

ABTL 2008 ANNUAL PROGRAM HYPOTHETICAL

BACKGROUND

American Dream Savings and Loan (“American Dream”) was founded in 1981 and operated successfully for many years as a friendly but conservative bank specializing in consumer lending, including home mortgages. It prided itself in providing “neighborhood banking” by offering standard loan products, maintaining a substantial number of convenient local branches, and actively participating in community affairs. It is a leading home mortgage lender in many communities throughout California.

In 2000, American Dream’s Board of Directors hired Richie Rich as the bank’s new Chief Executive Officer. Rich was an astute venture capitalist and promised that he would take American Dream national and greatly increase shareholder value. To that end, he diversified American Dream to offer a wider range of financial services, including mortgage lending to low income consumers and, hoping to attract institutional investors to put money into “deals,” investment banking products for higher end customers.

The centerpiece of Rich’s growth plan was a novel program called the Home Ownership Program of Empowerment (“HOPE”), through which home acquisition loans would be made available to low income individuals who would not otherwise qualify for standard mortgage products. The loans would then be packaged into securities that could be sold to investors by American Dream’s investment bankers. Proceeds from the sale of the securities would capitalize future loans, which, in turn, would be securitized and sold to more investors. American Dream would earn fees and other revenues at each stage.

Rich presented the HOPE program to the American Dream Board of Directors as a “win-win” proposal. As for the borrowers, the idea was that low income people who had no hope of becoming homeowners would be able to buy houses that they could not really afford but which could be paid for initially at rates within their reach. The addition of so many new buyers would stimulate the housing market, driving prices up so that by the time a loan’s interest rate was raised to market rates, the house could be sold at a profit. This would mean that the borrower would not only pay off the loan quickly, but also could use the profit from the sale to make a larger down payment on another house and thus get a home mortgage loan at lower monthly payments.

From the bank’s perspective, the sale of packaged loans reduced its exposure for defaults, generated capital for further loans, and generated substantial fees for loan servicing. Further, American Dream would be enhancing its longstanding mission to service consumers, who in turn would become grateful bank customers for other services and also attract wealthier clients who invested in the loan packages.

From the community’s perspective, low income people would be able to enter the booming housing market and ultimately realize the American dream. Existing homeowners would benefit because the housing market would be strengthened by the addition of more buyers for the available houses.

American Dream's Board enthusiastically authorized the program with the following suggestion that was recorded in the Board's minutes:

Many of the target borrowers likely lack the sophistication to understand the potential benefits from these loans. Thus, we should figure out a way to educate these people so that they will sign up for this program.

In response to this suggestion, American Dream's Investment Banker Division formed a new group called American Dream Economic Investment Opportunity Educational Services.

IMPLEMENTATION OF THE HOPE PROGRAM

HOPE was designed to help low income people with poor credit scores, who would not otherwise qualify for standard mortgages, to become homeowners through "creative financing," which included low (or no) down payments, lower income-to-debt ratios, and relaxed credit standards. The loans offered variable interest rates that were initially set below market for three-years and would then be raised to market rates.

American Dream Economic Investment Opportunity Educational Services offered free consultation to low income potential borrowers on how to modify their household budgets and finances so as to afford the initial mortgage, property tax, insurance, and other homeowner obligations. The group operated under the Investment Banking Division rather than the Consumer Division because it was concluded that having the aura of the investment experts would add credibility to the advice. Indeed, American Dream heavily advertised their services as "Have your own investment banker...for free...no matter what your income." Advice was available in 14 languages.

The American Dream Economic Investment Opportunity Educational Services group was headed by Clew Loess, the nephew of American Dream's CEO, Richie Rich. Loess's only previous work experience was as the Chief Creativity Officer of a failed dot.com company that sold sportswear for dogs. The "investment banker" advisors hired by Loess had little or no experience or training in financial matters but were instead former salespeople of automobiles, swimming pools, home siding, and in-home cosmetics. When one of them sent Loess an email asking for training on household finance and mortgages, Loess's email response said:

You don't get it. You can't teach these losers anything. Just give them common sense budgeting advice—like stop eating fast food and drinking Drainbucks coffee every day. You just have to do a little hand-holding to make them feel good, help them fill out the application, and let the math geeks figure out how to spin the numbers to make the sale.

Because American Dream offered loans on a "no down payment" basis, the "investment banker" advisors focused their advice to borrowers on steps needed to afford payments during the first years of the loan, when interest rates were low. No effort was made to assist borrowers

in preparing to afford the higher payments that would kick in later. Rather, borrowers were typically assured that they would be able to refinance their mortgages before the re-sets kicked in, and that “American Dream will stand by you.” The catchphrase used by the advisors among themselves was “Relocate, Refinance, or Reality.”

CREATION AND SALE OF MORTGAGE-BACKED SECURITIES

In order to implement the securitization side of HOPE, American Dream met with Mega Securities Corporation (“Mega Securities”), one of the country’s largest securities underwriters, to discuss packaging and securitizing its subprime mortgages. Mega Securities developed a program of securitizing American Dream subprime loans into mortgage-backed securities (“MBS). As soon as American Dream funded the mortgages, Mega Securities repackaged them as marketable securities, which were sold to institutional investors, including insurance companies, pension funds, and even other financial institutions.

Mega Securities hired a private rating agency, Bloomies, to analyze and rate the quality and creditworthiness of the MBS. Bloomies gave the MBS favorable ratings, and investors flocked to buy them. American Dream also began retaining large numbers of the securities for its own investment portfolio. Particularly in demand among investors were a series of securities called Dynamic Underwritten Mortgage Backed Securities—“DUMB Securities”—which offered increased yields through an unusually high percentage of higher-risk loans.

Not to lose out on the hot mortgage securitization market, John Q. Public (“Public”), trustee of the Genovia Public Employees Retirement Plan, invested millions of the State employees’ pension funds in DUMB Securities.

INITIAL SUCCESS OF THE HOPE PROGRAM

The HOPE program succeeded beyond anyone’s wildest expectations. The “investment banker” advisors were very successful in landing prospective borrowers. Borrowers with low incomes and weak credit scores were able to buy homes they could not otherwise afford, and many of them sold at a profit before their interest rates jumped up. Many of these borrowers upgraded to better homes at lower monthly payments. DUMB Securities became the darling of Wall Street.

By 2002 and 2003, American Dream became so well known for putting low income high-risk borrowers into homes that Richie Rich was recognized by *Money Magazine* as the most innovative banker in the United States, whose lending practices should be a model for a stingier “old school” lending institutions. American Dream’s reception area was covered with thank you letters from families who had become happy homeowners as a result of the HOPE program.

Inspired by all the favorable publicity and anxious to move out of her grandmother’s basement into a home of her own, Donna Trump (“Trump”), a low income, single mother of two who never graduated high school, met with a American Dream “investment banker” advisor, Slick Lender, in February 2004. While Trump didn’t have any savings for a down payment, she thought she could afford a small mortgage if she budgeted her \$34,000 per year income the right

way. Slick “helped” Trump fill out her mortgage application, overstating Trump’s income and understating her financial problems. Trump later recalled Slick telling her that “we do this all the time. You meet the numbers you gotta meet but it gives the lenders less heartburn if it’s just a little above. Trust me; it’s really no big deal.”

WARNINGS OF POTENTIAL TROUBLE AHEAD

At the 2005 American Dream shareholders meeting, Rich announced that profits had never been better and shareholders could be proud of a company that helped so many people achieve the American Dream of home ownership. Rich boldly identified American Dream as the engine driving the booming housing market, creating wealth for millions of homeowners and investors alike and profits for American Dream.

Rich did not tell the shareholders that in the Board Meeting the previous day, Sid Sack (“Sack”), American Dream’s chief financial officer, had described the concerns of the company’s conservative “old timers” about the HOPE program. Sack warned that the explosive growth of American Dream might have had led to the hiring of loan agents who had little or no lending experience or training. Sack also reported rumors that some agents engaged in “creative loan applications” to meet the already relaxed requirements of the HOPE program. Rich told the Board that Sack did not understand the new lending paradigm and that low default rates and higher home values belied Sack’s concerns.

Immediately after the board meeting, Sack sent Rich an email in which he tried again to explain his feeling of disquiet:

This program may look great today, but it is premised entirely upon housing pricing continuing to escalate. My concern is that borrowers will not understand the economics of their loans and will be unable to make their payments when the teaser rates are converted to market rate loans. We should re-think this program.

Tired of Sack’s constant gloom and doom approach, Rich sacked Sack.

LITIGATION ARRIVES

Two years after Sack delivered his warning, the bottom fell out of the housing market. Borrowers who could not sell their homes found themselves unable to make the higher payments required when the original low rates expired. Many defaulted on their loans, and a wave of foreclosures ensued. The nationwide market for MBS dried up, eliminating American Dream’s source of capital for making new loans and refinancing old ones (including those of HOPE borrowers who had been expecting to refinance their loans). The market value of existing MBS, especially DUMB Securities, plummeted. American Dream had to write down a large proportion of its own investment portfolio. American Dream laid off half of its workforce, including all of the HOPE program “investment banker” advisors.

When the interest rate on her mortgage reset to market, Donna Trump could no longer afford the payments. She was unable to refinance, because the value of her home had declined

and she had no equity. The loan went into foreclosure and she lost her home. She has filed a class action lawsuit against American Dream and Mega Securities on behalf of herself and others similarly situated. The gravamen of the complaint is that the HOPE program was a greedy scheme designed to milk poor people by trapping them into loans that were doomed from the start. This theme is embodied in causes of action for fraud, breach of the covenant of good faith and fair dealing implied in the loan documents, a litany of state and federal consumer protection laws, California Unfair Business Practices law, and a resurrected theory called “lender liability.” Trump claims American Dream and Mega Securities conspired together to entice her into obtaining a loan they knew she could not repay. The trial judge has announced that all issues will be tried simultaneously, with the jury giving advisory conclusions on the UCL issues.

Public has filed a class action on behalf of investors in DUMB securities against American Dream, Mega Securities, and Bloomies for violation of federal securities laws, fraud, aiding and abetting fraud, and negligence.

POTENTIAL WITNESSES

1. The plaintiff Donna Trump, whose formerly bleak financial condition has greatly deteriorated to the point that she is on welfare and lives in a homeless shelter with her children.
2. Richie Rich, the now-former CEO of American Dream. Rich resigned from the company after American Dream’s stock value fell by 75 percent. However, he earned \$5 million in salary and incentives his last full year with the company, and his severance package had an estimated value of \$12 million. He will explain the history and goals of the loan program as described above and give examples of success stories.
3. Plaintiffs’ economic expert, Gary Gloom, who will testify that the imprudent lending standards, reckless sales practices, and intentional obfuscation of investment risks by American Dream and the other defendants led to (a) significant financial hardship for families that were led to purchase homes they could not afford; (b) the sale of MBS securities at inflated prices that did not reflect their true risks and value; (c) great consumer unrest and a lack of faith in the economy in general and financial institution specifically; (d) an acceleration of the downward home price spiral; and (e) the likelihood of a recession.
4. Defendants’ economic expert, Polly Anna, who will testify that (a) 85% of the borrowers in American Dream’s program reaped the benefits of the program by selling their homes at great profit before their interest rates went up, repaid their loans, and went on to bigger, better and affordable homes; (b) homeowners who had not participated in the program were able to sell their homes at greater profits due to greater demand during the program; and (c) communities benefited by raising the property tax base as purchase prices skyrocketed, and that the mortgage “crisis” was largely the result of imprudent actions by certain Wall Street firms with which American Dream had no involvement.

5. A former American Dream's investment banker, Joe Kerr, who had worked with the bank's wealthier clients until he was laid off due to the decline in the bank's overall condition. He will testify that his colleagues in the "real" investment banking division derisively referred to the low income home loan group as the "No-Cap Investment Division" and frequently in such communications as random emails, idle chatter and Christmas party skits bemoaned what would happen when all of these loans defaulted as a result of the inevitable decline in the housing market. There was, however, no formal analysis conducted regarding that possibility.