**The Mortgage Industry: Where are the Standards?**

Catholic University of America

Strategic Standardization
(CMGT 564)

Kevin T. Karow August 7, 2008

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**INTRODUCTION**

Simply put, the United State's mortgage industry is a mess. Thousands of Americans are currently facing or have already experienced foreclosure, forcing them to abandon their homes and seek shelter elsewhere. The reasons behind the sudden and dramatic downturn in the housing market are debatable and complex; however, I believe that much of the blame rests with the complete lack of standards in the mortgage industry. If there were strict, defined, and followed loan standards, America wouldn't be in the dire economic position it finds itself in.

The mortgage problem has not gone unnoticed, and the situation now has politicians and other federal agencies involved. Congressmen, Senators, and the President are taking action to pass laws to prevent people from losing their homes because they can no longer afford to make the mortgage payments. Even recently, as of July 30th, President Bush signed a massive new law to rescue the thousands of people facing foreclosure. Many of those facing foreclosure were approved for mortgages they could not afford and were not aware of the risky mortgages they were agreeing to. Even state governments are getting involved by investigating mortgage lenders for deceptive lending practices.

Mortgages are important because they allow people to purchase homes, providing them shelter for their health and safety. After all the recent economic fallout, banks are only now raising their lending standards. However, it's too late and significant damage to our economy has already been done. Lax mortgage standards are a significant contributing factor to the dire economic situation America is now in. Analyzing the current mortgage process and its drawbacks, there are important observations and recommendations to be made to standardize the industry. Implementation of these standards would improve the future of the mortgage industry and, consequently, the U.S. economy.

## IMPORTANCE OF MORTGAGE STANDARDS

> [W]e're facing a credit crisis of very broad potential damage, the likes of which we haven't faced since the early thirties. What has happened is, by giving mortgages to people who really didn't qualify, we've created a problem that's having a domino effect. This problem is worldwide.[1]

Mortgages are important because they allow people to purchase a home that they could not afford would they be required to pay for the house all at once. For younger individuals or even newlywed couples, there are certain mortgages that allow them to purchase a home with little or no money required for a down payment. Mortgages *usually* aren't given to just anyone; individuals have to apply through a mortgage lender, usually a bank, to ensure that they can afford to make the monthly payments of the mortgage. Banks use lending standards to check the credit worthiness of the loan applicant. A credit check is critical to banks because this can ultimately decide whether a person can afford to pay off the loan. However, when banks disregard their standards and issue loans to people who can't afford to pay them, the consequences affect everyone.

Once and individual signs a mortgage, he has very few options to get out of the mortgage agreement. In many cases, when the homeowner can't afford to pay the mortgage, the only option is for him to default on the mortgage and abandon the house entirely. This places both the bank that issued the loan and the person who agreed to the loan in a difficult position. The bank is not getting paid back for the money that it loaned, and the borrower has no home and a ruined credit history. Many people, including children, are now homeless because a bank offered and a borrower subsequently accepted a mortgage that he or she could simply not afford.[2] Strict mortgage standards are critical to banks, borrowers, and the success of the U.S. economy.

**TYPES OF MORTGAGES AND STANDARDS**

Mortgage loans could essentially be considered a standard in themselves. Since a standard is an agreed-upon way of doing something through a set of requirements or rules between parties, a mortgage loan, likewise, is an agreed-upon way of loaning money from one party to another. Banks loan money through a mortgage to an applicant who agrees to pay the money back. The person receiving the loan usually uses the money to purchase an expensive piece of property, in our case a house.

There are numerous types of mortgage loans you can choose from depending on how you would like to pay the loan back. The two major types are fixed rate mortgages and adjustable rate mortgages. Fixed rate mortgages have a set interest rate that does not change during the duration of the mortgage. Fixed rate mortgages are the most common type of mortgage and are issued for 30 (or sometimes 15) years. Adjustable rate mortgages, also known as ARMs, do not have a set interest rate for the life of the loan. Rather, the interest rate is set for a certain amount of time, and then increases after that time is up.

ARMs come in an assortment of types, so they can be very complex. There are 1-month, 1-quarter, 1-year, 3-year, 5-year, and even 7-year ARM options. This means that if you choose a 3-year ARM, your interest rate will stay the same for the first three years, and then change after the third year. There are also caps on the interest rate after your initial rate has adjusted. The first type is a periodic adjustment cap— this limits how much your interest rate can change from one adjustment period to the next. The second type is a lifetime cap. ARMs, by law, must have lifetime caps that limit how high your interest rate can be over the life of the loan.[3]

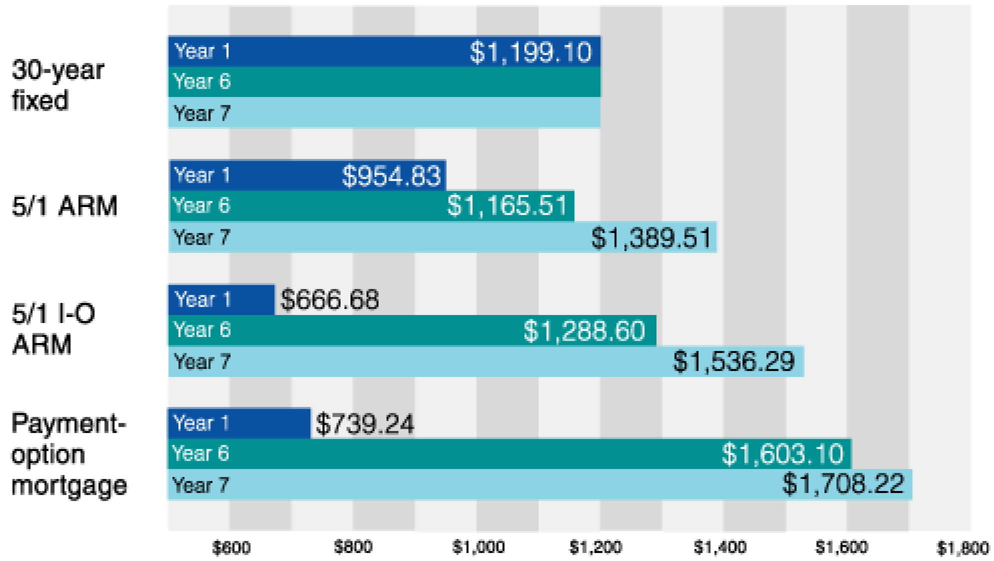
To complicate things, in addition to the length of the ARM varying, there are different types of ARMs depending on what part of the loan you are paying back. Hybrid ARMs are the most common. Hybrid ARMs have a set interest rate initially and increase after a predetermined amount of time. For example, an ARM that has a set interest rate for the first five years before it increases would be written as a 5/1 ARM. The first number (5) represents the length that the interest rate is fixed, the second number (1) represents how often the interest rate will adjust after the fixed interest rate ends.[3]

With Interest Only (I-O) ARMs, the borrower pays back only the interest (not the interest and principle) of the loan for a specific amount of time. The advantage of this type of loan is that it allows the borrower to pay less money initially. However, since this is an ARM, eventually the loan will adjust and the borrower will start to bay back the interest and principle of the loan. Additionally, the interest rate can increase to make the new payments significantly higher than the first mortgage payments.

The final type of ARM is the Payment-Option Only ARM— it is probably considered the most risky to take. With a Payment-Option ARM, the borrower can pick from several payment options each month. You can select the traditional payment where you pay back the principle and interest, lowering the amount you owe on the mortgage. You can choose to pay back only the interest, or you can choose to make a minimum payment. The minimum payment option is especially risky because:

> [T]he amount of any interest you do not pay will be added to the principal of the loan**,** increasing the amount you owe and your future monthly payments, and increasing the amount of interest you will pay over the life of the loan. In addition, if you pay only the minimum payment in the last few years of the loan, you may owe a larger payment at the end of the loan term, called a balloon payment.[3]

The following figure from the Federal Reserve's website shows what your monthly payments could be for a $200,000 loan depending on what type of mortgage you select:[3]




It is easy to see how your monthly payment can dramatically increase depending on what type of loan you choose. Interest-Only ARMs and Payment-Option ARMs, especially, can cause very large monthly increases; where the traditional 30-year fixed mortgage has no monthly increases. Borrowers who fail to fully understand the concept of an ARM could be in a serious financial situation when the loan resets and the interest rate increases.

**SUBPRIME MORTGAGES**

Most borrowers are eligible for what is called the prime interest rate. A prime interest rate is the rate given to borrowers who are in a good credit status. Borrowers who are not in good credit status are often only eligible for a subprime mortgage, meaning the interest rate is higher than prime mortgages. An estimated 15% of all mortgages are subprime mortgages, which also tend to be risky ARMs.[4] "The nonprime [subprime] boom introduced practices that made it easier to obtain loans. Some mortgages required little or no proof of income; others needed little or no down payment. Failure to appreciate the risks of nonprime loans prompted lenders to overly ease credit standards."[5]

With all the negative talk surrounding subprime mortgages, the American Dialect Society subsequently named “Subprime” the 2007 Word of the Year.[6] Unfortunately, the award is no cause for celebration, since subprime mortgages have forced thousands of people from their homes and the lack of standards in the subprime mortgage industry is considered largely to blame for the current economic situation. To escape the large monthly payments of a subprime mortgage, many homeowners simply assumed that they could sell their homes for a profit. This turned out to be an incorrect assumption because housing prices have sharply dropped in the past several years.[7] It is now not uncommon for a homeowner’s house to be worth less than what he or she originally paid for it.

Jim Cramer, the widely popular and outspoken financial expert with an investment television show on CNBC, accurately summed up the lack of bank standards and lackadaisical issuing of subprime mortgages: “The most unnerving thing about the whole period is that we really don’t know what standards banks used. We act as if all loans are created equal, which is nonsensical - as anyone who has gone through the process knows.”[8] This tends to be the underlying theme with the mortgage industry. Specifically, many people started to question what exactly the mortgage standards were and, for the standards in place, why people were being issued mortgages they could not afford. Americans wanted accountability for the banks issuing subprime mortgages to those who were not financially capable.

Banks that issued borrowers mortgages (usually subprime mortgages) they could not afford were labeled as “predatory lenders.” The Federal Trade Commission defines predatory lending as, “lending practices that often exploit lower-income and minority borrowers and frequently target elderly homeowners.”[9] Predatory lending is another example of the lack of standards in the mortgage industry. Although illegal, predatory lending grew in the mortgage industry with no one initially preventing the practice. Lenders were openly seeking out borrowers of certain demographics they knew could not afford a subprime ARM. The predatory lending practice was not something that lesser-known banks alone were pursuing; this was a practice that even the nation's largest mortgage lender, Countrywide Financial Corporation, was involved in.

Finally, in 2008 the state governments started to take action against the predatory lending techniques of the mortgage industry. The state of Illinois filed a lawsuit against Countrywide Financial for deceptive lending practices. Illinois's Attorney General, Lisa Madigan, blamed the company's complete lack of standards for the state's depressing housing situation:

> Countrywide's conduct has contributed to the high number of foreclosures in Illinois and caused significant harm to the public, the market, and scores of Illinois borrowers and homeowners. Unfair and deceptive advertising, marketing and sales practices were utilized to push mortgages, while hiding the real costs and risks to borrowers, including enticing borrowers with low teaser rates, low monthly payments and 'no closing cost' loans that failed to make clear and conspicious.[10]

It is not a stretch to conclude that a lack of standards in the mortgage industry is largely to blame for the deceptive predatory lending practices and subsequent approval for risky subprime ARMs. Had there been strict, defined standards, banks would not have approved borrowers for a loan.

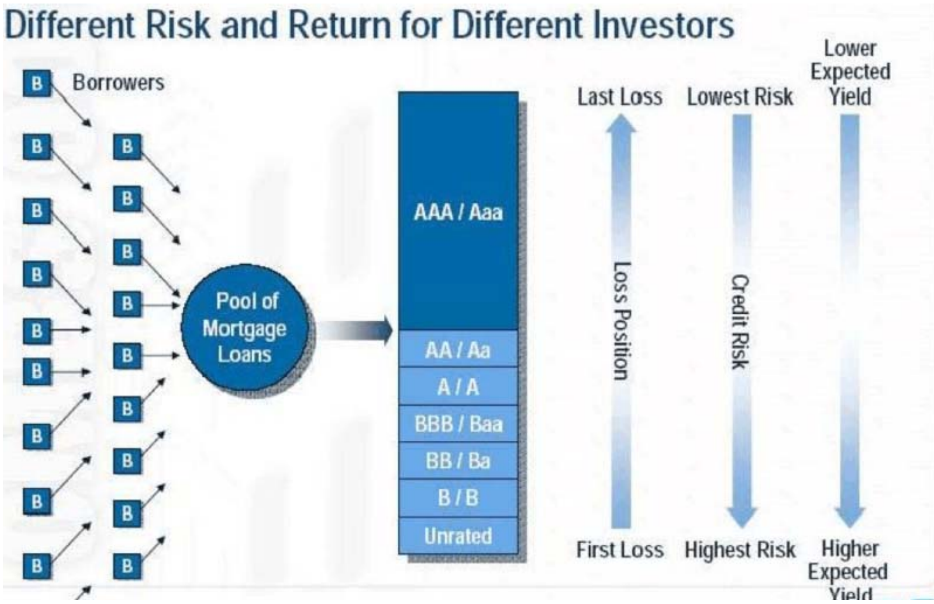
Robert Rubin, the former Treasury Secretary under President Clinton, described the current economic situation as a "perfect storm" resulting from the underweighting of risk across asset classes, massive use of financial engineering for subprime mortgages, and complacency among borrowers and lenders.[11] Many banks realized they were taking considerable risks when issuing subprime loans to borrowers with below average credit ratings. To transfer these risky mortgages, many banks used what Mr. Rubin refers to as "financial engineering" to move the mortgages off their financial books.

The "Perfect Storm" caused initially by the mortgage industry should not have come as a surprise to anyone because the condition of the subprime market was predicted to have drastic effects on the economy. John Dugan, the Department of the Treasury's Comptroller of the Currency, was busy voicing his opinion on the complete lack of mortgage standards back in 2005, well before the subprime meltdown:

> Some have suggested that payment option ARMs are inherently unsafe and unsound, and that regulators should banish them from reputable banking practice. I would characterize them differently, in this way: They have a legitimate use in the right hands, but they need to be handled with *extreme* care.[12]

Mr. Dugan was extremely concerned with the lack of standards for obtaining an ARM and the risks for the borrower who holds one.

Instead of banks "banishing" the ARMs altogether, they got sneaky and sold these risky mortgages to other companies. Although it has always been common for banks to re-sell mortgages, they utilized some new tricky and questionable "financial engineering" to remove the risky subprime loans from their balance sheets. Banks set up financial instruments called Special Purpose Vehicles (SPVs) to package the subprime mortgages into bond securities. These securities were then called residential mortgage-backed securities or RMBSs.[13] To sell the RMBSs, though, the banks had to rate the credit risk of such securities. The banks got a little sly here and started to assign the lowest risk RMBSs with an "AAA" rating. "AAA" ratings are usually reserved for senior class securities and normally provide low returns because of their low-risk. However, since these RMBSs were based of off risky subprime mortgages, they really weren't as low-risk as investors originally believed. This is when the rating of RMBSs became a little confusing because high-risk securities were labeled as low-risk, but the rating was all relative because almost all of the RMBSs were risky— some much more than others. The figure below from a Northern Texas court case shows how mortgage loans are packaged together and assigned a rating in relation to the risk:[14]




An "AAA" rating is supposed to be the highest quality securities with low risk, while a "B" rating should have more risk, but a greater opportunity for more yield.

The companies that assigned credit risk to securities soon came under fire with the Securities and Exchange Commission. The underlying theme was no surprise— a complete lack of and disregard for standards: "[T]he big three rating firms- Moody's, Standard and Poor's and Fitch- struggled to keep up with the workload of rating in an ever-increasing number of mortgage-backed securities from 2002 to 2007. As a result, all three lowered their standards in rating complex investments known as residential mortgage-backed securities."[15] The SEC pin-pointed three major reasons the credit agencies failed to properly rate the RMBSs: 1) the credit agencies failed to hire enough people to keep up with the high number of mortgages during the time period; 2) the agencies failed to keep proper records as to why the credit ranking standards were not being followed; and 3) the agencies failed to examine the actual performance of the securities (had they followed the performance, they would have known the RMBSs were actually very high-risk securities).[15] Not only were the standards not followed, they weren't very good to begin with. The federal government wanted a more transparent classification of the RMBSs so it could adequately assess their risk. One of the problems with this idea is that RMBSs consist of a variety of mortgages, so it is often difficult to properly rate the credit worthiness of the whole.[16]

The improper rating of RMBSs has had serious consequences within the entire U.S. economy. Many of the consequences resonate well beyond the scope of this research paper, but it is important to know that the lack of mortgage standards has compounded credit problems throughout the economy. Because high-risk subprime mortgages were packaged into RMBSs and sold off to unwitting financial institutions such as foreign banks, pension funds, and hedge funds. When word spread that the RMBSs might not be as safe as first thought, many banks had trouble removing the risky mortgages from their balance sheets.

Although hindsight is 20/20, the recent failure of the bank IndyMac shouldn't have been a surprise because they fell into the trap of purchasing risky RMBSs. In the middle of 2007, IndyMac was having difficulty selling its subprime mortgages to other investors, "IndyMac, as one of the country's biggest Alt-A originators, [and] is vulnerable as the defaults rise among these loans."[17] Though IndyMac was in a much better financial position than other large banks, experts believed the bank was in no immediate position of failing— the bank subsequently failed on July 11th, 2008, and the federal government took control of its assets. It is considered the second largest bank failure in U.S. history.[18] Many customers immediately wanted their money back and an explanation for how this happened.

## CREDIT RATING STANDARDS

Some of the most important standards the mortgage industry uses are credit worthiness standards. Almost all banks use the Fair Isaac Corporation (FICO) credit standard to asses a borrower's risk. Essentially, the FICO score analyzes the ability for a borrower to pay back the loan. Though the FICO score is not the only criterion a bank will analyze (a bank also checks your current income and employment history), it plays a significant role in deciding what type of loan and what interest rate you qualify for. The higher your FICO score, the better opportunity you will get a prime interest rate— 850 is the highest score possible, 300 is the lowest.

Your FICO score consists of five main factors, each weighted differently:

1. Payment History (35%) – have you historically paid your bills on time
2. Money Owed (30%) – do you have any current or outstanding debts
3. Length of Credit History (15%) – is your credit history long and reliable, or short and less dependable
4. New Credit (10%) – have you opened any new credit cards
5. Types of Credit (10%) – how diverse and/or healthy is your credit portfolio[19]

Credit standards such as your FICO score are extremely helpful for lenders analyzing a borrower's risk for a loan and should be applied universally and consistently. Many banks that issued subprime mortgages, however, lowered their standards for these types of loans. In the beginning of 2000, the cutoff between a prime mortgage and subprime mortgage was around a FICO score of 620. Banks now want to see scores closer to 700 to qualify for a prime mortgage.[20] The drastic change in acceptable FICO scores is another example of the industry's unorthodox fluctuating of acceptable standards.

The increase in the FICO score standard has upset new home borrowers who want to get the lowest possible interest rate available:

> The upward squeeze on FICO is putting a new premium on raising home buyers' numbers and obtaining correct scores, based on full reporting of credit data, mortgage and credit-market experts said. It's also triggering suits against lenders and credit card companies over their credit-reporting practices.[20]

Although your FICO is probably the most important standard used to determine if you qualify for a mortgage, lenders also usually look at other information. For example, banks analyze the loan-to-value ratio, or the ratio of the loan to the appraised value of the home.[21]

The real estate appraisers who perform the valuations have not gone unscathed in the mortgage industry mess. A number of mortgage industry experts blame appraisers for inflating the value of a home. The Uniform Standards of Professional Appraisal Practice (USPAP) are the generally accepted real estate standards for professional appraisal practice in North America, and home appraisers should be certified through a number of appraisal associations that follow these standards.[22] Appraisers in the mortgage mess say they were pressured by lenders to inflate home values:

> Have inflated appraisals helped fuel the surge in foreclosures on credit-strapped borrowers? Are such appraisals at the core of many mortgage-fraud schemes? The four largest trade groups representing appraisers say yes - and they are asking federal financial regulators to crack down on lenders and loan officers who put pressure on appraisers to raise valuations to allow overpriced deals to go through.[23]

To prevent the inflation of home appraisals, many lenders now want to see multiple appraisals and a comparison of similar houses for sale in the area.

Other criteria that lenders have been examining more closely are a person's financial reserves, or how much money they have in the bank. Some lenders want to see at least two full months of mortgage payments already on-hand.

**E-MORTGAGE STANDARDS**

The industry is starting to improve their standards in terms of processing mortgages electronically. While this initiative will not solve the lack of standards, it is an improvement that will help in some areas. Banks, lenders, and other financial organizations throughout the country have teamed together to form the Mortgage Industry Standards Maintenance Organization (MISMO). MISMO is a subsidiary of the Mortgage Bankers Association (MBA) and has been working to develop e-mortgage standards for the past 8 years. They believe they are within months of having approved standards for the industry.[24] MISMO standards are free, voluntary electronic standards for the residential and commercial mortgage industry. MISMO's openness and democratic philosophy to develop mortgage standards should accelerate acceptance of the e-standards.

As anyone who has gone through the mortgage process knows, there is a copious amount of paperwork that must be reviewed and signed. Most of the paperwork exchanges through the hands of multiple reviewers. The goal of MISMO is to streamline mortgage data and improve the information to make proper mortgage decisions:

> [T]he vision of the "e" in e-mortgages is introducing efficiencies and an auditable information trail that will put some clarity and sanity into the process. Whether or not the e-mortgage initiative reaches its full potential, experts in the mortgage field agree that, in this time of post subprime revisionism, individual lenders will play catch up with automation.[25]

Mortgage industry experts also hope that the e-mortgage standard will improve the decision process and reduce inappropriately approved subprime mortgages.[26] The problems in the mortgage industry have delayed the release of the e-mortgage standard because of all the turmoil caused by the subprime problems.

## RECOMMENDATIONS AND CURRENT INITIATIVES

Although MISMO's e-mortgage standard is a good proposal to improve the processing of financial data, it won't necessarily prevent the issuing of a mortgage to someone who should not have been approved for one in the first place. The industry needs mortgage standards to outline what is acceptable and what is not, and this will change the industry culture:

> Accomplishing this will require lenders to create cultures of compliance within their organizations. By integrating compliance into their workflow, lenders can monitor, analyze and manage critical data at multiple checkpoints. This will allow them to prevent non-compliant or fraudulent loans from being funded.[27]

I also believe that banks offer too many different types of mortgages. Although some people would like to believe that the option of multiple mortgages allows the borrower to pick the type of loan that best fits his or her needs based on financial stability, the wide variety actually causes too much confusion. Since the standards are so lax, borrowers are easily manipulated and approved into a mortgage that is not appropriate for them. Furthermore, risky payment-option ARMs should be banned, leaving room for only hybrid ARMs. Emphasis should also be placed on traditional 30-year fixed mortgages.

Additionally, the mortgage industry needs to develop strict standards to correlate to FICO scores. If FICO scores are too variable, then another credit standard should be developed and adhered to. Financial experts may disagree with this idea because if lenders are forced to adhere to the credit scores, it could place too many restrictions on the economy overall. Nonetheless, I believe the industry can agree on the intermediate and devise a set of approved standards built off of FICO scores.

Regarding the lack of standards in rating the credit risk of residential mortgage-backed securities (RMBSs), the industry needs to improve its accounting and ethical standards. When rating and selling the risky securities, there was conflict between buyers and sellers and important accounting data was not passed between the two. Paul Miller, member of the Securities and Exchange Commission's Office of the Chief of Accountant, disagrees with this idea, "this crisis wasn't created by poor accounting. It was bad management that led to losses, not bad standards."[28] Although management should be blamed for the problem, we can't let them accept all the blame. If managers had proper standards to follow it would have definitely helped them make better-informed strategic decisions.

The federal government is taking steps to improve the general accounting standards in the financial industry. While this does not specifically address the lack of standards in the mortgage industry, where all the problems started, the plan should make some improvements for the lack of standards. The United States Securities and Exchange Committee (SEC) Advisory Committee released a draft final report on the Improvements to Financial Reporting. Although this document is still in draft format, it was made available on July 11th, 2008, for discussion at an open committee meeting (the final report is expected to be available sometime in August 2008). The report was initiated as the result of the complete lack of standards in the financial documentation and reporting of risky residential mortgage backed securities. The report has five key recommendations: 1) increase the usefulness of information in SEC reports; 2) enhance the accounting standards-setting process; 3) improve the substantive design of new accounting standards; 4) delineate authoritative interpretive guidance; and 5) clarify guidance on financial restatements and accounting judgments. The recommendations are explained in greater detail within the report.[29]

**CONCLUSION**

It will take significant time before the economy has recovered from the economic troubles caused by the mortgage meltdown. Without knowing, people in the mortgage industry made financial decisions that have rippled through the entire economy. Few people imagined that the mortgage industry could have negatively influenced the entire U.S. economy. Blame can almost be assigned to everyone involved: lenders shouldn't have issued subprime mortgages to people who couldn't afford them; borrowers shouldn't have agreed to loans they could not pay back; credit raters shouldn't have rated a high-risk security as a low-risk investment; and appraisers shouldn't have inflated home values. Why did this all happen? The answer is simple, but implementing the solution remains complex: There is a complete lack of standards in the entire mortgage industry. In some instances, we have the necessary standardization framework, but people and organizations are ignoring these standards. For many Americans, owning a home is considered the “American Dream” and owning a home should still be something people aspire to achieve. While MISMO’s new e-mortgage standards and recent Security Exchange Commission standards are a step forward, more can be done for the industry. The success of our nation's economy depends on a standardized mortgage system.

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