Members of The Commission:

I have been asked to appear today to provide testimony as it relates to the subprime mortgage industry and its impact on the current financial crisis. For the record, my name is Richard Bitner. I am a former subprime lender who owned a wholesale mortgage lending company from 2000 to 2005. The term wholesale refers to the fact that mortgage brokers, and not the consumer, were my direct customer.

I have worked in the mortgage lending industry for 15 years. I presently own a firm that publishes finance and real estate related periodicals, most notably HousingWire Magazine. As such, my work requires a continuous monitoring and reporting on the activities that take place in the area of housing finance. Additionally, I am the author of the book, *Confessions of a Subprime Lender: An Insider's Tale of Greed, Fraud & Ignorance*. Since the book was written with the objective of bringing to light many of the issues I've been asked to address, I am sighting it as a reference source for the purpose of this testimony.

As background, subprime lending has no official start date, but three events paved the way for the industry's formation. First, the Depository Institutions Deregulation and Money Control Act (DIDMCA) of 1980 made the subprime business legal by allowing lenders to charge higher rates and fees to borrowers. Second, the Alternative Mortgage Transaction Parity Act (AMPTA) of 1982 allowed the use of variable interest rates (ARMs) and balloon payments. Finally, the Tax Reform Act (TRA) of 1986 prohibited the deduction of interest for consumer loans but allowed it for mortgages on a primary residence, increasing the demand for mortgage debt. When deductibility was factored in, even high-cost mortgage debt was a better option than consumer debt.

Although these changes helped launch the industry, two market-driven events contributed to the initial growth phase. First, by late 1993, the industry was coming to the end of a refinance cycle. With interest rates going up, loan volume in the conforming market was shrinking. To fill the void, brokers and lenders began originating subprime mortgages.

Second, Wall Street investment firms began securitizing these mortgages. Securitization is a process where thousands of mortgage loans are bundled together into financial products called mortgage-backed securities. These investments are secured by the principal and interest payments made by consumers. The process, which already existed for conforming and Alt-A mortgages, created an end or secondary market for the product.

Arguably, securitization could be the single greatest innovation to mortgage lending. Before loans were securitized, a consumer relied on a bank to supply the money to fund a mortgage. The entire process, from origination to servicing, stayed with the same institution. Since banks owned every aspect of the loan and were heavily regulated, they were motivated to manage risk and treat borrowers fairly. If a consumer got into financial trouble because of something like layoffs at a local factory, the local bank often knew about it before it became an issue. Owning the entire process gave banks the latitude and equally important, the motivation, to restructure the loan.

In addition to creating a renewable source of capital, mortgage securitization also helped fragment the industry. Instead of one institution that functioned in a true cradle to grave capacity, functionality became diversified. A broker originated a loan while a mortgage lender funded it. The lender either sold the loan to another financial institution that held it in portfolio or used an investment bank to package it into a mortgage-backed security. A myriad of investors, ranging from banks to hedge funds, bought the investments for their portfolio. A servicing company collected payments, and when a loan defaulted, foreclosed on the property. An entire process originally performed by one entity was divided into separate components.

This fragmentation gave each player a claim of plausible deniability. Mortgage brokers maintained that they only originated the loan, so any concerns about the loan's quality were the lender's responsibility. The lender underwrote the deal using the guidelines provided by the investment firms, so they merely delivered the final product investors wanted to buy. The Wall Street firms who packaged the securities and the investors who purchased them claimed to be "Holders in Due Course," which protected them from any liability when lenders and brokers acted illegally. While the entire food chain contributed to the current problems, fragmentation allowed each player to point an accusatory finger at someone else. While securitization allowed for unprecedented liquidity into the housing finance sector, it also gave birth to the "originate to distribute" model of lending. As a result, the industry saw a growth in the number of front-line originators who had little to no financial interest in whether a borrower was able to make his payment. I will address the growth of the mortgage broker segment shortly.

While the advent of securitization made it possible for subprime lending to develop, several events, beginning in 2000, promoted the expansion of this industry segment. While each one was independently significant, the collective impact served as a major catalyst for growth.

First, Standard and Poor's (S & P) concluded the piggyback mortgage (where the customer took out a simultaneous second loan in lieu of a down payment) was no more likely to default than a single loan. The other agencies took the same position shortly thereafter. While the event went largely unnoticed outside of the industry, its impact was important.

There was some consensus in the industry at the time that a piggyback or 80-20 mortgage would perform as well as the single 100% loan, provided the FICO score was over 680. However, by adopting a more liberal set of credit standards, one that allowed for these loans at lower credit scores, the rating agencies effectively gave birth to the subprime piggyback mortgage. Within a few years, this product became an industry staple.

It wasn't until six years later that S & P reversed its decision, determining that piggybacks had a much higher probability of default. Their initial decision proved to be disastrous. In July 2007, Moody's made the unprecedented move to downgrade every second-lien securitization it rated from 2005 until that time. It's clear the rating agencies initial announcement had been based on faulty assumptions.

Second, the decision on piggybacks also affected the mortgage insurance (MI) industry. MI companies provide coverage to lenders for loans over 80% loan-to-value (LTV) in case of borrower default. Since the ruling allowed second-lien mortgages to be used in place of mortgage insurance, the decision effectively neutered the MI industry and created a void.

Before S & P's announcement, a lender that wanted to offer a loan product over 80% LTV required MI to securitize the product. Since profitability was tied to effective risk management, most MI companies would err on the side of caution. They performed a check-and-balance function, which kept the industry thinking rationally and restricted lenders from implementing products that were poorly conceived.

Third, the GSEs (government–sponsored enterprises)—Fannie Mae and Freddie Mac—experienced their own problems a few years later. A deeper look into their accounting practices revealed that, unlike other business scandals in which companies tried to hide losses, the GSEs made so much profit they attempted to spread their income out over time.

Once their accounting practices became headline news, auditors were brought in to sort things out. That fact that the GSEs tried to alter their financials was enough incentive for Congress to impose restrictions. The decision to place caps on their portfolios ultimately hindered their ability to grow. At a time when the industry was experiencing record volume, the GSEs were made to sit in the penalty box.

The combination of all three events—the growth of piggyback mortgages, the neutralization of the MI companies, and the punishment of the GSEs—removed the last barriers to growth for the subprime industry. With the investment banks and rating agencies left to serve as the industry's moral compass, effective risk management gave way to reckless behavior.

The growth of securitization coupled with lax government oversight, meant the stage was set for rapid growth. With minimal barriers to entry and historically low interest rates, loan originators entered the business in droves. With respect to my firm, we had to hire more employees to process the applications. According to Wholesale Access, a residential lending market researcher, the industry peaked at 53,000 mortgage broker companies in 2006, nearly a 50% increase from the 2001 figure of 37,000. By some estimates, the number of new loan originators working for mortgage brokers increased by 100,000 during this period.

During the early years of subprime lending, few states had licensing requirements, which meant the barriers to entry were minimal. Even when states started requiring licenses, the typical prerequisites were disproportionately easy to meet, such as passing a multiple-choice test and not having any felony convictions.

The income potential made brokering mortgages an attractive business. In the same way investors pay lenders a premium to buy mortgages, lenders pay brokers a yield-spread premium (YSP) to sell a higher interest rate. This applies to all mortgages, not just subprime. For example, if the market or par rate on a subprime loan is 9%, brokers could earn 1 point (one point is equal to one percent of the loan amount) in YSP by selling 9.5%, and 2 points for selling 10.25%. Additionally, brokers could also earn revenue by charging borrowers an origination fee.

How much did a typical broker earn per loan? The answer was linked to how much they could charge the borrower in fees and the interest rate they could sell. The competitive nature of conforming mortgages usually limited brokers to making no more than 1-2 points. In a slower market, most of them struggle to make between 1 and 1.5 points. Since subprime borrowers were primarily concerned about getting approved, they weren't as rate sensitive as prime borrowers, enabling brokers to charge them higher rates and fees. On average, between what wholesale lenders paid brokers in yield spread premium and what brokers charged consumers in origination fees, a typical subprime loan afforded a broker between 2-3 points in commission. Thus, a loan officer who brokered a $400,000 subprime loan could expect to earn $10,000 in commissions.

Of course, this meant that wholesale lenders like myself stood to profit as well. When we formed our subprime lending operation in 2000, we were consistently selling mortgages to our investors (firms like Citigroup, HSBC, and Countrywide) and earning between 4-5 points on a gross basis. As a result, our organization experienced 30-35% ROI during the first few years we were in business, enough to make even the most successful Fortune 500 companies envious.

In many respects, the high-income opportunity contributed to the lack of judgment that overtook the industry. The extravagant wealth that many industry professionals experienced only fueled the desire to make even more money. At the time, I can recall thinking to myself that we were operating in a business environment that was unsustainable. Indeed, it was the desire to maintain this profitability that would be the industries ultimate undoing.

Perhaps nothing describes the sheer lunacy of the industry's growth better than an experience that occurred to my former business partner on a trip to mortgage broker's office in Houston in 2005. As background, a loan officer in Texas must either work for a mortgage lender or have a sponsoring mortgage broker to operate legally. The law doesn't require the broker and originator to work out of the same office as long as the loan officer's license is displayed in the broker's office.

His trip took him to a potentially new customer's office, located in a strip center in suburban Houston. The office was a single tiny room, maybe 12 x 12 in size. Every square inch of the office walls was covered top to bottom, side to side, with loan officer licenses. There were at least 250 licenses either stapled or taped to the walls. Additionally, the broker's loan files were stacked in piles around the room and he clearly didn't know where anything was. At one point, my business partner picked up a tax return that was lying loosely on the floor and asked the broker which file it belonged to. He didn't know.

Aside from not following the compliance requirements set forth by the state, the broker's decision to sponsor these loan officers was perfectly legal. The state allowed him to operate this way and he took advantage of it.

The lack of oversight became more pronounced with the proliferation of net branch companies, the mortgage equivalent of franchising without the large up-front fees. These companies handled the basic business functions (accounting, IT, licensing) so that brokers were freed up to generate more business. While some firms had stringent experience requirements and zero tolerance for inappropriate behavior, the typical net branch provided new loan officers with easy entry to the business. As a result the level of fraud that we experienced as a lender when reviewing files originated by mortgage brokers was unprecedented.

In my company's experience, from 2003 to 2005 more than 70% of all brokered loan files submitted for initial review were somehow deceptive, fraudulent or misleading. In other words, the majority of brokers who worked during this time frame operated in a dysfunctional manner. I define a dysfunctional act as anything that creates an additional layer of risk for the lender or does not serve the best interest of the borrower.

Even the most ethical brokers can be tempted to push in one area or cut corners in another. The practice of massaging loans, making them appear different from what they are, became standard operating procedure. With little accountability for their actions, the "originate to distribute" business model meant that brokers were left to decide for themselves how far they're willing to go.

The subprime lending business model, when implemented with the principles of risk management at the forefront of a lenders thinking, was a challenging one. Every loan reviewed had some type of problem, be it credit, income, employment, or all three. This was the nature of being a subprime lender. Even when fraud was not a factor, transactions often required an underwriting exception. When operating in an environment such as this, the temptation to either withhold information or modify documentation was great, particularly given the large monetary incentives. For a commissioned loan originator who had no monetary interest in how a loan performed but had everything to lose if the loan didn't close, the motivations were clear. If the difference between earning a paycheck was predicated, for example, on whether a borrower's employment history could be altered in order to qualify, some brokers did whatever they needed to do to close the loan.

The issue was further complicated by the fact that little could be done to rid the system of these violators. For example, if we found a broker was acting improperly, in fact committing fraud, the options for enforcement were minimal. First, a lender could remove the broker from their approved list of customers. However, since there was little information sharing taking place between lenders, the broker could easily submit loans to other mortgage companies who were unaware of the broker's history of inappropriate behavior. Second, many states did not have licensing requirements and those that did had weak enforcement standards. Assuming there was a state licensing authority, a lender could submit documentation in an effort to rescind the broker's license. In our experience, however, this seldom occurred due to the time and costs associated with doing so. In many cases, the path of least resistance for a lender was to place the broker on the lender's "do not do business with" list, which meant the broker was effectively barred from doing business with that firm, leaving them to pray on other firms.

The practice of risk management is dictated by the "c's" of underwriting. These refer to a borrower's capacity to pay, credit history and character. While all three are important, nothing is more critical in subprime lending than the fourth "c", collateral. Given that a typical subprime mortgage had questionable credit and/or spotty income, accurately determining property value became even more critical for these types of transaction. Occasionally, it was the only "c" that we as lenders could "hand our hat on" when trying to approve a loan application. Unfortunately, this was an area that proved most challenging for firms like mine.

Subprime lenders usually conducted a second party review for most broker-ordered appraisals because they were considered to be unreliable. For my firm, this figure reached as high as 80%. With the appraisal process highly susceptible to manipulation, lenders had to conduct business as though the broker and appraiser couldn't be trusted. This meant that either the majority of appraisers were incompetent or they were influenced by brokers to increase the value. Interestingly, brokers didn't need to exert direct influence. Instead they picked another appraiser until someone consistently delivered the results they needed.

To put things in perspective, during my company's history, half of all the loans we underwrote were overvalued by as much 10%. This meant one out of two appraisals were still within an acceptable tolerance for our end investors. Our experience showed that 10% was the most an appraisal could be overvalued and still be purchased by these investors. Another quarter that we reviewed were overvalued by 11-20%. These loans were either declined or we reduced the property value to an acceptable tolerance level. The remaining 25% of appraisals that we initially underwrote were so overvalued they defied all logic. Throwing a dart at a board while blindfolded would've produced more accurate results.

The implication from this trend becomes evident once doing the math. If multiple properties in an area are overvalued by 10%, they become comparable sales for future appraisals. The process then repeats itself. We saw it on several occasions. We'd close a loan in January and see the subject property show up as a comparable sale in the same neighborhood six months later. Except this time, the new subject property, which was nearly identical in size and style to the home we financed in January, was being appraised for 10% more. Of course, demand is a key component to driving value, but the defective nature of the appraisal process served as an accelerant. In the end, the subprime industry's willingness to consistently accept overvalued appraisals significantly contributed to the run-up in property values experienced throughout the country.

The question that frequently comes up when discussing this issue is how is this possible when a home or any asset should be worth whatever the market will bear? The answer lies with the down payment. For example, if similar homes in an area have sold for $350,000, and a seller gets a contract for $400,000, that's a function of market demand. A home is worth whatever someone is willing to pay for it. The appraisal, however, should still show that the property is only valued at $350,000. Since there are no comparable sales to justify the higher sales price, lenders should base the loan amount off the $350,000 value, not the $400,000 purchase price. If a borrower wishes to buy the home for a premium, they must bring an additional $50,000 in cash to closing, the difference between the purchase price and the appraised value.

If the appraisal process had worked correctly, a significant percentage of subprime borrowers would've been denied due to a lack of funds. Inevitably, this would have forced sellers to drop their exorbitant asking prices to more reasonable levels. The rate of property appreciation experienced on a national basis from 1998 to 2006 was not only a function of market demand, but was due, in part, to the subprime industry's acceptance of overvalued appraisals, coupled with a high percentage of credit-challenged borrowers who financed with no money down.

While fraud was nothing new to the mortgage industry, lack of government oversight, ease of entry for new loan originators, as well as a low interest rate environment served as a toxic combination. While these factors alone were sufficient to allow for increased malfeasance, the demand from Wall Street investment banks to feed the securitization machines couple with an erosion in credit standards led the industry to drive itself off the proverbial cliff.

From 2001 to 2006, the mortgage industry experienced a gradual shift between what was and what was not an acceptable form of risk. While there are numerous examples to illustrate this point, there are three areas in particular that had broad based implications.

- **100% Stated Income Loan.** Even though Countrywide wasn't the only lender to offer stated income loans, their offering was, by most industry standards, risky. Lending to borrowers with no down payment and no proof of income had worked in the past as long as the credit scores were high (700+). Countrywide offered this product to self-employed borrowers with 620 scores and wage earners with 640 scores.

When stated income loans were developed in the 1980s, they were designed specifically for the self-employed borrower. They required a sizable down payment, excellent credit history, and intense scrutiny of the appraisal. Allowing a borrower who earned a set wage to qualify for this program was not an option at that time. Once borrowers with mediocre credit could finance with no down payment and no income verification, it was the beginning of the end. Since the interest rate was only slightly higher for stated income loans compared to full income documentation, brokers opted for the path of least resistance. There was no need to bother with collecting tax returns and pay stubs when the interest rate for a stated income loan is only 3/8ths of a percent higher.

- **Investment Property Loans.** While low interest rates fueled the market for investment properties, riskier mortgage products took the demand to another level. A subprime product that historically required a minimum down payment of 10% and proof of income was being offered with no money down and no income verification. At one point, lenders advertised the loan for borrowers with 660 credit scores, enabling investors to simultaneously purchase multiple properties. As a result, speculative buying in markets like Las Vegas and Miami artificially inflated property values to unsustainable levels.

- **Guideline Changes.** While credit score had been an excellent indicator of loan performance, its reliability was predicated on holding other credit factors (housing history, bankruptcies, etc.) constant. This was another area where logic failed. For example, by no longer requiring solid rental verification (allowing a private verification in its place), the risk models became further skewed. When borrowers with bad credit, no money, no verifiable income, and no history of paying rent were approved for mortgages, there should be no surprise that loans defaulted.

In addition to the changes mentioned above, the industry had shown a history of forgetting that risk management, and not short-term profit motivation, is what matters most when competing for the long haul in the mortgage lending arena.

Of course, lapses in judgment are nothing new in the industry. Occasionally a subprime lender was too aggressive with a product offering, thinking they'd found an ingenious way to recreate the risk model. Inevitably, the product performed poorly and we'd attribute the lender's action to temporary insanity.

After the first subprime meltdown in 1997, the Associates (purchased by Citigroup in 2000) offered a 95% loan-to-value program (5% down payment) for borrowers with 540 credit scores. Historically, the product required a minimum credit score of 560 to 580, since default models clearly indicated loan performance dropped precipitously below that level. Their decision to break from conventional thinking reminded me of the Roadrunner cartoons, with the Associates playing the part of Wile E. Coyote, super genius.

When they paid us 600 basis points for the loans, we thought someone in their trading department had spiked the water cooler. As a new company struggling to survive, this product was instrumental in helping us to get over the initial hump. In our first four months, it represented nearly 40% of our business. It had the two things every subprime wholesale lender wanted—a unique niche and a high margin. Given the absurdity of the product, it seemed only fitting that the first mortgage we ever closed, which fit this guideline, went to foreclosure less than a year later. There was nothing fraudulent or deceptive about the deal. It was just a high-risk loan based on a flawed risk model.

The product offering was short-lived. When Citigroup purchased the Associates, they immediately discontinued the program. Some time later, a colleague confirmed what many of us had already expected—the product performed poorly.

Another profound lapse in judgment occurred in 2003 when GMAC Residential Funding (RFC) offered 100% financing for borrowers with 560 credit scores. Until that point, it was generally accepted that 580 was the minimum acceptable score for zero down financing. Writing a 100% loan with a 560 score was like swimming with sharks—it was only a matter of time until you were bitten.

We viewed it as a desperate act. Always the conservative stalwart, RFC seldom pushed the risk envelope. When I worked for RFC in 1998, one of the more unique industry product offerings was a 125% loan. As the name implies it was a second-lien mortgage that allowed consumers to borrow up to 125% of the value of their homes. When this industry segment imploded, RFC was the only major investor left standing. They built a reputation as a smart and conservative company because they understood how to manage risk.

When the Wall Street investment banks started capturing a larger share of the subprime market, RFC quickly fell behind. In a few years they went from being a top five investor to barely making the top 20. The 100% product was intended to help them reclaim market share.

Offered only to select customers, the product proved to be a disaster. Seldom in the history of mortgage lending had a new product been so quickly pulled from the market after it was introduced. It showed how the pressure to complete for market share could wear down even the smartest lenders.

This should've sounded some alarm bells. If a company widely regarded as the leader in managing risk for non-agency mortgages experienced such a profound lapse in judgment, how would other, less-skilled investors respond to the pressure? The answer, as we now know, is they couldn't.

I indicated in earlier testimony that my firm was paid between 450 to 500 basis points (bps) for each loan sold to our investors during the first few years we were in business. In some cases the figure exceeded 500 bps, as evidenced by the Associates example, but that was the exception. By 2003, we started experiencing a marked decline in profitability. With over 100 subprime wholesale mortgage companies competing for business, lenders grew volume at the expense of profit margin.

Although our volume grew substantially between 2003 and 2005 net revenue per loan was dropping fast. Even though expenses increased as result of growing the business, the decline was largely a result of being paid less for the product. Conversations with our competitors indicated they were experiencing a similar trend.

Several things contributed to this decline. First, the largest subprime lenders started a price war. Companies like New Century and Argent offered rates that weren't compatible with the risk levels. We tried to win customers by offering stellar service and for a while it worked. But once technology leveled the playing field, our competitors improved their service, making price the ultimate determinant for doing business. We had to shrink our profit margins to remain competitive.

The pricing pressures meant small and medium-sized lenders were hit the hardest. The same investors who purchased our loans (e.g. Countrywide) had wholesale divisions that undercut our pricing. Since the biggest lenders put loans directly into a security, their margins were higher, which enabled them to compete better in a price war. As a pass-through lender, another layer in the food chain, we didn't have that luxury.

Second, it's no coincidence that my firm's revenue peaked just as the fed funds rate bottomed out. As the Fed increased the funds rate by more than 4% from 2004 to 2006, interest rates for subprime ARMs, the dominant industry product, remained flat. The only way for revenues to keep pace was to increase loan production.

Watching it unfold, I realized the industry was quickly losing touch with reality. I frequently spoke with colleagues to talk about the state of the industry. We often discussed the risk-reward curve, which helped analyze the effectiveness of our business model. By late 2004, many of my colleagues along with myself felt the business had reached a point where the risk of being a wholesale subprime lender outweighed the financial rewards.

Rational thinking dictates that when the cost of money goes up, interest rates should follow. While some reduction in margin is acceptable and expected in a highly competitive market, the leading subprime companies took it to the extreme. Unfortunately, as margins were getting squeezed, the most critical factor was being ignored—risk.

At a basic level, mortgage lending is nothing more than effective risk management. If a lender offers a high-risk product and profit margins continue to drop, one of two things must happen. The lender either increases interest rates or tightens underwriting guidelines to compensate for the reduced margin and subsequent risk. Not only did the industry choose to ignore both principles, it went in the opposite direction by developing more aggressive products, as indicated earlier, and not pricing for the associated risk. Ultimately, these were the primary factors that contributed to the demise of the subprime lending industry and served as the catalyst for the financial crisis.