AMERICAN PREDATORY LENDING AND THE GLOBAL FINANCIAL CRISIS

ORAL HISTORY PROJECT

Interview with

Philip Lehman

Bass Connections

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PREFACE

The following Oral History is the result of a recorded interview with Philip Lehman conducted by Callie Naughton on February 21, 2020. This interview is part of the Bass Connections American Predatory Lending and the Global Financial Crisis Project.

Readers are asked to bear in mind that they are reading a transcript of spoken word, rather than written prose. The transcript has been reviewed and approved by the interviewee.

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Interviewer: Callie Naughton

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Callie Naughton: I'm Callie Naughton, a graduate student at Duke, and a member of the Bass Connections, American Predatory Lending and the Global Financial Crisis team, and today is February 21st. I am at Duke's Fuqua School of Business for an oral history interview with Philip Lehman, former Assistant Attorney General in the Consumer Production Division of the North Carolina Department of Justice. Thank you for joining me today.

Phil Lehman: Thank you. Good to be here.

Callie Naughton: I'd like to start by establishing a bit about your background. I believe that you went to Harvard University for your bachelor's and Catholic University for your JD?

Phil Lehman: That's correct.

Callie Naughton: And in the context of your work life, how did you first become involved with residential mortgages?

Phil Lehman: Well, I had been working at the North Carolina Attorney General's Office since 1987 and I began to specialize in credit issues, credit fraud, and particularly credit scams that have affected typically lower income people. These were kind of the underside of the lending market. Things like finance company loans, payday loans came in a little bit later, and to some extent, mortgage lending. But at the time when I started, it didn't seem to be a big problem. The typical mortgage lending we got complaints about were second mortgage loans made by finance companies.

At the time, and this was my attitude like probably through most of the ‘80s at least and into the ‘90s, was that mortgage lending had been pretty traditional plain vanilla. You had community banks that made a lot of the mortgage loans. The loans stayed with the banks. So these were people, the lenders were in the community and they made very plain vanilla loans to people who qualify. There wasn't much innovative going on. The people who got loans were typically credit worthy and had money to put down. And the lenders of course didn't want to lend to people who couldn't pay the loans back, which is pretty basic.

Callie Naughton: And when you say a plain vanilla loan, could you just describe what you mean by that?

Phil Lehman: Well, the interest rates were pretty well fixed for anybody. They didn't vary a lot. Maybe slightly for a slight credit risk. But, back in the day, the savings and loan executives had a saying - the three, six, three rule. They pay 3% on deposits, they lend at 6%, and they're on the golf course by 3 [o'clock]. That's what I mean, very simple, straight forward.

Callie Naughton: It's not a bad life.

Phil Lehman: Right.

Callie Naughton: And were there changes in the industry as we move away from plain vanilla lending?

Phil Lehman: Yeah, where I first saw it was with some of the non-bank finance companies. A couple of examples at the time – The Associates, Household Finance, both of whom we had cases against later on. Their typical bread and butter had been making consumer loans to individuals, cash loans, $1,500 up to about $5,000. They also made second mortgage loans, but they were beginning to get more into the first mortgage business because they realized they could make larger loans to people who were already customers and they could switch them up out of consumer loans or second mortgage loans into first mortgage loans at much higher amounts that were, very, very profitable.

The other thing that was beginning to happen that I didn't think a lot of people understood was the rise of the mortgage brokering industry. Because for many, many years, if you wanted a loan, you'd go to a bank and make an application. But then mortgage brokers started getting into the scene and they were promoting themselves as independent brokers who could find you the best quality loan from a range of lenders. They were very unregulated. They weren't even licensed at the time. There was a registration statute, so they had to register and there was a little bit of law that applied, but not very much. And it struck me as kind of unusual. These are people dealing with the biggest investment you have, six figures and the qualification and licensing requirements were less than say a barber or a used car salesman even, and they were beginning to grow.

Callie Naughton: How did the policy community kind of learn about this potential problem and what did you do about it?

Phil Lehman: Well, one of the ways is working with the Attorney General's office, we get individual consumer complaints about all kinds of things. Just anything you could imagine a consumer having a problem with – a product or even landlord-tenant or a service, but also loans, and complaints about loans began to pick up. I'm guessing I'm moving now into the mid-'90s. And we began to see loans that I thought were almost shocking. Again, I was used to the old banking, the community bank where all the loans are pretty much the same.

Callie Naughton: What was shocking about these types of loans?

Phil Lehman: Well, at the time it was mostly the fees that were charged. I remember we had an investigation of a mortgage broker who was making loans – what we called "table funding" – he was making loans on paper, but selling them immediately to somebody else. But there would be multiple fees charged. I mean, it was traditional at the time to pay a very small application fee and you might pay an origination fee usually. Usually minimal, maybe 1% total of the loan. Well, some of these brokers began to charge all kinds of fees. They would charge an origination fee, they would charge a doc prep fee [Documentation Preparation Fee], they would charge a processing fee and they'd list them all. I mean, it was right there on the loan papers.

And these weren't minimal amounts. I mean, they all together could get up to 10% of the loan. And the other thing – we had an investigation case against The Associates that was then acquired by CitiFinancial. And the problem with those loans was that people were buying credit insurance, which is what we call single premium pre-paid credit insurance. So what it theoretically does is it protects you, pays off your loan in the event that you die or you become disabled or unemployed. So those are three different credit insurance products and they sell them to you. When you take out the loan, it becomes part of the loan transaction.

Callie Naughton: Part of the principal of the loan?

Phil Lehman: Part of the principal. And again, it's pre-paid. So yes, you might get the insurance, maybe good for, say, 15 years. Pretty big premium, and theoretically they're lending money to you to buy this insurance, which you may or may not want, probably don't need and then it becomes part of the loan, part of your payments. And so what we found was with a lot of these borrowers, the large majority a) were not aware that they had credit insurance and b) they had no idea what it cost. And again, these premiums could be pretty high. If somebody got a loan of $100,000 and had all kinds of credit insurance, the premiums could get up to $10,000 on a loan that size – a lot of money. And say the loan is at 12%. So every month on a $100,000 loan, you're paying $100 extra. These are people that are often – you know, $100 a month is a lot.

But it was challenging, the legal case is challenging because people had disclosures. You look at the loan document, the disclosure statement, it had all the premiums right there and you had to sign a little box: I agree to purchase credit insurance on this loan. But despite that fact, people didn't know. Some people said they were told that it was required to take out the loan, which is not true, it's against the law. But nevertheless, it happened. So, that was something else we were seeing. So those are the changes in the lending market: brokers, finance companies getting bigger into lending and third parties and non-bank lenders popping up and not playing by the traditional rules of mortgage lending.

Callie Naughton: I want to go back for a second to these fees and this credit insurance. And you talked a bit about awareness and there being disclosures with people still not being aware. Were there other structural reasons why it was hard for borrowers to opt out of using a mortgage broker who had all these fees? So, I'm thinking if

I were shopping between loans and I saw one loan that had all these broker fees, I'd go with another one. Was that not an option for them?

Phil Lehman: Yes, technically. Here are some of the problems. One is that people did not look upon these lenders – these mortgage brokers, these lenders – as they would a used car salesman or something. They seemed to be trusted professionals. You don't have your guard up as you would if you know somebody knocks on your door and wants to sell you some siding or something like that. These were financial professionals, so people looked upon some of these guys, who were close to being con artists, as Jimmy Stewart in 'It's a Wonderful Life,' if you've ever seen that movie. Kind of the nice old guy just trying to help you out with a loan.

And the other thing was these are very unsophisticated people. They're trusting, and somebody comes and tells you what the benefits of the loan are. You want to sign and get it done. And I think the third that changed was instead of mortgage loans being, I guess, demand driven – you need money either to buy a house to make home improvements, you need money for something that happened to you, you have a real need for it. And you go to a lender to get the money. Well, these are more push kind of loans that lenders are getting very aggressive about reaching out to people and trying to sell. Instead of a need or a service it became like this commodity to sell, sell, sell. So there was a lot of hard salesmanship that happened around that time that spread very, very rapidly.

Callie Naughton: As an Assistant Attorney General, what tools did you have to intercede on behalf of consumers as you're seeing them encounter these tough circumstances?

Phil Lehman: Well, we have several. I mean, at the most basic is that we have consumer complaints and we typically, when we get a complaint against a business, we contact the business, ask them for an explanation, either ask them to fix a problem or tell them why, if they think they did nothing wrong, to [explain] that. So we did that. Lenders tend to be a little more difficult about resolving things because again, they had disclosures. "The borrowers knew what they were signing, we didn't do anything wrong." The other tools – we have investigative tools to demand to see records and interview members of the company. And then the third thing, the ultimate recourse is to file a lawsuit against the company. So all civil jurisdiction, we have no criminal jurisdiction at all.

Callie Naughton: And you spoke about credit fraud becoming more common and popping up more often, did you see that concentrated in specific types of products? You talked about payday lending versus mortgage lending. And did you see it concentrated in specific types of businesses like non-bank financial companies versus banks?

Phil Lehman: Yes, it definitely started out with non-bank financial companies. First with finance companies, and then independent mortgage companies started popping up. So yes, it was, at the time, initially it was a non-bank thing that changed over time, but at first, no. There was some fraud going on. Outright fraud would be, for example, the lender making up a source of income for the borrower that the borrower didn't have. And that became a little more common, but most of it was just kind of fraud light where they would misrepresent terms of the loan and tell the borrower that, "Oh yeah, your payments are a little high, but don't worry in a year you can refinance and we'll lower your payments, you're going to get more equity in the house."

And that was very common. They tell people that, you know, if they had trouble, they could get out of the loan, [it would] be very easy to refinance. And just other stuff telling them the fees are required, or in the case of mortgage brokers, the concept of the yield spread premium. So you came in, you qualified for a loan, say at 9%. But you don't know much about the market. These are very unsophisticated borrowers and the broker convinces you, man, he's got a great deal on this loan at 11% and you say, okay, and the borrower doesn't know that that yield spread – that difference between the 9 and 11% – goes to the broker as part of his commission. And whoever ends up with a loan is collecting 9% on it. So, at the time it's legal but deceptive, misleading and unethical. But the last resort of these scoundrels is always disclosures. They would say, "It was right on the papers" but disclosures aren't enough, particularly with unsophisticated borrowers.

Callie Naughton: So as we moved closer to the early 2000's, we've seen a lot in our data about housing prices going up and the market seems so great. How did you and your office experience that period, because you've also seen the dark side of what's going on?

Phil Lehman: Yeah, well at one point you asked about what tools we had. Well, another tool is to advocate for legislation. And do you want to get into that?

Callie Naughton: I'd love to.

Phil Lehman: That was in 1999 and that was in response to a lot of these bad loans we were seeing. Another [kind of] loan that I had never seen, and I remember interviewing borrowers about them, were balloon payment loans. Basically, interest only where you'd be paying on a loan, making payments for 15 years. At the end of 15 years, you owed what you started with. And many times, I'd asked people, "Do you realize that?" "No, I had no idea. Nobody told me that!" But the lender could bring the contract to a hearing and they'd hold up the paper, [and argue,] "you signed it, says right here."

Well, anyway, we figured more needed to be done. And so we advocated, the Attorney General and some consumer groups, particularly what later became the Center for Responsible Lending. And we came up with examples of some of these terrible loans, how people had been victimized. And we started talking about legislation, and we were told: "Try to work something out, get the banking community involved." And we did. At that time, the bankers we dealt with – and I think you said you're going to be interviewing Paul Stock, he was at the time, the director of the Bankers Association – they were legitimately concerned. They said, "We don't make loans like this. This stuff is terrible." And so they agreed to try to work out a solution.

So, we spent many months with representatives of the AG's [Attorney General's] office, with just me and Mike Calhoun of the Center for Responsible Lending and the legal counsel for First Citizens Bank, just trying to come up with a kind of a compromise solution. Something that the banks would be able to say didn't really impact their ability to make regular loans, but kind of cleaned up the underside of the market. And so, we came up with what became the first predatory mortgage lending act in the country.

Callie Naughton: Looking back on that legislation, what were some things that were in there that you can point to now, that was a really useful tool [that] maybe you didn't realize at the time, but turned out to be a more useful method?

Phil Lehman: Well, we had some general prohibitions that applied to all mortgage loans, but the purpose of the law was to sort of categorize these predatory loans and erect a lot of barriers and protections to them. But we had a couple of general ones. One was what we call the net tangible benefit test, which is: the loan has to have a net tangible benefit to the borrower. In other words, it can't just be in the interest of the lender to make the loan. That's the kind of language you come up with after, you know, lots of discussions. Banks didn't particularly like it, because it was too soft, too loose. But we had to have something that you could bring at least a basic case.

Callie Naughton: Did you propose a method to measure that? Or was it just left up to practitioners to figure that out?

Phil Lehman: Exactly. It was basically something that you could argue if you brought a case. We prohibited single premium credit insurance across the board, any kind of loan. And that was considered pretty radical at the time. But the banks didn't sell this stuff and so it didn't bother them. And the finance companies and the insurance industry that sold credit insurance were very aggrieved. But, politically we were able to get a lot of support. And by the time it came up for hearing in the legislature, it was pretty much a package deal. So even though there were people who felt that it was too punitive, the bill got through by incredible margins. I [wrote] it down – 109 to 9 in the House and 47 to 2 in the Senate, which today would be unheard of to get that kind of by bipartisan support.

And so, the rest of it, was we came up with, the main test was a fee test. So, if all the points and fees on the loan, including prepayment penalties that were over 1%, if they exceeded 5% of the loan, then that became a high cost mortgage loan. And if it was a high cost mortgage loan, then a lot of restrictions applied such as no prepayment penalties. We required credit counseling. The borrower had to go to an independent, state-certified counselor before the loan could close. There was a prohibition on flipping loans…

Callie Naughton: Could you describe flipping loans?

Phil Lehman: … Which is repeated refinancing of loans for the purpose of generating fees.

And they would aggressively come after borrowers, particularly if a borrower was having trouble keeping up with payments. Instead of declaring the loan to delinquent or trying to foreclose, they'd say: “Well we can refinance to get you back up to date, lend you money for your past payments.” And then possibly reduce the payments by extending the term of the loan, usually not. But then the fees would be packed in all over again. And so, people would be paying more money, more origination fees and all that.

Callie Naughton: So the principal might go up, the equity might go down when that happens?

Phil Lehman: Yes, exactly. If there was any equity. So, in my opinion, the law was a success. The Center for Responsible Lending did a study and said that they estimated it saved North Carolina borrowers $100 million in its first year of operation, largely from restricting fees and the sale of credit insurance. It became a model, and some other states started looking at it and trying to adapt something similar. But, unfortunately after a short period of time, the banking industry became opposed to it and they saw this as just kind of a camel's nose under the tent phenomenon. If you allow this, then they're going to start coming after the banks. And so, there was more resistance to it. When we got it through, we thought that the North Carolina banking community cooperation was key to it, and it was, but unfortunately that was not replicated everywhere.

Callie Naughton: What were some other states that tried to see [this] through, and did they reach out to you to ask for your expertise…?

Phil Lehman: No, we heard a lot about it and I had spoken at conferences about it. People were really interested in it, both on the regulatory side and on the lending side. There were, a bunch of states, a handful. I know Georgia enacted one and a couple of states – New Jersey. I can't remember all of them, but probably about 10 at least. So, two things about it that I can go on in greater detail. One was, we reached conflict with the federal regulatory agencies, primarily the Office of the Comptroller of Currency, which is the regulator of national banks. That was one problem. The second problem was other lending practices started popping up that our law did not address.

Callie Naughton: Can we take the first problem then the second maybe? With federal regulators, were they opposed to the bill the moment it passed? Did it take them a while to learn about it? How did they become involved in what was going on here?

Phil Lehman: That's a good question. The legal theory that allows the federal regulator to kind of control regulation is preemption. It's a federal law and any state law that conflicts with their authority to regulate national banks, they deem is preempted, and null and void. At the time, preemption in lending extended to interest rates. So, a state had no authority to regulate interest rates charged by a national bank.

Callie Naughton: What about state-chartered banks?

Phil Lehman: State chartered banks were subject to state law. But that became a problem also later. So, if a national bank lent money in your state, it could be a New York bank with a lending facility in North Carolina, or issuing credit cards [into other states]. That was how it came to citizens of other states. The idea was they could charge under a federal rate or under the state law where the bank was chartered. So what happened then was you had a couple of states, namely South Dakota and Delaware, that had no usury laws, and the banks opened up their credit card banks in those states. And so, the law of South Dakota or Delaware basically became national law for lending in the credit card business. We understood what preemption was, and what we couldn't do. So, in the Predatory Lending Act, we were very careful not to regulate rates. In other words, you can make all the bad loans you want to at the highest rate you want to charge. That's okay. But you have to comply with all these consumer protection provisions. There was no express limitation on rates or fees, but once they hit the trigger, then they were subjected to extra protection.

So, we had some informal discussions with [federal] banking regulators and they didn't think our law was a problem, particularly since the banks in North Carolina didn't seem to have a problem with it. But that was initially, and then several years later – I think it was around 2003 – they started to crack down on the law. So, it was ironic that our major difficulty, at least then, was not with the banking industry. It was with the banking regulator. We said, "You guys ought to be on board with us, doing the same thing." But they regarded it as an impermissible burden on [a national] bank's ability to do business in North Carolina.

The first thing they did, a bank asked them [for an opinion] on the Georgia predatory lending law, which was pretty much the same as ours. And so the OCC looked into it and they issued an opinion in great detail that went through every provision of that law and said it was [entirely] preempted because it was a substantial impairment, I think that was the phrase, of the bank's ability to do business. And the OCC was the only authority that could issue restrictions like [those in the state laws]. So that became a battleground for a while, and it was tremendously disappointing to us because the OCC gave lip service to the problem of predatory lending. But that was about it. I mean, they enacted some recommended guidelines and said it's basically up to the banking industry to clean this up and to not do it. And their position was that banks aren't doing this, so it's not that big a problem. But banks did start getting into it because these low-level finance companies had to sell their loans. And we also saw some lenders, like I mentioned earlier, one of the worst of the finance companies called The Associates was acquired by CitiFinancial. So I think the banking industry began to see the level of profitability of some of these loans and wanted to get in the business even though they weren't there at the outset.

Callie Naughton: And just to clarify, one of the big differences between financial companies that are not banks and financial companies that are banks is that they're selling those mortgages up to Fannie and Freddie or Wall Street banks to package into securities?

Phil Lehman: Yes. And that was one thing I didn't understand for a long time, working at the ground level and seeing these smaller lenders making these loans and how bad they were, lending to people that didn't have a realistic ability of repaying. And I thought, this doesn't make sense. I mean, no lender makes a loan to a borrower knowing the borrower was probably going to default on the loan. It makes no business sense. And so, I thought it was crazy. But it took me a while before, you know, cause you're getting kind of tunnel vision, you're looking at one loan, one borrower, a bunch of loans. You know, you're not thinking about, where are these loans going? What's the flow, where is the money coming from? And then I began to realize these loans are being sold and they're being packaged and resold and resold.

And whoever ends up with a loan doesn't understand how this loan was originated and doesn't know how high-risk these loans are. And the person who originated it doesn't care because they're not going to hold the loan. This is not like the old community bank that's going to have you in the same town, and they're going to be very careful about who they lend to. But if your only goal is to make as much money as you can off the loan and then get it out of there, then if you're unscrupulous, why do you care about whether the borrower's going to default or not?

Callie Naughton: How did you learn – I mean the system is huge and complicated and I'm thinking in our own project, we've found that difficult to wrap our heads around at times. We've tried to map it and draw it a hundred times.

Phil Lehman: Well one of the problems, it's so it's so complex, and these investment vehicles were packaged into all these different tranches and then you have these artificial instruments based on the real ones. It's tremendously complicated and largely unregulated, because you know, once you get to these investment houses, investment banks, there's really nobody that's overlooking them. And you have credit rating agencies that are not doing their job. One of the problems is this: that mortgage lending, mortgage notes had been a very secure investment. I'm talking about historically, the default rate is very low and they're a very, very stable investment. So, they were in demand.

But what happened was the interest rates got higher and higher on these things. And so, they became a lot more attractive. Treasury rates at the time were really low. If you're an investor looking for a source of investment, you're not going to want to get 2% or something like that. But there are these loans going out en masse, at rates like 12%. That's really high, that's a big rate of return and it's safe. It's an American mortgage loan, what could go wrong? And so, because of that demand from the investor side, that just sort of created this push down to the lower level and to the people who had interacted directly with borrowers. So, they had to sell, sell, sell because the demand was there. And that's what happened.

Callie Naughton: From your position in the Attorney General's office, how did you begin putting these pieces together and sort of seeing this whole system and seeing that supply side of capital?

Phil Lehman: Well, I think we were late to the game. One thing that happened was that we began to cooperate more across state lines – Attorney General offices – because these lenders were going more national and we realized that it takes a lot of resources to do it one by one in 50 different states, but if we pool our resources together, then we can have a lot more clout.

Callie Naughton: Sure.

Phil Lehman: And where there is one state going to a lender making demands, it's just one state. But if you get 20 states together, then they can't brush you off as easily. So that I think upped both our leverage and then that just sort of created some more of a pool of knowledge and ability to consult with others, with experts about what was going on and what to do.

Callie Naughton: I'd imagine you start to see patterns too, cause you spoke about working with one borrower and the next borrower and all of a sudden, you're not working with one borrower or just the borrowers in North Carolina. You're working with the borrowers in 20 states and you can see those patterns happening.

Phil Lehman: Right.

Callie Naughton: What actions did this group of attorney generals have? Just suing companies that were abusing consumers?

Phil Lehman: We brought some enforcement actions, which typically involved filing complaints and then getting together and negotiating settlements with refunds for borrowers and penalties and that kind of thing. But again, this is a little bit later on. Some of the lenders, I remember one was Ameriquest, that we had a multi-state case against. At the time they were the biggest subprime mortgage lender in the country. But they had left North Carolina because of our predatory lending law. They said it was too restrictive and they made it sound like we'd be in tears that they were leaving the state. No, we said that's fine with us. But yeah, they were one of the big opponents of our law. They came back a little later. I didn't mention this before – that's one of the other benefits. I don't think the mortgage crisis hit North Carolina as hard as other states, and one of the reasons was we had more protections than other states. Some of the worst lenders viewed North Carolina as inhospitable and stayed out.

Callie Naughton: It seems like it was okay with North Carolina.

Phil Lehman: So, it helped, yeah.

Callie Naughton: So, we've talked a little bit about that first problem of preemption. And the second problem you mentioned was innovation in term of mortgage products. Can you talk more about that?

Phil Lehman: Yeah, because the predatory lending law was largely focused on fees and making too much [upfront] profit off these loans, selling things that were worthless and that the borrower didn't understand. That was a problem at the time. It didn't really address what became the problem, which was lending to borrowers who were probably unqualified and would have difficulty paying the loan back and creating mortgage loan instruments that had different features, like adjustable rate mortgages and maybe with balloon payments or interest only. You know, a lot of creative packages. Typically, it was to sell the payment, to try to keep the payment low, and not worry about what would happen later on.

Callie Naughton: Just for context, ARMs, adjustable rate mortgages, were quite new. That didn't exist really before. Mortgages had been fixed rate.

Phil Lehman: Yeah, there were some ARMs, but they were typically sold to higher income borrowers, like home equity lines of credit and that kind of thing. But they were not at the time viewed as a product for higher-risk subprime lending. But all of a sudden, they came in and exploded.

Callie Naughton: When we were talking about preemption, you talked about how the OCC wasn't going to let you regulate interest rates, but that you did have some bandwidth to regulate terms. With ARMs, what's dangerous about them – what we've heard about a lot in our research – is you have things like "2 and 28" loans where you have a very low teaser rate and then it suddenly is very high. Were you able to regulate that change of rate without getting in trouble with the OCC or was that too complicated?

Phil Lehman: No. The OCC would absolutely say "Stay out." That's interference [with OCC jurisdiction.] Yes, definitely related to the rate. I mean, we were trying to argue that a lot of these loans were unfair and deceptive, which under federal law, the original FTC Act [Federal Trade Commission Act] prohibits unfair or deceptive practices in trade or commerce. And most states have laws that are close to identical to that. So, we would say, "the borrowers are being deceived." It's not the actual terms of the loans. It's just that this is creating ... But that didn't get too far. But we tried.

Callie Naughton: Same as before, these more innovative practices, were those often banks that were underwriting these kinds of mortgages? Were they non-bank financial companies? Were they federal lenders? State lenders? What kind of lenders were providing these loans?

Phil Lehman: The large majority came from non-bank finance lending companies, companies that were created, like Ameriquest, Countrywide, that were not real [depository] banks. They just basically were mortgage lenders. Some may have gotten bank charters and there were some banks that got into it – probably in conjunction with some of these other companies – and made really bad loans. But it was not widespread through the whole banking industry on the lending side. Now on the other side, you know, buying loans and investment banking then that was another situation.

Callie Naughton: I think we talked a little about [how] you worked with colleagues in the Attorney General's office and in the banking industry and in the General Assembly. How did you educate the General Assembly on what was going on when you were working on the 1999 law? Because it passed with such a majority, that takes some work to get people to lobby and to advocate for the law.

Phil Lehman: Yes. It's not typically how you read about how, if you're in ninth grade studying civics, about how a bill is made, where one member proposes it and it goes through committee and amendments and all that. We dealt with the leadership – the sponsor of the bill was State Senator Roy Cooper, who then became Attorney General and now is Governor, as you probably know. And so, we kind of relied on him to convince people, his fellow senators. And then we were told by the leadership – again, another thing we found out is legislators don't like to deal with controversy. And if you come with something, particularly like a consumer protection bill, that has an impact on a certain industry, they want you to work it out, take care of it. You know, they don't want to be the people making the hard choices.

So, that's basically what we did. And so, we came up with a bill that was negotiated between the Attorney General, consumer advocates, and the banking industry. And we said, "this is a delicate compromise, we gave, took and gave. And so, we don't want any amendments," because once you start pulling something out, then the whole thing starts falling together. The banking industry went around and told people that "It's okay, we're not opposed to it." And when we had committee hearings, we made sure to have banking representatives to speak up for it, so most everybody in the legislature had a comfort zone that they were doing something that would protect consumers but wouldn't have that big an impact on the mainstream lending industry. And so, once we negotiated the compromise, that was basically it for the legislation. I don't mean to be cavalier about it, but it was almost formality getting it through once we had that level of support.

Callie Naughton: And so just jumping around one last time before we wrap up, as you move closer to the crisis, we've talked about sort of activities for 2003, 2004. As we move closer and closer to 2007, 2008, do you see these changes becoming more rapid? Do you see products getting more innovative? What happened in sort of this last couple of years before everything blew up?

Phil Lehman: The amount of subprime lending just kind of reached fever proportions. I mean, I don't know what the data is on it, but to us it just seemed like lots and lots of loans were being made and these weren't to people who were needing loans to buy houses. These are mostly people who already had home loans and were being talked into refinancing and refinancing from say a 30-year fixed in one of these “2 and 28” things that made it look like their payments would be reduced, but it was just happening very, very rapidly.

Callie Naughton: Was your impression that these were all borrowers who were traditionally subprime borrowers or do you think there were traditionally prime borrowers, borrowers who could've gotten a prime loan who were getting shuffled into the subprime?

Phil Lehman: Yeah, that's a very good point. You're right. There were a lot of people who were prime borrowers, but again, instead of dealing directly with a bank, they dealt with a mortgage broker who could sell them on one of these funny money loans and convince them that it was a good deal. And sometimes if they made it look like that because they could reduce your [initial] rate. And as you were saying for the first two years, I'm like, “Wow, my payment is dropping $100 a month,” and not thinking what was going to be happening in two years. That was definitely a problem that I don't think is appreciated enough – that people who qualified for mainstream, prime loans were dragged into the subprime market by deceptive practices.

Callie Naughton: Was your impression that these types of loans concentrated in parts of the state, or was it sort of just everywhere?

Phil Lehman: You know, I thought it seemed like everywhere to me, at least early on when we were looking at pools of borrowers. Some of the worst ones were definitely on lower middle class and poor people. More of an impact on African American community. But at least North Carolina, I don't think there was any strong case for reverse red lining or anything. But they relied on people who didn't have a lot of means and were very focused on what the monthly payment was going to be. These are people living paycheck to paycheck and any rise or reduction in the mortgage payment made a whole lot of difference, and made them very vulnerable to pitches of reducing the rate or to consolidate loans. There was a lot of that going on to convince people that, “Oh, we'll pay off all your loans and just put it into one loan.”

Callie Naughton: And those loans might be credit cards or car loans, or other types of debt?

Phil Lehman: Right. You know, a credit card loan, if you default on it, the consequences aren't that severe. It's unsecured. I mean there's not much they could do. But if you roll that into a home loan and you default, you're losing your house and losing the only source of equity you might have or savings that you have. That was another big thing. I don’t think people understood it. It's not just a loan. I mean, it's a loan that's secured by your house, and for most people of minimal means, that's the only investment, the only source of real savings they have is equity in the house. And what these loans were doing, it was stripping away that equity. And appraisals began to get very soft and places were getting over-appraised and unrealistic. And so, I think the figures at the time, we're talking like around 2008, I think that like one in three mortgage loans were what they call "underwater," that the loan was greater than the value of the house. That happened big time.

Callie Naughton: So just to move toward some of our concluding questions. Over the last decade, we've seen a number of different narratives emerge to explain the financial crisis. How do you understand what caused the crisis?

Phil Lehman: It's a big question [laughs]. It could take a year course to discuss that. To get very basic, it was greed, coupled with under-regulation. The lending and banking industry getting overwhelmed by what looked like an easy way to make a lot of money and losing sight of what they are there for, which is to serve people and to be lenders to their customers. And the banking regulators, particularly at the federal level, not appreciating this and not wanting to be the ones that were stopping the flow of money by restricting it. And they had a lot of pressure to allow these loans because they seemed at the time very profitable. But it got way out of balance, the change in the market and the lack of regulatory response to it.

Callie Naughton: To what extent do you see your personal experience that adding something important to our understanding of what happened in the run up to 2007, 2008?

Phil Lehman: That's a better question to ask [laughs]. My personal experience was, at least initially, kind of from the ground level. It was more just seeing what the impact on people, individual people, was, and what a burden it was for lots of people to deal with these loans. So that's what I saw and I could bring to regulators and legislators to say, you know, there's some problems out there, there's some bad stuff going on. And a lot of them didn't know that, didn't understand it, because most of the people who were representing us in the legislature or in the agencies don't deal with those kinds of companies. They've got good loans and they don't understand what's going on in small towns or on the other side of their own town. So, I think it helped to be aware of what was going on at the ground level because that's where it starts happening and it takes several years to get it into a big national problem. But yeah, I think just being present there at the ground level helped a lot.

Callie Naughton: And last question, looking back on the crisis over a decade later, what do you see as its most important lessons for mortgage originators and state level policy makers?

Phil Lehman: Well, not to treat mortgage loans as a commodity to sell, to make money off of. These are financial transactions that require a great deal of care and trust and ethics and, unfortunately, require strong regulation and strong laws. They shouldn't be necessary – and that's what we were told originally, that we can police ourselves – but that didn't happen. I remember being on a group call with Elizabeth Warren when she was kind of explaining all of that, now this is more than 10 years later, but about how easy it is to make loans and these are huge transactions and they have less regulation than, in her words was like a toaster that explodes and you get some recourse for that. But, yeah sorry, I lost the question.

[END OF SESSION]