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dailybriefing

1 HUD Alleges Banks Took Kickbacks, Violating Respa
HUD's inspector general says a number of major banks, including Citigroup, Wells Fargo and SunTrust, took $6 billion in kickbacks from mortgage insurers over a decade, violating a federal law prohibiting abusive home sales practices. The allegations were referred two years ago to the Justice Department, where they still sit. "This thing has been going on for too damn long," HUD's acting IG says. **Page 1**

2 Bickering Dominates Cordray Confirmation Hearing
Richard Cordray's confirmation hearing devolved into Senate sparring over whether the Consumer Financial Protection Bureau's very structure needs revision. **Page 1**

3 The Dark Ages Redux
Faced with a deepening crisis and no quick or easy resolution, European banking leaders are increasingly drawing parallels with the industry's most despondent days: 2008. **Page 3**

4 At B of A, It's Only the Beginning
Bank of America's plan to cut some 3,500 jobs this quarter marks just the start of an efficiency drive that could reduce the company's global workforce by as many as 30,000 jobs, or about 10%. **Back page**

5 Cloud Technologies No Slam Dunk for Banks
Uncertainty and confusion still swirl in the financial services community as to whether cloud technologies afford the security, availability and capacity banks need. **Page 5**

6 C-Suite's Latest Member: Chief Revenue Officer
Andrew Samuel might get double takes as he passes out business cards next year, when he becomes the chief revenue officer at Susquehanna, a new post and a novel one in the industry. But as one analyst says: "It's good to see a bank trying to hire someone to drive revenue, instead of yet another person to deal with regulators and compliance." **Page 9**

7 Canadian Communications Giant Wants to Start a Bank
Taking advantage of smartphone technology, Rogers Communications, Canada's biggest wireless phone company, plans to start a bank, primarily focused on credit, payment and charge card services. **Page 2**

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Rep. Brad Miller lauded the FHFA, Fannie and Freddie's overseer, for filing lawsuits in an effort to recover billions of dollars from large financial institutions. **Page 2**

9 You Can Leave Home Without It. That's the Whole Idea.
Amex, which has been developing prepaid and digital payment options to expand its audience, has added another product: an online-only gift card. **Page 10**

10 Kelly's Exit Package Nearly $34 Million
BNY Mellon agreed to pay $33.8 million in severance and benefits to Robert P. Kelly, who stepped down as chief executive officer Aug. 31 after a dispute with the board. The bank will take a $22 million charge as a result. **Back page**

FORMER OHIO AG Richard Cordray's nomination as first director of the Consumer Financial Protection Bureau was not without party fireworks.

Off Come the Gloves Over CFPB in Cordray Hearing

By Kate Davidson

WASHINGTON – In a long-awaited showdown over the future of the Consumer Financial Protection Bureau on Tuesday, Republicans and Democrats sparred over whether the Senate should proceed with the nomination of the bureau's first director.

GOP members of the Senate Banking Committee dug in their heels and reiterated their pledge to block the confirmation of any nominee until changes are made to the agency's structure.

But Chairman Tim Johnson dismissed those senators as a "vocal minority," accusing them of playing games with the confirmation process and holding the nomination of former Ohio attorney general Richard Cordray hostage.

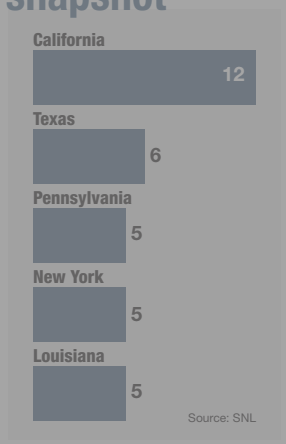
"This political gamesmanship is preventing Americans from receiving the consumer protections they deserve, and putting community banks and credit unions at a competitive disadvantage to nonbank financial companies," Johnson said at Cordray's confirmation hearing.

But Sen. Richard Shelby, the committee's top Republican, insisted the hearing was premature. He said the committee shouldn't even consider a nominee until certain changes are made, including changing the CFPB's leadership from a single director to a five-member commission, subjecting it to the appropriations process and making it easier for a council of regulators to override the bureau's decisions.

Neither the White House nor the Democrats have made any attempt to meet those demands, which were outlined in a letter signed by 44 GOP senators earlier this year, Shelby said.

See page 3

snapshot



GOLD RUSH: California could be the harbinger of a bank M&A wave. There were more deals in the state than in any other in the first half, and conditions are favorable for more.

See page 2

Banks Took Billions in Kickbacks: HUD Probe

By Jeff Horwitz

First of two parts

Many of the country's largest banks received $6 billion in kickbacks from mortgage insurers over the course of a decade, according to a previously undisclosed investigation by the inspector general of the Department of Housing and Urban Development.

The allegations, since referred to the Department of Justice, stem from lenders' demand that insurers cut them in on the lucrative business of insuring the mortgages they produced during the housing boom.

In exchange for their business, companies such as Citigroup Inc., Wells Fargo & Co., SunTrust Banks Inc. and Countrywide Financial allegedly required reinsurance partnerships on generous terms that violated the Real Estate Settlement Procedures Act, a 1974 law prohibiting abusive home sales practices.

During a two-day presentation in the summer of 2009, HUD's team presented DOJ attorneys with a thick binder of evidence that major banks had engineered

See page 6

FLASHBACK — 1933

Mitchell Subpoenaed In Senate Inquiry

Charles E. Mitchell, chairman of the board of the National City Bank of New York City, and other officials of the bank, have been subpoenaed to testify in the Senate stock market investigation. ...

"He took a 'go-to-hell' attitude toward the [Federal Reserve] board and got away with it."

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RISK MANAGEMENT

HUD Probe Targets Captive Loan Reinsurance Deals

Continued from page 1

a decade-long kickback scheme, people familiar with the investigation say.

Documents from the investigation show that the inspector general's staff concluded that banks and insurance companies had created elaborate financial structures that had the appearance of reinsurance but failed to transfer significant amounts of risk to their bank underwriters.

Some of the deals were designed to return a 400% profit on a bank's investment during good years and remain profitable even in the event of a real estate collapse.

Making matters worse, banks allegedly forced unknowing consumers to buy more insurance than they needed and failed to properly disclose the reinsurance agreements, another Respa violation.

HUD's acting inspector general, Michael Stephens, worked on the case before being appointed to head the IG's office last year. He acknowledged the investigation's existence and expressed frustration that the case had not yet produced a settlement or prosecution.

While Stephens said he was still "hopeful" that prosecutors would bring a case, "this thing has been going on for too damn long."

PUNISHING INSURERS

Market observers, analysts and ratings agencies long questioned the reinsurance deals, but banks and insurers publicly maintained they met the standard for arm's-length transactions set out in a 1997 policy letter circulated by HUD. The deals, they said, were not the result of coercion.

What those companies may have believed in private is another matter.

Wells Fargo and **Bank of America** Corp. have settled class-action cases alleging the same sort of misconduct flagged by HUD, and internal documents show that banks and insurers viewed the arrangements as a thinly veiled pay-to-play scheme. Even as insurers complained they couldn't afford the escalating cost of the reinsurance payments, banks threatened or punished companies that balked at providing them, documents obtained by *American Banker* show.

Wells Fargo told one insurer that it should consider giving Wells such deals if it wanted business referrals. After the insurer **MGIC** Investment Corp. announced plans to cut back on banks' share of premiums in 2003, Countrywide executives complained to an MGIC executive and told him that they were shifting Countrywide's business to MGIC's competitors.

"I think we should continue to decrease there [sic] share again," former Countrywide business operations executive Mitch Turley wrote in an email to colleagues that was later obtained by investigators and reviewed by *American Banker*. (B of A bought Countrywide in 2008, after the alleged wrongdoing occurred; Turley no longer works for B of A and did not respond to an interview request from *American Banker*.)

Noting that the mortgage industry was in dire shape when investigators handed their case to prosecutors, the inspector general's office proposed that much of the penalty should be stayed. Even still, the proposed settlement would be the most aggressive action ever pursued under Respa, requiring banks to pay hundreds of millions of dollars in fines and restitution.

> The deals are analagous to a gambler with $10 in chips betting $100 at blackjack.

Although HUD's investigation was referred to the Justice Department last year, people familiar with the case say that prosecutors have done little to advance it. Contacted by *American Banker*, a spokeswoman declined to discuss the case.

Prosecutors had agreed the case was well worth taking when it was first referred to them, said former HUD Inspector General Ken Donohue and others.

"I'm bewildered by why this wasn't pursued on an aggressive basis," Donohue said.

"NO BONA FIDE PURPOSE"

HUD's case began far from its Washington headquarters. Around 2007, Special Agent Julien Kubesh of the inspector general's Minneapolis field office teamed up with the Minnesota Department of Commerce in a review of the insurance on home loans, people familiar with the investigation say.

Mortgage insurance, often required for borrowers without sizable down payments, is a substitute for equity that serves to protect a loan's owner in the event of a borrower default. Banks typically choose the insurance carrier, but borrowers pay for the coverage in the form of higher net mortgage payments. In the industry's early years, there were no financial ties between banks and the insurers.

But Kubesh, a former IRS agent, found that the insurers had taken out reinsurance from subsidiaries of the banks that had produced the loans. Virtually all major lenders had established such ventures, which supposedly shared insurers' risk in exchange for a portion of the insurance premiums.

Kubesh was skeptical of the captive reinsurance agreements, which were entrenched in the mortgage insurance market but at best grudgingly tolerated by HUD in other areas. In a May 2007 settlement, for example, HUD slapped Beazer Homes for using a captive subsidiary to share in the proceeds of title insurance.

"There is almost never any bona fide need or business purpose" for captive title reinsurance, HUD noted at the time, adding that the deals' outsized profitability was "strong evidence there is a sham arrangement" to circumvent Respa.

Banks' captive mortgage reinsurance ventures were little different, Kubesh and his colleagues came to believe.

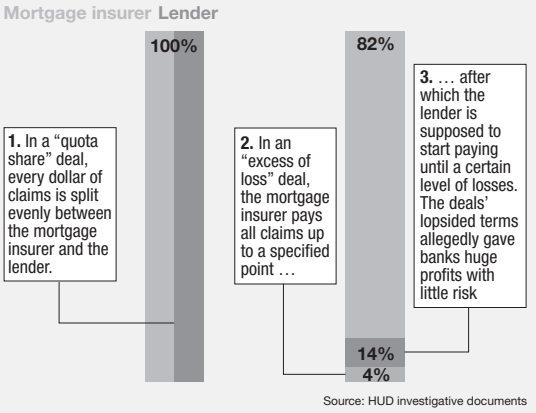
While designed to look like reinsurance, the deals weren't built to perform like it. The problem was how they split up the risks and rewards of insuring homeowners' mortgages.

When it comes to insurance, "if I get 50% of the profits, I have to take 50% of the risks," said Herman Thordsen, a California attorney who defends companies accused of Respa violations. "If they're not doing that, then there's likely a violation. And disclosure has to be there, absolutely."

Banks fell far short of both those standards with their captive reinsurance schemes, investigators and the companies' own records suggest. Over the course of two years, Kubesh and other investigators concluded that captive mortgage reinsurance had devolved into a way to hide illegal business referral fees.

Reinsurance vs. Kickbacks

How losses are split in reinsurance deals



Source: HUD investigative documents

THE $0 RESERVE

For a reinsurance agreement to be legitimate, it has to transfer risk from an insurer to a reinsurer. One simple way to do that would be for the insurer and the reinsurer to each collect a portion of the insurance premiums and each pay a similar portion of the insurance claims. In reinsurance, this is called a "quota share" structure.

A different way to split the risk is what's called an "excess of loss" arrangement, in which the insurer has to pay all claims up to a certain point, when the reinsurer steps in. Figuring out how to divide the premiums is now harder, because in the event of a loss the insurer and the reinsurer will no longer bear the load evenly – if the losses are modest, the reinsurer might not have to pay anything at all.

Still, so long as both the insurer and reinsurer hire actuaries and bargain for their own interests, the resulting agreement should make the reinsurer's reward proportionate to its risk.

Banks started demanding the excess-of-loss reinsurance deals in the mid-1990s. Unlike in the example above, however, the two parties didn't have equal leverage. The mortgage insurers' entire business depended on keeping the banks happy, and HUD investigators concluded that they gave banks reinsurance deals that would be profitable in virtually every circumstance.

This was partly because the initial terms of the deals were generous – the reinsurance vehicles collected 40% of the premiums but were responsible for a maximum of 10% of the losses – but also partly because insurers let banks tweak the terms of deals in their favor.

According to investigators, the contracts gave banks a large cushion before they would have to start paying claims. The partnerships excluded high-risk loans from the reinsurance coverage. And the deals were "self-capitalizing," meaning that a bank could fund its stake with incoming premiums. If the deal went bad, the bank could walk away and leave the insurer to cover its losses.

Conceptually, such arrangements are analogous to letting a gambler with $10 in casino chips place a $100 bet at a blackjack table on the assumption that he'll win. A 2003 Standard & Poor's analysis modeled the most popular type of deal and found that in the event of high claims, the reinsurance vehicle's funds wouldn't be enough to cover the losses it was supposed to take on.

"The captive is unable to pay its full contractual exposure," S&P wrote.

The deals had yet another unusual sweetener, investigators alleged.

Each of a bank's reinsurance vehicles was legally separate not only from the bank's main reinsurance subsidiary but also from all the other funds. If a reinsurance deal didn't have enough money to pay its obligations, the bank could abandon it and leave the mortgage insurer with the unpaid bill.

To carry on the casino analogy above, it would be as if the gambler with $10 in chips were allowed to make that same $100 bet at ten different blackjack tables, collecting on the winning bets and renouncing the losers.

Documents reviewed by *American Banker* suggest banks may have agreed they were not taking on significant risk.

At one point, Countrywide's Balboa Insurance division crunched the numbers to determine how much it should reserve for potential losses from the deal. The answer, the actuaries concluded, was "$0," according to a reserve analysis obtained by investigators and cited in a report to the Department of Justice.

All the same, banks persuaded state insurance regulators to sign off on the structures. To judge whether the reinsurance agreements were fair, state officials relied in part on actuarial analyses submitted by the banks and insurers.

"Review of these opinions has found them to frequently contain significant defects and omissions which render them inapplicable to the actual reinsurance agreements executed," HUD investigators later concluded.

"DEEP CEDE"

With state regulators blessing the deals, the captive mortgage reinsurance business was off to the races. Not everyone involved was thrilled about it.

Mortgage insurers, which had initially used reinsurance deals as a marketing tool, were unpleasantly surprised to find that banks demanded an ever-increasing share of the premiums.

Banks considered the insurers to be interchangeable, and companies like Wells Fargo made it clear as early as 2000 that they wanted "deep cede" deals in which their captives would receive as much as 40% of the insurance premiums in return for providing reinsurance.

In letters to insurer Triad Guaranty from the beginning of the last decade, Wells demanded that Triad "demonstrate a willingness to discuss a captive reinsurance structure with a 40% net ceded premium" in order to receive Wells' future business, according to a HUD investigators' report submitted to the Department of Justice. Further clarifying its demands, the company wrote that "consideration will be given to enhancement of our returns." Triad is now in liquidation.

Wells Fargo said in a written statement to *American Banker* that risk was split equitably under its contracts with mortgage insurers. It further denied that its captive reinsurance arrangements had ever been under HUD investigation.

"It is simply not true that Wells Fargo has ever been the subject of a HUD investigation involving either our captive reinsurance programs or our relationships with any private mortgage insurance company," the statement says.

"FEEDING THE BEAST"

Over time, the insurers came to realize that offering banks a taste of their profits only increased their demands for further financial concessions.

The aggressive revenue sharing was ruining insurers' profitability and emboldening lenders to demand even more outlandish deals in a cycle GE Capital Mortgage Insurance called "feeding the beast," a dour 1999 presentation to CitiMortgage noted.

The insurer – which eventually split from **General Electric** to become **Genworth** – was pressing Citi to restrain its demands. Ratings agencies and analysts were already flagging reinsurance deals as legally dubious, the insurer warned in a Power Point presentation obtained by HUD investigators, and "the MI industry and lenders won't be able to defend/sustain these structures."

Genworth declined to discuss the presentation.

"Captive reinsurance and excess of loss reinsurance structures have been a feature of the insurance industry for decades," a Genworth spokesman said in a written statement. "Genworth's arrangements with lender-affiliated reinsurers were structured in compliance with guidance from HUD."

> "The industry won't be able to defend or sustain these structures," an insurer warned.

Genworth further argued to *American Banker* that claims paid by the captive reinsurers in the wake of the mortgage industry's collapse proved the legitimacy of the financial structures. The captive reinsurers to which Genworth ceded premiums have covered a total of $850 million in claims, the company said.

But, as HUD's inspector general reported to the DOJ in 2009 – and as one investigator confirmed to *American Banker* recently – the fact that captive reinsurers paid claims does not mean the structures were unprofitable for the banks.

At least some of the deals were so generous that banks would still turn a profit even in the event of catastrophic claims, a Moody's Investors Service analysis cited by investigators found.

Because banks profited from selling their borrowers insurance, they sold it aggressively. In a presentation to the Department of Justice, the inspector general's investigators claimed that banks forced borrowers to buy more expensive policies than they needed.

"Nearly all loan files reviewed show borrowers with excessive coverage placed on their loan," the presentation concluded.

Most of the time, lenders did not tell borrowers in advance that their captives were reinsuring the deals, HUD investigators reported to the DOJ. In some cases, banks allegedly told customers that the charge for the reinsurance was "none."

Banks and insurers that spoke to *American Banker* denied that they had sold unnecessary or improperly disclosed insurance.

"Wells Fargo provided disclosures to consumers regarding its captive reinsurance programs along with the ability to opt out of reinsurance arrangements," a Wells spokeswoman told *American Banker*. SunTrust declined to comment for this story.

"CitiMortgage provided disclosures to borrowers and they were offered the choice to opt-out, which many did," a spokesman for Citigroup wrote. "This choice has no impact on the premiums charged to the borrower."

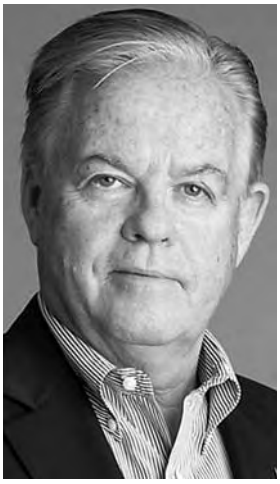
PASSING THE BATON

HUD Inspector General Ken Donohue – and his deputy, Mike Stephens, who succeeded him last year – were confident that they had a case. Initially the project of one regional investigator, the captive mortgage reinsurance probe drew the attention of senior officials in the inspector general's office as well as the Respa enforcement staff elsewhere in HUD.

In the summer of 2009, Kubesh and Minnesota Department of Commerce staff came to Washington to present their findings to the Department of Justice.

The DOJ said it wanted take the matter on, according to Inspector General Stephens and others. Six months later, HUD's attorneys formally referred its case to prosecutors, effectively ending the housing agency's involvement. Investigators believed a speedy settlement in the hundreds of millions of dollars was likely, and HUD's investigators even suggested that the proceeds should be used to pay for mortgage counseling for borrowers who were allegedly victims of kickback schemes.

Major banks deny that their reinsurance agreements were illegal, but they have not been eager to defend them in court. In July, B of A spent $34 million to settle a Respa class-action suit accusing Countrywide of taking the same mortgage insurance kickbacks alleged by HUD investigators.



FRUSTRATED: It has taken "too damn long" for prosecutors to move on HUD's findings, says Stephens, left, who succeeded Donohue as inspector general.

In court filings before that settlement, Countrywide's attorneys argued that eventual payouts made by the company's captive reinsurance vehicles demonstrated that they had taken on real risk.

A Bank of America spokesman made the same argument to *American Banker*.

"[W]hen loan default rates are low – there would be limited or no reinsured losses; and in other years – when loan default rates are high – there would be significant reinsured losses and, correspondingly, significant reserves," he wrote.

Court filings show that Countrywide paid zero reinsurance claims between 2000 and 2006. What losses Countrywide might have later sustained from the deals, however, is not in the public record.

Under an agreement between Countrywide and the plaintiffs' attorneys, case files documenting the company's alleged behavior – as well as how much it earned from reinsurance deals – were sealed by Judge Paul Diamond of the Eastern District of Pennsylvania.

Wells Fargo has also reached a preliminary settlement with the same law firm, Kessler Topaz Meltzer & Check LLP, in a case alleging "a secretive conspiracy to circumvent Respa's prohibition on kickbacks and unearned fees." A Wells spokeswoman said the company's decision to settle the case does not mean that the allegations had any merit.

"GETTING KICKED AROUND"

More than a year and a half after the Department of Justice took over the case, no settlement has been reached and there is serious doubt as to whether the case even remains active.

Bank of America has not received any HUD inquiries on the subject of Countrywide's captive mortgage reinsurance since 2008, according to a company spokesman, and is unaware of any current review of its deals.

People familiar with the case believe it may have stagnated because demonstrating that the captive reinsurance amounted to kickbacks would require accounting expertise that the Department does not possess.

HUD staffers who initially put the case together have moved on to new jobs. Just last month, HUD's authority to enforce Respa expired, and its responsibilities were transferred to the new **Consumer Financial Protection Bureau**.

The bureau declined to address questions from *American Banker* about whether it intends to pursue the matter.

The agency has hired at least two former enforcement officials from HUD who are familiar with the case, however. Both referred questions to the CFPB's press office.

"While we continue to build and staff our enforcement program, the CFPB is capable of exercising its Respa enforcement authority now," says a CFPB official.

If the Bureau doesn't take the case, there is also the possibility that Minnesota officials or another state would readopt it, Acting Inspector General Stephens and other people familiar with the case said.

"This thing is getting kicked around," Stephens said, arguing that a lack of enforcement on such matters has eroded consumers' faith in the process of buying a home. "The mortgage companies ... are responsible for those people feeling that way," he said.

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NEXT: How regulators and trial attorneys allowed banks to collect alleged kickbacks for a decade.

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dailybriefing

1 Mortgage Crisis: Do We Hear $100B? $130B? More?
Faulty mortgages and foreclosure abuses have cost the nation's five biggest home lenders at least $65.7 billion, and new claims may push the industrywide total to twice that amount. Bank of America? $39.1 billion since the start of 2007. JPMorgan Chase? $16.3 billion. The list goes on. **Page 5**

2 Home-Rent Plan May Be Easier in Theory than Practice
It's a great idea: turn the hundreds of thousands of vacant, foreclosed homes controlled by the federal government into rentals. The strategy faces enormous operational obstacles, however, including disagreement over the appropriate policy goals and questions about how to account for local nature of real estate across the United States. **Page 1**

3 Not Lending, New Business Banks Are Consolidating
Capital heavy and finding few lending opportunities, more young business banks are opting to sell themselves. **Page 3**

4 Missed Chance to Stop Mortgage Insurance Kickbacks
It was an open secret for years that in exchange for steering homebuyers to insurers, mortgage lenders were demanding unjustifiably lucrative reinsurance deals. Today, a HUD file alleging such kickbacks sits – and sits – at Justice, awaiting prosecution. If federal regulators, including HUD, state regulators, mortgage insurers and others had acted on what they knew, however, the alleged wrongdoing could have been addressed long ago. **Page 1**

5 Left at Altar by Fundtech, S1 Wants to Stay Single
S1 said its planned merger with Fundtech has been terminated. But S1's board still does not want the company to be bought by hostile suitor ACI Worldwide. **Page 11**

6 No Merit to Lawsuits Against Him, Perry Says
Mike Perry, who led IndyMac until its 2008 collapse, tries to rehabilitate his image. **Page 4**

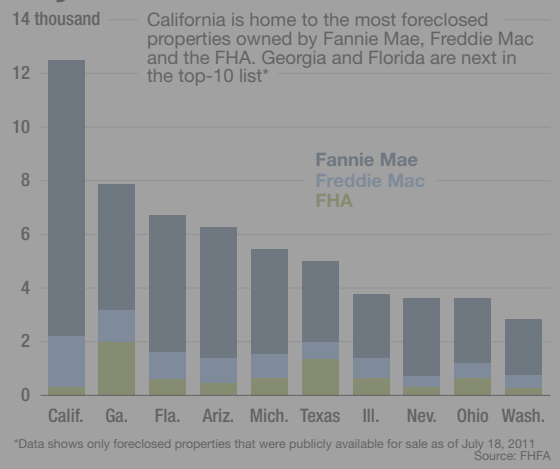
7 Mobile Phone Payments Not Quite Ready for Tap Dance
MasterCard is preparing for the launch of Google's mobile wallet, but executives do not expect to see consumers regularly paying with their phones anytime soon. **Page 4**

8 Basic Guidelines for Advanced Data Encryption
If a merchant plans to use advanced data encryption as a credit card data security measure, the Payment Card Industry Security Standards Council has some guidelines, just released, for how best to go about it. **Page 11**

9 Citi Streamlines Checking-Fee Regime
Starting in December, Citigroup is raising the fees it charges customers for basic checking accounts. It will also stop issuing debit card rewards. **Page 2**

10 Mississippi's First M&F Trims Down
First M&F is looking to divest itself of six branches, roughly 14% of its offices. The Mississippi company said the initiative is driven by the need to improve efficiencies and better prepare the company for uncertain economic times or growth opportunities. **Page 11**

Buyer's Markets



*Data shows only foreclosed properties that were publicly available for sale as of July 18, 2011
Source: FHFA

Foreclosure to Rental Great In Theory, Tough in Practice

By Kevin Wack

WASHINGTON – What seems like a no-brainer – turning the hundreds of thousands of vacant, foreclosed homes controlled by the federal government into rental units – is going to be tough to accomplish.

The logic behind the idea is compelling. Across the country today, the federal government controls around 250,000 foreclosed homes, through Fannie Mae, Freddie Mac and the Federal Housing Administration. Over a million more are in the foreclosure pipeline, with homeowners having fallen well behind on their mortgage payments.

Vacant homes deteriorate quickly. And the government is selling these homes individually at what some consider fire-sale prices, often to cash-paying investors, because it is hard to get financing to buy them.

At the same time, rental housing is becoming scarcer. The nationwide rental vacancy rate is currently 9.2%, its lowest level since 2002.

"You have people thrown out of their homes who are now finding it very difficult to afford to rent a modest place just to put their family," Sen. Jack Reed, D-R.I., said in a recent speech.

So the Obama administration is looking for a way to turn the real estate owned homes, or REOs, that it controls into rental housing.

"I would argue that this approach can create value if done carefully and diligently, not just minimizing losses," said Reed, a longtime champion of the idea. "The other way to look at it is: if five years from now, nothing's done, those houses are going to be, you know, it's a ghost town. The pipes will be gone. The roofs

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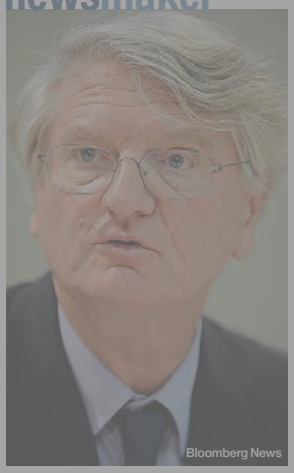
newsmaker


Bloomberg News

ARE YOU SURE? BNP Paribas' Baudouin Prot says BancWest is not for sale, but domestic banks hope troubled European institutions with U.S. units change their minds.

See page 2

Regulators Fiddled as Kickbacks Thrived

Mortgage insurance market red flags unheeded for years

By Jeff Horwitz
Second of a two-part series

Eight years ago a Bear Stearns research report on the mortgage insurance industry warned of a grave threat: in exchange for steering homebuyers to the insurers, mortgage lenders were demanding unjustifiably lucrative reinsurance deals.

"We find it difficult to understand how some of these arrangements conform" with legal prohibitions on mortgage kickbacks, Bear analysts wrote.

Six years later in 2009, amid the wreckage of the biggest housing bust in history, federal investigators concluded that what Bear had called sweetheart deals were just that. Beginning in the late 1990s major U.S. banks began coercing insurers into cutting them in on what would ultimately amount to $6 billion of insurance premiums in exchange for assuming little or no risk, investigators

See page 6

FLASHBACK — 1956

Holding Companies Pressure Ike to Veto Bill

According to reliable sources, an effort is being made to persuade the President not to sign the Bank Holding Company Bill.

Some of them apparently had been assured that the amendment by Sen. Douglas wouldn't pass. The amendment had to do with prohibitions against crossing state lines.

Read the original article at AmericanBanker.com/175

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RISK MANAGEMENT

Mortgage Kickback Scam Thrived Amid Reg Inaction

Continued from page 1

in the inspector general's office at the Department of Housing and Urban Development alleged. Inspired by the oversized profits, bankers further were found to have sold unwary homebuyers more mortgage insurance than they required.

As reported by *American Banker* on Sept. 9, the HUD inspectors presented their findings to the **Department of Justice** a year and a half ago in a bid to start a case against many of the nation's largest banks. The DOJ has taken no public action to date and declines to comment. It is one of several entities that appear to have failed to address the apparent wrongdoing, despite ample warning signs. They include the HUD officials who oversaw home lending for two decades, state regulators, mortgage insurers and class-action attorneys.

Though their institutions reaped large short-term profits from the captive reinsurance arrangements, in the end the bankers may have outsmarted even themselves by foisting insurance risk onto others.

"It gave the banks a false sense of confidence that they didn't need to pay attention to underwriting standards," says Joshua Rosner, managing director of Graham Fisher & Co., an independent research boutique.

COUNTRYWIDE LEADS

The alleged reinsurance kickbacks evolved from what was originally prudent practice. Bankers wanted to share in the profitable business of insuring mortgages against default. Insurers welcomed them to ensure careful underwriting. Early reinsurance agreements fulfilled both objectives by granting banks the premium revenue equal to the risk they incurred.

That began to change in the late 1990s at the behest of Angelo Mozilo, the pugnacious chief executive who built Countrywide Financial Corp. into the nation's largest home lender. Under Mozilo, Countrywide pushed into nontraditional areas such as low-documentation lending, property appraisals and title work. In mortgage insurance, Countrywide became the first lender to forge a risk-sharing arrangement known as "excess of loss."

Under a 1996 deal with Amerin Guaranty, a mortgage insurer absorbed in 1999 by **Radian** Group Inc., Countrywide's captive insurance subsidiary split risks unevenly. The agreement put the insurer in the first-loss position, meaning that Countrywide would only pay claims if they rose to a high level. Goodbye to proportional loss-splitting.

HUD's assistant secretary for housing declared in a 1997 opinion letter that such deals were acceptable, as long as they were not the result of coercion and transferred risk. "The reinsurance transaction cannot be a sham," the HUD letter stated.

With the pattern in place and the mortgage market heating up, home lenders pressed for increasingly favorable terms. That included so-called "4-10-40" deals in which the mortgage originators received 40% of premiums in exchange for reimbursing insurers for no more than 10% of claims – and even then only after the most likely 4% of losses were incurred.

Within a few years, excess-of-loss deals had become outright shams, the HUD inspector general's office later concluded. In addition to the 4-10-40 structures, investigators found terms were altered in numerous ways to benefit lenders, including SunTrust, GMAC, CitiMortgage and Countrywide. The biggest tweak was to make policies "self-capitalizing." Banks were required to put only "nominal initial capital" into the trusts that backstopped the reinsurance policies, according to a 2000 presentation to CitiMortgage by a predecessor of Genworth Financial. Banks' stakes were largely funded only as premiums came in from homebuyers.

The extent to which this occurred and the degree to which it advantaged the banks struck the HUD inspector general's office as highly unusual. The banks were supposedly providing catastrophic reinsurance, but the policies appeared to render it impossible that they'd ever suffer significant losses. In the event of catastrophic losses, a bank could simply walk away from its nominal initial investment and leave the insurer to bear the other costs.

Actuaries hired by the insurers signed off on such deals as meeting the narrow requirements for risk transfer. However, the policies were a bad deal for insurers in almost every circumstance, HUD investigators concluded. If defaults remained low, banks would pocket large premiums without paying any claims; if defaults were high, banks' losses would be capped at the amount of their small initial investments, plus the premiums paid by homeowners and passed along to them by their mortgage insurance partners. In other words, it appeared to be a no-lose proposition for the banks.

INSURER COMPLICITY

How banks supposedly got away with demanding kickbacks through sure-bet reinsurance deals harks back in part to the actions of the insurers themselves. As the excess-of-loss arrangements became more favorable to the banks, mortgage insurers complained regularly that they were bad business for them. Standard & Poor's agreed. The worst deals were slashing insurers' profit margins without reducing their risk, it declared in a 2003 report.

MGIC Chief Executive Curt Culver finally stood up. He was a longtime industry hand who arrived at the company in 1982 and took over as its leader in 2000.

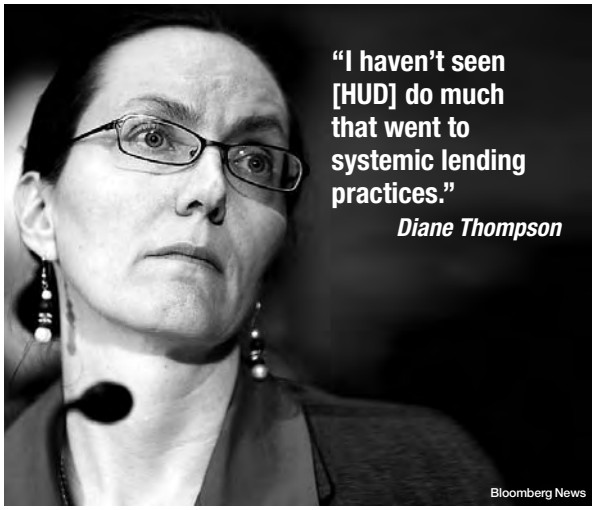
> "Banks got a false sense of confidence that they didn't need to pay attention to underwriting standards."

Two years later Culver announced MGIC would cap at 25% the share of total premium revenue shared with banks' captive reinsurance units.

"Frankly, the returns are unacceptable," Culver told analysts during a 2003 earnings call of 4-10-40 deals. "How can you run a company where you lose money on each policy that you write and justify that business?"

Revolting against the deals was certain to cost MGIC short-term market share, Culver admitted. But the pain would be minimized if other insurers followed suit. "I would think the whole industry would like to see this happen," said Culver, who still runs MGIC.

Analysts and ratings agencies applauded. MGIC's step "could constitute a critical mass that emboldens most or all of the industry to discontinue the 4-10-40 product as well," S&P wrote in 2003.



The faith that Culver and the ratings agency put in the industry proved misplaced. Countrywide started yanking business from MGIC even before its prohibition of 4-10-40 deals went into effect, internal company email obtained by HUD shows. Meanwhile, MGIC rivals rushed to take away customers. Culver ultimately abandoned MGIC's hard line.

"We tried to stem the tide, and that was unsuccessful," says Michael Zimmerman, MGIC's head of investor relations.

The episode has left MGIC in an awkward position. It concedes the captive reinsurance deals were terrible business propositions while insisting it willingly entered into them. Doing deals in exchange for business referrals "would be a violation of Respa," Zimmerman says, referring to the 1974 Real Estate Settlement Procedures Act, which prohibits payment of unearned fees. Rather it was unspecified "market forces" that prompted MGIC to enter into the deals, Zimmerman says.

"A KICKBACK SCHEME"

Individual homeowners proved equally impotent in opposing the banks. **Fannie Mae**, **Freddie Mac** and private investors required borrowers with low down payments to purchase mortgage insurance, which protects them against default. The homebuyer pays for the policy; lenders are the beneficiaries.

Few homeowners were ever told about the excess-of-loss arrangements, HUD's inspector general alleges. Even if they were, it would have been of no practical benefit since mortgage insurers charge standard rates.

Class-action attorneys likewise did little to alter industry practice. Respa recognizes private litigation as form or redress against kickbacks in the housing market. Under Respa, plaintiffs lawyers filed a series of class actions in 2000 on behalf of homeowners against industry leaders including **PMI** Mortgage Insurance Co., **Triad** Guaranty and GE Mortgage Insurance Co. (later spun off as **Genworth**).

A "concerted kickback scheme" is how attorneys described the arrangements in a suit brought in the U.S. District Court for the Southern District of Georgia against GE. The reinsurance fee that GE was paying to captive reinsurers "far exceeds the value of the risk assumed by the captive company and on terms more favorable than that provided to other reinsurers," attorneys for Milberg, Weiss, Bershad, Hynes & Lerach LLP and other firms wrote in wrote in Douglas v. General Electric Mortgage Insurance Co. Ten years later the HUD inspector general's report used virtually identical language.

Courts dismissed some suits, but banks paid millions of dollars to settle others. It did little to alter their behavior. In Douglas v. General Electric, for example, thousands of homeowners received $35.47 each; their lawyers received around $2 million. The four other settlements had similar terms.

Banks also agreed to have actuaries sign off on the validity of future reinsurance deals. Even so, they do not appear to have foreseen a big change in practices. GE Mortgage Insurance warned in a **Securities and Exchange Commission** filing it could be sued again within a few years for similar behavior.

"Any future claims made against us could allege ... that we violated the terms of the injunction," the company warned.

That class-action attorneys failed to reform the industry is

perhaps not surprising. If their financial incentive to do so was limited, so was their leverage: the court in the Douglas case noted that the plaintiffs' case faced procedural weaknesses. Attorneys involved in the 2000 case did not respond to interview requests.

"Litigation is a rough tool to try to reform industry practice," says Diane Thompson, an attorney for the **National Consumer Law Center**. Even so, "there's a general principle that you don't just do coupon settlements, that you want to get injunctive relief," she adds.

REGULATOR INACTION

One entity that faced fewer obstacles in enforcing Respa was HUD, which can address alleged violations through administrative actions or referrals to prosecutors. However, during the formative years of the housing bubble the agency largely limited itself to pursuing misconduct by individual companies.

"I haven't seen them do much that went to systemic lending practices," Thompson says of HUD's early efforts.

A spokesman for the department disagrees, arguing that HUD never signed off on the terms of specific captive reinsurance deals. Conversely, there is no record that HUD ever looked into whether the deals violated Respa, even as banks' rapidly expanded their captive mortgage reinsurance operations in ways that raised red flags at Bear Stearns, S&P and among the plaintiffs' bar.

In its 2009 presentation on captive mortgage reinsurance to the Department of Justice, officials from its inspector general's office said that HUD had missed opportunities to act. If DOJ prosecutors took the case, as the investigators argued they should, they needed to be aware of the "perception that the Department [HUD] allowed captive mortgage insurance arrangements" and then opposed them "after the fact."

HUD officials may have failed to intercede during the housing boom, but Vermont insurance regulators were vital in enabling the mortgage reinsurance business to flourish to begin with, the inspector general's office concluded.

Vermont has long promoted itself as a captive insurance haven as a way to capture tax dollars. Its insurance division boasts on its website of the "friendly" approach to captive insurance taken by Vermont, which ranks as one of the world's top three domiciles with Bermuda and the Cayman Islands. Among the captive reinsurance units set up in Vermont were those of Countrywide, GMAC and **Citigroup**.

The Captive Insurance Division of the **Vermont Department of Banking, Insurance, Securities and Health Care** approved insurance structures and accounting maneuvers that the HUD investigators later concluded violated both the law and basic principles of insurance, documents indicate. Vermont regulators signed off on actuarial opinions from banks and insurers that failed to accurately describe the terms of the reinsurance deals in question, overpaid banks for the risk they were taking and allowed banks to claim insurance trust accounts were capitalized with money that had been explicitly deemed off-limits for claims-paying purposes, HUD investigators alleged.

In one instance the Countrywide captive insurance subsidiary, Balboa Reinsurance, asked its actuaries to determine how much it would need to set aside to cover insurance losses, according to documents obtained by HUD investigators. "We believe that a reserve of $0 would provide adequate provision for all of Balboa's outstanding loss and loss adjustment expense liabilities," the actuaries wrote in an undated analysis.

> It took the collapse of housing prices to shut down the captive reinsurance business.

The terms were so favorable to Balboa that it actually proved troublesome, documents from Countrywide's insurance subsidiary show. The company did not want to disclose in accounting statements that its captive insurance subsidiary was getting paid for taking no risk. Setting aside assets to cover claims would give the deals a patina of legitimacy, but it did not "conform to statutory accounting guidelines" for insurance, according to the company's own analysis.

Faced with the prospect of either tacitly admitting that it was not taking on actual risk or filing financial statement that did not conform to accounting guidelines, Balboa was rescued by Vermont insurance officials.

"Balboa has received approval from its Vermont regulators to establish such a reserve as permitted practice," the company's analysis concluded.

David Provost, deputy commissioner of Vermont's captive insurance division, said he disagreed with the HUD investigators' contention that there had not been an adequate transfer of risk to the captive reinsurers. State insurance officials have discretion in approving accounting decisions, and actuarial opinions can be subjective, he added.

"I think we have placed reasonable reliance on the opinions of the actuaries that opined on the transactions," he told *American Banker*. "It sure seems that HUD or others could have looked at a few contracts or hired an actuary to determine if this was suitable in their eyes, rather than waiting 20-plus years to conduct a very expensive investigation."

BANK PAYBACK

The collapse of housing prices did what corporate executives, lawyers and regulators failed to accomplish – it shut down the captive mortgage reinsurance business.

As the residential bust unfolded mortgage insurers got hammered. Triad Guaranty was ordered by state regulators to cease writing new business. Other firms lost more than 90% of their market value.

How banks ultimately fared on the deals isn't entirely clear. New plaintiffs attorneys launched a second round of class actions in 2007 alleging that **Wells Fargo** and **Bank of America** (which acquired Countrywide in 2008) reinsurance subsidiaries paid no claims whatsoever between 2000 and 2006.

Given mortgage insurers' devastating losses in the years since, the banks' subsidiaries have presumably been required to cover at least some claims through the assets built up with homeowner premiums. How much the bust has cost them is not public.

The information was redacted from class action filings in the U.S. District Court for the Eastern District of Pennsylvania, where both Wells and Bank of America have been sued for allegedly receiving mortgage reinsurance kickbacks. Both companies are now in the process of settling those cases. Bank of America did not respond to a request for comment on the overall profitability of its captive reinsurance deals, and Wells Fargo declined to address that matter. Both banks have maintained that the reinsurance deals were legitimate.

There is reason to believe the banks were net winners on the reinsurance deals, however. According to MGIC's Zimmerman, his company has passed on more in net premiums to reinsurers than it has recovered from them to cover claims.

A even larger issue than kickbacks and risk-sharing is at work, industry observers say. Given the time frame in which the excess-of-loss policies were rolled out, the arrangements may have helped undermine lenders' underwriting standards.

Originally, risk-sharing among mortgage insurers and banks was supposed to ensure that both had an interest in minimizing claims. By adopting excess-of-loss structures that sheltered the banks from substantive losses, banks created an incentive to underwrite riskier mortgages.

These days the mortgage insurers' losses are coming back to bite the banks. With their capital decimated and little to lose, the insurers are now aggressively seeking to make the banks share the pain. In the second quarter of this year alone, Radian denied or rescinded coverage on $193 million in claims due to what it says are underwriting practices that render some policies ineligible for coverage.

Radian intends to deny at least $650 million more in future claims. Other insurers are making similar moves. Early this year PMI Group Inc. told investors it aimed to recoup $1.3 billion by denying claims.

"What this all led to is the mortgage insurers becoming not insurers but [insurance policy] rescission companies," says Graham Fisher's Rosner.

As banks have learned in other parts of the housing market, when the entire system gets into trouble all bets on transferring risk are off.

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