## APPENDIX C

### Description of the "B/C" Mortgage Market

Long Beach participates in what is called the "B/C" mortgage market. The home mortgage lending industry describes this market as serving borrowers who, because of flaws in their credit history or their excessive debt load, are unable to secure home mortgage loans that a primary lender (i.e., a depository institution or a mortgage company) would be able to sell on the secondary mortgage market. Long Beach accurately describes itself as occupying a position in between the finance companies that charge extraordinarily high rates to borrowers in distress and mainstream or "A" lenders.

<u>The "B/C" Market in Los Angeles</u>

In Los Angeles, the "B/C" market consists of about 10 to 15 mortgage companies, about the same number of large finance companies, many more small finance companies, and several thousand wholesale brokers (most of them extremely small) that find borrowers for the mortgage and finance companies. The extent of the dominance of the "B/C" lenders in minority Census tracts is difficult to document because finance companies are not required to report under the Home Mortgage Disclosure Act unless at least 10% of their dollar volume is in home mortgage loans. Among lenders that are HMDA reporters, those that specialize in the "B/C" market can be identified by their high proportion of minority borrowers (particularly black females), and their high overall denial rates.[1]

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[1] "B/C" lenders can also be identified by the high proportion of their denials that are for "insufficient collateral," a reflection of their willingness to lend at high rates to anyone, so long as the borrower has sufficient collateral to cover the loan in the event of default. In December 1994, the National Community Reinvestment Coalition released a study it had undertaken analyzing the 1990-1993 HMDA statistics for the nation's largest MSA's. The study ranked the lenders in each MSA on the basis of the proportion of their lending volume and their approval rates for black and Hispanic borrowers and for low- and moderate-income borrowers. Long Beach and Quality Mortgage (its major competitor in the "B/C" market) ranked first and second in Los Angeles. The same two lenders shared the top two spots in Anaheim, Oakland, and San Diego (but fell to sixth and seventh in Riverside). The NCRC could not include price in the rankings, because it is not included in the HMDA reporting requirements.

## Secondary Market Underwriting Standards

The secondary mortgage market consists mainly (but not exclusively) of the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). FNMA and FHLMC are Government Sponsored Enterprises created by Congress for the purpose of purchasing loans from primary lenders that provide home mortgage loans directly to consumer-homeowners in order to provide primary lenders with capital with which to extend additional mortgage credit.[2]

The primary lenders served by FNMA and FHLMC are referred to herein as constituting the "A" mortgage market. In order to be able to sell their loans on the secondary mortgage market, "A" lenders underwrite their loans according to guidelines promulgated by FNMA and FHLMC. These guidelines are intended to provide the secondary market purchasers with adequate assurance that the borrower has demonstrated (a) willingness to repay the loan, (b) ability to repay the loan, and (c) that the mortgaged property provides adequate security in the event of default of the loan. The guidelines measure these three factors, respectively, by (a) the borrower's credit history, (b) the borrower's two "debt ratios" (the first referring to monthly mortgage payment divided by monthly gross income and the second referring to total monthly debt divided by monthly gross income), and (c) loan-to-value ratio ("LTV" -- the loan amount divided by the selling price or appraised value of the mortgaged property, whichever is lower).

FNMA and FHLMC and "A" lenders prefer borrowers with (a) a measurable credit history containing no derogatory items, (b) debt ratios no higher than 28% and 36%, and (c) an LTV of 80% or lower. However, "A" lenders routinely approve (and FNMA and FHLMC routinely purchase) loans that do not meet these strict credit standards when borrowers have minor credit flaws or demonstrate their willingness to repay through other than prior credit history (such as payment of rent or utility bills), by evidence that their derogatory credit history occurred because of events beyond their control, or by demonstrating that they have

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[2] As a general rule there is no secondary market for "B/C" loans; therefore, most lenders in this market hold the loans in their own portfolios or sell them to investors on a "whole loan" basis. "Whole loan" literally means that the entire investment is transferred to another, although it is common for the seller to continue servicing the loan. In contrast, the major secondary market purchasers "securitize" packages of loans by converting them to various types of bonds. Long Beach is one of the few "B/C" lenders that has developed a secondary market for its loans, but it is a secondary market involving more risk (and a higher rate of return) than the one dominated by FNMA and FHLMC.

re-established their good credit. Similarly, "A" lenders routinely approve (and FNMA and FHLMC routinely purchase) loans to borrowers who exceed the above debt ratio standards by five percentage points (or more, depending on a variety of possible "compensating" or "offsetting" factors). They also purchase loans when the borrower obtains private mortgage insurance ("PMI") to cover the LTV that exceeds 80%.

With respect to both loans to obtain cash by refinancing an existing mortgage and loans to obtain cash where there is no existing mortgage, "A" lenders' ordinary practice is to require that the LTV not exceed 75%. Where the LTV is substantially lower than 75%, "A" lenders (and FNMA and FHLMC) routinely relax the credit and debt ratio standards described above, on the grounds that the additional security in the property can "offset" the increased risk inherent in such inadequacies.

<u>Long Beach's "B/C" Market Lending Standards</u>

The "B/C" market deals in "nonconforming" loans in that its creditworthiness standards do not conform with those of the secondary market.[3] In conducting its "B/C" residential mortgage loan business, Long Beach holds itself out to its potential retail borrowers and to wholesale mortgage brokers (and through them to potential borrowers) as willing to approve and fund loans to borrowers who have:

(a) derogatory credit histories, such as multiple payments paid more than 60 days late, collection accounts, judgments, bankruptcies, etc., and

(b) debt ratios that are higher than those accepted in the "A" mortgage market (up to 60%).

As conditions for its willingness to approve home mortgage loan applications of borrowers who may not meet the "A" mortgage market underwriting guidelines,

(a) Long Beach charges its retail and wholesale borrowers prices that are substantially higher than those that are prevalent in the "A" market. The higher loan cost takes the form of higher interest rates, a greater loan discount fee

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[3] However, the terms "B/C loans" and "nonconforming loans" are not synonymous. Home mortgage loans that are greater than the FNMA and FHLMC maximum (currently a little over $203,000) are referred to as "jumbo" loans and are also nonconforming. If the borrowers have "A" credit but greater than 80% LTV, they are able to obtain private mortgage insurance. In addition, there is a broad "private secondary market" (<u>e.g.</u>, insurance companies) that buys jumbo loans made to borrowers who are "A" credit risks.

(expressed as a number of discount "points," each point being one percent of the loan amount, paid at the time of loan closing), or both, and

(b) with relatively minor exceptions, Long Beach requires the loan-to-value ratio to be no more than 65%.[4]

"A" Borrowers in the "B/C" Mortgage Market

Before we began our investigation of Long Beach, a former employee of one of Long Beach's competitors in the Los Angeles "B/C" market (who is now working for a large "A" lender) approached us with the following information: He said that his former employer and other lenders in the Los Angeles "B/C" market (but making no reference to Long Beach) train their employees in the art of convincing potential borrowers that their credit history blemishes will make them unable to secure mortgage credit from mainstream lenders and that they must, therefore, rely on the "B/C" lenders [and pay premium prices]. An essential part of this ruse is convince the borrower that "the banks" (i.e., lenders in the "A" mortgage market) require "perfect" credit.

Perpetuation of the myth that "banks" require perfect credit[5] is an essential factor in Long Beach's direct mail solicitation materials, and the results of this tactic are apparent in the Long Beach loan files we reviewed. (See, in particular, the file summaries in Appendix A that describe borrowers whose credit risk levels were "A" or "A-.") As one of the lender's loan officers put it to us in an interview, if someone is willing to pay more than they have to for a loan, he is not going to try to talk them out of doing so.

"B/C" lenders (including Long Beach) are able to charge "A" borrowers "B/C" prices because of borrower ignorance of "A" market standards. This is partly the result of "A" market lenders' failure to serve low- and moderate-income communities (often minority neighborhoods) where "B/C" lenders fill the vacuum.

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[4] There is no PMI in the "B/C" market. "B/C" lenders rely on low LTV -- the security value of the collateral -- as their "insurance," and there are no PMI companies willing to underwrite the presumed poor credit risk inherent in being a "B/C" borrower.

[5] Neither "A" lenders nor their secondary market purchasers require perfect credit. Both FNMA and FHLMC guidelines allow leeway for borrowers who can show that their credit blemishes were caused by events beyond their control or who can show that they have corrected their problems and re-established their good credit. We have encountered countless examples of this in other cases when reviewing the approved loan files of "A" lenders.