standards for all banks operating in multiple states, Congress expressly provided in the "Riegle-Neal II" Act enacted in 1997 that state banks operating through interstate branches in multiple states should enjoy the same federal preemption and ability to operate with uniform standards as national banks.[4]

Accordingly, repealing uniform national standards for national banks would create fundamental, practical problems for all banks operating across state lines, large or small. For example, there are a number of areas in which complying with different standards set by individual states would require a bank to determine which state's law governs – the law of the state where a person provides a product or service; the law of the

[4] 12 U.S.C. § 1831a(j); *see also id*. at 1831d (interest rates; parity for state banks).

home state of the bank; or the law of the state where the customer is located. It is far from clear how a bank could do this based on objective analysis, and any conflicts could result in penalties and litigation in multiple jurisdictions.

And think about some of the practical problems that could arise from different grace periods for credit cards; different internet advertising rules; different solicitation standards for telephone sales, with different duties for sales personnel; different employee compensation limits; and different licensing requirements for new products.

Or consider a more detailed example involving terms for a checking account. Today a bank can offer customers checking accounts with uniform terms and uniform disclosures through branches in multiple states, over the Internet, and through various forms of media. Under the plan, individual states could adopt particular required or prohibited terms for different aspects of these checking accounts, as well as additional disclosure and advertising requirements. For example, there could be state-by-state differences in rules on the number and amount of withdrawals or deposits, permissible minimum balance requirements, and ATM screen disclosures. States could assert that those requirements apply according to the law of the state in which the branch offering the account is located, the home state of the bank, the state where the customer resides, or someplace else. States could have different standards for exerting jurisdiction over the terms and disclosures, creating the potential for the laws of two or more states to apply to the same transaction. How would a bank advertise in the newspaper or on the radio to promote its checking accounts if it were located in a multistate region – such as the Washington D.C. area – if different states imposed different requirements regarding terms and disclosures? Even if the bank figured all this out for a particular customer, that

could all change if the customer moved, or if the bank merged with another bank located in a different state. Would that mean the customer would have to open a new account to incorporate the state's required terms? And even if Congress added language to address some of the questions we can think of today, there would only be more uncertainties tomorrow – and no realistic possibility of writing a fix into national law each time a new issue arose.

Such uncertainties have the real potential to confuse consumers, subject providers to major new liabilities, and significantly increase the cost of doing business in ways that will be passed on to consumers. It could also cause providers to pull back where increased costs erase an already thin profit margin – for example, with "indirect" auto lending across state lines – or where they see unacceptable levels of uncertainty and risk.

Moreover, a bank with multistate operations might well decide that the only sensible way to conduct a national business would be to operate to the most stringent standard prevailing in its most significant state market. It should not be the case that a decision by one state legislature about how products should be designed, marketed, or sold should effectively replace a national regulatory standard established by the federal government based on thorough research and an open and nationwide public comment process, as would be the case with the new CFPA.

Finally, subjecting national banks to state laws and state enforcement of federal laws is a potentially crippling change to the national bank charter and a rejection of core principles that form the bedrock of the dual banking system. For nearly 150 years, national banks have been subject to a uniform set of federal rules enforced by the OCC, and state banks have generally been subject to their own states' rules. This dual banking

system has worked well, as it has allowed a state to serve as a "laboratory" for new regulation – without compelling adoption of a particular regulation as a national standard.

That is, the dual banking system is built on individual states experimenting with different kinds of laws, including new consumer protection laws, that apply to a state's own banks, but not to state banks in all states and not to national banks. Some of these individual state laws have proven to be good ideas, while others have not. When Congress has believed that a particular state's experiment is worthwhile, it has enacted that approach to apply throughout the country, not only to national banks, but to state banks operating in other states that have not yet adopted such laws. As a result, national banks operate under an evolving set of federal rules that are at any one time the same, regardless of the state in which the banks are headquartered, or the number of different states in which they operate. This reliable set of uniform federal rules is a defining characteristic of the national bank charter. It has helped banks provide a broader range of products at lower cost, with savings that can be passed along to the consumer.

Preemption Has Not Harmed Consumers

In short, there are many good reasons to oppose the plan's rejection of uniform national standards for national banks, especially given the strong rulewriting role envisioned for the CFPA. But are there good reasons for supporting this aspect of the proposal? I think not. The argument I've heard most often is that repealing national bank preemption is necessary to stop national banks from engaging in activities that caused the financial crisis, like predatory subprime lending, which critics say state consumer protection laws would have prevented.

That argument is just plain wrong. Its premise is that national banks were the source of predatory and unsafe mortgage loans, while state-regulated institutions were not. That's exactly backwards. It is widely recognized that the worst subprime loans that have caused the most foreclosures were originated by nonbank lenders and brokers regulated exclusively by the states. Although the OCC has little rulewriting authority in this area, we have closely supervised national bank subprime lending practices. As a result, national banks originated a relatively smaller share of subprime loans and applied better standards, resulting in significantly fewer foreclosures – as demonstrated in an attachment to this speech prepared last year by OCC staff. Meanwhile, nothing in federal law precluded states from effectively regulating their own nonbank mortgage lenders and brokers. Indeed, that's why the plan's grant of strong rulewriting and enforcement authority at the federal level over the shadow banking system of unregulated financial providers, through the CFPA, is such a good idea – and why granting the states new authority over national banks is not.

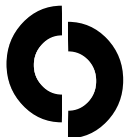
Another argument I hear focuses on enforcement, asserting that the new law should empower state officials to enforce consumer protection rules against national banks – including federal consumer protection rules issued by the new CFPA – because there supposedly can never be "too many cops on the beat." But this assertion is simply not true in a world that has only a limited number of "cops." State resources are finite, and there are hundreds of thousands of nonbank financial providers, including subprime lenders and brokers, that have been the disproportionate source of financial consumer protection problems. These are the firms most in need of supervisory and enforcement attention, by both the states and the new CFPA. That's where state enforcement

resources should be devoted, rather than diluting them on national banks that are already extensively supervised by the OCC. And if state officials have information that national banks appear to be violating applicable law or otherwise engaging in inappropriate practices, we want to hear about it, we will follow up on it, and we will be open with those officials about what we find and what we propose to do about it. All of us want consumers to be treated fairly and honestly; by collaborating rather than duplicating, we can better help achieve that result.

Conclusion

In sum, throughout our history, uniform national standards have proved to be a powerful engine for prosperity and growth. Such standards for national banks have been very much a part of this history, and have produced real benefits for consumers. As Congress moves forward with legislation on financial consumer protection, its goals should be to strengthen federal rules and apply them more uniformly to all providers of the same financial products – goals shared by the Treasury Plan. It should not be to undermine those goals by inviting every state to adopt its own rules for national banks – a course of action likely to produce far greater costs than benefits.

* * * *



Comptroller of the Currency
Administrator of National Banks

Washington, DC 2021

The Importance of Preserving a System of National Standards For National Banks

January 2010

The Importance of Preserving a System of National Standards for National Banks

I. Introduction

Since the establishment of the national banking system in 1863 and 1864, banks and their consumers have benefitted from the dynamic of the dual banking system. State banking systems can serve as laboratories of regulatory innovation, exploring new products and regulatory approaches to issues that, if successful, may be adopted at the federal level. The national banking system, operating under uniform federal standards across state lines, strongly fosters an open financial marketplace, the growth of national products and services in national and multi-state markets, and reduced costs.

The legal principle that supports uniform federal standards for national banks is the doctrine of federal "preemption," which flows directly from the Supremacy Clause of the U.S. Constitution. The Supreme Court has long held that, under the doctrine of federal preemption, any state law that conflicts, impedes, or interferes with national banks' federally-granted powers may not be applied to national banks – the state law is "preempted" by federal power. Preservation of the uniform federal standards has benefitted consumers of financial products by making a wider range of banking products and services available to more consumers and, overall, lowering the costs of credit and other banking products and services. In turn, the banking system benefits from greater economies of scale and improved risk management.

Critics of federal preemption have argued that it undermines the dual banking system. This argument, however, dismisses the clear benefits the system produces for consumers and banks alike, and shortchanges the state banking systems and the vital role they play in the dual banking system.

Other critics contend that federal preemption is contrary to consumers' interests and assert that preemption was one of the leading causes of the subprime mortgage lending crisis. The facts

simply do not bear this out. National banks and their subsidiaries originated only 12 to 14 percent of all subprime mortgages between 2005 and 2007. The vast majority of the subprime mortgages originated during these years were made by state licensed and supervised entities. The limited role that national banks and their subsidiaries played in the subprime mortgage lending crises strongly suggests that federal preemption had little to do with the crisis. This conclusion is bolstered by the track record of performance of subprime loans originated by national banks, which is better than the performance of subprime lending done by nonbanks in recent years.

II. The National Banking System and Federal Preemption

Congress enacted the National Currency Act of 1863 and the National Bank Act of 1864 to establish a national banking system to operate distinctly and separately from the existing system of private state banks. In adopting these measures, Congress did not abolish state banking, but was concerned about state legislation hostile to banks that the states did not create and control. To shield the national banks from such legislation, Congress included explicit protections in the new framework to ensure that national banks would be governed by Federal standards administered exclusively by a new federal agency – the Office of the Comptroller of the Currency. With the establishment of the national banks, Congress created the "dual banking system," in which both the states and the federal government have the power to charter banks and the power to supervise and regulate independently the banks they have chartered. The dual banking system remains in place today.

A. Doctrine of Federal Preemption Flows Directly from the Supremacy Clause of the United States Constitution

At the core of the national banking system is the principle that national banks, in carrying on the business of banking under a federal authorization, should be subject to uniform national

standards and uniform federal supervision.[1] The legal principle that produces such a result is the "preemption" of state law. The doctrine of preemption flows directly from the Supremacy Clause of the U.S. Constitution,[2] and provides that the Constitution and laws of the United States are the "Supreme Law" of the land, notwithstanding anything in the Constitution of laws of the States to the contrary. The Supremacy Clause was the basis for the landmark 1819 Supreme Court decision, *McCulloch v. Maryland*,[3] which established the bedrock principle that state law cannot stand as an obstacle to the accomplishment of federal legislative goals.

B. For Over 140 Years, the Supreme Court Has Held That State Laws Which Conflict, Impede, or Interfere with National Banks' Powers and Activities Are Preempted

In the years following the National Bank Act's enactment, the Supreme Court recognized the clear intent on the part of Congress to limit the authority of states over national banks precisely so that the nationwide system of banking that was created in the National Bank Act could develop and flourish. This point was highlighted by the Supreme Court in 1903 in *Easton v. Iowa.*[4] The Court stressed that the application of multiple states' standards would undermine the uniform, national character of the powers of national banks, which operate in –

> a system extending throughout the country, and independent, so far as powers conferred are concerned, of state legislation which, if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the states…. If [the states] had such power it would have to be exercised and limited by their own discretion, and confusion would necessarily result from control possessed and exercised by two independent authorities.[5]

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[1] In discussing the impact of the National Currency Act and National Bank Act, Senator Sumner stated that, "[c]learly, the [national] bank must not be subjected to any local government, State or municipal; it must be kept absolutely and exclusively under that Government from which it derives its functions." Cong. Globe, 38th Cong., 1st Sess., at 1893 (April 27, 1864).

[2] U.S. Constitution Article VI, cl. 2.

[3] *McCulloch v. Maryland*, 17 U.S. (4 Wheat) 316 (1819).

[4] 188 U.S. 220 (1903).

[5] *Id.* at 229, 230-31. A similar point was made by the Court in *Talbott v. Bd. of County Commissioners of Silver Bow County,* in which the court stressed that the entire body of the Statute respecting national banks, emphasize that which the character of the system implies - an intent to create a national banking system co-extensive with the territorial limits of the United States, and with uniform operation within those limits. 139 U.S. 438, 443 (1891).

The Supreme Court strongly reaffirmed this point in 2007 in *Watters v. Wachovia*,[6] stating:

> Diverse and duplicative superintendence [by the states] of national banks' engagement in the business of banking, we observed over a century ago, is precisely what the [National Bank Act] was designed to prevent.[7]

The Supreme Court and lower federal courts have repeatedly made clear that state laws that conflict, impede, or interfere with national banks' powers and activities are preempted. For example, in *Davis v. Elmira Savings Bank*,[8] the Supreme Court stated: "National banks are instrumentalities of the Federal Government, … It follows that an attempt, by a state, to define their duties or control the conduct of their affairs, is absolutely void." In *Franklin National Bank v. New York*,[9] the Supreme Court held that a state could not prohibit a national bank from using the word "savings" in its advertising, since the state law conflicts with the power of national banks to accept savings deposits. More recently, in *Barnett Bank v. Nelson*,[10] the Supreme Court affirmed the preemptive effective of federal banking law under the Supremacy Clause and held that a state statute prohibiting banks from engaging in most insurance agency activities was preempted by Federal law that permitted national banks to engage in insurance agency activities. In reaching its conclusion, the Court explained that the history of the National Bank Act "is one of interpreting grants of both enumerated and incidental 'powers' to national banks as grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law."

C. However, the Supreme Court Also Has Recognized That Many Types of State Commercial and Infrastructure Laws Do Apply to National Banks

The common thread running through these cases recited above is the preemption of a state law that impedes or interferes with national banks' powers. On the other hand, states are

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[6] 550 U.S. 1 (2007).
[7] *Id.* at 14.
[8] 161 U.S. 275, 283 (1896).
[9] 347 U.S. 373 (1954).
[10] 517 U.S. 25, 32 (1996).

permitted to regulate the activities of national banks where doing so does not impair, encroach upon, significantly interfere with, or prevent the exercise of these powers.[11] Thus, many types of state commercial and business "infrastructure" laws are not preempted, and national banks remain subject to significant state statutory schemes, including contracts, torts, criminal justice, zoning, right to collect debt, and many other generally applicable commercial and business standards. The OCC has recognized that such laws are not preempted.[12]

The Supreme Court, only five years after the enactment of the National Bank Act, recognized that national banks may be subject to some state laws in the normal course of business if there is no conflict with Federal law.[13] In holding that national banks' contracts, their acquisition and transfer of property, their right to collect their debts, and their liability to be sued for debts, are based on State law, the Court noted that national banks "are subject to the laws of the State, and are governed in their daily course of business far more by the laws of the State than of the nation."[14] The OCC does not dispute this basic proposition.

The courts have continued to recognize that national banks are subject to state laws, unless those laws infringe upon the national banking laws or impose an undue burden on the performance of the banks' federally-authorized activities. In *McClellan v. Chipman*,[15] the Supreme Court held that the application to national banks of a state statute forbidding certain real estate transfers by insolvent transferees was not preempted as the statute would not impede or hamper national banks' functions. In *Wichita Royalty Co. v. City Nat. Bank of Wichita Falls*,[16] the Court upheld the application of state tort law to a claim by a bank depositor against bank

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[11] *Barnett Bank*, 517 U.S. at 33 (1996).

[12] 12 C.F.R. § 7.4009(c) (2009). The OCC adopted this rule in 2004, noting that these laws do not attempt to regulate national banks' activities, but rather form the legal infrastructure that makes it practicable to exercise a permissible Federal power. 69 Fed.Reg. 1904, 1912 (Jan. 13, 2004).

[13] *National Bank v. Commonwealth*, 76 U.S. (9 Wall.) 353 (1869).

[14] *Id.* at 362 (1869).

[15] 164 U.S. 347 (1896).

[16] 306 U.S. 103 (1939).

directors. And in *Anderson Nat. Bank v. Luckett*,[17] the Supreme Court held that a state statute administering abandoned deposit accounts did not unlawfully encroach on the rights and privileges of national banks and, as a result, was not preempted.

As these cases demonstrate, there are numerous state laws to which national banks remain subject because the laws do not significantly impede or interfere with powers granted national banks under Federal Law. Yet, in reaching this conclusion, these cases serve to confirm the fundamental principle of federal preemption as applied to national banks: that is, that the banking business of national banks is governed by federal standards. These uniform national standards and the federal supervision under which national banks operate are the defining attributes of the national bank component of our dual banking system.

III. The Dual Banking System and Uniform Federal Standards for National Banks

In establishing the national banking system, Congress opted not to abolish existing private state banks, but rather to adopt a new framework in which national banks would be governed by uniform federal standards.[18] With this design, the state and national banking systems have grown up around one another, creating the "dual banking system" we know today.

A. Benefits of the Dual Banking System

Encompassing both large institutions that market products and services nationally and very small institutions that do business exclusively in their immediate communities, the dual banking system provides both banks and consumers with significant benefits. These benefits flow from the competitive dynamic between the national and state systems when each component system is allowed to function in accordance with its distinctive attributes.

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[17] 321 U.S. 233 (1944).

[18] The "very core of the dual banking system is the simultaneous existence of different regulatory options that are not alike in terms of statutory provisions, regulatory implementation and administrative policy." Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 20 Stan. L. Rev. 1, 41 (1977).

1. States may serve as laboratories for innovative and new approaches

One of the well-understood benefits of the dual banking systems is that, by having a separate system of state banks, states may serve as laboratories for innovation and for new approaches to an issue, without compelling adoption of a particular approach by all states or as a national standard. That is, the dual banking system is built on the ability of individual states experimenting with different kinds of laws, including new consumer protection laws that apply to state banks in a given state, but not to state banks in all states and not to national banks. Over time, some of these individual state laws have proven to be good ideas, while others have not. When Congress has believed that a particular state's experiment is worthwhile, it has enacted that approach to apply throughout the country, not only to all national banks, but to state banks operating in other states that have not yet adopted such laws.

The national banking system, on the other hand, is the venue for efficiencies and benefits that flow from uniform national standards. This role is increasingly important as the market for financial products and services has evolved, as advances in technology have enabled banks to do business with consumers in many states, and as consumer financial products have become commoditized and marketed nationally. In other words, the national banking system is a laboratory, too, but what it demonstrates is the value of applying uniform national standards to activities and products that, today, have national markets.

2. Promotion of a diverse and flexible financial marketplace

In large part attributable to the competitive dynamic between its national and state banking components, the dual banking system has produced a remarkably diverse and innovative financial marketplace. Bankers can make choices between state and national bank charters on the basis of their business needs and particular circumstances. Businesses and consumers have a wide range of options in the marketplace, as financial institutions are encouraged to respond dynamically to

the changing needs of borrowers and depositors and to provide services and products in an efficient and cost-effective manner. In short, the dual banking system has been critical in producing a banking system that is able to finance growth and meet customer needs through innovation, responsiveness, and flexibility.[19]

Each component of the dual banking system makes different, positive contributions to the overall strength of the U.S. banking system. Efforts to dilute – or eliminate – the unique characteristics of one component of the system undermine the collective strength that comes from the diverse contributions of the two systems. The U.S. banking system as a whole, including the state banking component, benefits from the national banking system's contributions, which flow from the efficiencies and benefits of operating under uniform national standards and a strong and uniform federal supervisory system.

B. The Existence of Federal Preemption as an Essential Characteristic of the Dual Banking System Established by Congress Does Not Disadvantage State Banks and the State Banking Charter

Notwithstanding the role that both the state and national banking components play in the collective strength of the dual banking system, some argue that federal preemption of state laws which interfere or impede with national banks' activities – that is, the application of the Supremacy Clause of the U.S. Constitution – is somehow unfair to the state banking system.

This argument profoundly short-changes the State banking systems and the crucial role they play in the modern financial services marketplace. More fundamentally, however, the argument is backwards. National and State charters each have their own distinct advantages. Indeed, State banking supervisors vigorously assert that the State charter is superior. Numerous State banking department websites provide lists of the advantages of the State charter, often including a side-by-side comparison of fees and assessments to demonstrate the lower costs of a

[19] *See* Susan S. Bies, Governor, Board of Governors of the Federal Reserve System, Remarks Before the Conference of State Bank Supervisors (May 30, 2003).

State charter.[20] One state banking department, after a listing of ten advantages of the State charter, concludes that the "state banking charter the charter of choice" for banks in that state.[21] Some states have actively marketed the State bank charter, sending unsolicited letters, and even videos, touting the benefits of a State bank charter to national banks.

When all factors are considered, the number of national and state-chartered banks simply does not suggest that the principle of preemption has eroded the dual banking system.[22] As of June 30, 2009, there were 5,490 FDIC-insured, state-chartered commercial banks, and 1,505 FDIC-insured, OCC-chartered national banks.[23] Far from signaling that state-chartered institutions are disadvantaged, these figures amply demonstrate the important role played by the state banking systems and the vitality of the dual banking system.[24]

C. Benefits of the National Banking System and Uniform Standards of Operation and Supervision

From its establishment, the national banking system has been governed by uniform federal standards of operation and supervision. When a state law has impeded or significantly interfered with powers granted national banks under Federal law, the courts have held that under the Supremacy Clause the state law is preempted. Over the years, preemption of state laws that

[20] *See, e.g.,* Texas Department of Banking, http://www.banking.state.tx.us/corp/charter/benefits.htm; California Department of Financial Institutions, http://www.dfi.ca.gov/cacharter/advantages.asp; South Dakota Division of Banking, http://www.state.sd.us/drr2/reg/bank/banktrust/State%20Charter%20Comparison.pdf;

[21] Tennessee Department of Financial Institutions, http://www.state.tn.us/tdfi/banking/charter.html.

[22] *See* "The Benefits of Charter Choice: The Dual Banking System As A Case Study," prepared by the Conference of State Bank Supervisors and the American Bankers Association (June 24, 2005) (concluding the dual banking system "works," fostering innovation, making products and services more widely available, and lowering costs). *See also* Testimony of Joseph A. Smith, Jr., North Carolina Commissioner of Banks, on behalf of the Conference of State Bank Supervisors, before the Committee on Financial Services of the U.S. House of Representatives (Sept. 23, 2009) (arguing that creation of a single federal financial regulator would undermine the dual banking system; state-chartered institutions and the financial system itself have benefited from the debate among state and federal regulators); Testimony of Jospeh A. Smith, Jr., North Carolina Commissioner of Banks, on behalf of the Conference of State Bank Supervisors, before the Committee on Financial Services of the U.S. House of Representatives (July 24, 2009) (stating that the dual banking system has produced a diverse, dynamic, and durable banking industry and broad access to affordable credit).

[23] FDIC Quarterly Banking Profile (June 30, 2009).

[24] Jeffery C. Vogel, Conference of State Bank Supervisors Chairman, 2007-08, "CSBS Year in Review," (May 21, 2008) (stating that "the state banking system is a significant and vital force in our local and national economies").

impede or interfere with national banks' activities has fostered the creation of a set of predictable rules for national banks, which has lowered the costs of interstate banking and opened the financial marketplace. Such openness benefits both consumers and banks alike.[25]

The banking system benefits from (1) greater economies of scale, as consumer products become commoditized and marketed in larger geographic areas; (2) improved risk management, as banks diversify across product offerings and across geographic markets; and (3) increased competition in the bank sector, a crucial factor in the continued vitality of the dual banking system. While these benefits accrue to all banks, they are especially important for smaller banking companies with customers in more than one state, where economies of scale and cost-effective risk management are critical if they are to operate efficiently.

D. Preemption and the Practical Impact of Applying State Laws to National Banks

As demonstrated above, important benefits flow from the ability of national banks to conduct their banking business under uniform national standards. Federal preemption of state laws that impede or interfere with national banks' activities preserves these uniform standards. Repeal or removal of federal preemption would create the potential for national banks to be subject to myriad state and local regulations and restrictions with significant practical impact on their banking activities. Such a balkanized approach would give rise to considerable uncertainty about which sets of standards apply to institutions conducting a multistate business. That, in turn, would generate major legal and compliance costs and impediments to product delivery for all banks, large or small.

For example, there are a number of areas in which complying with different standards set by individual states would require a bank to determine which state's law governs – the law of the

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[25] *Cf.* Jith Jayaratne & Philip E. Strahan, "The Benefits of Branching Deregulation," FRBNY Econ. Pol'y Rev. 13 (1997) (finding that, as geographic restrictions on interstate branching were removed between 1978 and 1992, bank efficiency improved greatly, with reduction in operating costs passed along to consumers in the form of lower loan rates).

state where a person provides a product or service; the law of the home state of the bank; or the law of the state where the customer is located. It is far from clear how a bank could do this based on objective analysis, and any conflicts could result in penalties and litigation in multiple jurisdictions. Practical problems could arise from different grace periods for credit cards; different internet advertising rules; different solicitation standards for telephone sales, with different duties for sales personnel; different employee compensation limits; and different licensing requirements for new products.

On this basis alone, the maintenance of uniform national standards is compelling. But on at a more granular level – at the level of potential types of state regulation of national banks' activities – the case in favor of preemption is forceful. In practical terms, there are generally three categories of state laws involved: 1) laws that prevent or impede the ability of a national bank to operate or offer a particular product or service; 2) laws that impose controls on pricing of particular products or indirectly affecting pricing by prohibiting specified terms; and 3) laws regulating the manner and means by which consumers are provided information about the bank's financial products and services.

1. Preventing or impeding the ability of a national bank to operate or offer a particular product or service

The banking business of national banks is controlled by Federal law, specifically the National Bank Act ("NBA"), 12 U.S.C. § 1 *et seq.*, and federal regulations. The NBA authorizes national banks to engage in activities that are part of, or incidental to, the business of banking, plus other specified activities set forth in the NBA. When a state attempts to regulate a national bank's activities by precluding national banks from operating within the state – where they are authorized to operate under Federal law – or to bar national banks from offering products or services – which they are authorized to offer under Federal law, the state is directly interfering with powers granted under Federal law. Such interference is fundamentally at odds with

Constitutional principles embodied in the Supremacy Clause. Examples of this type of state law include the following:

- Different states could impose licensing or product clearance requirements that could simply prevent national banks from providing certain products and services, or subject certain or new products and services to a state-by-state level pre-clearance.
- Different states could impose different capital or net worth requirements or security deposit requirements as preconditions for product providers operating in the state, such as net worth requirements for mortgage originators based on size or volume of business conducted in a state.
- Different states could specify requirements regarding the structures through which a bank must operate in order to provide certain products, based on a view that certain corporate structures or reporting lines are needed to effectively implement consumer protection objectives.

2. Imposing controls on pricing of particular products or indirectly affecting pricing by prohibiting specified terms

A second type of state law may attempt to impose controls on the pricing of particular products or indirectly affect pricing by prohibiting specified terms. A state could seek to impose direct price controls, by dictating how much a bank may charge for a product or service or when fees or other charges may be imposed, or may indirectly control prices, by prohibiting or conditioning the use of certain product features. Whether implemented directly or indirectly, such price controls represent the state telling a federally-chartered bank how much it can charge for particular products and services when no such pricing restriction exists under Federal law.

A national bank's authority to provide products or services to its customers necessarily encompasses the ability to charge a fee for the product or service.[26] This ability to charge a fee for the bank's products and services is expressly reaffirmed in OCC regulations.[27] As a result, state efforts to limit or otherwise control, directly or indirectly, the price a national bank may

[26] *Bank of America v. City and County of San Francisco*, 309 F.3d 551 (9th Cir. 2002), *cert. denied*, 538 U.S. 1069 (2003).

[27] 12 C.F.R. Section 7.4002(a) provides that "[a] national bank may charge its customers non-interest charges and fees, including deposit account service charges."

charge for its products and services are preempted and invalid under the Supremacy Clause.

Examples of these types of restrictions are:

- Different states could impose different limits on the rates of interest that may be charged to consumers in their states, and could prescribe different definitions of what types of charges constitute "interest" for purposes of each state's "interest" rate cap.
- Different states could impose other limits or directives on particular terms and conditions of any consumer financial product offered by the bank. Banks could be required to offer specified products and services that conform to specified terms. States also could dictate particular product features, such as minimum payment requirements, grace periods, minimum periods for loan repayment, and early termination of mortgage insurance.

3. Regulating the manner and means by which consumers are provided information about financial products and services

A third type of state law may attempt to regulate how national banks conduct business by dictating the manner and means by which consumers are provided information about financial products and services.[28] For example, states could impose different disclosure requirements in connection with sales and solicitations of products or even requirements dictating the presentation and format of such disclosures. Examples of this type of state law requirement include the following:

- Different states could impose different disclosure requirements in connection with sales and solicitations of particular products.
- Disclosure requirements could dictate not just substantive content, but also presentation and placement of disclosures, further impeding the ability of consumers to comparison shop.
- Different states could impose different standards concerning manner of negotiation, sales and solicitation of particular financial products and services with respect to consumers in each state.

In recent years, the federal government and agencies have developed a much-expanded rulewriting process for developing standards for consumer disclosures, and other

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[28] This type of law does not include a state law that embodies a business conduct standard, such as a prohibition on offering products and services in a manner that is unfair or deceptive, comparable to the standards in section 5 of the Federal Trade Commission Act.

communications, which convey important financial information to consumers. The process incorporates nationwide public comment process and extensive consumer testing to identify the information most meaningful to consumers and the most effective way to convey it to them. In the absence of preemption, a state could require – on any basis – that disclosures or communications take a form other than that required by the federal standards produced by this robust federal process. There is no basis to assume that the disclosure requirements imposed by any state – which would not be based on the comment process and testing used to develop a federal rule – would be better than the federal rule. For a national bank that operates interstate, the least costly option may be to cede to the requirements of the state with the apparently most extensive disclosure requirements, if doing so would satisfy the remaining states' requirements. The practical result would then be that a single state's requirements displace the standards promulgated in the federal rulemaking process, not just in one state, but in multiple states.

Permitting the states to adopt different disclosure requirements also has real downsides for consumers. As compliance costs increase, some portion of these costs is passed on to consumers of financial products and services. Yet, at the same time, consumers' ability to look out for themselves and comparison shop for the best deal is undermined if differences in disclosure and communication requirements undermine their ability to compare products.

E. Preemption Incentivizes Robust Federal Standards

A key to the benefits of preemption described above is strong consumer protection standards at the federal level – a position the OCC agrees with.[29] In fact, preemption, when coupled with robust federal standards for national banks, operates as an incentive for the application of robust standards at the federal level that will apply to all participants in the

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[29] *See* Testimony of John C. Dugan, Comptroller of the Currency, before the Committee on Financial Services of the U.S. House of Representatives, (Jun. 13, 2007) (setting forth in detail the OCC's comprehensive approach to consumer protection regulation).

financial marketplace. With comprehensive robust federal standards in place to identify and resolve problems before they explode, there is no need for state "first responders" to arrive at the scene of a disaster, assess the damage and treat the wounded. Strong federal standards should prevent the disaster. Prevention, and not response, should be the first goal.

IV. Preemption Did Not Cause the Subprime Mortgage Lending Crisis

Some critics of preemption allege that it was a primary cause of the subprime mortgage crisis. This argument crumbles when facts and hard numbers are analyzed. The vast majority of subprime loans were originated by state licensed and supervised lenders and mortgage brokers, not federally-regulated banks. National banks had a limited share of subprime lending during crucial recent years, and those loans have a better performance record than nonbank subprime lending. Indeed, a portion of national banks' loans labeled "subprime" was to low- and moderate-income borrowers in furtherance of banks' CRA obligations. Community advocates and Federal Reserve researchers agree that these loans are of higher quality and have performed better than mortgages made by lenders not covered by CRA.

A. National Banks Did Limited Subprime Lending, and when National Banks Originated Subprime Mortgage Loans, Those Loans Have Performed Better than Subprime Lending as a Whole

On a nationwide basis, national banks and their subsidiaries accounted for approximately 12 to 14 percent of all non-prime originations, in the years 2005-2007, the peak years for non-prime lending.[30] The overwhelming majority of non-prime loans originated during this period were made by entities licensed and supervised by the states.[31]

[30] Letter from John C. Dugan, Comptroller of the Currency, to Elizabeth Warren, Chair, Congressional Oversight Panel (Feb. 12, 2009) (analyzing data from Loan Performance Corporation and Home Mortgage Disclosure Act data).

[31] *Id. See also* Report and Recommendations by the Majority Staff of the Joint Economic Committee, "The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here," at p. 17 (Oct. 2007) ("The mortgages underwritten by subprime lenders come from many sources, but the overwhelming majority is originated through mortgage brokers.")

The subprime loans originated by national banks and their subsidiaries generally have performed better than subprime lending as a whole, with lower foreclosure rates.[32] The OCC identified the ten mortgage orginators with the highest rate of subprime and Alt-A mortgage foreclosures in the ten metropolitan statistical areas ("MSAs") experiencing the highest foreclosure rates for the years 2005-2007. Of the 21 firms comprising the "worst 10" in those 10 MSAs, 12 firms – accounting for nearly 60 percent of non-prime mortgage loans and foreclosures – were exclusively supervised by the states. *See* Attachment A. The lower foreclosure rates generally indicate that the subprime loans originated by national banks were relatively higher quality and better underwritten mortgages.

B. A Portion of National Banks' Subprime Lending Was Made to Low- and Moderate-Income Borrowers in Furtherance of CRA Obligations

A portion of the non-prime mortgage loan origination by national banks is traceable to efforts by national banks to fulfill their obligations to help meet the credit needs of their local communities, including low- and moderate-income ("LMI") areas, under the Community Reinvestment Act ("CRA"). Potential borrowers in LMI areas tend to have lower credit scores – average credit scores in LMI census tracts are about 90 points less than average scores in other census tracts – placing many of them in the "subprime" category. National banks can and do lend to borrowers with lower credit scores, but to do so prudently the banks generally price the loans to cover the higher risk associated with lower credit scores. The annual Home Mortgage Disclosure Act ("HMDA") data indicates that nearly 30 percent of mortgage loans with higher interest rates, so-called "rate spread loans,"[33] originated by national banks and their operating subsidiaries tended to be in LMI census tracts, even though those tracts account for only approximately 15

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[32] Testimony of John C. Dugan, Comptroller of the Currency, before the Committee on Financial Services of the U.S. House of Representatives, *supra* note 29; Letter from John C. Dugan, Comptroller of the Currency, to Elizabeth Warren, Chair, Congressional Oversight Panel, *supra* note 30.

[33] Rate spread loans and subprime loans are not exactly the same thing, but the HMDA data are more comprehensive and of higher quality than other data sources that focus narrowly on subprime loans, and the results likely are a good indication of overall tendencies in the market.

percent of national banks' mortgage lending overall. These numbers suggest a discernible share of subprime lending done by banks was done for CRA purposes.[34]

This portion of subprime lending was not, as some have suggested, the cause of the subprime crisis. Where CRA-covered banking institutions made subprime loans in their assessment areas, in aggregate these subprime loans have performed better than subprime loans made by other types of lenders. For example, a study by the Federal Reserve Bank of San Francisco concluded that subprime origination volume by CRA-covered lenders within CRA assessment areas was relatively small, and that loans made by a CRA-covered lender within its assessment area are markedly less likely to go into foreclosure than loans made in the same area by lenders not subject to CRA.[35] A second Federal Reserve study found that mortgages originated and held in portfolio under the affordable lending programs operated by the NeighborWorks partners[36] across the country have, along any measure of delinquency or foreclosure, performed better than subprime and FHA-insured loans and have a lower foreclosure rate than prime loans.[37]

In summary, a portion of national banks' non-prime loans were made to fill their obligations under CRA, but these loans did not cause the mortgage crisis. Subprime origination in CRA assessment areas was too small relative to the overall mortgage market to be a primary cause of the crisis, and subprime lending by CRA-covered lenders has been shown to outperform mortgages made by lenders not covered by CRA.

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[34] These figures were derived through analysis of FFIEC data on credit scores and HMDA data on 1-4 family first lien mortgage origination.

[35] Elizabeth Laderman and Carolina Reid, Federal Reserve Bank of San Francisco, "Lending in Low- and Moderate-Income Neighborhoods in California: The Performance of CRA Lending During the Subprime Meltdown" (Nov. 14, 2008), at pp. 14-16.

[36] Many loans originated through NeighborWorks programs are done in connection with CRA-covered institutions.

[37] Glenn Canner and Neil Bhutta, Board of Governors of the Federal Reserve System, Division of Research and Statistics, "Staff Analysis of the Relationship between the CRA and the Subprime Crisis," p. 3 and p. 8 table 3 (Nov. 21, 2008), at p.5 and table 9, p. 10.

VI. Conclusion

From its establishment, the national banking system has been governed by uniform federal standards of operation and supervision. These characteristics are fundamental to the distinctions that are the essence of the “dual banking system.” These uniform federal standards have fostered the creation of a set of predictable rules and consistent federal oversight for national banks, which has lowered the costs of interstate banking and opened the financial marketplace. The banking system benefits from greater economies of scale, improved risk management, and increased competition in the bank sector. In turn, consumers have benefitted from nationally uniform standards of consumer protection, the availability of a wider range of banking products and services and, overall, lowering the costs of credit and other banking products and services.

Attachment A

Worst Ten in the Worst Ten: Supervisory Status of Mortgage Originators

Originator	Supervisor	Foreclosures in Worst 10 Metro Areas, based on 2005-07 Originations
New Century Mortgage Corp.	State supervised. Subsidiary of publicly-traded REIT, filed for bankruptcy in early 2007.	14,120
Long Beach Mortgage Co.	State and OTS supervised. Affiliate of WAMU, became a subsidiary of thrift in early 2006; closed in late 2007 / early 2008.	11,736
Argent Mortgage Co.	State supervised until Citigroup acquired certain assets of Argent in 08/07. Held by Citigroup, new lending curtailed and merged into CitiMortgage (NB opsub) shortly thereafter.	10,728
WMC Mortgage Corp.	State supervised. Subsidiary of General Electric, closed in late 2007.	10,283
Fremont Investment & Loan	FDIC supervised. California state chartered industrial bank. Liquidated, terminated deposit insurance, and surrendered charter in 2008.	8,635
Option One Mortgage Corp.	State supervised. Subsidiary of H&R Block, closed in late 2007.	8,344
First Franklin Corp.	OCC supervised. Subsidiary of National City Bank. Sold to Merrill Lynch 12/06. Closed in 2008.	8,037
Countrywide	Data includes loans originated by (1) Countrywide Home Loans, an FRB and state-supervised holding company affiliate until 03/07, and an OTS and state-supervised entity after 03/07; and (2) Countrywide Bank, an OCC supervised entity until 03/07, and an OTS supervised entity after 03/07.	4,736
Ameriquest Mortgage Co.	State supervised. Citigroup acquired certain assets of Ameriquest in 08/07. Merged into CitiMortgage (NB opsub) shortly thereafter.	4,126
ResMae Mortgage Corp.	State supervised. Filed for bankruptcy in late 2007.	3,558
American Home Mortgage Corp.	State supervised. Filed for bankruptcy in 2007.	2,954
IndyMac Bank, FSB	OTS supervised thrift. Closed in July 2008.	2,882
Greenpoint Mortgage Funding	FDIC supervised. Acquired by Capital One, NA, in mid 2007 as part of conversion and merger with North Fork, a state bank. Closed immediately thereafter in 08/07.	2,815
Wells Fargo	Data includes loans originated by (1) Wells Fargo Financial, Inc., an FRB and state-supervised entity, and (2) Wells Fargo Bank, an OCC supervised entity.	2,697
Ownit Mortgage Solutions, Inc.	State supervised. Closed in late 2006.	2,533
Aegis Funding Corp.	State supervised. Filed for bankruptcy in late 2007.	2,058
People's Choice Financial Corp.	State supervised. Filed for bankruptcy in early 2008.	1,783
BNC Mortgage	State and OTS supervised. Subsidiary of Lehman Brothers (S&L holding company), closed in August 2007.	1,769
Fieldstone Mortgage Co.	State supervised. Filed for bankruptcy in late 2007.	1,561
Decision One Mortgage	State and FRB supervised. Subsidiary of HSBC Finance Corp. Closed in late 2007.	1,267
Delta Funding Corp.	State supervised. Filed for bankruptcy in late 2007.	598

APPENDIX B: ACTIVITIES OF NATIONAL BANKS RELATED TO SUBPRIME LENDING

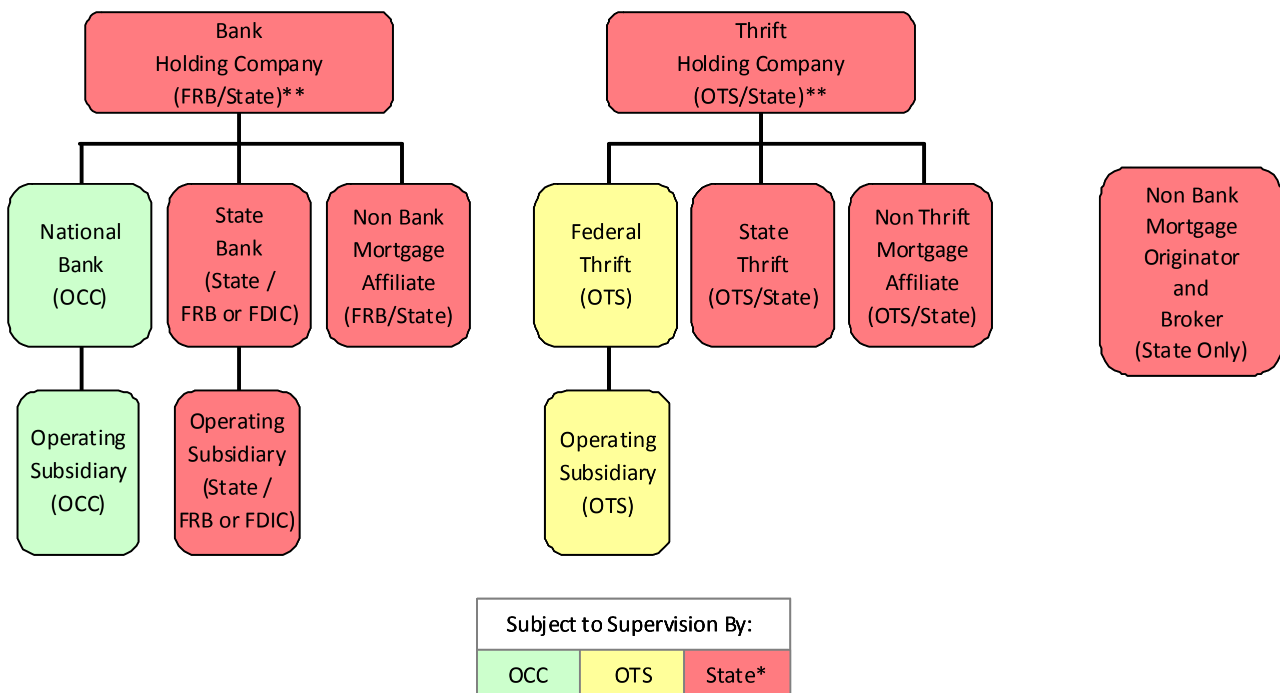
National banks and their operating subsidiaries can be engaged in several different types of activities that are related to nonprime residential mortgage lending, including direct loan origination, loan servicing, providing warehouse lines of credit to subprime originators, purchasing loan for securitization, or acquiring various types of securities that are backed by subprime loans.

I. Direct Origination

OCC analysis has found that national bank subprime origination during the period preceding the financial crisis was small relative to the total subprime market. However, some analyses by others have reached conflicting conclusions, finding significantly higher percentages of overall subprime mortgage lending. To some extent the existence of conflicting estimates is not surprising. Developing precise estimates of subprime lending activity is difficult because comprehensive data for the market simply do not exist, from either private or public sources. Statements about subprime activity also suffer from lack of agreement at a more basic level regarding how to define "subprime" or other variants of nonprime mortgage loans. Some of the potential approaches to measuring or approximating the size of the subprime market and banks' shares of that market are reasonable, others less so. As described below, the OCC has taken a rigorous approach that produces estimates of subprime activity that are more accurate than other, conflicting estimates.

Estimates of subprime activity often accompany discussions of which supervisors were responsible for subprime mortgages lenders. This requires careful identification of both lenders and their associated supervisor; a common source of confusion stems from failure to recognize important distinctions between banks, subsidiaries of banks, and affiliates of banks within bank holding companies, and how those distinctions determine the responsible regulator. Chart 1 illustrates the differences:

Chart 1



* As noted, some mortgage originators are regulated by both state and federal regulators.
** Some (mostly smaller) banks and thrifts are not part of holding companies and are not represented separately here.

Banks may make subprime loans, and may have operating subsidiaries that also make loans; however, other non-bank subsidiaries owned by parent holding companies can and do originate loans as well. In addition, many mortgage lenders, including independent mortgage companies and brokers, are not affiliated with banking or thrift companies at all. Only national banks, federal thrifts, and their operating subsidiaries (the green and yellow boxes in the chart) are subject to exclusive federal regulation; state-chartered banks and thrifts and nonbank subsidiaries of bank and thrift holding companies are subject to both federal and state regulation, and lenders that are not affiliated with banks or thrifts are not subject to regulation by the federal banking agencies.

Using the most reliable data available on nonprime mortgage lending, and accurately accounting for corporate organization and regulatory responsibilities, national banks and their subsidiaries subject to OCC supervision accounted for less than 15 percent of nonprime activity. This percentage is strikingly and disproportionately low, given the central role of national banks in the U.S. mortgage markets; according to the comprehensive data collected under the Home Mortgage Disclosure Act, national banks and their operating subsidiaries originated nearly 30 percent of all mortgages during the corresponding period. In contrast, lenders supervised solely by the states accounted for well over half of nonprime lending; combining originations by those lenders with the totals for state-chartered banks reveals that nearly three quarters of nonprime mortgages originated at lenders that were wholly or partly the responsibility of state authorities. Other, higher estimates of the share of national banks are based on less reliable data or fail to accurately account for the corporate structure of holding companies and the regulators responsible for different entities within those holding companies, *e.g.,* often combining a bank's holding company affiliates with the bank. Moreover, the data show that subprime mortgages originated by OCC-supervised lenders have performed better than other subprime loans, with lower rates of foreclosure.

A. OCC Estimates of Subprime Activity

1. Early estimates

In early 2007, OCC staff estimated that national banks accounted for about 10 percent of subprime (so-called "B/C") mortgage originations during 2006. This estimate was a rough approximation done on a best-efforts basis using the best information available at the time.

Specifically, in the absence of any formal reporting of subprime activity, OCC supervisory staff collected information on the dollar volume of subprime lending from major mortgage originators in the national bank population; this yielded an estimate of national bank subprime lending, although it was only an approximation since it reflected definitions of "subprime" that varied across banks. That supervisory estimate of national bank volume corresponded to about 10 percent of overall subprime market originations for 2006, estimated at $600 billion based on data published in the March 23, 2007, edition of the industry publication *Inside Mortgage Finance*.[1]

Using *Inside Mortgage Finance* to estimate the overall size of the market for the analysis was expedient, since it was one of the few sources of information on what had recently become a

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[1] March 23, 2007.

prominent part of the mortgage market. However, the figures presented in *Inside Mortgage Finance* were compiled by that publication from various sources (including analyst reports and self-reported figures from staff at the originating institutions), and may not be reliable; in some cases institutions chose to report figures using varying definitions and methods to create particular market perceptions. Market share figures computed from *Inside Mortgage Finance* may be particularly misleading, because the methods did not encompass the entire market, and the overall size of the market can only be very roughly approximated from the published tables of data.

2. Later estimates

To refine estimates of national bank activity in non-prime residential mortgage markets, the OCC acquired a database developed and marketed by Loan Performance Corp. (or "LPC," now a unit of First American CoreLogic Inc). This is the premier data source on nonprime (that is, both subprime or B/C and Alt-A) mortgage activity. LPC covers virtually all securitized B/C and Alt-A mortgages; the database covers the market fairly well because most such mortgages have been securitized since they were originated.

A 2008 OCC analysis focused on loans in LPC originated during the years 2005, 2006, and 2007, the peak years of subprime mortgage activity. One challenge with using LPC is that originator name information – that is, the identity of the bank or mortgage company that actually made the loan in the first place – is captured and presented inconsistently in the database. Many loans (about 43 percent) have no originator information, others have ambiguous names, and still others do not adequately distinguish among affiliated entities with similar names. OCC staff used a variety of automated and manual methods to identify the originators of as many loans in LPC as possible.

The result was a large dataset consisting of roughly five million nonprime loans for which the originator was known. For each originator in LPC, the OCC then identified the primary supervisor, taking into account dates at which the primary supervisor changed during the time period considered (for example, one major subprime originator, First Franklin, shifted from OCC to OTS supervision in late 2006), and wherever possible distinguishing between depository institutions and their holding company affiliates.

Some significant subprime originators had a large number of loans in LPC for which it was difficult to determine whether the loans were originated by the bank or by an affiliate within the larger holding company. Referring to Chart 1, it was clear that the loans originated somewhere within the holding company structure, but not from which specific box on the chart; without that, estimates of the sources of subprime (for example, OCC-supervised versus others) would remain imprecise. In those cases, other information available to the OCC in its supervisory role – including confidential information from resident examiners at banks – was used to determine realistic allocations of the loans in the database. However, the OCC also conducted sensitivity analysis to determine the impact of alternative allocations and how much the results might change. Estimates of the nonprime mortgage share of national banks varied from about 11 percent to about 15 percent, but the most likely allocations of originations suggested that the national bank share of nonprime loans in the LPC data originated during 2005, 2006, or 2007 was 14 percent or less.

3. Most recent estimates

More recently, the OCC has updated and refined the analysis of the LPC nonprime data. One obvious development since the 2008 analysis is that more loans have entered foreclosure. Summary results are presented in the tables below. Of the roughly 5 million nonprime loans from 2005-2007 in the LPC data for which the originator could be reliably identified, OCC-supervised institutions accounted for 10.6 percent of subprime loans (B/C), and 12.1 percent of nonprime loans including both B/C and Alt-A. Lenders supervised only by the states originated 63.6 percent of subprime loans during these years, and 57.1 percent of combined nonprime; including loans originated by state-chartered banks, 72 percent of all nonprime mortgages came from lenders subject to state authority.[2]

Nonprime (B/C and Alt-A) Originations, 2005-2007

Supervisor	Originations	Share
State	2,818,126	57.1%
FDIC	436,981	8.9%
Federal Reserve	295,343	6.0%
*Subtotal**	*3,550,450*	*72.0%*
OCC	**595,304**	**12.1%**
OTS	783,719	15.9%
NCUA	3,024	0.1%
Total	4,932,497	100.0%

*Subtotal reflects institutions subject to state supervision

Subprime (B/C) Originations, 2005-2007

Supervisor	Originations	Share
State	2,423,355	63.6%
FDIC	318,796	8.4%
Federal Reserve	224,882	5.9%
*Subtotal**	*2,967,033*	*77.9%*
OCC	**403,958**	**10.6%**
OTS	439,488	11.5%
NCUA	233	0.0%
Total	3,810,712	100.0%

Source: LPC data and OCC calculations

B. Other Estimates of Subprime Activity

Analyses conducted by others have produced different estimates of subprime activity and its allocation among institutions and regulators. After reviewing many of these analyses, the OCC has concluded that most have shortcomings that raise significant questions about their accuracy and relevance compared to results based on a careful analysis of the LPC data.

[2] The figure understates the actual extent of state authority, because loans made by affiliates of federal thrifts are included in the OCC/OTS total but actually are subject to state authority.

1. HMDA data

Some discussions of residential mortgage problems are based on the annual reporting required of mortgage lenders under the Home Mortgage Disclosure Act ("HMDA"). However, HMDA data cannot be relied upon directly to evaluate subprime lending by financial institutions, because rate-spread loans and subprime loans are not necessarily the same.

The HMDA data have the advantage of providing a fairly comprehensive picture of mortgage applications and originations, as well as identifying the originators and their associated regulators. But the HMDA data do not include any designation for subprime loans, nor do they include information such as credit scores (which might be used to infer subprime status). What HMDA *does* contain, which makes the data potentially relevant to subprime activity, is information on higher-priced or "rate-spread" loans. Under HMDA, a loan is deemed to have a high "rate spread" that must be reported if the loan has an APR at least 3 percentage points higher than the yield on a Treasury security of comparable maturity, for first-lien mortgages. Since subprime loans might be expected to have higher interest rates than otherwise similar loans, the HMDA rate-spread loan data may be useful as a supplement to other estimates of subprime activity, given the generally poor quality of information on subprime.

In view of this, it is not surprising that the rate-spread data are sometimes used in the context of subprime mortgage discussions. A notable example is the 2009 Senate testimony of Professor Patricia McCoy.[3] In that testimony, Professor McCoy observed "In 2006, depository institutions and their affiliates, which were regulated by federal banking regulators, originated about 54% of all higher-priced home loans. In 2007, that percentage rose to 79.6%." Professor McCoy's testimony accurately characterizes the figures on rate-spread loans.

However, the percentages quoted by Professor McCoy include a large number of loans made not by banks, but rather by other lenders owned by the banks' parent holding companies; as described above in the discussion of Chart 1, such lenders are subject to regulatory oversight that is different in nature and degree than the oversight of depository institutions. Excluding holding company affiliates, the corresponding percentages of rate-spread lending for depository institutions – banks and thrifts together – were 41 percent in 2006 and 62 percent in 2007. In fact, depository institutions actually account for a disproportionately low share of rate-spread loans in the HMDA data, considering their central role in providing mortgage credit in the United States; for example, in 2006 when their share of rate-spread loans was 41 percent, they accounted for 59 percent of all originations.

Moreover, the only reason the bank and thrift *share* of rate-spread loans rose between 2006 and 2007 was because a very large number of independent mortgage companies either disappeared or dramatically reduced originations, leaving banks and thrifts as the main providers of home loans of all types. The *number* of "higher-priced" originations by depository institutions and their affiliates actually fell in 2007, but since these institutions were the primary lenders remaining in the market for home loans, their *share* of lending increased.

[3] Prepared statement of Patricia A. McCoy, Hearing on "Consumer Protections in Financial Services: Past Problems, Future Solutions" before the Senate Committee on Banking, Housing, and Urban Affairs, March 3, 2009, *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=40666635-bc76-4d59-9c25-76daf0784239.

But rate-spread loans are not necessarily subprime, and subprime loans may not necessarily have high rate spreads. Using data from LPC and from the OCC's own Mortgage Metrics[4] database, the OCC has been able to assess the extent of overlap between HMDA rate-spread loans and the nonprime loans from the other data sources. This again requires a careful and complex process of matching loans from different data sources, to ensure that a particular loan reported under HMDA is in fact the same loan as one appearing in one of the other databases. The OCC has devoted significant resources to creating an accurate mapping of this type, because the matched data are valuable for supervision, analysis, policy development, and other uses.

For the peak subprime year of 2006, the OCC found that 64 percent of rate-spread loans were subprime, and another 11 percent were Alt-A; the remaining 25 percent of rate-spread loans were prime mortgages. However, not all subprime and Alt-A loans have rate spreads that cause them to be captured in the rate-spread reporting; again for 2006, the OCC found that 37 percent of the loans in Mortgage Metrics designated as "subprime" were not reported as rate-spread loans under HMDA, and the non-rate-spread percentage for Alt-A was much higher, at 82 percent. These percentages vary over time due to market conditions; in 2007 a higher percentage of prime loans were rate-spread loans and more rate-spread loans were prime compared to 2006, whereas the opposite was true in 2005.

Although data from HMDA are valuable for some purposes, the limited overlap between HMDA rate-spread loans and the nonprime loan population makes HMDA a potentially misleading source of information on subprime mortgage lending.

2. Inside Mortgage Finance

Some other discussions of subprime activity continue to rely on data from *Inside Mortgage Finance*, despite the clear drawbacks discussed above of using information from that source to make inferences about subprime market shares.

A notable recent example is a paper prepared by the National Consumer Law Center ("NCLC"). That report uses data from *Inside Mortgage Finance* to argue that a group of eight federally supervised institutions accounted for 31.5 percent of subprime originations, as shown in the table reproduced from that report[5] below:

[4] These data are the basis for the *Mortgage Metrics Report*, a joint publication of the OCC and the Office of Thrift Supervision that provides performance and other data on approximately 34 million first mortgage loans serviced by national banks and federal thrifts.

[5] *Preemption and Regulatory Reform: Restore the States' Traditional Role as 'First Responder'*, National Consumer Law Center White Paper (September 2009).

From NCLC White Paper:

Table 1: Subprime Loans By National Banks and Federal Thrifts 2006
(includes operating subsidiaries)

LENDER	RANK	$ (BILLIONS)	*MARKET SHARE*
CitiMortgage, NY*	4	$38	6.3%
WMC Mortgage (GE), CA	5	33	5.5%
Wells Fargo Home Mort., IA	9	28	4.6%
First Franklin (National City Bank), CA	10	28	4.6%
Washington Mutual, WA	11	27	4.4%
BNC Mortgage, CA (Lehman Bros. Bank)	16	15	2.4%
Chase Home Finance, NJ	17	12	1.9%
Equifirst, NC (Regions Bank)	18	11	1.8%
TOTAL		$190	31.5%

Source: Inside Mortgage Finance
*CitiMortgage became an operating subsidiary of CitiBank in October 2006. Its volume of subprime originations rose in the 4th quarter, and its market share increased to 10%.

NCLC incorrectly characterizes Equifirst as a national bank when in fact it was a subsidiary of state-chartered Regions Bank, and the figures given for some lenders (most notably WMC Mortgage) differ somewhat from the original source numbers provided by *Inside Mortgage Finance*. Removing Equifirst and correcting other data errors reduces the total "market share" of these federally supervised institutions to 26 percent.[6] However, as noted above, little confidence should be placed even in this corrected figure, due to the unreliable estimate of the overall size of the subprime market used as its denominator.

C. OCC Analysis of Subprime and Alt-A Loan Performance

National banks and their operating subsidiaries engaged in subprime mortgage lending to a relatively modest extent, as demonstrated above. However, not all subprime loans have subsequently caused problems for borrowers, lenders, and others. Subprime and Alt-A loans may be appropriate for some borrowers in some situations. The quality of the underwriting process – that is, determining through analysis of the borrower and market conditions that a borrower is highly likely to be able to repay the loan as promised – is a major determinant of subsequent loan performance. The quality of underwriting varies across lenders, a factor that is evident through comparisons of rates of delinquency, foreclosure, or other loan performance measures across loan originators. Through analysis of the available data, the OCC has determined that subprime loans originated by OCC-supervised institutions have generally performed better than similar loans originated by other lenders.

The subprime data from LPC used for the analysis of market share above also contains information on how loans have performed since they were originated. In analysis done in 2008, the OCC used that information to analyze the foreclosure experience in the ten metropolitan areas hardest hit by foreclosures, and to identify the ten originators with the largest number of non-prime loans that went into foreclosure in those markets. The results are described in the

[6] The correct figure for BNC Mortgage is $14 billion, and for WMC Mortgage $11 billion.

attached note on the "Worst 10 in the Worst 10" analysis. As noted there, nearly 60 percent of non-prime mortgage loans and foreclosures in the "Worst 10" markets were from originators not supervised by any federal banking agency. *See* Attachment 1.

The OCC recently updated the "Worst 10" analysis using the most recently available data from LPC. Market conditions have continued to deteriorate, and the identity of the hardest hits markets has evolved, with metropolitan areas in California and Florida now dominating the list. However, the list of originators is largely unchanged, as are the overall conclusions. The updated "Worst 10" tables are included as Attachment 2.

In addition to the Worst 10 analysis, the OCC also analyzed the performance of the broader nonprime mortgage market using LPC. That work, shown in Tables 1 and 2, below, found that nonprime loans originated by national banks and their subsidiaries have generally presented fewer problems than loans made by other lenders under two measures of distress. In the column headed "Foreclosure Start Rate," Table 1 shows the percentage of nonprime loans that entered foreclosure at any time after origination (even if they did not go all the way through to eventual foreclosure). Those results indicate that 22 percent of nonprime loans originated by national banks from 2005 through 2007 experienced a foreclosure start as of November 2009, compared to a market average of 25.7 percent. Aside from credit unions, which were not significant originators, that percentage was the lowest of any federal regulator. State-chartered banks, supervised by state regulators and either the FDIC or Federal Reserve, and other lenders subject solely to state authority were the source of 73 percent of the nonprime mortgages that experienced a foreclosure start.

The OCC conducted a similar analysis of the LPC data using a broader indicator of loan deterioration: whether a loan ever became 60 days or more delinquent. The results of that analysis, shown in Table 2, below, mirror those for foreclosures. Of the nonprime loans originated by national banks and their subsidiaries, 37.1 percent became delinquent by 60 days or more at some time after origination, compared to a market average of 45.5 percent. National banks originated 9.8 percent of those nonprime loans. State-chartered banks, supervised by state regulators and either the FDIC or Federal Reserve, and other lenders subject solely to state authority were the source of 73.9 percent of those loans, with the vast majority originated by non-bank lenders subject exclusively to state authority.

Table 1: Nonprime Loans that Experienced a Foreclosure Start

NONPRIME (COMBINED SUBPRIME AND ALT-A) LOANS

Agency	Originations	Market Share	Foreclosure Starts	Foreclosure Start Rate	Share of Foreclosure Starts
OTS	783,719	15.9%	210,943	26.9%	16.6%
STATE*	2,818,126	57.1%	741,068	26.3%	58.4%
FDIC	436,981	8.9%	110,976	25.4%	8.7%
FED	295,343	6.0%	74,169	25.1%	5.8%
OCC	595,304	12.1%	130,806	22.0%	10.3%
NCUA	3,024	0.1%	364	12.0%	0.0%
Total	4,932,497	100.0%	1,268,326	25.7%	100.0%

ALT-A LOANS

Agency	Originations	Market Share	Foreclosure Starts	Foreclosure Start Rate	Share of Foreclosure Starts
FDIC	118,185	10.5%	33,241	28.1%	13.3%
STATE*	394,771	35.2%	98,437	24.9%	39.5%
FED	70,461	6.3%	17,082	24.2%	6.9%
OTS	344,231	30.7%	74,028	21.5%	29.7%
OCC	191,346	17.1%	26,045	13.6%	10.5%
NCUA	2,791	0.2%	351	12.6%	0.1%
Total	1,121,785	100.0%	249,184	22.2%	100.0%

SUBPRIME LOANS

Agency	Originations	Market Share	Foreclosure Starts	Foreclosure Start Rate	Share of Foreclosure Starts
OTS	439,488	11.5%	136,915	31.2%	13.4%
STATE*	2,423,355	63.6%	642,631	26.5%	63.1%
OCC	403,958	10.6%	104,761	25.9%	10.3%
FED	224,882	5.9%	57,087	25.4%	5.6%
FDIC	318,796	8.4%	77,735	24.4%	7.6%
NCUA	233	0.0%	13	5.6%	0.0%
Total	3,810,712	100.0%	1,019,142	26.7%	100.0%

* Denotes entities not subject to supervision by any federal banking agency (reporting to HUD under HMDA).
"Originations" include all subprime and Alt-A loans in LPC originated during 2005-2007 for which the originator could be identified reliably.
"Foreclosure Starts" counts the number of loans that entered foreclosure at any time between origination and November 2009.

Table 2: Loans That Became 60 Days or More Delinquent at Any Time after Origination

NONPRIME (COMBINED SUBPRIME AND ALT-A) LOANS

Agency	Originations	Market Share	Number of Loans Ever 60 Days or More Delinquent	60 Days or More Delinquency Rate	Share of Loans Ever 60 Days or More Delinquent
OTS	783,719	15.9%	783,719	46.6%	16.3%
STATE*	2,818,126	57.1%	1,323,178	47.0%	58.9%
FDIC	436,981	8.9%	212,332	48.6%	9.5%
FED	295,343	6.0%	124,026	42.0%	5.5%
OCC	595,304	12.1%	220,895	37.1%	9.8%
NCUA	3,024	0.1%	538	17.8%	0.1%
Total	4,932,497	100.0%	2,246,092	45.5%	100.0%

ALT-A LOANS

Agency	Originations	Market Share	Number of Loans Ever 60 Days or More Delinquent	60 Days or More Delinquency Rate	Share of Loans Ever 60 Days or More Delinquent
FDIC	118,185	10.5%	46,632	39.3%	12.4%
STATE*	394,771	35.2%	143,402	36.3%	38.4%
FED	70,461	6.3%	24,255	34.4%	6.5%
OTS	344,231	30.7%	119,001	34.6%	31.8%
OCC	191,346	17.1%	40,221	21.0%	10.8%
NCUA	2,791	0.2%	455	16.3%	0.1%
Total	1,121,785	100.0%	373,726	33.3%	100.0%

SUBPRIME LOANS

Agency	Originations	Market Share	Number of Loans Ever 60 Days or More Delinquent	60 Days or More Delinquency Rate	Share of Loans Ever 60 Days or More Delinquent
OTS	439,488	11.5%	246,102	56.0%	13.1%
STATE*	2,423,355	63.6%	1,179,776	48.7%	63.0%
OCC	403,958	10.6%	180,674	44.7%	9.6%
FED	224,882	5.9%	99,791	44.4%	5.3%
FDIC	318,796	8.4%	165,940	52.1%	8.9%
NCUA	233	0.0%	83	35.6%	0.0%
Total	3,810,712	100.0%	1,872,366	49.1%	100.0%

* Denotes entities not subject to supervision by any federal banking agency (reporting to HUD under HMDA).
"Originations" include all subprime and Alt-A loans in LPC originated during 2005-2007 for which the originator could be identified reliably.
"Foreclosure Starts" counts the number of loans that entered foreclosure at any time between origination and November 2009.

D. Other Analyses of Mortgage Loan Performance

Other analysts have presented findings that appear to contradict these general results, finding worse performance for subprime mortgage (or other mortgage) loans from OCC-supervised originators. For example, a recent paper by Ding, Quercia, Reid, and White ("DQRW") released by the Center for Community Capitalism at the University of North Carolina examines the performance of mortgages originated by lenders subject to different regulators in states with and without anti-predatory lending laws.[7]

The study uses loan-level performance data for subprime and Alt-A loans matched to HMDA to compare delinquency rates for loans originated by OCC-regulated institutions in states with anti-predatory lending laws (APL states), before and after finalization of the OCC's 2004 preemption rules. DQRW state at the onset of the study that they expect to find that loans originated by national banks after preemption have higher delinquency rates than loans originated prior to 2004. To control for changes in market conditions before and after adoption of the preemption rules, the changes in OCC delinquency rates over time are compared to changes in delinquency rates for loans originated by independent mortgage companies (HUD-regulated).

DQRW find that delinquency rates increased for OCC loans originated after the preemption rules were issued (2005-2006) in states with anti-predatory lending laws - using HUD loans as a control group – in only one of the four categories of loans (refinance fixed-rate loans). DQRW interpret this result as indicating that the OCC's 2004 preemption regulation led "both to a deterioration in the quality of and an increase in the default risk for mortgages originated by OCC-regulated (or OCC-preempted) (sic) lenders in states with anti-predatory lending laws."

It is doubtful that the results from DQRW are relevant for the broad mortgage market. The unique sample used in the study has some advantages, but a significant disadvantage is that the sample is relatively small, and the mortgage loans contained in that unique dataset do not appear to be generally representative of the mortgage market. Loans from lenders regulated by the Federal Reserve, FDIC and NCUA are limited. Loans originated in California represent 25 percent of the sample (as compared to a 16 percent share in the HMDA data). In addition, although the analysis uses loans originated during the years 2002-2006, the data contain only the subsample of those originations that were active as of December 2006. Thus, loans originated early in the data period that had prepaid or already foreclosed (likely a large percentage) were excluded from the analysis.

But beyond that concern, the reported results do not support the authors' primary conclusion; if anything, the results tend to point in the other direction. For example, the authors find only one type of loan (fixed rate refinances) for which their delinquency measure increased more for OCC-supervised lenders than for other lenders, and emphasize that as their conclusion – ignoring the fact that the other loan types do not show that effect. Their own results show that the delinquency measure for adjustable-rate purchase loans – which are a much more important part of the market – increased by 30 percent less at national banks than at the lenders not subject

[7] Ding, Quercia, Reid, and White, "The Preemption Effect: the Impact of Federal Preemption of State Anti-Predatory Lending Laws on the Foreclosure Crisis", Research Report, Center for Community Capital University of North Carolina, Chapel Hill (March 23, 2010).

to federal preemption in their sample. They also find that loans from OCC-supervised institutions were less risky across the board than loans from other lenders, consistent with the OCC analysis of loan performance summarized above.

Table 6 in DQRW (reproduced below) provides their results from applying the well-accepted method of logit regression to the sample of loans to measure the risk of delinquency and to try to isolate the impact of being regulated by the OCC or by the states (the "IND lenders"). Odds ratios are used to measure how likely a loan is to become delinquent compared to a comparable or "reference" loan used as a neutral standard of comparison. The authors use as their neutral reference point the group of otherwise similar mortgage loans made by OCC-supervised banks in states that did not have anti-predatory lending laws (APLs) that could be preempted in 2004.

The odds ratios are uniformly lower for the national banks than for the state lenders; that is*, loans of all types in all periods made by national banks had lower delinquencies*. As an extreme example, fixed-rate home purchase loans in 2005-2006 were 28.4 percent less risky for national banks in these states than for the reference group, while the same type of loan from a state lender has an odds ratio of 1.399 for that vintage, making it about 40 percent riskier than the comparison group. The difference between 40 percent riskier for state lenders and 28 percent less risky for OCC lenders is a big difference.

Then the authors estimate the same odds-ratio risk measures after the preemption rule was issued, to see how they changed, and then compare the relative changes in risk for OCC-regulated lenders versus state-regulated lenders. The authors focus on the results for "refi_frm", that is for fixed-rate refinancings; those loans became more risky at OCC lenders after preemption, by about 20 percent, whether one looks at the 2004 loans or the 2005-2006 loans. But the other results in Table 6 are either very close to 1.0, suggesting no material difference, or less than 1.0 showing that risk actually *fell* at OCC-supervised lenders compared to state-supervised lenders. For example, the 2005-2006 adjustable-rate purchase loans made by national banks *became more than 30 percent less risky than the same loans made by state-regulated IND lenders. Thus the reported results for the "Preemption Effect" do not strongly support the authors' main conclusion, and a larger number of the results actually go the other way.*

Table 6 Impact of the OCC Preemption on Mortgage Performance (based on logit regression results)

	Before preemption (2002-2003)		Post-preemption (2004)		Post-preemption (2005-2006)		Relative change		Preemption Effect	
	p_value	Odds Ratio	p_value	Odds Ratio	p_value	Odds Ratio	2004/Pre	2005-2006/pre	2004	2005-2006
OCC lenders										
purchase_frm	0.007	0.753	0.004	0.806	<.0001	0.716	1.070	0.951	1.023	0.901
purchase_arm	0.000	0.797	0.001	0.882	<.0001	0.789	1.107	0.990	0.766	0.691
refi_frm	<.0001	0.653	0.047	0.864	<.0001	0.786	1.323	1.204	1.199	1.201
refi_arm	<.0001	0.728	0.587	1.026	<.0001	0.841	1.409	1.155	1.012	0.998
IND lenders										
purchase_frm	0.001	1.326	<.0001	1.388	<.0001	1.399	1.047	1.055		
purchase_arm	0.283	0.941	<.0001	1.359	<.0001	1.348	1.444	1.433		
refi_frm	0.986	1.001	0.103	1.105	0.921	1.003	1.104	1.002		
refi_arm	0.824	0.988	<.0001	1.376	<.0001	1.144	1.393	1.158		

Note: Odds ratios and p-values are obtained from a set of logit regression models where serious delinquency (90+day) is the outcome variable and the reference lender group is OCC_nonAPL (see Table 8); relative change=odds ratios for the 2004 or 2005-2006 cohort divided by the odds ratios for the pre-preemption cohort (2002-2003); preemption effect=relative change of OCC lenders/relative change of independent mortgage companies (IND_APL). The preemption effect with a value greater than one suggests the default risk for the lender type increases after the preemption after accounting for the change in market conditions. Conventional, 30-year, first-lien mortgages only; loans originated in states that adopted APLs after February 12, 2004 and before December 31 2007 were excluded.

II. Servicing

The quarterly OCC and OTS Mortgage Metrics Report ("MMR") provides extensive data on the extent to which major national banks and thrifts service first-lien residential mortgages of all types, including subprime loans. The OCC and OTS collect data on first-lien residential mortgages from the nine national banks and three thrifts with the largest mortgage-servicing portfolios among national banks and thrifts. [8] These 12 depository institutions are owned by nine holding companies,[9] and represent most of the industry's largest mortgage servicers, covering approximately 65 percent of all mortgages outstanding in the United States.

More than 90 percent of the mortgages in the portfolio were serviced for third parties because of loan sales and securitization. At the end of December 2009, the reporting institutions serviced almost 34 million first-lien mortgage loans, totaling nearly $6 trillion in outstanding balances.

MMR uses standardized definitions for three categories of mortgage creditworthiness based on the following ranges of borrowers' credit scores at the time of origination: "Prime" with scores of 660 and above, "Alt-A" with scores from 620 to 659, and "Subprime" with scores below 620.[10] Approximately 13 percent of loans in the data are not accompanied by credit scores and are classified as "other." This group includes a mix of prime, Alt-A, and subprime loans. In large part, the lack of credit scores results from acquisitions of loan portfolios from third parties for which borrower credit scores at the origination of the loans were not available.

As of December 31, 2009, these institutions serviced 2,758,613 loans in the Subprime score range, accounting for 8% of all loans serviced. The number of Subprime loans has declined by 9 percent over the past year, whereas the total portfolio declined 2 percent as origination of new Subprime loans has not kept pace with foreclosures, loan payoffs, and sales and transfers.

Table 3 displays the composition of the servicing portfolio covered by MMR. At year-end 2007, national bank servicers combined to service more than $267 billion in Subprime first mortgage loans; the volume of Serviced subprime loans increased to $283 billion at the end of 2008 and $378 billion at the end of 2009.

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[8] The nine banks are Bank of America, JPMorgan Chase, Citibank, First Tennessee (formerly referred to as First Horizon), HSBC, National City, USBank, Wachovia, and Wells Fargo. The thrifts are OneWestBank (formerly IndyMac), Merrill Lynch, and Wachovia FSB. Wachovia FSB was merged into Wells Fargo National Bank in November 2009.

[9] The holding companies are Bank of America Corp., JPMorgan Chase, Citigroup, First Horizon, HSBC, OneWest (formerly IndyMac), PNC, US Bancorp, and Wells Fargo Corp.

[10] Note that the definition of "subprime" used in MMR is based entirely on credit score in order to create a definition that is standardized across firms; this definition of subprime may not match definitions use in other contexts. In particular, this definition of subprime does not directly correspond to criteria used by institutions to self-identify loans considered subprime, which generally reflect a combination of credit scores, LTV, loan structure, and the institution's business focus.

Table 3

Overall Mortgage Portfolio in *Mortgage Metrics Report*					
	12/31/08	3/31/09	6/30/09	9/30/09	12/31/09
Total Servicing (Millions)	$6,106,764	$6,014,455	$5,969,246	$5,998,986	$5,952,423
Total Servicing (Number of Loans)	34,551,061	34,096,603	33,832,014	34,024,602	33,824,889
Composition (Percent of All Mortgages in the Portfolio)*					
Prime	66%	67%	68%	68%	68%
Alt-A	10%	10%	10%	10%	11%
Subprime	9%	8%	8%	8%	8%
Other	14%	14%	13%	14%	13%
Composition (Number of Loans in Each Risk Category of the Portfolio)					
Prime	22,963,965	22,867,059	22,929,113	23,064,371	23,136,115
Alt-A	3,567,323	3,519,821	3,528,840	3,524,305	3,560,656
Subprime	3,034,620	2,888,029	2,847,412	2,774,028	2,758,613
Other	4,985,153	4,821,694	4,526,649	4,661,898	4,369,505

* Percentages may not total 100 percent due to rounding.

III. Warehouse lines of credit to independent subprime originators

In the fourth quarter of 2006, large national banks had warehouse lines to subprime companies totaling $32.9 billion, although only approximately $12.4 billion had been advanced on those lines. The volume of such warehouse facilities decreased to $14.6 billion as of the third quarter of 2007, with approximately $6 billion advanced on the lines. These warehouse lines compare with the total market warehouse lending capacity, per *National Mortgage News*, of over $200 billion in 2006 and 2007. Total market capacity declined dramatically to approximately $20 to $25 billion in 2008.[11]

IV. Purchasing subprime loans for securitizations and purchasing interests in MBS

As previously discussed, in 2006 and 2007, subprime mortgages, mostly originated by nonbanks, were a very important share of the total market. Additionally, many subprime mortgages were bundled into residential mortgage-backed securities ("RMBS"), and many of these RMBS were then repackaged into collateralized debt obligations ("CDOs"). Both subprime RMBS and CDOs backed by subprime RMBS were sold to a broad range of investors. A few large national banks also were involved in structuring products to be sold that included subprime mortgages.

The Federal Reserve's Flow of Funds data presented in Table 4 below show that RMBS issued by or guaranteed by housing government sponsored enterprises ("GSEs") accounted for the largest share of outstanding RMBS during the subprime boom. Private-label RMBS were a much smaller component of the market, even during the peak subprime years, and of course not all of those securities were subprime. For example, credible estimates indicate that only one third

[11] *National Mortgage News*, October 20, 2008; March 23, 2009; and April 1, 2009.

of the outstanding dollar volume of private-label RMBS at the end of 2007 was subprime, although an additional 43 percent was Alt-A, with the remainder consisting largely of prime jumbo MBS.[12] Commercial banking firms as a group hold only a small share of the outstanding private-label RMBS, and national bank holdings are even smaller; as shown in Table 4, national banks hold between 5 and 10 percent of outstanding private RMBS.

Table 4: Residential Mortgage-Backed Securities Outstanding

Flow of Funds Data ($ bil)	**2005**	**2006**	**2007**	**2008**
Issued or guaranteed by GSEs	3,420	3,711	4,319	4,801
Private label RMBS	1,622	2,140	2,172	1,859
Held by commercial banking firms	170	192	272	246
Held by other investors	1,452	1,948	1,900	1,613
Total RMBS	5,042	5,851	6,491	6,660
Call Report Data ($ bil)				
National bank holdings of GSE RMBS	505	594	542	640
National bank holdings of private RMBS	87	114	193	155
Total national bank holdings of RMBS	592	709	735	795
National bank share of private RMBS	5.4%	5.3%	8.9%	8.4%

[12] Deutsche Bank "Projecting Mortgage Losses" MBS Special Report, May 5, 2008.

Attachment 1

11/13/2008

Worst Ten in the Worst Ten

- The table below sets forth the ten metropolitan areas experiencing the highest rates of foreclosure as reported by RealtyTrac (the "Worst Ten" MSAs). Foreclosure rates for sub-prime and Alt-A mortgages originated from 2005 through 2007 in these MSAs were computed using data from Loan Performance.

Rank	MSA	Non-prime Mortgage Foreclosure Rate
1	Detroit	22.9%
2	Cleveland	21.6%
3	Stockton	21.5%
4	Sacramento	18.0%
5	Riverside/San Bernardino	16.1%
6	Memphis	15.6%
7	Miami/Fort Lauderdale	14.3%
8	Bakersfield	14.3%
9	Denver	14.0%
10	Las Vegas	13.9%

- For each of these metro areas, the "Worst Ten" originators were identified: the ten originators in each MSA with the largest number of non-prime mortgage foreclosures in the Loan Performance database for 2005-2007 originations.

- Only 21 companies in various combinations (see attached tables for MSA-level details) occupy the Worst Ten slots in the Worst Ten metro areas:

AEGIS FUNDING CORPORATION
AMERICAN HOME MORTGAGE CORP.
AMERIQUEST MORTGAGE COMPANY
ARGENT MORTGAGE COMPANY
BNC MORTGAGE
COUNTRYWIDE
DECISION ONE MORTGAGE
DELTA FUNDING CORPORATION
FIELDSTONE MORTGAGE COMPANY
FIRST FRANKLIN CORPORATION
FREMONT INVESTMENT & LOAN
GREENPOINT MORTGAGE FUNDING
INDYMAC BANK, F.S.B.
LONG BEACH MORTGAGE CO.
NEW CENTURY MORTGAGE
OPTION ONE MORTGAGE CORP
OWNIT MORTGAGE SOLUTIONS INC.
PEOPLE'S CHOICE FINANCIAL CORP
RESMAE MORTGAGE CORPORATION
WELLS FARGO
WMC MORTGAGE CORP.

- Of these 21 firms, 12 were exclusively supervised by the states; overall, such originators accounted for nearly 60 percent of non-prime mortgage loans and foreclosures in the Worst Ten metro areas in 2005-2007.

- Only three firms on the list were subject to OCC supervision during 2005-2007, and those three accounted for fewer than 12 percent of foreclosures in the Worst Ten metro areas.

- Results for the U.S. as a whole are similar to those for the Worst Ten metropolitan areas. OCC-supervised institutions accounted for approximately 12 to 14 percent of the non-prime originations; moreover, foreclosure rates for OCC-supervised institutions were markedly lower on average than for other types of originators.

Worst Ten in the Worst Ten:
Results for individual metropolitan areas

Bakersfield

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	WMC MORTGAGE CORP.	731	3998	18.3%
2	LONG BEACH MORTGAGE CO.	680	2817	24.1%
3	NEW CENTURY MORTGAGE	647	3864	16.7%
4	OPTION ONE MORTGAGE CORP	302	1673	18.1%
5	ARGENT MORTGAGE COMPANY	276	1527	18.1%
6	OWNIT MORTGAGE SOLUTIONS INC.	232	1069	21.7%
7	FREMONT INVESTMENT & LOAN	207	1286	16.1%
8	FIRST FRANKLIN CORPORATION	206	1186	17.4%
9	AMERIQUEST MORTGAGE COMPANY	124	1002	12.4%
10	COUNTRYWIDE	106	1232	8.6%

Memphis

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	LONG BEACH MORTGAGE CO.	669	1853	36.1%
2	WMC MORTGAGE CORP.	376	2141	17.6%
3	FIRST FRANKLIN CORPORATION	355	3290	10.8%
4	OPTION ONE MORTGAGE CORP	300	1224	24.5%
5	NEW CENTURY MORTGAGE	295	1705	17.3%
6	WELLS FARGO	202	1249	16.2%
7	AMERIQUEST MORTGAGE COMPANY	184	900	20.4%
8	ARGENT MORTGAGE COMPANY	159	536	29.7%
9	DECISION ONE MORTGAGE	119	518	23.0%
10	FREMONT INVESTMENT & LOAN	92	393	23.4%

Cleveland

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	ARGENT MORTGAGE COMPANY	1327	3251	40.8%
2	NEW CENTURY MORTGAGE	912	2437	37.4%
3	LONG BEACH MORTGAGE CO.	525	968	54.2%
4	FIRST FRANKLIN CORPORATION	425	2332	18.2%
5	AEGIS FUNDING CORPORATION	412	1276	32.3%
6	OPTION ONE MORTGAGE CORP	370	1538	24.1%
7	AMERIQUEST MORTGAGE COMPANY	245	1166	21.0%
8	WELLS FARGO	239	1275	18.7%
9	PEOPLE'S CHOICE FINANCIAL CORP	217	550	39.5%
10	DELTA FUNDING CORPORATION	155	570	27.2%

Miami

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	FREMONT INVESTMENT & LOAN	1655	8961	18.5%
2	ARGENT MORTGAGE COMPANY	1383	8967	15.4%
3	LONG BEACH MORTGAGE CO.	1176	5255	22.4%
4	WMC MORTGAGE CORP.	1168	5861	19.9%
5	NEW CENTURY MORTGAGE	1018	7456	13.7%
6	OPTION ONE MORTGAGE CORP	883	4637	19.0%
7	FIRST FRANKLIN CORPORATION	777	3946	19.7%
8	AMERIQUEST MORTGAGE COMPANY	538	4002	13.4%
9	AMERICAN HOME MORTGAGE CORP.	508	4114	12.3%
10	COUNTRYWIDE	504	5568	9.1%

Denver

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	LONG BEACH MORTGAGE CO.	758	2570	29.5%
2	NEW CENTURY MORTGAGE	703	3585	19.6%
3	ARGENT MORTGAGE COMPANY	670	1737	38.6%
4	FREMONT INVESTMENT & LOAN	670	3129	21.4%
5	OPTION ONE MORTGAGE CORP	613	2770	22.1%
6	FIRST FRANKLIN CORPORATION	533	3325	16.0%
7	OWNIT MORTGAGE SOLUTIONS INC.	404	2292	17.6%
8	AMERIQUEST MORTGAGE COMPANY	293	1173	25.0%
9	FIELDSTONE MORTGAGE COMPANY	275	961	28.6%
10	WMC MORTGAGE CORP.	260	1099	23.7%

Riverside

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	NEW CENTURY MORTGAGE	4600	22736	20.2%
2	WMC MORTGAGE CORP.	4577	21191	21.6%
3	FREMONT INVESTMENT & LOAN	2380	11584	20.5%
4	LONG BEACH MORTGAGE CO.	2374	7608	31.2%
5	FIRST FRANKLIN CORPORATION	2301	10701	21.5%
6	ARGENT MORTGAGE COMPANY	2175	9138	23.8%
7	OPTION ONE MORTGAGE CORP	2175	10752	20.2%
8	RESMAE MORTGAGE CORPORATION	1717	5763	29.8%
9	COUNTRYWIDE	1304	13280	9.8%
10	BNC MORTGAGE	876	3591	24.4%

Detroit

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	ARGENT MORTGAGE COMPANY	2532	5582	45.4%
2	LONG BEACH MORTGAGE CO.	1956	3816	51.3%
3	NEW CENTURY MORTGAGE	1894	6376	29.7%
4	OPTION ONE MORTGAGE CORP	1757	5780	30.4%
5	FIRST FRANKLIN CORPORATION	1578	7733	20.4%
6	FREMONT INVESTMENT & LOAN	1308	3583	36.5%
7	AMERIQUEST MORTGAGE COMPANY	910	3347	27.2%
8	WELLS FARGO	671	2621	25.6%
9	AMERICAN HOME MORTGAGE CORP.	518	3365	15.4%
10	PEOPLE'S CHOICE FINANCIAL CORP	479	1284	37.3%

Sacramento

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	LONG BEACH MORTGAGE CO.	1997	4836	41.3%
2	NEW CENTURY MORTGAGE	1510	5878	25.7%
3	WMC MORTGAGE CORP.	1155	4082	28.3%
4	FREMONT INVESTMENT & LOAN	889	3444	25.8%
5	OPTION ONE MORTGAGE CORP	886	3518	25.2%
6	ARGENT MORTGAGE COMPANY	637	2067	30.8%
7	FIRST FRANKLIN CORPORATION	626	2686	23.3%
8	COUNTRYWIDE	565	4697	12.0%
9	GREENPOINT MORTGAGE FUNDING	535	4101	13.0%
10	RESMAE MORTGAGE CORPORATION	460	1472	31.3%

Las Vegas

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	NEW CENTURY MORTGAGE	1671	8623	19.4%
2	ARGENT MORTGAGE COMPANY	1093	4598	23.8%
3	WMC MORTGAGE CORP.	999	4886	20.4%
4	COUNTRYWIDE	957	9638	9.9%
5	FIRST FRANKLIN CORPORATION	945	4743	19.9%
6	FREMONT INVESTMENT & LOAN	879	4174	21.1%
7	OPTION ONE MORTGAGE CORP	696	3710	18.8%
8	AMERICAN HOME MORTGAGE CORP.	489	4904	10.0%
9	GREENPOINT MORTGAGE FUNDING	468	4963	9.4%
10	INDYMAC BANK, F.S.B.	423	4288	9.9%

Stockton

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	LONG BEACH MORTGAGE CO.	1213	3056	39.7%
2	NEW CENTURY MORTGAGE	870	3263	26.7%
3	WMC MORTGAGE CORP.	677	2259	30.0%
4	ARGENT MORTGAGE COMPANY	476	1402	34.0%
5	FREMONT INVESTMENT & LOAN	466	1762	26.4%
6	OPTION ONE MORTGAGE CORP	362	1448	25.0%
7	GREENPOINT MORTGAGE FUNDING	343	1978	17.3%
8	FIRST FRANKLIN CORPORATION	291	1046	27.8%
9	COUNTRYWIDE	263	1931	13.6%
10	AMERIQUEST MORTGAGE COMPANY	217	920	23.6%

11/13/2008

Worst Ten in the Worst Ten: Supervisory Status of Mortgage Originators

Originator	Supervisor	Foreclosures in Worst 10 Metro Areas, based on 2005-07 Originations
New Century Mortgage Corp.	State supervised. Subsidiary of publicly-traded REIT, filed for bankruptcy in early 2007.	14,120
Long Beach Mortgage Co.	State and OTS supervised. Affiliate of WAMU, became a subsidiary of thrift in early 2006; closed in late 2007 / early 2008.	11,736
Argent Mortgage Co.	State supervised until Citigroup acquired certain assets of Argent in 08/07. Merged into CitiMortgage (NB opsub) shortly thereafter.	10,728
WMC Mortgage Corp.	OTS supervised. Subsidiary of GE Money Bank, FSB, closed in late 2007.	10,283
Fremont Investment & Loan	FDIC and State supervised. California state chartered industrial bank. Liquidated, terminated deposit insurance, and surrendered charter in 2008.	8,635
Option One Mortgage Corp.	State supervised. Subsidiary of H&R Block, closed in late 2007.	8,344
First Franklin Corp.	Data includes loans originated by (1) OCC supervised subsidiary of National City Bank until 12/06; and (2) OTS supervised subsidiary of Merrill Lynch Bank & Trust Co., FSB, after 12/06. Closed in 2008.	8,037
Countrywide	Data includes loans originated by (1) Countrywide Home Loans, an FRB/State supervised entity until 03/07, and an OTS/State supervised entity after 03/07; and (2) Countrywide Bank, an OCC supervised entity until 03/07, and an OTS supervised entity after 03/07.	4,736
Ameriquest Mortgage Co.	State supervised. Citigroup acquired certain assets of Ameriquest in 08/07. Merged into CitiMortgage (NB opsub) shortly thereafter.	4,126
ResMae Mortgage Corp.	State supervised. Filed for bankruptcy in late 2007.	3,558
American Home Mortgage Corp.	State supervised. Filed for bankruptcy in 2007.	2,954
IndyMac Bank, FSB	OTS supervised thrift. Closed in July 2008.	2,882
Greenpoint Mortgage Funding	FDIC and State supervised. Acquired by Capital One, NA, in mid 2007 as part of conversion and merger with North Fork, a state bank. Closed immediately thereafter in 08/07.	2,815
Wells Fargo	Data includes loans originated by (1) Wells Fargo Financial, Inc., an FRB and State supervised entity, and (2) Wells Fargo Bank, an OCC supervised entity.	2,697
Ownit Mortgage Solutions, Inc.	State supervised. Closed in late 2006.	2,533
Aegis Funding Corp.	State supervised. Filed for bankruptcy in late 2007.	2,058
People's Choice Financial Corp.	State supervised. Filed for bankruptcy in early 2008.	1,783
BNC Mortgage	OTS supervised. Subsidiary of Lehman Brothers, FSB, closed in August 2007.	1,769
Fieldstone Mortgage Co.	State supervised. Filed for bankruptcy in late 2007.	1,561
Decision One Mortgage	State and FRB supervised. Subsidiary of HSBC Finance Corp. Closed in late 2007.	1,267
Delta Funding Corp.	State supervised. Filed for bankruptcy in late 2007.	598

Monday, March 22, 2010

Attachment 2

Worst Ten in the Worst Ten: Update

- This attachment updates the OCC's November 2008 analysis of subprime origination and performance in the markets hit hardest by foreclosures, using the most recently available LPC data (November 2009).
- An updated list of the ten metropolitan areas experiencing the highest rates of foreclosure (the "Worst Ten" MSAs) was developed from data reported by RealtyTrac. The ten worst metropolitan areas were distributed across seven states in 2008, but now are concentrated in only three: California, Florida, and Nevada. Six of the ten are in California.

Worst 10 Markets (from RealtyTrac data)

Rank	MSA/PMSA	Non-prime Mortgage Foreclosure Rate
1	Fort Myers-Cape Coral, FL MSA	43.3%
2	Merced, CA MSA	40.5%
3	Fort Pierce-Port St Lucie, FL MSA	40.1%
4	Stockton-Lodi, CA MSA	38.1%
5	Modesto, CA MSA	37.9%
6	Las Vegas, NV MSA	32.9%
7	Riverside-San Bernardino, CA PMSA	31.7%
8	Vallejo-Fairfield-Napa, CA PMSA	30.6%
9	Bakersfield, CA MSA	29.4%
10	Reno, NV MSA	27.5%

- As in the original analysis, the ten originators in each market with the most foreclosures were identified. (See the next page for lists of individual markets.)
  - The number of "worst" originators on the list decreased from 21 companies in November 2008 to 16 in November 2009.
  - In 2009, as in 2008, only three firms on the list were subject to OCC supervision at any time during 2005 through 2007. However, those three firms now account for a larger share of foreclosure starts (20 percent in 2009, compared to 12 percent in 2008).
  - The fraction of companies supervised exclusively by the states remained at roughly 56 percent, while their share of originations fell from 60 to 54 percent.

Worst Ten in the Worst Ten

Results for individual metropolitan areas - November 2009 data

Bakersfield, CA MSA

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	NEW CENTURY MORTGAGE	1,238	3,902	32%
2	WMC MORTGAGE CORP.	1,234	3,998	31%
3	LONG BEACH MORTGAGE CO.	1,186	2,817	42%
4	OPTION ONE MORTGAGE CORP	478	1,673	29%
5	OWNIT MORTGAGE SOLUTIONS INC.	442	1,069	41%
6	FIRST FRANKLIN CORPORATION	414	1,201	34%
7	ARGENT MORTGAGE COMPANY	394	1,527	26%
8	FREMONT INVESTMENT & LOAN	363	1,286	28%
9	COUNTRYWIDE	342	1,277	27%
10	AMERICAN HOME MORTGAGE CORP.	258	780	33%

Modesto, CA MSA

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	LONG BEACH MORTGAGE CO.	1,407	2,526	56%
2	NEW CENTURY MORTGAGE	918	2,337	39%
3	GREENPOINT MORTGAGE FUNDING	603	1,559	39%
4	OPTION ONE MORTGAGE CORP	521	1,222	43%
5	WMC MORTGAGE CORP.	505	1,218	41%
6	COUNTRYWIDE	426	1,285	33%
7	FREMONT INVESTMENT & LOAN	414	1,088	38%
8	FIRST FRANKLIN CORPORATION	358	792	45%
9	ARGENT MORTGAGE COMPANY	325	798	41%
10	INDYMAC BANK, F.S.B.	269	765	35%

Fort Myers-Cape Coral, FL MSA

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	NEW CENTURY MORTGAGE	1,067	2,579	41%
2	FREMONT INVESTMENT & LOAN	872	1,983	44%
3	FIRST FRANKLIN CORPORATION	822	1,526	54%
4	AMERICAN HOME MORTGAGE CORP.	760	1,590	48%
5	OPTION ONE MORTGAGE CORP	749	1,689	44%
6	COUNTRYWIDE	721	1,591	45%
7	WELLS FARGO	636	1,249	51%
8	LENDERS DIRECT CAPITAL CORP	603	1,085	56%
9	ARGENT MORTGAGE COMPANY	566	1,223	46%
10	WMC MORTGAGE CORP.	524	1,129	46%

Reno, NV MSA

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	NEW CENTURY MORTGAGE	372	1,168	32%
2	COUNTRYWIDE	208	727	29%
3	WELLS FARGO	203	647	31%
4	OPTION ONE MORTGAGE CORP	194	555	35%
5	AMERICAN HOME MORTGAGE CORP.	190	753	25%
6	ARGENT MORTGAGE COMPANY	173	446	39%
7	FIRST FRANKLIN CORPORATION	121	355	34%
8	WMC MORTGAGE CORP.	121	373	32%
9	GREENPOINT MORTGAGE FUNDING	112	436	26%
10	OWNIT MORTGAGE SOLUTIONS INC.	87	184	47%

Fort Pierce-Port St Lucie, FL MSA

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	OPTION ONE MORTGAGE CORP	531	1,230	43%
2	FREMONT INVESTMENT & LOAN	397	890	45%
3	NEW CENTURY MORTGAGE	340	905	38%
4	AMERICAN HOME MORTGAGE CORP.	326	826	39%
5	LONG BEACH MORTGAGE CO.	269	530	51%
6	ARGENT MORTGAGE COMPANY	263	602	44%
7	COUNTRYWIDE	240	544	44%
8	WMC MORTGAGE CORP.	222	477	47%
9	FIRST FRANKLIN CORPORATION	201	449	45%
10	AMERIQUEST MORTGAGE COMPANY	180	540	33%

Riverside-San Bernardino, CA PMSA

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	NEW CENTURY MORTGAGE	7,802	22,991	34%
2	WMC MORTGAGE CORP.	7,183	21,192	34%
3	FIRST FRANKLIN CORPORATION	4,387	10,822	41%
4	FREMONT INVESTMENT & LOAN	3,889	11,585	34%
5	OPTION ONE MORTGAGE CORP	3,709	10,752	34%
6	LONG BEACH MORTGAGE CO.	3,618	7,608	48%
7	COUNTRYWIDE	3,515	13,498	26%
8	ARGENT MORTGAGE COMPANY	3,150	9,138	34%
9	RESMAE MORTGAGE CORPORATION	2,587	5,812	45%
10	INDYMAC BANK, F.S.B.	2,427	8,098	30%

Las Vegas, NV MSA

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	COUNTRYWIDE	3,518	9,903	36%
2	NEW CENTURY MORTGAGE	3,144	8,722	36%
3	FIRST FRANKLIN CORPORATION	2,085	4,816	43%
4	ARGENT MORTGAGE COMPANY	1,774	4,598	39%
5	WMC MORTGAGE CORP.	1,759	4,886	36%
6	GREENPOINT MORTGAGE FUNDING	1,578	4,967	32%
7	FREMONT INVESTMENT & LOAN	1,546	4,175	37%
8	AMERICAN HOME MORTGAGE CORP.	1,439	4,905	29%
9	OPTION ONE MORTGAGE CORP	1,344	3,710	36%
10	INDYMAC BANK, F.S.B.	1,289	4,320	30%

Stockton-Lodi, CA MSA

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	LONG BEACH MORTGAGE CO.	1,652	3,056	54%
2	NEW CENTURY MORTGAGE	1,286	3,296	39%
3	WMC MORTGAGE CORP.	921	2,259	41%
4	GREENPOINT MORTGAGE FUNDING	782	1,978	40%
5	FREMONT INVESTMENT & LOAN	675	1,762	38%
6	COUNTRYWIDE	646	1,968	33%
7	ARGENT MORTGAGE COMPANY	597	1,402	43%
8	OPTION ONE MORTGAGE CORP	592	1,448	41%
9	AMERICAN HOME MORTGAGE CORP.	478	1,228	39%
10	FIRST FRANKLIN CORPORATION	467	1,064	44%

Merced, CA MSA

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	LONG BEACH MORTGAGE CO.	776	1,442	54%
2	NEW CENTURY MORTGAGE	411	1,054	39%
3	COUNTRYWIDE	281	676	42%
4	GREENPOINT MORTGAGE FUNDING	252	605	42%
5	FIRST FRANKLIN CORPORATION	214	436	49%
6	OPTION ONE MORTGAGE CORP	208	451	46%
7	WMC MORTGAGE CORP.	197	457	43%
8	FREMONT INVESTMENT & LOAN	177	438	40%
9	ARGENT MORTGAGE COMPANY	143	370	39%
10	INDYMAC BANK, F.S.B.	139	384	36%

Vallejo-Fairfield-Napa, CA PMSA

Rank	Originator	Foreclosure Starts	Originations	Foreclosure Rate
1	LONG BEACH MORTGAGE CO.	934	1,790	52%
2	WMC MORTGAGE CORP.	767	2,039	38%
3	NEW CENTURY MORTGAGE	651	1,844	35%
4	GREENPOINT MORTGAGE FUNDING	494	1,873	26%
5	FREMONT INVESTMENT & LOAN	416	1,177	35%
6	OPTION ONE MORTGAGE CORP	360	989	36%
7	AMERICAN HOME MORTGAGE CORP.	358	1,212	30%
8	COUNTRYWIDE	357	1,690	21%
9	FIRST FRANKLIN CORPORATION	284	777	37%
10	ARGENT MORTGAGE COMPANY	248	614	40%

Worst Ten in the Worst Ten: Supervisory Status of Mortgage Originators

Originator	Supervisor	Foreclosures in Worst 10 Metro Areas, based on 2005-07 Originations
New Century Mortgage Corp.	State supervised. Subsidiary of publicly-traded REIT, filed for bankruptcy in early 2007.	17,229
WMC Mortgage Corp.	OTS supervised. Subidiary of GE Money Bank, FSB, closed in late 2007.	13,433
Long Beach Mortgage Co.	State and OTS supervised. Affiliate of WAMU, became a subsidiary of thrift in early 2006; closed in late 2007 / early 2008.	10,997
Countrywide	Data includes loans originated by (1) Countrywide Home Loans, an FRB/State supervised entity until 03/07, and an OTS/State supervised entity after 03/07; and (2) Countrywide Bank, an OCC supervised entity until 03/07, and an OTS supervised entity after 03/07.	10,254
First Franklin Corp.	Data includes loans originated by (1) OCC supervised subsidiary of National City Bank until 12/06; and (2) OTS supervised subsidiary of Merrill Lynch Bank & Trust Co., FSB, after 12/06. Closed in 2008.	9,353
Fremont Investment & Loan	FDIC and State supervised. California state chartered industrial bank. Liquidated, terminated deposit insurance, and surrendered charter in 2008.	8,829
Option One Mortgage Corp.	State supervised. Subsidiary of H&R Block, closed in late 2007.	8,686
Argent Mortgage Co.	State supervised until Citigroup acquired certain assets of Argent in 08/07. Merged into CitiMortgage (NB opsub) shortly thereafter.	7,633
Greenpoint Mortgage Funding	FDIC and State supervised. Acquired by Capital One, NA, in mid 2007 as part of conversion and merger with North Fork, a state bank. Closed immediately thereafter in 08/07.	6,485
American Home Mortgage Corp.	State supervised. Filed for bankruptcy in 2007.	5,721
IndyMac Bank, FSB	OTS supervised thrift. Closed in July 2008.	5,508
ResMae Mortgage Corp.	State supervised. Filed for bankruptcy in late 2007.	4,019
Wells Fargo	Data includes loans originated by (1) Wells Fargo Financial, Inc., an FRB and State supervised entity, and (2) Wells Fargo Bank, an OCC supervised entity.	3,982
Ameriquest Mortgage Co.	State supervised. Citigroup acquired certain assets of Ameriquest in 08/07. Merged into CitiMortgage (NB opsub) shortly thereafter.	3,516
Ownit Mortgage Solutions, Inc.	State supervised. Closed in late 2006.	2,468
Lenders Direct Capital Corp.	State supervised. Closed in early 2007.	1,127

March 29, 2009 (Foreclosures in Worst 10 Metro Areas as of Nov. 2009, based on 2005-07 Originations)

Appendix C: Impact of the Community Reinvestment Act on Losses Incurred by National Banks

All the federal banking regulatory agencies have considered the impact of the Community Reinvestment Act ("CRA") on the losses incurred by depository institutions during the current crisis. Based on all available research, each has concluded that the CRA did not contribute in any material way to the mortgage crisis or the broader credit quality issues in the marketplace.[1] Attached to this Appendix are several key documents and studies related to these findings.

Studies Assessing the Impact of the CRA on the Economic and Financial Crisis

There has been much public discussion concerning whether CRA may have contributed to the current financial and economic crisis. This discussion has focused on the connection between CRA-related home mortgage lending to low- and moderate-income borrowers and what some allege to be a disproportionate representation in failing loans.

As described below, both independent and agency studies and the quantitative analysis of comprehensive home lending data sets lead to the conclusion that only a small portion of subprime loan originations (loans identified as "higher cost" under the Home Mortgage Disclosure Act ("HMDA")) are related to the CRA. In addition, these studies indicate that CRA-related loans appear to perform better than subprime loans generally.

For example, single-family CRA-related mortgages offered in conjunction with NeighborWorks organizations were found to perform on par with standard conventional mortgages.[2] Foreclosure rates within the NeighborWorks network were just 0.21 percent in the second quarter of 2008,[3] compared to 4.26 percent of subprime loans and 0.61 percent for conventional conforming mortgages.[4]

The Federal Reserve Board ("FRB") has reported extensively on these findings for all CRA loans. Using higher priced loans listed in the HMDA disclosures as a rough proxy for

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[1] *See* Remarks by John C. Dugan Comptroller of the Currency Before the Enterprise Annual Network Conference November 19, 2008, *available at* http://www.occ.treas.gov/ftp/release/2008-136a.pdf ; Speech entitled "CRA: A Framework for the Future," Governor Elizabeth A. Duke, February 24, 2009, *available at* http://www.federalreserve.gov/newsevents/speech/duke20090224a.htm; Remarks by FDIC Chairman Sheila C. Bair Before the Consumer Federation of America, December 4, 2008, *available at* http://www.fdic.gov/news/news/speeches/archives/2008/chairman/spdec0408_2.html; Speech entitled "The Community Reinvestment Act and the Recent Mortgage Crisis," Governor Randall S. Kroszner, December 3, 2008, *available at* http://www.federalreserve.gov/newsevents/speech/kroszner20081203a.htm#f6; John M. Reich, Director of the Office of Thrift Supervision (OTS) in response to question posed at the OTS Housing Summit, Washington DC, December 8, 2009.

[2] *See* "Low-Income Mortgage Borrowers with the Benefit of Homeownership Counseling Do Substantially Better than General Market, According to New Foreclosure Analysis," NeighborWorks America, *News Release*, September 25, 2008.

[3] Latest date for which data is available.

[4] A study by the University of North Carolina's Center for Community Capital also indicates that high-cost subprime mortgage borrowers default at much higher rates than those who take out loans made for CRA purposes. *See* Lei Ding, Roberto G. Quercia, Janneke Ratcliffe, Wei Li, "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models," University of North Carolina, Center for Community Capital, October 2008.

subprime loans, a FRB study of 2005 - 2006 HMDA data showed that banks subject to CRA and their affiliates originated or purchased only six percent of the reported higher-priced loans made to lower-income borrowers within their CRA assessment areas.[5] The FRB also found that less than 2 percent of the higher-priced and CRA credit-eligible mortgage originations sold by independent mortgage companies in 2006 were purchased by CRA-covered institutions. FRB loan data analysis also found that 60 percent of higher-priced loan originations went to middle- or higher-income borrowers or neighborhoods and, further, that more than 20 percent of the higher-priced loans extended to lower-income borrowers or borrowers in lower-income areas were made by independent non-bank institutions that are not covered by CRA.[6]

Federal Reserve Governor Randall S. Krozner affirmed these findings in a 2008 presentation,[7] and Governor Elizabeth Duke concurred in 2009.[8] A report issued in September 2009 by the United States Commission on Civil Rights concludes, "data reflect that the subprime loans made by banking institutions or their affiliates in their CRA assessment areas remained a marginal segment of the overall market."[9]

Additional reports by FRB economists comport with these findings that only a small percentage of higher priced loans were originated by CRA-regulated lenders to either lower-income borrowers or in neighborhoods in bank CRA assessment areas.[10] Similarly, they have concluded that banks purchased only a small percentage of higher-priced, CRA-eligible loans originated by independent mortgage companies.[11]

Finally, the performance of higher-cost loans originated by federally regulated banks and thrifts has proven markedly better than loans originated by non-bank institutions. One study found that even after controlling for a wide range of borrower, neighborhood, and loan characteristics, higher cost loans made by lenders regulated under the CRA were significantly less likely to go into foreclosure than those made by independent mortgage companies, *i.e.,* those mortgage originators that fall outside the regulatory reach of the CRA. "This provides

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[5] *See* Neil Bhutta and Glenn B. Canner, "Did the CRA cause the mortgage market meltdown?", *Community Dividend* (Federal Reserve Bank of Minneapolis: March 2009), *available at* http://www.minneapolisfed.org/publications_papers/issue.cfm?id=293. Most subprime and Alt-A loans fall within the definition of high-cost (higher-priced). Although the definition of high-cost (higher-priced) loans under Regulation Z (which implements the Truth in Lending Act) was recently changed, for loans originated during the years covered by this study, the previous definition of high-cost applied, which covered loans where the spread between the annual percentage rate and the yield on Treasury securities of comparable maturity was 3 percentage points or more for first-lien loans and 5 percentage points or more for subordinate lien loans.

[6] *See* "The Community Reinvestment Act and the Recent Mortgage Crisis," Governor Randall S. Kroszner, *supra* at n. 1.

[7] *Id.* at p. 3 ("I can state very definitively from the research that we have done, that the Community Reinvestment Act is not one of the causes of the current crisis.").

[8] *See* "CRA: A Framework for the Future," Governor Elizabeth A. Duke, *supra* at n. 1 (An "analysis of foreclosure rates in that study found that loans originated by CRA-covered lenders were significantly less likely to be in foreclosure than those originated by independent mortgage companies. Clearly, claims that CRA caused the subprime crisis are not supported by the facts.").

[9] United States Commission on Civil Rights, "Civil Rights and the Mortgage Crisis," September 2009, p. 69.

[10] Bhutta and Canner, "Did the CRA Cause the Mortgage Market Meltdown?", *supra* n. 5, at p. 2.

[11] Robert Avery et al, "The 2007 HMDA Data," *Federal Reserve Bulletin*, December 2008.

compelling evidence that the performance of [higher cost] loans made by CRA-regulated institutions has been significantly stronger than those by [independent mortgage companies].” [12]

Another researcher states, “Our research finds that after controlling for loan vintage, origination date, borrower, credit, and loan characteristics, the estimated cumulative default rate for a comparable group of subprime borrowers was about 3.5 times higher than that experienced for borrowers in our CRA portfolio. In outperforming other types of mortgage investments, CRA portfolios may have served as a stabilizing factor for many covered institution.” [13]

From such evaluations, the OCC and the other federal bank regulators have concluded that rather than causing losses to national banks, the Community Reinvestment Act has made a positive contribution to community revitalization across the country and has generally encouraged sound community development lending initiatives by regulated banking organizations.

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[12] Elizabeth Laderman and Carolina Reid, “CRA Lending During the Subprime Meltdown,” *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act*, a joint publication of the Federal Reserve Banks of Boston and San Francisco, February 2009, p. 122.

[13] Michael A. Stegman, testimony before the House Financial Services Committee on the subject of “Proposals to Enhance the Community Reinvestment Act,” September 16, 2009, p. 2.

LISTING OF ATTACHMENTS TO APPENDIX C

Comptroller John C. Dugan, speech before the Enterprise Annual Network Conference, November 19, 2008.

Elizabeth Laderman and Carolina Reid, "CRA Lending During the Subprime Meltdown," *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act*, a joint publication of the Federal Reserve Banks of Boston and San Francisco, February 2009.

Lei Ding, Roberto G. Quercia, et al, "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models," *Working Paper*, Center for Community Capital, December 2008.

Neil Bhutta and Glenn B. Canner, "Did the CRA Cause the Mortgage Market Meltdown?" *Community Dividend*, March 2009.

United States Commission on Civil Rights, "Civil Rights and the Mortgage Crisis," September 2009, pages 66-83.

Remarks by
John C. Dugan
Comptroller of the Currency
Before the
Enterprise Annual Network Conference
November 19, 2008

Thank you Mayor Rice. It's a real pleasure to have this opportunity to be here with you today at the Enterprise Annual Network Conference.

Growing up in Washington, D.C., I followed the work of Jim Rouse first-hand. He captivated us all with his festival marketplaces and his inspiring vision for America's cities. Baltimore, with its Inner Harbor and diverse neighborhoods, is one of the many places where his vision and the work of the Enterprise Foundation came alive and flourished.

Today, Enterprise brings that same spirit of innovation to projects benefiting low- and moderate-income households and green communities around the country. In the capable hands of Doris Koo and the Enterprise Board, Enterprise continues to be a respected intermediary that has raised and invested over $8 billion to support the creation of affordable homes. It is also currently investing in communities at a rate of $1 billion annually.

I would like to spend my time with you today discussing the current credit environment and the important contribution that community reinvestment makes – to individual communities and to our economy as a whole.

We continue to face an extraordinary market situation and unprecedented challenges to the flow of credit. These circumstances have put considerable pressure on borrowers and lenders alike. As so many people in this audience have witnessed, helping

low- and moderate-income individuals and families that Enterprise serves has become even more challenging with disruptions in the financial markets.

The good news is that although we have many challenges ahead, important steps have been taken to assure financial stability, and the financial system is definitely in better shape than it was six weeks ago. Our focus is now on continuing to reinforce that stability; enhancing the availability of sound credit; and moving forward with strategies to reduce the number of homes lost to foreclosure.

On this last point, I recognize that there is considerable discussion about the need for the government to provide direct funding to reduce foreclosures, and I think it's safe to assume that this debate will continue into the next Administration. In the meantime, however, I do think it's important to recognize the concerted and considerable efforts of the public, private, and nonprofit sectors to make meaningful progress. As many of you may know, the OCC has spearheaded an effort to collect reliable, validated, loan level data on the performance of individual mortgages throughout the country that are serviced by the large national banks that we supervise. The Office of Thrift Supervision has joined us in this effort, and together we have begun producing a quarterly Mortgage Metrics report that provides the best available information on more than 60 percent of all mortgages outstanding in the United States. The Mortgage Metrics report covering the second quarter of 2008 shows that new loan modifications – and I don't mean payment plans – increased by 50 percent from the previous quarter, with modifications accounting for nearly 45 percent of all workouts.[1] Our preliminary analysis of third quarter data shows that this trend is continuing, and we expect soon to have more data about the types of modifications being employed. Moreover, major lenders that we supervise have

recently announced comprehensive, proactive, and streamlined mortgage loan modification and loss mitigation programs. And a number of mortgages are being restructured and refinanced through Fannie Mae, Freddie Mac, and HUD's FHA Secure programs. While these actions and programs may not prove fully adequate to address the problem, they do constitute meaningful steps in the right direction.

Turning back to financial stability, I believe that all banks have benefited from the stabilizing effect of recent aggressive actions by the government to inject capital, to provide guarantees on bank deposit accounts and certain liabilities, and to ensure the availability of backup liquidity to our nation's banking organizations. At the same time, we recognize that banks must continue to perform their essential function of extending credit – in a safe and sound manner – to meet the needs of creditworthy borrowers.

In an interagency statement issued just last week, the federal banking agencies emphasized this – stressing both the importance of banks fulfilling their fundamental roles as credit intermediaries through prudent lending practices, and the need to work with existing borrowers to avoid preventable foreclosures. We support recent efforts by banking organizations to implement systematic loan modification protocols, and the objective of attaining modifications that borrowers are able to sustain. The OCC and the other federal banking supervisors are committed to fully supporting their regulated banking organizations as they work to implement effective and sound loan modification programs.

Indeed, all of these efforts are fully in keeping with the OCC's mission and the way that we approach our regulatory and supervisory responsibilities, including those under the Community Reinvestment Act. CRA supports banks doing what they do best

and what they should want to do well – making viable lending and investment decisions, with acceptable rates of return, consistent with their business plans, in their own communities.

Given recent public discussion, it is appropriate to ask about the role that CRA plays in the credit challenges we face on so many fronts. In my view, it plays a very positive role. Unfortunately, however, current market disruptions have clouded the accomplishments that CRA has generated, many of which we recognized last year during its 30th anniversary. There are even some who suggest that CRA is responsible for the binge of irresponsible subprime lending that ignited the credit crisis we now face.

Let me squarely respond to this suggestion: I categorically disagree. While not perfect, CRA has made a positive contribution to community revitalization across the country and has generally encouraged sound community development lending, investment, and service initiatives by regulated banking organizations.

CRA is not the culprit behind the subprime mortgage lending abuses, or the broader credit quality issues in the marketplace. Indeed, the lenders most prominently associated with subprime mortgage lending abuses and high rates of foreclosure are lenders not subject to CRA. A recent study of 2006 Home Mortgage Disclosure Act data showed that banks subject to CRA and their affiliates originated or purchased only six percent of the reported high cost loans made to lower-income borrowers within their CRA assessment areas.[2]

Over the last ten years, CRA has helped spur the doubling of lending by banking institutions to small businesses and farms, to more than $2.6 trillion. During this period, those lenders more than tripled community development lending to $371 billion.[3]

Overwhelmingly, this lending has been safe and sound. For example, single family CRA-related mortgages offered in conjunction with NeighborWorks organizations have performed on a par with standard conventional mortgages.[4] Foreclosure rates within the NeighborWorks network were just 0.21 percent in the second quarter of this year, compared to 4.26 percent of subprime loans and 0.61 percent for conventional conforming mortgages.[5] Similar conclusions were reached in a study by the University of North Carolina's Center for Community Capital, which indicates that high-cost subprime mortgage borrowers default at much higher rates than those who take out loans made for CRA purposes.[6]

Of course, not all single-family CRA mortgages performed this well, because these loans have experienced the same stresses as most other types of consumer credit. Nevertheless, a number of studies have shown that when these loans are made in conjunction with a structured homebuyer counseling program, mortgage performance is substantially improved.[7] Affordable CRA multi-family projects utilizing low-income housing tax credits have also performed well, with an average foreclosure rate through 2006 of 0.08 percent on the underlying mortgages.[8]

During the community tours I have taken over the past three years, I personally witnessed the positive impact that CRA partnerships have had in transforming communities, expanding homeownership, and promoting job creation and economic development. These partnerships between communities and financial institutions have also helped house senior citizens and people with special needs, built community facilities, and assisted small businesses serving low-income areas.

In the Anacostia community of D.C., an area of economic resurgence that I have toured on several occasions, Enterprise's Wheeler Creek project was a critical link in stabilizing a neighborhood that had been plagued by a troubled public housing project. Wheeler Creek involved development of for-sale homes in conjunction with a bank community development corporation, as well as a bank's purchase of low-income housing tax credits for rental housing.

CRA projects also act as catalysts for other investments, job creation, and housing development. Such infusion of capital into these markets leverages public subsidies, perhaps as much as 10 to 25 times, by attracting additional private capital. Many of these CRA equity investments can be made under national banks' public welfare investment authority. These bank investments have grown significantly over the years – totaling more than $25 billion over the past decade. Indeed, the OCC recently held its Managers Conference at the Grand Masonic Lodge on North Charles Street here in Baltimore, a public welfare investment funded by a national bank. To meet the demand to invest in similar types of projects, OCC successfully sought legislation last year to raise the cap on public welfare investments from 10 to 15 percent of a bank's capital and surplus. This rise will enable the amount of such investments to increase by as much as $30 billion.

Interpreting national bank public welfare investment authority, OCC recently issued an approval related to energy conservation that may be of interest to Enterprise. This approval clarifies that such authority extends to bank investments in renewable energy tax credits primarily benefiting low- and moderate-income individuals and areas, government revitalization areas, rural underserved and distressed middle-income areas, and designated disaster areas. The investing bank can claim the credits and, in some

instances, receive positive CRA consideration under the investment or community development tests.

Your Green Communities initiative, and others like it, may be able to take advantage of these tools to obtain additional resources under the public welfare investment authority, CRA, and other available incentives to build many more sustainable homes and communities across the country. The research and examples described on your Web site demonstrate that moving to a green economy can generate a significant number of jobs, stimulate economic growth, and create a healthy environment in communities that Enterprise serves.

As the credit market stabilizes, CRA-driven initiatives can also help us tackle challenges such as the preservation of homeownership opportunities and rental housing development. Opportunities also lie ahead for bank partnerships with Enterprise affiliates and other nonprofits to help mitigate the impact of foreclosures in communities across the country.

The National Community Stabilization Trust, which Enterprise and other national housing intermediaries recently formed, is an important new initiative to help coordinate the transfer of foreclosed properties from financial institutions, servicers, investors, and government-sponsored enterprises to local housing organizations funded by the Neighborhood Stabilization Program. The Trust has developed standardized transaction formats and valuation and pricing models to assist local programs in making acquisition decisions and sales efficiently.

For our part at the OCC, we have sought to clarify how banks might receive CRA consideration for the donation and discounted sales of foreclosed properties in

conjunction with these initiatives. We co-hosted a conference earlier this summer that highlighted many effective strategies employed by nonprofits and public agencies for coping with the rising number of foreclosures. We now have a Neighborhood Stabilization page on the OCC's Web site, which will serve as a resource to nonprofits and public agencies seeking to purchase foreclosed properties in your communities.

We have also hired a Community Affairs Officer, Vonda Eanes, to specialize in working with nonprofits and public agencies across the country to focus on neighborhood stabilization and serve as a resource for banks and communities developing initiatives regarding foreclosed property.

Vonda joins the OCC's Community Affairs department, headed by Barry Wides. The responsibilities of this department include sharing best practices, providing guidance on regulatory issues, and explaining to bankers how these initiatives can help their CRA performance. I encourage you to introduce yourself to Vonda, Barry, and the other OCC representatives attending this conference. They hope to learn more about how the OCC might assist your efforts.

Our nation has accomplished much since CRA's passage. Perhaps even Jim Rouse could not imagine how much the flow of CRA-related capital and credit has contributed to affordable homeownership, jobs and business development, and healthy neighborhoods. In today's challenging economy, the need for the positive results that CRA has generated are even greater, and the same is true for organizations like Enterprise.

Thank you very much.

[1] "OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data," January-June 2008. View the report at http://www.occ.gov/ftp/release/2008-105a.pdf.

[2] Glenn B. Canner, Senior Advisor, Federal Reserve Board, "2007 HMDA Data: Identifying Trends and Potential Regulatory Concerns," presentation at the Consumer Bankers Association's 2008 CRA and Fair Lending Colloquium, October 27, 2008.

[3] "Findings from Analysis of Nationwide Summary Statistics for Community Reinvestment Act Data," *FFIEC Fact Sheets*, July 1999 – July 2008.

[4] "Low-Income Mortgage Borrowers with the Benefit of Homeownership Counseling Do Substantially Better than General Market, According to New Foreclosure Analysis," NeighborWorks America, *News Release*, September 25, 2008.

[5] *Ibid*.

[6] Lei Ding, Roberto G. Quercia, Janneke Ratcliffe, Wei Li, "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models," University of North Carolina, Center for Community Capital, October 2008.

[7] "Measuring the Delivery Costs of Prepurchase Homeownership Education and Counseling," NeighborWorks America, May 2005, pp. 11-15.

[8] Ernst and Young LLP, "Understanding the Dynamics IV: Housing Tax Credit Investment Performance," 2007.

CRA Lending During the Subprime Meltdown

*Elizabeth Laderman and Carolina Reid**
Federal Reserve Bank of San Francisco

The current scale of mortgage delinquencies and foreclosures, particularly in the subprime market, has sparked a renewed debate over the Community Reinvestment Act (CRA) and the regulations governing home mortgage lending. On one side, detractors argue that the CRA helped to precipitate the current crisis by encouraging lending in low- and moderate-income neighborhoods.[1] Economist Thomas DiLorenzo, for instance, wrote that the current housing crisis is "the direct result of thirty years of government policy that has forced banks to make bad loans to un-creditworthy borrowers."[2] Robert Litan of the Brookings Institution similarly suggested that the 1990s enhancement of the CRA may have contributed to the current crisis. "If the CRA had not been so aggressively pushed," Litan said, "it is conceivable things would not be quite as bad. People have to be honest about that."[3]

On the other side, advocates of the CRA point to a number of reasons why the regulation should not be blamed for the current subprime crisis. Ellen Seidman, formerly the director of the Office of Thrift Supervision, points out that the surge in subprime lending occurred long after the enactment of the CRA, and that in 1999 regulators specifically issued guidance to banks imposing restraints on the riskiest forms of subprime lending.[4] In addition, researchers at the Federal Reserve Board of Governors have reported that the majority of subprime loans were made by independent mortgage lending companies, which are not covered by the CRA and receive less regulatory scrutiny overall.[5] In addition to being excluded from CRA obligations, independent mortgage companies are not regularly evaluated for "safety and soundness" (a key component of the regulatory oversight of banks) nor for their compliance with consumer protections such as the Truth in Lending Act and the Equal Credit Opportunity Act.[6] This has created what the late Federal Reserve Board Governor Ned Gramlich aptly termed, a "giant hole in the supervisory safety net."[7]

What has been missing in this debate has been an empirical examination of the performance of loans made by institutions regulated under the CRA, versus those made by independent mortgage banks. The ability to conduct this research has been limited by the lack of a dataset that links information on loan origination with information on loan performance. In this study, we use a unique dataset that joins lender and origination

* *This article is based on a longer working paper that is part of a Federal Reserve Bank of San Francisco's Working Paper Series, available at http://www.frbsf.org/publications/community/wpapers/2008/wp08-05.pdf.*

1 *Walker, David. Interview with Larry Kudlow. Lessons from Subprime. CNBC, April 4, 2008, and Steve Moore. Interview with Larry Kudlow. Kudlow & Company. CNBC, March 26, 2008.*

2 *DiLorenzo, Thomas J. "The Government-Created Subprime Mortgage Meltdown." September 2007, available at http://www.lewrockwell.com/dilorenzo/dilorenzo125.html.*

3 *Weisman, Jonathan (2008). "Economic Slump Underlines Concerns About McCain Advisers." Washington Post, April 2, 2008, A01.*

4 *Seidman, Ellen. "It's Still Not CRA," September 2008, available at http://www.newamerica.net/blog/asset-building/2008/its-still-not-cra-7222.*

5 *Avery, Robert B., Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner (2007). "The 2006 HMDA Data." Federal Reserve Bulletin 94: A73–A109. See also: Kroszner, Randall S. (2008). "The Community Reinvestment Act and the Recent Mortgage Crisis." Speech given at the Confronting Concentrated Poverty Policy Forum, Board of Governors of the Federal Reserve System, Washington, DC, December 3, 2008.*

6 *The federal laws that govern home mortgage lending, including the Equal Credit Opportunity Act, the Home Mortgage Disclosure Act, and the Truth in Lending Act, apply to both depository institutions and nonbank independent mortgage companies. However, the enforcement of these laws and the regulations that implement them differ greatly between banks and nonbanks. Banks are subject to ongoing supervision and examination by their primary federal supervisor. In contrast, the Federal Trade Commission is the primary enforcer of these laws for nonbanks and only conducts targeted investigations based on consumer complaints.*

7 *Gramlich, Edward M. (2007). "Booms and Busts: The Case of Subprime Mortgages." Paper presented in Jackson Hole, Wyoming, August 31, 2007, available at http://www.urban.org/UploadedPDF/411542_Gramlich_final.pdf.*

information from the Home Mortgage Disclosure Act (HMDA) reports with data on loan performance from Lender Processing Services, Inc. Applied Analytics (LPS).[8] We thus have access to information on borrower characteristics (including race, income, and credit score), loan characteristics (including its loan-to-value ratio, whether it was a fixed or adjustable-rate mortgage, and the existence of a prepayment penalty), institutional characteristics (whether the lending institution was regulated under the CRA and the loan source), and loan performance (delinquency and foreclosure).

In this article, we use these data to examine several interrelated questions:

- What is the neighborhood income distribution of loans made by independent mortgage companies versus those made by institutions regulated under the CRA?
- After controlling for borrower credit risk, is there a difference in the foreclosure rates for loans made by independent mortgage companies versus those made by institutions regulated under the CRA?
- How do other factors, such as loan terms and loan source, influence the likelihood of foreclosure?
- How do the factors that influence foreclosure differ in low- and moderate-income neighborhoods compared with the factors in middle- and upper-income neighborhoods?

The article is organized into four sections. In the first section, we provide background information on the CRA and review the existing literature on the relationship between the CRA and mortgage lending in low- and moderate-income communities. In the second section, we describe our data and methodology. The third section presents the results of our models. We conclude with the policy implications of this study and present suggestions for further research.

The Community Reinvestment Act

In 1977, concerned about the denial of credit to lower-income communities—both minority and white—Congress enacted the Community Reinvestment Act. The CRA encourages federally insured banks and thrifts to meet the credit needs of the communities they serve, including low- and moderate-income areas, consistent with safe-and-sound banking practices. Regulators consider a bank's CRA record in determining whether to approve that institution's application for mergers with, or acquisitions of, other depository institutions. A key component of the CRA is the Lending Test (which accounts for 50 percent of a Large Bank's CRA rating), which evaluates the bank's home mortgage, small-business, small-farm, and community-development lending activity. In assigning the rating for mortgage lending, examiners consider the number and amount of loans to low- and moderate-income borrowers and areas and whether or not they demonstrate "innovative or flexible lending practices."[9]

The CRA has generated significant changes in how banks and thrifts view and serve low- and moderate-income communities and consumers. Researchers who have studied the impact of the CRA find, on balance, that the regulations have reduced information costs and fostered competition among banks serving low-income areas, thereby generating larger volumes of lending from diverse sources and adding liquidity to the market.[10] In a detailed review, William Apgar and Mark Duda of the Joint Center for Housing Studies at Harvard University

8 Formerly known as McDash Analytics.

9 As part of their CRA exam, large banks are also evaluated on their investments and services. Under the Investment Test, which accounts for 25 percent of the bank's CRA grade, the agency evaluates the amount of the bank's investments, its innovation, and its responsiveness to community needs. Under the Service Test, which makes up the remaining 25 percent of the bank's evaluation, the agency analyzes "the availability and effectiveness of a bank's systems for delivering retail banking services and the extent and innovativeness of its community development services." Different rules apply for Small and Intermediate Small institutions. For more complete details on the CRA regulations, visit http://www.ffiec.gov/cra/default.htm for text of the regulations and Interagency Q&A.

10 Avery, Robert B., Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner (1996). "Credit Risk, Credit Scoring, and the Performance of Home Mortgages." Federal Reserve Bulletin 82: 621–48. See also: Avery, Robert B., Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner (1999). "Trends in Home Purchase Lending: Consolidation and the Community Reinvestment Act." Federal Reserve Bulletin 85: 81–102; Michael S. Barr (2005). "Credit Where It Counts: The Community Reinvestment Act and Its Critics." New York University Law Review 80(2): 513–652; Belsky, Eric, Michael Schill, and Anthony Yezer (2001). The Effect of the Community Reinvestment Act on Bank and Thrift Home Purchase Mortgage Lending (Cambridge, MA: Harvard University Joint Center for Housing Studies); Evanoff, Douglas D., and Lewis M. Siegal (1996). "CRA and Fair Lending Regulations: Resulting Trends in Mortgage Lending." Economic Perspectives 20(6): 19–46; and Litan, Robert E., et al. (2001). The Community Reinvestment Act After Financial Modernization: A Final Report (Washington, DC: U.S. Treasury Department).

concluded that the CRA has had a positive impact on low- and moderate-income communities. In particular, the study notes that "CRA-regulated lenders originate a higher proportion of loans to lower-income people and communities than they would if the CRA did not exist."[11]

Since the passage of the CRA, however, the landscape of financial institutions serving low- and moderate-income communities has changed considerably. Most notably, innovations in credit scoring, coupled with the expansion of the secondary market, have led to an explosion of subprime lending, especially in the last few years. According to one source, the subprime market accounted for fully 20 percent of all mortgage originations in 2005, with a value of over $600 billion.[12] Many of these loans were not made by regulated financial institutions; indeed, more than half of subprime loans were made by independent mortgage companies, and another 30 percent were made by affiliates of banks or thrifts, which also are not subject to routine examination or supervision.[13]

Given the large role played by independent mortgage companies and brokers in originating subprime loans, there has been growing interest in extending the reach of the CRA to encompass these changes in the financial landscape. Yet to date, there has been little research that has empirically assessed individual loan performance at CRA-regulated institutions versus loan performance at independent mortgage companies, particularly within low- and moderate-income areas. Instead, most of the existing literature has focused on determining the share of subprime lending in low-income communities and among different racial groups.[14] These studies, however, cannot assess whether loans made by institutions regulated by the CRA have performed better than those made by independent mortgage companies. Answering this question has been difficult given the lack of a single dataset that captures details on loan origination as well as details on loan performance.

A few recent studies attempt to match data from different sources to shed light on pieces of this puzzle. Researchers at Case Western's Center on Urban Poverty and Community Development used a probabilistic matching technique to link mortgage records from the HMDA data with locally recorded mortgage documents and foreclosure filings.[15] They found that the risk of foreclosure for higher-priced loans, as reported in the HMDA data, was 8.16 times higher than for loans that were not higher priced. They also found that loans originated by financial institutions without a local branch had foreclosure rates of 19.08 percent compared to only 2.43 percent for loans originated by local banks.

Another recent study released by the Center for Community Capital at the University of North Carolina uses a propensity score matching technique to compare the performance of loans made through a LMI-targeted community lending program (the Community Advantage Program [CAP] developed by Self-Help, a Community Development Financial Institution) to a sample of subprime loans in the McDash database.[16] They found that for borrowers with similar income and risk profiles, the estimated default risk was much lower for borrowers with a prime loan made through the community lending program than with a subprime loan. In addition, they found that broker-origination, adjustable-rate mortgages and prepayment penalties all increased the likelihood of default.

Both of these studies provide important insights into the relationship between subprime lending and foreclosure risk, and conclude that lending to low- and moderate-income communities is viable when those

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11 *Apgar, William, and Mark Duda (2003). "The Twenty-Fifth Anniversary of the Community Reinvestment Act: Past Accomplishments and Future Regulatory Challenges." Federal Reserve Bank of New York Economic Policy Review (June): 176.*

12 *Inside Mortgage Finance (2007). Mortgage Market Statistical Annual (Bethesda, MD: Inside Mortgage Finance Publications).*

13 *Avery, Brevoort, and Canner (2007). "The 2006 HMDA Data." See also: Kroszner (2008). "The Community Reinvestment Act."*

14 *See, for example: Avery, Robert B., Glenn B. Canner, and Robert E. Cook (2005). "New Information Reported Under HMDA and Its Application in Fair Lending Enforcement." Federal Reserve Bulletin (Summer 2005): 344–94; Gruenstein Bocian, Debbie, Keith Ernst, and Wei Li (2008). "Race, Ethnicity, and Bubprime Home Loan Pricing." Journal of Economics and Business 60: 110–24; and Calem, Paul S. Jonathan E. Hershaff, and Susan M. Wachter (2004). "Neighborhood Patterns of Subprime Lending: Evidence from Disparate Cities." Housing Policy Debate 15(3): 603–22.*

15 *Coulton, Claudia, Tsui Chan, Michael Schramm, and Kristen Mikelbank (2008). "Pathways to Foreclosure: A Longitudinal Study of Mortgage Loans, Cleveland and Cuyahoga County." Center on Urban Poverty and Community Development, Case Western University, Cleveland, Ohio.*

16 *Ding, Lei, Roberto G. Quercia, Janneke Ratcliffe, and Wei Li (2008). "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models." Center for Community Capital, University of North Carolina, Chapel Hill.*

loans are made responsibly. However, both studies are limited in certain important ways. Coulton and her colleagues do not examine the regulatory oversight of the banks that made the loans, and are only able to control for a limited number of borrower and loan characteristics. Ding and his colleagues are constrained by having access only to a relatively narrow subset of loans securitized by the CAP program. Because the sample of CAP mortgages may not be representative of a national sample of mortgage borrowers, and especially since being part of the CAP demonstration may influence the lender's behavior and the quality of the loans they sell to Self-Help, the study's findings may not be applicable to lending in low- and moderate-income areas more generally.

In this study, we attempt to build on these research contributions by: (a) examining the performance of a sample of all loans (prime and subprime, and not limited to a specific demonstration program) made in California during the height of the housing boom; and (b) controlling for a wider range of variables, examining not only borrower characteristics, but assessing the influence of loan and lender variables on the probability of foreclosure as well.

Methodology

The quantitative analysis we use relies on a unique dataset that joins loan-level data submitted by financial institutions under the Home Mortgage Disclosure Act (HMDA) of 1975[17] and a proprietary data set on loan performance collected by Lender Processing Services, Inc. Applied Analytics (LPS). Using a geographic crosswalk file that provided corresponding zip codes to census tracts (weighted by the number of housing units), data were matched using a probabilistic matching method that accounted for the date of origination, the amount of the loan, the lien status, the type of loan, and the loan purpose. To check the robustness of the matching procedure, we compared the sample statistics from the matched sample with the same sample statistics from the unmatched sample and found them to be similar. The LPS database provides loan information collected from approximately 15 mortgage servicers, including nine of the top ten, and covers roughly 60 percent of the mortgage market. Because the LPS includes both prime and subprime loans, the sample of loans tends to perform better than the sample in other databases such as Loan Performance First American's subprime database. However, we believe that for this paper it is important to consider both prime and subprime loans in evaluating the performance of loans made by institutions regulated under the CRA, since presumably the original intent of the CRA was to extend "responsible" credit to low- and moderate-income communities.

For this paper, we limit our analysis to a sample of conventional, first-lien, owner-occupied loans originated in metropolitan areas in California between January 2004 and December 2006. This time period represents the height of the subprime lending boom in California. We also limit our analysis in this instance to home purchase loans, although other studies have noted that much of the demand for mortgages during this period was driven by refinance loans and this will certainly be an area for further study. This leaves us with 239,101 matched observations for our analysis.

Borrower and Housing Market Characteristics

For borrower characteristics, we include information from the HMDA data on borrower race and/or ethnicity. Most of the existing research on subprime lending has shown that race has an independent effect on the likelihood of obtaining a higher-priced loan.[18] HMDA reporting requirements allow borrowers to report both an ethnicity designation (either "Hispanic or Latino" or "Not Hispanic or Latino") and up to five racial designations (including "white" and "African American" or "black"). We code and refer to borrowers who were

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17 Enacted by Congress in 1975, the Home Mortgage Disclosure Act (HMDA) requires banks, savings and loan associations, and other financial institutions to publicly report detailed data on their mortgage lending activity. A depository institution (bank, savings and loan, thrift, and credit union) must report HMDA data if it has a home office or branch in a metropolitan statistical area (MSA) and has assets above a threshold level that is adjusted upward every year by the rate of inflation. For the year 2006, the asset level for exemption was $35 million. A nondepository institution must report HMDA data if it has more than $10 million in assets and it originated 100 or more home purchase loans (including refinances of home purchase loans) during the previous calendar year. Beginning in 2004, lenders were required to report pricing information related to the annual percentage rate of "higher-priced" loans, defined as a first-lien loan with a spread equal to or greater than three percentage points over the yield on a U.S. Treasury security of comparable maturity.

18 Avery, Canner, and Cook (2005). "New Information Reported Under HMDA."

identified as "Hispanic or Latino" and "white" as Latino, borrowers who were identified as "African American or black" as black, and borrowers who were identified as "Asian" as Asian. We code borrowers and refer to them as "white" if they are "Not Hispanic or Latino" and only identified as "white" in the race field.

We use two other borrower-level variables in the analyses that follow. From the HMDA data, we include the borrower income, scaled in $1,000 increments. From the LPS data, we include the FICO credit score of the borrower at origination.[19] Because FICO scores are generally grouped into "risk categories" rather than treated as a continuous variable, we distinguish between "low" (FICO < 640), "middle" (640 >= FICO < 720) and "high" (FICO >= 720) credit scores.[20] We assume that lower credit scores would lead to a higher probability of delinquency and, subsequently, foreclosure.

At the neighborhood level, we include the FFIEC income designation for each census tract, the same measure that is used in evaluating a bank's CRA performance. Low-income census tracts are those that have a median family income less than 50 percent of the area median income; moderate-income census tracts are those that have a median family income at least 50 percent and less than 80 percent of the area median income; middle-income census tracts are those that have a median family income at least 80 percent and less than 120 percent of the area median income; and upper-income are those with a median family income above 120 percent of the area median income. In addition to tract income, we also include variables from the 2000 Census that attempt to capture the local housing stock, including the percent of owner-occupied units and the median year houses in the census tract were built.[21] We also include the tract's capitalization rate, defined as a ratio of the tract's annualized median rent divided by the median house value. A larger value for this measure is consistent with lower expected price appreciation or more uncertain future house prices.[22] We would expect this variable to be positively associated with the relative likelihood of foreclosure.

In addition to neighborhood-level variables, we also include a variable on the performance of the local housing market. Economic research conducted at the Federal Reserve Bank of San Francisco and the Federal Reserve Bank of Boston has shown that house price dynamics are an important predictor of foreclosure.[23] Because current house values may be endogenously related to foreclosure rates, we include an OFHEO variable that captures house price changes in the MSA/metropolitan division in the two years prior to the loan origination.[24] We assume that loans originated during a time of significant house price appreciation will be more likely to be in foreclosure, since it is areas that saw prices rising rapidly relative to fundamentals that have seen the most dramatic realignment of prices.

Loan Characteristics

In the models that follow, we also include various loan characteristics that may affect the probability of foreclosure. From HMDA, we include whether or not the loan was a "higher-priced" loan. Researchers have shown a strong correlation between higher-priced loans and delinquency and foreclosure.[25] Since higher-priced loans are presumably originated to respond to the cost of lending to a higher risk borrower (such as those with

19 *Although there are several credit scoring methods, most lenders use the FICO method from Fair Isaac Corporation.*

20 *In running the models with FICO treated as a continuous variable, foreclosure risk increased monotonically with FICO score declines, and did not significantly affect the other variables in the model.*

21 *In some models we tested, we also controlled for neighborhood-level variables such as the race distribution and educational level of the census tract, but these proved not to be significant in many of the model specifications, and tended to be highly correlated with the FFIEC neighborhood income categories. In addition, we were concerned about including too many 2000 census variables that may not reflect the demographic changes that occurred in neighborhoods in California between 2000 and 2006, years of rapid housing construction and price appreciation.*

22 *Calem, Hershaff, and Wachter (2004). "Neighborhood Patterns of Subprime Lending."*

23 *Doms, Mark, Frederick Furlong, and John Krainer (2007). "Subprime Mortgage Delinquency Rates." Working Paper 2007-33, Federal Reserve Bank of San Francisco. See also: Gerardi, Kristopher, Adam Hale Shapiro, and Paul S. Willen (2007). "Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures." Working Paper 07-15, Federal Reserve Bank of Boston.*

24 *We use OFHEO instead of Case Shiller because Case Shiller is available only for Los Angeles and San Francisco and we wanted to capture changes in house-price appreciation across a greater number of communities, particularly those in California's Central Valley.*

25 *Pennington-Cross, Anthony (2003). "Performance of Prime and Nonprime Mortgages." Journal of Real Estate Finance and Economics 27(3): 279–301. See also: Gerardi, Shapiro, and Willen (2007). "Subprime Outcomes;" and Immergluck, Dan (2008). "From the Subprime to the Exotic: Excessive Mortgage Market Risk and Foreclosures." Journal of the American Planning Association 74(1): 59–76.*

impaired credit scores), it is not surprising that this relationship exists. However, the current crisis has also shed light on the fact that many loans originated during the height of the subprime lending boom included additional features that can also influence default risk, such as adjustable mortgage rates, prepayment penalties, and the level of documentation associated with the loan.[26] For this reason, we include a wide range of variables in the LPS data on the terms of the loan, including the loan-to-value ratio, whether or not the loan has a fixed interest rate, whether or not it included a prepayment penalty at origination, and whether or not it was a fully documented loan. We also include data on the value of the monthly payment, scaled at $500 increments. While standard guidelines for underwriting suggest that monthly costs should not exceed 30 percent of a household's income, recent field research suggests that many loans were underwritten at a much higher percent.

Lender Characteristics

To determine whether or not a loan was originated by a CRA-regulated institution, we attach data on lender characteristics from the HMDA Lender File, following the insights of Apgar, Bendimerad, and Essene (2007)[27] on how to use HMDA data to understand mortgage market channels and the role of the CRA. We focus on two variables: whether or not the lender is regulated under the CRA, and whether or not the loan was originated within the lender's CRA-defined assessment area, generally defined as a community where the bank or thrift maintains a branch location.[28]

As was described above, CRA regulations apply only to the lending activity of deposit-taking organizations and their subsidiaries (and, in some instances, their affiliates). Independent mortgage companies not only fall outside the regulatory reach of the CRA but also a broader set of federal regulations and guidance designed to protect the "safety and soundness" of the lender.[29] In contrast to CRA-regulated institutions, independent mortgage companies are subject to state licensing and monitoring requirements and do not undergo routine examination.

We further distinguish between loans made by a CRA-regulated lender outside its assessment area and those made by a CRA-regulated lender within its assessment area. Mortgages made by banks and thrifts in their assessment areas are subject to the most detailed CRA review, including on-site reviews and file checks. The assessment-area distinction also correlates with differences in the way mortgages are marketed and sold.[30] For example, loans made to borrowers living inside the assessment area are likely to come through the institution's retail channel. In contrast, loans made to borrowers living outside the organization's CRA-defined assessment area are more likely to be originated by loan correspondents or mortgage brokers. We assume that if a lending entity subject to the CRA has a branch office in a metropolitan statistical area (MSA), then that MSA is part of the entity's assessment area. Loans made in MSAs where the lending entity does not have a branch office are assumed to be originated outside the entity's assessment area.[31]

Building on recent research suggesting the importance of mortgage brokers during the subprime lending boom,[32] we also include a loan-source variable that captures the entity responsible for the loan origination, even if the loan eventually was financed by a CRA-regulated lender or independent mortgage company. We control for whether the loan was made by a retail institution, a correspondent bank, or a wholesale lender. Wholesale lenders are third-party originators, generally mortgage brokers, that market and process the mortgage application. One important methodological note is that our models that include the loan-source variable are run on a smaller sample of loans. In these models, we

26 *Crews Cutts, Amy, and Robert Van Order (2005). "On the Economics of Subprime Lending." Journal of Real Estate Finance and Economics 30(2): 167–97. See also: Immergluck (2008). "From the Subprime to the Exotic."*

27 *Apgar, William, Amal Bendimerad, and Ren Essene (2007). Mortgage Market Channels and Fair Lending: An Analysis of HMDA Data (Cambridge, MA: Harvard University, Joint Center for Housing Studies).*

28 *We exclude loans originated by credit unions from this analysis; credit unions are not examined under the CRA and comprise a relatively small proportion of the home-purchase mortgage market.*

29 *Apgar, Bendimerad, and Essene (2007). Mortgage Market Channels and Fair Lending.*

30 *Ibid.*

31 *Our methodology is consistent with that of Apgar, Bendimerad, and Essene (2007), who assume that if a lending entity subject to the CRA has a branch office in a particular county, then that county is part of the entity's assessment area.*

32 *Ernst, Keith, D. Bocia, and Wei Li (2008). Steered Wrong: Brokers, Borrowers, and Subprime Loans (Durham, NC: Center for Responsible Lending).*

exclude loans where loan source is equal to "servicing right" due to endogeneity concerns.[33] Some financial institutions specialize in servicing "scratch and dent" mortgages, which, by their nature, would be more likely to foreclose.[34] Indeed, in early models we found loans obtained through a servicing right were significantly more likely to be in foreclosure than loans originated by any other loan source.

Findings

In Table 1 (at the end of this article), we present simple descriptive statistics that show the distribution of loan originations made by CRA-regulated institutions (CRA lenders) versus independent mortgage companies (IMCs), stratified by neighborhood income level. The table demonstrates the important role that IMCs have played in low- and moderate-income communities in California during the subprime boom. While CRA lenders originated more loans in low- and moderate-income tracts than did IMCs, IMCs originated a much greater share of higher-priced loans in these communities. Indeed, more than half of the loans originated by IMCs in low-income communities were higher priced (52.4 percent), compared with 29 percent of loans made by CRA lenders; in moderate-income communities, 46.1 percent of loans originated by IMC lenders were higher priced, compared with 27.3 percent for CRA lenders. In addition, 12 percent of the loans made by IMCs in low-income census tracts and 10.3 percent of loans in moderate-income census tracts are in foreclosure, compared with 7.2 percent of loans made by CRA lenders in low-income census tracts and 5.6 percent in moderate-income census tracts.

It is also worth noting the relatively small share of loans that were originated in low- and moderate-income communities; only 16 percent of loans made by CRA lenders were located in low- and moderate-income census tracts. IMCs made a slightly greater share of their total loans (20.5 percent) in low- and moderate-income communities. The relatively limited share of lending in low- and moderate-income communities may be due in part to the high cost of housing in California, yet it also suggests that on the whole, lending in low- and moderate-income communities remained a relatively small share of the lending market for regulated financial institutions, despite the incentive of the CRA.

These descriptive statistics, however, do not control for the wide range of borrower and loan characteristics that may influence the likelihood of foreclosure. For example, might the higher rates of foreclosure among IMC-originated loans be due to different risk profiles of the borrowers themselves? In the following tables, we present a series of binomial logistic regression models that predict the likelihood of a loan being in foreclosure, controlling for various borrower and loan characteristics. In all the models, we cluster the standard errors by census tract because standard errors are likely not independent across time within tracts. We also examined the correlation among the independent variables in each of the models and found that although many of the factors we include are interrelated, the models perform well and the coefficients and standard errors do not change erratically across different model specifications. We present the findings as odds ratios to assist in interpreting the coefficients.

In Table 2, we present the full model, including all variables with the exception of loan source. Several findings stand out. First, metropolitan house-price changes do have a significant effect on the likelihood of foreclosure. Rapid house-price appreciation in the two years preceding origination significantly increases the likelihood of foreclosure (odds ratio 1.26). This is consistent with previous research that has linked foreclosures and delinquencies to local housing market conditions, particularly in California, where house prices rose quickly in relation to fundamentals and where subsequent corrections have been quite dramatic.[35] A higher percent of owner-occupied housing in a tract and more recent construction both also seem to increase the likelihood of foreclosure, but only slightly. The tract's capitalization rate is not significant.

Second, and not surprisingly, FICO scores matter. A borrower with a FICO score of less than 640 is 4.1 times

33 "Servicing right" as the loan source means that only the servicing rights were purchased, not the whole loan. The lender was likely not involved in the credit decision or in determining the credit criteria. In some cases, the loan itself may not be salable or may be damaged ("scratch & dent"). Damaged loans are usually impaired in some way, such as missing collateral or an imperfect note/lien.

34 Pennington-Cross, Anthony and Giang Ho (2006). "Loan Servicer Heterogeneity and the Termination of Subprime Mortgages." Working Paper 2006-024A, Federal Reserve Bank of St. Louis.

35 Doms, Furlong, and Krainer (2007). "Subprime Mortgage Delinquency Rates."

more likely to be in foreclosure than a borrower with a FICO score of more than 720; for borrowers with a FICO score between 640 and 720, the odds ratio is 2.68. We also find that race has an independent effect on foreclosure even after controlling for borrower income and credit score. In particular, African American borrowers were 1.8 times as likely as white borrowers to be in foreclosure, whereas Latino and Asian borrowers were, respectively, 1.4 and 1.3 times more likely to be in foreclosure as white borrowers.[36] The income of the neighborhood also seems to have some effect on the foreclosure rate. Loans located in low-income tracts were 1.8 times more likely to be in foreclosure than those in upper-income tracts, with the risk declining monotonically as the income of the neighborhood increases.

Yet the model shows that even with controls for borrower characteristics included, the terms of the loan matter. Consistent with previous research, we find that higher-priced loans are significantly more likely (odds ratio 3.2) to be in foreclosure than those not designated as higher priced in the HMDA data. But we also find that other loan features—such as the presence of a prepayment penalty at origination, a fixed rate interest loan, a high loan-to-value ratio, a large monthly payment in relation to income, and the loan's level of documentation—all have a significant effect on the likelihood of foreclosure, even after controlling for whether the loan was a higher-priced loan or not. A fixed interest rate significantly and strongly reduces the likelihood of foreclosure (odds ratio 0.35), as does the presence of full documentation (odds ratio 0.61). An increase of ten percentage points in the loan-to-value ratio—for example, from 80 to 90 percent loan-to-value—increases the likelihood of foreclosure by a factor of 3.0.

What is interesting, however, is that even after controlling for this wide range of borrower, neighborhood, and loan characteristics, loans made by lenders regulated under the CRA were significantly less likely to go into foreclosure than those made by IMCs (odds ratio 0.703). This provides compelling evidence that the performance of loans made by CRA-regulated institutions has been significantly stronger than those made by IMCs.

Even more striking is what we find when we present the same model with the CRA lender status broken down by loans made within the CRA lenders' assessment area and loans made outside the CRA lenders' assessment area (with the omitted category being loans originated by IMCs). Presented in the second column of the table, we find that loans made by CRA lenders in their assessment areas were half as likely to be in foreclosure as loans made by IMCs (odds ratio 0.53). For loans made by a CRA lender outside its assessment area, the odds ratio is 0.87. In other words, loans made by CRA lenders within their assessment areas, which receive the greatest regulatory scrutiny under the CRA, are significantly less likely to be in foreclosure than those made by independent mortgage companies that do not receive the same regulatory oversight.

In Table 3, we add information about the source of the loan. As discussed earlier, we omit observations where the loan source is indicated as "servicing right." [37] The model demonstrates the importance of the originating mortgage-market channel in the performance of the loan. While the findings for other variables remained similar to those in models presented above, we find significant differences in the loan performance among loans originated at the retail branch, by a correspondent lender, or by a wholesale lender/mortgage broker. In particular, loans originated by a wholesale lender were twice as likely to be in foreclosure as those originated by a retail branch. This is a significant finding, and it supports other research that has shown that there were significant differences between broker and lender pricing on home loans, primarily on mortgages originated for borrowers with weaker credit histories.[38] Interestingly, the inclusion of loan source also weakens the effect of the CRA variables. While loans made by CRA lenders within their assessment area are still less likely to go into foreclosure than those made by IMCs (an odds ratio of 0.743), the coefficient for CRA loans made outside the assessment area is no longer significant. This suggests that the origination channel is a critical factor in determining the likelihood of foreclosure, even for CRA-regulated institutions.

36 *In some additional preliminary analysis, we interacted the race variables with income and found some variation among the coefficients. For example, while African American borrowers at all income levels were more likely to be in foreclosure, for Asian borrowers, as income went up, the risk of foreclosure decreased compared to white borrowers. The story for Latino borrowers was more mixed and warrants further research. However, these interaction terms did not meaningfully alter the other coefficients, and we do not include the interaction terms here.*

37 *This decreases our sample size from 239,101 to 195,698.*

38 *Ernst, Bocia, and Li (2008). Steered Wrong.*

The Performance of CRA Lending in Low- and Moderate-Income Census Tracts

While the models above control for the income category of the neighborhood, they do not explore the relative performance of loans from CRA-regulated institutions within low- and moderate-income census tracts. In other words, on average, the loan performance of CRA lenders may be better than that of IMCs, but does this hold true within low- and moderate-income census tracts, the areas that are intended to benefit the most from the presence of the CRA? In Tables 4–7, we replicate our analysis above by looking specifically at what happens when we stratify the models by neighborhood income level. For each neighborhood classification (low, moderate, middle, and upper), we present two models: the first including borrower and loan characteristics, and the second adding the loan source. Some interesting differences emerge, both in comparison to the full model and among the models for the different neighborhood income categories.

Regarding the restriction of the sample to low-income neighborhoods, it is interesting to see that the effect of being a CRA lender loses much of its strength as well as its statistical significance. With no loan-source control, the point estimate indicates that CRA loans made outside the assessment area were only slightly less likely to be in foreclosure than loans made by IMCs (an odds ratio of 0.95). However, loans made by a CRA lender within its assessment area remain quite a bit less likely (odds ratio of 0.73) to be in foreclosure than loans made by IMCs in the same neighborhoods, and the effect remains statistically significant. In moderate-income communities, loans made by CRA lenders, both outside and within their assessment areas, are significantly less likely to be in foreclosure. In moderate-income communities, loans made by CRA-regulated institutions within their assessment areas were 1.7 times less likely (an odds ratio of 0.58) to be in foreclosure than those made by IMCs.

Yet, when we include the loan-source variable, the statistical significance of the effect of CRA lending in low- and moderate-income neighborhoods disappears. It is possible that, in these neighborhoods, the explanatory variables other than the CRA-related variables fully capture the practical application of the prudent lending requirements of the CRA and other regulations. If this were the case, then regulations, working through those factors, would be significant underlying determinants of loan performance without the coefficients on the CRA-related variables themselves showing up as statistically significant. That said, the estimation results do demonstrate the importance of the terms of the loan and the origination source in predicting foreclosure, in particular, whether or not the loan was originated by a wholesale lender. Indeed, in low-income neighborhoods, wholesale loans were 2.8 times as likely to be in foreclosure as are those originated by the retail arm of the financial institution; in moderate-income neighborhoods, wholesale loans were two times as likely to be in foreclosure. Given that these regressions control for a wide range of both borrower and loan characteristics, it suggests that more attention be paid to the origination channel in ensuring responsible lending moving forward.

In the following tables, we present the same analysis for middle- and upper-income census tracts. Here the results are more in line with the full sample. Loans made by CRA lenders within their assessment area are significantly less likely to be in foreclosure than those made by IMCs, even after controlling for the loan source. Although at first glance this may be counterintuitive—why would the CRA have an effect in middle- and upper-income areas?—we believe that this finding reflects much broader differences in market practices between regulated depository institutions and IMCs. Specifically, while the CRA may have provided regulated financial institutions with some incentive to lend in low- and moderate-income communities, the CRA is really only a small part of a much broader regulatory structure. This regulatory structure, as well as the very different business models of regulated financial institutions compared with IMCs, has significant implications for loan performance, only some aspects of which we have controlled for in our regressions.

Although not our focus here, an interesting difference that emerges across neighborhood income classifications is the role of the loan-to-value ratio as well as the variable on previous house-price appreciation. In middle- and upper-income neighborhoods, these seem to carry more weight than in low- and moderate-income neighborhoods, suggesting that in higher income areas, investment and economic decisions may be more important in predicting the likelihood that a borrower enters foreclosure. In contrast, in low- and moderate-income neighborhoods, fixed rate and monthly payment seem to have relatively more importance in predicting the likelihood of foreclosure, indicating that in these communities it may be more of an issue of short-term affordability.

While these findings are very preliminary and deserve further exploration, they do suggest that there may be important differences among communities regarding the factors that influence the sustainability of a loan.

Conclusions and Policy Implications

This article presents the first empirical examination of the loan performance of institutions regulated under the CRA relative to that of IMCs using a large sample of loans originated in California during the subprime lending boom. Importantly, by matching data on mortgage originations from the HMDA with data on loan performance from LPS, we are able to control for a wide range of factors that can influence the likelihood of foreclosure, including borrower and neighborhood characteristics, loan characteristics, lender characteristics, and the mortgage origination channel.

Before turning to our conclusions and the policy implications of our research, we would like to emphasize that these findings are preliminary, and additional research is needed to understand more fully the relationship between borrowers, lending institutions, loan characteristics, and loan performance. We see several important gaps in the literature that still need to be addressed. First, it is unclear whether or not our findings for California are applicable to other housing and mortgage markets. The size and diversity of California lend it weight as a valid case study for the performance of CRA lending more generally. However, the high cost of housing in California may influence the nature of the findings, and it would be valuable to replicate this analysis in other markets. Second, we focused our analysis on loans made in low- and moderate-income census tracts, given the CRA's original "spatial" emphasis on the link between a bank's retail deposit-gathering activities in a neighborhood and its obligation to meet local credit needs. A yet-unanswered question is the performance of CRA lending for low- and moderate- income borrowers. In addition, we focus solely on mortgage lending activities and do not examine the impact that the CRA investment or service components may have had on the current crisis.[39] Third, the continued importance of race as a variable deserves further exploration. In all of the models, African Americans were significantly more likely to be in foreclosure than whites. While some of this is likely due to differences in assets and wealth (which we cannot control for), additional research that can tease out the underlying reasons for this disparity may have important implications for fair-lending regulations. Fourth, we focus this analysis on lending for home purchases, yet an examination of refinance loans may yield different results. Finally, it may be valuable to specify this model as a two-step process, where the choice of lender is modeled separately from loan outcomes, particularly if the decision to borrow from an IMC versus a CRA-regulated institution is correlated with unobservable characteristics that affect the likelihood of foreclosure.

Despite these caveats, we believe that this research should help to quell if not fully lay to rest the arguments that the CRA caused the current subprime lending boom by requiring banks to lend irresponsibly in low- and moderate-income areas. First, the data show that overall, lending to low- and moderate-income communities comprised only a small share of total lending by CRA lenders, even during the height of subprime lending in California. Second, we find loans originated by lenders regulated under the CRA in general were significantly less likely to be in foreclosure than those originated by IMCs. This held true even after controlling for a wide variety of borrower and loan characteristics, including credit score, income, and whether or not the loan was higher priced. More important, we find that whether or not a loan was originated by a CRA lender within its assessment area is an even more important predictor of foreclosure. In general, loans made by CRA lenders within their assessment areas were half as likely to go into foreclosure as those made by IMCs (Table 2). While certainly not conclusive, this suggests that the CRA, and particularly its emphasis on loans made within a lender's assessment area, helped to ensure responsible lending, even during a period of overall declines in underwriting standards.[40]

The exception to this general finding is the significance of the CRA variables in the models that focused

39 For example, regulated financial institutions may have increased their exposure to mortgage-backed securities to satisfy their requirements for the CRA Investment Test. However, analysis conducted by the Federal Reserve Board suggests that banks purchased only a very small percentage of higher-priced loans (Kroszner 2008),1.

40 For an analysis of the quality of loans between 2001 and 2006 see Demyanyk Yuliya, and Otto van Hemert (2008). "Understanding the Subprime Mortgage Crisis." Working Paper, Federal Reserve Bank of St. Louis, February 4, 2008.

on loans made in low- and moderate-income neighborhoods. In these regressions, when loan source was not included as an explanatory variable, loans from CRA-regulated institutions within their assessment areas performed significantly better than loans from IMCs. But, when we included loan source, the significance of the CRA variables disappeared. Even so, loans from CRA-regulated institutions certainly performed no worse than loans from IMCs. Moreover, as mentioned earlier, the practical application of the prudent lending requirements of the CRA (as well as other regulations) may have been captured in the other explanatory variables in the model without the coefficients on the CRA-related variables themselves showing up as statistically significant. For example, 28 percent of loans made by CRA lenders in low-income areas within their assessment area were fixed-rate loans; in comparison, 18.2 percent of loans made by IMCs in low-income areas were fixed-rate. And only 12 percent of loans made by CRA lenders in low-income areas within their assessment areas were higher priced, compared with 29 percent in low-income areas outside their assessment areas and with 52.4 percent of loans made by IMCs in low-income areas.

Yet the finding that the origination source of the loan—retail, correspondent, or wholesale originated—is an important predictor of foreclosure, particularly in low- and moderate-income neighborhoods, should not be ignored. This builds on evidence from other research that suggests that mortgage brokers are disproportionately associated with the origination of higher-priced loans, particularly outside depository institutions' CRA assessment areas[41] and that mortgage brokers may be extracting materially higher payments from borrowers with lower credit scores and/or less knowledge of mortgage products.[42]

The study also emphasizes the importance of responsible underwriting in predicting the sustainability of a loan. Loan characteristics matter: a higher-priced loan, the presence of a prepayment penalty at origination, a high loan-to-value ratio, and a large monthly payment in relation to income all significantly increase the likelihood of foreclosure, while a fixed interest rate and full documentation both decrease the likelihood of foreclosure. For example, in low- and moderate-income communities, higher-priced loans were 2.3 and 2.1 times, respectively, more likely to be in foreclosure than those that were not higher priced, even after controlling for other variables including loan source.

In that sense, our paper supports the need to reevaluate the regulatory landscape to ensure that low- and moderate-income communities have adequate access to "responsible" credit. Many of the loans analyzed in this paper were made outside the direct purview of supervision under the CRA, either because the loan was made outside a CRA lender's assessment area or because it was made by an IMC. Proposals to "modernize" the CRA, either by expanding the scope of the CRA assessment area and/or by extending regulatory oversight to IMCs and other nonbank lenders, certainly deserve further consideration.[43] In addition, the study's findings also lend weight to efforts to rethink the regulations and incentives that influence the practice of mortgage brokers.[44]

In conclusion, we believe that one of the more interesting findings of our research is the evidence that some aspect of "local" presence seems to matter in predicting the sustainability of a loan: once a lender is removed from the community (outside their assessment area) or from the origination decision (wholesale loan), the likelihood of foreclosure increases significantly. For low- and moderate-income borrowers and communities, a return to localized lending may be even more important. Research on lending behavior has suggested that "social relationships and networks affect who gets capital and at what cost."[45] Particularly in communities that have traditionally been denied credit, and where intergenera-

41 *Kenneth P. Brevoort, and Glenn B. Canner (2006). "Higher-Priced Home Lending and the 2005 HMDA Data." Federal Reserve Bulletin (September 8): A123–A166.*

42 *Ernst, Bocia, and Li (2008). Steered Wrong.*

43 *Apgar and Duda (2003). "The Twenty-Fifth Anniversary of the Community Reinvestment Act."*

44 *Ernst, Bocia, and Li (2008). Steered Wrong.*

45 *Uzzi, Brian (1999). "Embeddedness in the Making of Financial Capital: How Social Relations and Networks Benefit Firms Seeking Financing." American Sociological Review 64(4): 481–505. See also: Holmes, Jessica, Jonathan Isham, Ryan Petersen, and Paul Sommers (2007). "Does Relationship Lending Still Matter in the Consumer Banking Sector? Evidence from the Automobile Loan Market." Social Science Quarterly 88(2): 585–97.*

tional wealth and knowledge transfers integral to the home-ownership experience may be missing, social networks and local presence may be a vital component of responsible lending (see Moulton 2008 for an excellent overview of how these localized social networks may influence mortgage outcomes, for example, by filling information gaps for both lenders and borrowers).[46] Indeed, the relatively strong performance of loans originated as part of statewide affordable lending programs,[47] Self-Help's Community Action Program,[48] and loans originated as part of Individual Development Account programs[49] all suggest that lending to low- and moderate-income communities can be sustainable. Going forward, increasing the scale of these types of targeted lending activities—all of which are encouraged under the CRA—is likely to do a better job of meeting the credit needs of all communities and promoting sustainable homeownership than flooding the market with poorly underwritten, higher-priced loans. ■

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See Tables 1 – 7 on the following pages

46 Moulton, Stephanie (2008). "Marketing and Education Strategies of Originating Mortgage Lenders: Borrower Effects and Policy Implications." Paper presented at the Association for Public Policy Analysis and Management 30th Annual Research Conference, Los Angeles, November 6, 2008.

47 Ibid.

48 Ding, Quercia, Ratcliffe, and Li (2008). "Risky Borrowers or Risky Mortgages."

49 CFED (2008). "IDA Program Survey on Homeownership and Foreclosure," available at http://www.cfed.org/focus.m?parentid=31&siteid=374&id=2663.

Table 1: Distribution of Lending Activity: CRA Lenders vs. Independent Mortgage Companies

	CRA Lenders	Independent Mortgage Companies
Total Loans		
Low-Income Neighborhood	3,843	1,487
Moderate-Income Neighborhood	24,795	10,609
Middle-Income Neighborhood	67,766	24,606
Upper-Income Neighborhood	83,563	22,432
All Neighborhoods	179,967	59,134
Total High-Priced Loans		
Low-Income Neighborhood	1,116	779
Moderate-Income Neighborhood	6,765	4,892
Middle-Income Neighborhood	10,573	8,068
Upper-Income Neighborhood	5,307	4,338
All Neighborhoods	23,761	18,077
Total Foreclosures		
Low-Income Neighborhood	275	177
Moderate-Income Neighborhood	1,379	1,092
Middle-Income Neighborhood	2,517	1,945
Upper-Income Neighborhood	1,613	1,211
All Neighborhoods	5,784	4,425

Table 2: Model Predicting the Likelihood of Loan Foreclosure

	CRA		CRA with Assessment Area	
	Odds Ratio	Standard Error	Odds Ratio	Standard Error
NEIGHBORHOOD VARIABLES				
Neighborhood Income Level (omitted: Upper-Income)				
Low-Income	1.79 ***	0.149	1.73 ***	0.142
Moderate-Income	1.32 ***	0.067	1.28 ***	0.064
Middle-Income	1.21 ***	0.045	1.18 ***	0.044
Percent Owner-Occupied	1.00 ***	8.69×10^{-4}	1.00 ***	8.68×10^{-4}
Median Year Housing Built	1.01 ***	0.001	1.01 ***	0.001
Capitalization Rate	0.85	0.515	0.75	0.451
House Price Appreciation (2 years prior to origination)	1.26 ***	0.019	1.22 ***	0.019
BORROWER VARIABLES				
Borrower Race (omitted: Non-Hispanic White)				
African American	1.78 ***	0.084	1.79 ***	0.084
Latino	1.36 ***	0.044	1.36 ***	0.044
Asian	1.29 ***	0.052	1.29 ***	0.052
Borrower Income	1.00 **	7.17×10^{-5}	1.00 **	7.26×10^{-5}
Borrower FICO Score (omitted: High - Above 720)				
Low FICO - Below 640	4.09 ***	0.166	4.07 ***	0.165
Mid-level FICO - 640-720	2.68 ***	0.087	2.65 ***	0.086
LOAN VARIABLES				
Higher-Priced Loan (yes=1)	3.23 ***	0.004	3.05 ***	0.104
Fixed Interest Rate (yes=1)	0.35 ***	0.017	0.35 ***	0.017
Prepayment Penalty (yes=1)	1.30 ***	0.036	1.31 ***	0.036
Full Documentation (yes=1)	0.61 ***	0.021	0.63 ***	0.022
Monthly Payment	1.06 ***	0.110	1.05 ***	0.004
Loan-to-Value Ratio	3.00 ***	0.080	3.02 ***	0.081
LENDER VARIABLES				
CRA (omitted: Independent Mortgage Company)	0.70 ***	0.018		
CRA in Assessment Area			0.53 ***	0.017
CRA outside Assessment Area			0.87 ***	0.024
Observations	236,536			

*(**)(***) Statistically significant at 10(5)(1) level.

Table 3: Model Predicting the Likelihood of Loan Foreclosure, includes Loan Source

	CRA with Assessment Area		
	Odds Ratio		Standard Error
NEIGHBORHOOD VARIABLES			
Neighborhood Income Level (omitted: Upper-Income)			
Low-Income	2.11 ***		0.232
Moderate-Income	1.35 ***		0.096
Middle-Income	1.24 ***		0.063
Percent Owner-Occupied	1.00 ***		0.001
Median Year Housing Built	1.01 ***		0.002
Capitalization Rate	0.85		0.680
House Price Appreciation (2 years prior to origination)	1.20 ***		0.026
BORROWER VARIABLES			
Borrower Race (omitted: Non-Hispanic White)			
African American	1.77 ***		0.127
Latino	1.38 ***		0.066
Asian	1.24 ***		0.067
Borrower Income	1.00 **		8.91×10^{-5}
Borrower FICO Score (omitted: High - Above 720)			
Low FICO - Below 640	4.58 ***		0.266
Mid-level FICO - 640-720	2.73 ***		0.124
LOAN VARIABLES			
Higher-Priced Loan (yes=1)	2.47 ***		0.119
Fixed Interest Rate (yes=1)	0.39 ***		0.025
Prepayment Penalty (yes=1)	1.55 ***		0.072
Full Documentation (yes=1)	0.63 ***		0.027
Monthly Payment	1.05 ***		0.005
Loan-to-Value Ratio	2.53 ***		0.078
LENDER VARIABLES			
CRA (omitted: Independent Mortgage Company)	0.70 ***		0.018
CRA in Assessment Area	0.743***		0.043
CRA outside Assessment Area	0.995		0.057
Loan Source (omitted: retail branch)			
Correspondent Loan	1.45 ***		0.092
Wholesale Loan	2.03 ***		0.099
Observations	195,698		

*(**)(***) Statistically significant at 10(5)(1) level.

Table 4: Model Predicting the Likelihood of Loan Foreclosure in Low-Income Neighborhoods

	CRA Assessment Area		CRA with Assessment Area and Loan Source	
	Odds Ratio	Standard Error	Odds Ratio	Standard Error
NEIGHBORHOOD VARIABLES				
Percent Owner-Occupied	1.01 ***	0.005	1.01	0.008
Median Year Housing Built	1.00	0.006	1.00	0.008
Capitalization Rate	0.64	0.742	0.35	0.685
House Price Appreciation (2 years prior to origination)	1.16 *	0.092	1.17	0.125
BORROWER VARIABLES				
Borrower Race (omitted: Non-Hispanic White)				
African American	1.75 **	0.393	1.96 *	0.728
Latino	0.95	0.121	1.09	0.291
Asian	1.25	0.280	1.43	0.396
Borrower Income	1.00	4.43×10^{-4}	1.00	6.97×10^{-4}
Borrower FICO Score (omitted: High - Above 720)				
Low FICO - Below 640	4.10 ***	0.783	4.00 ***	1.130
Mid-level FICO - 640-720	2.41 ***	0.434	2.48 ***	0.632
LOAN VARIABLES				
Higher-Priced Loan (yes=1)	3.12 ***	0.559	2.31 ***	0.591
Fixed Interest Rate (yes=1)	0.29 ***	0.081	0.27 ***	0.104
Prepayment Penalty (yes=1)	1.28 *	0.180	1.42	0.361
Full Documentation (yes=1)	0.71 **	0.114	0.84	0.150
Monthly Payment	1.10 ***	0.031	1.15 ***	0.037
Loan-to-Value Ratio	2.35 ***	0.220	1.81 ***	0.262
LENDER VARIABLES				
CRA (omitted: Independent Mortgage Company)				
CRA in Assessment Area	0.73 **	0.115	0.89	0.264
CRA outside Assessment Area	0.95	0.121	0.86	0.244
Loan Source (omitted: retail branch)				
Correspondent Loan			1.58	0.536
Wholesale Loan			2.79 ***	0.702
Observations	5,271		3,981	

*(**)(***) Statistically significant at 10(5)(1) level.

Table 5: Model Predicting the Likelihood of Loan Foreclosure in Moderate-Income Neighborhoods

	CRA Assessment Area		CRA with Assessment Area and Loan Source	
	Odds Ratio	Standard Error	Odds Ratio	Standard Error
NEIGHBORHOOD VARIABLES				
Percent Owner-Occupied	1.00 **	0.002	1.00 **	0.002
Median Year Housing Built	1.00	0.002	1.00	0.003
Capitalization Rate	1.21	1.160	0.58	0.806
House Price Appreciation (2 years prior to origination)	1.10 ***	0.033	1.10 **	0.048
BORROWER VARIABLES				
Borrower Race (omitted: Non-Hispanic White)				
African American	2.13 ***	0.202	1.88 ***	0.269
Latino	1.32 ***	0.089	1.17	0.117
Asian	1.27 ***	0.115	1.15	0.145
Borrower Income	1.00	1.37×10^{-4}	1.00	1.14×10^{-4}
Borrower FICO Score (omitted: High - Above 720)				
Low FICO - Below 640	3.69 ***	0.310	3.72 ***	0.475
Mid-level FICO - 640-720	2.29 ***	0.162	2.38 ***	0.242
LOAN VARIABLES				
Higher-Priced Loan (yes=1)	2.64 ***	0.181	2.07 ***	0.207
Fixed Interest Rate (yes=1)	0.30 ***	0.032	0.37 ***	0.053
Prepayment Penalty (yes=1)	1.14 ***	0.057	1.55 ***	0.148
Full Documentation (yes=1)	0.73 ***	0.505	0.73 ***	0.062
Monthly Payment	1.09 ***	0.011	1.10 ***	0.015
Loan-to-Value Ratio	2.49 ***	0.106	2.04 ***	0.125
LENDER VARIABLES				
CRA (omitted: Independent Mortgage Company)				
CRA in Assessment Area	0.58 ***	0.04	0.96	0.119
CRA outside Assessment Area	0.84 ***	0.048	1.17	0.143
Loan Source (omitted: retail branch)				
Correspondent Loan			1.62 ***	0.221
Wholesale Loan			1.96 ***	0.212
Observations	34,933		26,248	

*(**)(***) Statistically significant at 10(5)(1) level.

Table 6: Model Predicting the Likelihood of Loan Foreclosure in Middle-Income Neighborhoods

	CRA Assessment Area		CRA with Assessment Area and Loan Source	
	Odds Ratio	Standard Error	Odds Ratio	Standard Error
NEIGHBORHOOD VARIABLES				
Percent Owner-Occupied	1.01 ***	0.001	1.01 ***	0.002
Median Year Housing Built	1.01 ***	0.002	1.00	0.002
Capitalization Rate	0.69	0.636	2.27	2.920
House Price Appreciation (2 years prior to origination)	1.27 ***	0.030	1.23 ***	0.041
BORROWER VARIABLES				
Borrower Race (omitted: Non-Hispanic White)				
African American	1.53 ***	0.113	1.52 ***	0.176
Latino	1.33 ***	0.063	1.31 ***	0.091
Asian	1.17 ***	0.073	1.09	0.093
Borrower Income	1.00 ***	1.14×10^{-4}	1.00 ***	1.42×10^{-4}
Borrower FICO Score (omitted: High - Above 720)				
Low FICO - Below 640	4.22 ***	0.261	5.13 ***	0.454
Mid-level FICO - 640-720	2.68 ***	0.130	2.82 ***	0.201
LOAN VARIABLES				
Higher-Priced Loan (yes=1)	2.93 ***	0.142	2.34 ***	0.172
Fixed Interest Rate (yes=1)	0.34 ***	0.025	0.35 ***	0.035
Prepayment Penalty (yes=1)	1.30 ***	0.055	1.51 ***	0.111
Full Documentation (yes=1)	0.61 ***	0.034	0.59 ***	0.040
Monthly Payment	1.06 ***	0.008	1.06 ***	0.010
Loan-to-Value Ratio	3.10 ***	0.159	2.67 ***	0.127
LENDER VARIABLES				
CRA (omitted: Independent Mortgage Company)				
CRA in Assessment Area	0.56 ***	0.028	0.80 ***	0.072
CRA outside Assessment Area	0.92 ***	0.038	1.06	0.091
Loan Source (omitted: retail branch)				
Correspondent Loan			1.39 ***	0.129
Wholesale Loan			1.97 ***	0.147
Observations	91,400		73,603	

*(**)(***) Statistically significant at 10(5)(1) level.

Table 7: Model Predicting the Likelihood of Loan Foreclosure in Upper-Income Neighborhoods

	CRA Assessment Area		CRA with Assessment Area and Loan Source	
	Odds Ratio	Standard Error	Odds Ratio	Standard Error
NEIGHBORHOOD VARIABLES				
Percent Owner-Occupied	1.01 ***	0.002	1.00 ***	0.002
Median Year Housing Built	1.01 ***	0.002	1.01 ***	0.003
Capitalization Rate	2.79	4.720	3.93	8.280
House Price Appreciation (2 years prior to origination)	1.27 ***	0.039	1.26 ***	0.051
BORROWER VARIABLES				
Borrower Race (omitted: Non-Hispanic White)				
African American	1.67 ***	0.148	1.69 ***	0.218
Latino	1.47 ***	0.088	1.65 ***	0.141
Asian	1.38 ***	0.096	1.33 ***	0.117
Borrower Income	1.00 ***	1.09×10^{-4}	1.00 ***	1.68×10^{-4}
Borrower FICO Score (omitted: High - Above 720)				
Low FICO - Below 640	3.99 ***	0.301	4.64 ***	0.498
Mid-level FICO - 640-720	2.83 ***	0.162	2.83 ***	0.213
LOAN VARIABLES				
Higher-Priced Loan (yes=1)	3.44 ***	0.225	2.96 ***	0.248
Fixed Interest Rate (yes=1)	0.41 ***	0.032	0.45 ***	0.045
Prepayment Penalty (yes=1)	1.40 ***	0.074	1.50 ***	0.119
Full Documentation (yes=1)	0.57 ***	0.036	0.59 ***	0.048
Monthly Payment	1.04 ***	0.006	1.05 ***	0.007
Loan-to-Value Ratio	3.52 ***	0.127	2.89 ***	0.152
LENDER VARIABLES				
CRA (omitted: Independent Mortgage Company)				
CRA in Assessment Area	0.49 ***	0.028	0.64 ***	0.067
CRA outside Assessment Area	0.84 ***	0.046	0.93	0.096
Loan Source (omitted: retail branch)				
Correspondent Loan			1.37 ***	0.164
Wholesale Loan			2.12 ***	0.180
Observations	104,932		91,866	

*(**)(***) Statistically significant at 10(5)(1) level.

RISKY BORROWERS OR RISKY MORTGAGES:
Disaggregating Effects Using Propensity Score Models

Working Paper: November 30, 2009

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Risky Borrowers or Risky Mortgages Disaggregating Effects Using Propensity Score Models

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Risky Borrowers or Risky Mortgages
Disaggregating Effects Using Propensity Score Models

Abstract:

In this research, we examine the relative risk of subprime mortgages and community reinvestment loans. Using the propensity score matching method, we construct a sample of comparable borrowers with similar risk characteristics but holding the two different loan products. We find that community reinvestment loans have a lower default risk than subprime loans, very likely because they are not originated by brokers and lack risky features such as adjustable rates and prepayment penalties. Our results suggest that similar borrowers holding community reinvestment loans exhibit significantly lower default risks.

Introduction

Explanations for the current foreclosure crisis abound. There are the obvious culprits: overextended borrowers, risky mortgages, reckless originators, and investors and other secondary market participants who failed to act with due diligence (e.g. Mian and Sufi, 2008; Quercia and Ratcliffe, 2008). Moreover, there are some who blame government regulation, such as the Community Reinvestment Act (CRA), designed to increase the credit supply to traditionally underserved, but creditworthy, population (Cravatts, 2008; Krauthammer, 2008). From this perspective, the CRA and similar regulation are said to have put pressure on lenders and the government sponsored enterprises (GSEs) to extent mortgages to over-leveraged, uncreditworthy, and/or irresponsible low-income and minority borrowers.

The debate over what caused the mortgage mess and how best to fix it has important policy implications. What is missing in the debate is an empirical examination of the relative performance of similar borrowers holding either a typical CRA loan or a subprime product. Such an analysis will help inform policy by answering the question of whether high default rates represent just the higher risk profile of borrowers holding subprime loans or the risky characteristics of subprime loans. Although borrowers holding subprime loans generally are weaker across key underwriting criteria, many borrowers holding subprime products actually qualify for a prime mortgage (Hudson and Reckard, 2005; Brooks and Simon, 2007). Some products or features that are more prevalent among subprime loans, such as prepayment penalties, adjustable rates, and balloon payments, have been found to be associated with elevated default risk (e.g. Ambrose, LaCour-Little and Huszar, 2005; Pennington-Cross and Ho, 2006; Quercia, Stegman and Davis, 2007). Are the higher default rates reported in the subprime sector mainly the result of risky loan products?

We address this issue by comparing the performance of subprime loans and CRA loans in a special lending program called Community Advantage Program (CAP). To solve the problem of selection bias since performance differences may be due to differences in the borrowers who receive each product type, we rely on propensity score matching methods to construct a sample of comparable borrowers. We find that for borrowers with similar risk characteristics, the estimated default risk is about 70 percent lower with a CRA loan than with a subprime mortgage. Broker-origination channel, adjustable rates, and prepayment penalties all contribute substantially to the elevated risk of default among subprime loans. When broker origination is combined with both adjustable rates and prepayment penalties, the borrower's default risk is four to five times higher than that of a comparable borrower with a prime-term CRA mortgage. Though CAP has some program specific characteristics, the results of this study clearly suggest that mortgage default risk cannot be attributed solely to borrower credit risk; the high default risk is significantly associated with the characteristics of loan products. Thus, the results are not consistent with the concerns of those blaming the borrowers likely to benefit from CRA and similar regulations. Done responsibly, targeted lending programs stimulated by the CRA can do a much better job in providing sustainable homeownership for the low- to moderate-income (LMI) population than subprime lending. The results have important policy implications on how to respond to the current housing crisis and how to meet the credit needs of all communities, especially the LMI borrowers, in the long run.

Compared with prior work, this study is characterized by several important differences. First, while most early studies focused on the performance of mortgages within different markets, the focus here is on similar LMI borrowers with different mortgages, allowing us to compare the relative risk of different mortgage products. Second, because of data constraints, research on the performance of CRA loans is scarce. With a unique dataset, this study examines the long term viability of the homeownership opportunities that CRA-type products provide, relative to that of subprime alternatives. Third, there have been few discussions and applications of the propensity score matching method in real estate research. This study uses propensity score models to explicitly address the selection bias issue and constructs a comparison group based on observational data. This method allows us to isolate the impact of loan product features and origination channel on the performance of mortgages. Finally, while the propensity score model cannot capture all the information for estimating the propensity of taking out a subprime loan, this study makes full use of the loan interest rate information to shed some light on the impact of the unobservable heterogeneity on the mortgage performance.

Literature Review

Risk of Subprime Mortgages

Subprime mortgages were originally designed as refinancing tools to help borrowers with impaired credit consolidate debt. With the reformed lending laws, the adoption of automated underwriting, risk-based pricing, as well as the persistent growth in

house prices nationwide, the subprime lending channel soon expanded its credit to borrowers on other margins. The subprime surge was rapid and wide: between 1994 and 2006, the subprime share of all mortgage originations more than quadrupled, from 4.5 percent to 20.1 percent; and subprime loan originations increased more than seventeen fold, from $35 billion to about $600 billion. The surge was largely fueled by securitization (private Wall Street issuances) over the same period, the volume of securitized subprime mortgage loans increased over forty-four-fold, from $11 billion to more than $483 billion in 2006, accounting for more than 80 percent of all subprime lending (Inside Mortgage Finance, 2008).

Beginning in late 2006, a rapid rise in subprime mortgage delinquency and foreclosure caused a so-called meltdown of the subprime market. The Mortgage Bankers Association (MBA) reports that the serious delinquency rate for subprime loans in the second quarter of 2008 was 7.6 times higher than that for prime loans (17.9 percent versus 2.35 percent). Although subprime mortgages represented about 12 percent of the outstanding loans, they represented 48 percent of the foreclosures started during the same quarter (MBA, 2008). Delinquency and default rates for subprime loans typically are six times to more than 10 times higher than those of prime mortgages (Pennington-Cross, 2003; Gerardi, Shapiro and Willen, 2007; Immergluck, 2008).

It may be true that borrowers holding subprime loans are generally weaker across key underwriting criteria. A subprime borrower used to refer to an individual who had any of the following characteristics: 1) a FICO score below 620, 2) a delinquent debt repayment in the previous two years, 3) a bankruptcy filing in the previous five years (Gerardi et al. 2007). Recent subprime home-purchase loans became available to borrowers who may have had impaired credit history or were perceived to have elevated credit risks, such as “low-doc” or “no doc” borrowers, “low-down” or “zero-down” payment borrowers, or borrowers with high debt-to-income ratios (DTIs). All these risk characteristics are usually significantly associated with a higher default risk of the mortgages these borrowers hold.

At this point, it is important to make a distinction between borrowers and mortgage products. It can be said that there are two types of borrowers and two types of mortgage products: prime and subprime. Not all prime borrowers get prime mortgages and not all subprime borrowers get subprime mortgages. Borrowers who do not meet all the traditional underwriting guidelines can be considered subprime but these borrowers can receive prime-type mortgages as they may through CRA efforts. Similarly, borrowers with good credit can receive subprime products characterized by high debt to income and loan to value ratios, no or low documentation, teaser and adjustable rates and other such risky characteristics (the so called Alt-A market).

Some loan features and loan terms are more prevalent in the subprime sector than in other markets and are also associated with higher default risk. As summarized by Cutts and Van Order (2005) and Immergluck (2008), characteristics of subprime loans relative to prime loans include: 1) high interest rates, points, and fees, 2)

prevalence of prepayment penalties, 3) prevalence of balloon payments, 4) prevalence of adjustable-rate mortgages (ARMs), 5) popularity of broker originations. After 2004, some “innovative” mortgage products, such as interest-only, payment option, negative amortization, hybrid ARMs, and piggy-back loans became more popular in the subprime sector (Immergluck, 2008). In the literature, Calhoun and Deng (2002) and Quercia et al. (2007) find that subprime ARMs have a higher risk of foreclosure because of the interest-rate risk. At the aggregate level, the share of ARMs appears to be positively associated with market risk as measured by the probability of the property value to decline in the next two years (Immergluck, 2008). Subprime hybrid ARMs, which usually have prepayment penalties, bear particularly high risk of default at the time the interest rate is reset (Ambrose et al. 2005; Pennington-Cross and Ho, 2006).

As to the feature of prepayment penalties and balloons, Quercia et al. (2007) find that refinanced loans with prepayment penalties are 20 percent more likely than loans without to experience a foreclosure while loans with balloon payments are about 50 percent more likely to experience a foreclosure than those without. Prepayment penalties also tend to reduce prepayments and increase the likelihood of delinquency and default among subprime loans (Danis and Pennington-Cross, 2005).

Recently, mortgage brokers have played a greater role in the subprime sector. In 2003 brokers originated about 48 percent of all subprime loans; in 2006 the share was estimated between 63 percent and 80 percent (Ernst et al. 2008), higher than the share of about 30 percent of broker-originated loans among all mortgages in recent years (Inside Mortgage Finance, 2008). Empirical evidence on the behavior of broker-originated mortgages is scarce. LaCour-Little and Chun (1999) find that for the four types of mortgages analyzed, loans originated by a third party (including broker and correspondence) were more likely to prepay than loans originated by a lender. Alexander, Grimshaw, McQueen and Slade (2002) find that third-party originated loans do not necessarily prepay faster but they default with greater frequency than similar retail loans, based on a sample of subprime loans originated from 1996 to 1998. They suggest that third-party originated mortgages have higher default risk than similar retail loans because brokers are rewarded for originating a loan but not held accountable for the loan’s subsequent performance.

Thus, the higher default rates reported in subprime lending may be because of risky borrowers, risky loan products, or a combination of both.

CRA Lending

The Community Reinvestment Act (CRA) of 1977 was created in response to charges that financial institutions were engaging in redlining and discrimination. The Act mandates that federally insured depository institutions help meet the credit needs of communities in which they operate in a manner consistent with safe and sound operation (Bernanke, 2007). Regulators assess each bank’s CRA record when evaluating these institutions’ applications for mergers, acquisitions, and branch

openings. The performance of large institutions is measured under three categories of bank activities: lending, services, and investment, with the lending test carrying the most weight (at least 50 percent).[1] For the lending test, it examines the amount and proportion of lending activities made within an institution's assessment area.[2] Usually, loans are regarded as "CRA-related" if they are made by CRA-regulated institutions within their assessment areas to low-income borrowers (those with less than 80% area median income (AMI), regardless of neighborhood income) or in a low- income neighborhood (with less than 80% AMI, regardless of borrower income) (Avery, Bostic and Canner, 2000).

The CRA lending test also examines the use of *innovative or flexible* lending practices to address the credit needs of LMI households and community. In response, many banks have developed "CRA Special Lending Programs" or have introduced mortgage products characterized by more flexible underwriting standards. Survey results suggest that most financial institutions offer these special programs, and that most of the programs relate to home mortgage lending, which typically feature some combination of special outreach, counseling and education, and underwriting flexibility (especially in terms of reduced cash to close, alternative credit verification and higher debt-to-income thresholds) (Avery et al. 2000). A review article by Apgar and Duda (2003) suggests the CRA has had a positive impact on underserved population by originating a higher proportion of loans to low-income borrowers and communities than they would have without CRA. At the same time, one study suggests that there is no evidence that CRA-affected lenders cut interest rates to CRA-eligible borrowers or that there is a regulation-driven subsidy for CRA loans (Canner, Laderman, Lehnert and Passmore, 2002).

CRA-type mortgages are different from subprime loans in that CRA products usually have prime-term characteristics. In general, they are believed to carry a higher risk because they are originated by liberalizing one or two underwriting criteria. Moreover, CRA products are originated by federally insured depository institutions covered by CRA while two out of three subprime lenders are independent mortgage companies not covered by CRA (Bernanke, 2007). A few studies investigating the delinquency behaviors among CRA borrowers suggest the delinquency rate of CRA mortgages is comparable to that of FHA loans after excluding loans with low loan-to-value ratios (LTV) (e.g., Quercia, Stegman, Davis and Stein, 2002). Because of data constraints, little is known about the long term viability of the homeownership opportunities that these products provide.

Why Different Markets Coexist

To increase the flow of funds into low-income population and neighborhoods, the CRA encourages lenders to meet credit needs within their service or catchment area, taking into account safety and soundness considerations. Liberalizing one or two traditional mortgage underwriting standards allows lenders to make loans to those who would otherwise not qualify for a prime mortgage (for instance, not requiring

mortgage insurance when the downpayment is less than 20 percent makes loans more affordable for some borrowers).

In this sense, both CRA and subprime products may target many of the same borrowers. In fact, recent studies suggest there is a significant overlap between borrowers holding subprime mortgages and those holding prime loans, FHA loans, and other loan products, particularly among LMI borrowers with marginal credit quality. Freddie Mac, for example, finds that about 20 percent of subprime borrowers could have qualified for a prime rate mortgage (Hudson and Reckard, 2005). A Wall Street Journal report suggests 61 percent of subprime mortgages went to borrowers with credit that would have qualified them for conventional loans by 2006 (Brooks and Simon, 2007). Bocian, Ernst and Li (2007) suggest that a significant portion of subprime borrowers (estimates range from 10 percent to almost 40 percent) could have qualified for low-priced prime loans.

Why would many people who could qualify for low-cost prime-type loans take out subprime products? First of all, many borrowers, especially those with impaired credit history, are usually financially unsophisticated and may feel they have limited options. Courchane, Surette and Zorn (2004) indicate that subprime borrowers "are less knowledgeable about the mortgage process, are less likely to search for the best rates, and are less likely to be offered a choice among alternative mortgage terms and instruments" (p.365). Especially, for some nontraditional mortgages, including interest-only mortgages, negative amortization mortgages, and mortgages with teaser rates, they were apparently not well understood by many borrowers. When borrowers do not know the best price and are less likely to search for the best rates, it is likely that they cannot make the right decision when they shop for mortgage products. In fact, Courchane et al. (2004) find that search behavior as well as adverse life events, age, and Hispanic ethnicity contribute to explaining the choice of a subprime mortgage.

Second, *predatory lending* or abusive lending practices are concentrated in the subprime sector which may explain why some borrowers end up with certain loans. Unscrupulous lenders, or brokers as their agents, may take advantage of uninformed borrowers by charging fees and rates not reflected of the risk, by not informing borrowers of lower cost loan alternatives, and by offering products and services without full disclosure of terms and options. Renuart (2004) highlights the role of loan steering and abusive push-marketing of subprime lending practices, in which lenders steer borrowers to subprime products instead of low-cost prime alternatives. A major reason for this is that there are higher incentives from originating subprime mortgages than from low-cost alternatives. Compared to traditional prime mortgages, subprime mortgages generated much higher profit for originators before the bust – 3.6 percent versus 0.93 percent for Countrywide alone in 2004 (Morganson, 2008). For brokers, in addition to the standard origination fees, they are compensated by a yield-spread premium (YSM), which is an extra payment that brokers receive from lenders for delivering a mortgage with a higher interest rate than that for which the borrower may qualify (Ernst et al. 2008). Thus, brokers are usually more concerned about

mortgage volume and features that generate fees and points from borrowers and commissions and premiums from lenders, instead of the loan's subsequent performance. Because the subprime market is characterized by complicated pricing tiers and product types that are not easy to understand, the steering problem is likely to be more pronounced in the subprime sector than in other markets in which products are generally standardized. Furthermore, the originators usually do not have to be held accountable for the loan's long term performance as most of subprime loans originated in recent years were securitized (80 percent in 2006). For brokers, broker fees and the yield spread premiums are paid upon settlement of the loan, at which point the broker would have no further stake in the performance of that loan. Of course, banks and investors, as well as brokers and banks, are involved in repeated relationships, reputation concerns may somewhat prevent the moral hazard of lenders. But the not well-designed compensation mechanism and the lack of responsibility for the long-term sustainability of mortgages provide the incentive for many lenders and brokers to originate subprime loans than other less profitable products to maximize their own profit.

In the literature, similar behaviors have been examined with the information asymmetry theory, moral hazard theory, and agency cost theory. For an originator to provide an efficient level of such services as marketing and underwriting mortgage products, it must be given the proper incentives to do so. But Alexander et al. (2002) suggest that third-party originators have the incentive to game with lenders and investors either passively or actively in the credit underwriting process: intentionally lacking rigor in the screening process, exaggerating measures of credit worthiness or property value, or targeting and putting borrowers with marginal quality to high-cost subprime with risky loan terms instead of lower cost alternatives.[3] Mian and Sufi (2008) blame the moral hazard on behalf of originators selling risky mortgages is the primary cause of the loose underwriting and the subsequent mortgage foreclosure crisis. Keys, Mukherjee, Seru and Vig (2008) also suggest that securitization leads to lax screening by adversely affecting the screening incentives of lenders.

In short, borrowers generally sort to prime/CRA, subprime or other mortgage markets based on their risk profile. However, the lack of financial sophistication of some borrowers, the poor alignment of incentives, and moral hazard considerations are some of the many reasons borrowers—especially marginally qualified borrowers—may receive less desirable mortgage products than they can be qualified for.

Data

Data for this study come from one LMI-targeted lending program, the Community Advantage Program (CAP), developed by Self-Help in partnership with a group of lenders, Fannie Mae, and the Ford Foundation. Participating lenders establish their own guidelines. The most common variants from typical conventional, prime standards are: reduced cash required to close (through lower down payment and/or lower cash reserve requirements);[4] alternative measures or lower standards of credit quality;[5] and flexibility in assessing repayment ability (through higher debt ratios and/or flexible requirements for employment history).[6] These guidelines variants could be combined or used to offset each other.[7] Nearly 90 percent of the programs feature exceptions in at least two of these areas, and more than half feature exceptions in all three. The majority of programs combine neighborhood and borrower targeting.

Under the LMI-targeted CAP lending program, participating lenders are able to sell these nonconforming mortgages to Self-Help, which then securitizes and sells them to Fannie Mae or other investors. Participating lenders originate and service the loans under contract with Self-Help. It should be emphasized that, while many of the borrowers are somewhat credit impaired, the program cannot be characterized as subprime. The vast majority of CAP loans are retail originated (in contrast to broker originated) and feature terms associated with the prime market: thirty-year fixed-rate loans amortizing with prime-level interest rates, no prepayment penalties, no balloons, with escrows for taxes and insurance, documented income, and standard prime-level fees. As a LMI-targeting program, CAP has some program-specific characteristics such as income and geographic limitations.[8]

The data of subprime loans come from a proprietary database from Lender Processing Services, Inc. (LPS, formerly McDash Analytics), which provides loan information collected from approximately 15 mortgage servicers. LPS' coverage in the subprime market by volume increased from 14 percent in 2004 to over 30 percent in 2006, based on our estimation using data from Inside Mortgage Finance. There is no universally accepted definition of *subprime mortgage*; the three most commonly used definitions are 1) those categorized as such by the secondary market, 2) those originated by a subprime lender as identified by HUD's annual list, and 3) those that meet HUD's definition of a "high-cost" mortgage (Gerardi et al. 2007). For the purposes of this paper we primarily follow the first definition, since we can identify those B&C loans in LPS but could not identify lenders' information and mortgages' APR. We further consider high-cost ARMs as subprime in this analysis. Less than 20% of loans in our LPS study sample are included solely because they are considered high-cost, defined as having a margin greater than 300 basis points (Poole, 2007). In addition, we appended to our data selected census and aggregated HMDA variables at a zip code level, including the Herfindahl-Hirschman Index ("HHI") calculated from HMDA, racial and educational distribution from census data, and area average FICO scores calculated from the LPS data.

We started from a sample of 9,221 CAP loans originated from 2003 to 2006. All are first-lien, owner-occupied, fixed-rate conforming home purchase loans with full or alternative documentation. National in scope, these loans were originated in 41 states, with about two-thirds concentrated in Ohio, North Carolina, Illinois, Georgia and Oklahoma. To make sure subprime loans are roughly comparable to CAP loans, as Exhibit 1 shows, we limited our analysis to subprime mortgages also characterized as first-lien, single-family, purchase-money, and conforming loans with full or alternative documentation that originated during the same period. We further excluded loans with missing values for some key underwriting variables (FICO score, LTV, DTI, and documentation status) and loans without complete payment history. Finally, because we want to compare CAP and subprime loans in the same market, we excluded those subprime loans in areas without CAP lending activities. This gave us a sample of 42,065 subprime loans. Table 2 summarizes some important characteristics of both CAP loans and subprime loans in this analysis. Significance tests show that almost all variables across the two groups differ significantly before matching, indicating that the covariate distributions are different between CAP and subprime loans in the original sample.

Though drawn from similar markets, the CAP borrowers (including all active loans originated as early as 1990s) are not experiencing the same mortgage woes as subprime borrowers. As Exhibit 2 shows, 3.21 percent of our sample of community lending borrowers were 90-days' delinquent or in foreclosure process in the second quarter of 2008. This was slightly higher than the 2.35 percent delinquency rate on prime loans but well below the 17.8 percent on subprime loans nationwide. Especially, over 27 percent of subprime ARMs were in foreclosure or serious delinquency, which was almost nine times that of community lending loans.

In summary, the CAP and subprime samples have identical characteristics for the following important underwriting variables: lien status, amortization period, loan purpose, occupancy status, and documentation type. They were originated during the same time period and roughly in the same geographic areas. But the two samples differ in other underwriting factors, including DTI, LTV, and FICO score, and in loan amount and some loan features that are more common only for subprime loans. In the next section, we use the propensity score matching (PSM) method to develop a new sample by matching CAP loans with comparable subprime loans.

Methodology

The PSM method has been widely used to reduce selection biases in recent program evaluation studies. PSM was first developed by Rosenbaum and Rubin (1983) as an effort to more rigorously estimate causal effects from observational data. Basically, PSM accounts for observable heterogeneity by pairing participants with nonparticipants on the basis of the conditional probability of participation, given the observable characteristics. The PSM approach has gained increasing popularity among researchers from a variety of disciplines, including biomedical research, epidemiology, education, sociology, psychology, and social welfare (see review in

Guo, et al., 2006). There is some evidence that nonparametric PSM methods can produce impact estimates that are closer to the experimental benchmark than the parametric approach (Essama-Nssah, 2006).

There are three basic steps involved in implementing PSM. First, a set of covariates is used to estimate the propensity scores using *probit* or *logit*, and the predicted values are retrieved. Then each participant is paired with a comparable nonparticipant based on propensity scores. In the last step, regression models or other methods can be applied to the matched group to compare the outcomes of participants and nonparticipants. Here we describe these steps in our analysis in more details.

In this case, because receiving a subprime is a choice/assignment process rather than randomly assigned we used the PSM method to adjust this selection bias. In the first step, we employed logistic regression models to predict the propensity ($e(x_i)$) for borrower i (i= 1,…,N) of receiving subprime loans (S_i= 1) using a set of conditioning variables (x_i).

$$e(x_i)=pr(S_i=1|X_i= x_i) \tag{1}$$

In the second step, we used the nearest-neighbor with caliper method to match CAP borrowers with borrowers holding subprime loans based on the estimated propensity scores from the first step. The method of nearest-neighbor with caliper is a combination of two approaches: traditional nearest-neighbor matching and caliper matching. [9] This method begins with a randomly sort of the participants and nonparticipants, then selecting the first participant and finding the nonparticipant subject with the closest propensity score within a predetermined common-support region called caliper (δ). The approach imposes a tolerance level on the distance between the propensity score of participant i and that of nonparticipant j. Formally, assuming $c(p_i)$ as the set of the neighbors of i in the comparison group, the corresponding neighborhood can be stated as follows.

$$c(p_i) = \{ j \mid \delta > \|p_i - p_j\| \} \tag{2}$$

If there is no member of the comparison group within the caliper for the treated unit i, then the participant is left unmatched and dropped from the analysis. Thus, caliper is a way of imposing a common support restriction. Naturally, there is uncertainty about the choice of a tolerance level since a wider caliper can increase the matching rate but it also increase the likelihood of producing inexact matching. A more restrictive caliper increases the accuracy but may significantly reduce the size of the matched sample.

In the third step, we employed a multinomial regression model (MNL) to further control factors that may influence the performance of the new sample after loan origination, many of which are time-varying. In each month the loan can be in only one state or outcome (active, default, or prepaid). Since the sum of the probabilities of each outcome must equal to one, the increase in the probability of one outcome

necessitates a decrease in the probability of at least one competing outcome. Thus the multinomial logit model is a competing risk model.

We can think of mortgage borrowers as having three options each month:

- DEFAULT: This study treats the incidence of the first 90-day delinquency as a proxy of default.
- PREPAID: If a loan was prepaid before it is seriously delinquent, it is considered a prepayment.
- ACTIVE: Active and not default (not seriously delinquent in some models)

The probability of observing a particular loan outcome is given by:

$$
\begin{aligned}
\Pr(y_{it} = j) &= \frac{e^{\beta_j Z_{it} + \gamma_j S_i}}{1 + \sum_{k=1}^{2} e^{\beta_k Z_{it} + \gamma_k S_i}} \quad for\ j = 1,2 \\
\Pr(y_{it} = j) &= \frac{1}{1 + \sum_{k=1}^{2} e^{\beta_k Z_{it} + \gamma_k S_i}} \quad for\ j = 0 \\
\ln L &= \sum_{t=1}^{T} \sum_{i=1}^{N} \sum_{j=0}^{2} d_{ijt} \ln(\Pr(y_{it} = j))
\end{aligned}
\tag{3}
$$

where $j=0,1,2$ represents the three possible outcomes of a loan and the omitted category ($j=0$) remains active and not seriously delinquent (ACTIVE). d_{ijt} is an indicator variable taking on the value 1 if outcome j occurs to loan i at time t, and zero otherwise. Z contains a set of explanatory variables and β is the coefficient. To identify the difference between the performance of CAP loans and subprime loans, S contains a subprime dummy variable or indicators of subprime loan characteristics. Specifically, we considered the impact one origination channel and two loan characteristics: the prepayment penalty, the adjustable rate, and the broker origination channel. We constructed six mutually exclusive dummy variables for the combinations of these three characteristics,[10] such as *sub_bro&arm&ppp* for "broker-originated subprime loans with adjustable rates and prepayment penalties" and *sub_arm* for "retail-originated subprime loans with adjustable interest rates and no prepayment penalties." None of the CAP loans have these features, and they are set as the reference group in both models.

In the context of observational studies, the PSM methods seek to mimic conditions similar to an experiment so that the assessment of the impact of the program can be based on a comparison of outcomes for a group of participants (i.e. those with $S_i = 1$) with those drawn from a comparison group of non-participants ($S_i = 0$). We need to check whether our observational data meet the two primary assumptions underlying the PSM methods: the *conditional independence* assumption and the *overlap* assumption.

Conditional Independence Assumption: [11]

To yield consistent estimates of program impact, matching methods rely on a fundamental assumption known as "*conditional independence,*" which can be formally stated as:

$$(y_0, y_1) \perp w | x \tag{4}$$

This expression states that potential outcomes are orthogonal to treatment status, given the observable covariates. In other words, conditional on observable characteristics, participation is independent of potential outcomes and unobservable heterogeneity is assumed to play no role in participation (Dehejia and Wahba, 2002). Assuming that there are no unobservable differences between the two groups after conditioning on x_i, any systematic differences in outcomes between participants and nonparticipants are due to participation. So the plausibility of an evaluation method depends largely on the correctness of the propensity score model underlying program design and implementation.

Our first strategy is to use a well specified logit regression to estimate the probability of taking out a subprime mortgage for each cohort, grounded on a sound understanding of the subprime market. We determined the conditional variables that are associated with the use of subprime loans based on a review of subprime lending and mortgage choice literature, as discussed in the next section. Second, it is possible that lenders have access to more information about the borrower and local market than the information in our dataset and the unobservable lender information would influence the estimation results. Our strategy is to rerun the multinomial regression model by including the unobservable borrower heterogeneity as an independent variable, which is proxied by interest rate variables if the mortgage note rate can be assumed to an effective predictor of the level of credit risk.

Overlap assumption:

For matching to be feasible, there must be individuals in the comparison group with the same or similar propensity as the participant of interest. This requires an overlap in the distribution of observables between the treated and the comparison groups.

The overlap assumption is usually stated as:

$$0 < pr(w = 1 | x) < 1 \tag{5}$$

This implies the possible existence of a nonparticipant analogue for each participant. When this condition is not met, then it would be impossible to find matches for a fraction of program participants.

In this case, as we discussed in the literature review, it is highly likely that there is significant overlap between the CRA-type CAP loans and the subprime sample since both of them focus on households with marginal credit quality and have identical loan characteristics such as lien status, loan purpose, occupancy status, and documentation type. As shown in Exhibit 3, the distribution of credit scores for the CAP and subprime borrowers, subprime borrowers tend to have lower FICO scores than CAP borrowers, but there is a significant overlap in these distributions. This overlap allows us to conduct a meaningful analysis of the performance of different loan products.

Empirical Analysis

Propensity Score Matching

Recent empirical studies suggest that borrowers take out subprime mortgages based on their credit score, income, payment history, level of down payment, debt ratios, and loan size limits; there is mixed evidence on the effect of demographics (Courchane et al. 2004; Cutts and Van Order, 2005; Chomsisengphet and Pennington-Cross, 2006; LaCour-Little, 2007). Based on the literature review, we included the key underwriting factors of FICO score and DTI in our analysis. These variables are assumed to directly affect credit risk and therefore affect mortgage choice/assignment, since higher credit risk is hypothesized to be associated with a greater probability of taking out a subprime mortgage. For example, lower FICO scores are assumed to be associated with higher credit risk, so we expect subprime loans to capture the majority of the borrowers with lower FICO scores. LTV, another important underwriting variable, is also generally considered to raise endogeniety concerns (LaCour-Little, 2007). In this case, higher LTV is one distinct characteristic of most CAP loans, with over 82 percent of CAP loans having an LTV equal to or higher than 97 percent. By contrast, most subprime loans have an LTV of less than 90 percent. Courchane et al. (2004) also suggest that high LTV may be associated with higher risk but is not necessarily associated with getting a subprime mortgage. Because our focus is the impact of borrower and neighborhood characteristics on borrowers' choice/assignment of mortgages, we decided not to include LTV variables in the model.[12]

In addition to the underwriting variables, we included loan amount as an explanatory variable since fixed costs are usually a large component of loan originations. We further included several factors measuring local market dynamics and credit risk. We constructed a zip-code-level credit risk measure: the mean FICO score for mortgages originated in the preceding year from the LPS data. Our hypothesis is that subprime lenders tend to market in neighborhoods or areas with a larger share of potential borrowers who have impaired credit history. The zip-code educational distribution was included as a proxy of residents' financial knowledge and literacy. Because some literature suggests that subprime lending is more likely to be concentrated in minority neighborhoods (Calem et al. 2004), we included the share of minority in the zip code in the models. Furthermore, we constructed a zip-code-level HHI using HMDA data to measure the extent of competition in the market in which borrowers' properties are

located.[13] The HHI measure also partially represents the volume of transactions in the area, since more transactions in a hot market could, though not necessarily would, attract more lenders to the market. In addition, we included quarterly calendar dummy variables to account for fluctuations in the yield curve that could affect market dynamics.

Exhibit 5 presents the results from logistic regression models for different vintages. Across different years, credit risk measures are highly predictive: borrower FICO score, coded into buckets with above 720 as the holdout category, is highly predictive of the use of subprime loans; coefficients are relatively large and decrease monotonically as credit score categories increase. In other words, as expected, the higher the FICO score, the lower the probability of taking out a subprime mortgage. Compared to those with very high DTI (>42 percent), borrowers with lower DTIs are generally less likely to receive subprime loans; exceptions are the buckets with low DTI (<28 percent) for the 2005 and 2006 samples. While it seems CAP borrowers had very high DTIs in 2006, the results generally suggest that borrowers with very high DTIs are more likely to receive subprime loans. In all the models, loan amount is positive for the use of subprime loans, consistent with the hypothesis that subprime borrowing involves higher costs, with costs being driven by large fixed components.

Further, zip-code-level average credit score is statistically significant and negatively related to the probability of taking out a subprime mortgage, suggesting that borrowers in areas with a higher share of low-score population are more likely to receive subprime loans. Zip-code-level education performs about as expected, with higher educational attainment roughly associated with a reduced probability of receiving a subprime mortgage. Borrowers in areas with a higher share of minorities are more likely to use subprime mortgages. Finally, higher HHIs are associated with a lower probability of taking out a subprime mortgage—suggesting that, at least in the period from 2003-2006, subprime loans were more likely to be in the markets with more intensive competition and/or more transactions.

In this analysis, we defined the logit rather than the predicted probability as the propensity score, because the logit is approximately normally distributed. For the one-to-one nearest neighbor with caliper match, we selected the subprime loan with the closest propensity score within a caliper for the first CAP loan after the subprime and randomly ordered CAP loans. We then removed both cases from further consideration and continued to select the subprime loan to match the next CAP loan. For the one-to-many match, we matched subprime loans with CAP loans with the closest propensity score within a caliper after all the loans were randomly sorted. Instead of removing the matched cases after matching, as in the one-to-one match, we kept the matched CAP loans in the sample and continued to find the matching CAP loans for the next subprime loan. This allows us to match as many subprime loans as possible for each CAP loan. We tried two different calipers, 0.1 and 0.25 times of standard error as suggested by Rosenbaum and Rubin (1985). In other words, we tried two matching algorithms, allowing us to match one CAP loan with one or multiple subprime loans, and two caliper sizes, allowing us to test the sensitivity of the

findings to varying sizes. For the one-to-many matched sample, to ensure that our analysis is representative of the matched set, we apply a system of weights, where the weight is the inverse of the number of subprime loans that matched to one single CAP loan.

Exhibit 6 describes the four matching schemes and numbers of loans for the resamples: Match 1 and Match 2 are based on the one-to-one match; Match 3 and Match 4 are based on the one-to-many match. Match 1 and Match 3 use nearest neighbor matching within a more restrictive caliper of 0.1, while other matching schemes employ a wider caliper (0.25 times of the standard deviation of the propensity scores). The results show that the more restrictive caliper does not dramatically reduce the sample size; we lost about 791 cases (12 percent) from Match 2 to Match 1 and only one CAP loan from Match 4 to Match 3. Because the qualitative results do not change and a restrictive caliper can lower the likelihood of producing inexact matching, we focused on the schemes using the more restrictive caliper size of 0.1 (Matches 1 and 3) in our analysis of loan performance. For the one-to-one match (Match 1), we ended up with a sample of 5,558 CAP loans and 5,558 matching subprime loans. For the one-to-many match, the sample was 35,971 subprime loans matched to 3,943 CAP loans (Match 3).

We checked covariate distributions after matching. Both Match 1 and Match 3 remove all significant differences, except LTV variables, between groups. For the matched groups, as Exhibit 7 shows, borrowers are remarkably similar across all groups except for LTV ratios, and we got a reduced but more balanced sample of CAP and subprime borrowers. Compared to CAP loans, which are usually fixed-rate retail loans with no prepayment penalty, subprime loans have distinctive features and terms. A vast majority (86 percent) of subprime loans are adjustable rate mortgages; most (70 percent) were obtained through brokers; and many (41 percent) have prepayment penalties.

Performance of the Matched Sample

We turn now to the comparison of CAP loans and subprime loans with similar characteristics. For the matched sample, we observed the payment history during the period from loan origination to March 2008. During this period, CAP loans had a lower serious delinquency rate: only 9.0 percent had ever experienced 90-day delinquencies before March 2008, compared to 19.8 percent of comparable subprime loans (Exhibit 8). Subprime loans also had a higher prepayment rate, 38 percent compared to about 18 percent for the matched CAP loans.

In addition to the subprime variables, we considered in the MNL model important underwriting variables, including borrower DTI ratio, credit history, loan age, and loan amount, as well as the put option. According to the option-based theory, home equity plays a central role in determining the probability of foreclosure (Quercia and Stegman 1992). The value of the put option is proxied by the ratio of negative equity (unpaid mortgage balance minus estimated house price based on the house price

index of the Office of Federal Housing Enterprise Oversight) to the original house price. We recognize that the inclusion of the put option may overestimate the risk of subprime loans since, as suggested in Zelman, McGill, Speer and Ratner (2007), some subprime loans may have second mortgages that were not captured here. We tried the same models without the put option variable; although the estimated default rate for the subprime loans is smaller, the qualitative results are fairly consistent with those in Exhibit 9 and Exhibit 10.

Falling interest rates may lead to faster prepayments and drive down delinquency rates as borrowers refinance their way out of potential problems. Rising interest rates can cause payment shocks at the reset date for adjustable-rate mortgages and reduce the ability of borrowers to afford a fixed-rate refinance. To capture the change in interest rate environment, we used the difference between the prevailing interest rates, which is proxied by the average interest rate of 30-year fixed-rate mortgages from the Freddie Mac Primary Mortgage Market Survey (PMMS), and the temporal average of the prevailing interest rates during the study period (Q1 2003 to Q1 2008).

Consistent with prior work, we further separated the matched sample into two cohorts based on years of origination. Subprime loans that originated in 2003 and 2004 were underwritten during a time of historically low interest rates and a strong economy, leading to a relatively good performance with very low default rates (Cutts and Merrill, 2008). Many borrowers were able to refinance their mortgages or sell their houses because of lax underwriting and high house price appreciation before 2007, which extinguished the default option. Instead, subprime loans that originated in 2005 and 2006, especially subprime ARMs, have not performed as well. These two cohorts capture some unobservable heterogeneity characterizing mortgages that originated in a booming housing market and those that originated in a softening housing market.

The results from the MNL regressions based on different matching samples are listed in Exhibit 9 (one-to-one match) and Exhibit 10 (one-to-many match). Model 1 considers the subprime dummy variable only, while Model 2 helps us explain the difference in performance between CAP and subprime loans. The results-based samples using varying algorithms are quite consistent; estimated coefficients for the explanatory variables are of the same sign and similar size, so Exhibit 10 only lists results for the subprime variables. Except for a few insignificant coefficients for the prepayment outcome, the subprime variables are significant and have expected signs. It is not easy to interpret the results based on the coefficients from the MNL regressions directly. We estimated the cumulative default and prepayment rates in the first 24 months after origination for borrowers with impaired credit score (FICO score 580-620) and with mean value of other regressors, except loan age and loan characteristics, based on the MNL regression results. The estimation results discussed below are listed in Exhibit 11, where we consider a 90-day delinquency as termination of a loan, although it may still be active after the delinquency.

Summary of Primary Findings

First of all, there is consistent evidence that subprime loans have a higher default risk and a higher prepayment probability than CAP loans. The estimated cumulative default rate for a 2004 subprime loan is 16.3 percent, about four times that of CAP loans (4.1 percent). For a 2006 subprime loan, the cumulative default rate is over 47.0 percent, about 3.5 times that of comparable CAP loans (13.3 percent). In other words, CAP loans are over 70 percent *less* likely to default than a comparable subprime loan across different vintages. We also notice that the default rate of the 2005-2006 cohort is significantly higher than that of the 2003-2004 cohort for loans with same loan features. Very likely this is because of changes in the underwriting standard and in economic conditions, as well as other unobservable heterogeneity.

We also found that subprime loans with adjustable rates have a significantly higher default rate than comparable CAP loans. And when the adjustable rate term is combined with the prepayment-penalty feature, the default risk of subprime loans becomes even higher. For a 2004 *sub_arm* loan (retail-originated subprime ARM without prepayment penalty), the estimated cumulative default rate would be 6.5 percent, slightly higher than that of CAP loans (4.1 percent). But if the adjustable rate subprime mortgage has a prepayment penalty, the estimated default rate increases to 13.5 percent for a 2004 *sub_arm&ppp* loan (retail-originated subprime ARM with prepayment penalty), over 100 percent higher than that of *sub_arm*. The same pattern also holds for the 2006 originations.

Finally, we found that the broker-origination channel is significantly associated with an increased level of default. For example, the estimated cumulative default rate for a 2004 *sub_bro&arm* loan (broker-originated adjustable-rate subprime loan without prepayment penalty) is 17.3 percent, significantly higher than the 6.5 percent of the *sub_arm* loans. For a 2006 *sub_bro&arm* loan, the estimated cumulative default rate is as high as 51 percent, much higher than the 16.8 percent of the *sub_arm* loans. The same pattern can also identified for adjustable-rate subprime loans with prepayment penalties. When a broker-originated subprime ARM has the term of prepayment penalty, the default risk for 2004 originations is 5.1 times as high as that of CAP loans (21.8 percent vs. 4.1 percent) and for 2006 originations 4.0 times as high (53.8 percent vs. 13.3 percent).

The results suggest that, all other characteristics being equal, borrowers are three to five times more likely to default if they obtained their mortgages through brokers. When this feature is combined with the adjustable rate and/or prepayment penalty, the default risk is even higher. One possible explanation is that, as suggested in Ernst et al. (2008) and Woodward (2008), loans originated through brokers have significantly higher closing costs and prices, which increases borrowers' costs and can lead to elevated default risk. It is also possible that borrowers obtaining loans through brokers are more likely to receive products with features that may increase the default risk. Finally, it is very likely that the broker-origination channel has a looser underwriting standard that has not been fully captured by the model, which allows unqualified borrowers to receive unsustainable risky products. All these contentions

are consistent with the results, and additional research is needed to examine this issue in more detail.

As to the outcome of prepayment, we observed two obvious trends. The first is that subprime loans, especially subprime ARMs, have a significantly higher prepayment rate than CAP loans (Exhibit 11). Second, for recent originations (2005-2006), subprime loans with prepayment penalties are less likely to prepay than loans with similar terms but without prepayment penalties. But for early originations (2003-2004), the pattern is reversed: subprime loans with prepayment penalties have a higher prepayment rate, probably because they are more likely to be prepaid after the prepayment penalty period has expired. Although we were not able to determine the prepayment penalty clauses for all subprime loans because of missing values, for those loans with complete information prepayment penalties were most frequently levied within the first two to three years of loan origination. As of March 2008, then, most prepayment penalties for 2003-2004 originations have expired. But prepayment may also be part of the problem if the borrower prepaid the loans by refinancing into another subprime product.

The Impact of Unobservable Heterogeneity

To check how unobservable borrower risk characteristics impact the results, we treated unobservable heterogeneity as an omitted variable, and solved this problem by including a proxy of the omitted variable as a regressor in the outcome equation along with the subprime dummy and other controls. Our first proxy of borrower unobservable heterogeneity is the risk premium (*rate_sp*), which is the mortgage interest rate minus the national average rate of 30-year fixed-rate mortgages from the PMMS. Of course, the risk premium variable may be an endogenous variable here, because if priced properly mortgage interest rates are determined by an assessment of a borrower's risk profile and some mortgage characteristics. To address the endogeneity issue, we used the residue of the risk premium (*rate_resid*) as a proxy of the unobservable lender/borrower risk characteristics based on an OLS model using observable information to predict mortgage risk premium.[14]

The qualitative results generally do not change when the proxies of unobservable heterogeneity are considered (Model 3 and Model 4 in Exhibit 12). The inclusion of the risk premium variables seems help explain the borrowers' prepayment behavior but not the default behavior. The coefficients of the subprime variables for the default option vary only slightly and have the same significance in different models. The noticeable difference is that for prepayment option once the risk premium variables are controlled, the coefficients of the subprime variables become much smaller for the 2005-2006 cohort but the signs and significance are the same. The coefficients of the risk premium variables (*rate_sp* and *rate_resid*) are generally insignificant for the default option (with only one exception of the 2003-2004 cohort which is slightly significant). As to the prepayment option, risk premium variables have a positive impact on the probability of prepayment for the 2005-2006 cohort but have a negative

impact, though with a magnitude close to zero, for the 2003-2004 cohort, possibly because of changes in some uncaptured market condition information.

In summary, we demonstrate that the results we obtained earlier are robust enough even after controlling for proxies of the unobservable heterogeneity among borrowers. As a result, we are more confident about the conclusions about the relative risk of different loan products.

Empirical Results of Other Controls

Because the results for most of the variables are generally consistent across different models, discussion of other control variables is based primarily on Model 1, as summarized in Exhibit 9. For other controlled variables, the results suggest:

Other risk variables

- Put option: Borrowers with less or negative equity in their homes (larger value of *put*) are more likely to default and less likely to prepay. The results confirm the common wisdom that the level of equity in a home is a strong predictor for prepayment and default.
- Credit history: As expected, there is consistent evidence that borrowers with lower credit scores are more likely to experience serious delinquency.
- Debt-to-income ratio: Higher debt-to-income ratios are associated with a higher default risk for the 2003-2004 cohort, but the coefficients are insignificant for the 2005-2006 sample.

Loan characteristics

- Size of unpaid balance: Larger loan size is generally associated with lower default risk. Larger loan size is also associated with higher prepayment probability for the 2003-2004 cohort.

Area and neighborhood controls

- Area credit risk: Average credit score in the zip code is significantly and negatively associated with default risk. There is also some evidence that zip code average credit score is positively associated with prepayment probability (for the 2005-2006 vintage).
- Interest rate dynamics: For different cohorts, the impact of interest rate environment is different. For the 2003-2004 cohort, the increase in average interest rate decreases the prepayment probability but for the recent cohort, the increase in average interest rate increases the default risk and has no significant impact on the prepayment probability.
- County unemployment rate: Average county unemployment rate is generally insignificant in explaining the default and prepayment behaviors across different models.

Time dummies

- Dummies of 2003 and 2005 originations: The 2005 originations are significantly less likely to default, compared to the 2006 cohort.

Conclusions

As the current economic crisis worsens, the debate continues as to what cause the initial foreclosure crisis in the mortgage markets. In this study, we examine the relative default risk of two of the suspects: subprime mortgages and community reinvestment loans. Using propensity matching methods, we constructed a sample of comparable borrowers with similar risk characteristics but holding the two different loan products. We found that, for comparable borrowers, the estimated default risk is much lower with a CRA loan than with a subprime mortgage. More narrowly, we found that the broker-origination channel, an adjustable rate, and a prepayment penalty, all contribute substantially to the elevated risk of default among subprime loans. In the worst scenario, when broker origination is combined with the features of adjustable rate and prepayment penalty, the default risk of a borrower is four to five times as high as that of a comparable borrower holding a CRA-type product. Though CAP has some program-specific features, the results clearly suggest that the relative higher default risk of subprime loans may not be solely attributed to borrower credit risk, instead it is significantly associated with the characteristics of the products and the origination channel in the subprime market. Thus, the results suggest that when done right and responsibly, lending to LMI borrowers is viable proposition. Borrowers and responsible CRA lending should not be blamed for the current housing crisis.

Our results are consistent with recent regulatory action.[15] Key features of subprime loans—underwriting that ignores ability to pay, the inclusion of prepayment penalties, escalating interest rates and hidden fees--make it difficult for families to stay current on their mortgage payments. Federal Reserve rules issued in 2006 and recent amendments to the Truth in Lending Act (Regulation Z) have banned negative amortization for high-priced loans and most prepayment penalties. They have also banned underwriting loans without regard to a borrower's ability to pay. Unfortunately, broker origination also significantly increases default risk. However, there is no Federal law and only a few states have sufficiently regulated the incentive structure of the broker origination channel, especially the yield spread premium which many have argued may lead brokers to originate loans that may not be in the best interest of the borrower.[16]

In the current economic situation, many borrowers holding subprime mortgages with risky loan features are having difficulty making their current payments and many have already been seriously delinquent or in default. One proposed solution has been to modify troubled owner-occupied subprime loans with FHA-insured loans or more sustainable fixed-rate products at a significant discount (Inside B&C Lending, 2008). This research demonstrates that if subprime-like borrowers receive loans with prime rather than subprime terms and conditions, their default rate would be much lower.

Because the mortgage industry was originally criticized for failing to serve lower-income and minority households and more recently for flooding the market with unsustainable mortgages with risky features, our findings are important for policymakers. This research suggests that loans with prime terms and conditions offered through special CRA lending programs provide LMI and minority households, even those with somewhat imperfect credit histories, more sustainable homeownership options than subprime loans.

While our results are interesting for understanding the performance difference between subprime and CRA loans, we would like to emphasize that CAP has some program specific characteristics. Though national in scope, CAP is geographically concentrated in certain markets. In addition, this analysis focuses solely on home purchase lending activities and borrowers with full or alternative documentation only. As such, it is unclear whether or not our findings for the CAP program are applicable to national population of CRA loans and the entire subprime market. However, CAP borrowers are matched with subprime borrowers with similar risk profiles, focusing in this way on the less risky portion of the subprime market. We have also excluded from the analysis investor loans and low- or no-doc subprime mortgages, all of which are generally associated with a higher credit risk. Further, if borrowers are indeed steered to low- and no-doc loans in the subprime market even when they could have documented their income, as has been asserted by some observers, this would suggest that the increased risk of having one's mortgage originate in the subprime market is even greater than captured in this paper. As such, this research provides more convincing evidence of the relative risk of the CRA-type loans and the impact of loan features and origination channels on loan performance.

Endnotes:

[1] For more complete details of CRA regulations, see http://www.ffiec.gov/cra/default.html.

[2] The CRA assessment area for a retail-oriented banking institution must include "the areas in which the institution operates branches and deposit-taking automated teller machines and any surrounding areas in which it originated or purchased a substantial portion of its loans" (Avery et al. 2000, p. 712).

[3] As Alexander et al. (2002) suggest that some practices of possible gaming of brokers with lenders include at least reporting the highest FICO score from the three bureaus, pulling a FICO score after challenging a derogatory, and shopping for cooperative appraisers.

[4] Examples of guidelines that reduced cash required to close include: Lesser of $500 or 1percent from borrower's own funds; Maximum LTV of 98percent and maximum combined LTV (including soft seconds) of 103percent; No reserves required.

[5] Examples of guideline flexibility with respect to credit history include: Demonstrate 6-month satisfactory payment history with four sources of credit, either traditional or non-traditional; FICO scores thresholds below 620 accepted in certain programs.

[6] Examples of underwriting flexibility in assessing the ability to repay include: Maximum total ratio of debt payments to income ratio of 43 percent, or up to 45 percent if new housing payment is not more than 25 percent higher than prior housing payment.

[7] Examples of offsetting or combined guideline flexibilities include: Maximum total ratio of debt payments to income varies from 38percent to 48percent with borrowers with higher credit scores allowed higher ratios; Higher downpayments or reserve requirements for borrowers with FICO below 620.

[8] To qualify for the CAP program, borrowers must meet one of three criteria: (1) have income under 80 percent of the area median income (AMI) for the metropolitan area; (2) be a minority with income below 115 percent of AMI; (3) or purchase a home in a high-minority (>30%) or low-income (<80% AMI) census tract and have an income below 115 percent AMI.

[9] Other common matching algorithms include: nearest-neighbor matching, kernel matching, local linear matching, Mahalanobis metric matching, Mahalanobis metric matching including the propensity score, and difference in differences methods (see review in Guo et al. 2006 and Essama-Nssah, 2006).

[10] Unfortunately, there are too few loans in the matched sample for retail-originated fixed-rate mortgages (less than 20 for the one-to-one match for each category), which does not allow us to conduct meaningful analysis, and so they were dropped from further analysis.

[11] This assumption is also known as the *exogeneity,* or *unconfoundedness,* or *ignorable treatment assignment,* or *conditional homogeneity, or selection on observables* assumption (Essama-Nssah, 2006).

[12] To empirically test the impact on results of including/excluding LTV variables, we tried logistic regression models with LTV variables. As expected, LTV ratio is highly significant in predicting the use of subprime loans, with lower LTVs consistently and monotonically related to the use of subprime loans. The match rate is lower than those reported in Exhibit 6, but the qualitative results on the performance of mortgages do not change.

[13] The HHI is constructed as the sum of squared market shares of firms in a zip code. Based on HMDA data, we got the market share of firms in a census tract and then matched to corresponding zip codes. When a census tract overlaps multiple zip codes, we assume the share of loans for the particular firm is the same as the share of house units of the tract in this zip code. As such, the index ranges from 10,000 in the case of 100% market concentration to near zero in the case of many firms with equally small market shares.

[14] We assume mortgage risk premium is determined by a set of borrower, neighborhood characteristics in the propensity score estimation and loan characteristics that may influence pricing including LTV, adjustable rates, and prepayment penalties. We ran OLS regressions for different cohorts and the R squares of the four regressions range from 0.4 for the 2004 cohort to 0.61 for the 2003 cohort. The regression results are available upon request.

[15] Home Ownership and Equity Protection Act bans balloon payments, negative amortization, most prepayment penalties for high-rate/high-fee loans. The Revision of Regulation Z of Truth in Lending Act in July 2008 further bans any prepayment penalties if the payment can change in the initial four years and for high-priced loans prepayment penalties cannot last for more than two years.

[16] Effective on October 1, the House Bill 2188 in North Carolina bans rate or yield spread premiums.

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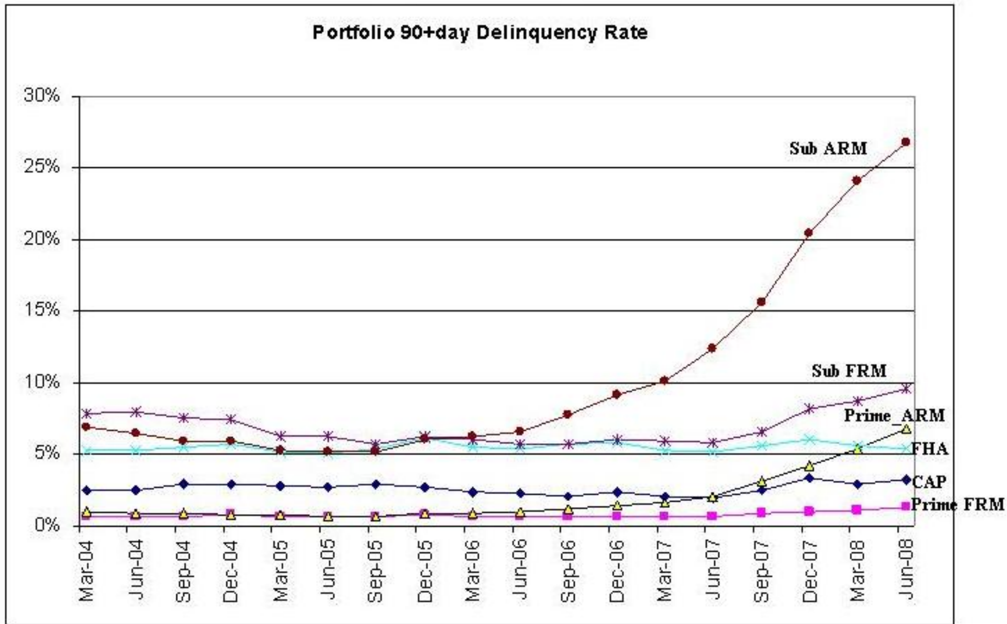
Exhibit 1 Construction of Subprime Study Sample

	# of Observations
	Subprime
Step 1 Subprime Loans meeting the following criteria: home purchase loans, first-lien; single family house, 30-year amortization, conforming loans with a minimum loan amount of $10,000 only	544,849
Step 2 Exclude loans with no or limited documentation or missing information for the following variables: LTV, Fico score, DTI**,** documentation	86,697
Step 3 Exclude loans not in zip codes with CAP activities and loans without complete payment history	42,065

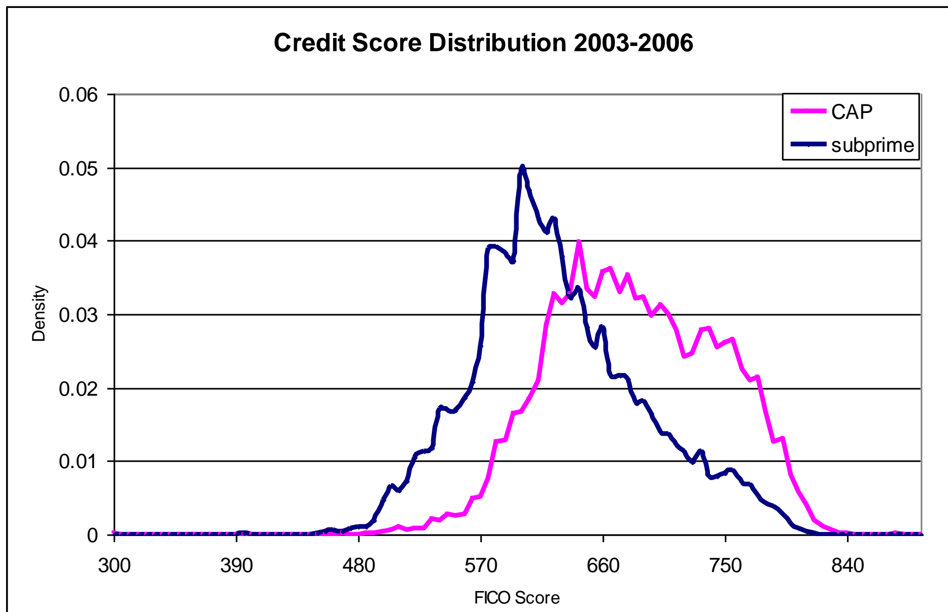
Note: based on authors' calculation from LPS. Subprime loans here include B&C loans and high-cost ARMs (with a margin greater than 300 basis points).

Exhibit 2 90-day Delinquency Rate by Loan Types



Source: Mortgage Banker Association (2008) and Self-Help

Exhibit 3 CAP and Subprime FICO Score Distribution (2003-2006)



Source: Lender Processing Services, Inc. (LPS) and Self-Help

Exhibit 4 Descriptive Statistics (Mean or Percentage)

Variable	CAP	Subprime
Debt-to-income ratio*		
DTI<28%	0.126	0.163
DTI 28-36%	0.278	0.158
DTI 36-42%	0.315	0.178
DTI>42%	0.281	0.501
FICO score*		
<580	0.031	0.213
580-620	0.109	0.263
620-660	0.224	0.225
660-720	0.324	0.192
>=720	0.312	0.107
LTV*		
<80%	0.037	0.369
80-90%	0.050	0.381
90-97%	0.090	0.167
>=97%	0.823	0.083
Loan characteristics		
Loan_amt*	100.86	148.1
ARMs*	-	0.903
Broker*	-	0.808
Prepayment penalty*	-	0.495
Note Rate*	6.66%	7.87%
Neighborhood/Local characteristics		
HHI index (in 10,000, 2005)*	0.051	0.036
Mean area FICO Score (2005)*	688.6	685.2
Share of minority *	0.293	0.482
Education distribution*		
Share of less high school	0.199	0.239
Share of high school	0.318	0.283
Share of some college	0.272	0.292
Share of college and above	0.211	0.186
Geography: top 5 states		
	OH (22.3%)	CA (19.2%)
	NC (14.6%)	TX (11.0%)
	IL (12.6%)	FL (10.1%)
	GA (11.4%)	IL (9.1%)
	OK (5.8%)	GA (5.3%)
Origination Year		
2003	2,670	4,680
2004	2,581	18,380
2005	2,251	11,703
2006	1,719	7,302
N	9,221	42,065

Note: * Bivariate χ^2 test or t test significant at the 0.01 level.

Exhibit 5 Logistic regression models predicting propensity scores

	2003		2004		2005		2006	
	Coef.	P-value	Coef.	P-value	Coef.	P-value	Coef.	P-value
dti<28	-0.172	0.088	0.006	0.941	0.616	0.000	1.324	0.000
dti 28-36	-1.369	0.000	-1.252	0.000	-0.603	0.000	0.216	0.018
dti 36-42	-1.411	0.000	-1.486	0.000	-0.837	0.000	-0.160	0.060
dti>42								
cscore<580	4.632	0.000	3.943	0.000	4.182	0.000	1.900	0.000
cscore 580-620	2.040	0.000	2.237	0.000	2.846	0.000	1.245	0.000
cscore 620-660	1.431	0.000	1.121	0.000	1.438	0.000	1.021	0.000
cscore 660-720	0.850	0.000	0.550	0.000	0.632	0.000	0.483	0.000
cscore >=720								
loan_amt	0.012	0.000	0.013	0.000	0.011	0.000	0.010	0.000
qtr1	0.055	0.585	-0.553	0.000	0.606	0.000	1.137	0.000
qtr2	-0.019	0.843	-0.062	0.407	0.315	0.000	0.891	0.000
qtr3	-0.545	0.000	0.070	0.342	0.073	0.372	0.601	0.000
qtr4								
HHI (in 10,000)	-14.763	0.000	-18.747	0.000	-21.058	0.000	-23.296	0.000
area credit score	-0.004	0.046	-0.004	0.053	-0.002	0.438	0.000	0.937
pctmin	-0.007	0.001	0.006	0.001	0.017	0.000	0.014	0.000
pct_less_high								
pct_high	-0.124	0.000	-0.077	0.000	-0.057	0.000	-0.144	0.000
pct_somecoll	0.062	0.000	0.049	0.000	0.054	0.000	0.015	0.037
pct_coll	-0.082	0.000	-0.067	0.000	-0.058	0.000	-0.092	0.000
_cons	6.015	0.000	5.411	0.000	2.164	0.177	6.127	0.001
Pseudo R^2	0.42		0.36		0.38		0.35	
	N=7,350		N=20,961		N=13,954			N=9,021

Exhibit 6 Description of matching schemes and resample sizes

Scheme	Description of matching method	N of original sample	N of the new sample	
		CAP	CAP	Subprime
Match1	Nearest 1-to-1 using caliper=0.1	9,221	5,558	5,558
Match2	Nearest 1-to-1 using caliper=0.25σ	9,221	6,349	6,349
Match3	Nearest 1-to-many using caliper=0.1	9,221	3,943	35,971
Match4	Nearest 1-to-many using caliper=0.25σ	9,221	3,944	36,236

Note: For the one-to-one nearest neighbor with caliper match, the subprime loan with the closest propensity score within a caliper for the first CAP loan was selected after the sample was randomly ordered. We then removed both cases from further consideration and continue to select the subprime loan to match the next CAP loan. For the one-to-many match, subprime loans were matched with CAP loans with the closest propensity score within a caliper after all the loans were randomly sorted. Instead of removing the matched cases after matching as in the one-to-one match, we kept the matched CAP loans in the sample and continued to find the matching CAP loan for the next subprime loan.

Exhibit 7 Significance tests of the resamples

Variable	Match 1		Match3	
Debt-to-income ratio	CAP	Subprime	CAP	Subprime
DTI<28%	0.229	0.221	0.223	0.218
DTI 28-36%	0.261	0.249	0.242	0.233
DTI 36-42%	0.375	0.391	0.397	0.403
DTI>42%	0.135	0.139	0.138	0.146
FICO score				
<580	0.047	0.049	0.165	0.164
580-620	0.15	0.155	0.251	0.241
620-660	0.256	0.241	0.296	0.292
660-720	0.305	0.305	0.165	0.164
>=720	0.242	0.25	0.123	0.139
LTV (* for match 1)				
<80%	0.042	0.314	0.044	0.305
80-90%	0.062	0.276	0.066	0.282
90-97%	0.11	0.209	0.117	0.208
>=97%	0.786	0.201	0.773	0.204
Loan characteristics				
loan_amt*	109.4	109.7	112.0	113.2
ARMs*		0.864		0.880
Broker*		0.696		0.682
Prepayment penalty*		0.413		0.422
Note Rate*	0.066	0.078	0.066	0.078
N	5,558	5,558	3,943	35,971**

Note: * Bivariate χ^2 test or t test significant at 0.01 level. **Statistics based on Match 3 are weighted average and the weight is the inverse of number of subprime loans that matched to one CAP loan.

Exhibit 8 Performance measures of the new samples

	Whole sample		2003-2004 Sample		2005-2006 Sample	
	% of 90-day	% prepayment	% of 90-day	% prepayment	% of 90-day	% prepayment
CAP	8.98	18.46	7.64	25.73	10.94	7.84
Subprime	19.81	38.27	12.97	50.06	29.81	21.04
N	11,116		6,600		4,516	

Note: Observation period is from origination to March 2008; if a loan was 90-day delinquent and then prepaid, it is considered as a 90-day delinquency only.

Exhibit 9 MNL regression results of default and prepayment (Match 1 in Exhibit 6)

		2003-2004 Sample				2005-2006 Sample			
		Model 1		Model 2		Model 1		Model 2	
	Variable	Coef.	P>z	Coef.	P>z	Coef.	P>z	Coef.	P>z
Default	put	0.041	0.000	0.044	0.000	0.050	0.000	0.052	0.000
	dti 28-36	0.581	0.000	0.585	0.000	0.083	0.528	0.093	0.480
	dti 36-42	0.632	0.000	0.599	0.000	0.025	0.847	0.018	0.890
	dti>42	0.323	0.029	0.522	0.000	-0.241	0.065	0.015	0.907
	cscore<580	2.414	0.000	2.196	0.000	1.682	0.000	1.477	0.000
	cscore 580-620	1.991	0.000	1.790	0.000	1.278	0.000	1.057	0.000
	cscore 620-660	1.471	0.000	1.286	0.000	1.033	0.000	0.907	0.000
	cscore 660-720	0.634	0.000	0.512	0.001	0.448	0.004	0.388	0.011
	unpaid balance (in log)	-0.357	0.000	-0.266	0.008	-0.163	0.079	-0.066	0.482
	loan age (in log mon)	1.007	0.000	1.084	0.000	1.043	0.000	1.093	0.000
	area credit score	-0.010	0.000	-0.009	0.000	-0.012	0.000	-0.010	0.000
	average interest rate	-0.128	0.346	-0.142	0.299	0.522	0.000	0.507	0.000
	area unemp rate	0.044	0.120	0.045	0.106	0.045	0.120	0.025	0.393
	y2003 (y2005)	-0.078	0.389	-0.153	0.097	-0.607	0.000	-0.491	0.000
	subprime	1.592	0.000			1.596	0.000		
	sub_arm			0.540	0.004			0.361	0.033
	sub_arm&ppp			1.546	0.028			1.898	0.000
	sub_bro			1.945	0.000			1.446	0.000
	sub_bro&ppp			1.985	0.000			1.527	0.000
	sub_bro&arm			1.661	0.000			1.898	0.000
	sub_bro&arm&ppp			1.987	0.000			1.818	0.000
	cons	0.818	0.544	-0.963	0.482	1.291	0.347	-1.241	0.371
Prepay	put	-0.015	0.000	-0.013	0.000	-0.007	0.061	-0.006	0.185
	dti 28-36	0.289	0.000	0.301	0.000	-0.045	0.760	0.015	0.920
	dti 36-42	0.348	0.000	0.354	0.000	0.058	0.683	0.149	0.311
	dti>42	0.015	0.825	0.119	0.088	-0.300	0.030	-0.175	0.248
	cscore<580	0.142	0.322	-0.001	0.996	-0.090	0.663	-0.012	0.956
	cscore 580-620	0.080	0.321	-0.006	0.945	0.237	0.069	0.274	0.045
	cscore 620-660	0.323	0.000	0.262	0.000	-0.193	0.131	-0.140	0.285
	cscore 660-720	0.149	0.005	0.139	0.008	-0.076	0.521	-0.114	0.344
	unpaid balance (in log)	0.329	0.000	0.298	0.000	-0.055	0.537	-0.117	0.201
	loan age (in log mon)	0.459	0.000	0.512	0.000	0.697	0.000	0.699	0.000
	area credit score	0.001	0.381	0.002	0.091	0.007	0.001	0.008	0.001
	average interest rate	-0.197	0.007	-0.187	0.011	0.200	0.203	0.188	0.237
	area unemp rate	-0.016	0.338	-0.022	0.185	-0.029	0.409	-0.031	0.375
	y2003 (y2005)	-0.021	0.640	0.029	0.519	0.278	0.003	0.317	0.002
	subprime	0.922	0.000			1.238	0.000		
	sub_arm			0.611	0.000			1.132	0.000
	sub_arm&ppp			1.685	0.000			2.289	0.000
	sub_bro			0.437	0.000			1.207	0.001
	sub_bro&ppp			0.979	0.000			-0.241	0.510
	sub_bro&arm			1.080	0.000			1.660	0.000
	sub_bro&arm&ppp			1.340	0.000			0.947	0.000
	cons	-11.241	0.000	-11.612	0.000	-11.908	0.000	-11.495	0.000
	Log likelihood		-16790.3		-16683.1		-8262.9		-8157.0
	N		N=192,179 of 6,600 loans				N=93,646 of 4,516 loans		

Note: *sub_arm* represents subprime retail originated ARMs without prepayment penalty;
sub_ arm&ppp represents subprime retail originated ARMs with prepayment penalties;
sub_bro represents subprime broker originated fixed-rate mortgages without prepayment penalties; *sub_bro&ppp* represents subprime broker originated fixed-rate mortgages with prepayment penalties;
sub_bro&arm represents subprime broker originated ARMs without prepayment penalties; *sub_bro&arm&ppp* represents subprime broker originated ARMs with prepayment penalties.

Exhibit 10 MNL regression results of default and prepayment (Match 3 in Exhibit 6)

		2003-2004 Sample				2005-2006 Sample			
		Model 1		Model 2		Model 1		Model 2	
	Variable	Coef.	P>z	Coef.	P>z	Coef.	P>z	Coef.	P>z
Default	subprime	1.448	0.000			1.616	0.000		
	sub_arm			0.482	0.003			0.189	0.208
	sub_arm&ppp			1.658	0.000			2.073	0.000
	sub_bro			1.721	0.000			1.418	0.000
	sub_bro&ppp			1.770	0.000			1.581	0.000
	sub_bro&arm			1.638	0.000			1.906	0.000
	sub_bro&arm&ppp			1.843	0.000			1.833	0.000
	cap								
Prepay	subprime	0.940	0.000			1.308	0.000		
	sub_arm			0.666	0.000			1.192	0.000
	sub_arm&ppp			1.544	0.000			2.220	0.000
	sub_bro			0.510	0.000			1.235	0.000
	sub_bro&ppp			0.901	0.000			-0.451	0.111
	sub_bro&arm			1.052	0.000			1.751	0.000
	sub_bro&arm&ppp			1.385	0.000			1.073	0.000
	cap								
	N	N=341,367 of 16,604 loans				N= 528,292 of 23,310 loans			

Note: see note in Exhibit 9 for the definition of different loan products.
There should be 8 dummies for different combinations of loan features but the sample sizes of the buckets of retail-originated fixed-rate subprime with and without prepayments are too small, which does not allow us conduct meaningful analysis.

Exhibit 11 Estimated cumulative default and prepayment rate
(24 months after origination for a borrower with impaired credit score of 580-620)

	2004 Origination		2006 Origination	
	Default	prepayment	Default	prepayment
CAP	4.08%	10.34%	13.32%	7.47%
Subprime	16.28%	22.81%	47.04%	17.69%
sub_arm	6.53%	17.93%	16.82%	20.82%
sub_arm&ppp	13.48%	41.43%	43.30%	39.42%
sub_bro	24.15%	13.92%	40.61%	18.76%
sub_bro&ppp	23.33%	22.48%	47.84%	4.74%
sub_bro&arm	17.30%	25.37%	51.00%	24.27%
sub_bro&arm&ppp	21.82%	30.40%	53.78%	13.36%

Note: see note in Exhibit 9 for the definition of different loan products. The predicted cumulative default and prepayment rate is as of 24 months after origination for a borrower with a FICO score between 580-620 and holding a mortgage originated in 2004 or 2006, with the mean value of other regressors. The estimation is based on regression results in Exhibit 9.

Exhibit 12 MNL Regression Results of Default and Prepayment (with proxy of unobservable heterogeneity)

		2003-2004 Sample						2005-2006 Sample					
		Model 1		Model 3		Model 4		Model 1		Model 3		Model 4	
	Variable	Coef.	P>z	Coef.	P>z	Coef.	P>z	Coef.	P>z	Coef.	P>z		
Default	put	0.041	0.000	0.041	0.000	0.041	0.000	0.050	0.000	0.049	0.000	0.049	0.000
	dti 28-36	0.581	0.000	0.571	0.000	0.582	0.000	0.083	0.528	0.081	0.543	0.078	0.560
	dti 36-42	0.632	0.000	0.606	0.000	0.632	0.000	0.025	0.847	0.024	0.859	0.018	0.893
	dti>42	0.323	0.029	0.349	0.019	0.323	0.030	-0.241	0.065	-0.232	0.077	-0.243	0.063
	cscore<580	2.414	0.000	2.271	0.000	2.413	0.000	1.682	0.000	1.628	0.000	1.690	0.000
	cscore 580-620	1.991	0.000	1.921	0.000	1.990	0.000	1.278	0.000	1.237	0.000	1.274	0.000
	cscore 620-660	1.471	0.000	1.422	0.000	1.471	0.000	1.033	0.000	1.015	0.000	1.032	0.000
	cscore 660-720	0.634	0.000	0.614	0.000	0.634	0.000	0.448	0.004	0.441	0.004	0.448	0.004
	unpaid balance (in	-0.357	0.000	-0.308	0.002	-0.357	0.000	-0.163	0.079	-0.122	0.240	-0.152	0.114
	loan age (in log mon)	1.007	0.000	0.996	0.000	1.007	0.000	1.043	0.000	1.040	0.000	1.042	0.000
	area credit score	-0.010	0.000	-0.010	0.000	-0.010	0.000	-0.012	0.000	-0.012	0.000	-0.012	0.000
	average interest rate	-0.128	0.346	-0.143	0.297	-0.128	0.348	0.522	0.000	0.518	0.000	0.522	0.000
	area unemp rate	0.044	0.120	0.038	0.186	0.044	0.121	0.045	0.120	0.044	0.121	0.045	0.120
	y2003 (y2005)	-0.078	0.389	-0.097	0.289	-0.077	0.393	-0.607	0.000	-0.602	0.000	-0.608	0.000
	rate_sp			0.075	0.033					0.038	0.274		
	rate_resid					-0.002	0.961					0.020	0.573
	subprime	1.592	0.000	1.446	0.000	1.594	0.000	1.596	0.000	1.515	0.000	1.559	0.000
	cons	0.818	0.544	0.268	0.846	0.814	0.546	1.291	0.347	0.719	0.629	1.237	0.371
Prepay	put	-0.015	0.000	-0.014	0.000	-0.014	0.000	-0.007	0.061	-0.018	0.000	-0.018	0.000
	dti 28-36	0.289	0.000	0.291	0.000	0.297	0.000	-0.045	0.760	-0.062	0.686	-0.139	0.356
	dti 36-42	0.348	0.000	0.356	0.000	0.360	0.000	0.058	0.683	0.082	0.579	-0.049	0.739
	dti>42	0.015	0.825	-0.008	0.906	0.002	0.975	-0.300	0.030	-0.123	0.386	-0.299	0.031
	cscore<580	0.142	0.322	0.264	0.068	0.117	0.405	-0.090	0.663	-0.734	0.001	-0.022	0.916
	cscore 580-620	0.080	0.321	0.136	0.099	0.072	0.376	0.237	0.069	-0.184	0.187	0.139	0.298
	cscore 620-660	0.323	0.000	0.361	0.000	0.324	0.000	-0.193	0.131	-0.373	0.004	-0.211	0.102
	cscore 660-720	0.149	0.005	0.158	0.003	0.143	0.007	-0.076	0.521	-0.159	0.181	-0.080	0.497
	unpaid balance (in	0.329	0.000	0.309	0.000	0.335	0.000	-0.055	0.537	0.338	0.002	0.129	0.157
	loan age (in log mon)	0.459	0.000	0.466	0.000	0.464	0.000	0.697	0.000	0.679	0.000	0.688	0.000
	area credit score	0.001	0.381	0.000	0.626	0.001	0.350	0.007	0.001	0.008	0.000	0.006	0.012
	average interest rate	-0.197	0.007	-0.184	0.012	-0.186	0.011	0.200	0.203	0.163	0.304	0.186	0.241
	area unemp rate	-0.016	0.338	-0.014	0.408	-0.014	0.385	-0.029	0.409	-0.022	0.528	-0.022	0.527
	y2003 (y2005)	-0.021	0.640	-0.023	0.613	-0.019	0.675	0.278	0.003	0.273	0.003	0.239	0.010
	rate_sp			-0.068	0.000					0.399	0.000		
	rate_resid					-0.059	0.002					0.367	0.000
	subprime	0.922	0.000	1.004	0.000	0.977	0.000	1.238	0.000	0.505	0.000	0.601	0.000
	cons	-11.24	0.00	-10.74	0.00	-11.39	0.00	-11.91	0.00	-17.37	0.00	-12.46	0.00
	Log likelihood	-16790.3		-16780.3		-16785.1		-8262.9		-8211.7		-8219.2	

Note: Model 1 is the same as the one in Exhibit 9. *rate_sp* represents the difference between the mortgage note rate and the average interest rate of 30-year fixed-rate mortgages from the Freddie Mac Primary Mortgage Market Survey in the same month. *rate_resid* represents the residue of the risk premium variable from OLS models of risk premium.

CommunityDividend

Did the CRA cause the mortgage market meltdown?

Two Federal Reserve economists examine whether available data support critics' claims that the Community Reinvestment Act spawned the subprime mortgage crisis.

Neil Bhutta - Economist
Glenn B. Canner - Economist
March 2009

As the current financial crisis has unfolded, an argument that the Community Reinvestment Act (CRA) is at its root has gained a foothold. This argument draws on the fact that the CRA encourages commercial banks and savings institutions (collectively known as banking institutions) to help meet the credit needs of lower-income borrowers and borrowers in lower-income neighborhoods.[1/] Critics of the CRA contend that the law pushed banking institutions to undertake high-risk mortgage lending.

This article discusses key features of the CRA and presents results from our analysis of several data sources regarding the volume and performance of CRA-related mortgage lending. On balance, the evidence runs counter to the contention that the CRA lies at the root of the current mortgage crisis.

Assessing banks in context

The CRA directs federal banking regulatory agencies, including the Federal Reserve, to use their supervisory authority to encourage banking institutions to help meet the credit needs of all segments of their *local* communities. These communities, referred to hereafter as *CRA assessment areas*, are defined as the areas where banking institutions have a physical branch office presence and take deposits, including low- and moderate-income areas. The banking agencies periodically assess the performance of banking institutions in serving their local communities, including their patterns of lending to lower-income households and neighborhoods, and take the assessments into consideration when reviewing the institutions' applications for mergers, acquisitions, and branches.

The CRA emphasizes that banking institutions fulfill their CRA obligations within the framework of safe and sound operation. CRA performance evaluations have become more quantitative since 1995, when regulatory changes were enacted that stress actual performance rather than documented efforts to serve a community's credit needs. However, the CRA does not stipulate minimum targets or even goals for the volume of loans, services, or investments banking institutions must provide. While it is fair to say that the primary focus of CRA evaluations is the number and dollar amount of loans to lower-income borrowers or areas, the agencies instruct examiners to judge banks' performance in light of 1) each institution's capacity to extend credit to lower-income groups and 2) the local economic and market conditions that might affect the income and geographic distribution of lending.

Timing and originations

Before we turn to our analysis of CRA lending data, we have two important points to note regarding the

CRA and its possible connection to the current mortgage crisis.

The first point is a matter of timing. The current crisis is rooted in the poor performance of mortgage loans made between 2005 and 2007. If the CRA did indeed spur the recent expansion of the subprime mortgage market and subsequent turmoil, it would be reasonable to assume that some change in the enforcement regime in 2004 or 2005 triggered a relaxation of underwriting standards by CRA-covered lenders for loans originated in the past few years. However, the CRA rules and enforcement process have not changed substantively since 1995.[2/] This fact weakens the potential link between the CRA and the current mortgage crisis.

Our second point is a matter of the originating entity. When considering the potential role of the CRA in the current mortgage crisis, it is important to account for the originating party. In particular, independent nonbank lenders, such as mortgage and finance companies and credit unions, originate a substantial share of subprime mortgages, but they are not subject to CRA regulation and, hence, are not directly influenced by CRA obligations. (We explore subprime mortgage originations in further detail below.)

The CRA may directly affect nonbank subsidiaries or affiliates of banking institutions. Banking institutions can elect to have their subsidiary or affiliate lending activity counted in CRA performance evaluations. If the banking institution elects to include affiliate activity, it cannot be done selectively. For example, the institution cannot "cherry pick" loans that would be favorably considered under the law while ignoring loans to middle- or higher-income borrowers.

In the next section, we discuss the data analysis we undertook to assess the merits of the claims that the CRA was a principal cause of the current mortgage market difficulties. The analysis focuses on two basic questions. First, what share of subprime mortgage originations is related to the CRA? Second, how have CRA-related subprime loans performed relative to other loans? We believe the answers to these two questions will shed light on the role of the CRA in the subprime crisis.

CRA-related lending volume and distribution

In analyzing the available data, we consider two distinct metrics of lending activity: loan origination activity and loan performance. With respect to the first question posed above concerning loan originations, we determine which types of lending institutions made higher-priced loans, to whom those loans were made, and in what types of neighborhoods the loans were extended.[3/] This analysis therefore depicts the fraction of subprime mortgage lending that could be related to the CRA.

Using loan origination data obtained pursuant to the Home Mortgage Disclosure Act (HMDA), we find that in 2005 and 2006, independent nonbank institutions—institutions not covered by the CRA—accounted for about half of all subprime originations. (See Table 1.) Also, about 60 percent of higher-priced loan originations went to middle- or higher-income borrowers or neighborhoods, populations not targeted by the CRA. (See Table 2.) In addition, independent nonbank institutions originated nearly half of the higher-priced loans extended to lower-income borrowers or borrowers in lower-income areas (share derived from Table 2).

In total, of all the higher-priced loans, only 6 percent were extended by CRA-regulated lenders (and their affiliates) to either lower-income borrowers or neighborhoods in the lenders' CRA assessment areas, which are the local geographies that are the primary focus for CRA evaluation purposes. The small share of subprime lending in 2005 and 2006 that can be linked to the CRA suggests it is very unlikely the CRA could have played a substantial role in the subprime crisis.

To the extent that banking institutions chose not to include their affiliates' lending in their CRA examinations, the 6 percent share overstates the volume of higher-priced, lower-income lending that CRA examiners would have counted.[4/] It is possible, however, the examiners might have considered at least some of the lower-income lending outside of CRA assessment areas if institutions asked that it be considered in their CRA performance evaluations. No data are available to assess this possibility; however, the majority of the higher-priced loans made outside of assessment areas were to middle- or higher-income borrowers. In our view, this suggests it is unlikely that the CRA was a motivating factor for such higher-priced lending. Rather, it is likely that higher-priced lending was primarily motivated by its apparent profitability.

It is also possible that the remaining share of higher-priced, lower-income lending may be indirectly attributable to the CRA due to the incentives under the CRA investment test. Specifically, examiners may have given banks "CRA credit" for their *purchases* of lower-income loans or mortgage-backed securities containing loans to lower-income populations, which could subsequently affect the supply of mortgage credit.

Although we lack definitive information on banks' CRA-induced secondary market activity, the HMDA data provide information on the types of institutions to which mortgages are sold. The data suggest that the link between independent mortgage companies and banks through direct secondary market transactions is weak, especially for lower-income loans. (See Table 3.) In 2006, only about 9 percent of independent mortgage company loan sales were to banking institutions. (Figure not shown in table.) And among these transactions, only 15 percent involved higher-priced loans to lower-income borrowers or neighborhoods. In other words, less than 2 percent of the mortgage originations sold by independent mortgage companies in 2006 were higher-priced, CRA-credit-eligible, and purchased by CRA-covered banking institutions.

Analyzing loan performance

To assess the relative performance of CRA-related, higher-priced loans, we use data from First American LoanPerformance (LP) on subprime and alt-A mortgage securitizations to compare delinquency rates for subprime and alt-A loans in lower-income neighborhoods relative to those in middle- and higher-income neighborhoods. The LP data do not provide information on borrower income or the type of originating institution, but do indicate the ZIP Code of the property, which we use to group loans into neighborhood income categories.[5/] The results indicate that the 90-days-or-more delinquency rate as of August 2008 for subprime and alt-A loans originated between January 2006 and April 2008 is high regardless of neighborhood income, with delinquency rates comparable across neighborhood income categories. (See Table 4.)[6/]

In order to gauge more precisely the possible effects of the CRA, we use the LP data again and focus attention on the subset of ZIP Codes that are similar, in principle, except for their relationship to the CRA. Specifically, we focus only on ZIP Codes right above and right below the CRA eligibility threshold. (A neighborhood meets the CRA threshold if it has a median family income equivalent to 80 percent or less of the median family income of the broader area.) As such, the only major difference between these two sets of neighborhoods should be that the CRA focuses on one group and not the other. This analysis indicates that subprime loans in ZIP Codes that are the focus of the CRA (those just below the threshold) have performed virtually the same as loans in the areas right above the threshold.[7/] (See Table 5.)

To gain further insight into the risks of lending to lower-income borrowers or areas, we also compared

the performance of first mortgages originated and held in portfolio under the nationwide affordable lending programs operated by the NeighborWorks® America (NWA) partners to the performance of loans of various types as reported by the Mortgage Bankers Association of America. Many loans originated through NWA programs are done in conjunction with banking institutions subject to the CRA, so the performance of these loans provides another basis to address the relationship between the CRA and the subprime crisis. Along any measure of the severity of loan delinquency or the incidence of foreclosure, the loans originated under the NWA program have performed better than subprime loans.[8/] (See Table 6.) Although the performance of loans in the NWA portfolio provides one benchmark to compare the performance of CRA-related loans with other loans, it is only one portfolio of such loans; further research of this type could provide a stronger base from which to draw conclusions.

Another way to measure the relationship between the CRA and the subprime crisis is to examine foreclosure activity across neighborhoods that are classified by income. Data made available by RealtyTrac on foreclosure filings from January 2006 through August 2008 indicate that most foreclosure filings (e.g., about 70 percent in 2006) have taken place in middle- or higher-income neighborhoods. More important, foreclosure filings have increased at a faster pace in middle- or higher-income areas than in lower-income areas that are the focus of the CRA.[9/] (See Table 7.)

Two basic points emerge from our analysis of the available data. First, only a small portion of subprime mortgage originations is related to the CRA. Second, CRA-related loans appear to perform comparably to other types of subprime loans. Taken together, the available evidence seems to run counter to the contention that the CRA contributed in any substantive way to the current mortgage crisis.

Neil Bhutta and Glenn B. Canner are economists in the Division of Research and Statistics at the Board of Governors of the Federal Reserve System. The views expressed are those of the authors and do not necessarily reflect those of the Board of Governors or members of its staff.

1/ Lower-income households are determined by comparing the income of the household to the median family income of the metropolitan statistical area (MSA) or statewide non-MSA in which the property being purchased or refinanced is located. "Lower" is less than 80 percent of the median, "middle" is 80 to 119 percent, and "higher" is 120 percent or more. Lower-income neighborhoods are determined by comparing the median family income of the census tract where the property being purchased or refinanced is located to the MSA or statewide non-MSA median family income. Income categories for census tract classification have the same numerical thresholds as those applied for households.

2/ The change in the CRA rules in 2005 focused primarily on reducing burden for smaller lenders and expanding the focus of the CRA to include some middle-income census tracts in distressed rural areas. No changes were made that encouraged lenders to relax their underwriting standards.

3/ A higher-priced loan is defined as a loan where the spread between the annual percentage rate on the loan and the rate on Treasury securities of comparable maturity is above designated thresholds. For first-lien loans, the focus of attention in this article, the designated threshold is 3 percentage points. For junior-lien loans, the threshold is 5 percentage points. The definition was adopted as part of Regulation C (the regulation that implements the Home Mortgage Disclosure Act) and was intended to identify loans that fell in the subprime portion of the mortgage market.

4/ About one-fifth of the higher-priced loans extended in the banking institutions' local communities were extended by their affiliates.

5/ We classify ZIP Code-based delinquency data by relative income in two different ways. First, we use information published by the U.S. Census Bureau on income at the ZIP Code Tabulation Area (ZCTA) level of geography. Because the ZCTA data provide an income estimate for each ZIP Code, delinquency rates can be calculated directly from the LP data based on the ZIP Code location of the properties securing the loans (see www.census.gov/geo/ZCTA/zcta.html). Second, we calculate delinquency rates for each relative income group (lower, middle, and higher) as the weighted sum of delinquencies divided by the weighted sum of mortgages, where the weights equal each ZIP Code's share of population in census tracts of the particular relative income group. Relative income is based on the 2000 census and is calculated as the median family income of the census tract divided by the median family income of its MSA or a nonmetropolitan portion of the state. The two approaches yield virtually identical results.

6/ A virtually identical relationship across neighborhood income groups is found if the pool of loans evaluated is expanded to cover those originated between January 2004 and April 2008. The only material difference is that the levels of delinquency are lower for both subprime and alt-A loans for the larger sample of loans. Such a relationship is expected, since loans that are relatively long-lived tend to perform well over time.

7/ See footnote 6.

8/ No information was available on the geographic distribution of the NWA loans. The geographic pattern of lending can matter, as certain areas of the country are experiencing much more difficult housing conditions than other areas. Also, no information was available on the age of the loans, which can have an important effect on performance.

9/ These data are reported at the ZIP Code level. We calculate the statistics by relative income group in Table 7 as before; see footnote 6. Foreclosure filings have been consolidated at the property level, so separate filings on first- and subordinate-lien loans on the same property are counted as a single filing.

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and the Mortgage Crisis

UNITED STATES COMMISSION ON CIVIL RIGHTS

September 2009

U.S. COMMISSION ON CIVIL RIGHTS

The U.S. Commission on Civil Rights is an independent, bipartisan agency established by Congress in 1957. It is directed to:

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- Appraise federal laws and policies with respect to discrimination or denial of equal protection of the laws because of race, color, religion, sex, age, disability, or national origin, or in the administration of justice.
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CIVIL RIGHTS

and the

Mortgage Crisis

UNITED STATES COMMISSION ON CIVIL RIGHTS

September 2009

LETTER OF TRANSMITTAL

The President
The President of the Senate
The Speaker of the House

Sirs and Madam:

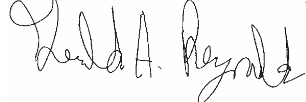
The United States Commission on Civil Rights transmits this report, *An Examination of Civil Rights Issues With Respect to the Mortgage Crisis,* pursuant to Public Law 103-419. The purpose of the report is to examine whether federal efforts to increase homeownership rates among minority and low-income individuals may have unintentionally weakened underwriting standards and lending policies to the point that too many borrowers were vulnerable to financial distress and heightened risk of default, thereby setting conditions for the current mortgage crisis. It also examines the policies of federal agencies in enforcing prohibitions against mortgage fraud and lending discrimination.

To that end, the Commission studied federal policies aimed at increasing low-income and minority homeownership, including the Community Reinvestment Act and the Department of Housing and Urban Development's lending goals for government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, and the critiques regarding the relationship of such policies to the mortgage crisis. As part of its analysis, the Commission also considered the impact of the growth of securitization on lending practices, including the availability of subprime mortgages and other kinds of credit, as well as the manner in which such credit was made available on the secondary market. This analysis involved gathering information from the GSEs and some eleven federal agencies with various levels of regulatory responsibility over the housing market and lending standards.

The Commission also looked at issues of predatory lending, mortgage fraud, and lending discrimination and assessed the efforts of eight federal agencies with responsibility for enforcing the Fair Housing and Equal Credit Opportunity Acts to combat such practices. The result, we hope, will contribute to the growing body of literature for consideration by policy makers as they examine whether existing lending policies require revision, modification, or elimination to avoid a future similar crisis while enhancing the possibility that the American dream of homeownership remains an attainable goal for low and middle-income Americans.

On August 7, 2009, the Commission approved this report. The vote was as follows: Chapters 1-5 and the appendix were approved by Commissioners Reynolds, Thernstrom, Kirsanow and Taylor, with Commissioners Yaki, Melendez, Heriot and Gaziano abstaining. The Commission declined to adopt findings and recommendations to this report with six Commissioners voting against adoption, and with Vice Chair Thernstrom and Commissioner Melendez abstaining. The report includes a joint statement and separate rebuttal statements submitted by Commissioners Melendez and Yaki, a separate statement by Vice Chair Thernstrom, and a joint rebuttal statement by Commissioners Gaziano, Reynolds, Kirsanow, and Taylor.

For the Commissioners,



Gerald A. Reynolds
Chairman

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By far the highest rate of foreclosure is attributable to subprime ARMs. While the rate of foreclosure for such loans declined from 2001 to 2005, it began to rise dramatically thereafter. By 2006, the rate of foreclosure for such loans had risen to 5.6 percent, and had increased to 13.4 percent by 2007. The rate of foreclosure in 2008 was 22.2 percent. By that point, the gap in foreclosure rates between prime ARMs and subprime ARMs, which had been at 2.9 percentage points in 2005, had increased to 16.5 percentage points.

V. Community Reinvestment Act

This section seeks to determine to what extent the requirements of the CRA may have affected residential mortgage lending practices and the existing mortgage crisis.

The mortgage lending data presented in this section are restricted to conventional first liens on home purchase and refinance loans for owner-occupied properties.[26] Conventional mortgage loans exclude those made by the Federal Housing Administration (FHA loans) and those guaranteed by the Veterans Administration (VA loans) and the Rural Housing Service of the U.S. Department of Agriculture (RHS Loan Programs).[27]

In order to analyze the effect of the CRA, this section examines practices of banking institutions and their affiliates and independent mortgage companies. This analysis compares and contrasts Performance with regard to a variety of factors in order to determine to what extent the CRA has played a role over approximately the last decade.

In this regard, section A compares the number and monetary value of (i) prime loans; (ii) subprime loans; and (iii) subprime loans by banking institutions and affiliates within their CRA assessment areas. Section B then examines the decreasing amount of mortgage lending within CRA assessment areas. Section C then examines the distribution of subprime loans from 2004 to 2007 by examining differences between loans made to low- and moderate-income individuals as compared to middle- and upper-income individuals. This section looks not only at loan counts and the monetary value of such loans, but the percent distributed by year and by lender type. Section D undertakes a similar analysis with regard to prime loans.

Sections E and F then analyze the race and types of neighborhoods that receive different types of loans. Section E examines mortgage lending by neighborhood income for the year 2006, while Section F examines mortgage lending by race for the same year.

---

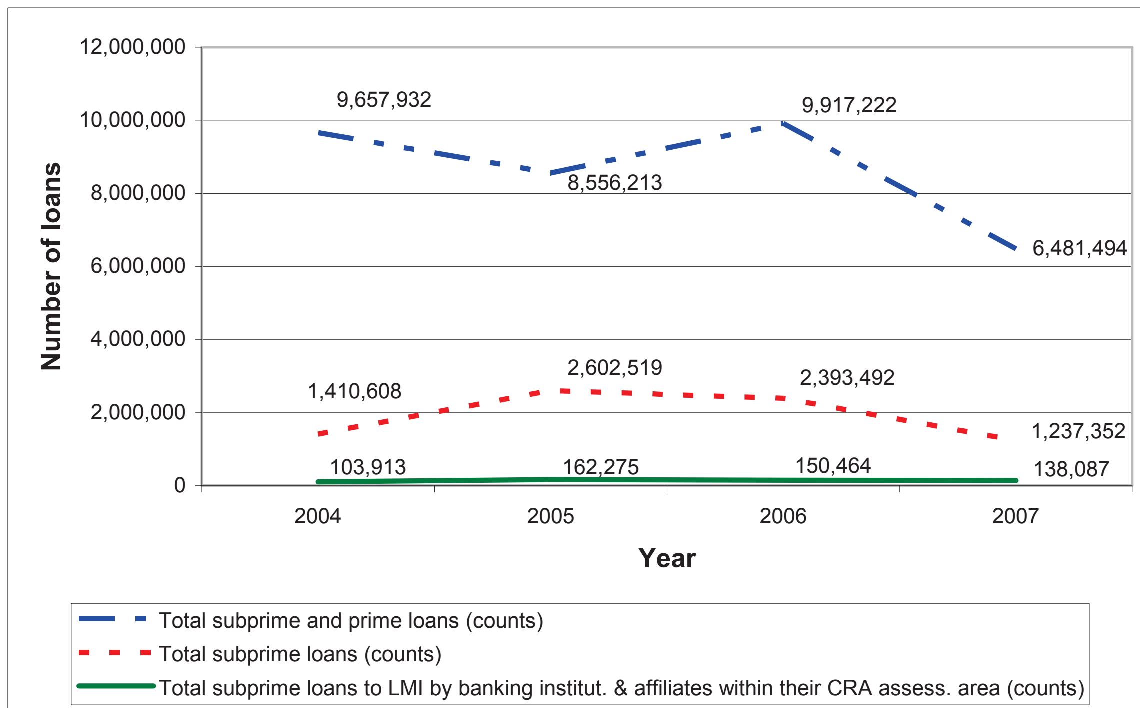
[26] Neighborhood income level in the context of the CRA is defined in relation to a designated geographic area's median family income; "lower income" is defined as less than 50 percent of the area's median family income; "moderate income," from 50 percent to less than 80 percent; "middle income," 80 percent to less than 120 percent; and "upper income," greater than or equal to 120 percent. Lower income neighborhoods include low- and moderate-incomes ones, the focus of the CRA. Non-lower income neighborhoods include middle and higher income ones. *See* The Federal Reserve, Briefing on CRA and Credit Scoring Issues to the U.S. Commission on Civil Rights, January 7, 2009 ("definition" and "the CRA"). Glenn B. Canner, senior advisor, The Federal Reserve, e-mail to Sock-Foon C. MacDougall, social scientist, U.S. Commission on Civil Rights, Apr. 29, 2009.

[27] Mortgage-X Mortgage Information Service, *Types of Mortgage Loans,* <http://mortgage-x.com/library.loans.htm> (last accessed Feb. 24, 2009).

A. Number and Monetary Value of Prime v. Subprime Loans

Figure 3.13 contrasts (i) the number of all loans (subprime and prime) originated, with (ii) all subprime loans originated, and (iii) all subprime loans originated by banking institutions and their affiliates within their CRA assessment areas to low- and moderate-income borrowers/neighborhoods.

Figure 3.13
Subprime (Higher-Priced) and All Home Mortgage Loans (Loan Counts) Originated, 2004–2007



Note: Restricted to conventional first liens on home purchase and refinance loans for owner-occupied properties.

Source: "Statistics on Mortgage Lending from HMDA Data," EXCEL spreadsheet, Glenn B. Canner, senior advisor, The Federal Reserve, to Sock-Foon C. MacDougall, social scientist, U.S. Commission on Civil Rights, Feb. 19, 2009.

Caption: During this period, the number of subprime loans compared to all loans originated was no more than 30.4 percent at its peak in 2005. At the same time, during its peak in 2007 the number of subprime loans made to low and moderate income borrowers/neighborhoods was no more than 11 percent of all such loans originated.

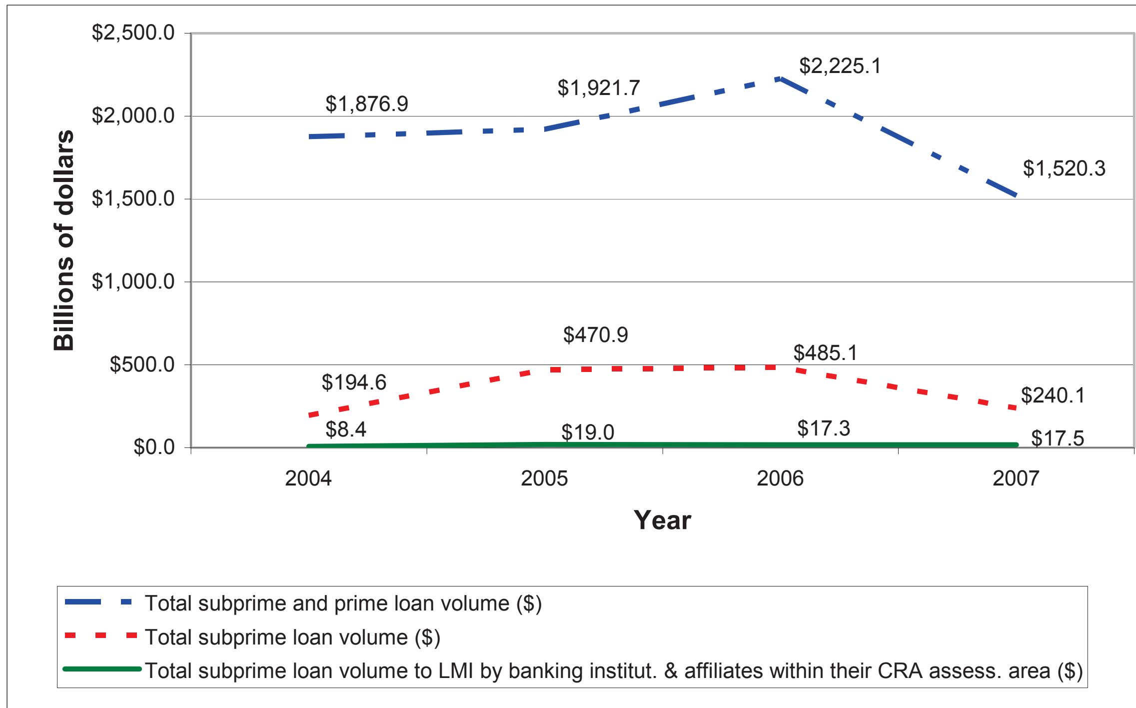
Figure 3.13 shows that, from 2004–2007, the total number of subprime loans made up just 14.6 percent of the total market in 2004, but that the number of such loans rose to 30.4 percent of the total market in 2005 as the market peaked. The share then fell to 24.1 percent in 2006, and by 2007 had decreased to 19.1 percent.[28]

[28] The figure for each year is obtained by calculating the percentage that the total number of subprime loans constituted of the total number of subprime and prime loans originated.

The total number of subprime loans that banking institutions and their affiliates made in their CRA assessment areas to low- and moderate-income borrowers/neighborhoods represented an even smaller fraction of the total number of subprime loans originated. Specifically, such loans constituted a mere 7 percent of all subprime loans in 2004, 6 percent in 2005 and 2006, and 11.0 percent in 2007.[29]

Figure 3.14 presents the same three categories, measured by the monetary value of the loans.

Figure 3.14
Subprime (Higher-Priced) and All Home Mortgage Loans (Billions of Dollars), 2004–2007



Note: Restricted to conventional first liens on home purchase and refinance loans for owner-occupied properties.

Source: "Statistics on Mortgage Lending from HMDA Data," EXCEL spreadsheet, Glenn B. Canner, senior advisor, The Federal Reserve, to Sock-Foon C. MacDougall, social scientist, U.S. Commission on Civil Rights, Feb. 19, 2009.

Caption: During this period, the monetary value of subprime loans compared to all loans originated was no more than 24.5 percent at its peak in 2005. Meanwhile, at its peak in 2007, the monetary value of subprime loans made to low and moderate income borrowers/neighborhoods was no more than 7 percent of all such loans originated.

[29] The figure for each year is obtained by calculating the percentage that the total number of subprime loans banking institutions and their affiliates originated to low- and moderate-income borrowers/neighborhoods within their CRA assessment areas constituted of the total number of subprime loans originated.

HMDA data show that the monetary value of subprime loans constituted 10.4 percent of overall volume in 2004, a percentage that climbed to 24.5 percent in 2005, decreased to 21.8 percent in 2006 and fell to 15.8 percent in 2007.[30]

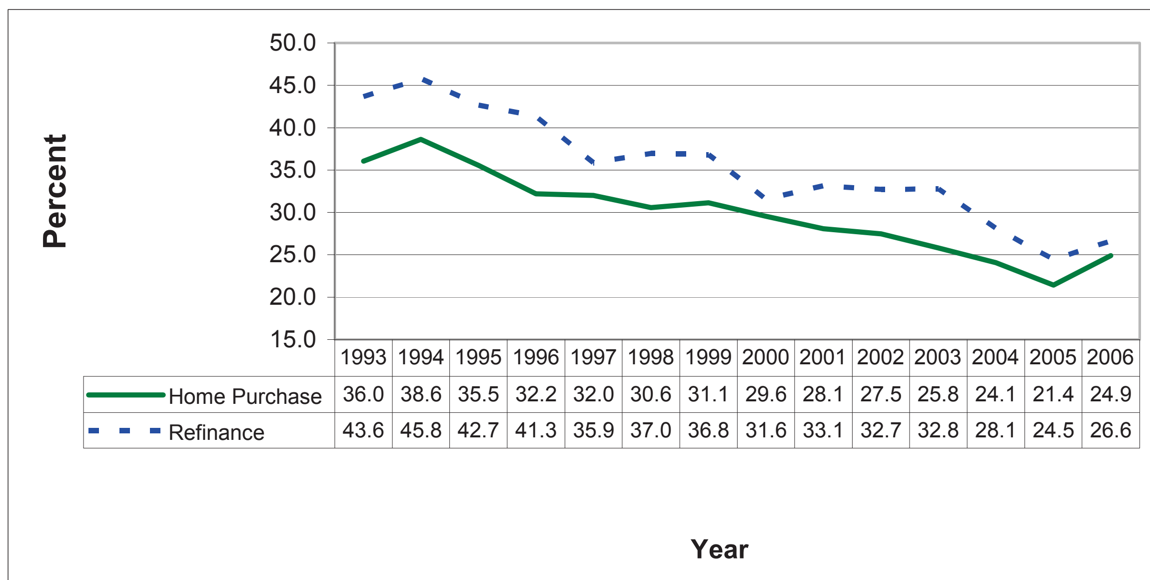
Most notably, the monetary volume of subprime loans made by banking institutions and their affiliates to lower-income borrowers/neighborhoods within their CRA assessment areas comprised a very small segment of all subprime loans originated. Specifically, such loans accounted for only 4 percent of overall volume from 2004 to 2006. By 2007, the figure had risen to only 7 percent.[31]

Based on Figures 3.13 and 3.14, the data indicate that, whether measured by number of loans, or monetary value of loans, subprime loans reached their peak in 2005 and never exceeded more than 30.4 percent of the number of loans or 24.5 percent of the value of loans. In addition, said data reflect that subprime loans made by banking institutions or their affiliates in their CRA assessment areas remained a marginal segment of the overall market.

B. Mortgage Lending Within CRA Assessment Areas 1993-2006

Figure 3.15 documents home purchase and refinance mortgage lending within CRA assessment areas, irrespective of neighborhood income.

Figure 3.15
Mortgage Lending Within CRA Assessment Areas, 1993–2006



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Home Purchase	36.0	38.6	35.5	32.2	32.0	30.6	31.1	29.6	28.1	27.5	25.8	24.1	21.4	24.9
Refinance	43.6	45.8	42.7	41.3	35.9	37.0	36.8	31.6	33.1	32.7	32.8	28.1	24.5	26.6

[30] The figure for each year is obtained by calculating the percentage that the total volume subprime loans constituted of the total volume of subprime and prime loans originated.

[31] The figure for each year is obtained by calculating the percentage that the total volume of subprime loans banking institutions and their affiliates originated to low- and moderate-income borrowers/neighborhoods within their CRA assessment areas constituted of the total volume of subprime loans originated.

Note: The Figure shows the percentage of mortgage loans originated by deposit-taking organizations within their assessment areas. This graph was presented by Ren S. Essene and William C. Apgar, "The 30th Anniversary of the CRA: Restructuring the CRA to Address the Mortgage Finance Revolution in *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act,* A Joint Publication of the Federal Reserve Banks of Boston and San Francisco, February 2009, p. 22, exhibit 1: Assessment Area Lending Has Fallen Steadily. The source of the raw data for the graph is the JCHS enhanced HMDA database.

Source: Ren Essene, policy analyst, Federal Reserve Bank of Boston, PowerPoint file "Exhibit 1: Assessment Area Lending has Fallen" to Sock-Foon C. MacDougall, social scientist, U.S. Commission on Civil Rights, Mar. 25, 2009, 11.01 p.m.

Caption: Within CRA assessment areas, home mortgage lending and home refinancing particularly had been decreasing steadily from 1993 to 2006.

As reflected in Figure 3.15, mortgage lending within CRA assessment areas has decreased steadily over time. From 1993 to 2006, home purchase mortgage lending in CRA assessment areas, as a percent of all home purchase loans, decreased from 36.0 percent to 24.9 percent, a drop of 11.1 percentage points.[32]

In the same period, mortgage lending in CRA assessment areas for home refinancing decreased at a higher rate, falling from 43.6 percent to 26.6 percent, a drop of 17.0 percentage points. This decrease, at a time when overall mortgage lending was increasing, indicates that persons in lower-income neighborhoods were increasingly using banking institutions and their affiliates outside the CRA areas, as well as to independent mortgage companies.[33]

C. Distribution of Subprime Loans 2004-2007

Subprime loans traditionally have been made to those of low or moderate incomes. People of lower income often have lower levels of creditworthiness and, thus, are charged higher rates of interest on loans. The next set of Figures examines how such loans were distributed between low- and moderate-income borrowers/neighborhoods and middle- and upper-income borrowers/neighborhoods, for the period 2004-2007. Noticeably, as housing prices increased, even those with higher levels of income began obtaining subprime loans.

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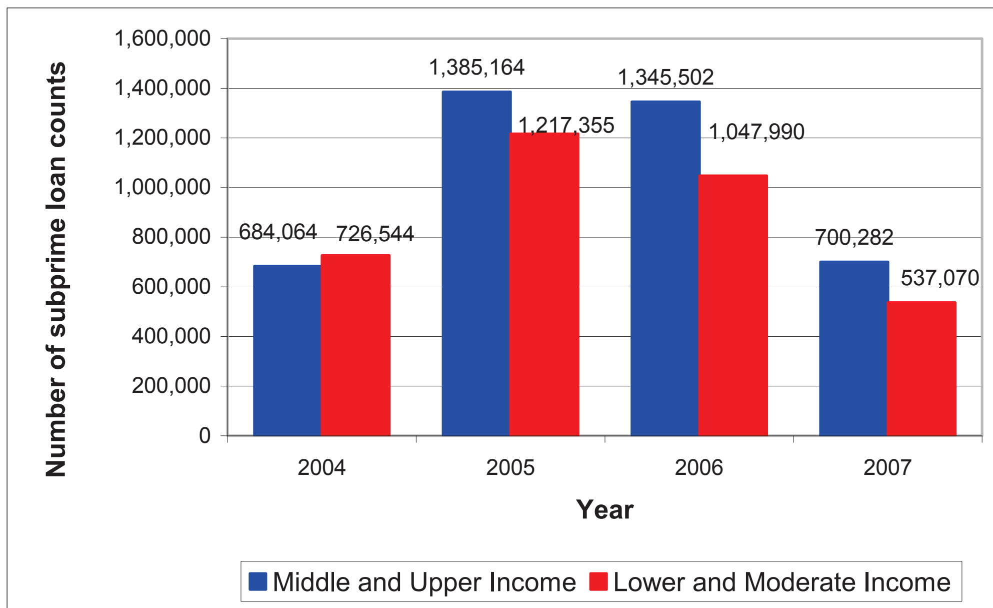
[32] *See* Ren S. Essene and William C. Apgar, "The 30th Anniversary of the CRA: Restructuring the CRA to Address the Mortgage Finance Revolution," *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act*, A Joint Publication of the Federal Reserve Banks of Boston and San Francisco, February 2009, p. 22. *See also* KEVIN PARK, "SUBPRIME LENDING AND THE COMMUNITY REINVESTMENT ACT," JOINT CTR. FOR HOUSING STUDIES OF HARV. U.

[33] One possible explanation for this phenomenon was as follows:

> I don't want to say it's in the cultural DNA, but a lot of us who are older than 30 have some memory of disappointment or humiliation related to banks," Mr. Grannum said. "The white guy in the suit with the same income gets a loan and you don't?" "So you turn to local brokers, even if they don't offer the best rates." This may help explain an unusual phenomenon: Upper-income black borrowers in the region are more likely to hold subprime mortgages than even blacks with lower incomes, who often benefit from homeownership classes and lending assistance offered by government and nonprofits.

Michael Powell and Janet Roberts, *Minorities Affected Most as New York Foreclosures Rise*, N.Y. TIMES, May 16, 2009, at A1.

Figure 3.16
Distribution of Subprime (Higher-Priced) Mortgage Loans (Loan Counts) by Income of Borrowers and/or Neighborhood, 2004–2007



Note: Restricted to conventional first liens on home purchase and refinance loans for owner-occupied properties.

Source: "Statistics on Mortgage Lending from HMDA Data," EXCEL spreadsheet, Glenn B. Canner, senior advisor, The Federal Reserve, to Sock-Foon C. MacDougall, social scientist, U.S. Commission on Civil Rights, Feb. 19, 2009.

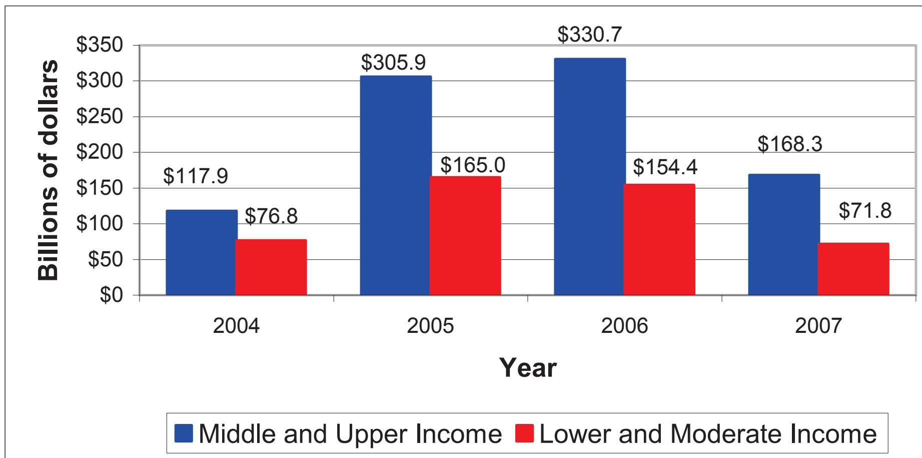
Caption: For three of the four years of this period, a smaller number of subprime loans were originated to low- and moderate-income borrowers/neighborhoods than to middle- and upper-income ones, with most being made in 2005.

Figure 3.16 shows that, except in 2004, the number of subprime loans made to low- and moderate-income borrowers/neighborhoods by financial institutions was smaller than that to middle- and upper-income ones. The number of such loans to low and moderate borrowers was among the highest in 2005 and 2006 and evidenced considerable variation over time. Rising from about 726,000 in 2004, such loans peaked at 1.2 million in 2005, an increase of 67.6 percent. In 2006, the number of such loans decreased somewhat, by 13.9 percentage points, but remained above a million. By 2007, they had fallen precipitously, bottoming out at about 537,000, a decrease of 48.8 percentage points over the previous year.

For every year, other than 2004, the number of middle- and upper-income subprime loans exceeded those for low- and moderate-income groups.

Figure 3.17 shows the distribution of subprime loans broken down by volume.

Figure 3.17
Distribution of Subprime (Higher-Priced) Mortgage Loan Volume (Billions of Dollars) by Income of Borrowers and/or Neighborhood Income, 2004–2007



Note: Restricted to conventional first liens on home purchase and refinance loans for owner-occupied properties.

Source: The Reserve Board, "Statistics on Mortgage Lending from HMDA Data," EXCEL spreadsheet, Glenn B. Canner, senior advisor, to Sock-Foon C. MacDougall, social scientist, U.S. Commission on Civil Rights, Feb. 19, 2009.

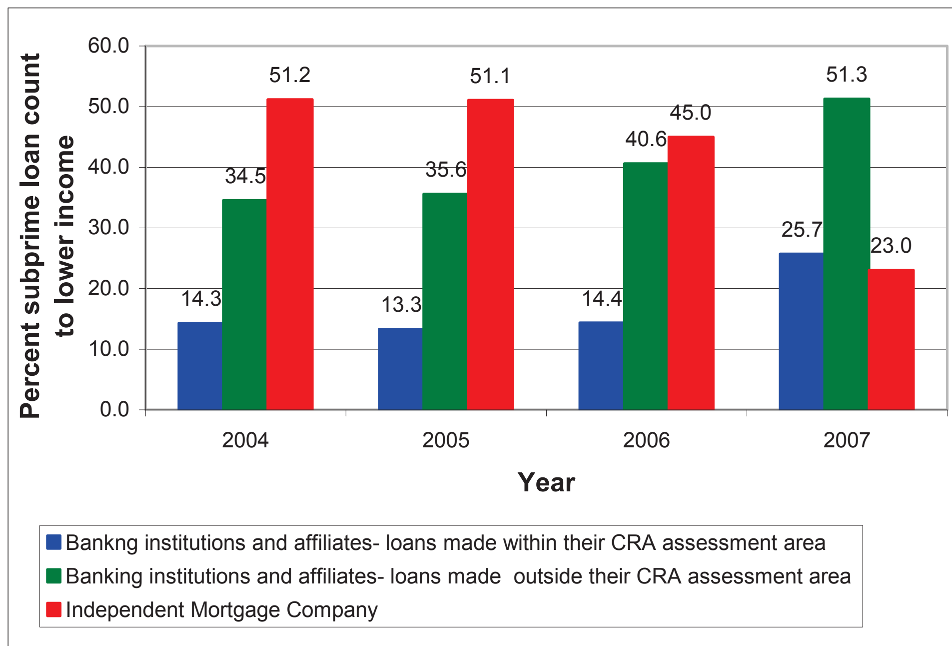
Caption: The monetary value of subprime loans to low- and moderate-income borrowers/neighborhoods is consistently lower than that to middle- and upper-ones and evidenced decline. Meanwhile, the overall monetary value of subprime loans had grown substantially since 2004, noticeably in 2005 and 2006.

Figure 3.17 reflects that, during this period, the monetary volume of subprime loans to middle- and upper-income borrowers/neighborhoods consistently exceeded those made to lower- and moderate-income groups. Indeed, during the critical years of 2005, 2006, and 2007, subprime loans to lower- and moderate-income borrowers/neighborhoods were often less than half the dollar value of subprime loans made to middle- and upper-income borrowers/neighborhoods.

In addition, Figure 3.17 reflects the growth of subprime loans generally over this period. For example, the total value of subprime loans reflected in Figure 3.17 for 2004 was 194.7 billion. By 2005 that figure had risen to 470.9 billion, and by 2006 the figure had reached 485.1 billion.

The next set of Figures seeks to examine to what extent subprime loans were made within CRA assessment areas. For that purpose, Figure 3.18 presents the number of subprime loans originated by different lender types, including independent mortgage companies.

Figure 3.18
Percent Distribution of Subprime (Higher-Priced) Mortgage Loans (Loan Counts) to Lower-Income of Borrowers and/or Neighborhoods by Lender Type, 2004–2007



Note: Restricted to conventional first liens on home purchase and refinance loans for owner-occupied properties.

Source: "Statistics on Mortgage Lending from HMDA Data," EXCEL spreadsheet, Glenn B. Canner, senior advisor, The Federal Reserve, to Sock-Foon C. MacDougall, social scientist, U.S. Commission on Civil Rights, Feb. 19, 2009.

Caption: Independent mortgage companies dominated the market for subprime loans to low and moderate borrowers/neighborhoods from 2004 through 2006. Banking institutions and their affiliates made the smallest percentage of subprime loans within their assessment areas but growth of such loans outside these areas was discernable, particularly in 2006 and 2007.

As reflected above, independent mortgage companies made the highest percentage of such loans for three of the four years, with their market share falling precipitously in 2007.[34] In the first two years, they consistently claimed a majority of subprime loans. By 2006, however, that share had decreased to 45 percent and, by 2007, their market share fell further to 23.0 percent.

Of the subprime loans made by banking institutions and their affiliates, the smallest percentages were originated within an institution's CRA assessment area. From 2004 to 2006, for example, the figures were consistently low, 14.3, 13.3, and 14.4 percent, respectively. Only in 2007 did this share in the market increase rising to 25.7 percent.

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[34] The rather dramatic increase and decrease in market shares in 2007 on the part of the banking institutions and their affiliates and the independent mortgages, respectively, might be explained by a reduction in the number of lenders. In 2007, 169 lenders that reported data for 2006 ceased operations and did not report in 2007. With the exception of two lenders, all were independent mortgage companies. The Federal Reserve, Briefing on the 2007 HMDA Data to the U.S. Commission on Civil Rights, Jan. 28, 2009.

At the same time, progressively higher percentages were originated outside CRA assessment areas. Such loans initially increased modestly, rising from 34.5 percent in 2004 to 35.6 percent in 2005. They then increased to 40.6 in 2006, and finally to 51.3 percent in 2007. Between 2004 and 2007, there was an increase of 16.8 percentage points.

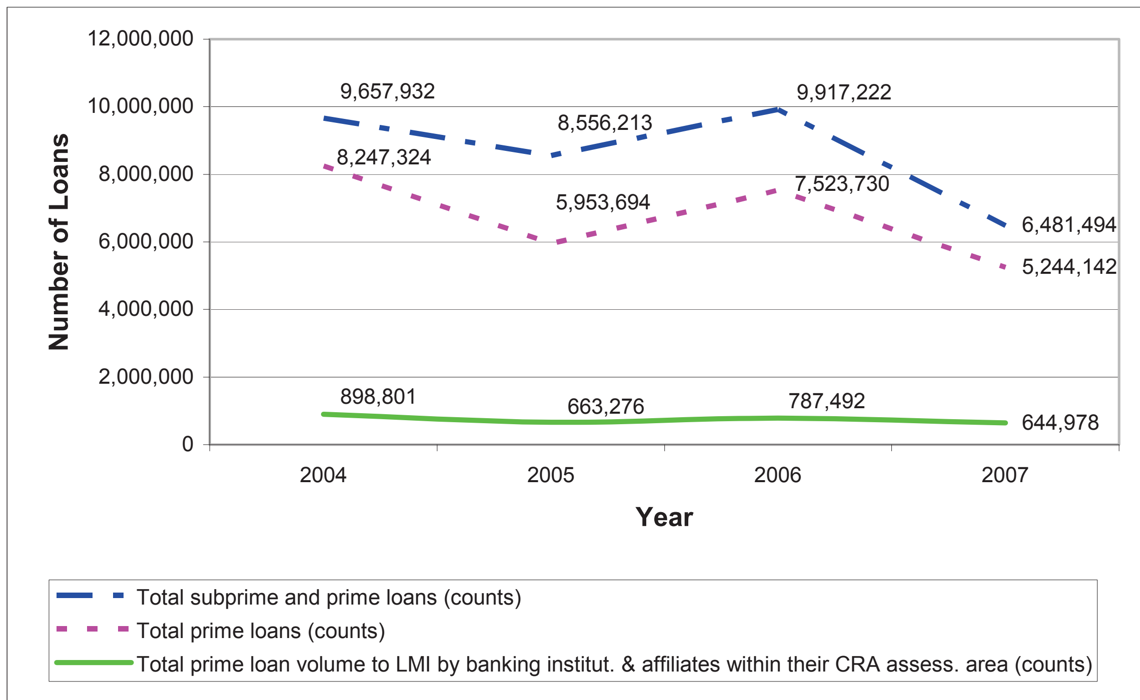
Based on Figures 3.16-3.18, two major points can be discerned. First, during the time period in question, middle- and upper-income borrowers/neighborhoods were the largest consumers of subprime loans. This is so whether measured by number of loans or monetary volume. Second, as reflected in Figure 3.18, the largest percent of subprime loans, by a substantial margin, was made by either independent mortgage companies or banking institutions outside their CRA assessment areas.

Both of these findings call into question not only the argument that the CRA played a major role in the current mortgage crisis, but also the CRA's continued relevance as a means to ensure sound lending to low- and moderate-income borrowers/neighborhoods.

D. Distribution of Prime Loans 2004-2007

The focus of the next examination is on the extent of prime loans originated within CRA assessment areas. To that end, Figure 3.19 examines the number of such loans, while Figure 3.20 examines their monetary value.

Figure 3.19
Distribution of Prime (Lower-Priced) and All Home Mortgage Loans (Loan Counts) Originated, 2004–2007



Note: Restricted to conventional first liens on home purchase and refinance loans for owner-occupied properties.

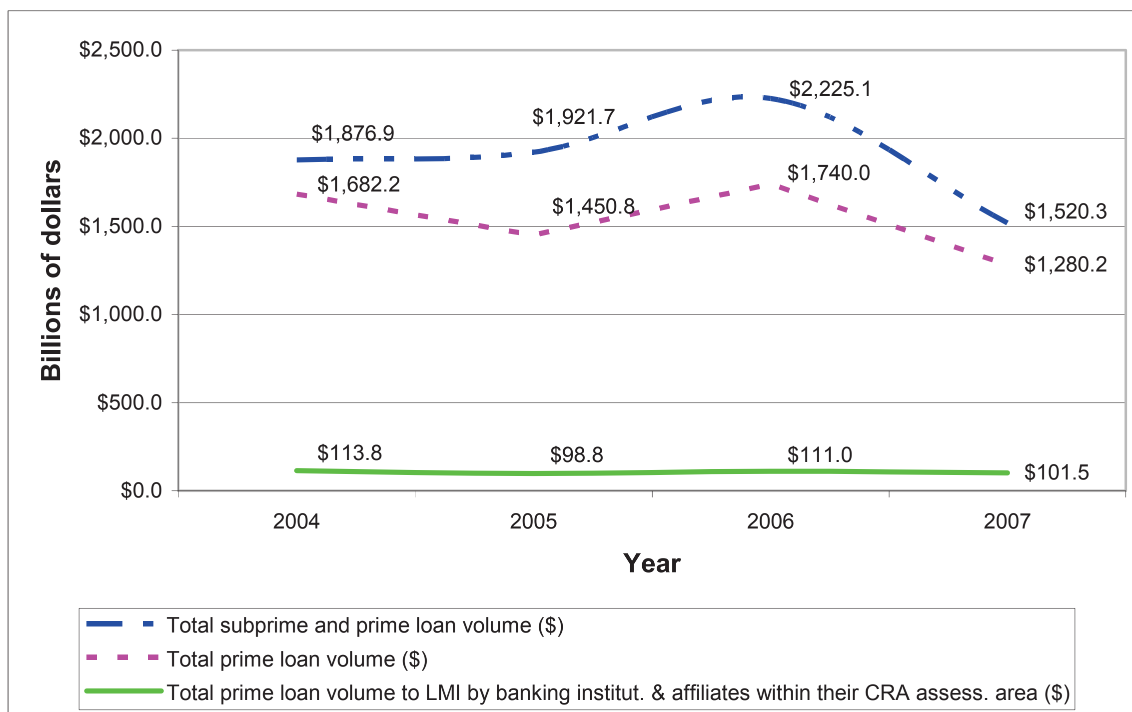
Source: "Statistics on Mortgage Lending from HMDA Data," EXCEL spreadsheet, Glenn B. Canner, The Federal Reserve, senior advisor, to Sock-Foon C. MacDougall, social scientist, U.S. Commission on Civil Rights, Feb. 19, 2009.

Caption: During this period, prime loans constituted a substantial percentage of all loans originated, no less than 69.6 percent in 2005. In contrast, at its peak in 2007 prime loans to low- and moderate-income borrowers/neighborhoods comprised no more than 12 percent of all prime loans originated.

As reflected in Figure 3.19, the total number of prime loans constituted a substantial proportion of all loans originated (prime and subprime), particularly in 2004 and 2007. In percentage terms, prime loans constituted 85.4 percent of the total in 2004, 69.6 percent in 2005, 75.9 percent in 2006, and 80.9 percent in 2007.[35]

At the same time, the number of prime loans that banking institutions and their affiliates originated to low- and moderate-income borrowers/neighborhoods within their CRA assessment areas was consistently a very small portion of all prime loans originated. In percentage terms, such loans represented only 11 percent of the total in 2004 and 2005, 10 percent in 2006, and 12 percent in 2007.[36]

Figure 3.20
Distribution of Prime (Lower-Priced) and All Home Mortgage Loans (Billions of Dollars), 2004–2007



Note: Restricted to conventional first liens on home purchase and refinance loans for owner-occupied properties.

Source: “Statistics on Mortgage Lending from HMDA Data,” EXCEL spreadsheet, Glenn B. Canner, senior advisor, The Federal Reserve, to Sock-Foon C. MacDougall, social scientist, U.S. Commission on Civil Rights, Feb. 19, 2009.

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[35] The figure for each year is obtained by calculating the percentage that the total number of prime loans constituted of the total number of subprime and prime loans originated.

[36] The figure for each year is obtained by calculating the percentage that the total number of prime loans banking institutions and their affiliates originated to low- and moderate-income borrowers/neighborhoods within their CRA assessment areas constituted of the total number of prime loans originated.

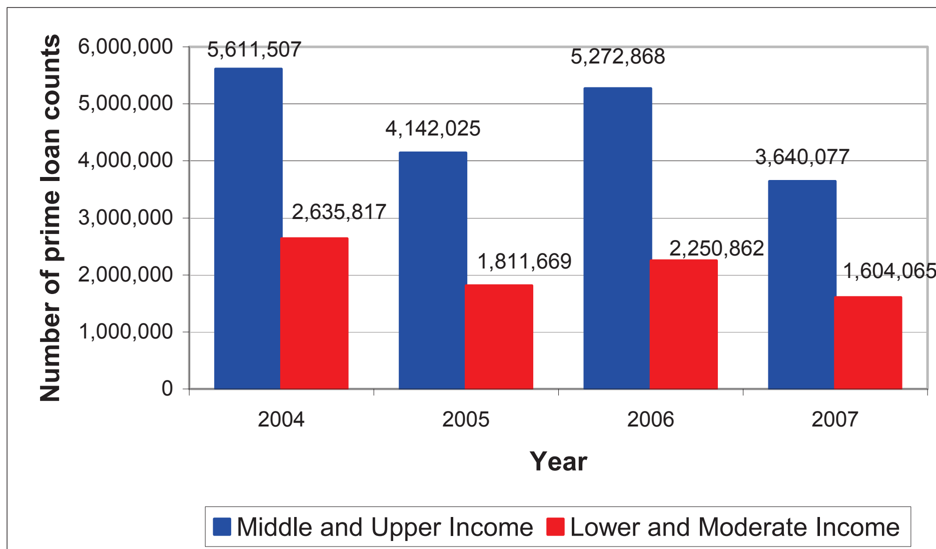
Caption: During this period, the monetary value of prime loans constituted a substantial percentage of all loans originated, no less than 75.5 percent in 2005. In contrast, the monetary value of prime loans to low- and moderate-income borrowers/neighborhoods constituted a significantly lower percentage of all prime loans originated, no more than 8 percent in 2007.

Figure 3.20 presents similar results by examining the monetary value of such loans. HMDA data show that, during the period in question, the volume of prime loans made up a substantial portion of the total of all loans (subprime and prime) originated, particularly in 2004 and 2007. From a high of 89.6 percent in 2004, the monetary share of prime loans bottomed out in 2005 to 75.5 percent, but rose to 78.2 percent in 2006 and climbed to 84.2 percent in 2007.[37]

Most notably, the volume of prime loans that banking institutions and their affiliates originated to low- and moderate-income borrowers/neighborhoods within their CRA assessment areas is consistently a very small portion of all prime loan volume originated, a finding similar to that relating to prime loan counts. Such loans represented only 7 percent of the total in 2004 and 2005, 6 percent in 2006, and 8 percent in 2007.[38]

The next set of Figures examines the distribution of prime mortgages between middle- and upper-income and low- and moderate-income borrowers/neighborhoods. The evidence indicates that middle- and upper-income individuals were the primary recipients of prime mortgage loans.

Figure 3.21
Distribution of Prime Mortgage Loans (Loan Counts) by Income of Borrowers and/or Neighborhood, 2004–2007



Note: Restricted to conventional first liens on home purchase and refinance loans for owner-occupied properties.

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[37] The figure for each year is obtained by calculating the percentage that the total volume prime loans constituted of the total volume of subprime and prime loans originated.

[38] The figure for each year is obtained by calculating the percentage that the total volume of prime loans banking institutions and their affiliates originated to low- and moderate-income borrowers/neighborhoods within their CRA assessment areas constituted of the total volume of prime loans originated.

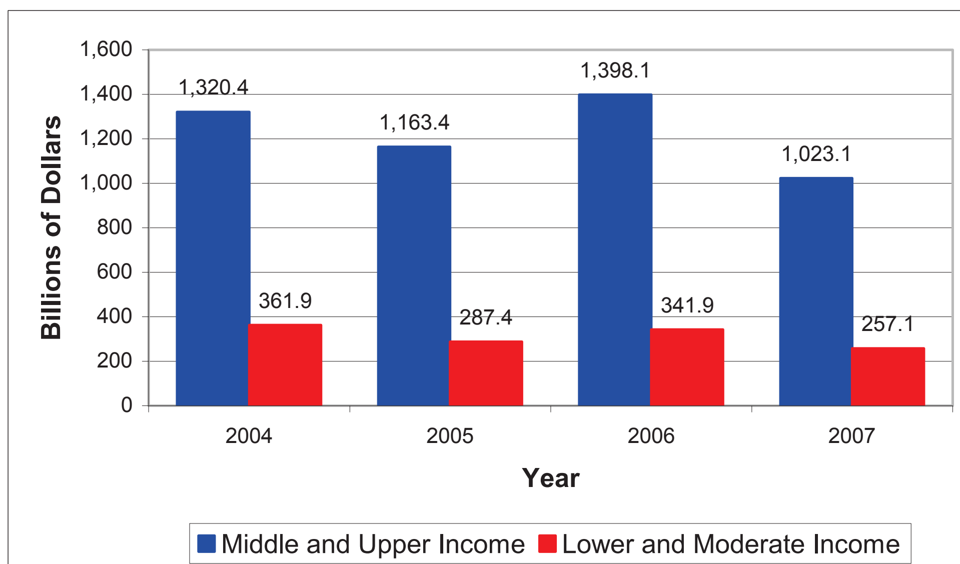
Source: "Statistics on Mortgage Lending from HMDA Data," EXCEL spreadsheet, Glenn B. Canner, The Federal Reserve, senior advisor, to Sock-Foon C. MacDougall, social scientist, U.S. Commission on Civil Rights, Feb. 19, 2009, 1:33 pm.

Caption: During this period, more than twice the number of prime loans was made to middle- and upper-income borrowers/neighborhoods than to low and moderate ones.

As reflected in Figure 3.21, financial institutions consistently originated a higher number of prime loans to middle- and upper-income borrowers. During each of the four years examined, the number of prime mortgage loans made to middle- and upper-income borrowers/neighborhoods was more than twice that to low- and moderate-income borrowers/neighborhoods.

Figure 3.22 examines similar information with regard to the volume of such loans. While Figure 3.21 indicated that middle- and upper-income borrowers/neighborhoods received the largest number of prime loans, Figure 3.22 reflects that the monetary value of such loans is even greater, with the monetary value of loans to middle- and upper-income borrowers/neighborhoods often exceeding three times the value of such loans to low- and moderate-income borrowers/neighborhoods.

Figure 3.22
Prime Mortgage Loan Volume (Billions of Dollars) by Income of Borrowers and/or Neighborhood Income, 2004–2007



Note: Restricted to conventional first liens on home purchase and refinance loans for owner-occupied properties.

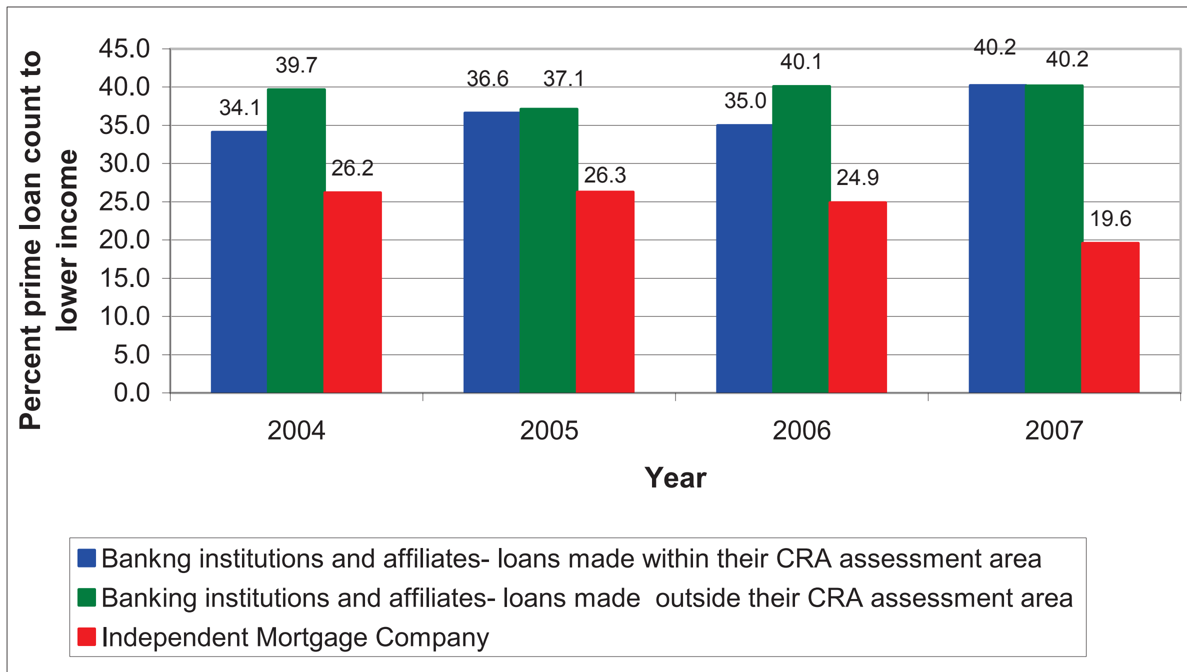
Source: "Statistics on Mortgage Lending from HMDA Data," EXCEL spreadsheet, Glenn B. Canner, senior advisor, The Federal Reserve, to Sock-Foon C. MacDougall, social scientist, U.S. Commission on Civil Rights, Feb. 19, 2009.

Caption: For this period, the monetary value of prime loans to middle and upper income borrowers/neighborhood exceeds that to low and moderate ones by more than three times.

In sum, as was the case with subprime lending, CRA-related prime loans made up only a minor part of the market, and the largest number and value of prime loans went to middle- and upper-income borrowers/neighborhoods.

The next series of Figures examines the extent to which prime loans made to low- and moderate-income borrowers/neighborhoods occur within CRA assessment areas. As reflected in Figure 3.23, and in this case unlike the situation with subprime loans,[39] the percentage of prime loans made within a CRA assessment area is very similar to those made outside the CRA assessment area.

Figure 3.23
Percent Distribution of Prime (Lower-Priced) Mortgage Loans (Loan Counts) to Low- and Moderate-Income Borrowers and/or Neighborhoods by Lender Type, 2004–2007



Note: Restricted to conventional first liens on home purchase and refinance loans for owner-occupied properties.

Source: "Statistics on Mortgage Lending from HMDA Data," EXCEL spreadsheet, Glenn B. Canner, senior advisor, The Federal Reserve, to Sock-Foon C. MacDougall, social scientist, U.S. Commission on Civil Rights, Feb. 19, 2009.

Caption: Banking institutions and their affiliates made similar percentages of prime loans within and outside their CRA assessment areas while independent mortgage companies made the least, no more than 26.3 percent.

In the case of prime loans, the percentages originated to low- and moderate-income borrowers/neighborhoods within and outside the CRA assessment areas were generally similar. Loans made within CRA assessment areas ranged from 34.1 to 40.2 percent of the total, while loans made outside the areas ranges from 37.1 to 40.2 percent. In contrast, the independent mortgage companies, which focused primarily on subprime lending, originated the lowest percentages of prime loans, which decreased steadily over time from 26.2 percent in 2004 to 19.6 percent in 2007.

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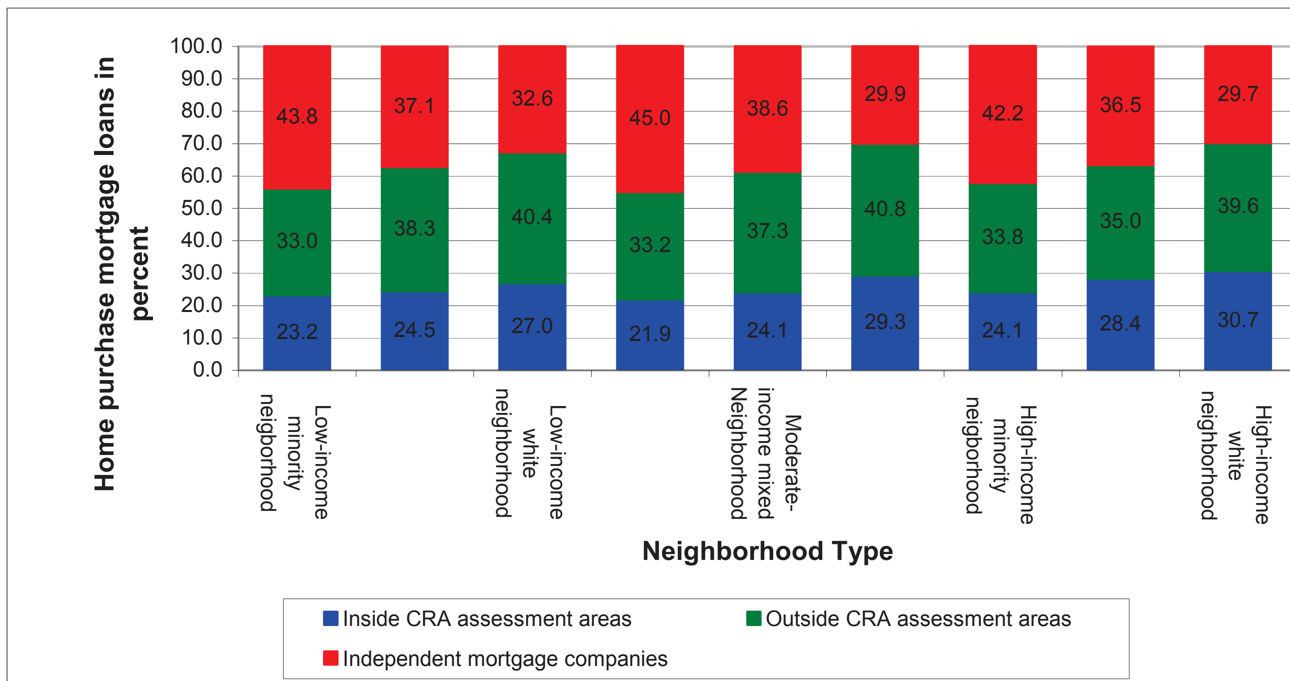
39 *See* Figure 3.18.

E. Mortgage Lending by Neighborhood Income, 2006

Figures 3.24 to 3.25 take a snapshot of mortgage lending in neighborhoods with different mixes of racial/ethnic populations and income levels for the year 2006. Figure 3.24 reviews home purchase lending.

Figure 3.24
Home Purchase Mortgage Loans by Type of Neighborhood Income, 2006



Note: First-lien loans for owner occupied properties only. The small share of loans originated by credit unions is included in "outside assessment area" totals.

Source: Ren S. Essene and William C. Apgar, “The 30th Anniversary of the CRA: Restructuring the CRA to Address the Mortgage Finance Revolution,” *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act*, A Joint Publication of the Federal Reserve Banks of Boston and San Francisco, February 2009, p. 23 exhibit 2: Assessment Area Lending Lags in Low-income and Minority Areas. The source of the raw data for Exhibit 2 is the JCHS enhanced HMDA database, 2006.

Caption: In 2006, banking institutions and their affiliates were less likely to make home purchase mortgage loans within CRA assessment areas irrespective of the racial/ethnic composition and income level of the neighborhoods. Independent mortgage companies were more likely to make the highest percentage of home purchase mortgage loans in minority neighborhoods regardless of income level.

As reflected in Figure 3.24, in 2006, irrespective of the racial composition and income level of neighborhoods, banking institutions and their affiliates were still less likely to make home purchase loans within their CRA assessment areas than outside them. For example, of the total number of loans made in low-income minority neighborhoods, banking institutions and their affiliates originated 23.2 percent within their assessment areas compared to 33.0 percent outside of them. Among the loans made in moderate-income White neighborhoods, banking institutions and their affiliates originated 29.3 percent within their CRA assessment areas compared to 40.8 percent outside of them. Across the nine types of racial/ethnic income neighborhoods, the proportions of home purchase loans within CRA

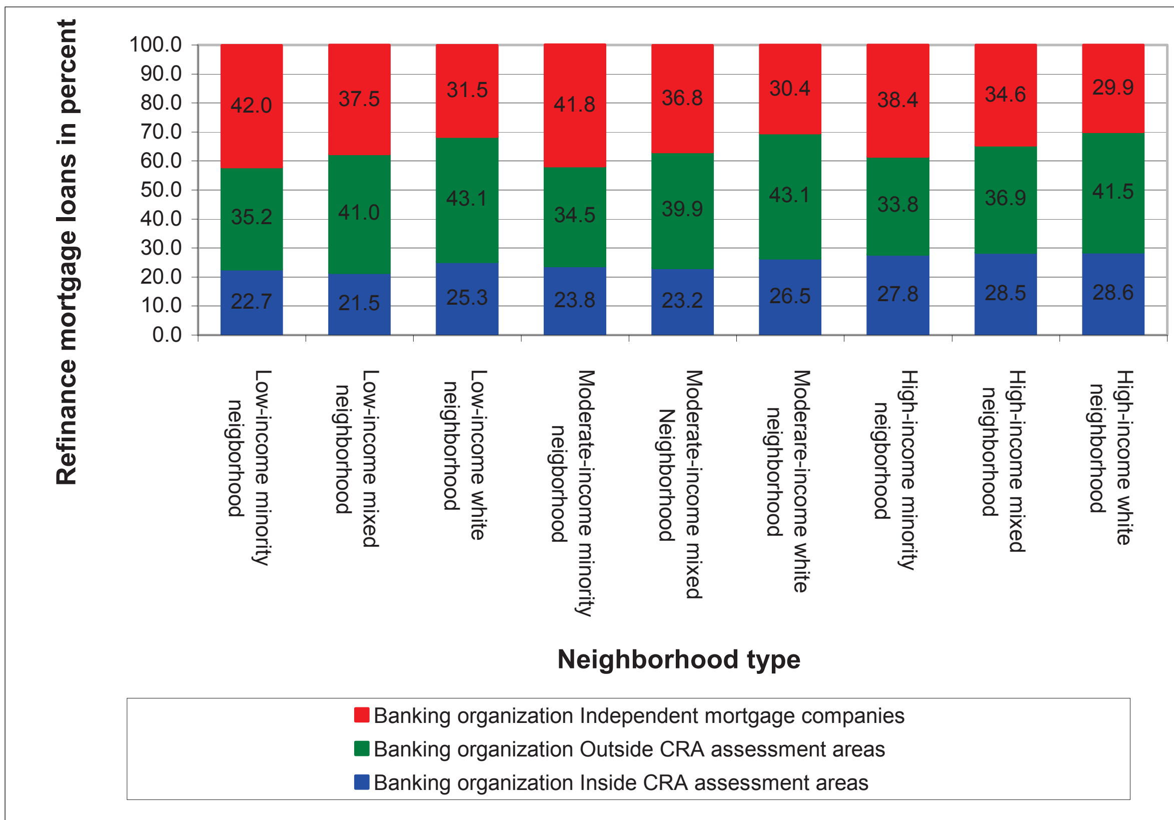
assessment areas were narrowly bounded, between 21.9 and 30.7 percent, a range of just 8.8 percentage points.

Of greatest significance, the percentages of home purchase loans originated by banking institutions and their affiliates within their CRA assessment areas to minority neighborhoods were the lowest compared to other types of racial/ethnic neighborhoods irrespective of income level. For example, in low-income neighborhoods, the percentage of loans to minorities was 23.2 percent compared to 24.5 percent and 27.0 percent to mixed neighborhoods and White neighborhoods, respectively. In moderate-income neighborhoods, the comparable figures were 21.9 percent in minority neighborhoods matched against 24.1 percent and 29.3 percent in mixed and White neighborhoods respectively. Similarly, in high income neighborhoods, the percentage of loans to minority neighborhoods was 24.1 percent compared to 28.4 percent and 30.7 in mixed and White neighborhoods, respectively.

Tellingly, independent mortgage companies are most likely to make the highest percentage of house purchase loans in minority neighborhoods, regardless of income level.

Figure 3.25 reviews similar information with regard to refinance mortgage lending. Again, the figures only relate to a single year, 2006.

Figure 3.25
Refinance Mortgage Loans by Type of Neighborhood Income, 2006



Note: First-lien loans for owner occupied properties only. The small share of loans originated by credit unions is included in "outside assessment area" totals.

Source: Ren S. Essene and William C. Apgar, “The 30th Anniversary of the CRA: Restructuring the CRA to Address the Mortgage Finance Revolution, Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act, A Joint Publication of the Federal Reserve Banks of Boston and San Francisco, February 2009, p. 23 exhibit 2: Assessment Area Lending Lags in Low-income and Minority Areas. The source of the raw data for Exhibit 2 is the JCHS enhanced HMDA database, 2006.

Caption: In 2006, banking institutions and their affiliates were less likely to make refinance mortgage loans within CRA assessment areas regardless of the racial/ethnic composition and income level of the neighborhoods. Independent mortgage companies were most likely to make the highest percentages of refinance mortgage loans to minority neighborhoods irrespective of income level.

As was the case of home purchase loans, irrespective of the racial composition and income levels of neighborhoods, banking institutions and their affiliates were less likely to originate refinance loans within their CRA assessment areas than outside them. However, unlike with home purchase loans, the percentages of refinance loans banking institutions and their affiliates made within their assessment areas was lowest for minority neighborhoods only in high income areas, 27.8 percent. In low- and moderate-income areas, it was racially mixed neighborhoods that received the lowest share, 21.5 percent and 23.2 percent, respectively.

Across the nine types of racial/ethnic income neighborhoods, the proportions of refinance purchase loans within CRA assessment areas are clustered closely together, between 21.5 and 28.6 percent, a range of only 7.1 percentage points.

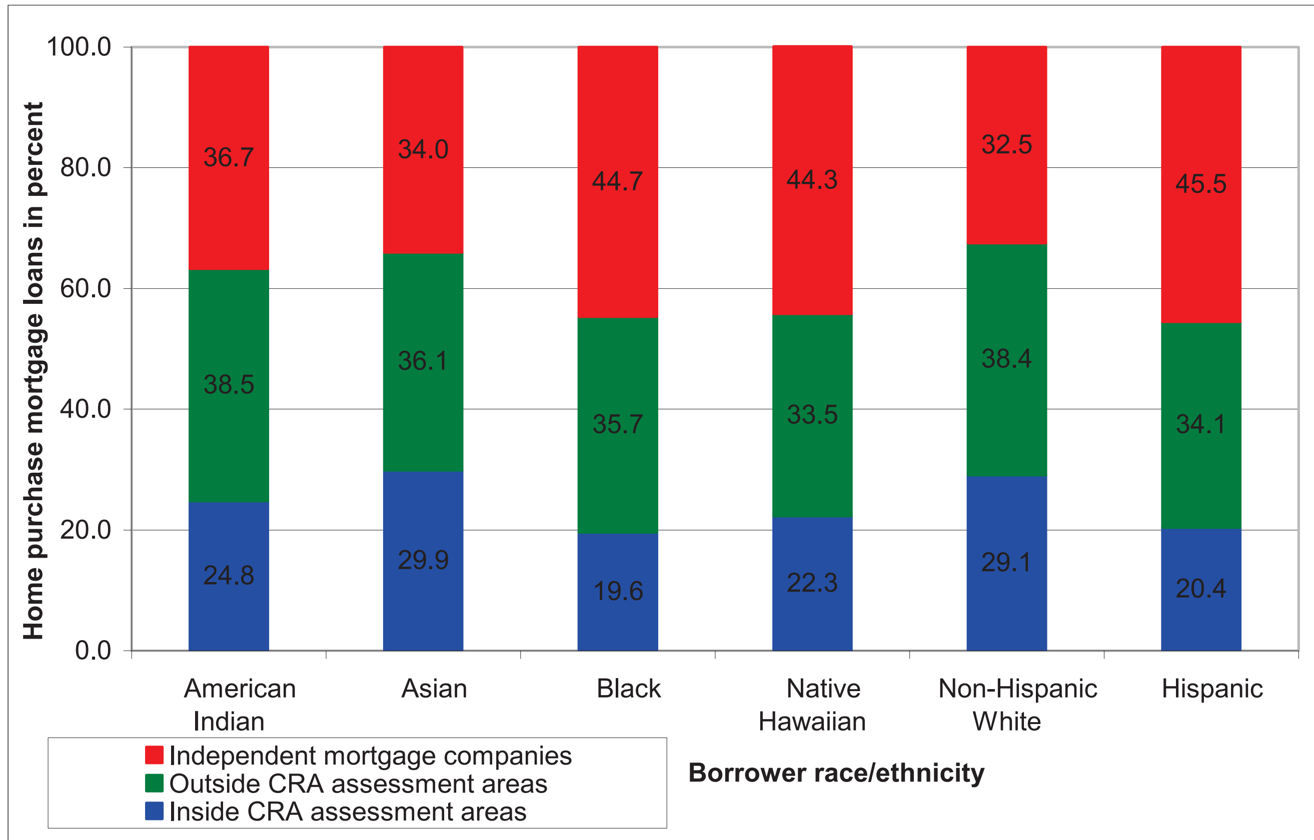
Again independent mortgage companies continued to be most likely to make the highest percentage of refinance loans in minority neighborhoods, regardless of income.

F. Mortgage Lending By Race

Figures 3.26 to 3.27 shift the focus to borrower race and ethnicity in examining home purchase and refinance lending. This analysis is particularly informative in determining the degree to which CRA loans are ultimately obtained by various racial and/or ethnic groups.

Figure 3.26 documents home purchase lending practices for the year 2006.

Figure 3.26
Home Purchase Loans by Race, 2006



Note: First-lien loans for owner occupied properties only. The small share of loans originated by credit unions is included in "outside assessment area" totals.

Source: Ren S. Essene and William C. Apgar, "The 30th Anniversary of the CRA: Restructuring the CRA to Address the Mortgage Finance Revolution, *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act*, A Joint Publication of the Federal Reserve Banks of Boston and San Francisco, February 2009, p. 23 exhibit 2: Assessment Area Lending Lags in Low-income and Minority Areas. The source of the raw data for Exhibit 2 is the JCHS enhanced HMDA database, 2006.

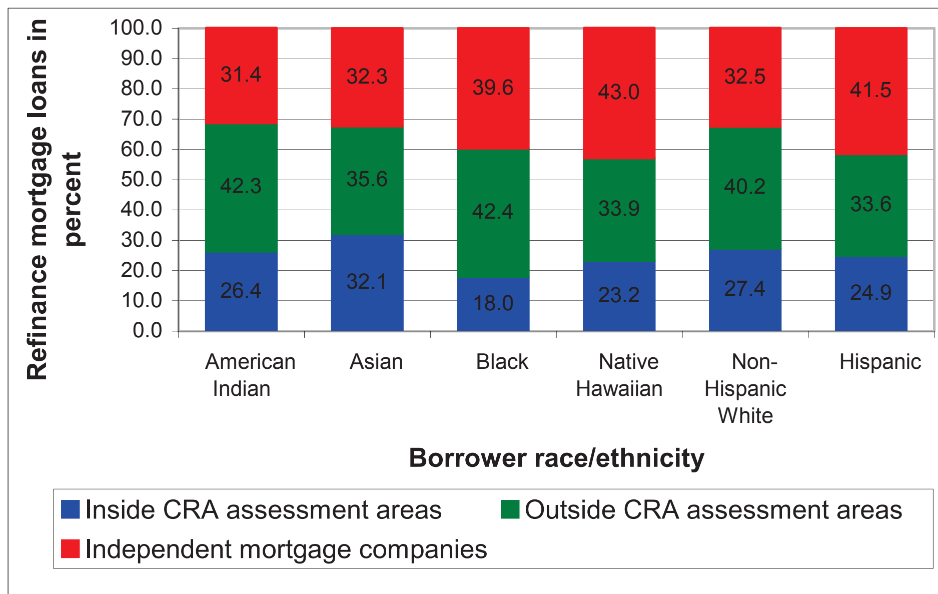
Caption: Banking institutions and their affiliates were less likely to make home purchase loans within their assessment areas regardless of the race or ethnicity of the borrowers.

The data in Figure 3.26 indicate that, in 2006, banking institutions and their affiliates were less likely to make home purchase loans within their assessment areas, irrespective of the race or ethnicity of the borrowers. For example, home purchase loans made to Blacks within CRA assessment areas equaled 19.6 percent. Such loans made outside the CRA areas, however, equaled 35.7 percent. Similar percentages apply with equal force to other groups. For Hispanics, the respective figures were 20.4 percent versus 34.1 percent; for Whites, 29.1 percent versus 38.4 percent; and for Asians/Pacific Islanders, 29.9 percent versus 36.1 percent.

While a single year is hardly determinative, for 2006, the minorities who were to most benefit from the CRA, were more likely to obtain loans from other sources.

Figure 3.27 examines the same information with regard to home refinance lending practices. Again, the figures only apply to 2006.

Figure 3.27
Home Refinance Loans by Race/Ethnicity, 2006



Note: First-lien loans for owner-occupied properties only. The small share of loans originated by credit unions are included in "outside assessment area" totals.

Source: Ren S. Essene and William C. Apgar, “The 30th Anniversary of the CRA: Restructuring the CRA to Address the Mortgage Finance Revolution,” *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act*, A Joint Publication of the Federal Reserve Banks of Boston and San Francisco, February 2009, p. 23 exhibit 2: Assessment Area Lending Lags in Low-income and Minority Areas, p. 23. The source of the raw data for Exhibit 2 is the JCHS enhanced HMDA database, 2006.

Caption: Banking institutions and their affiliates were less likely to make home refinance loans within their assessment areas regardless of the race or ethnicity of the borrowers.

Figures for refinance loans mirror those in Figure 3.26, regarding home purchase loans. In both cases, banking institutions and their affiliates were less likely to make loans within their CRA assessment areas, regardless of the race or ethnicity of borrowers. For example, the percentage of refinance loans to Black borrowers within CRA assessment areas was 18 percent, while the percentage of such loans outside the area was 42.4 percent. The respective figures for Hispanics were 24.9 percent and 33.6 percent, while the percentages for Whites were 27.4 percent and 40.2 percent.

VI. HUD’s Lending Goals

This next section examines the performance of GSEs generally, and Fannie Mae and Freddie Mac in particular, with regard to HUD’s lending goals. First, this section examines performance of Fannie Mae and Freddie Mac against the HUD lending goals. These reflect that, until the market began to collapse, the goals were being met.

Appendix D: Changes in Laws and Regulations Impacting National Banks Engaging in the Issuance and Sale of Asset-Backed and Structured Investments

The roles of banks in mortgage asset securitization in recent years is the product of an evolution in recognition by agencies, courts and Congress of the authority and desirability of permitting asset securitization as a means of selling or borrowing against loan assets.[1] National banks engaged in the first securitizations of residential mortgage loans as far back as the 1970s under the same laws that permit national banks to securitize their assets today. Since that time, there has been significant growth in the number and complexity of asset-backed securitizations.[2] Congress encouraged some of this growth in the 1980s and 1990s by expanding the authority of national banks and other financial institutions to purchase certain mortgage-related and small business-related securitized assets.

But many other factors, beyond legal authority, have driven the tremendous growth of the securitization market by creating incentives for market participants to use securitizations. These factors, as described below, include reallocating risks such as credit and interest rate risk among originators and investors, providing new sources of funding and liquidity and achieving favorable accounting and capital treatment. Market events, along with recent changes in regulatory capital requirements and accounting rules have altered some of these incentives. Nevertheless, the securitization market is expected to continue to be an important source of credit for the economy in the future.[3]

I. Evolution and Growth of Asset-Backed Securitization

The origin of securitization activities in the United States is generally attributed to the evolution and developments in the secondary markets for residential mortgages.[4] In 1938, the Federal National Mortgage Association (Fannie Mae's ancestor) was created to encourage the maintenance of an active secondary market for mortgages.[5] The first pass-through mortgage securities were introduced by the Government National Mortgage Association ("GNMA") in 1970.[6] Until that time, lenders that wanted to reduce their exposure to rising interest rates had to buy and sell whole loans. But the market for whole loans was relatively illiquid and buying and selling individual whole loans was costly and inefficient. By combining mortgage loans into pools, GNMA was able to pass the mortgage payments through to the certificate holders or investors. Although this innovation provided lenders and investors with a more liquid market, it left investors exposed to prepayment risk (the unexpected return of principal).

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[1] National banks may play a number of different roles in securitization transactions, including lender, investor, originator, servicer and sponsor.

[2] Asset-backed securitization is a financing technique in which loans or other financial assets are pooled and converted into instruments that may be offered and sold in the capital markets. Asset-backed commercial paper conduits fit within this broad definition and specifically involve the financing of assets through the continuous roll-over of short-term liabilities, typically commercial paper. *See generally* Comptroller's Handbook, *Asset Securitization* (Nov. 1997) ("Comptroller's Handbook"); Securities and Exchange Commission (SEC), *Asset-Backed Securities,* 70 Fed. Reg. 1506, 1511-12 (Jan. 7, 2005).

[3] The securitization market accounted for about 30 percent of credit provision in the United States by the end of 2008.

[4] *See* Christine A. Pavel, *Securitization: The Analysis and Development of the Loan-Based/Asset-Backed Securities Markets* (Probus Publishing) (1989).

[5] Frank J. Fabozzi, editor, *Advances & Innovations in the Bond and Mortgage Markets*, p. 175 (Probus Publishing) (1989) ("Fabozzi").

[6] *Id.* at 262.

In response to investor demand, in 1983, Freddie Mac issued the first collateralized mortgage obligation (CMO), which allowed payments to be directed to certain classes of debt securities in a specified order, allowing for different interest rates, payment schedules, and maturity dates.[7]

The securitization market continued its exponential growth through the 1990s and into the 2000s.[8] In particular, the last decade has witnessed tremendous growth in the use of special purpose entities (SPEs) to securitize assets.[9] To appreciate the reason for this growth, it is important to understand the motivations of originators and investors in using these structures. For example, one of the primary purposes of SPEs is reallocating credit risk by legally isolating the assets held by the SPE from the originating institution. For the originator, this has the advantage of potentially limiting its legal obligation to perform on the debts issued by the SPE.[10] For the investor, investing in a bankruptcy remote entity allows the investor to focus on the risks associated with certain assets rather than having to assess the entire business of the originator and its creditworthiness.

Another key motivation for originators to use SPEs is to access additional sources of funding and liquidity and to reduce funding costs. One of the primary functions that SPEs serve is to allow the originating institution to transform less liquid, non-rated exposures into more liquid, rated securities. This can provide the issuing institution enhanced liquidity through an expanded funding base and lower funding costs. This enhanced liquidity is also a benefit to investors because these securities can be more easily traded in the secondary market or used as collateral in securities funding transactions.[11]

Originators have also used SPEs to achieve off-balance sheet accounting treatment. Recent changes in accounting standards have significantly reduced the ability of sponsors to use SPEs to achieve off-balance sheet treatment, however. These new standards, FAS 166 and FAS

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[7] Creating different classes of debt securities, known as "tranched" securitization, was later applied to other asset classes, such as equipment leases and auto loans, starting in 1985. Fabozzi, *supra* at 527.

[8] In the early 2000s, there was significant growth in the issuance of private-label securitizations. This period also witnessed a rapid growth in the unregulated financial industry – resulting from the use of SPEs to raise money in the capital markets for lending and investing, rather than through the use of bank balance sheets. This discussion focuses on asset securitizations involving regulated financial institutions.

[9] An SPE is a legal entity created at the direction of a sponsoring firm. An SPE can take the form of a corporation, trust, partnership, or limited liability company. SPEs are generally structured to be bankruptcy remote from the sponsoring firm. As discussed below, SPEs are used for a variety of business purposes. *See also* Basel Committee on Bank Supervision, *The Joint Forum Report on Special Purpose Entities* (Sept. 2009) (Joint Forum Report).

[10] The originator is the entity that generates receivables by means that include selling loans, selling goods and services on credit, and providing financing for the acquisition of goods and services, and then transfers those receivables (as Transferor), directly or indirectly, to an asset backed security issuing special purpose vehicle. Originators create and often service the assets that are sold or used as collateral for asset-backed securities. Originators include commercial banks, thrift institutions, captive finance companies of the major automakers, insurance companies, securities firms, and others.

[11] *See* Joint Forum Report at 18.

167, determine the extent to which a securitization transaction is on or off the financial statements of originators, servicers, and investors.[12]

Regulatory capital considerations also have played a significant role in the use of SPEs. The U.S. federal banking agencies have used generally accepted accounting principles (GAAP) as the initial basis for determining whether an exposure is treated as on- or off-balance sheet for risk-based and leverage capital purposes.[13] Since many securitization transactions were accorded sales treatment under prior accounting standards, significant capital benefits were derived from securitization of bank assets. Recent capital regulatory changes fundamentally changed the capital consequences of securitizations. That is, because capital rules will generally continue to follow GAAP as the basis for determining whether an asset is on- or off-balance sheet, the fact that fewer SPEs will be treated as off-balance sheet for accounting purposes means that the same will be true for regulatory capital purposes.

Other recent changes to regulatory capital requirements also have significantly altered the incentives associated with securitization and other similar structures. For example, the development of the Basel II Framework has materially lessened the capital benefits associated with securitization. Under Basel I, banks could realize regulatory capital benefits from securitizations that transferred assets through SPEs. Due to its risk invariant capital requirements, Basel I created an incentive to remove assets from the balance sheet of a bank that had high regulatory capital requirements relative to the market's assessment of the assets' economic risk.[14]

Recently the Basel Committee on Banking Supervision announced additional enhancements to the Basel II Framework that materially affect securitization activities and the capital requirements for the largest U.S. banking companies. These enhancements will result in significant increases in the capital requirements for re-securitizations, such as collateralized debt obligations or CDOs.[15] Bank regulators hope to implement these changes by rules that would take effect at the beginning of 2011.

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[12] FAS 166 addresses whether securitizations and other transfers of financial assets are treated as sales or financings. *See* Statement of Financial Accounting Standards No. 166, Accounting for Transfers of Financial Assets (FAS 166). FAS 167 addresses whether certain legal entities often used in securitization and other structured finance transactions should be included in the consolidated financial statements of any particular interested party. *See* Statement of Financial Accounting Standards No. 167 (FAS 167).

[13] While GAAP does not dictate regulatory capital requirements, bank regulators believe GAAP is the most effective starting point for the development of regulatory capital requirements because GAAP is a consistent standard that can be used to compare bank performance, and financial reports under GAAP are subject to external audit. In addition, Federal statute requires the use of GAAP for financial reporting purposes. *See* 12 U.S.C. § 1831n.

[14] Differences between Basel I and Basel II's treatment of retained securitization exposures also provided incentives to securitize. The increased risk sensitivity of Basel II in measuring capital requirements for securitization-related exposures has reduced both of these incentives.

[15] These enhancements will result in increased capital requirements for securitization positions held in the trading book and the banking book as well as liquidity facilities for asset-backed commercial paper programs and securitizations where the bank failed to do its own due diligence on external credit quality, relying instead exclusively on credit ratings. *See* "Basel II Capital Framework Enhancements Announced by the Basel Committee" (July 13, 2009).

In sum, a number of factors have influenced the growth of securitizations and the use of SPEs in particular. Although the recent disruption in the securitization market has stalled this growth, some of the factors that influenced originators and investors to use securitizations in the past are still relevant today. For example, asset securitization will continue to provide an additional source of funding and liquidity even if SPEs are consolidated on the bank's balance sheet for regulatory capital purposes.[16]

II. Legal Authority for National Banks to Issue and Securitize Assets

A. 12 U.S.C. § 24(Seventh)

National banks and other U.S.-regulated financial institutions have long been permitted to use asset securitization as a means of selling or borrowing against loan assets. In language unaltered since the enactment of the National Bank Act in 1864, national banks are granted express authority to "carry on the business of banking; by discounting and negotiating promissory notes . . . and other evidences of debt.[17] The Courts have held that the right to discount and negotiate includes the right to buy and sell evidences of debt, including securitized assets.[18] In a leading case, the Second Circuit Court of Appeals held that Security Pacific National Bank could issue and sell interests in a pool of mortgages as a mechanism for selling loans.[19] The court recognized that the "pass-through certificate mechanism permits the bank to offer purchasers an interest in a pool of mortgage loans, rather than just single mortgage loans. . . With the increased marketability that pass-through certificates make possible comes increased liquidity, an important benefit as banks face the task of funding long term mortgage loans with short term deposits."[20]

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[16] *See* Joint Forum Report at 19.

[17] 12 U.S.C. § 24(Seventh). While 12 U.S.C. § 24(Seventh) on its own provides sufficient authority for these activities, 12 U.S.C. § 371(a) also permits the sale of mortgage-related assets. Section 371(a) authorizes a national bank to make and sell loans or extensions of credit secured by liens on interests in real estate, subject to any conditions or limitations set forth by the OCC.

[18] *See First Nat'l Bank of Hartford v. City of Hartford,* 273 U.S. 548, 559-60 (1927) (the Supreme Court determined that the sale of mortgages and other evidences of debt acquired through a national bank's exercise of its express power to lend money on the security of real estate, and to discount and negotiate other evidences of debt, was authorized as part of the business of banking under 12 U.S.C. § 24 (Seventh)). The courts have long held that the term "discount" includes the purchases of notes and other evidences of debt. *See, e.g., Danforth v. Nat'l State Bank,* 48 F. 271, 273-74 (3rd. Cir. 1891).

[19] *See Securities Industry Ass'n v. Clarke,* 885 F.2d 1034, 1050 (2d Cir. 1989), *cert. denied,* 439 U.S. 1070 (1990) ("*Security Pacific*"). The Second Circuit's decision upheld the OCC's interpretation under 12 U.S.C. § 24(Seventh) in Interpretive Letter No. 388, (June 16, 1987). The court also indicated that it had no difficulty concluding that the section 371(a) supported the OCC's conclusion that the bank had the express power to sell its mortgage loans. 885 F.2d. at 1048. In Interpretive Letter No. 388, the OCC explained the mortgage-backed pass-through certificates evidencing ownership interests in the banks' mortgage assets represented nothing more than the negotiation of evidences of debt and sale of real estate loans, under the express authority of 12 U.S.C. § 24(Seventh) and § 371(a). More generally, the OCC opined the transaction involved a sale of bank assets, which is fully permitted under the national banking laws.

[20] *Security Pacific,* 885 F.2d at 1049.

The Second Circuit held that the bank's activities were authorized as part of the business of banking and thus, were not prohibited by Section 16 of the Glass-Steagall Act.[21] The court recognized that the fact that the negotiation and sale may be accomplished through the creation and sale by a bank of asset-backed securities does not alter in any respect the substance of the transaction, nor its permissibility under the national banking laws.[22] Indeed, Courts have recognized that section 24(Seventh)'s grant of authority extends beyond the label given a certain activity and permits activities that are fundamentally banking in nature.[23]

B. Congress Has Repeatedly Reaffirmed the Authority of National Banks to Securitize Assets

Congress has recognized and enhanced the authority of national banks to engage in securitization activities under 12 U.S.C. § 24(Seventh). In an effort to encourage private investment in the housing and small business markets, Congress removed the investment limits for certain types of mortgage and small business-related securities with the passage of the Secondary Mortgage Market Enhancement Act of 1984 ("SMMEA") and the Riegle Community Development and Regulatory Improvement Act of 1994 ("CDRI"). Prior to enactment of SMMEA and CDRI, national banks generally could not invest more than 10 percent of unimpaired capital and stock and surplus in the investment securities of any one issuer, with certain exceptions.[24] More recently, Congress recognized and preserved the ability of banks to engage in asset-backed transactions through the provisions enacted in the Gramm-Leach Bliley Act ("GLBA").

1. SMMEA

SMMEA amended 12 U.S.C. § 24(Seventh) to permit national banks to purchase without limitation certain residential and commercial mortgage-related securities offered and sold pursuant to section 4(5) of the Securities Act of 1933, 15 U.S.C. § 77d(5), or residential mortgage related securities as defined in section 3(a)(41) of the Exchange Act, 15 U.S.C. § 78c(a)(41).[25] The stated intent of Congress was to increase the flow of funds to the housing

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[21] Section 16 of the Glass-Steagall Act generally prohibits banks from underwriting or dealing in securities. The Second Circuit concluded that an activity that "falls within the business of banking is not subject to the restrictions [that] … section 16 places on a bank's 'business of dealing in securities and stocks.'" *Id.* at 1048. *See also, Securities Industry Ass'n v. Board of Governors of the Federal Reserve System*, 468 U.S. 137, 158 n.11 (1984). OCC decisions also recognized that the Glass-Steagall Act did not restrict the means by which national banks could sell or transfer interests in their assets. *See e.g.,* OCC Interpretive Letter No. 388, *supra* (pass-through certificates representing undivided interests in pooled bank assets are legally transparent for purposes of the Glass-Steagall analysis).

[22] *See* OCC Interpretive Letter No. 388 (June 16, 1987).

[23] *See American Ins. Ass'n v. Clarke,* 656 F. Supp. 404, 408-10 (D.D.C. 1987), *aff'd,* 856 F.2d 278 (D.C. 1988); *M&M Leasing Corp. v. Seattle First Nat'l Bank,* 563 F.2d 1377, 1382-83 (9th Cir. 1977); *see also* OCC Interpretive Letter No. 494 (Dec. 20, 1989); No-Objection Letter No. 87-9 (Dec. 16, 1987).

[24] Section 24 (Seventh) imposed no investment limitations on housing revenue bonds issued by municipalities and states and obligations of the Federal housing agencies, Ginnie Mae, Fannie Mae and Freddie Mac.

[25] SMMEA required that a "mortgage related security" be rated in one of the two highest rating categories. *See* 15 U.S.C. 78c(a)(41).

market by facilitating the participation of the private sector in the secondary mortgage market.[26] To accomplish this, SMMEA amended the Securities Exchange Act of 1934 to facilitate the development of a forward trading market in "mortgage related securities" and designate such securities as "legal investments" for state and federally regulated financial institutions.

2. CDRI

CDRI amended 12 U.S.C. § 24(Seventh) by removing limitations on purchases by national banks of certain small business-related and commercial mortgage-related securities.[27] The stated intent of Congress was to increase small business access to capital by removing impediments in existing law to the securitizations of small business loans.[28] CDRI built on the framework for securitizations established by SMMEA to create a similar framework for these securities with the goal of stimulating the flow of funds to small businesses.

CDRI also removed certain impediments to trading and investing in commercial mortgage related securities, including easing margin requirements under the federal securities laws and authorizing depository institutions to purchase these securities under conditions established by their regulators. At the same time, the CDRI preserved the existing authority of federal bank regulators to regulate bank purchases of commercial mortgage related securities.

3. GLBA Exemption for Bank Securitization Activities

GLBA amended the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(5), to eliminate the complete exemption of banks from the definition of "dealer" for purposes of the securities laws.[29] In so doing, however, Congress specifically provided certain exemptions for banks from the definition of dealer including a specific provision on asset-backed transactions. Section 78c(a)(5) provides:

> Exception for certain bank activities. A bank shall not be considered to be a dealer because the bank engages in any of the following activities under the conditions described: . . .

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[26] Senate Report (Banking, Housing and Urban Affairs Committee) No. 98-293 to accompany S. 2040 (Secondary Mortgage Market Enhancement Act of 1984), Vol. 130 Cong. Record 2809, 2814 (Sept. 26, 1984).

[27] CDRI defined a new type of "small business-related security" in section 3(a)(53)(A) of the Exchange Act, 15 U.S.C. § 78c(a)(53(A), and added a class of commercial mortgage related securities to section 3(a)(41) of the Exchange Act., 15 U.S.C. § 78c(a)(41). CDRI also provided that eligible residential and commercial mortgage-related securities must receive a rating from an NRSRO in one of the top two rating categories. Small business-related securities were required to receive a rating in one of the top four rating categories.

[28] *See* Conference Report on the CDRI, Vol. 140 Cong. Record, pp. H6685, H6690 (Aug. 2, 1994). *See also* Remarks of Sen. Domenici, Vol. 140 Cong. Record, p. S11039, S11043-43 (Aug. 2, 1994) (discussing national banks' authority to purchase commercial mortgage related securities under conditions established by the OCC).

[29] In adopting rules under this provision, the SEC noted that the question of whether a bank acts as a "dealer" under the securities laws is entirely separate from the banking law considerations. It is possible for a bank to be a "dealer" under the securities laws and not under the banking laws. *See* 68 Fed. Reg. 8686, 8689 (Feb. 24, 2003). Likewise, in the securitization context, it is important to recognize important distinctions in the applicable terminology to the parties involved in each transaction.

Asset-backed transactions. The bank engages in the issuance or sale to qualified investors, through a grantor trust or other separate entity, of securities backed by or representing an interest in notes, drafts, acceptances, loans, leases, receivables, other obligations (other than securities of which the bank is not the issuer), or pools of any such obligations predominantly originated by--

- the bank;
- an affiliate of any such bank other than a broker or dealer; or
- a syndicate of banks of which the bank is a member, if the obligations or pool of obligations consists of mortgage obligations or consumer related receivables.

The exception recognized and preserved the ability of banks to engage directly in these types of securitization activities, rather than conduct them in separate SEC-registered broker-dealer subsidiaries or affiliates.

C. The Impact of GLBA's Repeal of Certain Glass-Steagall Act Restrictions

In 1999, as part of the GLBA, Congress repealed restrictions in the Glass-Steagall Act on affiliations between member banks and firms principally engaged in securities underwriting, distribution, and dealing activities that were not permissible for national banks. While GLBA repealed these restrictions, the repeal was not a marked change in the types of mortgage asset securitizations activities that could be conducted by banking organizations, since a wide range of mortgage asset securitization activities already were recognized as permissible for banks and had been specifically authorized by Congress and therefore were not within the scope of Glass-Steagall prohibitions.

Yet, the GLBA changes to the Glass-Steagall Act did have several notable results. The changes permitted affiliations between banks and firms engaged in more extensive investment banking business than had been permitted for affiliates of commercial banks. On the one hand, this introduced more of the investment banking culture into certain banking holding companies and a level of risk tolerance not typical for traditional bank risk managers. The manifestations of this culture shift presented new challenges for banking supervisors. On the other hand, the changes GLBA made to the framework for regulated bank holding companies ultimately were essential to enable large bank holding companies to rescue major securities firms that had been operating under less rigorous prudential standards than bank holding companies, and which were threatened by the financial turmoil. These acquisitions and the ability of major securities firms to fit into the bank holding company framework provided crucial support and market reassurance that was part of the process of restoring confidence in the stability of the financial system as a whole.

D. OCC Interpretive Letters and Regulations

1. OCC Interpretive Letters

On the basis of banks' 12 U.S.C. § 24(Seventh) and 12 U.S.C. § 371(a) authorities, the OCC through the years has approved various structures and issuances of mortgage-backed

securities ("MBS"), ABS, and other similar instruments.[30] For example, in 1988, in Interpretive Letter No. 418, the OCC approved a bank's operating subsidiary securitizing and issuing mortgage-related instruments based on assets held by its affiliates. As the OCC explained:

> [T]he activity of selling mortgages into the secondary market, or alternatively raising lendable funds by borrowing in the market secured by mortgages, may be accomplished by the use of the securitized formats which the market has developed in the last decades as well as by direct methods. The securitized formats are tools used to effect the selling, purchasing, borrowing, and lending functions of the secondary market. They were developed so that these market functions could be accomplished more efficiently, but they are mere tools, another means of performing the same functions.[31]

2. 12 C.F.R. Part 1

In 1996, the OCC codified at 12 C.F.R. § 1.3(g) its long-standing position, as affirmed by case law, that a national bank may securitize and sell assets that it originates or has acquired from others.[32] Section 1.3(g) today remains the same as in 1996 and provides:

> A national bank may securitize and sell assets that it holds, as a part of its banking business. The amount of securitized loans and obligations that a bank may sell is not limited to a specified percentage of the bank's capital and surplus.

In addition, the OCC's 1996 amendments to Part 1 added two new types of securities to effect the changes made by SMMEA and CDRI, as discussed above, and developments in

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[30] *See, e.g.,* Letter from Robert L. Clarke, Comptroller of the Currency, to the Honorable Alfonse M. D'Amato, United States Senate (Jun. 18, 1986); Letter from Robert Bloom, Acting Comptroller of the Currency, to Bank of America (Mar. 29, 1977). In addition, earlier letters addressed the application of 12 U.S.C. § 82, now repealed, which limited the borrowings of a national bank, and the language of 12 U.S.C. § 378 (section 21of the Glass-Steagall Act), which was viewed originally as providing certain authorizing language (subsequently amended by the Secondary Mortgage Market Enhancement Act of 1983). *See, e.g.,* OCC Interpretive Letter No. 257 (Apr. 12, 1983).

[31] OCC Interpretive Letter No. 418 (Feb. 17, 1988). It has long been recognized that national banks have the power to borrow funds. Borrowing is an incidental bank power—a traditional power, "necessary to carry on the business of banking." *See Securities Industry Association v. Board of Governors of the Federal Reserve System*, 468 U.S. 137, 158 n.11 (1984). Moreover, the power to sell or transfer interests in one's assets is simply an incident of ownership. Ownership is defined in Black's Law Dictionary 997 (rev. 5th ed. 1979) as the "collection of rights to use and enjoy property, including [the] right to transmit it to others." As with any other corporation, in order to operate effectively, a bank must be able to sell its assets, or interests therein, as economic conditions or safety and soundness considerations warrant. The OCC has recognized that a bank's ability to sell interests in its long term mortgage-related portfolio serves specific banking purposes. The ability to sell mortgages which would otherwise be held for twenty or thirty years provides needed liquidity to the mortgage portfolio, resulting in the generation of additional funds for new lending and other purposes. The ability to sell mortgage assets on a regular basis also facilitates management of the maturity mismatch problems inherent in funding long term mortgages with shorter term deposits.

[32] Comptroller of the Currency, *Investment Securities*, 61 Fed. Reg. 63972, 63977 (Dec. 2, 1996) (adopting final rule and providing long list of OCC precedents). *See, e.g.,* OCC Interpretive Letter No. 585 (Jun. 8, 1992) (securitized motor vehicle retail installment sales contracts); OCC Interpretive Letter No. 540 (Dec. 12, 1990) (securitized credit card receivables); Interpretive OCC Letter No. 514 (May 5, 1990) (securitized mortgages).

national banks' treatment of their assets.[33] Thus, besides recognizing the ability of a national bank to securitize and sell its assets, Part 1 also recognizes a national bank's ability to purchase securitized assets as investment securities.

Specifically, the OCC amended 12 C.F.R. Part 1 to add "Type IV" securities, which are defined as certain types of asset-backed securities identified in SMMEA and CDRI, and which are exempt from the 10 percent investment limitation of 12 U.S.C. § 24(Seventh). Distinct from the Type IV securities, the 1996 rule also added "Type V" securities to address "investment grade" securities representing interests in assets a bank may invest in directly.[34] The rule defines a Type V security as a security rated investment grade, marketable, not a Type IV, and fully secured by interests in a pool of loans to numerous obligors and in which a national bank could invest in directly.[35] The OCC reiterated that "this definition reflect[s] the OCC's long-standing interpretations that, in addition to investments described in 12 U.S.C. § 24(Seventh), a national bank may hold securitized forms of assets in which it may invest directly."[36] The rule limits a bank's purchase of Type V securities from any one issuer (or certain related issuers) to 25% of the bank's capital and surplus.[37]

Separate from a national bank's ability to purchase and hold assets under the investment authority of 12 U.S.C. § 24(Seventh) and 12 C.F.R. Part 1, the OCC also has long recognized the ability of a national bank to acquire asset-backed securities representing participation interests in loan pools under a bank's general lending authority, subject to safety and soundness requirements.[38] The purchase of interests as loan participations merely constitutes another way for a bank to engage in permissible lending activities.[39] Under this analysis, the OCC views the purchase of the interests as a purchase of a share of the assets they represent. Significantly,

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[33] Part 1 prescribes standards for national banks engaged in purchasing, selling, dealing in, underwriting, and holding securities, consistent with the authority contained in 12 U.S.C. § 24(Seventh) and safe and sound banking practices. *See* 12 C.F.R. § 1.1.

[34] The rule defines the term "investment grade" to mean a security that is rated in one of the four highest rating categories by either (1) two or more nationally recognized statistical rating organization ("NRSROs"); or (2) one NRSRO if the security has been rated by only one NRSRO. 12 C.F.R. § 1.2(d). By definition, an "investment security" is a marketable debt obligation that is not predominantly speculative in nature. A security is not predominantly speculative in nature if it is rated investment grade. When a security is not rated, the security must be the credit equivalent of a security rated investment grade. 12 C.F.R. § 1.2(e).

[35] 12 C.F.R. § 1.2(n). In this context, "obligor" means the borrowers on the underlying loans backing the security. In contrast, in applying the investment limits to Type V securities, the limit applies to the "issuer" of the security and not each underlying "obligor" on the underlying loans.

[36] 61 Fed. Reg. at 63976.

[37] *See* 12 C.F.R. § 1.3(f). The rule states that in calculating the limits for Type V securities a bank must take into account the Type V securities the bank is legally committed to purchase or sell in addition to the bank's "existing holdings." Section 1.4(d) clarifies that aggregation requirements apply separately to Type III and Type V securities. However, in the rule's preamble the OCC cautions that credit concentrations in excess of 25% from one issuer, but representing different "types" of securities, may raise potential safety and soundness concerns. Similarly, the OCC notes credit concentration standards would be applicable to curtail the amount of a bank's holdings of an issuer's debt obligations that rely on two different sources of authority. *See* 61 Fed. Register at 63979.

[38] Twelve U.S.C. § 24(Seventh) specifically authorizes national banks to discount and negotiate evidences of debt. This authority has long included a national bank's power, using their lending authority, to purchase and hold a variety of debt and debt-like instruments, including certain instruments denominated as securities. *See, e.g.,* OCC Interpretive Letter No. 600 (July 31, 1992).

[39] *See* OCC Interpretive Letter No. 911 (June 4, 2001).

however, bank purchasers relying on their lending authority must adhere to the legal lending limits, the prudential requirements of the OCC as set forth in Banking Circular 181, and other relevant guidance.[40]

3. *12 C.F.R. Part 3*

The minimum capital adequacy requirements for national bank are codified at 12 C.F.R. Part 3. These rules were first adopted by the OCC in 1985 pursuant to the OCC's general rulemaking authority (12 U.S.C. § 93a) and the International Lending Supervision Act of 1983.[41] These rules contain the requirements and calculations of the minimum regulatory capital requirements for national banks, including the capital treatment of securitization exposures held by national banks. The national bank capital requirements have evolved over the past 25 years reflecting the efforts of the OCC, in conjunction with the other Federal bank supervisory agencies, to make the capital requirements more risk sensitive to activities and risks held by national banks.[42]

Primary and Secondary Capital Requirement. The initial capital requirements adopted in 1985 required banks to maintain two minimum capital ratios: (1) 6 percent total capital (consisting of "primary" and "secondary" capital) to adjusted balance sheet asset and (2) 5.5 percent primary capital to adjusted balance sheet assets.[43] These rules contained no specific provision relating to securitizations.

Risk-Based Capital Guidelines. In 1989, the primary and secondary capital requirements[44] were supplemented with the addition of the Risk-Based Capital Guidelines issued by the OCC and the other Federal banking supervisory agencies.[45] The Risk-Based Capital Guidelines implemented in the U.S. the first international Basel agreement on bank capital, often

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[40] *See* 12 U.S.C. § 84 and 12 C.F.R. § 32 (statutory and regulatory lending limits for national banks); OCC Banking Circular No. 181 (Rev.), *Purchases of Loans In Whole or In Part-Participations* (Aug. 2, 1984). *See, e.g.,* Interpretive Letter No. 930 (Mar. 11, 2002) (Apr. 2002) (the OCC requires banks to implement "satisfactory controls" over loans, including: [1] written lending policies and procedures governing those transactions; [2] an independent analysis of credit quality by the purchasing bank; [3] agreement by the obligor to make full credit information available to the selling bank; [4] agreement by the selling bank to provide available information on the obligor to the purchaser; and [5] written documentation of recourse arrangements outlining the rights and obligations of each party); *see also* OCC Bulletin 2002-19, *Unsafe and Unsound Investment Portfolio Practices* (May 22, 2002) (recognizing use of lending authority to acquire securities, but emphasizing the need to measure, manage, and control investment risks).

[41] *See* 50 Fed. Reg. 10207 (Mar. 14, 1985).

[42] This section summarizes the OCC rules relating to the capital treatment of securitization exposures where the bank acts as originator or sponsor of the securitization (as opposed to investor). This summary only includes final rulemakings.

[43] *See* 50 Fed. Reg. 10207 (Mar. 14, 1985).

[44] Specifically, the Risk-Based Capital Guidelines provided that mortgage backed securities (MBSs) issued by the government or government-sponsored agency would be risk-weighted according to the risk-weight of the issuer (zero percent for government issuer; 20 percent for government-sponsored agency). Privately issued MBSs would be risk weighted according to the highest risk weight asset in the pool (typically 50 percent for qualifying mortgages). Any subordinated interest (non pro-rata) to a MBS and interest-only or principle-only strips would be risk weighted at 100 percent.

[45] *See* 54 Fed. Reg. 4168 (Jan. 27, 1989).

referred to as Basel I.[46] Under the Risk-Based Capital Guidelines, a bank is required to maintain a minimum capital ratio of total capital (consisting of Tier 1 and Tier 2 capital) to risk-weighted assets of 8 percent.

The Risk-Based Capital Guidelines represented a significant change in the capital requirements for national banks in that, among other things, regulatory capital would be required to be held against off-balance sheet exposures. While recourse and securitization exposures generally would be captured by the Risk-Based Capital Guidelines as either an on-balance sheet asset or an off-balance sheet item, specific provision addressing securitization exposures were limited to mortgage backed securities[47] held by the bank and the treatment of assets sold with recourse. Under the Risk-Based Capital Guidelines, the full amount of an asset or a pool of assets sold with recourse remained on the balance sheet of the bank and was subject to the capital charge as if the asset were not sold (essentially a 100 percent credit conversion factor for off-balance sheet items and a credit risk weight based on the type of asset).

<u>Insignificant Recourse Rule.</u> In 1992, the OCC revised the capital treatment of assets sold with recourse to provide an exception for insignificant recourse. Specifically, the amendment provided that an exception to the recourse treatment for certain sales of mortgage loan pools with less than significant risk of loss, provided that the bank has not retained any significant risk of loss, the maximum contractual exposure is less than the amount of probable loss, and the bank creates a special reserve to cover the maximum contractual exposure.[48]

<u>Low Level Recourse Rule</u>. In 1995, the OCC amended the Risk-Based Capital Guidelines to adopt the Low Level Recourse Rule as required by the Riegle Community Development and Regulatory Improvement Act of 1994. Generally, under the Low Level Recourse Rule, where the amount of recourse liability retained by a bank is less than the capital requirement for the credit exposure, the amount capital that a bank must hold is limited to the amount of the bank's maximum contractual exposure under the recourse obligation.[49]

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[46] *See* International Convergence of Capital Measurement and Capital Standards (July 1988).

[47] The primary and secondary capital ratio was subsequently replace in 1990 with the now current Tier 1 Leverage Capital Ratio which essentially requires a bank to maintain a Tier 1 capital to adjusted total assets of 4 percent (or alternatively, 3 percent for banks with a composite CAMELS rating of 1). *See* 55 Fed. Reg. 38797 (Sept. 21, 1990).

[48] *See* 57 Fed. Reg. 44078 (Sept. 24, 1992). The OCC rule represented a clarification, and not a change, of the existing treatment of recourse arrangements under the risk-based capital guidelines. See discussion at 57 Fed. Reg. 44078, 44083 (Sept. 24, 1992). The rule was generally consistent with the Federal Reserve's treatment of recourse exposures. *See* 56 Fed. Reg. 51151 (Oct. 10, 1991).

[49] *See* 60 Fed. Reg. 17986 (April 10, 1995). As required by CDRI, the Low Level Recourse Rule was also adopted by the other Federal bank supervisory agencies in separate rulemakings. *See* 60 Fed. Reg. 8177 (Feb. 13, 1995) (Board); 60 Fed. Reg. 15858 (March 28, 1995) (FDIC). The OTS's rules already contain a low level recourse provisions so no rulemaking was necessary. *See* 66 Fed. Reg. 59614, 59615 (November 29, 2001). The Federal bank supervisory agencies' low-level recourse rules appeared at: 12 CFR 3, appendix A, section 3(d) (OCC); 12 CFR 208, appendix A, section III.D.1.g and 225, appendix A, section III.D.1.g (FRB); 12 CFR 325, appendix A, section II.D.1 (FDIC); and 12 CFR 567.6(a)(2)(i)(C) (OTS). *See* discussion at 65 Fed. Reg. 57993, 57996 (Note 10) (Sept. 27, 2000). These provisions were later incorporated into the Federal bank supervisory agencies' joint rulemaking on recourse and direct credit substitutes. *See* 66 Fed. Reg. at 59617.

Small Business Loan Recourse Rule. In 1995, the OCC and the other Federal bank supervisory agencies issued an interim rule to amend the Risk-Based Capital Guidelines to adopt the Small Business Loan Recourse Rule as required by the Community Development and Regulatory Improvements Act of 1994. Specifically, the Small Business Loan Recourse Rule generally provided an alternative capital charge based on the amount of the retained recourse for small business obligations transferred with recourse for certain well capital banks that establishes a non-capital reserve sufficient to cover the estimated liability under the recourse arrangement up to an aggregate limit of 15 percent of the bank's total capital.[50]

Recourse Rule In 2001, the OCC and the other Federal bank supervisory agencies issued the "recourse" rule, which amended the Risk-Based Capital Guidelines to add provisions specifically on the treatment of securitization exposures retained in connection with a bank's securitization activities. As part of the securitization process, banks often retain subordinate securities which act as credit enhancement to the senior securities sold to investors. Under the Recourse Rule, banks may apply the "ratings based approach" specified in the rule to qualifying retained securitization exposures. The ratings-based approach assigns risk weights ranging from 20 percent (for triple-A ratings) to 200 percent (for double-B ratings), depending on the rating. A securitization exposure rated below double-B does not qualify for the ratings-based approach and is assigned a dollar-for-dollar capital charge that approximates a 1,250 percent risk weight.[51]

The adoption of the Recourse Rule represented a significant increase in the risk sensitivity of the current Risk-Based Capital Guidelines (which reflected the Basel I international capital framework) with respect to securitization exposures. The principles developed in the US capital treatment for securitization exposures in the Recourse Rule would later serve as the basis, with some enhancement, for the securitization framework in the Basel II international capital framework.

Asset-Backed Commercial Paper ("ABCP") Rule. In 2003, the OCC and the other Federal bank supervisory agencies issued an interim final rule that addressed the consolidation of ABCP program assets and liquidity facilities to ABCP conduits. Specifically, the ABCP rule allowed sponsoring banks to remove consolidated ABCP program assets from their risk-weighted assets for the purpose of calculating their risk-based capital ratios. Under the ABCP Rule, sponsoring banks were required to hold capital against all other risk exposures arising in connection with ABCP programs.[52] The exception to consolidation of ABCP program assets was eliminated in 2010.[53] Consequently, following a transition period, the consolidated assets of an ABCP program will be reflected in a bank's risk-based capital ratios.

Under the Risk-Based Capital Guidelines, long-term liquidity facilities with an original maturity of over one year were converted to an on-balance sheet credit equivalent amount using the 50 percent credit conversion factor. Short-term liquidity facilities with an original maturity of one year or less were converted to an on-balance sheet credit equivalent amount utilizing the zero percent credit conversion factor, which result in no capital charge. In the final ABCP Rule,

[50] *See* 60 Fed. Reg. 47455 (Sept. 13, 1995); 62 Fed. Reg. 55490 (Oct. 24, 1997).

[51] *See* 66 Fed. Reg. 59614 (Nov. 29, 2001).

[52] *See* 68 Fed. Reg. 56530 (Oct. 1, 2003); 69 Fed. Reg. 44908 (July 28, 2004) (Final Rule).

[53] *See* 75 Fed. Reg. 4636 (Jan. 28, 2010).

the OCC and other Federal bank supervisory agencies revised the capital treatment of liquidity facilities. Specifically, under the ABCP Rule, subject to an asset quality test, long-term facilities receive a credit conversion factor of 50 percent, and short term facilities receive a credit conversion factor of 10 percent. If the asset quality test is not met, the liquidity facility is subject to a 100 percent credit conversion factor.

Basel II Advanced Approaches Rule. In 2007, the OCC and the other Federal bank supervisory agencies supplemented the current capital rules with the addition of the Basel II Advanced Approaches Rule, which implemented in the U.S. the Basel revised capital framework, often referred to as Basel II.[54] The Basel II Advanced Approaches Rule represented a significant change in the capital requirements for certain internationally active banks in that regulatory capital requirement for these banks generally is based on an advanced internal ratings-based approach for credit risk and an advanced measurement approach for operational risk. With respect to securitization exposures, under the Basel II Advanced Approaches Rule, gain-on-sale and credit enhancing interest only strips, which are often recognized or retained by an issuing bank, are deducted from capital. Banks must apply a ratings-based approach to qualifying retained securitization exposures that are not already deducted that is similar to the capital treatment under the Recourse Rule provided in the Risk-Based Capital Guidelines. Under the Risk-Based Capital Guidelines, the capital treatment for retained exposures that are not eligible for the ratings-based approach may be modeled if there is sufficient information. However, generally, the modeling alternatives are equal to or harsher than the treatment provided under the ratings-based approach. If a bank does not use any of the treatments described above, it must deduct the exposure from capital.[55]

[54] *See* International Convergence of Capital Measurement and Capital Standards: A Revised Framework (June 2006).

[55] *See* 72 Fed. Reg. 69288 (Dec. 7, 2007).

LISTING OF ATTACHMENTS TO APPENDIX D

Select OCC Interpretive Letters

Letter from Robert Bloom, Acting Comptroller of the Currency, to Bank of America (Mar. 29, 1977)

Letter from Robert L. Clarke, Comptroller of the Currency, to the Honorable Alfonse M. D'Amato, United States Senate (June 18, 1986)

OCC Interpretive Letter No. 388 (June 16, 1987)

OCC Interpretive Letter No. 418 (Feb. 17, 1988)

Select OCC Supervisory Guidance

OCC Comptroller's Handbook, *Asset Securitization* (Nov. 1997)

OCC Bulletin 99-46 (December 1999), *Interagency Guidance on Asset Securitization Activities*

OCC Bulletin 2007-1 (January 2007), *Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities*

DocDate: March 29, 1977

Type: Letter

Author: Bloom, Robert, Acting Comptroller of the Currency

Addressee: (Illegible Lines)

Dear Mr.(Illegible Word)

This is in response to a letter dated December 22, 1976, from(Illegible Words) Bank of America, to Ford Barrett, Assistant Chief Counsel of the Office of the Comptroller of the Currency, concerning the bank's mortgage backed securities proposal.

On June 1, 1976, the Comptroller's Office approved the issuance of mortgage backed bonds by a trust to which Bank of America would sell without recourse uninsured single family residential real estate loans. At that time, the Office expressed the opinion that the bank's proposal would not violate section 20 of the Glass-Steagall Act (12 U.S.C. 377), which bars member banks from being affiliated as described in 12 U.S.C. 221a with an entity engaged principally in the issue, flotation, underwriting, public sale or distribution of securities. It was also determined that the proposal is not prohibited by section 21 (12 U.S.C. 378), which prohibits institutions "in the business of receiving deposits" from engaging simultaneously "in the business of issuing, underwriting, selling, or distributing" securities.

Following the Comptroller's approval, the bank sought the views of the Federal Reserve Board on the imposition of reserve requirements, measured either by the bank's or the trust's liability on the stand-by letter of credit used to provide more "comfort" to investors or by the proceeds received from the sale of loans to the trust. During these discussions, the use of a trust as issuer of the securities was eliminated, and the security itself was changed from a bond type instrument to a passthrough type patterned as closely as possible after the fully modified Ginnie Mae security which has received regulatory approval and wide acceptance in the marketplace. Under the modified proposal, the pool of conventional residential mortgages serving as collateral would be segregated from the bank's existing mortgage portfolio and held by another California bank, which would function both as custodian of the mortgage documents and as trustee to represent the interests of security holders. Third party insurance against losses on the mortgages would be obtained by the bank in an amount initially equal to 5% of the aggregate outstanding principal amount of the mortgages in the pool.

In view of the modifications, the only Glass-Steagall question is whether the bank would be engaged in the business of issuing, underwriting, selling or distributing securities within the

meaning of section 21.

While the guideposts in the legislative history of the Glass-Steagall Act on the question of the extent to which banks may issue securities without becoming engaged "in the business" of issuing, etc., securities are few, common sense and observation of industry practice tell us that banks can issue securities frequently without being considered "in the business" of issuing securities in the same sense as investment bankers. For example, banks issue their own securities in the form of equity and debt, and engage every day in the sale of certificates of deposit and loan participations, both of which can be considered securities in certain contexts. n1 Thus, notwithstanding the statute's broad language, the frequent issue or sale of securities does not in itself mean that the issuing bank is engaged "in the business" of issuing securities. Rather, we think whether the bank is issuing or selling securities on behalf of another issuer, whether the issuance or sale of the securities in question constitutes a vital part of the bank's overall business, and the manner in which the securities are sold are important considerations. n2

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n1 See, e.g., Garner v. Pearson, 374 F. Supp. 591, 596 (M.D. Fla. 1974) (certificate of deposit); Lehigh Valley Trust Co. v. Central Nat'l Bank of Jacksonville, 409 F.2d 989 (5th Cir. 1969) (loan participation). But see Burrus, Cootes & Burrus v. MacKethan, 537 F.2d 1262 (4th Cir. 1976) (certificate of investment), opinion withdrawn on rehearing but judgment affirmed, No. 75-2130, Dec. 10, 1976.

n2 Some of the same factors were used by the Federal Reserve Board in concluding that the issuance and sale of "thrift notes" by a bank holding company violated the Glass-Steagall Act. 12 CFR 250.221. On the other hand, commercial banks routinely issue Ginnie Mae securities, and federal savings and loan associations have been authorized to issue mortgage backed bonds. No one has suggested that the issuance of these securities raises any problems under the Glass-Steagall Act.

In this case, Bank of America is not issuing, selling or distributing securities on behalf of another issuer. The securities represent the sale of an interest in bank assets, conventional mortgage loans. Significantly, Section 21 of the Act contains a specific provision which states, "Provided further, That nothing in this paragraph shall be construed as affecting in any way such right as any bank, banking association, savings bank . . . may otherwise possess to sell, without recourse or agreement to repurchase, obligations evidencing loans on real estate." It is our opinion that Bank of America's proposal fits precisely within this statutory language. Indeed, this language underscores the evident intent of Congress not to disturb the secondary market for real estate loans made by financial institutions.

Moreover, while the sale of mortgage-backed securities will furnish another means to liquify long term loans, thereby enabling the bank to make more mortgage loans, it hardly represents a principal element of the bank's line of business. Unlike an investment banking firm for which the

issue, sale and distribution of securities is a sine qua non, Bank of America's banking business will not be substantially affected either by the issue and sale of mortgage-backed securities or by the bank's failure to undertake such an issue and sale. Finally, the actual issuance of the securities is being accomplished through an investment banking firm acting as underwriter, and sales will be made only to sophisticated customers in denominations of $ 100,000 or more.

In light of these factors, we believe that, under the bank's plan, the issuance and sale of mortgage-backed securities on a quarterly basis will not violate Section 21 of the Glass-Steagall Act, 12 U.S.C. 378.

The bank's proposal raises questions concerning the application of 12 U.S.C. 82, which limits the borrowings of a national bank. In our letter of June 1, 1976, we viewed the transaction as a sale of assets. The same rationale is applicable to the revised proposal. While the bank is permitted to make advances irrespective of receipts from obligors on notes in the pool and would have the option to purchase defaulted loans from the pool, these rights (both of which are normal in connection with Ginnie Mae securities) would be limited to advances and purchases covered by third-party insurance. Thus, the availability of the insurance coverage enables the bank to avoid the risk associated with the underlying assets. Moreover, the bank is prohibited from exchanging or substituting mortgages in its portfolio for mortgages in the pool once the pool has been established.

These arrangements lead us to conclude that the transaction is a bona fide sale of assets, with the bank retaining no risk on the underlying mortgages. Accordingly, 12 U.S.C. 82 is not applicable.

We trust the above, together with our letter of June 1, 1976, is sufficiently responsive to the issues raised by the bank's proposal.

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

June 18, 1986

The Honorable Alfonse M. D'Amato
Chairman
Subcommittee on Securities
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator D'Amato:

In response to your June 3, 1986 inquiry, this letter contains the Office of the Comptroller of the Currency's ("Office") legal analysis regarding the May 22, 1986 no-objection letter written in response to a request from Liberty Norstar Bank, N.A., Buffalo, New York ("Liberty Norstar" or "Bank"). As indicated in our June 10, 1986 letter to you, the May 22 letter was based on a long line of precedents which recognize that national banks may transfer their mortgage and mortgage-related assets in transactions substantially similar to those in question.

The Office has taken the view that a collateralized mortgage obligation (cmo), in the broadest sense, is a bond or other obligation or evidence of indebtedness representing the transfer of an interest in an underlying mortgage, pool of mortgages or mortgage-related obligations. A bank generally uses cmos as a source of liquidity in conjunction with its ownership of mortgage assets; this enables an issuing bank to obtain funds for additional lending activities.

The transfer of a cmo by a bank can be characterized in a number of ways--as a sale of an interest in real estate obligations, as a borrowing, or as the receipt of a deposit. Since at least 1976, [1] this Office has recognized the

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[1] In fact, the Office first approved the sale of interests in GNMA-insured loans in 1970. *See* Banking Circular No. 24
(Footnote continued on next page)

legitimacy of national bank transfer--or issuance and sale--of mortgage backed instruments to their customers and to the public. In a 1977 interpretive letter, the Office stated:

> The sale of mortgage backed instruments will provide a commercial bank another means of adding liquidity to its long term conventional mortgage portfolio. Instead of holding these mortgages, the bank will in effect sell them, thereby generating more funds to make more mortgage loans. . . . The net effect of the proposal, therefore, is to bring additional funds into the home mortgage market.

OCC Press Release of March 30, 1977 and letter from Robert Bloom, Acting Comptroller of the Currency, to Leland S. Prussia, Fed. Banking L. Rep. (CCH) ¶ 97,093. 2/

The letter recognized that banks regularly issue equity and debt securities to raise funds and purchase and sell on a daily basis deposits and loans, and interests therein. The Office acknowledged that the proposed activity could constitute the issuance of securities, but determined that the activity did not constitute engagement "in the business" of issuing securities "in the same sense as investment bankers". Instead, the Office viewed the securities to "represent the sale of an interest in bank assets, conventional mortgage loans." Id. Support for the ability of national banks to sell obligations evidencing mortgage-related interests was found in explicit language contained within Section 21 of the Glass-Steagall Act, 12 U.S.C. § 378(a)(1) ("Glass-Steagall" or "Act"):

(Footnote continued from previous page)
(April 16, 1970). Section 16 of the Glass-Steagall Act, 12 U.S.C. § 24 (Seventh), explicitly authorizes bank "underwriting" of issues guaranteed by the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA") and the Federal Home Loan Mortgage Corporation ("FHLMC").

2/ The March 30, 1977 letter approved Bank of America's issuance of mortgage backed securities representing interests in conventional loans from the bank's portfolio. While it was initially contemplated that the securities would be sold only to institutional investors, the plan of distribution was broadened to include sales to the public.

> Significantly, Section 21 of the Act contains a specific provision which states, "Provided further, that nothing in this paragraph shall be construed as affecting in any way such right as any bank, banking association, savings bank . . . may otherwise possess to sell, without recourse or agreement to repurchase, obligations evidencing loans on real estate." It is our opinion that Bank of America's proposal fits precisely within this statutory language. Indeed, this language underscores the evident intent of Congress not to disturb the secondary market for real estate loans made by financial institutions. 3/

Id. The Office's determination that the sale of mortgage backed securities was in effect the sale of a national bank's mortgage-related assets provided the basis for a substantial series of precedents, each recognizing a variant of the activity approved in the Bank of America letter, supra. In each of the precedents mentioned below, the bank was either selling interests in some of its mortgages or its mortgage-related assets, or it was borrowing money, using those assets as collateral. See, e.g., February 14, 1978 letter from Charles B. Hall, Deputy Comptroller for Banking Operations, Fed. Banking L. Rep. (CCH) ¶ 85,100 (permitting bank employees, rather than underwriters, to market the mortgage backed obligations); May 18, 1978 letter from John G. Heimann, Comptroller of the Currency, Fed. Banking L. Rep. (CCH)

3/ While the proviso to Section 21 was a technical amendment, enacted without comment as part of the Banking Act of 1935, there is ample evidence in the legislative history indicating that the 1935 Congress was concerned with increasing banks' real estate loan activities in order to promote the development of an organized, secondary mortgage market. For example, in the House Report's discussion of a provision intended to liberalize the limitations on bank real estate lending, it is stated that this provision was intended to "increase the ability of the banks to serve their communities, to provide a greater outlet for the banks' funds, and to promote business recovery by opening up the mortgage market and reviving the construction industry." H.R. Rep. No. 742, 74th Cong., 1st Sess. 14 (1935). It was also noted in this Report that real estate loans had suffered historically as compared with other loans because "there was no organized market where they could be sold even at a reduced value." Id. at 15.

¶ 85,116 (permitting a national bank's trust division rather than an independent trustee to serve as trustee for the mortgage pool and deleting the requirement that the transaction be treated as a sale for tax purposes); October 17, 1978 letter from H. Joe Selby, Deputy Comptroller for Operations, Fed. Banking L. Rep. (CCH) ¶ 85,144 (concerning collateral trust certificates); April 20, 1979 letter from Paul M. Homan, Senior Deputy Comptroller for Bank Supervision, Fed. Banking L. Rep. (CCH) ¶ 85,167 (permitting the sale of two classes of certificates, with the result that Class B certificateholders would not receive the "passed-through" mortgage payments and interest until full payment had been made to Class A certificateholders; permitting the creation of a "reserve fund" at the Bank against risk of default; recognizing that this activity might constitute a bank borrowing of funds); July 31, 1979 letter from John M. Miller, Deputy Chief Counsel, Fed. Banking L. Rep. (CCH) ¶ 85,182 (permitting the formation of a conduit mortgage company to package loans made by participating banks); February 1, 1980 letter of Paul M. Homan, Senior Deputy Comptroller for Bank Supervision, Fed. Banking L. Rep. (CCH) ¶ 85,213 (permitting national bank to use its standby letter of credit rather than mortgage insurance to insure against risk of default, with recognition that the retained risk made this activity a borrowing for purposes of 12 U.S.C. § 82); July 9, 1980 letter from Ford Barrett, Assistant Chief Counsel, Fed. Banking L. Rep. (CCH) ¶ 85,226 (12 U.S.C. § 82 considered not applicable to voluntary advance feature for standby letter of credit); May 29, 1981 letter from Billy C. Wood, Deputy Comptroller, Multinational Banking, Fed. Banking L. Rep. (CCH) ¶ 85,275 (inclusion of second mortgages in mortgage pools). See also October 3, 1979 letter from the Federal Reserve Board, Fed. Banking L. Rep. (CCH) ¶ 98,013 (permitting the replacement of third-party mortgage insurance with a standby letter of credit for purposes of Regulation D); October 5, 1979 letter from Federal Reserve Board, Fed. Banking L. Rep. (CCH) ¶ 98,014 (permitting the inclusion of loans which would mature within five years, even though the bank had committed to make a new loan to each mortgagor not in default).

The basis for these determinations was further articulated in the April 12, 1983 letter of Chief Counsel Brian W. Smith, Fed. Banking L. Rep. (CCH) ¶ 85,421. The Smith letter described the Office's view that bank-issued pass-through certificates and the pool containing the underlying loan obligations were "legally transparent" since the certificateholders had essentially . . . (through an undivided interest in the underlying obligations held by a trustee) . . . the same rights, liabilities and risks as if they were the direct owners

of the loans." Chief Counsel Smith referred to the specific exemption for FHA-insured mortgages contained in Section 16 of the Glass-Steagall Act, 12 U.S.C. § 24 (Seventh). However, he also referred to the Office's long-held position that Section 21 "clearly authorizes national banks to purchase and sell real estate loans, as well as pass-through certificates representing such loans." This reiterated the Office view, stated in the earlier precedents, that the transfer of interests in a pool of conventional mortgage loans or obligations from a national bank's portfolio is an authorized activity, not prohibited by the Glass-Steagall Act. Thus, for Glass-Steagall purposes, the Office stated that the sale of the interests did not alter the character of the transaction--the bank's sale of instruments in its mortgage-related portfolios.

It is clear from these precedents that the Office's determinations have rested squarely on relevant statutory language in the national banking laws and the Glass-Steagall Act. First, as previously stated, Section 16 of the Glass-Steagall Act authorizes a bank's activity with regard to the GNMA, FNMA and FHLMC obligations. Moreover, national banks may raise funds by selling interests in their mortgage-related assets, thereby assuring adequate liquidity for continued mortgage origination and investment. In fact, for accounting purposes the cmo sale may be a straightforward sale of interests in the bank's assets, or it may represent a borrowing collateralized by some of the bank's assets. 4/ See, e.g., Fed. Banking L. Rep. (CCH) ¶¶ 85,116, 85,167 and 85,213, supra. In some instances, the transfer of a bank's interest in mortgage-related obligations is permissible not merely because the bank may sell these obligations pursuant to Section 21, but because it has long been recognized that national banks have the power to borrow funds. 5/ In those instances where a bank's sale of cmos represents the bank's borrowing of funds, the Glass-Steagall prohibitions are inapplicable. Borrowing is

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4/ As stated in our May 22 letter, Liberty Norstar has taken a number of steps to ensure that the transaction is not a reservable deposit for purposes of Regulation D. In this regard, see the Regulation D analyses contained in the previously cited Office and Federal Reserve Board precedents. In any event, even where alterations in the structure of the transaction result in certain legal distinctions, these differences are not germane for purposes of the Glass-Steagall analysis.

5/ See, e.g., Wyman v. Wallace, 201 U.S. 230, 243 (1906); Aldrick v. Chemical National Bank, 176 U.S. 618, 626-628 (1900); Auten v. United States National Bank, 174 U.S. 125, 141-143 (1899).

an incidental bank power--a traditional power, "necessary to carry on the business of banking." See Securities Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 137, 158 n.11 (1984) ("Becker"). More generally, it is unquestioned that national banks can sell their assets. If banks were unable to achieve adequate liquidity through transactions in the relevant market when economic conditions and safety and soundness concerns so dictated, the consequences could be serious. In summary, a bank's ability to obtain funds--through a borrowing or sale based upon the bank's transfer of interests in its mortgage-related obligations to the secondary mortgage market--is essential to the bank's role in the real estate and housing markets and its ability to conduct its business generally. See, e.g., supra note 3.

The Liberty Norstar proposal does not differ in any material respect from the previously cited Office precedents. The May 22, 1986 no-objection letter does not extend the prior approvals to incorporate new kinds of loans or obligations. It does provide that in some instances an underlying pool will be mixed, in that it may consist of a combination of whole conventional mortgages from the Bank's portfolio and GNMA, FNMA and FHLMC mortgage certificates, rather than a pool containing only a single kind of mortgage obligation. 6/

In addition, in some instances the pass-through would be a double layer pass-through, since bond purchasers would have an interest in certificates representing interests in Government insured mortgage loans. However, because in every case the trustee would be the record owner of all certificates, the application of the Office's Section 21 pass-through rationale is proper. The trustee's ownership of the certificates is governed by the provisions of an indenture filed in accordance with the requirements of the Trust Indenture Act, which would require the trustee to seek payments from the appropriate guarantor on behalf of the bondholders. Therefore, bondholders would have "essentially . . . the same rights, liabilities and risks as if they were the direct owners of the loans." See Smith letter, supra.

6/ In any instance in which the underlying pool is mixed, the Bank has agreed to ensure that the pool meets all requirements of the Section 3(c)(5)(C) exemption from the Investment Company Act of 1940 for entities "primarily engaged in [the business of] . . . purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." Thus, the Bank will not be affiliated with an investment company.

The May 22, 1986 letter does not conflict with the language or purpose of the Secondary Mortgage Market Enhancement Act of 1984, Public Law No. 98-440, Title 1, § 105(c), 98 Stat. 1691 (1984) ("Mortgage Act") because the activity in question amounts only to a transfer by the Bank of its own mortgage assets and obligations. The Mortgage Act amended Section 16 of the Glass-Steagall Act to permit bank investment in privately insured mortgage obligations originated by "financial institutions", enabling banks to invest in mortgage-backed securities representing interests in the mortgage portfolios of other financial institutions. Thus, the Mortgage Act enhanced the investment power of banks without affecting their pre-existing authority to sell interests in loans and other mortgage-related obligations from their own portfolios. 7/

In summary, we wish to assure you that the Liberty Norstar letter is based on long-standing precedents and is consistent with applicable law. 8/ The banking system must be able to

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7/ Proposed provisions for banks to underwrite and deal in the mortgage backed securities of qualified "financial institutions" were deleted from the legislation. However, the legislation also was based on the recognition that for at least a decade banks had sold their own mortgage backed securities. See, e.g., Secondary Mortgage Market Enhancement Act of 1983: Hearings on S. 1821, S. 1822 and S. 2040 Before the Subcommittee on Housing and Urban Affairs of the Senate Committee on Banking, Housing, and Urban Affairs, 98th Cong., 1st Sess. 319 (1983), where the Congressional Research Service stated: "The first publicly offered direct PC [participation certificate] issue, for $150 million, was made by the Bank of America in 1977"; id. at 226, the statement by Preston Martin, Vice Chairman, Board of Governors of the Federal Reserve System: "While a fair number of banks, thrift institutions, mortgage companies, insurance companies and so-called conduit organizations have issued private pass-throughs. . . ."

8/ Becker, supra, and the "IRA cases" support the activity in question. In Becker, the Supreme Court explicitly recognized that Glass-Steagall was not intended to interfere with those banking powers "necessary to carry on the business of banking." Becker, 468 U.S. at 158 n.11. In scrutinizing the creation of bank collective investment trusts for the assets of IRA trusts, the courts have largely recognized, in reliance on Investment Company Institute v. Camp, 401 U.S. 617 (1971), that a bona fide bank fiduciary activity was not prohibited under the Glass-Steagall Act. See, e.g., Investment Company Institute v. Conover, No. 85-5019 (D.C. Cir. May 20, 1986); Investment Company Institute v. Clarke, No. 86-6033 (2d Cir. May 2, 1986), aff'g 630 F. Supp. 593 (D. Conn. 1986).

engage in prudent funds management policies in connection with bank assets and liabilities and generate or maintain adequate liquidity in the course of providing long-term, often fixed-rate real estate and housing finance. We are sure you will agree that the Glass-Steagall Act was never intended to interfere with these activities. The Office's May 22, 1986 no-objection letter follows from the long-standing recognition that national banks can obtain funds from time to time through borrowing or sales transactions based upon some of their underlying mortgage-related assets. In our view, the powers conferred by the national banking laws including 12 U.S.C. § 24 (Seventh), the proviso to Section 21 of the Act, the authority of national banks to borrow funds, and a long line of published Office precedent, support the result we reached in the Liberty Norstar matter. We trust that our reasoning will resolve your concerns about the May 22 letter.

Sincerely yours,

Robert L. Clarke
Comptroller of the Currency

Enclosure

DocDate: June 16, 1987

Type: Letter

Subject: Interpretive Letter #388

Author: Clark, Robert L., Comptroller of the Currency

Addressee: Freeman, Russell A., Executive Vice President and General Counsel Security Pacific National Bank, P.O. Box 60468 Los Angeles, California 90060

Dear Mr. Freeman:

This responds to your June 12, 1987 request on behalf of Security Pacific National Bank ("Bank"). In your letter, you ask that we provide you with a copy of our response to the letter of April 2, 1987 from the Securities Industry Association ("SIA") for a determination that the Glass-Steagall Act ("Act") prohibits the Bank from selling mortgage-backed pass-through certificates evidencing interests in pools of its conventional mortage loans, as described in the Bank's Prospectus and Prospectus Supplement, dated January 23, 1987. You state that the Bank is requesting a copy of our response so that it may conduct its activities in accordance with our determination. Because this Office is the primary regulator of the Bank's activities, however, we have determined to respond directly to the Bank concerning the SIA's inquiry.

We have reviewed the offering materials and have concluded that the Bank's program n1 is authorized under the national banking laws and is substantially in accord with a long line of OCC precedents recognizing that the Glass-Steagall Act does not restrict the means by which national banks may sell or transfer interests in, among other assets, their mortgage and mortgage-related assets.

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n1 We have also consulted the Bank's counsel, to obtain clarification of certain technical aspects of the Bank's program.

According to the Bank's Prospectus, a separate series of mortgage-backed pass-through certificates ("Certificates") will be issued in connection with each mortgage pool. n2

Each mortgage pool will be composed of mortgages originated by the Bank in the ordinary course of its mortgage lending activities. Upon the issuance of a certificate series, the Bank will assign the loans in the mortgage pool without recourse to a trustee for the benefit of the Certificateholders. Each Certificate will represent a fractional undivided interest in the trust property, which will consist solely of the mortgage loans in the pool for that series and certain related property, including mortgage payments awaiting distribution, property acquired by foreclosure or otherwise, and the Certificateholders' interest in any insurance policies maintained with respect to the mortgage loans. n3

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n2 The details concerning each series of Certificates will be contained in a Prospectus Supplement to be prepared in connection with each series.

n3 While the SIA's letter designates the Bank's program as involving a "distribution of collateralized mortgage obligations," that description is not technically correct. A collateralized mortgage obligation ("CMO") is a specialized mortgage-backed obligation, or bond, that is typically issued in a series of classes, with each class having an expected maturity different from the loans in the underlying mortgage pool. This serialization provides a degree of protection to investors against the risk of early maturity. See Financial Accounting Standards Board (FASB) Technical Bulletin 85-2: Accounting for Collateralized Mortgage Obligations, March 18, 1985. See also Smith and D'Annolfo, Collateralized Mortgage Obligations: An Introduction, 16 Real Estate Review 30-42 (Spring 1986). This Office has permitted national banks to transfer interests in their mortgage assets through the use of CMO's in a variety of transactions. See, e.g., March 24, 1987 letter of Emory W. Rushton, Deputy Comptroller for Multinational Banking, [Current Developments] Fed. Banking L. Rep. (CCH) P85,602; June 18, 1986 letter of Robert L. Clarke, Comptroller of the Currency, to Senator Alphonse M. D'Amato; May 22, 1986 letter of Richard V. Fitzgerald, Chief Counsel, [1985-87 Transfer Binder] Fed. Banking L. Rep. (CCH) P85,532.

The Bank's program, by contrast, involves a simple pass-through certificate, which represents an undivided ownership interest in the underlying pool of mortgage loans. Pass-through certificates are designed to closely resemble the underlying mortgages with respect to the timing and amount of principal and interest payments. All of the risk of uncertain maturity due to prepayments is borne by the purchasers of the certificates, as if they were the owners of the mortgages.

Under a pooling and servicing agreement to be entered into with each trustee, the Bank will service the mortgages and receive a fee for this service. Distributions of principal and interest at the pass-through rate n4 will be made by the Bank, as agent for the trustee, to the Certificateholders each month. The Prospectus Supplement contains a boldface

statement that the Certificates are not obligations of the Bank or its parent, Security Pacific Corporation, and that neither the Certificates nor the underlying mortgage loans are insured or guaranteed by the Federal Deposit Insurance Corporation, the Government National Mortgage Association, or any other governmental agency or entity.

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n4 The pass-through rate is equal to the weighted average interest rate of the mortgage loans as of the first day of the month of the creation of the trust, less the servicing compensation payable to the Bank.

Credit support for each series will be provided by a Bank-issued standby letter of credit or a limited guaranty to be issued by Security Pacific Corporation or some entity other than the Bank, and/or pool insurance to be obtained by the Bank as servicer of the loans.n5 In those instances where the Bank elects to provide its own letter of credit, the letter of credit will be issued pursuant to established credit criteria, in accordance with the Bank's normal credit extension practices. Credit coverage will be provided up to the amount specified in the Prospectus Supplement, but in no event will that coverage be more than 10% of the initial aggregate principal balance of the subject mortgage pool. Provision is made for the Bank to make reimbursable voluntary monthly advances to the pool if delinquencies on the underlying mortgages cannot be covered from the funds available for distribution, but only to the extent of the amounts available under the limited guaranty or pool insurance. All risks of delinquency and loss resulting from defaults on the underlying mortgage loans that are not covered by the applicable credit support will be borne by the Certificateholders.

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n5 Security Pacific Corporation is providing the limited guaranty for the certificate series described in the Prospectus Supplement dated January 23, 1987.

Under generally accepted accounting principles, regulatory accounting principles and for other bank regulatory purposes, the Bank will account for the transaction as a sale of assets. <u>See</u> FASB Statement of Financial Accounting Standards No. 77: Reporting by Transferors for Transfers of Receivables with Recourse, December 1983 (conditions for transfer to be recognized as sale under generally accepted accounting principles); Instructions, Consolidated Reports of Condition and Income for Insured Commercial Banks with Domestic and Foreign Offices, Glossary A-28 (regulatory reporting by issuing bank for privately-issued certificates of participation in pools of residential mortgages) (hereinafter "FFIEC Call Report Instructions"). In no case (other than where

the Bank provides its letter of credit, as described herein) n6 will the Bank retain any risk associated with the underlying mortgages. n7

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n6 In any instance where the Bank elects to provide its own standby letter of credit, the Bank will take steps to ensure that the transaction may be reported as a total sale of assets under the FFIEC Call Report Instructions. Additionally, should the Bank provide its own letter of credit, we expect that its obligation would be exempt from the definition of "deposit" under Federal Reserve Board Regulation D, 12 C.F.R. § 204.2(a)(2)(ix), and therefore not a reservable liability.

n7 In order to terminate the pool in an orderly fashion, the Bank has the option (but not the obligation) to repurchase the mortgages when the pool has been amortized to 10% of its initial aggregate principal balance.

The Certificates are to be sold in a series of public offerings registered by the Bank with the Securities and Exchange Commission. The Prospectus Supplement dated January 23, 1987 names Kidder, Peabody & Co., Inc., as underwriter and provides that this series may also be sold directly to the public by a division of the Bank. Thereafter, the Bank will not buy or sell the Certificates in the secondary market.

The Bank's program closely resembles other national bank transactions involving the sale of interests in mortgage assets, or the pledge of those assets as collateral to support a borrowing, which have received this Office's approval since the mid-1970's. Several national banks, beginning at least with Bank of America in 1977, have been permitted to sell participations in pools of their conventional mortgage loans, i.e., mortgage loans that are not federally insured. See OCC Press Release of March 30, 1977 and letter from Robert Bloom, Acting Comptroller of the Currency, [1973-78 Transfer Binder] Fed. Banking L. Rep. (CCH) P 97,093 (hereinafter "Bank of America Letter"); February 14, 1978 letter from Charles B. Hall, Deputy Comptroller for Banking Operations, id. [1978-79 Transfer Binder] P 85,100; May 18, 1978 letter from John G. Heimann, Comptroller of the Currency, id. P 85,116; October 17, 1978 letter from H. Joe Selby, Deputy Comptroller for Operations, id. P 85,144; April 20, 1979 letter from Paul M. Homan, Senior Deputy Comptroller for Bank Supervision, id. P 85,167; July 31, 1979 letter from John M. Miller, Deputy Chief Counsel, id. P 85,182; February 1, 1980 letter from Paul M. Homan, Senior Deputy Comptroller for Bank Supervision, id. [1981-82 Transfer Binder] P 85,213; May 29, 1981 letter from Billy C. Wood, Deputy Comptroller, Multinational Banking, id. P 85,275.

We have reviewed this Office's previous determinations concerning national banks' sale of assets through offerings of mortgage-backed pass-through certificates and we find that nearly every feature of the Bank's program has met with this Office's prior approval. See

Bank of America Letter, supra (registered public offering underwritten by investment banking firm); Fed. Banking L. Rep. (CCH), supra P 85,100 (permitting bank employees rather than underwriters to market mortgage-backed obligations); id. P 85,116 (permitting bank's trust division rather than an independent trustee to serve as trustee for the certificateholders); id. P 85,213 (permitting national bank to use its standby letter of credit rather than third party mortgage insurance).

The SIA's letter states its view that the Bank's involvement in this transaction violates the Glass-Steagall Act, 12 U.S.C. §§ 24 (Seventh), 78, 377 and 378. We are providing an analysis of this transaction to demonstrate why the SIA's conclusion is incorrect.

In our view, a national bank's issuance of mortgage-backed pass-through certificates evidencing ownership interests in its conventional mortgage assets, of the sort evidenced by the transaction in question, represents nothing more than the negotiation of evidences of debt and the sale of real estate loans, which is expressly authorized under 12 U.S.C. §§ 24 (Seventh) and 371(a). More generally, this transaction involves a sale of bank assets, which is fully permitted under the national banking laws. The fact that the negotiation and sale may be accomplished through the creation and sale by a bank of participation certificates, an activity which this Office long has approved, does not alter in any respect the substance of the transaction, nor its permissibility under the national banking laws.

In language unaltered since the enactment of the National Bank Act in 1864, national banks are granted express authority to "carry on the business of banking; . . . by . . . negotiating promissory notes, . . . and other evidences of debt." 12 U.S.C. § 24 (Seventh). The term "negotiating" authorizes a bank's transfer of its notes or other evidences of debt acquired in the course of the banking business. See Danforth v. National State Bank, 48 F. 271 (3rd Cir. 1891); First National Bank v. Elmer, 278 S.W. 826 (Mo. App. 1926).

The authority for national banks to make mortgage loans and to sell such loans is provided in 12 U.S.C. § 371(a), as follows:

Any national banking association may make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real estate, subject to such terms, conditions, and limitations as may be prescribed by the Comptroller of the Currency by order, rule, or regulation. n8

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n8 See 12 C.F.R. Part 29 (Adjustable-Rate Mortgages) and Part 30 (Real Estate Loans).

Even prior to the creation of this express authority for banks to sell their mortgage loans, however, the Supreme Court had already determined that the sale of mortgages and other evidences of debt acquired through a national bank's exercise of its express power to lend

money on the security of real estate, and to discount and negotiate other evidences of debt, was authorized as part of the business of banking under 12 U.S.C. § 24 (Seventh). First National Bank of Hartford v. Hartford, 273 U.S. 548, 560 (1927). Thus, it is clearly established that national banks may sell their mortgage assets under the express authority of 12 U.S.C. §§ 24 (Seventh) and 371(a).

For a number of other reasons, also, a national bank's power to sell any of its lawfully acquired assets is clear. The power to sell or transfer interests in one's assets is simply an incident of ownership. Ownership is defined in Black's Law Dictionary 997 (rev. 5th ed. 1979) as the "collection of rights to use and enjoy property, including [the] right to transmit it to others." As with any other corporation, in order to operate effectively, a bank must be able to sell its assets, or interests therein, as economic conditions or safety and soundness considerations warrant. See Fed. Banking L. Rep. (CCH), supra P85,602. If banks were unable to achieve adequate liquidity through sales transactions in the relevant market for their assets, the consequences to the banking system would be serious indeed. See June 18, 1986 letter of Robert L. Clarke, supra. This Office has recognized that a bank's ability to sell interests in its long term mortgage-related portfolio serves specific banking purposes. The ability to sell mortgages which would otherwise be held for twenty or thirty years provides needed liquidity to the mortgage portfolio, resulting in the generation of additional funds for new lending and other purposes. The ability to sell mortgage assets on a regular basis also facilitates management of the maturity mismatch problems inherent in funding long term mortgages with shorter term deposits. See Bank of America Letter, supra.

In short, prudent banking practices may require that banks sell or transfer interests in their assets from time to time. Given the current, troubled condition of the banking industry and certain sectors of the nation's economy, the need for liquidity and the ability to engage in sound asset-liability management practices is all the more important to the maintenance of a safe and sound banking system. See June 18, 1986 letter of Robert L. Clarke, supra.

Thus, there is no doubt that national banks may sell their mortgage assets or any other lawfully acquired assets. Similarly, there can be no legitimate doubt that the national banking laws permit such sales to be accomplished through the issuance and sale of mortgage-backed or other asset-backed certificates. In a recent decision addressing the scope of the "business of banking" under 12 U.S.C. § 24 (Seventh), the District Court for the District of Columbia strongly endorsed the position of this Office that it may "look beyond the label given a certain activity to determine whether or not it is permissible." American Insurance Association v. Clarke, No. 85-1489 (D.D.C. March 10, 1987) ("AMBAC"). The court upheld the Comptroller's determination that a national bank's issuance of standby credit in the form of municipal bond insurance was, in substance, a letter of credit, the issuance of which is a permissible banking practice under 12 U.S.C. § 24 (Seventh). Although neither letters of credit nor municipal bond insurance are specifically enumerated as permissible bank products under the national banking laws, the court recognized that extending credit is a fundamental banking practice which can take a variety of forms, regardless of the label given the activity. The court emphasized

that the powers analysis should focus on the substance of the transaction in question and not proceed "from a narrow and artificially rigid view of both the business of banking and the statute that governs that business." Id. at 8.

The AMBAC analysis draws support from the case of M & M Leasing Corp. v. Seattle First National Bank, 563 F.2d 1377 (9th Cir. 1977), cert. denied, 436 U.S. 956 (1978) ("M & M Leasing") in which the Ninth Circuit determined that national banks are authorized under the incidental powers clause of 12 U.S.C. § 24 (Seventh) n9 to lease personal property in circumstances where the lease is "functionally interchangeable" with a secured loan. Id. at 1382-83. In reaching this conclusion, the Ninth Circuit observed that whatever the scope of the powers of national banks, they "must be construed so as to permit the use of new ways of conducting the very old business of banking." Id. at 1382.

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n9 The National Bank Act provides that national banks possess "all such incidental powers as shall be necessary to carry on the business of banking." 12 U.S.C. § 24 (Seventh).

In view of the foregoing, it is appropriate in this instance to look beyond the Bank's use of the certificate form to the substance of the transaction, which is no more than the lawful negotiation or sale of bank assets. Since this is a permitted activity for national banks, there need not be a separate authorization for the form of the sale. See AMBAC, supra. The use of this form of sale by national banks, since at least 1977, is properly characterized as a "new way" of conducting an established banking practice. See M & M Leasing, supra.

Even if we apply the most restrictive test of "incidental to banking," enunciated in Arnold Tours Inc. v. Camp, 472 F.2d 427, 432 (1st Cir. 1972) ("Arnold Tours"), that for an activity to be authorized as an incidental bank power it must be "convenient or useful" to the performance of an expressly authorized banking power, the process of pooling bank assets and selling certificates representing interests therein can be "convenient or useful" to a bank's ability to sell its assets. n10 As discussed above, national banks are expressly authorized to sell their mortgage assets under 12 U.S.C. §§ 24 (Seventh) and 371(a). This Office has previously recognized that the ability to sell participation interests in pools of mortgage loans provides national banks "a new means of recycling their mortgage dollars." By packaging their mortgage assets for sale in this marketable form, national banks can more easily achieve the liquidity and asset liability management benefits discussed above. See Bank of America Letter, supra; June 18, 1986 letter of Robert L. Clarke, supra. Thus, whether the Bank's use of the mortgage-backed pass-through certificate is viewed as a new way of selling bank assets or as an activity incidental to an authorized banking practice, we are satisfied that the issuance and sale of participation interests in pooled bank mortgage assets is permitted under 12 U.S.C. § 24 (Seventh).

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n10 This Office considers the Arnold Tours test to be overly restrictive, especially in view of the more flexible standards employed by the Supreme Court in construing the incidental powers clause. See, e.g., Merchants' National Bank v. State Bank, 77 U.S. 604, 648 (1871) (whether the activity has grown out of the business needs of the country); First National Bank v. National Exchange Bank, 92 U.S. 122, 127 (1876) (whether the activity is a reasonable and appropriate measure); Wyman v. Wallace, 201 U.S. 230, 243 (1906) (whether the activity is in terms prohibited by the national banking act); Clement National Bank v. Vermont, 231 U.S. 120, 140 (1913) (whether the activity would promote the convenience of the business of banking); Colorado National Bank v. Bedford, 310 U.S. 41, 50 (1940) (whether the activity is a generally adopted method of banks); Franklin National Bank v. New York, 347 U.S. 373, 377 (1954) (whether modern competition finds the activity usual and useful. In AMBAC, the court has indicated even more directly that the "convenient or useful" test may be overly literal and restrictive where the transaction at issue is, in substance, itself an accepted banking practice.

Because the sale of bank assets through this medium is authorized under the national banking laws, the prohibitions of the Glass-Steagall Act are inapplicable to this transaction. An analysis of the statute confirms that the Bank is not involved in a prohibited securities activity within the meaning of the Act.

As you know, the Glass-Steagall Act was designed in large part to remove commercial banks from the business of investment banking. See generally Banking Act of 1933, Pub. L. No. 73-66, S. Rep. No. 77 to Accompany S. 1631, 730 Cong., 1st Sess. (1933). In so doing, the Act addressed itself primarily to the risks to commercial bank assets and capital posed by bank participation in speculative securities investment and trading activities, as well as to the peculiar "hazards" present in the combination of commercial banking with traditional securities dealing and underwriting activities. There is no suggestion either in the language or legislative history of the Act, however, that it was designed to interfere with lawful banking functions such as the Bank's program discussed herein.

First, the Glass-Steagall Act is not implicated because the Bank's program does not involve a "security" for purposes of the Act. For the following reasons, we do not believe that the pass-through certificates are properly characterized as "securities" within the meaning of the Glass-Steagall Act. n11

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n11 Although the Bank has registered the certificate offering with the Securities and Exchange Commission, this fact, in and of itself, does not determine whether the certificates are securities for Glass-Steagall purposes. See Investment Company Institute

v. Conover, 790 F.2d 925, 933-4 (D.C. Cir.), cert. denied sub nom. Investment Company Institute v. Clarke, __ U.S. __, 107 S. Ct. 421 (1986); Investment Company Institute v. Clarke, 793 F.2d 220 (9th Cir.), cert. denied, __ U.S. __, 107 S. Ct. 422 (1986); Investment Company Institute v. Clarke, 789 F.2d 175 (2d Cir.) (per curiam), aff'd 630 F. Supp. 593 (D. Conn.), cert. denied, __, 107 S. Ct. 422 (1986) (hereinafter collectively cited as the "IRA cases").

In Investment Company Institute v. Camp, 401 U.S. 617 (1971) ("Camp"), the Supreme Court found that a bank's offering of participation units in a collective fund for managed agency accounts resulted in the illegal distribution of securities under the Glass-Steagall Act. See id. at 624-25. The Court determined that the bank's activity was, in substance, the creation of a mutual fund, which gave rise to all of the "subtle hazards" that Glass-Steagall was designed to prevent. See id. at 634-38. By contrast, in the recent IRA cases upholding the permissibility of national banks' establishing and marketing collective investment trusts for individual retirement account assets (IRAS), the Second Circuit, the Ninth Circuit and the District of Columbia Circuit all concluded that the participation units in the IRA trust funds were not "securities" for purposes of the Act. All courts affirmed the Comptroller's conclusion that these transactions were, in substance, a sale of bank fiduciary services, which did not fall within the purview of the Glass-Steagall Act. See IRA cases, supra.

This Office has previously considered pass-through certificates representing undivided interests in pooled bank assets to be legally transparent for purposes of the Glass-Steagall analysis. In other words, because the certificateholders have essentially the same rights, liabilities, and risks as if they were the owners of the underlying assets, the certificates are considered to be substantially the same as those assets. See April 12, 1983 letter of Brian W. Smith, Chief Counsel, [1983-84 Transfer Binder] Fed. Banking L. Rep. (CCH) P85,421. To the extent that the participation certificates represent "investment opportunities", the opportunity being offered is, in substance, no different than the opportunity of investment in the underlying loans which banks are clearly authorized to sell. See 12 U.S.C. §§ 24 (Seventh) and 371(a). We do not believe that the pooling and packaging of these assets alters the fundamental character of the transaction so as to create a security within the meaning of Glass-Steagall. n12 This conclusion is reinforced by our determination that the Bank's activities do not raise the "subtle hazards" that the Supreme Court has identified as being the focus of Congressional concern in enacting the Glass-Steagall Act. See discussion infra at pages 18-20.

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n12 Our position that mortgage-backed certificates are not securities under the Glass-Steagall Act draws support also from the second proviso to Section 21 of the Act, 12 U.S.C. § 378(a)(1), where Congress has indicated its clear intent not to disturb the secondary market for real estate loans made by financial institutions. See discussion infra

at page 18.

Even if the pass-through certificates are considered securities within the meaning of the Glass-Steagall Act, however, the Act's prohibitions are still not applicable to the Bank's program. Section 16 of the Act provides, in relevant part, that the "business of dealing in securities and stock [by a national bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the [bank] shall not underwrite any issue of securities or stock." This section explicitly restricts national banks' securities dealing and underwriting activities. As described in the Bank's Prospectus and Prospectus Supplement, the Bank serves as issuer of the Certificates and may also participate in their sale or distribution to the public. The first question, therefore, is whether the Bank's involvement in the distribution of these Certificates falls within the meaning of the terms "dealing" or "underwriting" in Section 16.

The term "underwriting", as used in the investment banking business, is commonly understood to refer to the process by which newly issued securities are purchased by another firm for distribution and sale to investors. See L. Loss, Fundamentals of Securities Regulation 81-90 (1983). Similarly, the term "dealing" also generally encompasses purchase and sale activity with respect to the securities of other issuers. An issuer that merely participates in the initial placement of its own securities with investors, and does not subsequently engage in the business of repurchasing those securities, does not thereby enter into the "business of underwriting" nor does it become involved in the "business of dealing." In this regard, we underscore the point that the activity in question is, in substance, a sale of the Bank's assets. n13 The Bank is not in this transaction purchasing and selling securities of other issuers but, rather, is participating in the placement of certificates representing interests in its own assets. n14 As this Office has recently stated, Section 16 is intended to control the types and amount of national bank purchase and sale activity with respect to securities issued by others, but this section does not affect a bank's activities with respect to its own securities. See Fed. Banking L. Rep. (CCH), supra P85,602. n15 Because we conclude that the Bank's activities are specifically authorized under the national banking laws, including 12 U.S.C. § 24 (Seventh), these activities are not prohibited by Section 16 of the Glass-Steagall Act, incorporated as an amendment thereto in 1933.

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n13 The Supreme Court's decision in Securities Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 137 (1984) ("Becker"), does not mandate a contrary result. In Becker, the Court rejected the Federal Reserve Board's conclusion that commercial paper should not be treated as a "note" under Section 21 of the Glass-Steagall Act, stating that the Act does not allow for making distinctions based on the characteristics of particular notes. In addition because the Board had issued

guidelines to govern the placement of third party commercial paper by state member banks, the Court concluded that the Board had converted one of the Act's flat prohibitions into a system of administrative regulation. Also, the Court was unable to find authority in the national banking laws for the business of "dealing" in commercial paper, as opposed to bank purchases of such paper which the Court described as the business of "discounting" notes. Finally, the Court suggested that the Board's analysis had caused it to ignore the bank's role in placing the commercial paper of other issuers, a practice which the Court felt raised the very hazards that Glass-Steagall was intended to prevent. The Court observed that a bank engaged in the distribution of third party commercial paper might improperly advise its clients to issue commercial paper so as to profit from the distribution process or in order to use the proceeds of the offering to retire a debt owed the bank. The Court was also concerned that such banks might use their credit facilities to shore up clients whose commercial paper they were distributing.

By contrast, the subject transaction raises none of these concerns. The Supreme Court specifically noted in Becker that the Glass-Steagall Act is not intended to affect the authority of commercial banks to conduct the business of banking. Id. at 158-59 n.11. Because the Bank's program in this case merely involves the sale of bank assets, which is part of the business of banking, the national banking laws, including Glass-Steagall, do not restrict the means by which this activity may be conducted. The OCC does not rely on the particular characteristics of the Bank's Certificates or establish a scheme of administrative regulation in order to assure the legality of the Bank's activity. Unlike in Becker, the Bank's activity cannot even arguably be characterized as "dealing" in or "underwriting" another issuer's securities but is an authorized banking practice. See discussion supra at pages 11-12. Further, because, among other things, the Bank is selling interests in its own assets rather than the securities of a third party issuer, the Bank's program does not present the inherent conflicts of interest which were the focus of the Court's concern in Becker. See discussion infra at pages 18-20.

n14 The fact that the Prospectus Supplement designates the Bank as "underwriter" of the Certificate series has no bearing on the Glass-Steagall analysis. Whether the Bank is underwriting within the meaning of the Glass-Steagall Act depends upon the transaction itself [e.g., there must be a public offering, See Securities Industry Association v. Board of Governors of the Federal Reserve System, 807 F.2d 1052, 1066 (D.C. Cir. 1986) ("SIA v. Board of Governors")], and upon the Bank's role in the transaction, as discussed herein. Here, the Prospectus Supplement has merely labeled the Bank as underwriter for purposes of indicating that it may place the Certificates directly with investors, but this does not change the Bank's role in the transaction. Cf. Becker, 468 U.S. at 154-60 (bank's role in transaction is significant part of Glass-Steagall analysis).

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n15 It is also instructive to note that the Bank's conduct in this transaction does not appear to bring it within the definitions of the terms "underwriter" or "dealer" contained in the Securities Act of 1933 ("Securities Act"). The Securities Act defines "underwriter"

as "any person who has purchased from an issuer with a view to, or offers to sell for an issuer in connection with, the distribution of any security. . ." 15 U.S.C. § 77b(11). Similarly, the Securities Act defines "dealer" as one who "engages . . . in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person." 15 U.S.C. § 77b(12). Thus, as defined in the Securities Act, both of these terms denote activity with respect to the securities of another issuer. While the broader definitions of the federal securities laws are not controlling for purposes of the Glass-Steagall Act, these statutes were enacted during the same time period, and the Supreme Court has previously sought guidance from the securities laws in understanding the ordinary meaning of terms that also appear in Glass-Steagall. See Becker, 468 U.S. at 150-52. See also SIA v. Board of Governors, 807 F.2d at 1062-64. We do not believe, however, that activities not subject to the federal securities laws could ever be subject to Glass-Steagall.

If the Bank's activities are permissible under Section 16, there is no need to conduct any inquiry under Section 21 of the Act. n16 That section prohibits any organization "engaged in the business of issuing, underwriting, selling, or distributing, . . . securities" from engaging at the same time in the business of receiving deposits. Even if separate consideration of Section 21 is warranted, however, the Bank's involvement in this transaction is permitted because the Bank is not engaged in any of the prohibited businesses. n17

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n16 In a recent case addressing the inteerplay of these two sections, the Court of Appeals for the District of Columbia Circuit explained that Section 21 must be addressed only if Section 16 is inapplicable. See SIA v. Board of Governors, 807 F.2d at 1057.

n17 Having determined that the Bank is not "underwriting" in violation of Section 16, no further analysis is necessary to conclude that the Bank is also not in violation of the underwriting prohibition contained in Section 21. See Becker, 468 U.S. at 149.

In analyzing this section, it is important to recognize that it does not absolutely prohibit depository institutions from conducting the listed activities. Specifically, Section 21 provides that it does not prohibit national banks from "issuing securities" to the extent permitted under 12 U.S.C. § 24. Further, it is beyond dispute that Section 21 does not affect national banks' ability to raise funds from their operations through the issuance, distribution and sale of a variety of debt and equity securities. The authority for national banks to issue these securities is evident from several different provisions of the national banking laws, and the Comptroller's regulations thereunder. See, e.g., 12 U.S.C. § 51

(requirement of capital); 12 U.S.C. § 51c (defining "capital" as including common stock plus outstanding preferred stock); 12 U.S.C. § 51a (authorizing the issuance of preferred stock); 12 U.S.C. § 52 (prescribing form of stock certificates and indicating possibility of more than one class of stock); 12 C.F.R. § 3.100 (subordinated notes and debentures may be treated as part of capital if certain criteria are met).

In this context, the power to issue securities to raise funds for national bank operations necessarily encompasses the power to distribute and sell these securities to the investing public. In fact, national banks have for years sold their own debt and equity securities directly to investors through public offerings without there being any suggestion that this activity is barred by the Glass-Steagall Act. See 12 C.F.R. Part 16. Moreover, as you are aware, members of the SIA frequently assist in the marketing of mortgage-backed and other asset-backed certificates for national banks. If the "issuance" of these instruments is not legal, these SIA members could be exposed to liability under Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (civil liability for false registration statement).

For similar reasons, in considering the subject transaction, we do not believe that Section 21 is intended to affect a bank's ability to raise funds for its operations through the issuance (and distribution and sale) of certificates representing interests in its own assets. Section 21 is primarily intended to prevent investment banks from receiving deposits. Recent court decisions have emphasized, however, that the Glass-Steagall Act is not intended to bar national banks, which obviously do receive deposits, from activity that is authorized under other provisions of the Act or the national banking laws. See, e.g., Becker, 468 U.S. at 158 n.11 (Glass-Steagall not intended to interfere with activities authorized as part of the "business of banking"); Board of Governors of Federal Reserve System v. Investment Company Institute, 450 U.S. 46, 63 (1981) ("Board of Governors") (Section 21 not intended to require abandonment of accepted banking practice consistent with Section 16); SIA v. Board of Governors, 807 F.2d at 1057 (Section 21 cannot be read to prohibit what Section 16 permits); IRA cases, supra (Glass-Steagall does not prohibit national banks from conducting bona fide fiduciary activity through operation of an IRA trust, notwithstanding recent entry of banks into this field). As we have seen, Section 16 places no limitations on the issuance of securities by national banks, and the national banking laws permit the use of the participation certificate form as a means of selling or transferring interests in bank assets. In view of this analysis, and the above discussion concerning the permissibility of various national bank securities issuances, distributions, and sales under Section 21, we think it clear that the Glass-Steagall Act does not prohibit national banks from raising funds through the issuance of certificates representing interests in their pooled assets. n18

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n18 The SIA's letter also suggests that the Bank's activity involves violations of Sections 20 and 32 of Glass-Steagall, 12 U.S.C. §§ 377 and 78. Section 20 prohibits affiliations between national banks and organizations "engaged principally in the issue, flotation, underwriting, public sale, or distribution . . . of securities." Section 32 prohibits national banks from sharing officers, directors or employees with organizations "primarily

engaged" in these same activities. These sections of the Act would only be applicable if the trust created in the course of pooling the mortgage loans were viewed as an entity distinct from the Bank. In the past, since the trust is merely the vehicle used for packaging the bank's assets, this Office has considered the trust to be legally transparent and not a distinct entity for purposes of the Glass-Steagall analysis. Cf. Fed. Banking L. Rep. (CCH), supra P 85,421 (pool of FHA-insured mortgages assigned to trustee considered legally transparent for purposes of Section 16).

Even if we consider the trust to be a distinct entity, however, the Supreme Court has made it abundantly clear that a one-time initial issuance of securities, as in the issuance of a closed-end investment company's shares, is not sufficient to render a company "principally engaged" in the issuance of securities within the meaning of Section 20. Otherwise, "all corporations, including banks, would at some point be engaged principally in the issuance of securities." Board of Governors, 450 U.S. at 60-61 n.26. For the same reasons, it seems obvious that a one-time issuance could not result in an entity's being "primarily engaged" in the issuance of securities within the meaning of Section 32. Further, as this Office has recently stated, securities activities which are authorized for national banks under Section 16 are similarly permitted for their affiliates under Section 20. See January 29, 1987 letter of Richard V. Fitzgerald, Chief Counsel. See also Board of Governors, 450 U.S. at 61 n.26 (conclusion that Federal Reserve Board regulation is permitted under §§ 16 and 21 subsumes the argument that it violates § 20); Camp, 401 U.S. at 626 n.12 (limitations placed on activities of national banks are at least as great as limitations placed on activities of their affiliates). Based on the foregoing, and our conclusions supra regarding the permissibility of the Bank's activities under Sections 16 and 21, we are satisfied that the Bank's program does not involve any violation of Section 20 or Section 32.

Further, in the case of national banks' issuance and sale of mortgage related pass-through certificates, this Office has in the past also relied upon explicit language contained in Section 21, "that nothing in this paragraph shall be construed as affecting in any way such right as any bank . . . may otherwise possess to sell, without recourse or agreement to repurchase, obligations evidencing loans on real estate." This language is understood to reflect the intent of Congress not to disturb the secondary market for real estate loans made by financial institutions. See June 18, 1986 letter from Robert L. Clarke, supra, and letters cited therein.

Finally, a review of the Bank's program in light of the purposes of the Glass-Steagall Act, as identified by the Supreme Court in Camp and Becker, supra, and in other court cases, reinforces our conclusion that the Bank's activities are fully permissible under applicable law. At the outset, we note that the most obvious of the Glass-Steagall hazards, the danger of commercial bank investment in speculative stock or securities, is wholly absent from the Bank's program. See Camp, 401 U.S. at 630. At no time will the Bank's resources be committed to any securities investment whatsoever, since the program

involves only the sale of bank assets.

The Bank's program also does not present the significant "subtle hazards" associated with prohibited bank securities activities under the Supreme Court's previous Glass-Steagall determinations. These "subtle hazards" are thought to arise when a commercial bank's promotional interest in the success of particular securities investments or its securities affiliates might interfere with the bank's ability to act as an impartial source of credit or to render disinterested investment advice. See Camp, 401 U.S. at 630-34; Becker, 468 U.S. at 145-47.

Under the Bank's program, which does not involve the marketing of bank customers' securities, most of the conflicts of interest identified by the Supreme Court in Becker, supra, are simply not at issue. The Bank does not have a promotional interest in the success of any customer's securities, thus it will not be tempted to make unsound loans to customers in order to influence the success of their securities offerings. Similarly, there is no possibility that the Bank might improperly advise its customers on how and when to issue securities in order to profit from the distribution process or to use the proceeds in obtaining repayment on outstanding loans. n19

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n19 The Bank's program might affect its ability to serve as disinterested financial advisor to customers who are potential purchasers of the Certificates. This hazard, however, is not unique to the securities business. Indeed, it is present in any sale to customers of bank services or products. In fact, this very hazard was found to be present in SIA v. Board of Governors, supra, where the Court observed that "'subtle hazards' counsel prohibition of a banking practice only when the practice gave rise to each and every one of the hazards." 807 F.2d at 1069.

We also do not believe that the possibility of the Bank's providing limited credit support for future certificate series raises any Glass-Steagall hazard. In actuality, if the Bank were to issue its own letter of credit, this would only mean that the Bank would retain a small portion of the credit risk it had already incurred in the normal course of originating the underlying mortgage loans. Considering that in the absence of the Bank's sale of these assets it would retain 100% of the associated credit risk, it is difficult to conceive how a decision to provide credit support for no more than 10% of the initial aggregate principal balance of a pool comprised of these same assets could be the product of "unsound" lending practices.

Nor do we think it likely that the Bank's program will have any effect on the soundness of its mortgage lending practices. Traditionally, banks have sold their mortgage assets through loan participations, and the use of the pass-through certificate to accomplish such sales raises no additional safety and soundness issues. The Bank's use of the pass-through

certificate to sell whole mortgage loans merely allows it to utilize the most efficient means of transferring these assets. We think it extremely unlikely that a bank would engage in unsafe mortgage lending practices simply because of the possibility that the resulting mortgage loans might thereafter be placed in a pool and sold in certificate form. In this regard, at the time of origination, it will generally not be possible for the Bank to know whether a particular loan will be suitable for subsequent inclusion in a public offering. In addition, the Bank would have difficulty marketing the Certificates if the underlying mortgages were themselves unsound investments because the federal securities laws require full disclosure of all material facts concerning the Certificates and the offering. In short, the Bank does not stand to profit by making unsound loans with the intent of remarketing them to uniformed purchasers. See SIA v. Board of Governors, 807 F.2d at 1068 (economic realities and impact of full disclosure under federal securities laws are relevant to hazards analysis).

We also do not believe that the Bank's involvement in this program is likely to result in its making unsound loans to deposit customers in order to finance their purchase of the pass-through certificates. Because of the servicing fee, the pass-through rate will be lower than the interest rates on the underlying mortgage loans. From the customer's point of view, it would be irrational to obtain a bank loan at the higher commercial rate so as to invest in the Bank's Certificates at the lower pass-through rate. Similarly, since the Bank's objective is to sell the mortgage loans, it would hardly make economic sense for it to replace these assets with unsound loans acquired in the process. Finally, there is no risk that the Bank's reputation might suffer as a result of its being identified with the Certificates because the Prospectus makes full disclosure of all material risks associated with the offering. Accordingly, we conclude that the Bank's program overall does not raise the conflicts of interest and other hazards that are characteristic of the securities activities prohibited to national banks under the Glass-Steagall Act.

In conclusion, we are satisfied that the Bank's program, as described in the Prospectus and Prospectus Supplement dated January 23, 1987, is squarely based on long-standing precedent that is fully supported by applicable law and subsequent court decisions interpreting these laws. In pooling its mortgage loans and selling interests therein, the Bank is merely engaging in a permitted sale of its mortgage assets. We cannot conclude that the Glass-Steagall Act is intended to preclude banks from conducting this activity. We trust that this letter has been responsive to your request.

Sincerely,

Comptroller of the Currency
Washington, DC 20219

Release Date: March 1988
Interpretive Letter No. 418

1988 OCC Ltr. LEXIS 16; Fed. Banking L. Rep. (CCH) P85,642

February 17, 1988

[*1]

Re: BancBoston Mortgage Securities, Inc.

Douglas A. Bacon, Esq.
Senior Counsel
The First National Bank of Boston
Boston, Massachusetts 02106

Dear Mr. Bacon:

This letter responds to the notification by The First National Bank of Boston ("Bank") of its intent to establish a new operating subsidiary, BancBoston Mortgage Securities, Inc. ("Mortgage Securities"). Mortgage Securities will be a wholly owned subsidiary of an existing wholly owned operating subsidiary of the Bank, BancBoston Mortgage Companies, Inc. ("Mortgage Companies"). Mortgage Securities is being organized to facilitate the securitization of mortgage assets held by Mortgage Companies and its other mortgage subsidiaries in the course of their mortgage banking business. The Office previously has found similar proposals permissible for national banks. Accordingly, the Office approves the Bank's establishment of Mortgage Securities.

The Bank's Proposal

Our understanding of the Bank's proposal is based upon the Bank's operating subsidiary notification letter, dated March 9, 1987, the Bank's supplemental letter, dated June 18, 1987, and your telephone conversations with Richard H. Cleva, a senior [*2] attorney in the Legal Advisory Services Division of this Office.

Mortgage Companies is an existing subsidiary of the Bank which engages in the mortgage banking business both directly and through three wholly owned second-tier subsidiaries. Mortgage Securities will be a wholly owned subsidiary of Mortgage Companies and is being organized to facilitate the sale, in securitized forms, of mortgage assets held by Mortgage Companies, its three other subsidiaries, the Bank, or affiliates of the Bank. Mortgage Securities will conduct its business from an office located in Jacksonville, Florida, which is neither the main office nor a branch of the Bank.

Mortgage Securities is being organized to issue mortgage-related instruments based upon mortgage assets held by its affiliates. In so doing, Mortgage Securities will engage in the following activities. First, it will acquire, own, hold, sell, transfer, assign, pledge, finance, refinance, and/or otherwise

deal in (a) fully modified pass-through certificates ("GNMA Certificates") guaranteed as to the timely payment of principal and interest by the Government National Mortgage Association ("GNMA"), (b) mortgage pass-through certificates [*3] ("FNMA Certificates") guaranteed as to the timely payment of principal and interest by the Federal National Mortgage Association ("FNMA"), (c) mortgage participation certificates ("FHLMC Certificates", and, together with the GNMA Certificates and the FNMA Certificates, "Agency Certificates") guaranteed as to the ultimate payment of principal and the timely payment of interest by the Federal Home Loan Mortgage Corporation ("FHLMC"), and (d) conventional residential mortgage loans.

Second, it will authorize, issue, and deliver bonds or other evidences of indebtedness (in single or multi-class form) either directly or through grantor trusts established by Mortgage Securities, which bonds or other evidences of indebtedness would be collateralized by a pool of Agency Certificates and/or conventional residential mortgage loans (each such bond or other evidence of indebtedness a "Collateralized Mortgage Obligation" or "CMO"). Third, it will authorize, issue, and deliver certificates or other evidences of an ownership interest (in single or multi-class form) in a pool of Agency Certificates and/or conventional residential mortgage loans (each such certificate or other evidence of an ownership [*4] interest a "Pass-Through Certificate"). Fourth, it will authorize, issue, and deliver any other similar instruments, bonds, certificates, evidences of indebtedness or ownership, or securities as may by law be permitted. Fifth, it will engage in other activities incidental to accomplishing the foregoing.

The CMOs or Pass-Throughs issued by Mortgage Securities may be backed by either Agency Certificates or mortgage loans. The Agency Certificates are intended primarily to be Agency Certificates issued by GNMA, FNMA, or FHLMC in exchange for mortgage loans originated by Mortgage Companies or other affiliates of Mortgage Securities. However, it is also intended that Mortgage Securities will supplement such Agency Certificates with other Agency Certificates purchased in the open market.

Of the mortgage loans used to back CMOs or Pass-Throughs issued by Mortgage Securities, approximately fifty percent of the mortgages in Mortgage Securities portfolio will have been originated by parties unrelated to Mortgage Securities, i.e., correspondent institutions, and approximately fifty percent will have been originated by Mortgage Companies, its subsidiaries, the Bank, and its other [*5] subsidiaries and affiliates. Mortgage Companies and its mortgage banking subsidiaries regularly sell and purchase mortgages from other institutions in the secondary mortgage market as a routine part of their mortgage banking business. They purchase only mortgages which comply with Mortgage Companies' own underwriting standards used on direct originations. Those underwriting standards are FNMA/FHLMC standards for conventional loans and FHA/VA standards for FHA and VA loans, as applicable. Any mortgages purchased by Mortgage Companies or its subsidiaries are reviewed to ensure that they meet or exceed these standards. Whether originated by Mortgage Companies and its affiliates or purchased, it is expected that substantially all of the conventional residential mortgage loans acquired by Mortgage Securities and used to collateralize CMOs or underlie Pass-Through Certificates issued by Mortgage Securities will be loans serviced by Mortgage Companies, its subsidiaries, or other affiliates of the Bank.

Transactions would be structured as follows: Mortgage Securities would purchase the mortgage loans or Agency Certificates from the affiliates referred to above and would then issue [*6] and sell the CMOs or Pass-Through Certificates to the underwriter, securing them with a pledge of the

mortgages or Agency Certificates to a trustee. The proceeds of each issuance of CMOs or Pass-Through Certificates will be used to purchase the collateral necessary to secure the CMOs or to purchase the mortgage interests underlying the Pass-Through Certificates. It is presently contemplated that the CMOs or Pass-Through Certificates proposed to be issued by Mortgage Securities would be issued in a number of series under a pooling agreement, indenture, or similar document between Mortgage Securities or a trust established by Mortgage Securities and an unaffiliated trustee, and would bear interest at rates to be determined for each series. Mortgage Securities may elect to treat certain of the CMOs or Pass-Through Certificates issued as regular or residual interests in a real estate mortgage investment conduit ("REMIC") under the Internal Revenue Code of 1986.

The CMOs or Pass-Through Certificates issued by Mortgage Securities would be registered with the Securities and Exchange Commission under the Securities Act of 1933. The holders of any CMOs or Pass-Through Certificates issued [*7] by Mortgage Securities would not have any recourse against the Bank, Mortgage Companies, its mortgage subsidiaries, or any other affiliate of the Bank (except against Mortgage Securities in the case of a CMO issued by Mortgage Securities directly). The only recourse of the holders of any CMOs (other than those issued by Mortgage Securities directly) or Pass-Through Certificates would be to exercise their rights with respect to such collateral or such underlying mortgage interests, as the case may be, and to enforce the guaranty of any third party, such as GNMA. This fact would be brought prominently to the attention of prospective investors, who would also be specifically informed that the CMOs or Pass-Through Certificates do not represent bank deposits and are not insured by the Federal Deposit Insurance Corporation.

The Bank has engaged the services of an independent, unrelated investment banking firm to act as underwriter for the initial offering by Mortgage Securities. The Bank, Mortgage Securities, and other affiliates do not intend to engage in activities which would cause them to be treated as underwriters of Mortgage Securities' issuances under the federal securities [*8] laws.

In addition, the Bank will not finance any purchaser's acquisition of the CMOs or Pass-Through Certificates, will not purchase any of the CMOs or Pass-Through Certificates for any trust or agency account as to which it has investment discretion or for the Bank's pension accounts, will not promote the CMOs or Pass-Through Certificates, and will not lend money to Mortgage Securities.

Discussion

These activities -- i.e., participation in the mortgage banking business including the buying and selling of mortgage assets (and lending or borrowing collateralized by mortgage assets) in both direct and securitized formats -- are permissible activities for national banks and their subsidiaries and have been previously approved by this Office. Accordingly, we believe the proposed activities of Mortgage Securities are permissible and approve the Bank's proposal.

The origination and making of real estate loans on the part of the bank; the purchase and sale of real estate loans and participations therein; and the originating, warehousing, and servicing of loans on behalf of other investors are centrally traditional banking activities. See, e.g., *12 U.S.C. §§ 24*(7) [*9] & 371(a); 12 C.F.R. § 34.1; 12 C.F.R. § 7.7379; *First National Bank of Hartford v. City of Hartford, 273 U.S. 548, 559-60 (1927).*

This mortgage banking business includes making loans and holding them in portfolio, making loans and selling them on to other lenders, purchasing loans from other loan-originators and holding them, purchasing loans and selling them on, and servicing loans. The mix of activities in any given bank's mortgage banking business at any particular time depends on such factors as local lending opportunities, secondary market lending opportunities, local funding opportunities, secondary market funding opportunities, and so on.

The Office also believes that the activity of selling mortgages into the secondary market, or alternatively raising lendable funds by borrowing in the market secured by mortgages, may be accomplished by the use of the securitized formats which the market has developed in the last decades as well as by direct methods. The securitized formats are tools used to effect the selling, purchasing, borrowing, and lending functions of the secondary market. They were developed so that these market functions could be accomplished more efficiently; [*10] but they are mere tools, another means of performing the same functions.

In keeping with this view, the Office, at least as far back as 1977, has approved of national banks' use of pass-through certificates, collateralized mortgage obligations, or similar instruments as vehicles for selling, or borrowing against, mortgage assets. See, e.g., Letter of Robert L. Clarke, Comptroller of the Currency (June 18, 1986) (unpublished) (surveying prior letters and elaborating Office's legal analysis); OCC No-action Letter No. 86-9 (May 22, 1986), reprinted in *Fed. Banking L. Rep (CCH) P84,015* (bank issuance and sale of CMOs based on pools of agency mortgage certificates and/or mortgage loans); OCC Interpretive Letter No. 257 (April 12, 1983), reprinted in *Fed. Banking L. Rep. (CCH) P85,421* (bank selling and dealing in pass-through certificates where pool of loans consists of obligations expressly eligible under section 24(7)); OCC Interpretive Letter No. 92 (April 20, 1979), reprinted in *Fed. Banking L. Rep. (CCH) P85,167* (pool of conventional mortgage loans, bank sale through issuance of pass-through certificates in two classes); OCC Interpretive Letter No. 41 (May 18, 1978), [*11] reprinted in *Fed. Banking L. Rep. (CCH) P85,116* (pool of conventional mortgage loans, bank sale through issuance of pass-through certificates); OCC Interpretive Letter No. 25 (February 14, 1978), reprinted in *Fed. Banking L. Rep. (CCH) P85,100* (pool of conventional mortgages, bank sale through issuance of pass-through certificates, and bank employees marketing the certificates in private placements); Letter of Robert Bloom, Acting Comptroller of the Currency (March 29, 1977), reprinted in *Fed. Banking L. Rep. (CCH) P97,093* (pool of conventional mortgage loans, bank sale through issuance of pass-through certificates).

In addition, on two more recent occasions, the Office has reiterated its views on national banks' use of pass-through certificates and CMO vehicles. In one letter, in addition to the Office's traditional analysis of the bank's power to use these vehicles, various operational legal, accounting, and reporting questions in the use of CMOs were discussed. See OCC Interpretive Letter No. 378 (March 24, 1987), reprinted in *Fed. Banking L. Rep. (CCH) P85,602.* In another letter, the Office considered the additional factual element that the bank participated [*12] in the public selling efforts for its pass-through certificates, in addition to using an independent investment bank for sales efforts, and concluded this activity was also permissible for banks. See OCC Interpretive Letter No. 388 (June 16, 1987), reprinted in *Fed. Banking L. Rep. (CCH) P85,612,* suit pending, Securities Industry Association v. *Clarke, No. 87-4504* (S.D.N.Y. filed June 25, 1987).

As can be seen from the foregoing list of prior letters, the activities involved in the Bank's proposal are within the scope of these contemplated in the Office's various prior authorizations from 1977

forward. Indeed, since the Bank intends to use an independent investment bank and will not itself participate in the selling efforts, the Bank's proposal is within the Office's pre-1987 letters and does not involve a factual setting similar to Letter No. 388 of June 16, 1987. Inasmuch as the Office has previously determined these activities to be permissible for national banks, we find the Bank's proposed activities in Mortgage Securities similarly permissible.

Mortgage Securities will conduct its activities from an office which is neither the head office nor a branch [*13] of the Bank. However, in our opinion the proposed activities of Mortgage Securities do not include the types of business for which a branch license is required under *12 U.S.C. § 36*(f), because its activities do not involve the three types of banking business enumerated in section 36(f) -- i.e., making loans, receiving deposits, or paying checks. See *Clarke v. Securities Industry Association, 479 U.S. , 93 L. Ed. 2d 757, 772-75 (1987).* Thus, Mortgage Securities' activities may be performed at locations other than branches, and the Bank's proposal is accordingly consistent with *12 U.S.C. § 36.*

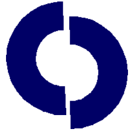
Finally, the Bank's proposal is not affected by the recently enacted Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552. In section 201(b) of the Act, Congress passed a temporary moratorium on approvals of certain securities activities of banking organizations. Under section 201(b)(2)(B), a federal banking agency may not authorize a bank to engage "in any securities activity not legally authorized in writing prior to March 5, 1987." Assuming without deciding that the Bank's proposal would involve a "securities activity" within the meaning of the [*14] Act, it is nevertheless not covered by the moratorium since the activities in the Bank's proposal are like those authorized in the Office's prior letters from 1977 onward, such as those discussed earlier. Moreover, the Act also does not affect "activities which had been lawfully engaged in prior to March 5, 1987." Because banks have previously engaged in the activities involved in the Bank's proposal (as shown, for example, in the transactions which were the subjects of the Office's prior letters), the Bank's proposal is not affected by the moratorium also under this provision.

Conclusion

As set forth above, the proposed activities of Mortgage Securities are within the scope of activities previously determined to be permissible for national banks and their operating subsidiaries. Thus, in light of the above precedents and based upon our review of your description of Mortgage Securities' activities and your legal analysis, we believe the proposed activities are permissible. Accordingly, the Bank may proceed with its proposal under 12 C.F.R. § 5.34.

Very truly yours,

J. Michael Shepherd
Senior Deputy Comptroller for Corporate and Economic Programs



L-Sec

Comptroller of the Currency
Administrator of National Banks

Asset Securitization

Comptroller's Handbook

November 1997

Liquidity and Funds Management

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Background

Asset securitization is helping to shape the future of traditional commercial banking. By using the securities markets to fund portions of the loan portfolio, banks can allocate capital more efficiently, access diverse and cost-effective funding sources, and better manage business risks.

But securitization markets offer challenges as well as opportunity. Indeed, the successes of nonbank securitizers are forcing banks to adopt some of their practices. Competition from commercial paper underwriters and captive finance companies has taken a toll on banks' market share and profitability in the prime credit and consumer loan businesses. And the growing competition within the banking industry from specialized firms that rely on securitization puts pressure on more traditional banks to use securitization to streamline as much of their credit and originations business as possible. Because securitization may have such a fundamental impact on banks and the financial services industry, bankers and examiners should have a clear understanding of its benefits and inherent risks.

This booklet begins with an overview of the securitization markets, followed by a discussion of the mechanics of securitization. The discussion evolves to the risks of securitization and how, at each stage of the process, banks are able to manage those risks.

A central theme of this booklet is the bank's use of asset securitization as a means of funding, managing the balance sheet, and generating fee income. The discussion of risk focuses on banks' roles as financial intermediaries, that is, as loan originators and servicers rather than as investors in asset-backed securities. Although purchasing asset-backed securities as investments clearly helps to diversify assets and manage credit quality, these benefits are discussed in other OCC publications, such as the "Investment Securities" section of the *Comptroller's Handbook*.

Definition

Asset securitization is the structured process whereby interests in loans and other receivables are packaged, underwritten, and sold in the form of "asset-backed" securities. From the perspective of credit originators, this market enables them to transfer some of the risks of ownership to parties more willing or able to manage them. By doing so, originators can access the funding markets at debt ratings higher than their overall corporate ratings, which generally gives them access to broader funding sources at more favorable rates. By removing the assets and supporting debt from their balance sheets, they are able to save some of the costs of on-balance-sheet financing and manage potential asset-liability mismatches and credit concentrations.

Brief History

Asset securitization began with the structured financing of mortgage pools in the 1970s. For decades before that, banks were essentially portfolio lenders; they held loans until they matured or were paid off. These loans were funded principally by deposits, and sometimes by debt, which was a direct obligation of the bank (rather than a claim on specific assets).

But after World War II, depository institutions simply could not keep pace with the rising demand for housing credit. Banks, as well as other financial intermediaries sensing a market opportunity, sought ways of increasing the sources of mortgage funding. To attract investors, investment bankers eventually developed an investment vehicle that isolated defined mortgage pools, segmented the credit risk, and structured the cash flows from the underlying loans. Although it took several years to develop efficient mortgage securitization structures, loan originators quickly realized the process was readily transferable to other types of loans as well.

Since the mid 1980s, better technology and more sophisticated investors have combined to make asset securitization one of the fastest growing activities in the capital markets. The growth rate of nearly every type of securitized asset has been remarkable, as have been the increase in the types of companies using securitization and the expansion of the investor base. The business of a credit intermediary has so changed that few banks, thrifts,

or finance companies can afford to view themselves exclusively as portfolio lenders.

Market Evolution

The market for mortgage-backed securities was boosted by the government agencies that stood behind these securities. To facilitate the securitization of nonmortgage assets, businesses substituted private credit enhancements. First, they overcollateralized pools of assets; shortly thereafter, they improved third-party and structural enhancements. In 1985, securitization techniques that had been developed in the mortgage market were applied for the first time to a class of nonmortgage assets — automobile loans. A pool of assets second only to mortgages, auto loans were a good match for structured finance; their maturities, considerably shorter than those of mortgages, made the timing of cash flows more predictable, and their long statistical histories of performance gave investors confidence.

The first significant bank credit card sale came to market in 1986 with a private placement of $50 million of bank card outstandings. This transaction demonstrated to investors that, if the yields were high enough, loan pools could support asset sales with higher expected losses and administrative costs than was true within the mortgage market. Sales of this type — with no contractual obligation by the seller to provide recourse — allowed banks to receive sales treatment for accounting and regulatory purposes (easing balance sheet and capital constraints), while at the same time allowing them to retain origination and servicing fees. After the success of this initial transaction, investors grew to accept credit card receivables as collateral, and banks developed structures to normalize the cash flows.

The next growth phase of securitization will likely involve nonconsumer assets. Most retail lending is readily "securitizable" because cash flows are predictable. Today, formula-driven credit scoring and credit monitoring techniques are widely used for such loans, and most retail programs produce fairly homogeneous loan portfolios. Commercial financing presents a greater challenge. Because a portfolio of commercial loans is typically less homogeneous than a retail portfolio, someone seeking to invest in them must often know much more about each individual credit, and the simpler tools for

measuring and managing portfolio risk are less effective. Nonetheless, investment bankers and asset originators have proven extremely innovative at structuring cash flows and credit enhancements. Evidence of this can be seen in the market for securitized commercial real estate mortgages. Commercial real estate is one of the fastest-growing types of nonconsumer assets in the securitization markets, which fund approximately 10 percent of commercial mortgage debt.

Benefits of Asset Securitization

The evolution of securitization is not surprising given the benefits that it offers to each of the major parties in the transaction.

For Originators

Securitization improves returns on capital by converting an on-balance-sheet lending business into an off-balance-sheet fee income stream that is less capital intensive. Depending on the type of structure used, securitization may also lower borrowing costs, release additional capital for expansion or reinvestment purposes, and improve asset/liability and credit risk management.

For Investors

Securitized assets offer a combination of attractive yields (compared with other instruments of similar quality), increasing secondary market liquidity, and generally more protection by way of collateral overages and/or guarantees by entities with high and stable credit ratings. They also offer a measure of flexibility because their payment streams can be structured to meet investors' particular requirements. Most important, structural credit enhancements and diversified asset pools free investors of the need to obtain a detailed understanding of the underlying loans. This has been the single largest factor in the growth of the structured finance market.

For Borrowers

Borrowers benefit from the increasing availability of credit on terms that lenders may not have provided had they kept the loans on their balance

sheets. For example, because a market exists for mortgage-backed securities, lenders can now extend fixed rate debt, which many consumers prefer over variable rate debt, without overexposing themselves to interest rate risk. Credit card lenders can originate very large loan pools for a diverse customer base at lower rates than if they had to fund the loans on their balance sheet. Nationwide competition among credit originators, coupled with strong investor appetite for the securities, has significantly expanded both the availability of credit and the pool of cardholders over the past decade.

Before evaluating how a bank manages the risks of securitization, an examiner should have a fundamental understanding of asset-backed securities and how they are structured. This section characterizes asset-backed securities, briefly discusses the roles of the major parties, and describes the mechanics of their cash flow, or how funds are distributed.

Basic Structures of Asset-Backed Securities

A security's structure is often dictated by the kind of collateral supporting it. Installment loans dictate a quite different structure from revolving lines of credit. Installment loans, such as those made for the purchase of automobiles, trucks, recreational vehicles, and boats, have defined amortization schedules and fixed final maturity dates. Revolving loans, such as those extended to credit card holders and some home equity borrowers, have no specific amortization schedule or final maturity date. Revolving loans can be extended and repaid repeatedly over time, more or less at the discretion of the borrower.

Installment Contract Asset-Backed Securities

Typical installment contract asset-backed securities, which bear a close structural resemblance to mortgage pass-through securities, provide investors with an undivided interest in a specific pool of assets owned by a trust. The trust is established by pooling installment loan contracts on automobiles, boats, or other assets purchased from a loan originator, often a bank.

The repayment terms for most installment contract asset-backed securities call for investors to receive a pro rata portion of all of the interest and principal received by the trust each month. Investors receive monthly interest on the outstanding balance of their certificates, including a full month's interest on any prepayments. The amount of principal included in each payment depends on the amortization and prepayment rate of the underlying collateral. Faster prepayments shorten the average life of the issue.

Revolving Asset Transactions

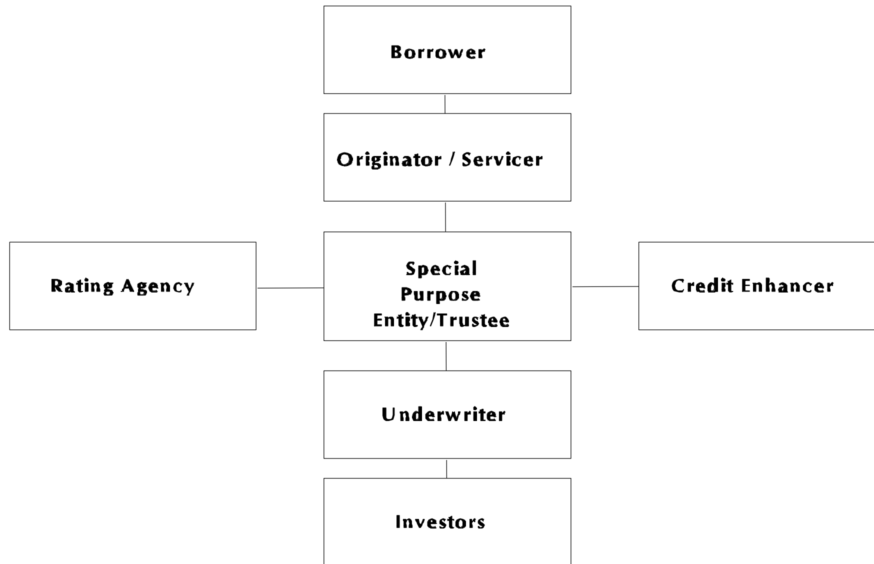
The typically short lives of receivables associated with revolving loan products (credit cards, home equity lines, etc.) require issuers to modify the structures used to securitize the assets. For example, a static portfolio of credit card receivables typically has a life of between five months and ten months. Because such a life is far too short for efficient security issuance, securities backed by revolving loans are structured in a manner to facilitate management of the cash flows. Rather than distributing principal and interest to investors as received, the securities distribute cash flow in stages — a revolving phase followed by an amortization phase. During the revolving period, only interest is paid and principal payments are reinvested in additional receivables as, for example, customers use their credit cards or take additional draws on their home equity lines. At the end of the revolving period an amortization phase begins, and principal payments are made to investors along with interest payments. Because the principal balances are repaid over a short time, the life of the security is largely determined by the length of the revolving period.

Parties to the Transaction

The securitization process redistributes risk by breaking up the traditional role of a bank into a number of specialized roles: originator, servicer, credit enhancer, underwriter, trustee, and investor. Banks may be involved in several of the roles and often specialize in a particular role or roles to take advantage of expertise or economies of scale. The types and levels of risk to which a particular bank is exposed will depend on the organization's role in the securitization process.

With sufficient controls and the necessary infrastructure in place, securitization offers several advantages over the traditional bank lending model. These benefits, which may increase the soundness and efficiency of the credit extension process, can include a more efficient origination process, better risk diversification, and improved liquidity. A look at the roles played by the primary participants in the securitization process will help to illustrate the benefits.

Exhibit 1: Parties Involved in Structuring Asset-Backed Securities



Borrower. The borrower is responsible for payment on the underlying loans and therefore the ultimate performance of the asset-backed security. Because borrowers often do not realize that their loans have been sold, the originating bank is often able to maintain the customer relationship.

From a credit risk perspective, securitization has made popular the practice of grouping borrowers by letter or categories. At the top of the rating scale, 'A'-quality borrowers have relatively pristine credit histories. At the bottom, 'D'-quality borrowers usually have severely blemished credit histories. The categories are by no means rigid; in fact, credit evaluation problems exist because one originator's 'A' borrower may be another's 'A-' or 'B' borrower. Nevertheless, the terms 'A' paper and 'B/C' paper are becoming more and more popular.

Exhibit 2 is an example of generic borrower descriptions used by Duff and Phelps Credit Rating Corporation in rating mortgage borrowers. The borrowers' characteristics in the exhibit are generalizations of each category's standards and fluctuate over time; however, the table does provide an illustration of general standards in use today. For example, an 'A' quality

Exhibit 2: Borrower Credit Quality Categories

Generic Borrower Credit Quality Description	Mortgage Credit	Other Credit	Recency of Bankruptcy	Debt to Income Ratio	Loan-to-Value Guidelines
A: Standard agency quality	1 x 30 last 12 months	No derogatories	5 yrs.	36%	97%
A-: Very minor credit problems	1 x 30 last 12 months 2 x 30 last 24 months	Minor derogatories explained	5 yrs.	42%	90%
B: Minor to moderate credit problems	4 x 30 last 12 months 1 x 60 last 24 months	Some prior defaults	3 yrs.	50%	75%
C: Moderate to serious credit problems	6 x 30 last 12 months 1 x 60 & 1 x 90 last 12 months	Significant credit problems	18 months	55%	70%
D: Demonstrated unwillingness or inability to pay	30-60 constant delinquent, 2 x 90 last 12 months	Severe credit problems	12 months	60%	65%

(Source: Duff & Phelps)

borrower will typically have an extensive credit history with few if any delinquencies, and a fairly strong capacity to service debt. In contrast, a 'C' quality borrower has a poor or limited credit history, numerous instances of delinquency, and may even have had a fairly recent bankruptcy. Segmenting borrowers by grade allows outside parties such as rating agencies to compare performance of a specific company or underwriter more readily with that of its peer group.

Originator. Originators create and often service the assets that are sold or used as collateral for asset-backed securities. Originators include captive finance companies of the major auto makers, other finance companies, commercial banks, thrift institutions, computer companies, airlines, manufacturers, insurance companies, and securities firms. The auto finance companies dominate the securitization market for automobile loans. Thrifts securitize primarily residential mortgages through pass-throughs, pay-throughs, or mortgage-backed bonds. Commercial banks regularly originate and securitize auto loans, credit card receivables, trade receivables, mortgage loans, and more recently small business loans. Computer companies, airlines, and other commercial companies often use securitization to finance receivables generated from sales of their primary products in the normal course of business.

Servicer. The originator/lender of a pool of securitized assets usually continues to service the securitized portfolio. (The only assets with an active secondary market for servicing contracts are mortgages.) Servicing includes customer service and payment processing for the borrowers in the securitized pool and collection actions in accordance with the pooling and servicing agreement. Servicing can also include default management and collateral liquidation. The servicer is typically compensated with a fixed normal servicing fee.

Servicing a securitized portfolio also includes providing administrative support for the benefit of the trustee (who is duty-bound to protect the interests of the investors). For example, a servicer prepares monthly informational reports, remits collections of payments to the trust, and provides the trustee with monthly instructions for the disposition of the trust's assets. Servicing reports are usually prepared monthly, with specific format requirements for each performance and administrative report. Reports are distributed to the investors, the trustee, the rating agencies, and the credit enhancer.

Trustee. The trustee is a third party retained for a fee to administer the trust that holds the underlying assets supporting an asset-backed security. Acting in a fiduciary capacity, the trustee is primarily concerned with preserving the rights of the investor. The responsibilities of the trustee will vary from issue to issue and are delineated in a separate trust agreement. Generally, the trustee oversees the disbursement of cash flows as prescribed by the indenture or pooling and servicing agreement, and monitors compliance with appropriate covenants by other parties to the agreement.

If problems develop in the transaction, the trustee focuses particular attention on the obligations and performance of all parties associated with the security, particularly the servicer and the credit enhancer. Throughout the life of the transaction the trustee receives periodic financial information from the originator/servicer delineating amounts collected, amounts charged off, collateral values, etc. The trustee is responsible for reviewing this information to ensure that the underlying assets produce adequate cash flow to service the securities. The trustee also is responsible for declaring an event of default or an amortization event, as well as replacing the servicer if it fails to perform in accordance with the required terms.

Credit Enhancer. Credit enhancement is a method of protecting investors in the event that cash flows from the underlying assets are insufficient to pay the interest and principal due for the security in a timely manner. Credit enhancement is used to improve the credit rating, and therefore the pricing and marketability of the security.

As a general rule, third-party credit enhancers must have a credit rating at least as high as the rating sought for the security. Third-party credit support is often provided through a letter of credit or surety bond from a highly rated bank or insurance company. Because there are currently few available highly rated third-party credit enhancers, internal enhancements such as the senior/subordinated structure have become popular for many asset-backed deals. In this latter structure, the assets themselves and cash collateral accounts provide the credit support. These cash collateral accounts and separate, junior classes of securities protect the senior classes by absorbing defaults before the senior position's cash flows are interrupted.

Rating Agencies. The rating agencies perform a critical role in structured finance — evaluating the credit quality of the transactions. Such agencies are considered credible because they possess the expertise to evaluate various underlying asset types, and because they do not have a financial interest in a security's cost or yield. Ratings are important because investors generally accept ratings by the major public rating agencies in lieu of conducting a due diligence investigation of the underlying assets and the servicer.

Most nonmortgage asset-backed securities are rated. The large public issues are rated because the investment policies of many corporate investors require ratings. Private placements are typically rated because insurance companies are a significant investor group, and they use ratings to assess capital reserves against their investments. Many regulated investors, such as life insurance companies, pension funds, and to some extent commercial banks can purchase only limited amounts of securities rated below investment grade.

The rating agencies review four major areas:

- Quality of the assets being sold,
- Abilities and strength of the originator/servicer of the assets,

- Soundness of the transaction's overall structure, and
- Quality of the credit support.

From this review, the agencies assess the likelihood that the security will pay interest and principal according to the terms of the trust agreement. The rating agencies focus solely on the credit risk of an asset-backed security. They do not express an opinion on market value risks arising from interest rate fluctuations or prepayments, or on the suitability of an investment for a particular investor.

Underwriter. The asset-backed securities underwriter is responsible for advising the seller on how to structure the security, and for pricing and marketing it to investors. Underwriters are often selected because of their relationships with institutional investors and for their advice on the terms and pricing required by the market. They are also generally familiar with the legal and structural requirements of regulated institutional investors.

Investors. The largest purchasers of securitized assets are typically pension funds, insurance companies, fund managers, and, to a lesser degree, commercial banks. The most compelling reason for investing in asset-backed securities has been their high rate of return relative to other assets of comparable credit risk. The OCC's investment securities regulations at 12 CFR 1 allow national banks to invest up to 25 percent of their capital in "Type V" securities. By definition, a Type V security:

- Is marketable,
- Is rated investment grade,
- Is fully secured by interests in a pool of loans to numerous obligors and in which a national bank could invest directly, and
- Is not rated as a mortgage-related or Type IV security.

Structuring the Transaction

The primary difference between whole loan sales or participations and securitized credit pools is the structuring process. Before most loan pools can be converted into securities, they must be structured to modify the nature of the risks and returns to the final investors. Structuring includes the isolation

and distribution of credit risk, usually through credit enhancement techniques, and the use of trusts and special purpose entities to address tax issues and the management of cash flows.

Examiners performing a comprehensive review of a specific securitization process should read through the pooling and servicing agreement and/or a specific series supplement for explicit detail on the structure and design of the particular asset-backed security and the responsibilities of each involved party. For purposes of this booklet, the following is an overview of the structuring process and a description of what the documents usually contain.

Generally, the structure of a transaction is governed by the terms of the pooling and servicing agreement and, for master trusts, each series supplement. The pooling and servicing agreement is the primary contractual document between the seller/servicer and the trustee. This agreement documents the terms of the sale and the responsibilities of the seller/servicer. For master trusts, the pooling and servicing agreement, including the related series supplement, document the terms of the sale and responsibilities of the seller/servicer for a specific issuance. The following section describes the four major stages of the structuring process:

- Segregating the assets from the seller/originator.
- Creating a special-purpose vehicle to hold the assets and protect the various parties' interests.
- Adding credit enhancement to improve salability.
- Issuing interests in the asset pool.

Segregating the Assets

Securitization allows investors to evaluate the quality of a security on its own (apart from the credit quality of the originator/seller). To accomplish this, the seller conveys receivables to a trust for the benefit of certificate holders. For revolving-type assets, this conveyance includes the amount of receivables in certain designated accounts on a specific cutoff date, plus the option for the trust to purchase any new receivables that arise from those designated accounts subsequent to the cutoff date. The accounts and receivables are subject to eligibility criteria and specific representations and warranties of the seller.

Choosing Accounts — Initial Pool Selection

The seller designates which accounts' receivables will be sold to a trust. The selection is carried out with an eye to creating a portfolio whose performance is not only predictable but also consistent with the target quality of the desired security. Step one is determining which accounts will be "designated" as those from which receivables may be included in the trust. For example, past-due receivables may be left in the eligible pool, but accounts that have had a default or write-off may be excluded. Some issuers include written-off receivables, allowing the revenue from recoveries to become part of the cash flow of the trust. Other selection criteria might include data elements such as geographic location, maturity date, size of the credit line, or age of the account relationship.

Step two, asset selection, can either be random, in order to create selections that are representative of the total portfolio, or inclusive, so that all qualifying receivables are sold. In random selection, the issuer determines how many accounts are needed to meet the target value of the security; then the accounts are selected randomly (for example, every sixth account is selected from the eligible universe).

Account Additions and Removals

For trusts with a revolving feature, such as credit cards or home equity lines of credit, the seller may be required to designate additional accounts that will be assimilated by the trust. This may be required for a variety of reasons, for example, when the seller's interest (the interest in the receivables pool retained by the seller subsequent to transfer into the trust) falls below a level specified in the pooling and servicing agreement. The seller also typically reserves the ability to withdraw some accounts previously designated for the trust.[1] Rating agencies must often be notified when account additions or removals reach certain thresholds. For example, the terms of the rating may

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[1] The issue of whether provisions for the removal of accounts are in-substance call options retained by the seller (which may compromise sales treatment) is under consideration by FASB at the time of this writing. A formal FASB interpretation is expected to be issued in exposure draft form. Until then, the guidance under Emerging Issues Task Force (EITF) Issue 90-18 remains in effect.

require rating agency confirmation that account additions or removals do not lower outstanding ratings when additions or removals exceed 15 percent of the balance at the beginning of the previous quarter.

Creating Securitization Vehicles

Banks usually structure asset-backed securities using "grantor trusts," "owner trusts," or other "revolving asset trusts," each of which customarily issues different types of securities. In choosing a trust structure, banks seek to ensure that the transaction insulates the assets from the reach of the issuer's creditors and that the issuer, securitization vehicle, and investors receive favorable tax treatment.

In a *grantor trust*, the certificate holders (investors) are treated as beneficial owners of the assets sold. The net income from the trust is taxed on a pass-through basis as if the certificate holders directly owned the receivables. To qualify as a grantor trust, the structure of the deal must be passive — that is, the trust cannot engage in profitable activities for the investors, and there cannot be "multiple classes" of interest. Grantor trusts are commonly used when the underlying assets are installment loans whose interest and principal payments are reasonably predictable and fit the desired security structure.

In an *owner trust*, the assets are usually subject to a lien of indenture through which notes are issued. The beneficial ownership of the owner trust's assets (subject to the lien) is represented by certificates, which may be sold or retained by the bank. An owner trust, properly structured, will be treated as a partnership under the Internal Revenue Code of 1986. A partnership, like a grantor trust, is effectively a pass-through entity under the Internal Revenue Code and therefore does not pay federal income tax. Instead, each certificate holder (including the special-purpose corporation) must separately take into account its allocated share of income, gains, losses, deductions, and credits of the trust. Like the grantor trust, the owner trust is expressly limited in its activities by its charter, although owner trusts are typically used when the cash flows of the assets must be "managed" to create "bond-like" securities. Unlike a grantor trust, the owner trust can issue securities in multiple series with different maturities, interest rates, and cash flow priorities.

Revolving asset trusts may be either stand-alone or master trust structures. The stand-alone trust is simply a single group of accounts whose receivables are sold to a trust and used as collateral for a single security, although there may be several classes within that security. When the issuer intends to issue another security, it simply designates a new group of accounts and sells their receivables to a separate trust. As the desire for additional flexibility, efficiency, and uniformity of collateral performance for various series issued by the same originator has increased over time, the stand-alone structure evolved into the master trust structure.

Master trusts allow an issuer to sell a number of securities (and series) at different times from the same trust. All of the securities rely on the same pool of receivables as collateral. In a master trust, each certificate of each series represents an undivided interest in all of the receivables in the trust. This structure provides the issuer with much more flexibility, since issuing a new series from a master trust costs less and requires less effort than creating a new trust for every issue. In addition, credit evaluation of each series in a master trust is much easier since the pool of receivables will be larger and less susceptible to seasonal or demographic concentrations. Credit cards, home equity lines of credit, and other revolving assets are usually best packaged in these structures. A revolving asset trust is treated as a "security arrangement" and is ignored for tax purposes. (See following discussion under "Tax Issues.")

Legal Issues

When banks are sellers of assets, they have two primary legal concerns. They seek to ensure that:

- A security interest in the assets securitized is perfected.
- The security is structured so as to preclude the FDIC's voiding of the perfected security interest.

By perfecting security interests, a lender protects the trustee's property rights from third parties who may have retained rights that impair the timely payment of debt service on the securities. Typically, a trustee requires a legal opinion to the effect that the trust has a first-priority perfected security interest in the pledged receivables. In general, filing Uniform Commercial Code

documents (UCC-1) is sufficient for unsecured consumer loan receivables such as credit cards. For other types of receivables whose collateral is a reliable fall-back repayment source (such as automobile loans and home equity lines of credit), additional steps may be required (title amendments, mortgage liens, etc.) to perfect the trustee's security interest in the receivables and the underlying collateral.

If the seller/originator is a bank, the provisions of the U.S. Bankruptcy Code (11 USC 1 *et seq.*) do not apply to its insolvency proceedings. In the case of a bank insolvency, the FDIC would act as receiver or conservator of the financial institution.[2] Although the Federal Deposit Insurance Act does not contain an automatic stay provision that would stop the payout of securities (as does the bankruptcy code), the FDIC has the power to ask for a judicial stay of all payments or the repudiation of any contract. In order to avoid inhibiting securitization, however, the FDIC has stated[3] that it would not seek to void an otherwise legally enforceable and perfected security interest provided:

- The agreement was undertaken in the ordinary course of business, not in contemplation of insolvency, and with no intent to hinder, delay, or defraud the bank or its creditors;
- The secured obligation represents a bona fide and arm's length transaction;
- The secured party or parties are not insiders or affiliates of the bank;
- The grant of the security interest was made for adequate consideration; and
- The security agreement evidencing the security interest is in writing, was duly approved by the board of directors of the bank or its loan committee, and remains an official record of the bank.

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2 A national bank may not be a "debtor" under the bankruptcy code. *See* USC 109(b)(2). The FDIC may act as receiver or conservator of a failed institution, subject to appointment by the appropriate federal banking agency. *See* 12 USC 1821.

3 "Statement of Policy regarding Treatment of Security Interests after Appointment of the FDIC as Conservator or Receiver." March 31, 1993, 58 FR 16833.

Tax Issues

Issuers ordinarily choose a structure that will minimize the impact of taxes on the security. Federal income tax can be minimized in two principal ways — by choosing a vehicle that is not subject to tax or by having the vehicle issue "debt" the interest on which is tax deductible (for the vehicle or its owners).

In a grantor trust, each certificate holder is treated as the owner of a pro rata share of the trust's assets and the trust is ignored for tax purposes. To receive the favorable tax treatment, each month the grantor trust must distribute all principal and interest received on the assets held by the trust. A grantor trust is not an "entity" for federal tax purposes; rather, its beneficiaries are treated as holders of a ratable share of its assets (in contrast to partnerships, which are treated as entities, even though their income is allocated to the holders of the partnership interests). The requirement that the trust be "passive" generally makes the grantor trust best suited for longer-term assets such as mortgages or automobile receivables.

An owner trust generally qualifies as a partnership for tax purposes. Because the issuer usually retains an interest in the assets or a reserve account, it is usually a partner; if so, the transfer of assets to the trust is governed by tax provisions on transfers to partnerships. Although the partnership itself would generally not be subject to tax, its income (net of deductions for interest paid to note holders) would be reportable by the partner certificate holders and the issuer. Partnership owner trusts are commonly used in fixed pool transactions involving the same kinds of assets that are securitized through grantor trusts; assets in owner trusts typically require more management or will be issued as more than one class of security.

The cash flows for shorter-term assets, such as credit cards, require too much management for a grantor trust. Although owner trusts are theoretically the appropriate vehicle for issuing such assets, in practice revolving asset trusts are usually used when the parties structure the transaction *for tax purposes* as a secured loan from the investors to the seller of the receivables. The trust is simply a means of securing financing and is ignored for tax purposes. (Such treatment — as a "security arrangement" — is like that accorded a grantor trust, which is also ignored for tax purposes, except that a grantor trust must file a tax report and a "security arrangement" does not.)

Assets requiring managed cash flows can also be structured as a special-purpose corporation (SPC), in which the asset-backed securities are debt of the issuer rather than ownership interests in the receivables. In this structure an SPC typically owns the receivables and sells debt that is backed by the assets, thus allowing the SPC to restructure the cash flows from the receivables into several debt tranches with varying maturities. The interest income from the receivables is taxable to the corporation, and this taxable income is largely offset by the tax deduction from the interest expense on the debt it issues.

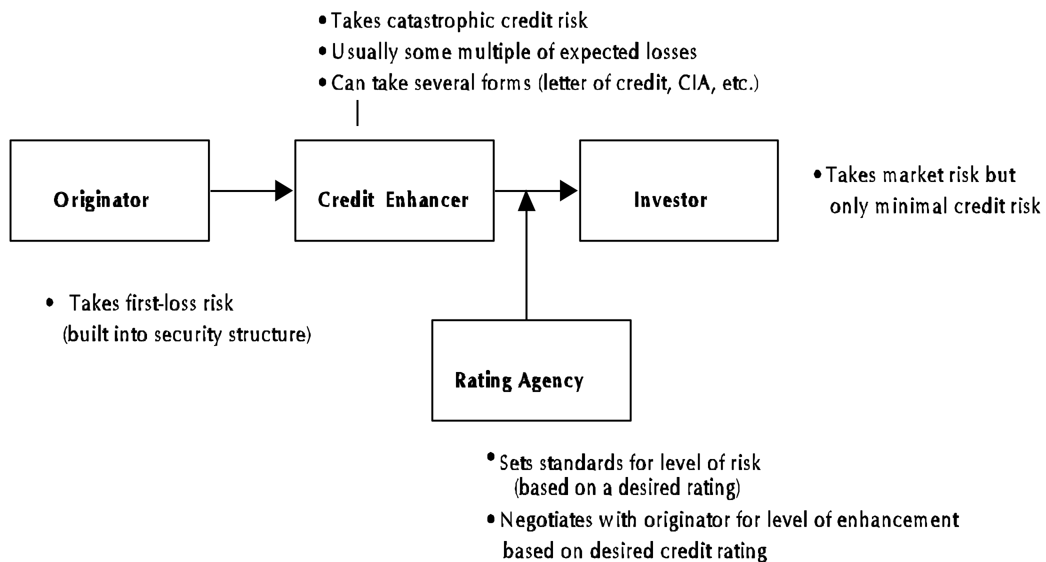
Other securitization vehicles, such as real estate mortgage investment conduits (REMICs) and, more recently (effective September 1, 1997), financial asset securitization investment trusts (FASITs), are essentially statutory structures modeled after the "common law" structures described in the foregoing examples. In any event, the overriding objective remains the same: to receive the equivalent of "flow-through" treatment that minimizes the tax consequences for the cash flows. Because interpretations concerning tax treatment may change as structures evolve, banks are encouraged to consult with tax counsel on taxation issues arising from securitization.

Providing Credit Enhancement

Securitization typically splits the credit risk into several tranches, placing it with parties that are willing or best able to absorb it. The first loss tranche is usually capped at levels approximate to the "expected" or "normal" rate of portfolio credit loss. All credit losses up to this point are effectively absorbed by the credit originator, since it typically receives portfolio cash flow after expenses (which include expected losses) in the form of excess spread.

The second tranche typically covers losses that exceed the originator's cap. This second level of exposure is usually capped at some multiple of the pool's expected losses (customarily between three times and five times these losses), depending on the desired credit ratings for the senior positions. This risk is often absorbed by a high-grade, well-capitalized credit enhancer that is able to diversify the risk (exhibit 3). The third tranche of credit risk is

Exhibit 3: Credit risk diversification



undertaken by the investors that buy the asset-backed securities themselves. Although investors are exposed to other types of risk, such as prepayment or interest rate risk, senior-level classes of asset-backed securities typically have little exposure to credit loss.

Aside from the coupon rate paid to investors, the largest expense in structuring an asset-backed security is the cost of credit enhancement. Issuers are constantly attempting to minimize the costs associated with providing credit protection to the ultimate investors. Credit enhancement comes in several different forms, although it can generally be divided into two main types: external (third-party or seller's guarantee) or internal (structural or cash-flow-driven). Common types of credit enhancements in use today include:

Credit Enhancement Provided by External Parties

- *Third-party letter of credit.* For issuers with credit ratings below the level sought for the security issued, a third party may provide a letter of credit to cover a certain amount of loss or percentage of losses. Draws on the letter of credit protection are often repaid (if possible) from excess cash flows from the securitized portfolio.

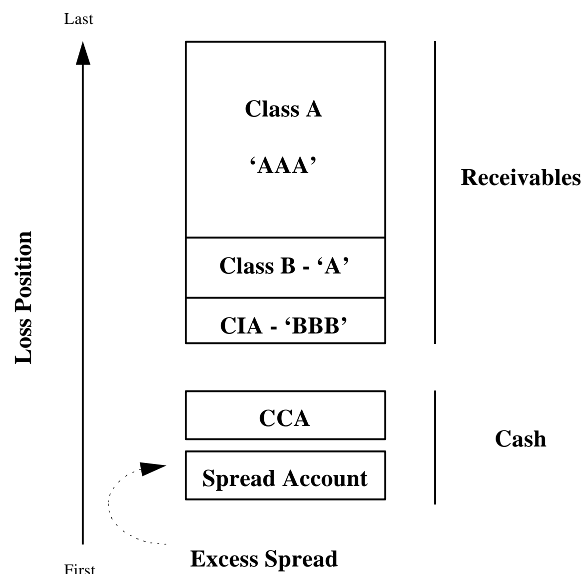
- *Recourse to seller.* Principally used by nonbank issuers, this method uses a limited guaranty of the seller covering a specified maximum amount of losses on the pool.

- *Surety bonds.* Guarantees issued by third parties, usually AAA-rated mono-line insurance companies. Surety bond providers generally guarantee (or wrap) the principal and interest payments of 100 percent of a transaction.

Although the ratings of third-party credit enhancers are rarely lowered, such an event could lower the rating of a security. As a result, issuers are relying less and less on third-party enhancement.

Credit Enhancement Provided by Internal Structure

Structural features can be created to raise the credit quality of an asset-backed security. For example, a highly rated senior class of securities can be supported by one or more subordinate security classes and a cash collateral account. Senior/subordinate structures are layered so that each position benefits from the credit protection of all the positions subordinate to it. The junior positions are subordinate in the payment of both principal and interest to the senior positions in the securities.



A typical security structure may contain any of the following internal enhancements (which are presented in order from junior to senior, that is, from the first to absorb losses to the last):

1. *Excess spread.* The portfolio yield for a given month on the receivables supporting an asset-backed security is generally greater than the

coupon, servicing costs, and expected losses for the issued securities. Any remaining finance charges after funding, servicing costs, and losses is called “excess spread.” (See the cash flow waterfall discussion in the “Mechanics of Cash Flow” section, which follows, for an illustration of how excess spread is determined.) This *residual* amount normally reverts to the seller as additional profit. However, it is also commonly available to the trust to cover unexpected losses.

2. *Spread account.* Monthly finance charges from the underlying pool of receivables are available to cover unexpected losses in any given month. If not needed, this “excess spread” generally reverts to the seller. Many trusts provide that, if portfolio yield declines or losses increase, the monthly excess spread is captured, or “trapped,” in a spread account (a form of cash collateral account) to provide future credit enhancement.

3. *Cash collateral accounts.* A cash collateral account is a segregated trust account, funded at the outset of the deal, that can be drawn on to cover shortfalls in interest, principal, or servicing expense for a particular series if excess spread is reduced to zero. The account can be funded by the issuer, but is often funded by a loan from a third-party bank, which will be repaid only after holders of all classes of certificates of that series have been repaid in full.

4. *Collateral invested amount (CIA).* The CIA is an uncertificated, privately placed ownership interest in the trust, subordinate in payment rights to all investor certificates. Like a layer of subordination, the CIA serves the same purpose as a cash collateral account: it makes up for shortfalls if excess spread is negative. The CIA is itself often protected by a cash collateral account and available monthly excess spread. If the CIA absorbs losses, it can be reimbursed from future excess spread if available.

5. *Subordinate security classes.* Subordinate classes are junior in claim to other debt — that is, they are repayable only after other classes of the security with a higher claim have been satisfied. Some securities contain more than one class of subordinate debt, and one subordinate class may have a higher claim than other such positions.

Most structures contain a combination of one or more of the enhancement techniques described above. For example, some issuers combine surety bond protection with senior/subordinate structures, creating "super senior" classes that are insulated from third-party risk and have higher rated subordinated classes because of the credit-wrap. The objective from an issuer's viewpoint is to find the most practical and cost-effective method of providing the credit protection necessary for the desired credit rating and pricing of the security.

Most securities also contain performance-related features designed to protect investors (and credit enhancers) against portfolio deterioration. These "performance triggers" are designed to increase the spread account available to absorb losses, to accelerate repayment of principal before pool performance would likely result in losses to investors, or both. The first (most sensitive) triggers typically capture excess spread within the trust (either additions to existing spread accounts or a separate reserve fund) to provide additional credit protection when a portfolio begins to show signs of deterioration. If delinquencies and loss levels continue to deteriorate, early amortization events may occur. Early amortization triggers are usually based on a three-month rolling average to ensure that amortization is accelerated only when performance is consistently weak.

The originator or pool sponsor will often negotiate with the rating agencies about the type and size of the internal and external credit enhancement. The size of the enhancement is dictated by the credit rating desired. For the highest triple-A rating, the rating agencies are likely to insist that the level of protection be sufficient to shield cash flows against circumstances as severe as those experienced during the Great Depression of the 1930s.

Issuing Interests in the Asset Pool

On the closing date of the transaction, the receivables are transferred, directly or indirectly, from the seller to the special-purpose vehicle (trust). The trust issues certificates representing beneficial interests in the trust, investor certificates, and, in the case of revolving asset structures, a transferor (seller) certificate.

Investors' Certificate

The investor certificates are sold in either public offerings or private placements, and the proceeds, net of issuance expenses, are remitted to the seller. There are two main types of investor interests in securitized assets — a discrete interest in *specific* assets and an undivided interest in a *pool* of assets. The first type of ownership interest is used for asset pools that match the maturity and cash flow characteristics of the security issued. The second type of interest is used for relatively short-term assets such as credit card receivables or advances against home equity lines of credit. For the shorter-term assets, new receivables are generated and added to the pool as the receivables liquidate, and the investor's undivided interest automatically applies to the new receivables in the pool.

Seller's Interest

When receivables backing securities are short-term or turn over rapidly, as do trade receivables or credit cards, the cash flows associated with the receivables must be actively managed. One objective is to keep the outstanding principal balance of the investor's interest equal to the certificate amounts. To facilitate this equalization, an interest in trust structures, known as the "seller's" or "transferor's" interest, is not allocated to investors. The seller's interest serves two primary purposes: to provide a cash-flow buffer when account payments fall short of account purchases and to absorb reductions in the receivable balance attributable to dilution and noncomplying receivables.

To calculate the size of the seller's interest, subtract the amount of securities issued by the trust (liabilities) from the balance of principal receivables in the trust (assets). The seller's interest is generally not a form of credit enhancement for the investor interests.

The Mechanics of Cash Flow

Cash Flow Allocations

Pass-Through Securities

The payment distribution for securities backed by installment loans is closely tied to the loans' payment flows. Interest is customarily paid monthly, and the principal included in each payment will depend on the amortization schedule and prepayment rate of the underlying collateral.

Pay-Through Securities

For revolving asset types such as credit cards, trade receivables, and home equity lines, the cash flow has two phases:

- The revolving period; and
- The principal pay-down period (amortization phase).

During the revolving period, investors receive their pro rata share of the gross portfolio yield (see below) based on the principal amount of their certificates and the coupon rate. The remaining portion of their share of the finance charges above the coupon rate is available to pay the servicing fees and to cover any charge-offs, with residual amounts generally retained by the seller or credit enhancement provider as excess spread. This distribution of cash is often referred to as the "cash flow waterfall."

The cash flow waterfall for credit card securities may look like this (percentages based on investor's pro rata share of outstanding receivables):

Revenue

Finance Charges	16.5%*
Annual Fees	1.5%
Late Fees and Other Fees	0.7%
Interchange	1.8%
Gross Portfolio Yield (finance charges)	**20.5%**

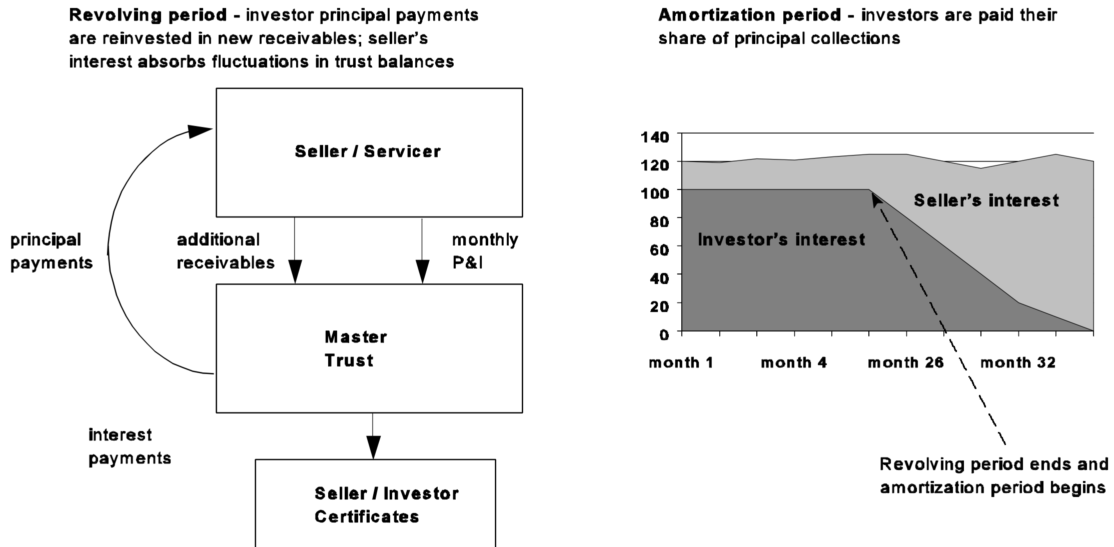
Expenses

Investor Coupon	7.0%*	
Servicing Expense	2.5%	
Charge-offs	5.0%	
Total Expenses		**14.5%**
Excess Spread		**6.0%**

During the revolving period, monthly principal collections are used to purchase new receivables generated in the designated accounts or to purchase a portion of the seller's participation if there are no new receivables. If the percentage of the seller's interest falls below a prescribed level of principal outstanding because of a lack of new borrowings from the designated accounts, new accounts may be added.

After this revolving period comes the amortization period. During this phase, the investors' share of principal collections are no longer used to purchase replacement receivables. These proceeds are returned to investors as received. This is the simplest form of principal repayment. However, because over time investors have preferred more stable returns of principal, some issuers have created structures to accumulate principal payments in a trust account ("accumulation account") rather than simply passing principal payments through to investors as received. The trust then pays principal on a specific, or "bullet," maturity date. Bullet maturities are typically either "hard" or "soft," depending on how the structure compensates when funds in the accumulation account are not sufficient to pay investors in full on the scheduled maturity date. Under a hard bullet structure, a third-party maturity guaranty covers the shortfall. Under a soft bullet structure, the entire accumulation account is distributed to the investors and further funds are paid as received. Soft bullet structures usually include an expected maturity date and a final maturity date.

Exhibit 4: The Two Stages of a Revolving-Receivable Asset-Backed Security



Early Amortization Protection

In addition to the previously discussed credit enhancement types, revolving asset-backed securities typically use early amortization triggers to protect investors from credit risk. These triggers, or payout events, accelerate the repayment of investor principal if cash flow from the pool declines or the condition of the pooled assets deteriorates. This accelerated repayment method requires that the investors' share of all principal collections be returned immediately as it is received by the trust. The payout events are defined in the pooling and servicing agreement and series supplement of each securitization, and are intended to protect investors from prolonged exposure to deteriorating performance of the underlying assets or the default of a servicer.

To monitor the asset-backed security's performance, the trustee, the rating agencies, and investors focus on several indicators of pool performance: portfolio yield, the loss rate, the monthly payment rate, and the purchase rate.

- *Portfolio yield* generally consists of three types of payments: finance charges, fees, and interchange. Finance charges are the periodic

interest costs associated with an unpaid balance at the end of a grace period. Fees include annual membership fees, late payment fees, cash advance transaction fees, and over-limit fees. Interchange is the fee paid by merchants and passed to the card-issuing bank for completing the transaction.

- *Loss rates* are evaluated relative to the seasoning of the pool and the marketing and underwriting strategies of the originator. Rating agencies pay particular attention to estimated and actual loss rates when settling on credit enhancement levels and monitoring securities for potential ratings actions.

- The *monthly payment rate* includes monthly collections of principal, finance charges, and fees paid by the borrower. Payment rate monitoring is focused on principal collections since it is principal repayments that will be used to pay down the investor's outstanding principal.

- The *purchase rate* is the amount of new charges transferred to the trust each month from the designated accounts as a percent of the receivables outstanding. New purchases keep the amount of principal receivables in the trust from falling. If the pool balance falls below a minimum, the seller is usually required to assign additional accounts to the pool.

Other items of interest are finance charge and principal allocations among the various interests in the trust and, for floating rate issues, coupon rates. Should any of the aforementioned indicators show prolonged signs of deterioration by tripping a preset trigger, early amortization would begin.

Common early amortization triggers include:

- A reduction in the portfolio yield (net of defaults) below a base rate (investor coupon plus the servicing fee) averaged over a three-month period.
- A reduction in the seller's interest below a fixed percentage of the total principal receivables outstanding.

- A failure of the seller, servicer, or the credit enhancement provider to perform as required by the terms of the pooling and servicing agreement.

An early return of principal is not always welcomed by investors, so a well-structured agreement should balance the need for predictable repayment with the need to maintain satisfactory credit quality.

Impact of Securitization on Bank Issuers

Properly managed, securitization enables a bank to originate a higher volume of assets while managing deposit insurance and reserve requirement costs; reducing credit risk, liquidity risk, and interest rate risk; diversifying funding sources and tenors; and maintaining (and expanding) customer relationships. The net effects of these benefits can be improved return-on-asset and return-on-equity ratios, enhanced customer service, and reduced exposure to concentration risks.

Examiners should be aware, however, that management at some banks may overestimate the risk transfer of securitization or may underestimate the commitment and resources required to effectively manage the process. Such mistakes may lead to highly visible problems during the life of the transaction that could impair future access to the securitization markets as a funding source. The risks faced by a bank will largely be a function of the roles they play in the transaction and the quality of the underlying assets they originate and/or service. The objective of the risk management evaluation performed by examiners should be to assess the impact of all aspects of securitization on the overall financial condition and performance of the institution.

Process Management

Banks that have been able to exploit the full range of benefits offered by securitization typically view the process as a broad-based strategic initiative. As part of this approach they have integrated their risk management systems into all facets of the securitization process.

New Product Evaluation

First-time securitizers should ensure that the proposed process has been thoroughly reviewed before the first transaction. The business plan for securitization (or for introducing any new product) should detail the business

rationale, how existing policies should be modified, a performance measurement process, a list of potential counterparties (credit enhancers, underwriters, trustees, etc.), and assurances that the bank has adequate controls and procedures, systems, and risk analysis techniques. The business proposal should at least provide a description of:

- The proposed products, markets, and business strategy;
- The risk management implications;
- The methods to measure, monitor, and control risk;
- The accounting, tax, and regulatory implications;
- Any legal implications; and
- Any necessary system enhancements or modifications.

All relevant departments should review and approve the proposal. Key parties normally include the risk oversight function, operations, information technology, finance/accounting, legal, audit, and senior line management. A rigorous approval process for new products or activities lessens the risk that bank management may underestimate the level of due diligence required for risk management or the ongoing resources required for process management.

Responsibility and Accountability

While ad hoc committees often form the initial steering group for a securitization transaction, proficient issuers usually assign responsibility for managing securitization to a dedicated individual or department. This manager (or group) should have the experience and skills to understand the various components of securitization and the authority to communicate and act across product and department lines. The manager should consider the effects that proposed changes in policies or procedures on origination or servicing may have on outstanding or future securitization issues. He or she should communicate observations and conclusions to senior management.

Oversight

All risk management programs should be independently monitored and evaluated, usually by an internal audit unit or another risk control unit. The control group determines whether internal control practices are in accordance with risk management policies, whether controls are adequate,

whether risk levels are accurately estimated, and whether such levels are appropriate.

To facilitate the development of internal controls, risk managers should be informed about the securitization process at the earliest possible stage. During the initial due diligence for a securitization transaction, the underwriter (often an investment banker), the rating agencies, and the independent outside accountants thoroughly review the bank's securitization process. Their review, however, takes place primarily in the early stages of the process; they do little direct review after the initial transaction is complete. At that point, the bank's internal oversight takes on vast importance.

The bank's risk control unit should report directly to a senior executive to ensure the integrity of the process. The unit, which should evaluate every role the bank has in securitization, should pay special attention to the origination and servicing operations. In the origination area, the unit should take significant samples of credit decisions, verify information sources, and track the approval process. In the servicing area, the unit should track payment processing, collections, and reporting from the credit approval decision through the management and third-party reporting process. The purpose of these reviews is to ensure that activities are consistent with policy and trust agreements and to detect operational weaknesses that leave the bank open to fraud or other problems. Risk managers often suggest policies or procedures to prevent problems, such as documenting exceptions to bank policies. Any irregularities discovered in the audits should be followed up and discussed with senior management.

Monitoring of Securitization Transactions

Management reports should monitor the performance of the underlying asset pools for all outstanding deals. Although the bank may have sold the ownership rights and control of the assets, the bank's reputation as an underwriter or servicer remains exposed. To control the impact of deterioration in pools originated or serviced by the bank, a systematic reporting process allows management to track pool quality and performance throughout the life of the transactions.

Reports on revolving transactions (credit cards, home equity lines, etc.) should monitor:

- The portfolio's gross yield;
- Delinquencies;
- The charge-off rate;
- The base rate (investor coupon plus servicing fees);
- Monthly excess spread;
- The rolling three-month average excess spread; and
- The monthly payment rate.

Reports on securities backed by installment loans (automobiles, equipment leases, etc.) should monitor:

- The charge-off rate;
- The net portfolio yield (portfolio yield minus charge-offs);
- Delinquencies (aged);
- Principal prepayment speeds; and
- Outstanding principal compared to original security size.

Communication with Outside Parties

To maintain market confidence, reputation, and the liquidity of securities, issuers and servicers should be able to supply accurate and timely information about the performance of underlying assets to investors, rating agencies, and investment bankers. The bank's cost of accessing the capital markets can depend on this ability. The securitization manager or management unit should regularly verify information on performance.

Risks and Controls

Although it is common for securitization transactions to receive substantial attention early in their lives, the level of scrutiny generally declines over time. Many of the problems that institutions have experienced, such as rising delinquencies and charge-offs, inaccurate investor reporting, and bad publicity, have occurred in the later stages of the transaction. The bank should supervise and monitor a transaction for the duration of the institution's involvement.

Examiners assess banking risk relative to its impact on earnings and capital. From a supervisory perspective, risk is the potential that events, expected or unanticipated, will have an adverse impact on the bank's earnings or capital. The primary risks associated with securitization activities are reputation, strategic, credit, transaction, liquidity, and compliance. The types and levels of risk to which a particular banking organization is exposed will depend upon the organization's role or roles in the securitized transactions. The definitions of these risks and their pertinence to securitization are discussed below. For more complete definitions, see the "Bank Supervision Process" booklet of the *Comptroller's Handbook*.

Reputation Risk

Reputation risk is the risk to earnings or capital arising from negative public opinion. This affects the institution's ability to establish new relationships or services or continue servicing existing relationships. This risk can expose the institution to litigation, financial loss, or damage to its reputation. Reputation risk is present throughout the organization and includes the responsibility to exercise an abundance of caution in dealing with its customers and community.

Nature of Reputation Risk

Exposure to reputation risk is essentially a function of how well the internal risk management process is working in each of the other risk categories and the manner and efficiency with which management responds to external influences on bank-related transactions. Reputation risk has a "qualitative" nature, reflecting the strength of an organization's franchise value and how it is perceived by other market participants. This perception is usually tied to performance over time. Although each role a bank plays in securitization places its reputation on the line, it stakes its reputation most heavily on the quality of the underlying receivables and the efficiency of its servicing or other fiduciary operations.

Asset performance that falls short of expectations will reflect poorly on the underwriting and risk assessment capabilities of the originator. Because the asset performance of securitized pools is publicly disclosed and monitored by

market participants, securitization can highlight problems that were less obvious when reported as a smaller component of overall portfolio performance.

The best evidence of positive or negative perception is how the market accepts and prices newly issued asset-backed securities. Poorly performing assets or servicing errors on existing transactions can increase the costs and decrease the profitability of future deals. Reputation as an underwriter or servicer is particularly important to issuers that intend to securitize regularly. For some issuers, negative publicity from securitization transactions may cause the market to avoid other liability as well as equity issuances.

Managing Reputation Risk

The most effective method of controlling reputation risk is a sound business plan and a comprehensive, effective risk management and control framework that covers all aspects of securitization activities. Up-front effort will minimize the potential for unexpected errors and surprises, most of which are quite visible to public market participants.

Management of reputation risk often involves business decisions that extend beyond the technical, legal, or contractual responsibilities of the bank. For securitization activities, problems are most often associated with revolving assets. Although the bank has transferred legal liability for performance of such receivables, it is nevertheless closely associated with the assets through servicing, through replacement receivables sales, or simply by name. Decisions to protect franchise value by providing additional financial support should be made with full recognition of the potential long-term market, accounting, legal, and regulatory impacts and costs.

Strategic Risk

Strategic risk is the risk to earnings and capital arising from adverse business decisions or improper implementation of those decisions. This risk is a function of the compatibility of an organization's strategic goals, the business strategies developed to achieve those goals, the resources deployed against those goals, and the quality of implementation. The resources needed to carry out business strategies are both tangible and intangible. They include

communication channels, operating systems, delivery networks, and managerial capacities and capabilities.

Nature of Strategic Risk

To assess a bank's strategic risk exposure, one must recognize the long-term impacts of securitization on operations, profitability, and asset/liability management. Such exposure increases if transactions are undertaken without considering the long-term internal resource requirements. For example, while the existing systems in the credit and collections department may be adequate for normal operations, securitization transactions are often accompanied by rapid growth in the volume of transactions and more timely and precise reporting requirements. At a minimum this may require improved computer systems and software and dedicated operational and treasury personnel. Business and strategic plans should delineate the long-term resources needed to handle the projected volume of securitization.

Decisions on credit quality and origination also expose a bank to strategic risk. The availability of funding, the opportunity to leverage systems and technology, and the ability to substantially increase fee income through securitization should not lure issuers into a business line about which they don't have sufficient knowledge. For example, banks that are successful at underwriting and servicing 'A' quality paper may not be as successful with 'B/C' paper, because different skills are needed to service higher risk loans. Banks that have been successful in entering new product lines are those that have first acquired the necessary expertise.

Competition is a prime source of strategic risk. Securitization provides economical funding to a far greater pool of credit originators than banks have traditionally had to compete against. The long-term effects of this greater competition may be to erode profit margins and force banks to seek further efficiencies and economies of scale. Tighter profitability margins diminish the room for error, increasing the importance of strategy. Many market participants (including banks) will be forced to find where their competitive advantages lie and what new or additional skills they need to compete.

Managing Strategic Risk

Before initiating a securitization transaction, management should compare the strategic and financial objectives of proposed securitization activities with the risk exposures and resource requirements. A thorough analysis would include the costs of the initial transaction and any systems or technology upgrades necessary to fulfill servicing obligations. Because securitization affects several different areas in a bank, the assessment should describe the responsibilities of each key person or department. Each manager responsible for an area involved in the securitization process should review the assessment.

Credit Risk

Credit risk is the risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the bank or otherwise to perform as agreed. Credit risk is found in all activities where success depends upon counterparty, issuer, or borrower performance. It arises any time bank funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements, whether on or off the balance sheet.

One of the primary benefits of securitization is its usefulness in managing credit risk exposure. For example, overall portfolio quality may improve because of the opportunity to diversify exposure to a particular industry (e.g., oil and gas, real estate, retail credit, etc.) or geographic area. Securitization structures reduce the credit exposure of the assets sold by transferring the unexpected portion of the default risk to credit enhancement providers and investors. Effective risk management requires recognizing the extent and limits of this risk transfer and planning for the capital and other resource requirements necessary to support the remaining risk levels.

Nature of Credit Risk

Although financial reporting and regulatory risk-based capital practices are useful indicators of the credit impact of securitization on a bank, these guidelines do not fully capture the economic dimensions of the originator's exposure to credit risk from a sale of securitized assets. Although important, an examiner's inquiry should extend beyond whether the sale of assets is

accounted for on or off the balance sheet. It should assess the fundamental residual credit risks left with the bank after the transaction. In addition, the assessment should be made in the context of a total return standard rather than focusing solely on absolute loss and delinquency levels. For example, some pools, such as sub-prime automobile loans, are expected to have relatively high loss and delinquency rates. These pools, if properly underwritten, can be economically successful as long as the pricing and structure of the loans reflects the inherent risks.

A bank that sells assets in a securitization transaction confronts three main forms of credit risk:

- Residual exposure to default.
- Credit quality of the remaining on-balance-sheet portfolio.
- Possibility that it will have to provide moral recourse.

Default Exposure. Securitizing banks must evaluate how much default risk remains with them after a sale. Quantifying the residual default risk or contingent liability requires an in-depth review of the cash flow structure of the transaction and its third-party support. In most structures, credit risk is allocated so that the originator bears default losses up to a certain point, typically based on historic losses and projected performance. The first loss exposure assumed by the originator is a function of its acceptance of excess portfolio yield as a residual interest, that is, after the coupon and servicing expense are paid and loan losses are calculated. As pool performance deteriorates and charge-offs increase, excess spread (which could eventually return to the bank) declines.

Subject to certain structural provisions, excess spread may be diverted to fund or supplement cash collateral accounts for the benefit of investors and credit enhancers. Once excess spread is exhausted, the risks of credit default customarily shift to credit enhancers up to some additional multiple of projected losses. Only defaults above these multiples are borne by investors. As previously discussed, other protective measures, such as early amortization provisions, insulate investors and, to some extent, credit enhancers. Since losses of the magnitude required to trigger early amortization are infrequent, originators effectively absorb a substantial portion of realized losses in most securitized pools.

Remaining Asset Quality. Securitization readily lends itself to high-quality assets that provide a predictable, steady cash flow stream. Higher and more predictable net cash flows translate into lower credit enhancement fees and higher excess spread income. This may tempt banks to securitize the better-quality assets while keeping lower quality assets on the balance sheet. Because a bank new to the securitization markets does not have a track record with investors, it may be especially inclined to do so. If this approach becomes a habit, the bank will be required to hold more capital and loan loss reserves for the assets that remain on the books. Such an approach can compromise the integrity of loan loss reserve analyses that are based on historical performance.

Moral Recourse. Most prospectuses on asset-backed securities issued by banks clearly state that *the offering is not an obligation of the originating bank*. Despite this lack of legal obligation, in certain circumstances an originator may feel compelled to protect its name in the marketplace by providing support to poorly performing asset pools. Because there is some precedent in the market for preventing ratings downgrades or early amortization, many investors expect sponsors to aid distressed transactions.

Deciding to provide financial support for sold assets is difficult for banks. In addition to the immediate costs associated with steps to improve the yield on the asset pool, there may be other accounting, legal, and regulatory costs. For example, actions taken to support previously sold assets may compromise both the transaction's legal standing as a sale and the ability to treat the assets as off-balance-sheet items for GAAP and regulatory capital purposes. If this occurs, performance ratios, regulatory capital charges, and perhaps the tax treatment of the transaction may be affected.

Prudent business practice dictates that management consider all of the potential costs of providing additional enhancement to poorly performing asset pools. Not only would the bank supply direct financial support but it may also be obliged by its assumption of greater risk to meet a higher capital requirement. From a practical viewpoint, examiners should recognize that banks may decide to support outstanding securitization transactions to retain access to the funding source, even though doing so may require them to hold additional capital. For example, if bankers were to allow early amortization, they might need to obtain both new funding for the assets returning to the

balance sheet and additional risk-based capital. Although such a decision is for management to make, examiners should ensure appropriate risk-based capital levels are maintained for the risks assumed. (See the risk-based capital discussion under "Other Issues" for additional guidance.)

Other Credit Quality Issues. Banks can also assume credit risk exposure from securitized asset pools by becoming a credit enhancer for assets originated by a third party. Doing so exposes a bank to credit risk from a pool of loans it had no part in originating. So credit-enhancing banks must understand the transaction structure and perform adequate due diligence, especially when exceptions to underwriting policies and overrides are involved.

Managing Credit Risk

Because originating banks absorb most of the expected losses from both on-balance-sheet and securitized pools, sound underwriting standards and practices remain the best overall protection against excessive credit exposure. These banks should include experienced credit personnel in the strategic and operating decision-making process. Investment-banker, marketing, or other volume-oriented parties should not drive the process. Often, sustained periods of dramatic growth, aggressive teaser rates, and liberal balance transfer strategies are indications of an easing of underwriting standards. No matter how competitive the market, decisions on credit quality should be careful ones. In effective risk management systems, audit or credit review functions regularly test the lenders' compliance with underwriting standards for both on- and off-balance-sheet credits.

Most banks recognize the broad effects of securitization on credit risk and strategically attempt to ensure that sold and retained loans are of the same general quality. To protect against the tendency to loosen underwriting standards for pools that lenders believe may be sold, many banks require that all loans be subject to the same loan policy and approval process. To minimize the potential that the quality of securitized and retained loans differ, many banks employ a random selection process to ensure that every pool of assets reflects the overall quality of the portfolio and underwriting standards. If a business decision is made to choose a specific quality of loans for sale, special precautions are warranted.

If the sold loans are of *higher* quality than retained loans, then management should acknowledge the increased level of on-balance-sheet risk by ensuring that the bank's capital level and allowance for loan and lease losses are maintained at appropriate levels. If sold loans are to be *lower* quality than retained loans, the business and/or capital plans should acknowledge the increased vulnerability to moral recourse.

Other Credit Issues

Automated Underwriting Systems. Because securitization rewards economies of scale and allows a bank to originate a greater volume of receivables, many originators now use automated underwriting systems such as credit scoring and the electronic services of ratings companies such as Dun & Bradstreet. The objective is to speed credit approvals by allowing computers to accept (or reject) the large number of applications that are well within (or outside) the underwriting guidelines. Marginal applications are then processed individually. Use of these systems also improves the ability to predict and model pool performance, which in turn can lower the cost of credit enhancement and security coupon rates.

In addition to loan quality problems, poorly designed automated underwriting and scoring systems can adversely affect some borrowers or groups of borrowers. The bank's CRA policy, or loan policy, should address the needs of low- to moderate-income members of the trade area. The bank should be aware of the possibility of economic redlining, which could be caused, in part, by its desire to conform to the criteria handed down by the secondary market. Compliance reviews should include originations for securitization to ensure compliance with CRA. Automated scoring systems should be managed like other risk management models. For example, they should be tested periodically for continued relevance and validity.

Stress Testing of Securitized Pools. Many banks use cash flow models to simulate the structure and performance of their securitized asset pools. These models trace funds through the proposed transaction structure, accounting for the source and distribution of cash flows under many possible scenarios. Because the cash flows from any pool of assets can vary significantly depending on economic and market events, banks often subject proposed

structures to severe stress-testing to predict the loss exposures of investors and credit enhancers under most-likely and worst-case scenarios.

The effectiveness of models used to predict the performance of loan pools depends on disciplined adherence to clear underwriting standards for individual loans. Although a potentially powerful tool, models can be misused, become outdated, or skew results because of inaccurate or incomplete information. Any of these factors may cause projections to vary from the actual performance of the asset pool. To control potential weaknesses, management should back-test model results regularly, revalidate the logic and algorithms, and ensure the integrity of data entry/capture and assumptions.

Vintage Analysis. Another technique used to monitor loan quality and estimate future portfolio performance is vintage analysis. This type of analysis tracks delinquency, foreclosure, and loss ratios for similar products over comparable time periods. The objective is to identify sources of credit quality problems (such as weak or inappropriate underwriting standards) early so that corrective measures can be taken. Because loan receivables often do not reach peak delinquency levels until they have seasoned for several months, tracking the payment performance of seasoned loans over time allows the bank to evaluate the quality of newer receivables over comparable time periods and to forecast the impact that aging will have on portfolio performance.

Disclosure vs. Confidentiality. Most commercial loan files contain a substantial amount of nonpublic information. Much of this information is confidential. Although banks want to honor this confidence, they also feel obligated to disclose all the material information that a prospective investor should know. The problem is less daunting with homogeneous consumer loan products that lend themselves to aggregate performance analysis than it is in the growing markets for small business loans and other commercial loan products.

Bank policy on securitization of commercial loans should address the disclosure of confidential information provided by borrowers that are privately owned companies. The bank should obtain legal advice concerning what information should be disclosed or not disclosed about an issue of

securitized loans. Bank counsel should also sign off on decisions whether to inform borrowers of the disclosure of nonpublic information. To avoid problems with large commercial borrowers, bank management may wish to routinely obtain an acknowledgment or release from customers.

Transaction Risk

Transaction risk is the risk to earnings or capital arising from problems with service or product delivery. This risk is a function of internal controls, information systems, employee integrity, and operating processes. Transaction risk exists in all products and services.

For most securitized asset sales, the responsibility for servicing the assets is retained by the originator. This obligation usually extends throughout the life of the issued securities. Since the fee associated with servicing the portfolio is typically fixed, the risk of inefficiency from an operational point of view is retained by the originator. The length of the obligation and the volume-driven nature of these activities increase the possibility that banks, especially those with limited securitization experience, will overestimate their capacity to meet obligations, will underestimate the associated costs, or both.

Nature of Transaction Risk

The pooling and servicing agreement is the primary document defining the servicers' responsibilities for most securitization transactions. Transaction risk exposure increases when servicers do not fully understand or fulfill their responsibilities under the terms of this agreement. Servicing difficulties, such as incorrect loan and payment processing, inefficient collection of delinquent payments, or inaccurate investor reporting, expose the servicer to transaction risk. Effective servicing helps to ensure that receivables' credit quality is maintained. The main obligations assumed by the servicing bank are transaction processing, performance reporting, and collections.

Transaction Processing. Processing problems can occur when existing bank systems, which were designed to service volumes and types of loans that met certain portfolio objectives and constraints, are now subject to larger volumes or unanticipated loan types. Excessive volume may overextend systems and contribute to human error.

For most deals, the servicer agrees to service and administer the receivables in accordance with its customary practices and guidelines. The servicer also has the responsibility and authority to make payments to and withdrawals from deposit accounts that are governed by the documents. Servicers are typically paid a fixed percentage of the invested amount for their obligation to service the receivables (often between 1.5 percent and 2.5 percent for consumer products such as credit cards). Many bank servicers are highly rated and are able, under the pooling and servicing agreement, to commingle funds until one business day before the distribution date. Those lacking short-term, unsecured ratings of 'A-1' or better must customarily deposit collections in an eligible deposit account at another institution within one or two business days of receipt.

Reporting. Bank management, investors, and rating agencies all require that the performance of security pools be reported accurately and in a timely manner. Such reporting can be an especially difficult challenge for first-time issuers or for banks without integrated systems. For example, reporting difficulties have occurred when lead banks or holding companies have attempted to pool loans from various affiliates with different processing and reporting systems, or when bank-sponsored conduits have pooled receivables from various third-party originators. Servicing agreements are usually specific about the timing of payment processing and the types and structures of required reports, and trustees and investors have little tolerance for errors or delays.

Collections. A bank may also be exposed to transaction risk when its systems or personnel are not compatible with new types of borrowers or new products. Although securitization often provides incentives to expand activity beyond traditional markets and products, the staff members of some banks have done business only with certain customer types or are used to considerable flexibility in dealing with customers, particularly in workout situations. These bankers may have difficulties adjusting to the restrictions or specific requirements of securitization agreements. For example, the decision to compete for market share by expanding into markets for borrowers with poor credit histories may require a change in collection methods. Front-line relationship managers may be uncomfortable with the labor-intensive methods necessary for long-term success in this market segment, and pool performance may suffer.

The increased transaction volumes and risk transfers associated with securitization have, in some ways, depersonalized the lending and collections process. For example, limiting bankers' ability to work out problems with customers may pose special problems. In order to maintain strong relationships with customers, some bankers may wish to ignore the limits of typical pool requirements in renegotiating repayment terms and collateral positions. If longstanding customer relationships are valuable enough, some bankers may decide to repurchase securitized loans and draw up more flexible workout terms. Management should recognize that decisions to repurchase loans may compromise "sales treatment" for some transactions.

Liquidity Enhancement. As part of the servicing agreement, seller/servicers are sometimes obligated to enhance the liquidity of receivables securitized. The purpose of doing so is *not* to protect against deterioration in the credit quality of the underlying receivables but rather to ensure that the security issuer (the trust) will have sufficient funds to pay obligations as scheduled. Funding becomes necessary when the due date of payments to investors arrives before sufficient collections accrue. This liquidity enhancement requires a servicer to make cash advances to the trustee on behalf of obligors who may not pay as scheduled or estimated. However, a servicer can usually exempt itself from making such advances by formally determining that the funds would not be recoverable. In many cases the accuracy of a servicer's "recovery determination" is reviewable by the trustee. If the servicer does advance funds against receivables that later default for credit quality purposes, the liquidity provider obtains the investor's rights to use proceeds from the credit enhancement to repay any advances it has made.

Managing Transaction Risk

The effective management of servicing obligations requires a thorough understanding of the securitization process and especially the associated information and technology requirements. To reduce the bank's exposure to transaction risk, management should evaluate staffing, skill levels, and the capacity of systems to handle the projected type and volume of transactions.

The largest hurdle is typically the development of system enhancements that provide timely and accurate information on both the securitized loan pools

and the bank's remaining portfolio. Reports should be designed and modified as necessary to allow servicing managers to evaluate the performance of specific loan types and to monitor continuing performance. Quality control of the servicing operation may require periodic reports and an analysis of borrowers' complaints, which are usually about servicing problems or loan quality. The servicer should also have adequate insurance against errors and omissions. The volume and types of loans serviced by the bank will dictate the amount of insurance.

To mitigate transaction risk exposure, pooling and servicing agreements usually require independent accounting reviews of the servicer at least annually. These reviews result in written opinions on the servicer's compliance with the documents and on the adequacy of its operating policies and procedures. Efficient servicers supplement this annual external review of operations with periodic internal reviews.

Servicing capabilities, which should be a subject of long-range technology planning, should keep pace with projected volumes. Plans for servicing should prepare the company to resolve possible incompatibilities of loan systems within the company, as well as incompatibilities of internal systems with pools purchased from third parties. Every bank should have a back-up system, which should be tested at least annually. At a minimum, the guidelines provided in Banking Circular 177, "Corporate Contingency Planning," must be followed.

Liquidity Enhancement. In view of the responsibilities and liabilities that may accrue to the servicer as a liquidity provider, a formal policy should be developed that determines how the bank will respond to situations that require funds to be advanced. Servicers who provide back-up liquidity will often protect against exposure to deteriorating asset quality by defining a borrowing base of eligible (performing) assets against which they will advance. They may require that there be no existing breach of covenants or warranties on the loans, and that neither borrowers nor seller have initiated bankruptcy proceedings. Liquidity providers will often have senior liens on the eligible assets, or will otherwise be senior to credit enhancement facilities or other obligations of the issuer.

Liquidity Risk

Liquidity risk is the risk to earnings or capital arising from a bank's inability to meet its obligations when they come due, without incurring unacceptable losses. Liquidity risk includes the inability to manage unplanned decreases or changes in funding sources. Liquidity risk also arises from the bank's failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.

Given adequate planning and an efficient process structure, securitization can provide liquidity for balance sheet assets, as well as funding for leveraging origination capacity. This not only provides banks with a ready source of managed liquidity, but it increases their access to, and presence in, the capital markets.

Nature of Liquidity Risk

The securitization of assets has significantly broadened the base of funds providers available to banks and created a more liquid balance sheet. Too much reliance on a single funding vehicle, however, increases liquidity risk.

Banks must prepare for the possible return of revolving-credit receivable balances to the balance sheet as a result of either scheduled or early amortization. The primary risk is the potential that large asset pools could require balance sheet funding at unexpected or inopportune times. This risk threatens banks that do not correlate maturities of individual securitized transactions with overall planned balance sheet growth. This exposure is heightened at banks that seek to minimize securitization costs by structuring each transaction at the maturity offering the lowest cost, without regard to maturity concentrations or potential long-term funding requirements.

A second concern is unmitigated dependence on securitization markets to absorb new asset-backed security issues — a mistake that banks originating assets specifically for securitization are more likely to make. Such a bank may allocate only enough capital to support a "flow" of assets to the securitization market. This strategy could cause funding difficulties if circumstances in the markets or at the bank were to force the institution to hold assets on its books.

Managing Liquidity Risk

The implications of securitization for liquidity should be factored into a bank's day-to-day liquidity management and its contingency planning for liquidity. Each contemplated asset sale should be analyzed for its impact on liquidity both as an individual transaction and as it affects the aggregate funds position.

Liquidity management issues include:

- The volume of securities scheduled to amortize during any particular period;
- The plans for meeting future funding requirements (including when such requirements are expected);
- The existence of early amortization triggers;
- An analysis of alternatives for obtaining substantial amounts of liquidity quickly; and
- Operational concerns associated with reissuing securities.

The bank should monitor all outstanding transactions as part of day-to-day liquidity management. The bank should develop systems to ensure that management is forewarned of impending early amortization triggers, which are often set off by three successive months of negative cash flow (excess spread) on the receivables pool. Management should be alerted well in advance of an approaching trigger so that preventive actions can be considered. Thus forewarned, management should also factor the maturity and potential funding needs of the receivables into shorter-term liquidity planning.

Contingency planning should anticipate potential problems and be thorough enough to assume that, during a security's amortization phase, management will be required to find replacement funding for the full amount of the receivables. Plans should outline various funding alternatives, recognizing that a complete withdrawal from the securitization market or a cutback in lending could affect the bank's reputation with investors and borrowers.

Compliance Risk

Compliance risk is the risk to earnings or capital arising from violations or nonconformance with laws, rules, regulations, prescribed practices, or ethical standards. Compliance risk also arises in situations where the laws or rules governing certain bank products or activities of the bank's clients may be ambiguous or untested. Compliance risk also exposes the institution to fines, civil money penalties, payment of damages, and the voiding of contracts. Compliance risk can lead to a diminished reputation, reduced franchise value, limited business opportunities, lessened expansion potential, and lack of contract enforceability.

Consumer laws and regulations, including fair lending and other anti-discrimination laws, affect the underwriting and servicing practices of banks even if they originate loans with the intent to securitize them. Management should ensure that staff involved in the underwriting and servicing functions (including collections) comply fully with these laws and regulations. Examiner's should refer to the *Comptroller's Handbook for Compliance* for detailed guidance on identifying and assessing compliance risk in the lending process.

Other Issues

There are two significant events, effective January 1, 1997, that affect the capital and financial reporting requirements for sales of assets associated with securitization transactions. First, the Federal Financial Institutions Examination Council (FFIEC) decided that banks should follow generally accepted accounting principles (GAAP) for their quarterly reports of condition and income (call reports). Second, The Financial Accounting Standards Board (FASB) adopted Financial Accounting Standard 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (FAS 125). Both of these changes affect how banks must recognize revenue and maintain capital for securitization transactions.

Accounting

Under GAAP, the applicable accounting guidance for asset transfers in a securitization transaction is FAS 125. Although primarily concerned with

differentiating sales from financing treatment, FAS 125 also describes how to properly account for servicing assets and other liabilities in securitization transactions. FAS 125 applies to all types of securitized assets, including auto loans, mortgages, credit card loans, and small business loans. FAS 125 replaced previous accounting guidance including FAS 77, "Reporting by Transferor for Transfers of Receivables with Recourse," FAS 122, "Accounting for Mortgage Servicing Rights," and various guidance issued by FASB's Emerging Issues Task Force.

Generally, the accounting treatment for an asset transfer under FAS 125 is determined by whether legal control over the financial assets changes. Specifically, a securitization transaction will qualify for "sales" treatment (i.e., removal from the seller's reported financial statements) if the transaction meets the following conditions:

- The transferred assets are isolated from the seller (that is, they are beyond the reach of the seller and its creditors, even in bankruptcy or other receivership);

- The buyer can pledge or exchange the transferred assets, or the buyer is a qualifying special-purpose entity and the holders of the beneficial interests in that entity have the right to pledge or exchange those interests; and

- The seller does not retain effective control over the transferred assets through an agreement that

    - Both entitles and obligates it to repurchase the assets before maturity, or
    - Entitles it to repurchase transferred assets that are not readily obtainable in the market.

If the securitization transaction meets the FAS 125 criteria, the seller:

- Removes all transferred assets from the balance sheet;
- Recognizes all assets obtained and liabilities incurred in the transaction at fair value; and
- Recognizes in earnings any gain or loss on the sale.

Any recourse obligation in a transaction qualifying for sales treatment should be recorded as a liability, at fair value, and subtracted from the cash received to determine the gain or loss on the transaction. If the "sales treatment" criteria are not met, the transferred assets remain on the balance sheet and the transaction is accounted for as a secured borrowing (and no gain or loss is recognized).

A Sample Transaction. The adoption of GAAP for regulatory reporting purposes and FAS 125 change the accounting for asset sales associated with securitization transactions. Certain gains or losses that were deferred under previous regulatory accounting practices are now recognized on the sale date.

The following is an *example* of the accounting entries a seller might make when transferring credit card receivables to a master trust:

The initial sales transaction:

Principal amount of initial receivables pool:	$120,000
Carrying amount net of specifically allocated loss reserve	$117,000
Servicing fee (based on outstanding receivables balance)	2%
Up-front transaction costs:	$ 600
Seller's interest:	$ 20,000
Value of servicing asset	$ 1,500

Transaction structure

	Fair Value*	Allocated % of total Fair Value	Carrying Amount	Portion Sold	Portion Retained
Class A	$ 100,000	(117/124.5)	$ 93,976	$ 93,976	
Seller's Interest	$ 20,000	(117/124.5)	$ 18,795		$ 18,795
IO Strip**	$ 3,000	(117/124.5)	$ 2,819		$ 2,819
Servicing	$ 1,500	(117/124.5)	$ 1,410		$ 1,410
Total	$124,500		$117,000	$ 93,796	$ 23,024

**Must be estimated. See guidance under "Estimating Fair Value."*

***An IO (interest-only) strip is a contractual right to receive some or all of the interest due on an interest bearing financial instrument. In a securitization transaction, it refers to the present value of the expected future excess spread from the underlying asset pool.*

The journal entries to record the initial transaction on the books of the bank are:

		Debits		
Entry #1.	Cash	$99,400		($100,000 - 600)
	IO Strip	2,819		
	Servicing Asset	1,410		
	Seller's Certificate	18,795		
			Credits	
	Net Carrying Amount of Loans		$117,000	
	Pretax Gain		5,424	

(To record securitization transaction by recognizing assets retained and by removing assets sold.)

FAS 125 requires the seller to record the IO strip at its allocated cost. However, since the IO strip is treated like a marketable equity security, it must be carried at fair market value throughout its life. Therefore, adjusting entries are necessary if the asset's estimated value changes. The following journal entry represents the recognition of an increase in the fair value of the asset. (The reverse of this entry would occur if the periodic estimate found that the value had declined or been impaired.)

		Debits	Credits
Entry #2.	IO Strip	$181	
	Equity		$181

(To measure an IO strip categorized as an available-for-sale security at its fair market value as required under FAS 115).

As the bank receives cash associated with excess spread from the trust, the effect of the journal entries is to increase cash and reduce the amount of the IO strip. In effect, the entry would be:

		Debits	Credits
Entry #3.	Cash	$10	
	IO Strip		$10

(To recognize cash "excess spread" from the trust.)

If the transaction meets the FAS 125 sales criteria, a selling bank should recognize the servicing obligation (asset or liability) and any residual interests in the securitized loans retained (such as the IO strip and the seller's certificate). The bank should also recognize as assets or liabilities any written or purchased options (such as recourse obligations), forward commitments, or other derivatives (e.g., commitments to deliver additional receivables during the revolving period of a securitization), or any other rights or obligations resulting from the transaction.

Estimating Fair Value. FAS 125 guidance states that the fair value of an asset (or liability) is the amount for which it could be bought or sold in a current transaction between willing parties — that is, in other than a forced liquidation sale. Quoted market prices in active markets are the best evidence of fair value and, if available, shall be used as the basis for the pricing.

Unfortunately, it is unlikely that a securitizer will find quoted market prices for most of the financial assets and liabilities that arise in a securitization transaction. Accordingly, estimation is necessary. FAS 125 says that if quoted market prices are not available, the estimate of fair value shall be based on the best information available. Such information includes prices for similar assets and liabilities and the results of valuation techniques such as:

- The present value of estimated expected future cash flows using a discount rate commensurate with the risks involved;
- Option-pricing models;
- Matrix pricing;
- Option-adjusted spread models; and
- Fundamental analysis.

These techniques should include the assumptions about interest rates, default rates, prepayment rates, and volatility that other market participants employ in estimating value. Estimates of expected future cash flows should be based on reasonable and supportable assumptions and projections. All available evidence should be considered in developing estimates of expected future cash flows. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. If a range is

estimated for either the amount or timing of future cash flows, the likelihood of possible outcomes should be considered to determine the best estimate.

Recognition of Servicing. A servicing asset should be recorded if the contractual servicing fee more than adequately compensates the servicer. (Adequate compensation is the amount of income that would fairly compensate a substitute servicer, and includes the profit that would be required in the market place.) The value of servicing assets includes the contractually specified servicing fees, late charges, and other related fees and income, including float.

A servicing liability should be recorded when the estimated future revenues from stated servicing fees, late charges, and other ancillary revenues are not expected to adequately compensate the servicer for performing the servicing.

The recorded value of servicing rights is initially based on the fair value of the servicing asset relative to the total fair value of the transferred assets. Servicing assets must be amortized in proportion to estimated net servicing income and over the period that such income is received. In addition, servicing assets must be periodically evaluated and measured for impairment. Any impairment losses should be recognized in current period income.

According to FAS 125, servicing assets should be subsequently measured and evaluated for impairment as follows:

1. Stratify servicing assets based on one or more of their predominant risk characteristics. The risk characteristics may include financial asset type, size, interest rate, date of origination, term, and geographic location.

2. Recognize impairment through a valuation allowance for each individual stratum. Impairment should be recognized as the amount by which the carrying amount of a category of servicing assets exceeds its fair value. The fair value of servicing assets that have not been recognized should not be used in this evaluation.

3. Periodically adjust the valuation allowance to reflect changes in impairment. However, appreciation in the fair value of a stratum of servicing assets over its carrying amount should not be recognized.

Treatment of Excess Cash Flows. The right to future income in excess of contractually stated servicing fees should be accounted for separately from the servicing asset. The right to these cash flows is treated as an interest-only strip and accounted for under FAS 115 as either an available-for-sale or trading security.

If IO strips or other receivables or retained interests in securitizations can be contractually prepaid or settled in a way that the holder might not substantially recover its recorded investment, FAS 125 requires that they be measured at fair value and that the treatment be similar to that given available-for-sale and trading securities under FAS 115. Accordingly, these items are initially recorded at allocated fair value. (Allocating fair value refers to apportioning the previous carrying amount of the transferred assets between the assets sold and the interests retained by the seller based on their relative fair values at the date of transfer. See example entry #1.) These items are periodically adjusted to their estimated fair value (example entry #2) based on their expected cash flows.

Recognition of Fees. The accounting treatment of fees associated with loans that will be securitized should be in accordance with FAS 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases" and FAS 65, "Accounting for Certain Mortgage Banking Enterprises." In accordance with these statements' standards for pools of loans that are held for sale, the loan origination fees and direct loan origination costs should be deferred and recognized in income when the loans are sold.

Risk-Based Capital[4]

Asset Sales without Recourse

Securitization can have important implications for a bank's risk-based capital requirement. (For a more complete discussion of OCC risk-based capital requirements, see the "Capital and Dividends" section of the *Comptroller's Handbook*.) If asset sales meet the "sale" requirements of FAS 125 and the assets are sold without recourse, the risk-based capital standards do not require the seller to maintain capital for the assets securitized. The primary attraction of securitization for bank issuers (notwithstanding the wealth of liquidity inherent in selling loans quickly and efficiently for cash) is the ability to avoid capital requirements while realizing considerable financial benefits (e.g., servicing fees, excess servicing income, and origination fees). Several of the "pure play" or monoline banks have off-balance-sheet, securitized assets that are several times larger than their on-balance-sheet loan amounts.

Although the risk-based capital standards are heavily weighted toward credit risk, a bank's capital base must also be available to absorb losses from other types of risk, such as funding source concentrations, operations, and liquidity risk. For this reason, it is prudent for banks to evaluate all of the exposures associated with securitizing assets, especially revolving assets such as credit cards and home equity lines of credit for which the bank retains a close association with the borrower even after a specific receivable balance has been sold.

Using models or other methods of analysis, a bank should allocate the appropriate amount of capital to support these risks. At least two major off-balance-sheet risk areas pertinent to securitization are not specifically discussed in the minimum capital requirements of risk-based capital:

- Servicing obligations.
- Liquidity risk associated with revolving asset pools.

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4 At the time of this writing there are a number of pending regulations that affect capital (servicing assets, recourse, small business recourse, etc.). The reader should refer to 12 CFR 3 and "Instructions for the Consolidated Reports of Condition and Income" for definitive capital regulations and guidance.

Servicing Obligations. Securitization is a volume business that rewards economies of scale. The amount of capital support should be commensurate with the expected transaction volumes, the nature of the transactions (revolving or amortizing), the technology requirements, and the complexity of the collections process. A bank should consider increasing capital for servicing if bank personnel are not experienced with the asset and borrower types anticipated, the bank is offering a new product or entering a new business line, or the complexity of the servicing is growing.

Liquidity Risks. Securitization transactions involving revolving assets (for example, credit cards and home equity lines of credit) pose more liquidity risk than amortizing assets such as automobile loans. When a revolving-asset securitization matures, the bank must either roll any new receivables into another securitization or find another way to fund the assets. While most banks will not find it difficult to access the securitization markets in normal times, the risk of overall market disruption does exist. In addition, if a bank's financial condition or capacity to provide servicing deteriorates, access to the markets may be limited or using them may not be cost effective. These possibilities should be reflected in determining capital adequacy.

Other Factors. Other factors not related to credit may expose a bank to additional risk, such as representations and warranties provided by the seller, and some kinds of obligations associated with acting as a trustee or advisor for a transaction. These may vary with specific transactions and should be included in any analysis of capital adequacy.

Capital Reserves. When an issuer securitizes receivables, it usually reverses the bad debt reserves previously held against the receivables and takes that amount into income. Often, at the time of sale, issuers will use these freed-up reserves to set up new capital reserves for potential exposures associated with securitization transactions. While these new reserves are a healthy recognition that all risk exposures are not eliminated when assets are securitized, the capital allocation for exposures to off-balance-sheet securitization transactions should specifically reflect the nature and volume of the remaining exposures. These transaction, liquidity, and other risks may not be identical to the credit risk that has been transferred, and the capital analysis and resulting reserve decisions should focus on actual risk exposure.

Asset Sales with Recourse

Generally, the risk-based capital requirements for assets transferred with recourse were not changed by the adoption of GAAP for regulatory reporting purposes on January 1, 1997. Guidance for the accounting and risk-based capital treatment of asset sales with recourse can be found in 12 CFR 3, appendix A, section 3(b)(1)(B)(iii), with accompanying footnote; in the instructions for the preparation of the consolidated reports of condition and income (the call reports); and in periodic interpretive letters issued by the regulatory agencies. These guidelines address the determination of recourse in an asset sale, the associated risk-based capital requirements, and the treatment of limited, or "low-level," recourse transactions.

Recourse Determination. In securitization activities, "recourse" typically refers to the risk of loss that a bank retains when it sells assets to a trust or other special-purpose entity established to issue asset-backed securities. The general rule is that a transfer that qualifies for sales treatment under GAAP does not require risk-based capital support provided the transferring bank:

1. Does not retain risk of loss on the transferred assets from any source, and

2. Is not obligated to any party for the payment of principal or interest on the assets transferred resulting from:

   a. Default on principal or interest by the obligor of the underlying instrument or from any other deficiencies in the obligor's performance.

   b. Changes in the market value of the assets after they have been transferred.

   c. Any contractual relationship between the seller and purchaser incident to the transfer that, by its term, could continue after final payment, default, or other termination of the assets transferred.

   d. Any other cause.

If risk or obligation for payment of principal or interest is retained by, or may revert to, the seller in an asset transfer that qualifies for sale treatment under GAAP, the transaction *must* be considered an "asset sale with recourse" for risk-based capital purposes.

Two exceptions to the general recourse rule do not by themselves cause a transaction to be treated as a sale with recourse. These exceptions are contractual provisions that:

- Provide for the return of the assets to the seller in instances of incomplete documentation or fraud.

- Allow the purchaser a specific period of time to determine that the assets transferred are as represented by the seller and to return deficient paper to the seller.

Assets transferred in transactions that do not qualify as sales under GAAP should continue to be reported as assets on the call report balance sheet and are subject to regulatory capital requirements.

Most transactions that involve recourse are governed by contracts written at the time of sale. These contracts set forth the terms and conditions under which the purchaser may compel payment from the seller. In some instances of recourse a bank assumes risk of loss without an explicit contractual agreement or in amounts exceeding a specified contractual limit. A bank suggests that it may have granted *implicit* recourse by taking certain actions subsequent to the sale. Such actions include: a) providing voluntary support for a securitization by selling assets to a trust at a discount from book value; b) exchanging performing for nonperforming assets; c) infusing additional cash into a spread account or other collateral account; or d) supporting an asset sale in other ways that impair the bank's capital. Proving the existence of implicit recourse is often a complex and fact-specific process. Therefore, the OCC expects that the general test of loss retention and capital impairment, supplemented by periodic interpretations as structures and asset-types evolve, will be the most effective method of determining the existence of recourse in securitization transactions.

Risk-Based Capital Treatment. Asset sales with recourse are reported on the call report in Schedule RC-L, "Off-Balance-Sheet Items," and Schedule RC-R, "Regulatory Capital." Under the risk-based capital standards, assets sold with recourse are risk-weighted using two steps. First, the full outstanding amount of assets sold with recourse is converted to an on-balance-sheet credit equivalent amount using a 100 percent credit conversion factor, except for certain low-level recourse transactions (described below) and small business obligations transferred with recourse. Second, the credit equivalent amount is assigned to the appropriate risk-weight category according to the obligor or, if relevant, the guarantor or the nature of the collateral.

Low-Level Recourse Transactions. According to the risk-based capital standards, the amount of risk-based capital that must be maintained for assets transferred with recourse should not exceed the maximum amount of recourse for which a bank is contractually liable under the recourse agreement. This rule applies to transactions in which a bank contractually limits its risk of loss or recourse exposure to less than the full effective minimum risk-based capital requirement for the assets transferred. The low-level recourse provisions may apply to securitization transactions that use contractual cash flows (e.g., interest-only strips receivable and spread accounts), retained subordinated interests, or retained securities (e.g., collateral invested amounts and cash collateral accounts) as credit enhancements. If the low-level recourse rule applies to these credit enhancements, the maximum contractual dollar amount of the bank's recourse exposure, and therefore that amount of risk-based capital that must be maintained, is generally limited to the amount carried as an asset on the balance sheet in accordance with GAAP. The call report instructions for Schedule RC-R provide specific guidance for the reporting and capital requirements for low-level recourse transactions.

1. To determine the quantity of risk and the quality of risk management by assessing whether the bank is properly identifying, measuring, monitoring, and controlling the risks associated with its securitization activities.

2. To determine whether the bank's strategic or business plan for asset securitization adequately addresses resource needs, capital requirements, and profitability objectives.

3. To determine whether asset securitization policies, practices, procedures, objectives, internal controls, and audit functions are adequate.

4. To determine that securitization activities are properly managed within the context of the bank's overall risk management process.

5. To determine the quality of operations and the adequacy of MIS.

6. To determine compliance with applicable laws, rulings, regulations, and accounting practices.

7. To determine the level of risk exposure presented by asset securitization activities and evaluate that exposure's impact on the overall financial condition of the bank, including the impact on capital requirements and financial performance.

8. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient, or when violations of law, rulings, or regulations have been noted.

Many of the steps in these procedures require examiners to gather information from or review information with examiners in other areas, particularly those responsible for originating assets used in securitized pools (e.g., retail lending, mortgage banking, credit card lending). To avoid duplicating examination procedures already being performed in these areas, examiners should discuss and share examination data related to asset securitization with examiners from these other areas before beginning these procedures.

Examiners should cross-reference information obtained from other areas in their examination work papers. When information is not available from other examiners, it should be requested directly from the bank. The final decision on the scope of the examination and the most appropriate way to obtain information rests with the examiner-in-charge (EIC).

The examination procedures in the first section ("Overview") will help the examiner determine how the bank securitizes and the general level of management and board oversight. The procedures in the second section ("Functions") supplement the "Overview" section and will typically be used for more in-depth reviews of operational areas. The procedures in "Overall Conclusions" (#s 67-71) should be completed for each examination.

Overview

1. Obtain and review the following documents:

   - ☐ Previous examination findings related to asset securitization and management's response to those findings.
   - ☐ Most recent risk assessment profile of the bank.
   - ☐ Most recent internal/external audits addressing asset securitization and management's response to significant deficiencies.
   - ☐ Supervisory Monitoring System (SMS) reports.
   - ☐ Scope memorandum issued by the bank EIC.

☐ Strategic or business plan for asset securitization.

☐ All written policies or procedures related to asset securitization.

☐ A description of the risk measurement and monitoring system for securitization activities and a copy of all related MIS reports. (Measurement systems may include tracking reports, exposure reports, valuation reports, and profitability analyses. See the examination procedures under "Management Information Systems" for additional details.)

☐ A summary or outline of all outstanding asset-backed issuances. Document for the permanent work paper file information for each outstanding security including:
- The origination date, original deal amount, current outstanding balance, legal maturity, expected maturity, maturity type (hard bullet, soft bullet, controlled `amortization, etc.), revolving period dates, current coupon rates, gross yield, loss rate, base rate, excess spread amounts (one month and three month), monthly payment rates, and the existence of any interest rate caps.
- The amount and form of credit enhancements (over-collateralization, cash collateral accounts, spread accounts, etc.).
- Performance triggers relating to early amortization events or credit enhancement levels.

☐ Copies of pooling and servicing agreements and/or series supplements for major asset types securitized or those targeted at this exam.

☐ Information detailing the potential contractual or contingent liability from guarantees, underwriting, and servicing of securitized assets.

☐ Copies of compensation programs, including incentive plans, for personnel involved in securitization activities.

☐ Current organizational chart for the asset securitization unit of the bank.

☐ A list of board and executive or senior management committees that supervise the asset securitization function, including a list of members and meeting schedules. Also, minutes documenting meetings held since the last examination should be available for review.

2. Determine whether any material changes have occurred since the last review regarding originations and purchases, servicing, or managing securitized portfolios.

3. Based on results from the previous steps and discussions with the bank EIC and other appropriate supervisors, determine the scope and objectives of the examination.

   Select from among the following examination procedures the steps necessary to meet examination objectives. Examiners should tailor the procedures to the specific activities and risks faced by the bank. Note: Examinations will seldom require completion of all steps.

4. As examination procedures are performed, test for compliance with established policies and confirm the existence of appropriate internal controls. Identify any area that has inadequate supervision or poses undue risk, and discuss the need to perform additional or expanded procedures with the EIC.

Management Oversight

5. Review the bank's securitization business plan. Determine that it has been reviewed by all significant affected parties and approved by the bank's board of directors. At a minimum, the plan should address the following:

   a. The integration of the securitization program into the bank's corporate strategic plan.

   b. The integration of the securitization program into the bank's asset/liability, contingency funding, and capital plans.

   c. The integration of the securitization program into the bank's compliance review, loan review, and audit program.

   d. The specific capacities in which the bank will engage (servicer, trustee, credit enhancer, etc.).

e. The establishment of a risk identification process.

f. The type(s) and volume of business to be done in total (aggregate of deals in process as well as completed deals that are still outstanding).

g. Profitability objectives.

6. Evaluate the quality of the business plan. Consider whether:

a. The plan is reasonable and achievable in light of the bank's capital position, physical facilities, data processing systems capabilities, size and expertise of staff, market conditions, competition, and current economic forecasts.

b. The feasibility analysis considers tax, legal, and resource implications.

c. The goals and objectives of the securitization program are compatible with the overall business plan of the bank, the holding company, or both.

7. Determine whether the bank has and is following adequate policies and operating procedures for securitization activities. At a minimum, policies should address:

a. Permissible securitization activities including individual responsibilities, limits, and segregation of duties.

b. Authority levels and responsibility designations covering:

- Transaction approvals and cancellations;
- Counterparty approvals for all outside entities the bank is doing business with (originators, servicers, packagers, trustees, credit enhancers, underwriters, and investors);
- Systemic and individual transaction monitoring;
- Pricing approvals;
- Hedging and other pre-sale decisions;

- Quality standard approvals; and
- Supervisory responsibilities over personnel.

c. Exposure limits by:

- Type of transaction;
- Individual transaction dollar size;
- Aggregate transactions outstanding (because of the moral recourse implicit in the bank's name on the securities);
- Geographic concentrations of transactions (individually and in aggregate);
- Maturities of transactions (particularly important in evergreen deals, i.e., credit cards and home equity lines); and
- Originators (for purchased assets), credit enhancers, trustees, and servicers.

d. Quality standards for all transactions in which the bank plans to participate. Standards should extend to all counterparties conducting business with the bank.

e. Minimum MIS reports to be presented to senior management and the board or appropriate committees. (During reviews of applicable meeting minutes, ascertain which reports are presented and the depth of discussions held).

8. Review the organizational structure and determine who is responsible for coordinating securitization activities.

a. Determine whether the board of directors or appropriate committee and management have a separate securitization steering committee. If so, review committee minutes for significant information.

b. Determine whether decision making is centralized or delegated.

c. Determine which individuals are responsible for major decisions and where final decisions are made.

9. Determine whether, before approving a new securitization transaction, the bank requires sign-off from the following departments:

   - Appropriate credit division
   - Treasury or capital markets
   - Audit
   - Asset and liability management
   - Capital planning committee
   - Legal
   - Liquidity management
   - Operations

10. Assess the expertise and experience of management responsible for securitization activities.

    a. Conduct interviews and review personnel files and resumes to determine whether management and other key staff members possess appropriate experience or technical training to perform their assigned functions.

    b. Review management succession plans and determine whether designated successors have the necessary background and experience.

11. Review incentive plans covering personnel involved in the securitization process. Determine whether plans are oriented toward quality execution and long-run profitability rather than high-volume, short-term asset production and sales.

    a. Ensure that such plans have been approved by the board of directors or an appropriate committee.

    b. Determine that senior management and the board of directors are aware of any substantial payments or bonuses made under these plans.

12. Evaluate the pricing system used in all aspects of securitization.

    a. Determine that the bank has a system for quantifying costs and risks (liquidity, credit, transaction, etc.) and for making incremental adjustments to compensate for the less readily quantifiable costs and risks.

    b. Determine whether decision makers use an effective pricing system to determine whether prospective transactions will be profitable.

Risk Management

13. Determine whether the risk management process is effective and based on timely and accurate information. Evaluate its adequacy in managing significant risks in each area of the securitization process.

    a. Ascertain whether management has identified all significant risks in each of the bank's planned roles.

    b. Determine how these risks are monitored and controlled.

    c. Evaluate how controls are integrated into overall bank systems.

    d. Evaluate management's method of allocating capital or reserves to various business units in recognition of securitization risks.

14. Determine that the bank's obligations from securitization activities have been reviewed by appropriate legal counsel.

    a. Ensure that legal counsel has reviewed and approved any standardized documents used in the securitization process. Counsel should also review any transactions that deviate significantly from standardized documents.

    b. If the bank is involved in issuing prospectuses or private placement memoranda, ensure that legal counsel has reviewed them. Also,

ensure that operating practices require a party independent of the securitization process to check the financial and statistical information in the prospectus for accuracy.

15. Determine that the scope of credit and compliance reviews includes loans originated for securitization or purchased for that purpose.

    a. Ascertain appropriateness of scope, frequency, independence, and competency of reviews in view of the bank's activity volume and risk exposure.

    b. Credit and compliance reviews should include:

       - Loans on the bank's books and not yet securitized;
       - Loans in process of being securitized; and
       - Completed deals that bear the bank's name or in which the bank has ongoing responsibilities (servicer, trustee, etc.).

Portfolio Management

16. Determine whether management's assessment of the quality of loan origination and credit risk management includes *all* managed assets (receivables in securitization programs and on-balance-sheet assets). At a minimum, the assessment should include:

    a. A review of the number and dollar volume of existing past-due loans, early payment defaults, and repurchased loans from securitized asset pools. The review should also compare the bank's performance to industry, peer group averages, or both.

    b. An analysis of the cause of delinquencies and repurchases.

    c. The impact on delinquencies and losses of altered underwriting practices, new origination sources, and new products.

    d. Determination of whether repurchases or other workout actions compromised the sales status of problem credits or related assets.

17. Determine whether the bank performs periodic stress tests of securitized asset pools. Determine whether these tests:

    a. Consider the appropriate variables affecting performance according to asset or pool type.

    b. Are conducted well in advance of approaching designated early amortization triggers.

    c. Are adequately documented.

18. If third parties provide credit or liquidity enhancements for bank-sponsored asset-backed securities, determine whether their credit rating has been downgraded recently or whether their credit quality has deteriorated. If so, determine what actions the bank has taken to mitigate the impact of these events.

19. Assess whether securitization activities have been adequately integrated into liquidity planning. Consider whether:

    a. The cash flows from scheduled maturities of revolving asset-backed securities are coordinated to minimize potential liquidity concerns.

    b. The impact of unexpected funding requirements due to early amortization events are factored into contingency funding plans for liquidity.

Internal and External Audit

20. Review the bank's internal audit program for securitization activities. Determine whether it includes objectives, written procedures, an audit schedule, and reporting systems that are appropriate in view of the bank's volume of activity and risk exposure.

    a. Review the education, experience, and ongoing training of the internal audit staff and evaluate its expertise in auditing securitization activities.

b. Determine whether comprehensive audits of all securitization areas are conducted in a timely manner. Ensure that the scope of internal audit includes:

   - An evaluation of compliance with pooling and servicing agreement requirements; and
   - Periodic verification of the accuracy of both internal and external portfolio performance reports.

c. Review management's responses to audit reports for timeliness and implementation of corrective action when appropriate.

21. If the external auditors review the major operational areas involved in securitization activities, review the most recent engagement letter, external audit report, and management letter. Determine:

    a. To what extent the external auditors rely on the internal audit staff and the internal audit report.

    b. Whether the external auditors rendered an opinion on the effectiveness of internal controls for the major products or services related to securitization.

    c. Whether management promptly and effectively responds to the external auditor's concerns and recommendations. Assess whether management makes changes to operating and administrative procedures that are appropriate responses to report findings.

Management Information Systems

22. Review management information systems to determine whether they provide appropriate information for monitoring securitization activities.

    a. Evaluate reports produced for each capacity in which the bank is involved. At a minimum, the following should be produced:

       - Tracking reports to monitor overall securitization activity. Reports should include:

- Completed transactions, transactions in process, and prospective transactions;
- Exposure reports detailing exposures by specific function (credit enhancer, servicer, trustee, etc.) and by counterparties; and
- Profitability analysis by product and functional department (originations, servicing, trustees, etc.). Profitability reports should include cost-center balance sheet and earnings statements. The balance sheets should reflect the amount of capital and reserves set aside for risks within the various functions.

• Inventory reports to monitor available transaction collateral. Reports should include summaries by:

  - Product type, including outstanding and committed receivable amounts;
  - Geographic or other types of concentrations; and
  - Sale status (for transactions in process).

• Performance reports by portfolio and specific product type. Reports should reflect performance of both assets in securitized pools and total managed assets. Reports should include:

  - Credit quality (delinquencies, losses, portfolio aging, etc.);
  - Profitability (by individual transaction and product type); and
  - Performance compared with expected performance (portfolio yields, monthly principal payment rates, purchase rates, charge-offs, etc.).

b. Determine whether MIS provides sufficient detail to permit reviews for compliance with policy limits and to make appropriate disclosures on regulatory reports and other required financial statements. Evaluate whether:

- The frequency of report generation is commensurate with volume and risk exposure; and
- Reports are distributed to, and reviewed by, appropriate management, board committees, or both.

23. Determine whether investor reporting is accurate and timely. Choose a sample of outstanding transactions and compare internal performance reports with those provided to investors. Note: Examiners can supplement this procedure by comparing internal reports with information reported by external sources (such as Bloomberg, Fitch, and Moody's). Discrepancies should be brought to management's attention immediately.

Accounting and Risk-Based Capital

24. Determine whether the bank is classifying securitization transactions appropriately as "sales" or "financings."

    a. Determine that the bank has a system to ensure that independent personnel review transactions and concur with accounting treatment.

    b. Ensure that audit has tested for proper accounting treatment as part of its normal reviews.

25. For transactions that qualify for sales treatment under FAS 125, review the written policies and procedures to determine whether they:

    a. Allocate the previous book carrying amount between the assets sold and the retained interests based on their fair market values on the date of transfer.

    b. Adjust the net proceeds received in the exchange by recording, on the balance sheet, the fair market value of any guarantees, recourse obligations, or derivatives such as put options, forward commitments, interest rate swaps, or currency swaps.

    c. Recognize gain or loss only on assets sold.

d. Continue to carry on the balance sheet any retained interest in the transferred assets. Such balance sheet items should include servicing assets, beneficial debt or equity interests in the special-purpose entity, or retained undivided interests.

26. Determine whether the asset values and periodic impairment analyses for servicing assets and rights to future excess interest (IO strips) are consistent with FAS 125 and regulatory accounting requirements.

    a. Determine whether the bank has a reasonable method for determining fair market value of the assets.

    b. Determine whether recorded servicing and IO strip asset values are reviewed in a timely manner and adjusted for changes in market conditions.

    For servicing assets, verify that:

    - Servicing assets are appropriately stratified by predominant risk characteristics (e.g., asset type, interest rate, date of origination, or geographic location);
    - Impairment is recognized by stratum;
    - Impairment is assessed frequently (e.g., at least quarterly);
    - Assumptions and calculations are documented; and
    - Servicing assets are not recorded at a value greater than their original allocated cost.

    For IO strip assets, verify that:

    - Valuation considers changes in expected cash flows due to current and projected volatility of interest rates, default rates, and prepayment rates; and
    - IO strips are recorded at fair market value consistent with available-for-sale or trading securities.

    c. Determine that servicing assets and IO strips are accorded appropriate risk-based capital treatment. Ensure that:

- Nonmortgage servicing assets are fully deducted from Tier 1 capital and risk-weighted assets. (Mortgage-related servicing assets and purchased credit card relationships may be included in Tier 1 capital; however, the total of all mortgage related servicing assets and purchased credit card relationships is limited. See 12 CFR 3 and related interpretations.)
- Risk-based capital is allocated for the lower of the full amount of the assets transferred or the amount of the IO strip, consistent with low-level recourse rules.

27. For revolving trusts, review procedures for accounting for new sales of receivables to the trust.

    a. Verify that accrued interest on receivables sold is accounted for properly.

    b. Determine whether gain or loss is properly booked.

28. Determine whether the bank maintains capital reserves for securitized assets. Determine whether the method for calculating the reserves is reasonable. Consider:

    a. The volume and nature of servicing obligations.

    b. The potential impact on liquidity of revolving-asset pools.

    c. Other potential exposures.

Recourse Transactions

29. Determine whether the bank transfers loans with recourse. If so, determine whether:

    a. Written policies guide management with respect to the type and amount of recourse it can offer. Such policies should address:

        - Full or partial recourse specified in the servicing contract;

- Warranties and representations in the sale of loans, including warranties against noncompliance with consumer laws and regulations;
- Repurchase agreements in case of early default or early prepayment of securitized loans;
- Spread accounts or cash reserves;
- Vested business relationships with purchasers of whole loans or investors in asset-backed securities; and
- Environmental hazards.

b. Adequate management information systems exist to track all recourse obligations.

c. Asset sales with recourse, including low-level transactions, are reported appropriately in schedule RC-R of the report of condition and income (call report).

d. If recourse is limited, determine whether the bank's systems prevent it from making payments greater than its contractual obligation to purchasers.

30. Determine whether the bank has developed written standards for refinancing, renewing, or restructuring loans previously sold in asset-backed securities transactions. Determine whether:

a. The standards distinguish a borrower's valid desire to reduce an interest rate through renewal, refinancing, or restructuring designed to salvage weak credits.

b. The standards prevent the bank from repurchasing distressed loans from the securitized credit pool and disguising their delinquency in the bank's loan portfolio.

Functions

The following guidelines supplement the procedures in the "Overview" section. These procedures will often be performed by product (loan) type and should be coordinated with other examination areas to avoid duplication of effort.

Originations

31. Determine whether senior management or the board is directly involved in decisions concerning the quality and types of assets that are to be securitized as well as those to be retained on the balance sheet. Ensure that written policies:

    a. Outline objectives relating to securitization activities.

    b. Establish limits or guidelines for:

    - Quality of loans originated
    - Maturity of loans originated
    - Geographic dispersion of loans
    - Acceptable range of loan yields
    - Credit quality
    - Acceptable types of collateral
    - Types of loans

32. Determine whether the credit standards for loans to be securitized are the same as the ones for loans to be retained.

    a. If not, ascertain whether management consciously made this decision and that it is clearly stated in the securitization business plan.

    b. If higher quality loans are to be securitized in order to gain initial market acceptance, determine whether the bank limits the amount of lower quality assets it originates or retains. Also, determine whether the allowance for loan and lease losses and capital are adjusted for the higher proportion of risk in total assets.

c. Determine whether there are sufficient administrative and collection personnel on hand to properly administer and collect lower quality credits.

33. Ensure that there is a complete separation of duties between the credit approval process and loan sales/securitization effort. Determine whether lending personnel are solely responsible for:

    a. The granting or denial of credit to customers.

    b. Credit approvals of resale counterparties.

34. Ensure that loans to be sold or securitized are segregated or otherwise identified on the books of the originating bank. Also, determine that the bank is following appropriate accounting standards regarding market valuation procedures on assets held for sale.

35. If loans are granted or denied based on a credit scoring system, ascertain whether the system was developed based on empirically derived data. Ensure that it is periodically revalidated.

36. Determine whether the bank is making efforts to ensure that the customer base is not suffering from economic redlining. If economic redlining is occurring, determine what actions the bank is taking to counteract these effects. (Evidence of redlining should be immediately discussed with the EIC and/or appropriate compliance examiner.)

37. Determine whether written policies address borrower's expectations of confidentiality and rights to financial privacy by requiring:

    a. The opinion of counsel on what matters may be disclosed.

    b. Written notice (when counsel deems it necessary) that loans may be sold in whole or pledged as collateral for asset-backed securities and that certain confidential credit information may be disclosed to other parties.

    c. When necessary, the borrower's written waiver of confidentiality.

Purchased Loans

38. Determine whether the bank has written procedures on acquiring portfolios for possible securitization. If so, determine whether the procedures are adequate given the volume and complexity of the potential purchases.

39. Evaluate management's method of determining whether prospective asset purchases meet the quality standards represented by the seller. Ensure that the process considers whether purchased assets are compatible with the bank's data systems, administration and collection systems, credit review talent, and compliance standards, particularly consumer protection laws.

40. If the bank has recently purchased a portfolio for use in a securitization transaction, review the due diligence work papers to assess their adequacy and compliance with policy.

41. Determine whether the bank conducts postmortem reviews on acquired portfolios, and, if so, what procedures are used. Identify who receives the results and whether appropriate follow-up action is taken (changes in quality standards, due diligence procedures, etc.)

42. Ensure that operating systems segregate or otherwise identify loans being held for resale. Review accounting practices to ensure appropriate treatment of assets held for resale.

43. Evaluate the measures taken to control pipeline exposure.

    a. If pre-sales are routine, determine whether credit approval and diversification standards for purchasers are administered by people who are independent of the asset purchasing and packaging processes.

    b. Evaluate the reasonableness of limits on inventory positions that are not pre-sold or hedged.

c. If assets held for resale are required to be hedged, ensure that controls over hedging include:

- An approved list of hedging instruments;
- Minimum acceptable correlation between the assets held for sale and the hedging vehicle;
- Maximum exposure limits to unhedged loan commitments under various interest rate simulations;
- Credit limits on forward sale exposure to a single counterparty;
- A prohibition against speculation; and
- Acceptable reporting systems for hedging transactions.

Servicing

44. Determine whether written policies are in place for servicing activities that:

a. Outline objectives for the servicing department.

b. List the types of loans that the bank is permitted to service.

c. Specify procedures for valuing retained and purchased servicing rights.

d. Require legal counsel to review each transaction for conflicts of interest when the bank serves in multiple capacities such as:

- Originator
- Servicer
- Trustee
- Credit enhancer
- Market maker
- Lender in other relationships to borrowers, investors, originators
- Investor

45. Determine whether MIS reports for the servicing operation provide adequate information to monitor servicing activities. Reports by asset pool or transaction should include:

    a. Activity data, including:

        - Aggregate data such as number of loans, dollar amount of loans, yield on loans.
        - Delinquency information for at least the loans that are more than 15/30/60/90 days past due;
        - Number and dollar amount of early payment default (within first three months of closing);
        - Charge-off data; and
        - Repossession costs (if applicable).

    b. Profitability information, including all costs associated with direct and indirect overhead, capital, and collections.

    c. Comparisons of the servicer's costs and revenues with industry averages.

46. Evaluate management's planning process for future servicing activities. Determine whether:

    a. Current systems are capable of handling the requirements for the current and anticipated securitization volume.

    b. The planning process for the development of operating systems has been coordinated with plans for anticipated future growth in servicing obligations.

    c. Provisions exist for complete testing and personnel training before adding systems or changing existing ones significantly.

    d. A sufficient number of experienced credit administration and workout personnel are available to meet the added demands associated with increased transaction and account volumes.

47. Determine whether the bank has contracted for an appropriate amount of errors and omissions insurance to cover the risks associated with the added transaction volumes from securitization activities.

48. Determine whether internal or external auditors review the servicing function. Determine whether they:

    a. Verify loan balances.

    b. Verify notes, mortgages, security interests, collateral, etc., with outside custodians.

    c. Review loan collection and repossession activities to determine that the servicer:

        - Promptly identifies problem loans;
        - Charges off loans in a timely manner;
        - Follows written guidelines for extensions, renegotiations, and renewal of loans;
        - Clears stale items from suspense accounts in a timely manner; and
        - Accounts for servicing fees properly (by amortizing excess servicing fees, for example).

Collections

49. Review policies and procedures for collecting delinquent loans.

    a. Determine whether collection efforts are consistent with pooling and servicing agreement guidelines.

    b. Determine whether the bank documents all attempts to collect past-due payments, including the date(s) of borrower contact, the nature of communication, and the borrower's response/comment.

    c. Evaluate methods used by management to ensure that collection procedures comply with applicable state and federal laws and regulations.

Other Roles

Credit Enhancement Provider

50. If the bank enhances the credit of securitized products it *originates*, ensure that:

    a. It appropriately classifies the transactions as “financings” or “sales.”

    b. Accounting for this obligation does not underestimate predictable losses or overestimate the adequacy of loan loss reserves.

    c. Standards for enhancing the bank’s own originations are not more liberal than standards applied to securitized products originated by others.

51. Ensure that the authority to enhance the credit of other banks’ securitization programs is solely in the hands of credit personnel.

52. Determine that *all* credit enhancement exposures are analyzed during the bank’s internal credit review process. At a minimum, ensure that:

    a. The accounting for this contingent obligation does not underestimate predictable loan losses or overestimate the adequacy of loan loss reserves.

    b. The limits on securitized credits that the bank enhances reflect the bank’s overall exposure to the originator and packager of the securitized credits.

    c. The bank consolidates its exposure to securitized credits it enhances with exposure to the same credits held in its own loan portfolio.

53. Determine whether the bank has established exposure limits for pertinent credit criteria, such as the enhancer’s exposure by customers, industry, and geography. Determine whether these exposures are incorporated into systemic exposure reports.

54. Ascertain whether the bank has the capacity to fund the support they have provided. Evaluate whether the bank considers this contingent obligation in its contingency funding plans.

55. Determine that the bank's business plan for credit enhancement addresses capital allocation and ensure that the associated costs of capital usage are incorporated into pricing and transaction decisions.

56. If credit enhancement facilities are provided for third parties, ensure that risk-based capital allocations are consistent with current guidelines set forth in 12 CFR 3 and the "Instructions for the Consolidated Reports of Condition and Income."

Trustee

These procedures supplement those in the *Comptroller's Handbook for National Trust Examiners* and are intended only to guide examiners during the evaluation of the trustee's role in the securitization process.

57. Determine whether all indentures and contracts have been reviewed by appropriate legal counsel. Establish whether the agreements have been carefully worded to specify only services that the bank is capable of performing.

58. Review how bank management evaluates proposed customers and transactions that involve the bank as trustee. At a minimum, an evaluation should consider:

    a. The bank's capacity to perform all the tasks being requested.

    b. The financial and ethical backgrounds of the customer.

    c. The reputation and financial risks of entering into a relationship with the customer or acting as trustee for the transaction.

59. Review conflicts of interest that could arise when the bank trustee acts in an additional capacity in the securitization process. If the potential for conflicts of interest is apparent, determine whether the bank's legal

counsel has reviewed the situation and rendered an opinion on its propriety.

60. Determine whether the audit of trust work on securitized products is adequate.

Liquidity Enhancement Provider

61. Review agreements in which the bank agrees to provide back-up liquidity (either as a servicer or third-party provider of liquidity enhancement), and determine whether liquidity will be provided in the event of credit problems. Consider whether:

    a. The bank (as liquidity provider) is required to advance for delinquent receivables.

    b. The liquidity agreements cite credit-related contingencies that would allow the bank to withhold advances.

62. If the bank, in agreeing to provide back-up liquidity, assumes any risk of loss that would constitute providing recourse, ensure that appropriate risk-based capital is maintained by the bank.

Underwriter and Packager

63. Determine whether legal counsel has been used in arriving at appropriate policies and procedures governing due diligence and disclosure to investors.

    a. Ascertain whether the bank's policy or practices require the bank to inform customers that nonpublic information in the bank's possession may be disclosed as part of the underwriting process. If not, determine whether legal counsel concurred with the decision not to provide the disclosure and ensure that the rationale behind it has been documented.

    b. Determine whether the bank has procedures to disclose all material information to investors.

c. Determine whether the bank has procedures to ensure that:

- Publicly offered securities are registered under the Securities Act of 1933; or
- Any reliance upon an exemption from registration (privately offered securities are exempt from such registration) is supported by the opinion of counsel.

64. Evaluate the measures taken to limit the bank's exposure in the event that an issue the institution has agreed to underwrite cannot be sold. Review systems used to quantify underwriting risks and to establish risk limits. Consider:

    - Funding capacity necessary to support temporary and long-term inventory positions;
    - Balance sheet compatibility;
    - Diversity of customer sales base and prospects for subsequent sale; and
    - Hedging strategies.

65. Ascertain whether the bank is prepared to make a market for all asset-backed securities that it underwrites. Also, determine whether this question is addressed in the bank's contingency funding plan.

66. Determine whether the bank monitors securities it has underwritten and adjusts funding plans according to noted or perceived market shifts and investor actions.

67. Review the bank's files for current information on the asset-backed security originator, credit enhancer, and other pertinent parties. Assess the ability of these parties to meet their obligations.

Overall Conclusions

68. Prepare a summary memorandum detailing the results of the asset securitization examination. Address the following:

a. Adequacy of risk management systems, including the bank's ability to identify, measure, monitor, and control the risks of securitization.

b. Adequacy of the strategic plan or business plan for asset securitization.

c. Adequacy of policies and operating procedures and adherence thereto.

d. Quality and depth of management supervision and operating personnel.

e. Adequacy of management information systems.

f. Propriety of accounting systems and regulatory reporting.

g. Compliance with applicable laws, rulings, and regulations.

h. Adequacy of audit, compliance, and credit reviews.

I. Recommended corrective action regarding deficient policies, procedures, or practices and other concerns.

j. Commitments received from management to address concerns.

k. The impact of securitization activities on reputation risk, strategic risk, credit risk, transaction risk, liquidity risk, and compliance risk.

l. The impact of securitization activities on the bank's earnings and capital.

m. The bank's future prospects based on its finances and other considerations.

n. Other matters of significance.

69. Discuss examination findings and conclusions with the EIC. Based on

this discussion, set up a meeting with bank management to share findings and obtain any necessary commitments for corrective action.

70. Write a memorandum specifically setting out what the OCC needs to do in the future to effectively supervise the asset securitization function. Include time frames, staffing, and workdays required.

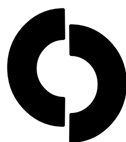
71. Update the examination work papers.

Regulations

12 CFR 3, Minimum Capital Ratios; Issuance of Directives (including Appendix A)

Issuances

Banking Circular 177, "Corporate Contingency Planning"
Comptroller's Handbook , "Capital and Dividends"
Comptroller's Handbook , "Mortgage Banking"
Comptroller's Handbook for National Bank Examiners, "Funds Management," Section 405
Consolidated Reports of Condition and Income (the Call Reports)
Financial Accounting Standard 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities"
OCC 96-52, "Securitization — Guidelines for National Banks"



OCC BULLETIN

Comptroller of the Currency
Administrator of National Banks

Subject: Interagency Guidance on Asset Securitization Activities

Description: Asset Securitization

TO: Chief Executive Officers of All National Banks, Department and Division Heads, and All Examining Personnel

The attached "Interagency Guidance on Asset Securitization Activities" was issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (the Agencies) on December 13, 1999. The provisions included in this policy statement are effective immediately.

For several years, large commercial banks have been using asset securitization as an alternative method of funding balance sheet assets, improving financial performance ratios and generating fee income. While the OCC continues to endorse the use of asset securitization as a tool to manage the bank's balance sheet and more efficiently meet customer needs, we remind bankers that such activity is only appropriate when properly managed. During recent examinations, our examiners have noted an unacceptable number of national banks with risk management systems or internal control infrastructures insufficient to support the institution's securitization activities. Particularly disturbing is the number of cases where the valuation of retained interests on the bank's balance sheet have not been in compliance with the standards prescribed in Statement of Financial Accounting Standard No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." In addition, several banks have inaccurately reported their risk-based capital by failing to appropriately account for recourse obligations arising from securitization activities.

The attached statement highlights particular areas of weakness, including the board and senior management oversight. **The statement reiterates our expectation that critical components of an effective oversight program for asset securitization activities include: (1) independent risk management commensurate with the complexity of securitization activities, (2) comprehensive audit coverage, (3) appropriate residual interest valuation and modeling methodologies, (4) accurate and timely risk-based capital calculations, and (5) prudent internal limits to control the amount of equity capital at risk that is used to support securitization retained interests.**

OCC examiners will continue to review asset securitization activities in national banks to ensure that the board of directors and senior management are complying with the risk management expectations detailed in this policy statement. In those cases where examiners identify weak risk management practices or lax internal controls, bank management will be directed to take immediate corrective action. In situations where bank management cannot provide objectively verifiable support for the valuation of the retained interest, the asset will be classified as loss and disallowed as an asset of the bank for regulatory capital purposes.

Additional guidance on OCC expectations for national banks involved in asset securitization activities can be found in the "Asset Securitization" booklet of the *Comptroller's Handbook.*

Questions about the interagency statement or other policy issues related to asset securitization activities may be directed to Kathy Dick, Director, Treasury and Market Risk Division at (202) 874-5670. Technical assistance can be provided by Greg Coleman or Jeffery Power at the same location.

Emory Wayne Rushton
Senior Deputy Comptroller
Bank Supervision Policy

Attachment

INTERAGENCY GUIDANCE ON ASSET SECURITIZATION ACTIVITIES

BACKGROUND AND PURPOSE

Recent examinations have disclosed significant weaknesses in the asset securitization practices of some insured depository institutions. These weaknesses raise concerns about the general level of understanding and controls among institutions that engage in such activities. The most frequently encountered problems stem from: (1) the failure to recognize and hold sufficient capital against explicit and implicit recourse obligations that frequently accompany securitizations, (2) the excessive or inadequately supported valuation of "retained interests,"[1] (3) the liquidity risk associated with over reliance on asset securitization as a funding source, and (4) the absence of adequate independent risk management and audit functions.

The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision, hereafter referred to as "the Agencies," are jointly issuing this statement to remind financial institution managers and examiners of the importance of fundamental risk management practices governing asset securitization activities. This guidance supplements existing policy statements and examination procedures issued by the Agencies and emphasizes the specific expectation that any securitization-related retained interest claimed by a financial institution will be supported by documentation of the interest's fair value, utilizing reasonable, conservative valuation assumptions that can be objectively verified. Retained interests that lack such objectively verifiable support or that fail to meet the supervisory standards set forth in this document will be classified as loss and disallowed as assets of the institution for regulatory capital purposes.

The Agencies are reviewing institutions' valuation of retained interests and the concentration of these assets relative to capital. Consistent with existing supervisory authority, the Agencies may, on a case-

[1] In securitizations, a seller typically retains one or more interests in the assets sold. **Retained interests** represent the right to cash flows and other assets not used to extinguish bondholder obligations and pay credit losses, servicing fees and other trust related fees. For the purposes of this statement, **retained interests** include over-collateralization, spread accounts, cash collateral accounts, and interest only strips (IO strips). Although servicing assets and liabilities also represent a retained interest of the seller, they are currently determined based on different criteria and have different accounting and risk-based capital requirements. See applicable comments in Statement of Financial Accounting Standard No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (FAS 125), for additional information about these interests and associated accounting requirements.

by-case basis, require institutions that have high concentrations of these assets relative to their capital, or are otherwise at risk from impairment of these assets, to hold additional capital commensurate with their risk exposures. Furthermore, given the risks presented by these activities, the Agencies are actively considering the establishment of regulatory restrictions that would limit or eliminate the amount of certain retained interests that may be recognized in determining the adequacy of regulatory capital. An excessive dependence on securitizations for day-to-day core funding can also present significant liquidity problems - either during times of market turbulence or if there are difficulties specific to the institution itself. As applicable, the Agencies will provide further guidance on the liquidity risk associated with over reliance on asset securitizations as a funding source and implicit recourse obligations.

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DESCRIPTION OF ACTIVITY

Asset securitization typically involves the transfer of on-balance sheet assets to a third party or trust. In turn the third party or trust issues certificates or notes to investors. The cash flow from the transferred assets supports repayment of the certificates or notes. For several years, large financial institutions, and a growing number of regional and community institutions, have been using asset securitization to access alternative funding sources, manage concentrations, improve financial performance ratios, and more efficiently meet customer needs. In many cases, the discipline imposed by investors who buy assets at their fair value has sharpened selling institutions' credit risk selection, underwriting, and pricing practices. Assets typically securitized by institutions include credit card receivables, automobile receivable paper, commercial and residential first mortgages, commercial loans, home equity loans, and student loans.

While the Agencies continue to view the use of securitization as an efficient means of financial intermediation, we are concerned about events and trends uncovered at recent examinations. Of particular concern are institutions that are relatively new users of securitization techniques and institutions whose senior management and directors do not have the requisite knowledge of the effect of securitization on the risk profile of the institution or are not fully aware of the accounting, legal and risk-based capital nuances of this activity. Similarly, the Agencies are concerned that some institutions have not fully and accurately distinguished and measured the risks that have been transferred versus those

retained, and accordingly are not adequately managing the retained portion. It is essential that institutions engaging in securitization activities have appropriate front and back office staffing, internal and external accounting and legal support, audit or independent review coverage, information systems capacity, and oversight mechanisms to execute, record, and administer these transactions correctly.

Additionally, we are concerned about the use of inappropriate valuation and modeling methodologies to determine the initial and ongoing value of retained interests. Accounting rules provide a method to recognize an immediate gain (or loss) on the sale through booking a “retained interest;” however, the carrying value of that interest must be fully documented, based on reasonable assumptions, and regularly analyzed for any subsequent value impairment. The best evidence of fair value is a quoted market price in an active market. In circumstances where quoted market prices are not available, accounting rules allow fair value to be estimated. This estimate must be based on the "best information available in the circumstances."[2] An estimate of fair value must be supported by reasonable and current assumptions. If a best estimate of fair value is not practicable, the asset is to be recorded at zero in financial and regulatory reports.

History shows that unforeseen market events that affect the discount rate or performance of receivables supporting a retained interest can swiftly and dramatically alter its value. Without appropriate internal controls and independent oversight, an institution that securitizes assets may inappropriately generate “paper profits” or mask actual losses through flawed loss assumptions, inaccurate prepayment rates, and inappropriate discount rates. Liberal and unsubstantiated assumptions can result in material inaccuracies in financial statements, substantial write-downs of retained interests, and, if interests represent an excessive concentration of the institution’s capital, the demise of the sponsoring institution.

Recent examinations point to the need for institution managers and directors to ensure that:

- Independent risk management processes are in place to monitor securitization pool performance on an aggregate and individual transaction level. An effective risk management function includes appropriate information systems to monitor securitization activities.

- Conservative valuation assumptions and modeling methodologies are used to establish, evaluate and adjust the carrying value of retained interests on a regular and timely basis.

- Audit or internal review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets retained by the institution. The findings of such reviews should be reported directly to the board or an appropriate board committee.

- Accurate and timely risk-based capital calculations are maintained, including recognition and reporting of any recourse obligation resulting from securitization activity.

- Internal limits are in place to govern the maximum amount of retained interests as a percentage of total equity capital.

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[2] FAS 125, at par. 43

- The institution has a realistic liquidity plan in place in case of market disruptions.

The following sections provide additional guidance relating to these and other critical areas of concern. Institutions that lack effective risk management programs or that maintain exposures in retained interests that warrant supervisory concern may be subject to more frequent supervisory review, more stringent capital requirements, or other supervisory action.

INDEPENDENT RISK MANAGEMENT FUNCTION

Institutions engaged in securitizations should have an independent risk management function commensurate with the complexity and volume of their securitizations and their overall risk exposures. The risk management function should ensure that securitization policies and operating procedures, including clearly articulated risk limits, are in place and appropriate for the institution's circumstances. A sound asset securitization policy should include or address, at a minimum:

- A written and consistently applied accounting methodology;
- Regulatory reporting requirements;
- Valuation methods, including FAS 125 residual value assumptions, and procedures to formally approve changes to those assumptions;
- Management reporting process; and
- Exposure limits and requirements for both aggregate and individual transaction monitoring.

It is essential that the risk management function monitor origination, collection, and default management practices. This includes regular evaluations of the quality of underwriting, soundness of the appraisal process, effectiveness of collections activities, ability of the default management staff to resolve severely delinquent loans in a timely and efficient manner, and the appropriateness of loss recognition practices. Because the securitization of assets can result in the current recognition of anticipated income, the risk management function should pay particular attention to the types, volumes, and risks of assets being originated, transferred and serviced. Both senior management and the risk management staff must be alert to any pressures on line managers to originate abnormally large volumes or higher risk assets in order to sustain ongoing income needs. Such pressures can lead to a compromise of credit underwriting standards. This may accelerate credit losses in future periods, impair the value of retained interests and potentially lead to funding problems.

The risk management function should also ensure that appropriate management information systems (MIS) exist to monitor securitization activities. Reporting and documentation methods must support the initial valuation of retained interests and ongoing impairment analyses of these assets. Pool performance information has helped well-managed institutions to ensure, on a qualitative basis, that a sufficient amount of economic capital is being held to cover the various risks inherent in securitization transactions.

The absence of quality MIS hinders management's ability to monitor specific pool performance and securitization activities more broadly. At a minimum, MIS reports should address the following:

Securitization summaries for each transaction - The summary should include relevant transaction terms such as collateral type, facility amount, maturity, credit enhancement and subordination features, financial covenants (termination events and spread account capture "triggers"), right of repurchase, and counterparty exposures. Management should ensure that the summaries are distributed to all personnel associated with securitization activities.

Performance reports by portfolio and specific product type - Performance factors include gross portfolio yield, default rates and loss severity, delinquencies, prepayments or payments, and excess spread amounts. The reports should reflect performance of assets, both on an individual pool basis and total managed assets. These reports should segregate specific products and different marketing campaigns.

Vintage analysis for each pool using monthly data - Vintage analysis helps management understand historical performance trends and their implications for future default rates, prepayments, and delinquencies, and therefore retained interest values. Management can use these reports to compare historical performance trends to underwriting standards, including the use of a validated credit scoring model, to ensure loan pricing is consistent with risk levels. Vintage analysis also helps in the comparison of deal performance at periodic intervals and validates retained interest valuation assumptions.

Static pool cash collection analysis - This analysis entails reviewing monthly cash receipts relative to the principal balance of the pool to determine the cash yield on the portfolio, comparing the cash yield to the accrual yield, and tracking monthly changes. Management should compare the timing and amount of cash flows received from the trust with those projected as part of the FAS 125 retained interest valuation analysis on a monthly basis. Some master trust structures allow excess cash flow to be shared between series or pools. For revolving asset trusts with this master trust structure, management should perform a cash collection analysis for each master trust structure. These analyses are essential in assessing the actual performance of the portfolio in terms of default and prepayment rates. If cash receipts are less than those assumed in the original valuation of the retained interest, this analysis will provide management and the board with an early warning of possible problems with collections or extension practices, and impairment of the retained interest.

Sensitivity analysis - Measuring the effect of changes in default rates, prepayment or payment rates, and discount rates will assist management in establishing and validating the carrying value of the retained interest. Stress tests should be performed at least quarterly. Analyses should consider potential adverse trends and determine "best," "probable," and "worst case" scenarios for each event. Other factors to consider are the impact of increased defaults on collections staffing, the timing of cash flows, "spread account" capture triggers, over-collateralization triggers, and early amortization triggers. An increase in defaults can result in higher than expected costs and a delay in cash flows, decreasing the value of the retained interests. Management should periodically quantify and document the potential impact to both earnings and capital, and report the results to the board

of directors. Management should incorporate this analysis into their overall interest rate risk measurement system.[3] Examiners will review the analysis conducted by the institution and the volatility associated with retained interests when assessing the Sensitivity to Market Risk component rating.

Statement of covenant compliance - Ongoing compliance with deal performance triggers as defined by the pooling and servicing agreements should be affirmed at least monthly. Performance triggers include early amortization, spread capture, changes to over-collateralization requirements, and events that would result in servicer removal.

VALUATION AND MODELING PROCESSES

The method and key assumptions used to value the retained interests and servicing assets or liabilities must be reasonable and fully documented. The key assumptions in all valuation analyses include prepayment or payment rates, default rates, loss severity factors, and discount rates. The Agencies expect institutions to take a logical and conservative approach when developing securitization assumptions and capitalizing future income flows. It is important that management quantifies the assumptions on a pool-by-pool basis and maintains supporting documentation for all changes to the assumptions as part of the valuation process, which should be done no less than quarterly. Policies should define the acceptable reasons for changing assumptions and require appropriate management approval.

An exception to this pool-by-pool valuation analysis may be applied to revolving asset trusts if the master trust structure allows excess cash flows to be shared between series. In a master trust, each certificate of each series represents an undivided interest in all of the receivables in the trust. Therefore, valuations are appropriate at the master trust level.

In order to determine the value of the retained interest at inception, and make appropriate adjustments going forward, the institution must implement a reasonable modeling process to comply with FAS 125. The Agencies expect management to employ reasonable and conservative valuation assumptions and projections, and to maintain verifiable objective documentation of the fair value of the retained interest. Senior management is responsible for ensuring the valuation model accurately reflects the cash flows according to the terms of the securitization's structure. For example, the model should account for any cash collateral or over-collateralization triggers, trust fees, and insurance payments if appropriate. The board and management are accountable for the "model builders" possessing the necessary expertise and technical proficiency to perform the modeling process. Senior management should ensure that internal controls are in place to provide for the ongoing integrity of MIS associated with securitization activities.

As part of the modeling process, the risk management function should ensure that periodic validations

[3] Under the Joint Agency Policy Statement on Interest Rate Risk, institutions with a high level of exposure to interest rate risk relative to capital will be directed to take corrective action. Savings associations can find OTS guidance on interest rate risk in Thrift Bulletin 13a - Management of Interest Rate Risk, Investment Securities, and Derivative Activities.

are performed in order to reduce vulnerability to model risk. Validation of the model includes testing the internal logic, ensuring empirical support for the model assumptions, and back-testing the models with actual cash flows on a pool-by-pool basis. The validation process should be documented to support conclusions. Senior management should ensure the validation process is independent from line management as well as the modeling process. The audit scope should include procedures to ensure that the modeling process and validation mechanisms are both appropriate for the institution's circumstances and executed consistent with the institution's asset securitization policy.

USE OF OUTSIDE PARTIES

Third parties are often engaged to provide professional guidance and support regarding an institution's securitization activities, transactions, and valuing of retained interests. The use of outside resources does not relieve directors of their oversight responsibility, or senior management of its responsibilities to provide supervision, monitoring, and oversight of securitization activities, and the management of the risks associated with retained interests in particular. Management is expected to have the experience, knowledge, and abilities to discharge its duties and understand the nature and extent of the risks presented by retained interests and the policies and procedures necessary to implement an effective risk management system to control such risks. Management must have a full understanding of the valuation techniques employed, including the basis and reasonableness of underlying assumptions and projections.

INTERNAL CONTROLS

Effective internal controls are essential to an institution's management of the risks associated with securitization. When properly designed and consistently enforced, a sound system of internal controls will help management safeguard the institution's resources, ensure that financial information and reports are reliable, and comply with contractual obligations, including securitization covenants. It will also reduce the possibility of significant errors and irregularities, as well as assist in their timely detection when they do occur. Internal controls typically: (1) limit authorities, (2) safeguard access to and use of records, (3) separate and rotate duties, and (4) ensure both regular and unscheduled reviews, including testing.

The Agencies have established operational and managerial standards for internal control and information systems.[4] An institution should maintain a system of internal controls appropriate to its size and the nature, scope, and risk of its activities. Institutions that are subject to the requirements of FDIC regulation 12 CFR Part 363 should include an assessment of the effectiveness of internal controls over their asset securitization activities as part of management's report on the overall effectiveness of the system of internal controls over financial reporting. This assessment implicitly includes the internal controls over financial information that is included in regulatory reports.

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[4] Safety and Soundness Standards 12 CFR Part 30 (OCC), 12 CFR Part 570 (OTS).

AUDIT FUNCTION OR INTERNAL REVIEW

It is the responsibility of an institution's board of directors to ensure that its audit staff or independent review function is competent regarding securitization activities. The audit function should perform periodic reviews of securitization activities, including transaction testing and verification, and report all findings to the board or appropriate board committee. The audit function also may be useful to senior management in identifying and measuring risk related to securitization activities. Principal audit targets should include compliance with securitization policies, operating and accounting procedures (FAS 125), and deal covenants, and accuracy of MIS and regulatory reports. The audit function should also confirm that the institution's regulatory reporting process is designed and managed in such a way to facilitate timely and accurate report filing. Furthermore, when a third party services loans, the auditors should perform an independent verification of the existence of the loans to ensure balances reconcile to internal records.

REGULATORY REPORTING

The securitization and subsequent removal of assets from an institution's balance sheet requires additional reporting as part of the regulatory reporting process. Common regulatory reporting errors stemming from securitization activities include:

- Failure to include off-balance sheet assets subject to recourse treatment when calculating risk-based capital ratios;
- Failure to recognize retained interests and retained subordinate security interests as a form of credit enhancement;
- Failure to report loans sold with recourse in the appropriate section of the regulatory report; and
- Over-valuing retained interests.

An institution's directors and senior management are responsible for the accuracy of its regulatory reports. Because of the complexities associated with securitization accounting and risk-based capital treatment, attention should be directed to ensuring that personnel who prepare these reports maintain current knowledge of reporting rules and associated interpretations. This often will require ongoing support by qualified accounting and legal personnel.

Institutions that file the Report of Condition and Income (Call Report) should pay particular attention to the following schedules on the Call Report when institutions are involved in securitization activities: *Schedule RC-F: Other Assets*; *Schedule RC-L: Off Balance Sheet Items*; and *Schedule RC-R: Regulatory Capital*. Institutions that file the Thrift Financial Report (TFR) should pay particular attention to the following TFR schedules: *Schedule CC: Consolidated Commitments and Contingencies, Schedule CCR: Consolidated Capital Requirement, and Schedule CMR: Consolidated Maturity and Rate.*

Under current regulatory report instructions, when an institution's supervisory agency's interpretation of how generally accepted accounting principles (GAAP) should be applied to a specified event or transaction differs from the institution's interpretation, the supervisory agency may require the institution to reflect the event or transaction in its regulatory reports in accordance with the agency's interpretation and amend previously submitted reports.

MARKET DISCIPLINE AND DISCLOSURES

Transparency through public disclosure is crucial to effective market discipline and can reinforce supervisory efforts to promote high standards in risk management. Timely and adequate information on the institution's asset securitization activities should be disclosed. The information contained in the disclosures should be comprehensive; however, the amount of disclosure that is appropriate will depend on the volume of securitizations and complexity of the institution. Well-informed investors, depositors, creditors and other bank counterparties can provide a bank with strong incentives to maintain sound risk management systems and internal controls. Adequate disclosure allows market participants to better understand the financial condition of the institution and apply market discipline, creating incentives to reduce inappropriate risk taking or inadequate risk management practices. Examples of sound disclosures include:

- Accounting policies for measuring retained interests, including a discussion of the impact of key assumptions on the recorded value;
- Process and methodology used to adjust the value of retained interests for changes in key assumptions;
- Risk characteristics, both quantitative and qualitative, of the underlying securitized assets;
- Role of retained interests as credit enhancements to special purpose entities and other securitization vehicles, including a discussion of techniques used for measuring credit risk; and
- Sensitivity analyses or stress testing conducted by the institution showing the effect of changes in key assumptions on the fair value of retained interests.

RISK-BASED CAPITAL FOR RECOURSE AND LOW LEVEL RECOURSE TRANSACTIONS

For regulatory purposes, recourse is generally defined as an arrangement in which an institution retains the risk of credit loss in connection with an asset transfer, if the risk of credit loss exceeds a pro rata share of the institution's claim on the assets.[5] In addition to broad contractual language that may require

[5] The risk-based capital treatment for sales with recourse can be found at 12 CFR Part 3 Appendix A, Section (3)(b)(1)(iii) {OCC}, 12 CFR Part 567.6(a)(2)(i)(c) {OTS}. For a further explanation of recourse see the glossary entry "Sales of Assets for Risk-Based Capital Purposes" in the instructions for the Call Report.

the selling institution to support a securitization, recourse can also arise from retained interests, retained subordinated security interests, the funding of cash collateral accounts, or other forms of credit enhancements that place an institution's earnings and capital at risk. These enhancements should generally be aggregated to determine the extent of an institution's support of securitized assets. Although an asset securitization qualifies for sales treatment under GAAP, the underlying assets may still be subject to regulatory risk-based capital requirements. Assets sold with recourse should generally be risk-weighted as if they had not been sold.

Securitization transactions involving recourse may be eligible for "low level recourse" treatment.[6] The Agencies' risk-based capital standards provide that the dollar amount of risk-based capital required for assets transferred with recourse should not exceed the maximum dollar amount for which an institution is contractually liable. The "low level recourse" treatment applies to transactions accounted for as sales under GAAP in which an institution contractually limits its recourse exposure to less than the full risk-based capital requirements for the assets transferred. Under the low level recourse principle, the institution holds capital on approximately a dollar-for-dollar basis up to the amount of the aggregate credit enhancements.

Low level recourse transactions should be reported in Schedule RC-R of the Call Report or Schedule CCR of the TFR using either the "direct reduction method" or the "gross-up method" in accordance with the regulatory report instructions.

If an institution does not contractually limit the maximum amount of its recourse obligation, or if the amount of credit enhancement is greater than the risk-based capital requirement that would exist if the assets were not sold, the low level recourse treatment does not apply. Instead, the institution must hold risk-based capital against the securitized assets as if those assets had not been sold.

Finally, as noted earlier, retained interests that lack objectively verifiable support or that fail to meet the supervisory standards set for in this document will be classified as loss and disallowed as assets of the institution for regulatory capital purposes.

INSTITUTION IMPOSED CONCENTRATION LIMITS ON RETAINED INTERESTS

The creation of a retained interest (the debit) typically also results in an offsetting "gain on sale" (the credit) and thus generation of an asset. Institutions that securitize high yielding assets with long durations may create a retained interest asset value that exceeds the risk-based capital charge that would be in place if the institution had not sold the assets (under the existing risk-based capital guidelines, capital is not required for the amount over eight percent of the securitized assets). Serious problems can arise for institutions that distribute contrived earnings only later to be faced with a downward valuation and charge-off of part or all of the retained interests.

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[6] The banking agencies' low level recourse treatment is described in the Federal Register in the following locations: 60 Fed. Reg. 17986 (April 10, 1995) (OCC); 60 Fed. Reg. 8177 (February 13, 1995)(FRB); 60 Fed. Reg. 15858 (March 28,1995)(FDIC). OTS has had a low level recourse rule in 12 CFR Part 567.6(a)(2)(i)(c) since 1989. A brief explanation is also contained in the instructions for regulatory reporting in section RC-R for the Call Report or schedule CCR for the TFR.

As a basic example, an institution could sell $100 in subprime home equity loans and book a retained interest of $20 using liberal "gain on sale" assumptions. Under the current capital rules, the institution is required to hold approximately $8 in capital. This $8 is the current capital requirement if the loans were never removed from the balance sheet (eight percent of $100 = $8). However, the institution is still exposed to substantially all of the credit risk, plus the additional risk to earnings and capital from the volatility of the retained interest. If the value of the retained interest decreases to $10 due to inaccurate assumptions or changes in market conditions, the $8 in capital is insufficient to cover the entire loss.

Normally, the sponsoring institution will eventually receive any excess cash flow remaining from securitizations after investor interests have been met. However, recent experience has shown that retained interests are vulnerable to sudden and sizeable write-downs that can hinder an institution's access to the capital markets, damage its reputation in the market place, and in some cases, threaten its solvency. Accordingly, the Agencies expect an institution's board of directors and management to develop and implement policies that limit the amount of retained interests that may be carried as a percentage of total equity capital, based on the results of their valuation and modeling processes. Well constructed internal limits also serve to lessen the incentive of institution personnel to engage in activities designed to generate near term "paper profits" that may be at the expense of the institution's long term financial position and reputation.

SUMMARY

Asset securitization has proven to be an effective means for institutions to access new and diverse funding sources, manage concentrations, improve financial performance ratios, and effectively serve borrowing customers. However, securitization activities also present unique and sometimes complex risks that require board and senior management attention. Specifically, the initial and ongoing valuation of retained interests associated with securitization, and the limitation of exposure to the volatility represented by these assets, warrant immediate attention by management.

Moreover, as mentioned earlier in this statement, the Agencies are studying various issues relating to securitization practices, including whether restrictions should be imposed that would limit or eliminate the amount of retained interests that qualify as regulatory capital. In the interim, the Agencies will review affected institutions on a case-by-case basis and may require, in appropriate circumstances, that institutions hold additional capital commensurate with their risk exposure. In addition, the Agencies will study, and issue further guidance on, institutions' exposure to implicit recourse obligations and the liquidity risk associated with over reliance on asset securitization as a funding source.

OCC 2007-1

OCC BULLETIN

Comptroller of the Currency
Administrator of National Banks

Subject: **Complex Structured Finance Transactions** Description: **Notice of Final Interagency Statement**

Date: January 5, 2007

TO: Chief Executive Officers of National Banks, Department and Division Heads, All Examining Personnel, and Other Interested Parties

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the Securities and Exchange Commission (the agencies) are adopting the attached "Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities" that may pose heightened legal or reputational risks to financial institutions. The statement was issued on January 5, 2007, and will be published in the *Federal Register*.

SUMMARY

In May 2004, the agencies issued and requested comment on a proposed "Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities" (initial statement). After carefully considering comments received, the agencies issued a revised statement for comment in May 2006. The modifications to the initial statement addressed issues and concerns raised by commenters. These modifications made the statement more principles-based; focused the statement on those complex structured finance transactions (CSFTs) that may pose heightened levels of legal or reputational risk to the relevant institution (referred to as elevated risk CSFTs); recognized more explicitly that an institution's review and approval process for elevated risk CSFTs should be commensurate with, and should focus on, the potential risks presented by the transaction to the institution; clarified that the statement does not create any private rights of action, nor does it alter or expand the legal duties and obligations that a financial institution may have to a customer, to its shareholders, or to other third parties under applicable law; and noted that it does not affect the vast majority of financial institutions, including most small financial institutions. The agencies have adopted the final statement with minor modifications designed to clarify, but not alter, the principles outlined in the revised statement.

Examples of CSFTs that often pose elevated risks and thus would be covered by the final statement include transactions that:

- Lack economic substance or business purpose;

- Are designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year end or at the end of a reporting period for the customer;
- Raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or with applicable regulatory or accounting requirements;
- Involve circular transfers of risk (either between the financial institution and the customer or between the customer and other related parties) that lack economic substance or business purpose;
- Involve oral or undocumented agreements that, when taken into account, would have a material impact on the regulatory, tax, or accounting treatment of the related transaction, or the client's disclosure obligations;
- Have material economic terms that are inconsistent with market norms (*e.g.*, deep "in the money" options or historic rate rollovers); or
- Provide the financial institution with compensation that appears substantially disproportionate to the services provided or investment made by the financial institution or to the credit, market, or operational risk assumed by the institution.

The statement points out that if a financial institution determines through its due diligence that participation in a particular CSFT would create significant legal or reputational risks for the institution, the institution should take appropriate steps to address those risks. Such actions may include declining to participate in the transaction, or conditioning its participation upon the receipt of representations or assurances from the customer that reasonably address the heightened legal or reputational risks presented by the transaction. The statement also establishes that a financial institution should decline to participate in an elevated risk CSFT if, after conducting appropriate due diligence and taking appropriate steps to address the risks from the transaction, the institution determines that the transaction presents unacceptable risk to the institution or would result in a violation of applicable laws, regulations, or accounting principles.

FURTHER INFORMATION

For further information, please contact Kathy Dick, Deputy Comptroller for Credit and Market Risk, (202) 874-4660; Grace Dailey, Deputy Comptroller for Large Banks, (202) 874-4610; or Ellen Broadman, Director, Securities and Corporate Practices Division, (202) 874-5210.

/signed/
Emory W. Rushton
Senior Deputy Comptroller and Chief National Bank Examiner

/signed/
Douglas W. Roeder
Senior Deputy Comptroller for Large Bank Supervision

Attachment – http://www.occ.treas.gov/ftp/bulletin/2007-1a.pdf
[http://www.occ.treas.gov/ftp/bulletin/2007-1a.pdf]

DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
[Docket No. 06-17]

Office of Thrift Supervision
[Docket No. 2006-55]

FEDERAL RESERVE SYSTEM
[Docket No. OP-1254]

FEDERAL DEPOSIT INSURANCE CORPORATION

SECURITIES AND EXCHANGE COMMISSION
[Release No. 34-55043; File No. S7-08-06]

Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities

AGENCIES: Office of the Comptroller of the Currency, Treasury ("OCC"); Office of Thrift Supervision, Treasury ("OTS"); Board of Governors of the Federal Reserve System ("Board"); Federal Deposit Insurance Corporation ("FDIC"); and Securities and Exchange Commission ("SEC") (collectively, the "Agencies").

ACTION: Notice of final interagency statement.

SUMMARY: The Agencies are adopting an Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities ("Final Statement"). The Final Statement pertains to national banks, state banks, bank holding companies (other than foreign banks), federal and state savings associations, savings and loan holding companies, U.S. branches and agencies of foreign banks, and SEC-registered broker-dealers and investment advisers (collectively, "financial institutions" or "institutions") engaged in complex structured finance transactions ("CSFTs"). In May 2004, the Agencies issued and requested comment on a proposed interagency statement ("Initial Proposed Statement"). After reviewing the comments received on the Initial Proposed Statement, the Agencies in May 2006 issued and requested comment on a revised proposed interagency statement ("Revised Proposed Statement"). The modifications to the Revised Proposed Statement, among other things, made the statement more principles-based and focused on the identification, review and approval process for those CSFTs that may pose heightened levels of legal or reputational risk to the relevant institution (referred to as "elevated risk CSFTs"). After carefully reviewing the comments on the Revised Proposed Statement, the Agencies have adopted the Final Statement with minor modifications designed to clarify, but not alter, the principles set forth in the Revised Proposed Statement. The Final Statement describes some of the internal controls and risk management procedures that may help financial institutions identify, manage, and address the heightened reputational and legal risks that may arise

from elevated risk CSFTs. As discussed further below, the Final Statement will not affect or apply to the vast majority of financial institutions, including most small institutions, nor does it create any private rights of action.

EFFECTIVE DATE: The Final Statement is effective upon [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER].

FOR FURTHER INFORMATION CONTACT:

OCC: Kathryn E. Dick, Deputy Comptroller, Credit and Market Risk, (202) 874-4660; Grace E. Dailey, Deputy Comptroller, Large Bank Supervision, (202) 874-4610; or Ellen Broadman, Director, Securities and Corporate Practices Division, (202) 874-5210, Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219.

OTS: Fred J. Phillips-Patrick, Director, Credit Policy, (202) 906-7295, and Deborah S. Merkle, Project Manager, Credit Policy, (202) 906-5688, Examinations and Supervision Policy; or David A. Permut, Senior Attorney, Business Transactions Division, (202) 906-7505, Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552.

Board: Sabeth I. Siddique, Assistant Director, (202) 452-3861, or Virginia Gibbs, Senior Supervisory Financial Analyst, (202) 452-2521, Division of Banking Supervision and Regulation; or Kieran J. Fallon, Assistant General Counsel, (202) 452-5270, or Anne B. Zorc, Senior Attorney, (202) 452-3876, Legal Division, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, DC 20551. Users of Telecommunication Device for Deaf (TTD) only, call (202) 263-4869.

FDIC: Jason C. Cave, Associate Director, (202) 898-3548; Division of Supervision and Consumer Protection; or Mark G. Flanigan, Counsel, Supervision and Legislation Branch, Legal Division, (202) 898-7426, Federal Deposit Insurance Corporation, 550 17th Street, NW, Washington, DC 20429.

SEC: Mary Ann Gadziala, Associate Director, Office of Compliance Inspections and Examinations, (202) 551-6207; Catherine McGuire, Chief Counsel, Linda Stamp Sundberg, Senior Special Counsel (Banking and Derivatives), or Randall W. Roy, Branch Chief, Division of Market Regulation, (202) 551-5550, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

I. Background

Financial markets have grown rapidly over the past decade, and innovations in financial instruments have facilitated the structuring of cash flows and

allocation of risk among creditors, borrowers, and investors in more efficient ways. Financial derivatives for market and credit risk, asset-backed securities with customized cash flow features, specialized financial conduits that manage pools of assets, and other types of structured finance transactions serve important purposes, such as diversifying risk, allocating cash flows and reducing cost of capital. As a result, structured finance transactions, including the more complex variations of these transactions, now are an essential part of U.S. and international capital markets.

When a financial institution participates in a CSFT, it bears the usual market, credit, and operational risks associated with the transaction. In some circumstances, a financial institution also may face heightened legal or reputational risks due to its involvement in a CSFT. For example, a financial institution involved in a CSFT may face heightened legal or reputational risk if the customer's regulatory, tax or accounting treatment for the CSFT, or disclosures concerning the CSFT in its public filings or financial statements, do not comply with applicable laws, regulations or accounting principles.[1]

In some cases, certain CSFTs appear to have been used in illegal schemes that misrepresented the financial condition of public companies to investors and regulatory authorities. After conducting investigations, the OCC, Federal Reserve System and SEC took strong and coordinated civil and administrative enforcement actions against certain financial institutions that engaged in CSFTs that appeared to have been designed or used to shield their customers' true financial health from the public. These actions involved the assessment of significant financial penalties on the institutions and required the institutions to take several measures to strengthen their risk management procedures for CSFTs.[2] The complex structured finance relationships involving these financial institutions also sparked an investigation by the Permanent Subcommittee on Governmental Affairs of the United States Senate,[3] as well as numerous lawsuits by private litigants.

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[1] For a memorandum on the potential liability of a financial institution for securities laws violations arising from participation in a CSFT, see Letter from Annette L. Nazareth, Director, Division of Market Regulation, Securities and Exchange Commission, to Richard Spillenkothen and Douglas W. Roeder, dated December 4, 2003 (available at http://www.federalreserve.gov/boarddocs/srletters/2004/ and http://www.occ.treas.gov).

[2] See, e.g., In the Matter of Citigroup, Inc., Securities Exchange Act Release No. 48230 (July 28, 2003), Written Agreement by and between Citibank, N.A. and the Office of the Comptroller of the Currency, No. 2003-77 (July 28, 2003) (pertaining to transactions entered into by Citibank, N.A. with Enron Corp.) and Written Agreement by and between Citigroup, Inc. and the Federal Reserve Bank of New York, dated July 28, 2003 (pertaining to transactions involving Citigroup Inc. and its subsidiaries and Enron Corp. and Dynegy Inc.); SEC v. J.P. Morgan Chase, SEC Litigation Release No. 18252 (July 28, 2003) and Written Agreement by and among J.P. Morgan Chase & Co., the Federal Reserve Bank of New York, and the New York State Banking Department, dated July 28, 2003 (pertaining to transactions involving J.P. Morgan Chase & Co. and its subsidiaries and Enron Corp.).

[3] See Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions, Report Prepared by the Permanent Subcomm. on Investigations, Comm. on Governmental Affairs, United States Senate, S. Rpt. 107-82 (2003).

The OCC, Federal Reserve System and SEC also conducted special reviews of several large financial institutions engaged in CSFTs, and the Agencies have focused attention on the CSFT activities of financial institutions in the normal course of the supervisory process. These reviews and activities indicate that many of the large financial institutions engaged in CSFTs have taken meaningful steps in recent years to improve their control infrastructure relating to CSFTs.

II. Initial and Revised Proposed Statements

To assist financial institutions in identifying, managing, and addressing the risks that may be associated with CSFTs, the Agencies developed and requested public comment on the Initial Proposed Statement.[4] The Initial Proposed Statement described the types of policies and procedures that a financial institution engaged in CSFTs should have in place to allow the institution to identify, document, evaluate, and control the full range of credit, market, operational, legal, and reputational risks that may arise from CSFTs. The agencies collectively received comments from more than 40 commenters on the Initial Proposed Statement. Although commenters generally supported the Agencies' efforts to describe the types of risk management procedures and internal controls that may help institutions manage the risks associated with CSFTs, virtually all of the commenters recommended changes to the Initial Proposed Statement.

After carefully reviewing the comments on the Initial Proposed Statement, the Agencies issued and requested comment on a Revised Proposed Statement.[5] The Revised Proposed Statement was modified in numerous respects to clarify the purpose, scope and effect of the statement; make the statement more risk-focused and principles based; and focus the statement on those CSFTs that may pose elevated levels of legal or reputational risk to the relevant institution.[6]

III. Overview of Comments on the Revised Proposed Statement

The Agencies collectively received written comments from 19 commenters on the Revised Proposed Statement, although many commenters submitted identical comments to multiple Agencies. Commenters included banking organizations, financial services trade associations, and individuals. Commenters generally expressed strong support for the Revised Proposed Statement, including its principles-based structure and focus on elevated risk CSFTs. Many commenters also asserted that the Revised Proposed Statement provides a financial institution appropriate flexibility to develop internal controls and risk management procedures that are tailored to the institution's own business activities and organizational structure.

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[4] See 69 FR 28980, May 19, 2004.

[5] See 71 FR 28326, May 16, 2006.

[6] A more detailed summary of the comments on the Initial Proposed Statement, as well as the changes made in response to those comments, is contained in the Federal Register notice accompanying the Revised Proposed Statement (71 FR 28326, 28328-29 (May 16, 2006)).

Several commenters requested that the Agencies clarify or revise the Revised Proposed Statement in certain respects. For example, some commenters asked the Agencies to further streamline the provisions in the statement pertaining to documentation of elevated risk CSFTs, or clarify how the U.S. branches or agencies of foreign banks might implement risk management systems, policies or controls consistent with the statement's principles. In addition, some commenters asked the Agencies to set forth or clarify the legal standards governing the potential liability of financial institutions for CSFTs or provide "safe harbors" from such potential liability. One group of commenters also argued that the Revised Proposed Statement should not be implemented because it allegedly would encourage or condone illegal conduct by financial institutions. The comments received on the Revised Proposed Statement are further discussed below.

IV. Overview of Final Statement

After carefully reviewing the comments on the Revised Proposed Statement, the Agencies have made minor modifications to the Revised Proposed Statement in response to comments and to clarify the principles, scope, and intent of the Final Statement. The Final Statement has been adopted as supervisory guidance by the Board, OCC, FDIC and OTS and as a policy statement by the SEC. The Agencies will use the Final Statement going forward in reviewing the internal controls and risk management policies, procedures and systems of financial institutions engaged in CSFTs as part of the Agencies' ongoing supervisory process.

The Agencies continue to believe that it is important for a financial institution engaged in CSFTs to have policies and procedures that are designed to allow the institution to effectively manage and address the full range of risks associated with its CSFT activities, including the elevated legal or reputational risks that may arise in connection with certain CSFTs. For this reason, the Final Statement describes the types of risk management principles that the Agencies believe may help a financial institution to identify elevated risk CSFTs and to evaluate, manage, and address these risks within the institution's internal control framework.[7] These policies and procedures should, among other things, be designed to allow the institution to identify elevated risk CSFTs during its transaction and new product approval processes, and should provide for elevated risk CSFTs to be reviewed by appropriate levels of control and management personnel at the institution, including personnel from control areas that are independent of the business line(s) involved in the transaction.

The Final Statement – like the Revised Proposed Statement – applies to financial institutions that are engaged in CSFT activities and focuses on those CSFTs that may create heightened levels of legal or reputational risks for a participating financial institution. Because CSFTs typically are conducted by a limited number of large

[7] As noted in the Final Statement, financial institutions are encouraged to refer to other supervisory guidance and materials prepared by the Agencies for further information concerning market, credit and operational risk, as well as for further information on legal and reputational risk, internal audit and internal controls.

financial institutions, the Final Statement will not affect or apply to the vast majority of financial institutions, including most small institutions.

As the Final Statement recognizes, structured finance transactions encompass a broad array of products with varying levels of complexity. Most structured finance transactions, such as standard public mortgage-backed securities and hedging-type transactions involving "plain vanilla" derivatives or collateralized debt obligations, are familiar to participants in the financial markets, have well-established track records, and typically would not be considered CSFTs for purposes of the Final Statement. Some commenters requested that the Agencies provide a more extensive list of structured finance transactions that typically would not be considered CSFTs. The Agencies note that the types of non-complex transactions listed in the Final Statement are only examples of the types of transactions that typically would not be considered CSFTs and that any list of examples would not, and could not, be all inclusive given the changing nature of the structured finance market. Consistent with the principles-based approach of the Final Statement, the Agencies believe the statement appropriately highlights the hallmarks of a non-complex transaction – i.e., a well established track record and familiarity to participants in the financial markets – that may guide institutions and examiners in considering whether a particular type of transaction should be considered a CSFT now or in the future.

A. Identification, Due Diligence, and Approval Processes for Elevated Risk CSFTs

As noted above, a financial institution should establish and maintain policies, procedures and systems that are designed to identify elevated risk CSFTs as part of the institution's transaction or new product approval processes, and to ensure that transactions or new products identified as elevated risk CSFTs are subject to heightened review.[8] In general, a financial institution should conduct the level and amount of due diligence for an elevated risk CSFT that is commensurate with the level of risks identified. A financial institution's policies and procedures should provide that CSFTs identified as potentially having elevated legal or reputational risk are reviewed and approved by appropriate levels of management. The Agencies continue to believe that the designated approval process for elevated risk CSFTs should include the institution's representatives from the relevant business line(s) and/or client relationship management, as well as from appropriate control areas that are independent of the business line(s) involved in the transaction. An institution's policies should provide that new complex

[8] In response to comments, the Agencies have modified the Final Statement to clarify that a U.S. branch or agency of a foreign bank is not necessarily expected to establish or adopt separate U.S.-based risk management structures or policies for its CSFT activities. In addition, the Agencies believe the Final Statement provides U.S. branches and agencies of foreign banks sufficient flexibility to develop controls, risk management and reporting structures, and lines of authority that are consistent with the internal management structure of U.S. branches and agencies. However, the risk management structure and policies used by a U.S. branch or agency, whether adopted or implemented on a group-wide or stand-alone basis, should be effective in allowing the branch or agency to manage the risks associated with its CSFT activities.

structured finance products receive the approval of all relevant control areas that are independent of the profit center before the product is offered to customers.[9]

The Final Statement – like the Revised Proposed Statement – provides examples of transactions that may warrant additional scrutiny by an institution. These examples include, among other things, transactions that appear to the institution to:

- Lack economic substance or business purpose;
- Be designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year-end or at the end of a reporting period for the customer; or
- Raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements.

A few commenters contended that the examples of elevated risk CSFTs contained in the Revised Proposed Statement have characteristics that are signals, if not conclusive proof, of fraudulent activity, and recommended that the Agencies inform financial institutions that transactions or products with any of these characteristics should be considered presumptively prohibited. The commenters also argued that the statement encourages or condones illegal conduct by financial institutions. The Agencies believe that CSFTs that initially appear to an institution, during the ordinary course of its new product or transaction approval process, to have one or more of the characteristics identified in the Final Statement should generally be identified as an elevated risk CSFT, and the institution should conduct due diligence for the transaction that is commensurate with the level of identified, potential risks. The Agencies, however, do not believe it is appropriate to provide that all transactions initially identified as potentially creating elevated legal or reputational risks for an institution should be considered presumptively prohibited. For example, an institution, after conducting additional due diligence for a transaction initially identified as an elevated risk CSFT, may determine that the transaction does not, in fact, have the characteristics that initially triggered the review. Alternatively, the institution may take steps to address the legal or reputational risks that initially triggered the review. In this regard, the Final Statement expressly provides that, if after evaluating an elevated risk CSFT, a financial institution determines that its participation in the transaction would create significant legal or reputational risks for the institution, the financial institution should take appropriate steps to manage and address these risks. Such steps may include modifying the transaction or conditioning the institution's participation in the transaction upon the receipt of representations or

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[9] One commenter sought clarification regarding when during the new product approval process a new complex structured finance product should receive the approval of relevant control areas. The Agencies note that the Final Statement is not intended to prevent institutions from engaging in initial or preliminary discussions or negotiations with potential customers about a new complex structured finance product. However, an institution should obtain the necessary approvals for a new complex structured finance product from appropriate control areas before the institution enters into, or becomes obligated to enter into, a transaction with the customer.

assurances from the customer that reasonably address the heightened risks presented by the transaction.

Importantly, the Final Statement continues to provide that a financial institution should decline to participate in an elevated risk CSFT if, after conducting appropriate due diligence and taking appropriate steps to address the risks from the transaction, the institution determines that the transaction presents unacceptable risks to the institution or would result in a violation of applicable laws, regulations or accounting principles.[10] The Final Statement also expressly notes that financial institutions must conduct their activities in accordance with applicable statutes and regulations. The Agencies believe the Final Statement should assist financial institutions engaged in CSFTs in managing the risks associated with these activities and complying with the law, and does not, as some commenters alleged, encourage or condone illegal conduct.

Some commenters also requested that the Agencies enunciate, clarify or modify the legal standards governing the potential liability of a financial institution for participating in a CSFT that is used for fraudulent or illegal purposes. For example, some commenters asked the Agencies to declare that institutions do not have a duty to ensure the accuracy of a client's public filings or accounting. Other commenters asked that the Agencies state that an institution will not be held liable or responsible for a CSFT if the institution has a reasonable degree of confidence that the customer will report or account for the transactions properly. Other commenters expressed concern that the Revised Proposed Statement, or the comments submitted on that document, attempted to alter the current legal standards under which a financial institution may be held liable for fraudulent activity or criminally responsible under the Federal securities law or other laws.

As events in recent years have highlighted, institutions may in certain circumstances bear significant legal or reputational risk from participating in a CSFT. In light of these risks, the Final Statement describes the types of risk management systems and internal controls that may help a financial institution engaged in CSFTs to identify those CSFTs that may pose heightened legal or reputational risk to the institution, and to evaluate, manage, and address those risks. Because the Final Statement represents guidance on the part of the Banking Agencies and a policy statement on the part of the SEC, it does not, by itself, establish any legally enforceable requirements or obligations. Moreover, as the Final Statement expressly provides, it does not create any private rights of action, nor does it alter or expand the legal duties and obligations that a financial institution may have to a customer, its shareholders or other parties under applicable law.

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[10] Some commenters asked the Agencies to clarify that the Final Statement does not necessarily prevent a financial institution from proceeding with a CSFT simply because there may be some ambiguity in how the transaction might be viewed under the law or applicable accounting principles. The Agencies recognize that in certain circumstances ambiguities may exist as to how the law or accounting principles apply to a CSFT, particularly in light of the inherent complexity and rapidly evolving nature of CSFTs. Nevertheless, as discussed in the Final Statement, a financial institution should maintain strong and effective processes and controls designed to determine whether any such ambiguities may create significant legal or reputational risks for the institution and to manage and address those risks as appropriate.

Accordingly, the Agencies do not believe it is appropriate or possible to address in the Final Statement these legal concerns expressed by commenters.

B. Documentation

The Final Statement states that a financial institution should create and collect sufficient documentation to, among other things, verify that the institution's policies and procedures related to elevated risk CSFTs are being followed and allow the internal audit function to monitor compliance with those policies and procedures. The Final Statement also provides that, when an institution's policies and procedures require an elevated risk CSFT to be submitted for approval to senior management, the institution should maintain the transaction-related documentation provided to senior management as well as other documentation that reflect management's approval (or disapproval) of the transaction, any conditions imposed by senior management, and the reasons for such action.

Several commenters strongly suggested that the Agencies should eliminate or modify the portions of the statement that provide for a financial institution to maintain certain documentation related to elevated risk CSFTs that are submitted to the institution's senior management for approval (or denial). For example, some commenters argued that institutions should not be required to maintain any documentation for declined transactions. Other commenters expressed concern that this provision was inconsistent with the current practice of financial institutions, would require financial institutions to create new and potentially extensive documentation to memorialize all aspects of the institution's analytical and decision-making process with respect to an elevated risk CSFT, or would require institutions to create or maintain extensive documentation even for transactions that are approved or rejected by junior staff.

As an initial matter, the Agencies note that the Final Statement's provisions regarding documentation for elevated risk CSFTs submitted to senior management for approval (or disapproval) do not apply to transactions that may be reviewed and acted on by more junior personnel in accordance with the institution's policies and procedures. Rather, these provisions apply only to those elevated risk CSFTs that are identified by the institution as potentially involving the greatest degree of risk to the institution and, for this reason, are required to be reviewed by the institution's senior management. The Agencies believe that it is important for institutions to maintain documentation for this category of elevated risk CSFTs, whether approved or declined, that reflects the factors considered by senior management in taking such action. The Agencies believe this type of documentation may be of significant benefit to the institution and to the Agencies in reviewing the effectiveness of the institution's CSFT-related policies, procedures, and internal controls. However, to help address the commenter's concern about potential burden, the Agencies have modified the Final Statement to recognize that the minutes of an institution's reviewing senior management committee may have the information described and to clarify that the documentation for a transaction should reflect the factors considered by senior management in taking action,

but does not have to detail every aspect of the institution's legal or business analysis of the transaction.[11]

C. General Risk Management Principles for Elevated Risk CSFTs

The Final Statement – like the Revised Proposed Statement – also describes some of the other key risk management policies and internal controls that financial institutions should have in place for elevated risk CSFTs. For example, the Final Statement provides that the board of directors and senior management of an institution should establish a "tone at the top" through both actions and formalized policies that sends a strong message throughout the financial institution about the importance of compliance with the law and overall good business ethics. The Final Statement also describes the types of training, reporting mechanisms, and audit procedures that institutions should have in place with respect to elevated risk CSFTs. The Final Statement also provides that a financial institution should conduct periodic independent reviews of its CSFT activities to verify and monitor that its policies and controls relating to elevated risk CSFTs are being implemented effectively and that elevated risk CSFTs are accurately identified and receive proper approvals.

In response to comments, the Agencies have modified the Final Statement to clarify that the independent reviews conducted by a financial institution may be performed by the institution's audit department or an independent compliance function within the institution. One commenter also asked the Agencies to state that the proper role of an institution's independent review function is only to confirm that the institution's policies and procedures for elevated risk CSFTs are being followed and that the function should not assess the quality of the decisions made by institution personnel. The Agencies believe that an institution's audit or compliance department should have the flexibility, in appropriate circumstances, to review the decisions made by institution personnel during the review and approval process for elevated risk CSFTs and for this reason have not made the recommended change.

V. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. § 3506; 5 CFR 1320 Appendix A.1), the Agencies reviewed the Final Statement. The Agencies may not conduct or sponsor, and an organization is not required to respond to, this information collection unless it displays a currently valid OMB control number. The Agencies previously determined that certain provisions of the Revised Proposed Statement contained information collection requirements. OMB reviewed and approved the information collections contained in the Revised Proposed Statement for the FDIC, OTS, OCC and SEC; and the Board reviewed the Revised Proposed Statement under the authority delegated to the Board by OMB (5 CFR 1320, Appendix A.1).

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[11] In light of comments, the Agencies have modified the Documentation section of the Statement to clarify that an institution should retain sufficient documentation to establish that it has provided the customer any disclosures concerning an elevated risk CSFT that the institution is otherwise required to provide to the customer.

OMB control numbers:

OCC: 1557-0229.
OTS: 1550-0111.
FRB: 7100-0311.
FDIC: 3064-0148.
SEC: 3235-0622.

Burden Estimates

OCC

Number of Respondents: 21.
Estimated Time per Response: 25 hours.
Total Estimated Annual Burden: 525 hours.

OTS

Number of Respondents: 5.
Estimated Time per Response: 25 hours.
Total Estimated Annual Burden: 125 hours.

Board

Number of Respondents: 20.
Estimated Time per Response: 25 hours.
Total Estimated Annual Burden: 500 hours.

FDIC

Number of Respondents: 5.
Estimated Time per Response: 25 hours.
Total Estimated Annual Burden: 125 hours.

SEC

Number of Respondents: 5.
Estimated Time per Response: 25 hours.
Total Estimated Annual Burden: 125 hours.

No commenters addressed the Agencies' information collection estimates. The Agencies do not believe that the clarifications included in this Final Statement impact the burden estimates previously developed and approved for these information collections. The Agencies have a continuing interest in the public's opinions of our collections of information. At any time, comments regarding the burden estimate, or any other aspect of this collection of information, including suggestions for reducing the burden, may be sent to:

OCC: You should direct your comments to:

Communications Division, Office of the Comptroller of the Currency, Public Information Room, Mailstop 1-5, Attention: 1557-0229, 250 E Street, SW., Washington, DC 20219. In addition, comments may be sent by fax to (202) 874-4448, or by electronic

mail to regs.comments@occ.treas.gov. You can inspect and photocopy the comments at the OCC's Public Information Room, 250 E Street, SW., Washington, DC 20219. You can make an appointment to inspect the comments by calling (202) 874-5043. Additionally, you should send a copy of your comments to OCC Desk Officer, 1557-0229, by mail to U.S. Office of Management and Budget, 725 17th Street, NW., #10235, Washington, DC 20503, or by fax to (202) 395-6974.

You can request additional information or a copy of the collection from Mary Gottlieb, OCC Clearance Officer, or Camille Dickerson, (202) 874-5090, Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219.

OTS: Information Collection Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552; send a facsimile transmission to (202) 906-6518; or send an e-mail to infocollection.comments@ots.treas.gov. OTS will post comments and the related index on the OTS Internet site at http://www.treas.gov. In addition, interested persons may inspect the comments at the Public Reading Room, 1700 G Street, NW., by appointment. To make an appointment, call (202) 906-5922, send an e-mail to public.info@ots.treas.gov, or send a facsimile transmission to (202) 906-7755.

To obtain a copy of the submission to OMB, contact Marilyn K. Burton at marilyn.burton@ots.treas.gov, (202) 906-6467, or fax number (202) 906-6518, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552

Board: You may submit comments, identified by FR 4022, by any of the following methods:

- Agency Web site: http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- E-mail: Regs.comments@federalreserve.gov. Include docket number in the subject line of the message.
- Fax: (202) 452-3819 or (202) 452-3102.
- Mail: Michelle Long, Federal Reserve Board Clearance Officer (202) 452-3829, Division of Research and Statistics, Board of Governors of the Federal Reserve System, Washington, DC 20551. Telecommunications Device for the Deaf (TDD) users may contact (202) 263-4869, Board of Governors of the Federal Reserve System, Washington, DC 20551.

All public comments are available from the Board's Web site at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, NW) between 9 a.m. and 5 p.m. on weekdays.

FDIC: Interested parties are invited to submit written comments to the FDIC concerning the Paperwork Reduction Act implications of this proposal. Such comments should refer to "Complex Structured Finance Transactions, 3064-0148." Comments may be submitted by any of the following methods:

- http://www.FDIC.gov/regulations/laws/federal/propose.html.
- E-mail: comments@FDIC.gov. Include Complex Structured Financial Transactions, 3064-0148 in the subject line of the message.
- Mail: Steven F. Hanft (202) 898-3907, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.
- Hand Delivery: Comments may be hand-delivered to the guard station at the rear of the 17th Street Building (located on F Street), on business days between 7 a.m. and 5 p.m.

SEC: You should direct your comments to: Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, with a copy sent to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090 with reference to File No. S7-08-06.

The Final Statement follows:

Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities

I. Introduction

Financial markets have grown rapidly over the past decade, and innovations in financial instruments have facilitated the structuring of cash flows and allocation of risk among creditors, borrowers and investors in more efficient ways. Financial derivatives for market and credit risk, asset-backed securities with customized cash flow features, specialized financial conduits that manage pools of assets and other types of structured finance transactions serve important business purposes, such as diversifying risks, allocating cash flows, and reducing cost of capital. As a result, structured finance transactions now are an essential part of U.S. and international capital markets. Financial institutions have played and continue to play an active and important role in the development of structured finance products and markets, including the market for the more complex variations of structured finance products.

When a financial institution participates in a complex structured finance transaction ("CSFT"), it bears the usual market, credit, and operational risks associated with the transaction. In some circumstances, a financial institution also may face heightened legal or reputational risks due to its involvement in a CSFT. For example, in some circumstances, a financial institution may face heightened legal or reputational risk if a customer's regulatory, tax or accounting treatment for a CSFT, or disclosures to

investors concerning the CSFT in the customer's public filings or financial statements, do not comply with applicable laws, regulations or accounting principles. Indeed, in some instances, CSFTs have been used to misrepresent a customer's financial condition to investors, regulatory authorities and others. In these situations, investors have been harmed, and financial institutions have incurred significant legal and reputational exposure. In addition to legal risk, reputational risk poses a significant threat to financial institutions because the nature of their business requires them to maintain the confidence of customers, creditors and the general marketplace.

The Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission (the "Agencies") have long expected financial institutions to develop and maintain robust control infrastructures that enable them to identify, evaluate and address the risks associated with their business activities. Financial institutions also must conduct their activities in accordance with applicable statutes and regulations.

II. Scope and Purpose of Statement

The Agencies are issuing this Statement to describe the types of risk management principles that we believe may help a financial institution to identify CSFTs that may pose heightened legal or reputational risks to the institution ("elevated risk CSFTs") and to evaluate, manage and address these risks within the institution's internal control framework.[12]

Structured finance transactions encompass a broad array of products with varying levels of complexity. Most structured finance transactions, such as standard public mortgage-backed securities transactions, public securitizations of retail credit cards, asset-backed commercial paper conduit transactions, and hedging-type transactions involving "plain vanilla" derivatives and collateralized loan obligations, are familiar to participants in the financial markets, and these vehicles have a well-established track record. These transactions typically would not be considered CSFTs for the purpose of this Statement.

Because this Statement focuses on sound practices related to CSFTs that may create heightened legal or reputational risks – transactions that typically are conducted by a limited number of large financial institutions – it will not affect or apply to the vast majority of financial institutions, including most small institutions. As in all

[12] As used in this Statement, the term "financial institution" or "institution" refers to national banks in the case of the Office of the Comptroller of the Currency; federal and state savings associations and savings and loan holding companies in the case of the Office of Thrift Supervision; state member banks and bank holding companies (other than foreign banking organizations) in the case of the Federal Reserve Board; state nonmember banks in the case of the Federal Deposit Insurance Corporation; and registered broker-dealers and investment advisers in the case of the Securities and Exchange Commission. The U.S. branches and agencies of foreign banks supervised by the Office of the Comptroller, the Federal Reserve Board and the Federal Deposit Insurance Corporation also are considered to be financial institutions for purposes of this Statement.

cases, a financial institution should tailor its internal controls so that they are appropriate in light of the nature, scope, complexity and risks of its activities. Thus, for example, an institution that is actively involved in structuring and offering CSFTs that may create heightened legal or reputational risk for the institution should have a more formalized and detailed control framework than an institution that participates in these types of transactions less frequently. The internal controls and procedures discussed in this Statement are not all inclusive, and, in appropriate circumstances, an institution may find that other controls, policies, or procedures are appropriate in light of its particular CSFT activities.

Because many of the core elements of an effective control infrastructure are the same regardless of the business line involved, this Statement draws heavily on controls and procedures that the Agencies previously have found to be effective in assisting a financial institution to manage and control risks and identifies ways in which these controls and procedures can be effectively applied to elevated risk CSFTs. Although this Statement highlights some of the most significant risks associated with elevated risk CSFTs, it is not intended to present a full exposition of all risks associated with these transactions. Financial institutions are encouraged to refer to other supervisory guidance prepared by the Agencies for further information concerning market, credit, operational, legal and reputational risks as well as internal audit and other appropriate internal controls.

This Statement does not create any private rights of action, and does not alter or expand the legal duties and obligations that a financial institution may have to a customer, its shareholders or other third parties under applicable law. At the same time, adherence to the principles discussed in this Statement would not necessarily insulate a financial institution from regulatory action or any liability the institution may have to third parties under applicable law.

III. Identification and Review of Elevated Risk Complex Structured Finance Transactions

A financial institution that engages in CSFTs should maintain a set of formal, written, firm-wide policies and procedures that are designed to allow the institution to identify, evaluate, assess, document, and control the full range of credit, market, operational, legal and reputational risks associated with these transactions. These policies may be developed specifically for CSFTs, or included in the set of broader policies governing the institution generally. A financial institution operating in foreign jurisdictions may tailor its policies and procedures as appropriate to account for, and comply with, the applicable laws, regulations and standards of those jurisdictions.[13]

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[13] In the case of U.S. branches and agencies of foreign banks, these policies, including management, review and approval requirements, should be coordinated with the foreign bank's group-wide policies developed in accordance with the rules of the foreign bank's home country supervisor and should be consistent with the foreign bank's overall corporate and management structure as well as its framework for risk management and internal controls.

A financial institution's policies and procedures should establish a clear framework for the review and approval of individual CSFTs. These policies and procedures should set forth the responsibilities of the personnel involved in the origination, structuring, trading, review, approval, documentation, verification, and execution of CSFTs. Financial institutions may find it helpful to incorporate the review of new CSFTs into their existing new product policies. In this regard, a financial institution should define what constitutes a "new" complex structured finance product and establish a control process for the approval of such new products. In determining whether a CSFT is new, a financial institution may consider a variety of factors, including whether it contains structural or pricing variations from existing products, whether the product is targeted at a new class of customers, whether it is designed to address a new need of customers, whether it raises significant new legal, compliance or regulatory issues, and whether it or the manner in which it would be offered would materially deviate from standard market practices. An institution's policies should require new complex structured finance products to receive the approval of all relevant control areas that are independent of the profit center before the product is offered to customers.

A. Identifying Elevated Risk CSFTs

As part of its transaction and new product approval controls, a financial institution should establish and maintain policies, procedures and systems to identify elevated risk CSFTs. Because of the potential risks they present to the institution, transactions or new products identified as elevated risk CSFTs should be subject to heightened reviews during the institution's transaction or new product approval processes. Examples of transactions that an institution may determine warrant this additional scrutiny are those that (either individually or collectively) appear to the institution during the ordinary course of its transaction approval or new product approval process to:

- Lack economic substance or business purpose;
- Be designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year end or at the end of a reporting period for the customer;
- Raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements;
- Involve circular transfers of risk (either between the financial institution and the customer or between the customer and other related parties) that lack economic substance or business purpose;
- Involve oral or undocumented agreements that, when taken into account, would have a material impact on the regulatory, tax, or

accounting treatment of the related transaction, or the client's disclosure obligations;[14]

- Have material economic terms that are inconsistent with market norms (e.g., deep "in the money" options or historic rate rollovers); or
- Provide the financial institution with compensation that appears substantially disproportionate to the services provided or investment made by the financial institution or to the credit, market or operational risk assumed by the institution.

The examples listed previously are provided for illustrative purposes only, and the policies and procedures established by financial institutions may differ in how they seek to identify elevated risk CSFTs. The goal of each institution's policies and procedures, however, should remain the same – to identify those CSFTs that warrant additional scrutiny in the transaction or new product approval process due to concerns regarding legal or reputational risks.

Financial institutions that structure or market, act as an advisor to a customer regarding, or otherwise play a substantial role in a transaction may have more information concerning the customer's business purpose for the transaction and any special accounting, tax or financial disclosure issues raised by the transaction than institutions that play a more limited role. Thus, the ability of a financial institution to identify the risks associated with an elevated risk CSFT may differ depending on its role.

B. Due Diligence, Approval and Documentation Process for Elevated Risk CSFTs

Having developed a process to identify elevated risk CSFTs, a financial institution should implement policies and procedures to conduct a heightened level of due diligence for these transactions. The financial institution should design these policies and procedures to allow personnel at an appropriate level to understand and evaluate the potential legal or reputational risks presented by the transaction to the institution and to manage and address any heightened legal or reputational risks ultimately found to exist with the transaction.

Due Diligence. If a CSFT is identified as an elevated risk CSFT, the institution should carefully evaluate and take appropriate steps to address the risks presented by the transaction with a particular focus on those issues identified as potentially creating heightened levels of legal or reputational risk for the institution. In general, a financial institution should conduct the level and amount of due diligence for an elevated risk CSFT that is commensurate with the level of risks identified. A financial institution that structures or markets an elevated risk CSFT to a customer, or that acts as an advisor to a customer or investors concerning an elevated risk CSFT, may have additional responsibilities under the federal securities laws, the Internal Revenue Code, state fiduciary laws or other laws or regulations and, thus, may have greater legal and

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[14] This item is not intended to include traditional, non-binding "comfort" letters or assurances provided to financial institutions in the loan process where, for example, the parent of a loan customer states that the customer (i.e., the parent's subsidiary) is an integral and important part of the parent's operations.

reputational risk exposure with respect to an elevated risk CSFT than a financial institution that acts only as a counterparty for the transaction. Accordingly, a financial institution may need to exercise a higher degree of care in conducting its due diligence when the institution structures or markets an elevated risk CSFT or acts as an advisor concerning such a transaction than when the institution plays a more limited role in the transaction.

To appropriately understand and evaluate the potential legal and reputational risks associated with an elevated risk CSFT that a financial institution has identified, the institution may find it useful or necessary to obtain additional information from the customer or to obtain specialized advice from qualified in-house or outside accounting, tax, legal, or other professionals. As with any transaction, an institution should obtain satisfactory responses to its material questions and concerns prior to consummation of a transaction.[15]

In conducting its due diligence for an elevated risk CSFT, a financial institution should independently analyze the potential risks to the institution from both the transaction and the institution's overall relationship with the customer. Institutions should not conclude that a transaction identified as being an elevated risk CSFT involves minimal or manageable risks solely because another financial institution will participate in the transaction or because of the size or sophistication of the customer or counterparty. Moreover, a financial institution should carefully consider whether it would be appropriate to rely on opinions or analyses prepared by or for the customer concerning any significant accounting, tax or legal issues associated with an elevated risk CSFT.

Approval Process. A financial institution's policies and procedures should provide that CSFTs identified as having elevated legal or reputational risk are reviewed and approved by appropriate levels of control and management personnel. The designated approval process for such CSFTs should include representatives from the relevant business line(s) and/or client management, as well as from appropriate control areas that are independent of the business line(s) involved in the transaction. The personnel responsible for approving an elevated risk CSFT on behalf of a financial institution should have sufficient experience, training and stature within the organization to evaluate the legal and reputational risks, as well as the credit, market and operational risks to the institution.

The institution's control framework should have procedures to deliver the necessary or appropriate information to the personnel responsible for reviewing or approving an elevated risk CSFT to allow them to properly perform their duties. Such information may include, for example, the material terms of the transaction, a summary of the institution's relationship with the customer, and a discussion of the significant legal, reputational, credit, market and operational risks presented by the transaction.

[15] Of course, financial institutions also should ensure that their own accounting for transactions complies with applicable accounting standards, consistently applied.

Some institutions have established a senior management committee that is designed to involve experienced business executives and senior representatives from all of the relevant control functions within the financial institution (including such groups as independent risk management, tax, accounting, policy, legal, compliance, and financial control) in the oversight and approval of those elevated risk CSFTs that are identified by the institution's personnel as requiring senior management review and approval due to the potential risks associated with the transactions. While this type of management committee may not be appropriate for all financial institutions, a financial institution should establish processes that assist the institution in consistently managing the review and approval of elevated risk CSFTs on a firm-wide basis.[16]

If, after evaluating an elevated risk CSFT, the financial institution determines that its participation in the CSFT would create significant legal or reputational risks for the institution, the institution should take appropriate steps to address those risks. Such actions may include declining to participate in the transaction, or conditioning its participation upon the receipt of representations or assurances from the customer that reasonably address the heightened legal or reputational risks presented by the transaction. Any representations or assurances provided by a customer should be obtained before a transaction is executed and be received from, or approved by, an appropriate level of the customer's management. A financial institution should decline to participate in an elevated risk CSFT if, after conducting appropriate due diligence and taking appropriate steps to address the risks from the transaction, the institution determines that the transaction presents unacceptable risk to the institution or would result in a violation of applicable laws, regulations or accounting principles.

<u>Documentation.</u> The documentation that financial institutions use to support CSFTs is often highly customized for individual transactions and negotiated with the customer. Careful generation, collection and retention of documents associated with elevated risk CSFTs are important control mechanisms that may help an institution monitor and manage the legal, reputational, operational, market, and credit risks associated with the transactions. In addition, sound documentation practices may help reduce unwarranted exposure to the financial institution's reputation.

A financial institution should create and collect sufficient documentation to allow the institution to:

- Document the material terms of the transaction;
- Enforce the material obligations of the counterparties;
- Confirm that the institution has provided the customer any disclosures concerning the transaction that the institution is otherwise required to provide; and

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[16] The control processes that a financial institution establishes for CSFTs should take account of, and be consistent with, any informational barriers established by the institution to manage potential conflicts of interest, insider trading or other concerns.

- Verify that the institution's policies and procedures are being followed and allow the internal audit function to monitor compliance with those policies and procedures.

When an institution's policies and procedures require an elevated risk CSFT to be submitted for approval to senior management, the institution should maintain the transaction-related documentation provided to senior management as well as other documentation, such as minutes of the relevant senior management committee, that reflect senior management's approval (or disapproval) of the transaction, any conditions imposed by senior management, and the factors considered in taking such action. The institution should retain documents created for elevated risk CSFTs in accordance with its record retention policies and procedures as well as applicable statutes and regulations.

C. Other Risk Management Principles for Elevated Risk CSFTs

General Business Ethics. The board and senior management of a financial institution also should establish a "tone at the top" through both actions and formalized policies that sends a strong message throughout the financial institution about the importance of compliance with the law and overall good business ethics. The board and senior management should strive to create a firm-wide corporate culture that is sensitive to ethical or legal issues as well as the potential risks to the financial institution that may arise from unethical or illegal behavior. This kind of culture coupled with appropriate procedures should reinforce business-line ownership of risk identification, and encourage personnel to move ethical or legal concerns regarding elevated risk CSFTs to appropriate levels of management. In appropriate circumstances, financial institutions may also need to consider implementing mechanisms to protect personnel by permitting the confidential disclosure of concerns.[17] As in other areas of financial institution management, compensation and incentive plans should be structured, in the context of elevated risk CSFTs, so that they provide personnel with appropriate incentives to have due regard for the legal, ethical and reputational risk interests of the institution.

Reporting. A financial institution's policies and procedures should provide for the appropriate levels of management and the board of directors to receive sufficient information and reports concerning the institution's elevated risk CSFTs to perform their oversight functions.

Monitoring Compliance with Internal Policies and Procedures. The events of recent years evidence the need for an effective oversight and review program for elevated risk CSFTs. A financial institution's program should provide for periodic independent reviews of its CSFT activities to verify and monitor that its policies and controls relating to elevated risk CSFTs are being implemented effectively and that

[17] The agencies note that the Sarbanes-Oxley Act of 2002 requires companies listed on a national securities exchange or inter-dealer quotation system of a national securities association to establish procedures that enable employees to submit concerns regarding questionable accounting or auditing matters on a confidential, anonymous basis. See 15 U.S.C. 78j-1(m).

elevated risk CSFTs are accurately identified and received proper approvals. These independent reviews should be performed by appropriately qualified audit, compliance or other personnel in a manner consistent with the institution's overall framework for compliance monitoring, which should include consideration of issues such as the independence of reviewing personnel from the business line. Such monitoring may include more frequent assessments of the risk arising from elevated risk CSFTs, both individually and within the context of the overall customer relationship, and the results of this monitoring should be provided to an appropriate level of management in the financial institution.

Audit. The internal audit department of any financial institution is integral to its defense against fraud, unauthorized risk taking and damage to the financial institution's reputation. The internal audit department of a financial institution should regularly audit the financial institution's adherence to its own control procedures relating to elevated risk CSFTs, and further assess the adequacy of its policies and procedures related to elevated risk CSFTs. Internal audit should periodically validate that business lines and individual employees are complying with the financial institution's standards for elevated risk CSFTs and appropriately identifying any exceptions. This validation should include transaction testing for elevated risk CSFTs.

Training. An institution should identify relevant personnel who may need specialized training regarding CSFTs to be able to effectively perform their oversight and review responsibilities. Appropriate training on the financial institution's policies and procedures for handling elevated risk CSFTs is critical. Financial institution personnel involved in CSFTs should be familiar with the institution's policies and procedures concerning elevated risk CSFTs, including the processes established by the institution for identification and approval of elevated risk CSFTs and new complex structured finance products and for the elevation of concerns regarding transactions or products to appropriate levels of management. Financial institution personnel involved in CSFTs should be trained to identify and properly handle elevated risk CSFTs that may result in a violation of law.

IV. Conclusion

Structured finance products have become an essential and important part of the U.S. and international capital markets, and financial institutions have played an important role in the development of structured finance markets. In some instances, however, CSFTs have been used to misrepresent a customer's financial condition to investors and others, and financial institutions involved in these transactions have sustained significant legal and reputational harm. In light of the potential legal and reputational risks associated with CSFTs, a financial institution should have effective risk management and internal control systems that are designed to allow the institution to identify elevated risk CSFTs, to evaluate, manage and address the risks arising from such transactions, and to conduct those activities in compliance with applicable law.

Dated: December 12, 2006.

John C. Dugan (signed)
John C. Dugan,
Comptroller of the Currency.

Dated: December 21, 2006.

Scott M. Polakoff (signed)
By the Office of Thrift Supervision.
Scott M. Polakoff,
Deputy Director & Chief Operating Officer

By order of the Board of Governors of the Federal Reserve System, December 20, 2006.

Jennifer J. Johnson (signed)
Jennifer J. Johnson,
Secretary of the Board.

Dated at Washington, DC, the 22nd day of December, 2006.

Robert E. Feldman (signed)
By order of the Federal Deposit Insurance Corporation.
Robert E. Feldman,
Executive Secretary.

Dated: January 5, 2007

Nancy M. Morris (signed)
By the Securities and Exchange Commission
Nancy M. Morris
Secretary

APPENDIX E: OCC SUPERVISION OF CITIBANK, N.A.

I. OCC's Supervision of Large National Banks

The foundation of the OCC's supervision of the largest national banks is our continuous, on-site presence of examiners at each of our 15 largest banking companies. Citibank is one of the banks in our Large Bank Program. These 15 banking companies account for approximately 89 percent of the assets held in all of the national banks under our supervision. The resident examiner teams are supplemented by subject matter experts in our Policy Division, as well as Ph.D. economists from our Risk Analysis Division trained in quantitative finance. Since 2005, the resident examiner team at Citibank averaged approximately 50 resident examiners, supplemented by the subject matter experts and economists mentioned above, and additional examiners as needed on specific targeted examinations.

Our Large Bank Program is organized with a national perspective. It is highly centralized and headquartered in Washington, and structured to promote consistency and coordination across institutions. The onsite teams at each or our 15 largest banks are led by an Examiner-In-Charge ("EIC"), who reports directly to one of the Deputy Comptrollers in our Large Bank Supervision Office in Washington, DC. This enables the OCC to maintain an on-going program of risk assessment, monitoring, and communication with bank management and directors.

Resident examiners apply risk-based supervision to a broad array of risks, including credit, liquidity, market, compliance, and operational risks. Supervisory activities are based on supervisory strategies that are developed for each institution that are risk-based and focused on the more complex banking activities. Although each strategy is tailored to the risk profile of the individual institution, our strategy development process is governed by supervisory objectives set forth annually in the OCC's Bank Supervision Operating Plan. Through this operating plan, the OCC identifies key risks and issues that cut across the industry and promotes consistency in areas of concerns.

With the operating plan as a guide, EICs develop detailed strategies that will direct supervisory activities and resources for the coming year. Each strategy is reviewed and approved by the appropriate Large Bank Deputy Comptroller. Our risk-based supervision is flexible, allowing strategies to be revised, as needed, to reflect the changing risk profile of the supervised institutions.

Our risk-based supervision seeks to identify the most significant risks and then to determine whether a bank has systems and controls appropriate to identify, measure, monitor, and control those risks affecting the institution. We assess the integrity and effectiveness of risk management systems, with appropriate validation through testing.

Our supervisory process involves a combination of ongoing monitoring and targeted examinations. Our ongoing supervision allows us to review management reports, discuss business and risk issues, and maintain an understanding of the bank's risk profile. The purpose of our targeted examinations is to validate that risk management systems and processes are functioning as expected and do not present significant supervisory concerns. Our supervisory conclusions are communicated directly to bank senior management. When we identify concerns,

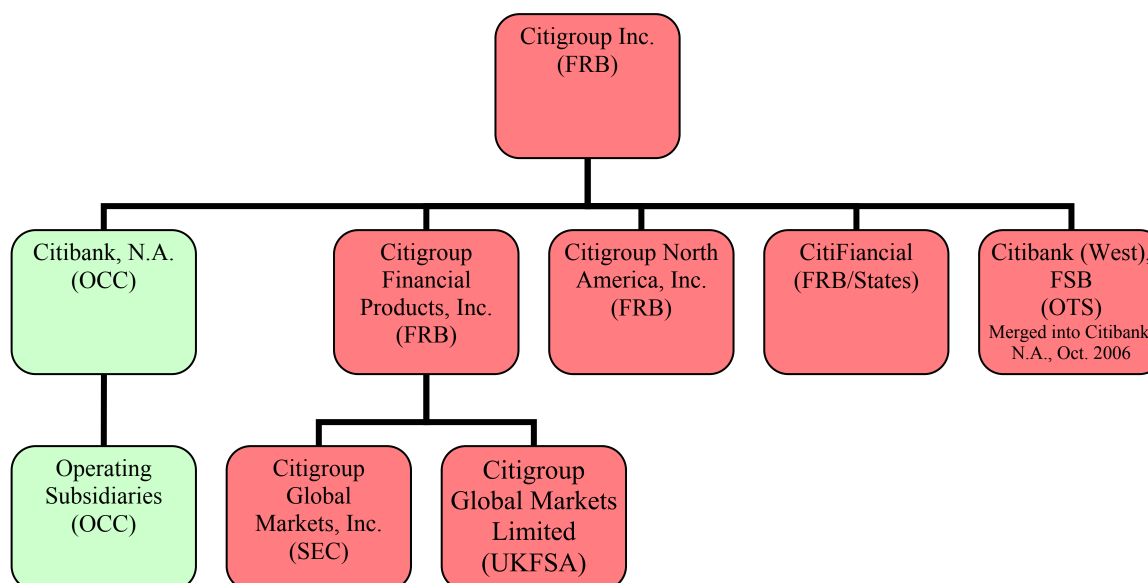
we "drill down" to test additional transactions. These concerns are then highlighted for management and the Board as "Matters Requiring Attention" ("MRAs") in supervisory communications. If these concerns are not appropriately addressed within a reasonable period, we have a variety of regulatory and enforcement tools with which to respond, ranging from informal supervisory actions directing corrective measures, to formal enforcement actions, to referrals to other regulators or law enforcement.

It is not uncommon to find weaknesses in structure, organization, or management information, which we address through MRAs and other supervisory processes described above. But more significantly at some of our institutions, what appeared to be an appropriate governance structure was made less effective by a weak corporate culture, which discouraged credible challenge from risk managers and did not hold lines of business accountable for inappropriate actions. Corporate culture issues can be difficult to assess during benign economic times. But when the market disruption began to occur in mid-2007, we began to document examples where risk management did not appropriately constrain certain business activities, at least in part due to its relative lack of stature.

As previously noted, we have a staff of experts who provide on-going technical assistance to our on-site examination teams. Our Risk Analysis Division includes 40 Ph.D. economists and mathematicians who have strong backgrounds in statistical analysis and risk modeling. These individuals frequently participate in our examinations to help evaluate the integrity and empirical soundness of banks' risk models and the assumptions underlying those models. Our policy experts help keep abreast of emerging trends and issues within the industry and the supervisory community. Staffs from our Credit and Market Risk, Operational Risk, and Capital Policy units have been key participants and contributors to the ongoing work of the Senior Supervisors Group, Financial Stability Forum, President's Working Group, and Basel Committee on Bank Supervision.

II. Citigroup/Citibank Organization

Citigroup is one of the largest financial institutions in the world. It has operations in approximately 100 countries and provides a full set of financial products. Its major business segments are commercial banking, consumer financial services, and broker-dealer and investment banking activities. These businesses are conducted through a variety of legal entities, including national banks and their subsidiaries, which are subject to regulation and supervision by the OCC, and non-bank subsidiaries of the holding company that are affiliates but not subsidiaries of Citibank ("holding company affiliates"), which are subject to regulation by other federal and state regulators. The key entities referred to in the discussion below, and their relevant regulators, are depicted in the simplified chart below, with the green boxes depicting the entities subject to OCC supervision.



A. Citibank, N.A.

Citibank, N.A., is the largest single legal entity in Citigroup, although it represented less than half of Citigroup's assets for the five years prior to the financial crisis. In 2002, Citibank constituted 43.1 percent of Citigroup assets. In 2006, it constituted 49.5 percent of the group total. Throughout this time, Citibank, N.A. functioned primarily as a corporate bank in the United States and abroad, with retail operations mainly in New York State and internationally. A major legal vehicle restructuring occurred in late 2006 that brought most domestic retail activities into Citibank, N.A. and OCC supervised subsidiaries of the bank. At year-end 2009, the bank constituted 62 percent of Citigroup. Citigroup also uses separate national banks to conduct its credit card lending. Citibank, N.A., its operating subsidiaries, and the other national banks and their subsidiaries are supervised by the OCC.

B. Key Non-bank Entities Owned by Citigroup

Citigroup conducts a substantial amount of its business in holding company affiliates. These holding company affiliates are subject to regulation by the Federal Reserve, the states, and in some cases, other regulators such as the Securities and Exchange Commission. Holding company affiliates are not regulated by the OCC. For the purposes of the Commission's inquiry, several key holding company affiliates are as follows:

- Citigroup Global Markets, Inc. ("CGMI"), a holding company affiliate of the bank, is a U.S. broker-dealer subject to supervision primarily by the Securities and Exchange Commission ("SEC"), but also by the Federal Reserve. CGMI conducted the cash collateralized debt obligation ("CDO") structuring business for the group and was the main warehouse for the CDO structuring business.
- Citigroup Financial Products, Inc. ("CFPI"), a holding company affiliate, was used as a warehouse for the CDO structuring business. It is supervised by the Federal Reserve.

- CitiFinancial is a non-bank holding company affiliate used for subprime lending and consumer finance activities and is supervised by the Federal Reserve and the states.
- Citigroup North America, Inc. ("CNAI") is a non-bank holding company affiliate used for booking and assigning capital for certain leveraged loans and bridge loans. CNAI is also supervised by the Federal Reserve.

C. Legal Vehicle Simplification Project

Citigroup completed a major legal vehicle simplification project in October 2006. Citigroup management recognized the need to streamline its activities and improve oversight and control. It wanted to concentrate its business activities in three main legal vehicles: an investment bank, a commercial bank, and a credit card bank. This project also diversified Citibank's domestic activities.

The simplification project reduced the number of insured depository institutions from twelve to five, and consolidated approximately $200 billion of assets into Citibank, N.A. Approximately 10 percent of these assets were subprime mortgages that had been originated outside of the national bank (either through the CitiFinancial or Citibank (West), FSB).

After the consolidation, the OCC discovered that management was not consistently applying the Interagency Policy Statement on Loan Loss Reserves at its former thrift and finance company entities. The OCC directed bank management to improve processes and augment reserves. In addition, the quality of mortgages was substantially worse than expected. At the time of the conversion, the 2005 and most of the 2006 mortgage vintages had already been completed, and the 2007 production was gearing up. As with other mortgage lenders, these three years turned out to be problematic. Citibank subsequently incurred substantial credit losses and increased loan loss provisions from this mortgage lending business.

D. Current Operating Structure

Citigroup currently operates, for management reporting purposes, via two primary business segments which span multiple legal entities: Citicorp and Citi Holdings. Citicorp (core business) includes the Institutional Clients Group (securities & banking and transaction services) and Regional Consumer Banking (traditional banking services). Citi Holdings (noncore business) include Brokerage and Asset Management, Local Consumer Lending (residential mortgages, private-label cards, student and auto loans, Primerica Financial Services), and a special asset pool (securities, wholesale and consumer credits, leverage loans, SIV assets). Management plans to reduce the assets in Citi Holdings over time through asset and business sales and amortizations.

III. Citibank's Financial Condition

Citibank, N.A., the largest national bank owned by the holding company, Citigroup, had substantial financial strength as it entered the crisis. Citigroup management had committed to the OCC to maintain Citibank's capital at a range significantly above minimum "well capitalized" levels of 6 percent Tier 1 risk-based capital, 10 percent total risk-based capital, and

5 percent leverage capital. In fact, for many years, Citibank's Tier 1 capital was above 8 percent and its total risk-based capital was above 12 percent. Citibank would dividend capital in excess of this range for Citigroup's strategic use. At year end 2006, Citibank had total equity capital of $72 billion, Tier 1 capital of 8.3 percent, and Total capital of 12.4 percent, which was consistent with this agreement. Nevertheless, the bank's Tier 1 leverage capital ratio had been declining, and the OCC downgraded its capital rating at that time to reflect this trend. Around this time, Citibank was assigned a "Aaa" rating from Moody's.

As shown in the chart below, Citibank, N.A., and its sister national bank (a credit card specialty bank), reported net income of $13.1 billion in 2006. As the financial crisis began to unfold, the national banks reported a positive, though decreased, net income in 2007 of $5.1 billion, compared with a loss of $1.5 billion in Citigroup, excluding the national banks. In 2008, the national banks reported a loss of $6.3 billion, compared with losses of approximately $21.4 billion in Citigroup, again excluding the national banks. For 2009, the national banks reported a loss of $3.0 billion. In both 2008 and 2009, OCC examiners required management to downstream capital to strengthen the bank.

Net Income $B	2006	2007	2008	2009
National Banks	$13.1	$5.1	- $6.3	-$3.0
Non-Banks	$8.5	-$1.5	-$21.4	$1.4

Prior to the crisis, Citigroup management faced ongoing shareholder criticism for lackluster stock performance. Management attempted to improve income by making the strategic decisions to expand the cash CDO structuring business, synthetic CDO business, and syndicated (including) leveraged lending activities. These activities crossed multiple products, legal vehicles, and geographies. The cash CDO business was run from the CGMI, the U.S. broker-dealer, which also served as the main warehouse for the CDO structuring business; a CDO warehouse also was run from CFPI; the synthetic CDO business was managed in London, at both the national bank branch and a London-based holding company affiliate, Citigroup Global Markets Limited ("CGML"); and the loan syndication and bridge loan business was booked primarily through the non-bank holding company affiliate, CNAI. The complexity of the exposures and processes made it difficult to have a complete picture of the risks. These businesses became the sources of most of the bank's subprime and leveraged lending exposures and its subsequent losses.

IV. Citigroup's Subprime Exposure

Leading up to the crisis, Citigroup's exposure to subprime credit risk took various forms. One was from the direct origination of subprime loans that were held on the company's books. These were predominantly originated by entities other than OCC-supervised national banks or national bank subsidiaries.

A second form was from the structuring and ownership of securities backed by subprime loans. Most, but not all, of this structuring business was conducted by holding company affiliates of Citibank that were not supervised by the OCC. However, Citibank, N.A. came to

own and otherwise be exposed to significant risks from those securities, which resulted in significant losses during the crisis.

A Subprime Loan Origination

Subprime mortgages were originated by CitiFinancial, a holding company affiliate, and to a lesser degree by CitiMortgage, while it was an OTS-regulated subsidiary of Citibank (West), FSB. As a result of the Legal Simplification Project described above in subsection II.C., subprime mortgages originated by CitiFinancial and Citibank (West), FSB, were transferred to Citibank, N.A. After the consolidation, Citibank continued to originate and hold on its books a limited volume of subprime mortgages in 2007, but these mortgages became subject to the new interagency guidance on subprime lending adopted that year, as well as OCC lending standards. As with many of the mortgages on Citibank's books, both prime and nonprime, originated during 2005 – 2007, the bank has taken significant losses on these subprime loans.

B. Exposure to Securities backed by Subprime Loans

A significant exposure of Citibank, N.A. to securities backed by pools of subprime loans came from collateralized debt obligations, or CDOs. In particular, Citibank was exposed to the highest or "safest" tranches of these subprime CDOs, sometimes referred to as "super senior" tranches that were rated "triple A" by the credit rating agencies. The bank had two sources of super senior exposure: liquidity puts issued to support Citigroup's Cash CDO Business in the U.S., and synthetically produced CDO exposure through its London branch office.

1. Liquidity Puts and Cash CDO Exposures

In late 2004, Citigroup management made the strategic decision to expand the CDO structuring and warehousing business. It is our understanding that this business purchased mortgages, including subprime mortgages, from third parties (not from the national bank or its subsidiaries) and packaged them into residential mortgage-backed securities ("RMBS"). These RMBS, along with other RMBS purchased from third parties, were then packaged into cash CDOs. Each cash CDO was sold to investors through an off-balance sheet, special purpose vehicle or SPV. The CDO SPV issued equity and classes of debt, with short-term commercial paper constituting the most senior class of debt. In essence, the first cash flows of the CDO/SPV were dedicated to the commercial paper investors, and because of the credit support provided in lower tiers of the funding structure, the commercial paper investors had very limited or "super senior" credit exposure to losses generated by the loans underlying the CDO.

This CDO structuring business, and the associated pipeline and warehouse activities, was not conducted by the national bank. Instead, it was conducted by the Cash CDO Desk of CGMI, the U.S. broker-dealer holding company affiliate of the bank, as well as by CFPI, a CDO warehousing affiliate. However, the national bank became exposed to the CDO SPV by issuing "liquidity puts" that guaranteed funding to the SPV in the event that short-term commercial paper investors became unwilling, presumably in a liquidity crisis, to roll over their funding. Such puts, which helped obtain high credit ratings for the commercial paper, were similar in nature to the kind of liquidity support that the bank typically provided to other funding vehicles,

such as multi-seller conduits, that issued commercial paper. By providing this support, the bank was essentially assuming, in the event of a prolonged and critical liquidity problem, the "super senior" credit exposure that had been held by the commercial paper investors. The deals supported by these puts were all managed by external investment managers. This did not serve to reduce franchise risk.

The OCC is restricted in its ability to examine broker-dealer or other holding company affiliates. As a result, examiners did not possess direct knowledge of the nature or quality of the loans that backed the cash CDOs. However, because of the high credit ratings of the exposure, and the fact that the liquidity support was similar in nature to other kinds of low risk support provided to other funding conduits, the risk of these liquidity puts was viewed as low. Indeed, Citigroup management considered the possibility of losses from liquidity puts to be extremely remote based on a variety of factors, including that the bank would only be legally required to fund in a short-term market liquidity event; that the puts only covered the super senior exposures of the CDO, and could not be exercised in the event of credit problems rather than liquidity problems; and that super senior positions were above the highest AAA ratings provided by the rating agencies , and the commercial paper rating was the highest as well. These ratings indicated that the exposure was extremely well protected by the other, subordinate classes in the CDO.

Moreover, when the liquidity puts were first provided to CDOs, nearly seven years ago, only high quality asset-backed securities ("ABS") and mortgage product was included in these structures, and they performed well. However, during the middle years of this past decade, the business and the industry began introducing riskier subprime collateral into the CDOs. While the credit ratings for the super senior exposures remained high, the use of this riskier collateral was a significant change. As the OCC was not able to examine the structuring and warehousing elements of this business, we are not able to comment on the risk assessments and controls over this change.

When the liquidity crisis occurred, Citibank, as the result of the liquidity puts, assumed the credit risk of super senior exposures to subprime RMBS CDOs totaling $25 billion. This exposure generated significant mark-to-market losses to the bank, although the obligations remain current and the ultimate credit loss is not yet known.

2. Synthetic CDOs

Citibank's London branch and CGML, its London-based operating subsidiary also supervised by the OCC, created synthetic CDO exposures through its ABS correlation desk in London. These exposures were ramped up in 2006 and early 2007, reportedly following the capping of the limit on the New York Cash CDO business. The bank's activities were reviewed by the OCC during an examination of the EMEA (Europe, Middle East, and Africa) Structured Credit Business in the first quarter of 2007. Exposure to subprime credit was created synthetically using credit derivatives on either the underlying ABS securities or relevant indices. When the structured deals were packaged, equity and mezzanine tranches were sold to Citigroup clients, and unlike the NY CDO desk that distributed the super senior positions, the London trading desk retained the super senior position. Super senior exposure is the most protected level

in a CDO structure, with all subordinate classes expected to absorb any expected or stressed losses anticipated in the deal. As such, these super senior pieces were either rated or sat above the AAA by rating agencies who routinely provided ratings to these structures. Our understanding is that for a synthetically created CDO, a total return swap can be used to transfer the economic exposure from the synthetically created pool of credit risk exposure (ABS and/or RMBS) into the associated special purpose entity. The special purpose entity would then create the tranched securities to be sold to investors. An estimate of $6 billion of super senior notional exposure was created in the bank; and additional exposures were also created and booked in CGML, the non-bank entity in London that was a subsidiary of the bank. The amounts of exposure reported in late 2007 were significantly greater than what we observed on risk reports earlier in the year.

V. Impact on Citibank of Syndicated and Leveraged Lending Conducted in Holding Company Affiliates

Citigroup also committed itself to the syndicated and leverage lending markets. Group management felt that as a major financial institution, it was important for it to participate in a large percentage of the syndicated market. In 2006, bank management increased its loan syndication pipeline limit 40 percent (from $35B to $50B), and then doubled it to $100B six months later in 2007. Management expected to participate in all large, significant sponsor-backed transactions, and it joined in more than ten material transactions simultaneously in 2007.

Citigroup used CNAI, the non-bank, holding company affiliate supervised by the Federal Reserve Bank of New York, as the primary vehicle for managing the syndication process. Approximately 80 percent of leveraged syndications and bridge loans were booked in CNAI, and the remaining 20 percent booked directly in the bank. When the syndication markets closed down in mid-2007, CNAI did not have the capital or liquidity to support the huge pipeline. Citigroup management then decided to use Citibank's balance sheet to book these high-risk and ultimately costly deals. The assets came on balance sheet, and ultimately some had to be substantially written down.

VI. OCC Regulatory Focus

A. Overview

The OCC identified a number of risk management issues over the years that we treated as "Matters Requiring Attention" in Supervisory Letters to bank management. Some of the issues involved consolidated risk reporting, risk measurement, model validations, and credible challenge by independent risk management. We brought forward certain issues to our Reports of Examination that were presented to the bank's audit committee. We also had enforcement actions specific to identified issues. Management was responsive to each individual issue, and personnel actions and organizational changes periodically occurred as a result of our letters.

One regulatory focus during these years was on the massive expansion of the complexity and volume of credit derivatives instruments. These risks centered on a problematic operational risk profile, and control over highly complex products and risk exposures via complex modeling.

In 2005, we were highly critical of management and risk management oversight of the areas that were considered higher risk. In this case, management responded to our criticisms by curtailing trading activities and changing management within the business. As such, our supervision was trying to ensure that the growth in a complex business was prudent and commensurate with infrastructure.

The company's Capital Markets Approval Committee process had looked at and approved liquidity puts and management's desire to book synthetic exposures in the bank. However, nowhere did these documents discuss the deterioration in collateral supporting these "highly rated" ABS securities or indices. Market events, and the substantial deterioration in the quality of underlying mortgage collateral, placed a significant burden on vehicles that were intended to work under usual and expected stressed situations. That said, participants in this business, and with this collateral, should have anticipated the potential for this market event, and risk management should have been aware of the asset quality deterioration that effectively went unheeded.

In early 2007, we examined the activities of the London branch and its ABS correlation desk. During this examination, we noted that the desk had switched emphasis to structured deals, and that synthetic exposures had been created at both the branch and the local non-bank entity, CGML. We determined that risk was high, and required additional work on the expansion of risk in synthetic exposures in concert with market events unfolding. By this time, the bank's exposure was already considerable. Just prior to issuing our supervisory letter, the bank changed desk management to an individual with whom we were comfortable.

During the summer of 2007, as events were unfolding related to subprime mortgages, we were informed of the critical nature of this exposure by Citigroup's Treasury upon the funding of the liquidity puts in August 2007. We and examiners from other agencies then began additional research on the liquidity puts and the potential exposures. We found that the assets under the liquidity puts had older vintages than the production the markets had seen in the most recent run-up of subprime loans in 2006 and 2007. This was due to the longer existence of those structures and the fact that replenishment of those structures was reportedly mostly subprime, where initial RMBS were of higher quality.

We were also informed that Commercial and Investment Bank management sought to acquire its own subprime mortgage origination source after confirming that Citibank would not be a source of subprime mortgage paper. This led management to pursue the purchase of a subprime originator Argent. While the Commercial and Investment Bank management's decision to bring in house a subprime originator was faulty, Argent did not include any loans, and no additional loans were generated by the entity due to the fact that the market had significantly deteriorated by that time.

We performed a comprehensive examination in the fourth quarter of 2007 to determine the nature of the problem and whether the company was properly valuing these CDO instruments. The findings of this exam are in the materials that have been provided to the commission.

B. Administrative Actions

During the five year period prior to the crisis, Citibank was subject to both formal and informal regulatory actions. Formal action came in 2003 when the OCC put Citibank under a Formal Agreement for activities related to Enron, WorldCom, and others. The bank was using Complex Structured Financial Products to provide funding to these companies without having the transactions appear on the client's financial statements. The formal agreement ("FA") required the bank to implement enhanced oversight and controls over all complex structured finance transactions. Most of the requirements of the FA were later codified in an interagency policy statement on Complex Structured Financial Products issued to the industry. The bank achieved compliance with the FA in late 2006.

Informal actions were imposed to address legal, compliance, and control issues that became evident in a number of high-profile events. These included deficiencies in Citibank's Japan Private Bank, a trading incident in London, and a number of other non-public events. The bank embarked on a "Five Point Plan for Improvement" in 2005 to strengthen culture and control. The five point plan was supplemented by an extensive corrective action plan to address legal, compliance, and control issues. Extensive work was performed to improve processes and controls, and the bank achieved substantial compliance with this plan in early 2007.

The OCC's administrative actions did not directly apply to the syndicated lending and CDO businesses. The FA dealt with client specific transactions. Informal actions covered legal, compliance, and internal control issues. Neither dealt with specific businesses, and as such, they did not constrain the group's expansion into syndicated lending and CDO warehousing. In fact, the bank began increasing syndicated loan limits while the FA was still in place. Moreover, both businesses were mostly conducted in legal vehicles outside of the OCC's supervisory control. Syndicated lending was managed mostly through the non-bank holding company affiliate CNAI, and CDO structuring and warehousing was done in the broker-dealer and CFPI, both of which were holding company affiliates.