Senate Committee on
Banking, Finance & Insurance

Michael J. Machado, Chair

Informational Hearing on
Nontraditional Residential Mortgage Products

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State Capitol, Room 112

SENATOR MICHAEL J. MACHADO: …first hearing as chair of this committee, I want to welcome back my returning colleagues, and we'll have some new members joining us—Senators Correa and Wiggins—and I want to extend a warm welcome to them. And I also want to extend a warm welcome to my new vice-chair, Senator George Runner.

SENATOR GEORGE RUNNER: Thank you.

SENATOR MACHADO: To those of you in the audience, I want to say thank you for coming. I understand that several of you have flown great distances to be here today, and I want to say I appreciate you taking the time to be here. As you can see, and it's probably customary of my committee, we oftentimes have a very full agenda. And I would like to strive to try to conclude by 4:00, but I don't want to cut off any of you, so what I would ask is that the witnesses be insightful and be brief. And to my fellow members, while I understand this is a very interesting topic, that they too try to be somewhat sparing in the questions that they ask because I want to make sure that all of our invited witnesses have the time to testify before you leave and also be able to make a full presentation of their thoughts.

Deregulation in the financial community and the economy in the mid-80s has brought the introduction of many innovative, new, nontraditional loan products that made home ownership a reality to those who previously could not afford home ownership. A strong housing economy minimized the risk both to homeowners and also to investors who were financing those homes. Now with the softening of the market, there's a question as to whether people in nontraditional mortgage products can maintain home ownership and what are the ripple effects in the broader economy. I also, it's my understanding, that the Department of Financial Institutions expects now that all licenses to comply with the October 4, 2006, final guidance on nonresidential mortgage products that was issued earlier late last year.

I have two goals in this hearing.

First, we're looking to provide the committee and interested members of the public with a balanced view of the subject of nontraditional mortgage lending. There have been a number of media stories on some of the pitfalls of subprime lending, but I know that the lending community too has a good story to tell about the opportunity of homeownership that's been afforded to those who may not otherwise have been able to get into a home and realize the American dream. The agenda is long, but I want to hear from both sides, both about the opportunities that nontraditional loans offer and about the problems they can cause if they're marketed and underwritten irresponsibly.

Second, it's important to look at the federal guidelines that were issued in October and how it's being received by borrowers and lenders. Now what does it mean when it's reported that the Department of Financial Institutions expects all licensees to comply with the guidance? Will legislation be necessary? If so, what should that legislation look like?

So I think it's a timely topic. It's one, I think, that has ramifications not only into the investment side, the secondary market, but very basically it has ramifications down to the individual homeowners and families who have engaged in these products with the hope of being able to realize the American dreams, and I think it's really important to know whether or not we have the type of disclosures that are necessary so that those who engage in those products fully understand what they're getting into and can use it to an advantage in partnership with those who issue those products to realize the American dream and also have a risk absorbance in the secondary market that's reasonable and acceptable.

With that, I'd like to call—excuse me—Senator Runner, would you like to make a comment?

SENATOR RUNNER: I look forward to working on not only this issue but a host of others that I know you're ready to roll up your sleeves, so I want to get out of here by 4 o'clock too.

SENATOR MACHADO: Thank you.

So with that, we'll go onto our first witness, Mr. Smith, Ed Smith.

MR. AARON REID: Mr. Chairman, Mr. Chairman and Members, I'm Aaron Reid, and I've had the privilege for the last several years to be the legislative representative for the California Association of Mortgage Brokers, commonly called CAMB. I had an occasion to work with Mr. Ed Smith, Jr., for quite some time as he is in leadership in that organization, in addition to being an expert in this field, and of course being the CEO of Plaza Financial. So I wanted to take this opportunity to introduce to you my good friend. We call him Smitty, and I know he'll certainly answer to that if you care to do that as well. But we also want to thank you for having this hearing because the California Association of Mortgage Brokers is dedicated to serving the public, to making sure that the industry is held to the highest ethical standards. So with that, it's my pleasure to not only represent them here in the Capitol but to introduce to you Mr. Ed Smith.

SENATOR MACHADO: Thank you, Mr. Reid, and I know we're asking him to draw on his vast experience in the marketplace to talk about and describe the many types of nontraditional mortgage products that are out there and explain some of the practices associated with the use of those products.

Welcome, Smitty.

MR. ED SMITH, JR.: Thank you. Thank you very much, Senator, and to all others. I appreciate your opportunity to enlighten you a little bit about subprime products and nontraditional products.

My background for the last 24 years has been working in San Diego County and predominantly working with underserved communities, bringing home ownership opportunities, and refinance opportunities for individuals to preserve their home. I know we're here limited for five minutes, and I wanted to take pick three of the top products that you may see that are going on in the marketplace now that may cause some type of consternation with regards to the way their products are being marketed and what the consumers actually understand. So if you bear with me, I'm going to go through the top three, the number one being the interest-only loan.

The interest-only loan is a product that a consumer only makes the interest payments on a monthly basis where their loan balance is not changed unless they elect to make a principal reduction on that loan. Many consumers do not elect to do that, and they end up owing the same amount of money on their loan within a couple of years or so. You may have heard the term 2/28. And I don't want to use a lot of industry acronyms here. I want to kind of make it plain for you. A 2/28 loan basically means that the first 24 months of that loan, your payment is fixed, but it's an adjustable-rate mortgage. You are only required to make a minimum interest-only payment for the first 24 months of that loan. Upon the 25th month of that loan, if you still have it, it turns into an adjustable-rate mortgage. And more times than not, your payment will go up. That's an interest-only product. That's a very, very predominant product that's in the marketplace now because it keeps people with the ability to make their mortgage payments.

All of the nontraditional products we see today—the interest-only product, the pay option, negative amortization loan, which I'm going to go into later, and a 40- and 50-year amortized loans—are a direct answer to the high cost of living and the high cost of homes in California, specifically in my marketplace. When consumers walk into my office, the first thing they want to know is, How much are my payments? Because I want to put a face on it. You have a hardworking family, normally with a couple of kids; they walk in; they want to buy their first home, and they go through payment shock the minute they find out what their payments are going to be. So these nontraditional products have been introduced into the marketplace in order to kind of ease that transition into home ownership. It gives them an opportunity to get used to making a payment. It gives them an opportunity to get used to fixing things at the house when the water heater goes out and all the other associated things that go along with home ownership. But the problem I see is that many consumers have not prepared an exit strategy or a succession plan in order to get into any long-term, sustainable loan product. Many kinds of consumers have been mismatched with a product, for whatever various reasons there may be. It may education on behalf of the originator; it may be misunderstanding on behalf of the consumer; but we worked through our customers backwards and forwards to make sure they understand the terms of that loan.

The next product that I want to go into—and I'm going to do the pay option last because that's the most controversial—is the 40- and 50-year amortized loan. That product has been introduced into the marketplace because consumers have asked for it. We don't want interest only. We want some type of principal reduction in our mortgages. So the industry has created a product that amortizes your loan out 40 or 50 years now which basically keeps your payment down, but it also has some principal reduction on a monthly basis when you make that payment. It's basically a loan that offers the next step to interest only with some semblance of principal reduction.

The last one is the pay-option ARM, negative amortization. This product has been widely used as a vehicle to get people into homes. It allows you to be able to afford a little bit more of a house, a little bit more benefits for its case, for monthly payments are concerned, but that danger to this loan—and this is something that I really, really want to drive home—is that if it's not properly used or if it's mismatched with the wrong product, the wrong product with the wrong customer profile, it could be a recipe for disaster. This product is primarily used from a payment standpoint because it allows people to be able to get into a home and keep lower payments so they can maintain their lifestyles and take care of their families.

The caveat that most customers don't understand is, when they make that minimum payment, their mortgage balance is actually increasing on a monthly basis. For example, if you start out with a $500,000 loan and you neg or you create negative amortization, potentially within a year or two, you get $510,000, $515,000 on that same loan and never actually realize every month that your loan balance is going up. And when we're in a marketplace where appreciation is not as strong, that appreciation normally kind of counteracts the negative amortization. But we're in a marketplace now where that's not true at all in all markets. So that product is a viable product for the right scenario. There are no bad products. There are products that are mismatched for customer profiles.

We look at this and say, What can we do to keep people in their homes? We want to preserve the homeownership opportunity and help people build generational wealth. We sit down and we counsel, we educate our customers. I know I do. This is extremely important that customers know the nuances of their loan products before they get into it. There's plenty disclosures in our industry. There is more disclosure for every type of product there possibly is, but the key is, consumer education.

SENATOR MACHADO: Thank you very much. If you can briefly comment—you mentioned that you try to match the product to the customer. The standards that you use to do that, do they come from the source of the loans that you are brokering, or is that something that you've developed within your own job?

MR. SMITH: No, sir. No mortgage broker in the State of California ever writes underwriting guidelines. Those guidelines are always written by the investors who put capital into the marketplace. There's a myriad of investors throughout the United States and in California. Each one of those investors sets their own criteria for the loan products that they're putting into the marketplace. We as mortgage brokers, our fiduciary responsibility as licensed mortgage brokers, are to the consumer and to the investor. We never underwrite guidelines. We mach our customer's profile with a particular product that meets their financial needs and objectives.

SENATOR MACHADO: Senator Runner.

SENATOR RUNNER: Thank you, Mr. Smith.

One of the comments I heard you say as you were going through that, and I think it's pretty clear, a home owner never realizes that his balance is going up.

MR. SMITH: Sometimes that's very true.

SENATOR RUNNER: How can that happen in the sense is it not reflected on a monthly statement? How would a person never realize that their balance is going up?

MR. SMITH: That's a wonderful question. They never opened the mail to look at it. It's as simple as that in many cases.

SENATOR RUNNER: So the context of that isn't that it's kept from them at that point anyway; it's just that they are not paying attention to the material that's coming to them?

MR. SMITH: That's correct, in many cases. Most cases that I've seen with my experience is that the customers do realize what negative amortization means, and it just kind of creeps up on them because this month they can't make that interest-only payment or a fully amortized payment. They do that for a few months, and then they get into the routine of their budget being based on the minimum payment. The balance then creeps up, and then they become a little alarmed and they have to refinance or a payment change comes in the terms of their loan and their payment jumps and it's called payment shock and it happens very frequently. Payments can go up anywhere from 30 to 50, in some cases, 100 percent from what you're normally paying. That's the recipe that most customers come to see us, and what can I do to save my home?

SENATOR RUNNER: Thank you.

SENATOR MACHADO: Senator Lowenthal.

SENATOR ALAN LOWENTHAL: Do they often know that their payments can go up 100 percent when they're taking out the loan? How do they deal with the fact, or do they not really understand that frequently that, for example, the one that you just described, the negative-amortization loan, that there's a potential that their payments could go up 50, 80, 100 percent, you said. Are they aware of that?

MR. SMITH: Yes, sir. And in every case in the State of California, for a licensed broker, a DRE regulated broker, there's disclosures that delineate the terms and conditions of that loan. However, many consumers may or may not take the time or maybe, in certain cases, maybe not fully explained to them with a level of understanding for them, that this is a potential of that loan. This is why it's so critical in the beginning of the process to fully explain the loan terms and conditions to the consumer so they can make an informed, educated choice that fits into their financial profile for their future income. Many people don't want to necessarily keep that type of loan product. That's a product that's more of a short-term product that leads you into a sustainable, suitable loan for them.

SENATOR LOWENTHAL: One last question. In your experience, have you found now with these loans that there has been recently, or in the last few years, any kind of increase in people's inability to pay or foreclosures over more traditional loans?

MR. SMITH: I couldn't say necessarily over traditional loans because I don't have that data to make an intelligent answer about that. But I can tell you what I see at the ground level when I meet with customers every day.

SENATOR LOWENTHAL: What do you see?

MR. SMITH: I see people missing their payments because of payment shock or for other reasons too—employment, income loss from divorces and other situations, illness. But what gets most customers in front of me is when that payment has gone up, they can't make their mortgage payments, and they're one or two payments behind. That's when they come in and that's when the process starts of foreclosure. For many customers, the number reason that I believe most customers actually get that far, other than the financial aspect, is—and it's kind of a sad answer—they don't pick up the phone and call their lender. They ignore the phone calls, and they don't open their mail because the lenders are readily willing to work with you to work out payment arrangements. There's modification agreements. There's all different types of things that the lender will do to work with the customer to help them keep their home. They're in a business like we are. We're in the business to have people maintain their homes and build strong families and build generational and net worth for those families. That's the American dream. But it also has some responsibility on behalf of the consumer. The consumer has to have a participatory part in that process. They have to know, that if I don't make my payments, this is not just going to go away. I've got to call; I've got to do something about it.

SENATOR MACHADO: Senator Cox.

SENATOR DAVE COX: Mr. Smith, thank you for coming today.

You've outlined three types of mortgage repayment. There are obviously more than that. My question has to do with compensation of the person who is doing the transaction for the lender. Generally speaking, are there various compensation models? For example, if I do an interest only, I get 3 percent; if I do a negative amortization, I get 6 percent as a commission; or if it's a 428, do I get 4 percent? Does it make any difference to the person who's doing the transaction?

MR. SMITH: No, sir. The product, in and of itself, does not drive the commission. The commission that an individual earns is a negotiated fee between the customer and the loan originator. One product doesn't necessarily generate more income than another product. It just depends on the interest rates and how that customer and how that consumer chooses to, what kind of payments they choose, what kind of terms they choose, how they want to handle their closing costs on an upfront basis. So it's on a case-by-case basis.

SENATOR COX: Mr. Chairman, thank you.

Explain that to me from a standpoint that, is it well promulgated in the mortgage industry that this is a negotiable fee?

MR. SMITH: Yes, sir. Yes. Let me give you a ground view. If you walk into my office and say, Smitty, I want to refinance my house. We analyze your financial situation and we look at your credit; we look at your income; we look at your equity position; and we determine that a 30-year fix is the best product that meets your needs and meets our needs. In my office, that product would be a 1 percent commission. That's what I would charge you. That's what you would agree to, if in fact you agree to pay a 1 percent commission, that's what it is. You may go to another originator that may have a different pricing model than what you had in my office, and they may charge you a different compensation package depending on that business model that they operate on.

SENATOR MACHADO: Thank you. Mr. Smith, thank you very much for that presentation. I know you'll be with us for the rest of the afternoon, and there may be other questions later.

MR. SMITH: Thank you very much, sir.

SENATOR MACHADO: Thank you.

SENATOR COX: Thank you.

SENATOR MACHADO: Our next witness is Professor Bostic. He's distinguished in the field of nontraditional lending. He's written extensively on home ownership, fair lending and discrimination issues, credit scoring, et al.

Welcome. I'm looking forward to your comments on the economic impacts of the nontraditional market.

PROFESSOR RAPHAEL BOSTIC: Thank you, Mr. Chairman. Good afternoon, everyone. It's good to be here to talk about a topic that I've actually spent a lot of time thinking about and worrying about.

For my comments today, I'd like to touch on four topics. The first is the characteristics or the character of the actual products that we're talking about. The second is the characteristics of the borrowers. There was some discussion about that in the previous testimony. The third is, I'd like to talk about some of the key players, aside from the borrower or the actual lender. And then fourth, I'd like to make some general comments about broad impacts and how we might think about these products. And I'm hopeful that after all that, I provide a sense of how I view these products in terms of their market impact, and I should also emphasize this is going to be a broad-brush discussion, given the time constraints.

So in terms of the character of the products, the first point that I'd like to make is that when we talk about these nontraditional products, we're really talking about two classes of products. The first class is one that's trying to deal with risk and trying to expand access to credit for households that have higher levels of risk. You might have heard people talk about the democratization of credit. Some of these products deal with that. The second class of products is really about matching a payment flow to a particular need for a household. So an interest only, we have the lower cost, the lower payments in the early phase, and they will then translate into higher payments later on in the experience. But in both of these cases, what we're trying to do is provide consumers at households with things that are going to allow them to benefit. And to my knowledge, none of these products have been designed to develop with the idea of promoting foreclosure or default, which gets to the second point, which is the characteristics of the borrower.

When we get to these sorts of products, one of the things that's particularly important is that they all require significant borrower sophistication. These are not your standard cookie-cutter products. There are a lot of moving parts and an unsophisticated borrower can be exposed to considerable risk beyond what they might expect. We're dealing with products with higher leverage, with idiosyncratic cash flows, households are necessarily closer to the edge, and in all of these instances—you know, I'm an economist—there are no free lunches, so there is going to be a potential price that you might have to pay for these things.

Now I should emphasize this is not necessarily a problem—it's not inherently a problem—if households aren't informed and educated. Households make bets all the time, and sometimes they pay out and sometimes they don't. And one of the questions or issues we've got to face is, under what circumstances are they bad bets and under what circumstances should we prevent households from making those bad bets?

One other thing I wanted to say on this is that particularly in a state like California, which is a high-cost state, the American dream and emotionally the

American dream is particularly powerful. People really want to own and they will do what they feel is necessary to own. And so when we talk about exposing them and telling people your costs may go up three years from now, those are emotional exercises that for many instances will be distant for a household and their heart just sort of makes concrete. People do know, that if they agree to these things, they'll get the keys tomorrow and that's what they focus on, and so I think that's an important aspect. And one of the difficulties in this dimension is the scale of the change. When we talk about your payments doubling, that's a hard thing to fully operationalize for many households.

The third area I want to talk about are other key players. And in this context, one thing that's important to recognize is that, for many of the lenders that engage in these nontraditional products, they don't have their own independent sources of capital to provide to fund these mortgages. And in fact, they rely on the secondary market, basically Wall Street interests, to fund these sorts of activities. I'll just say a few things about the Wall Street and the secondary markets.

The first is that for investors in these things, their risk exposure tends to be relatively low because the secondary market issues are over-collateralized, such that if there is some performance deterioration, there's extra collateral to cover that. So there's not a lot of market discipline that's provided for a loan-level monitoring of these issues.

The second thing I would say is that the regulatory oversight on these activities is relatively lax as compared with what banking institutions do, and we'll hear from banking regulators through the course of the rest of this testimony. Secondary market activities, you can pretty much do, pretty much, what you want aside from some reporting requirements.

The third point I want to make is that this—what we've seen in these products is significant growth in them recently. And there's not a lot of experience about how these mortgages will perform as we move forward through business cycles and the like And what that means is that the secondary market is really operating on faith at this point. They've had good experiences with prime-market securities and it remains to be seen what will happen as things change, as the conditions change.

The fourth area and the final area I'd like to discuss are sort of broader impacts. And the first point I think to be made is that what we like to say when we're economists is that everyone wants to maximize their utility, and the way you do that is by providing enough flexibility in the marketplace to allow people to tailor their experience to what they wish. These sorts of alternative products are a step in that direction certainly and can get people into home ownership and accessing the equity in their homes in ways that they haven't previously been able to. And so from that perspective, there are benefits associated with these things. As I said earlier, though, there is no free lunch, and this increased flexibility leaves us access to increased negative exposure to risk. And what that can translate to is elevated levels of default and foreclosure, loss of household wealth and security, and a host of other bad outcomes. This is especially problematic if we think that sophistication on the household side is not geographically distributed in an even way. If they're concentrated neighborhoods or areas where we think the households are less sophisticated in these things, then we can see particular concentration of foreclosure in defaults that can have additional negative impacts on community well-being.

The other point I want to say is that we are in a period now where we're about to learn quite a bit. The exposure of these sorts of products, the growth of these sort of products, is unprecedented. We've never had this volume of these sorts of products in the marketplace, and so we don't have a track record about how they're going to perform. We don't know how households are going to respond to these things. And as we move through the cycle, as the market softens and we start to see household responses, it will give us a sense of the magnitude of these difficulties. I will say, there's a difference, however, and this is a point that will come up again and again between sort of the broader market and the realities of individual families and households because each household that goes through this is exposed to difficulty and a pain that needs to be acknowledged.

SENATOR MACHADO: Thank you.

You mentioned about the need for oversight of regulation. Have you studied enough to see where that need, where that weight is, and what may be needed and if anything should go beyond what the guidelines that have been proposed at the federal level?

PROFESSOR BOSTIC: It's funny that you mention that. I'm doing some research on secondary market activities right now because, you know, one of the areas that you might explore is sort of dealing with the spigot and finding ways to slow down the flow of capital to these things in the circumstances where you think there's a problem. One of the things we don't really understand is ways in which we can provide some market discipline, some signals, some targets for the funders of these things so that they understand that we're watching them and can provide those sorts of insights. So one of the things I'm hoping for is, that as these securities are bundled and put together, we can institute some sort of checklist or some way for investors and for the marketplace at large to think about these and really ask the question: Are these contributing to household difficulties and exposing the marketplace to undue risk?

SENATOR MACHADO: One is the protection of the secondary market but also—but then the other side, I don't think you've quite addressed is, if the borrower is being driven by the American dream to own a home, it's his choice as to the risk level he's willing to accept. And so if the one hand you set higher standards on availability of capital, aren't we prejudging the decision process that the borrower should be making?

PROFESSOR BOSTIC: If that were their full characterization, I would say yes. I would echo the comments of the first testifier. That consumer education is critical, and any kind of situation where you have—regardless of how much capital is or isn't available, if the borrower is not sophisticated enough to understand the instrument, you're going to have problems and you're going to have difficulties. So I think that the burden of responsibility falls on all players in the marketplace, and that would include households to understand these products, to have a deeper appreciation for the risks associated with them, and be able to make what we objectively view as prudent decisions.

SENATOR MACHADO: Senator Runner.

SENATOR RUNNER: Yes. Just to follow up on one of your comments, and you used the illustration of turning down the spigot, and does that mean turning down the available funds into that market? Is that what you were referring to?

PROFESSOR BOSTIC: To some extent, yes.

SENATOR RUNNER: Okay. And if you do that, don't you then also then—help me understand how that accomplishes the informed buyer or the informed participant or just limits the number who will be able to have that product?

PROFESSOR BOSTIC: It will do the latter.

SENATOR RUNNER: And how does that help somebody become informed?

PROFESSOR BOSTIC: I think this speaks to the first question, which is, we've got to think about this from both sides. One aspect or one issue is that bad products, bad loans get funded, and we've got to address that. A second issue…

SENATOR RUNNER: Real quick. What's the difference between a bad loan and a bad product?

PROFESSOR BOSTIC: So bad loan is a loan where the borrower, we don't have a reasonable expectation that they will be able to pay this such that they won't lose access to their wealth and their security. What I said at the very outset of my comments was that almost every product has been developed with the idea of providing a service that allows households to better match their needs and desires to the instrument and the cash flows. So I think in almost every instance, there are legitimate justifications for products. And what we are really dealing with is the administration of that product and how we monitor that over time, and there's going to be discipline both on the household side and on the supply side as well.

SENATOR RUNNER: Again, my question still is the same. If you limit the supply, how does that enhance the knowledge of the person who's acquiring that loan?

PROFESSOR BOSTIC: It does not.

SENATOR RUNNER: Okay. Thank you.

SENATOR MACHADO: Senator Lowenthal.

SENATOR LOWENTHAL: Yes. I'm wondering, this product especially, let's just take the one in terms of the negative amortization, is that affected, have you noticed, by the housing market, that is, are we seeing less of that product now as the market has kind of come to kind of a—the rise has at least leveled off and, as shown in many market places, declined? Do you see, is it a function of the actual market also that's out there?

PROFESSOR BOSTIC: I don't have exact, specific statistics on that but that's my sense, and those products will be particularly attractive in situations where we're expecting significant price appreciation.

SENATOR LOWENTHAL: Right. So you would anticipate that we would be seeing a lessening of this product now; is that what you're saying?

PROFESSOR BOSTIC: That's correct.

SENATOR MACHADO: Senator Margett, do you have a question?

SENATOR BOB MARGETT: Yes. Thank you. I'm thinking here, we're talking in terms of protecting maybe the first-time borrower, a high-risk borrower. What about a sophisticated borrower or in the sense that—I'll give you an example. Maybe I'm going to call it an exotic loan for this reason: Maybe this person wants to retain a substantial amount of cash, and he may very well want to be able to have a home that is really a substantial amount of mortgage on it, well able to pay it, but would like to be able to play the market. In other words, when those interest rates on an ARM go up, he would take that cash and come into the market and have rather an arbitrage between the mortgage that he has, or interest on the mortgage that he has the house, and what he could earn from the marketplace from interest-free notes. Any product out there for that?

PROFESSOR BOSTIC: If there isn't, I'm sure the folks in the room will come up with one.

SENATOR MARGETT: Someone would devise one, huh?

SENATOR MACHADO: You have some cash lying around, Senator Margett?

SENATOR MARGETT: Well, I tell you. I've been through—Senator, I've been through a period of time when cash is very hard to replace, and I think maybe you have too as a farmer. But sometimes those who are sophisticated enough want to retain cash. It's a very important thing and hard to replace.

PROFESSOR BOSTIC: And I would wholeheartedly agree. One of the difficulties in this industry when we talk about things like predatory loans and the like is that an observationally, two observationally equivalent loans—one could be predatory and one could be, make a lot of sense—and that creates a real challenge in terms of providing a regulatory framework because the context matters in a significant, significant way. So your point about sophisticated borrowers being able to use these things to maximum advantage is on point.

SENATOR MARGETT: But does it put the lender at risk?

PROFESSOR BOSTIC: Presumably but probably less at risk than if they were dealing with an unsophisticated borrower.

SENATOR MACHADO: You mentioned reasonable expectation of repayment, and I think that's really what gets down to the borrower who's coming in and whether or not he's able to, he or she is able to, demonstrate that. And if it's adequate disclosure, what's that mean? And on the other side of this equation is somebody who's probably far more sophisticated than the relative few that Senator Margett has been referencing. So if we're looking at a regulatory guideline and criteria, have you looked, have you seen in your studies as to how or what the criteria should be and who should be responsible for assessing reasonable expectation, or is that taken care of in the guidelines that have been promulgated?

PROFESSOR BOSTIC: That's a difficult question. I have not identified sort of a bright-line threshold for determining that. And on some level, that's a joint decision between the borrower and the lender as to what's appropriate. And to the extent that we want to introduce credit counselors or others who might provide perspectives on those things, I would encourage that because more perspective and more expertise being introduced into the process is important. It's very difficult to come up with those sorts of guidelines if you think about, for example, a Housing Choice Voucher Program which is related to issues of affordability. In that program, they give households an option of spending more of their income than the original guideline. So allowing the, for some flexibility in these things, means that it's very hard to hard and fast identify those sorts of thresholds or cutoffs.

SENATOR MACHADO: Thank you very much.

Senator Wiggins.

SENATOR PAT WIGGINS: Can you explain the Housing Choice Voucher Program?

PROFESSOR BOSTIC: Sure. That's our Section 8 program, and basically what happens is that households get a voucher to go find a rental unit and that meets some rental guidelines, and then they will pay some fraction of their income and then the voucher covers the rest. And so historically, they've been allowed—the original program is set up, so, say, would spend 30 percent of their income. But in recent iterations of that, they've been allowed to spend up to 40 percent with the idea that some people want to consume more housing, want bigger units, and have access to their benefits that way.

SENATOR MACHADO: Thank you, Professor Bostic. That's been very informative and will help with the rest of the discussion coming forward.

Our next panel will be the Nontraditional Market—Lender and Borrower Experiences. We have four parties, if they can make their way. We have Rich Fikani, Retail Mortgage and Credit Operations for Wachovia; Marc Lowenthal, senior vice-president of New Century Financial Corporation; Pam Canada, executive director of Neighbor Works Home Ownership Center; and Marna Schwartz, Mission Economic Development Agency.

Mr. Fikani, would you like to start off and describe the products within Wachovia and the experience with those products, and also I believe you're pretty much nationwide.

MR. RICHARD FIKANI: Absolutely. So thank you, Chairman Machado, Vice-Chairman Runner, and Members of the Banking, Finance & Insurance Committee for the opportunity to appear before the panel and discuss the alternative products available in the marketplace today.

My responsibilities for Wachovia is head of retail credit, mortgage credit, and operations since I have responsibility for all of mortgage fulfillment throughout the company as well as loan servicing. And I also oversee some of the direct, consumer-direct lending operations via telephone, loan originations via telephone, internet, and employee loans. I held similar positions with World Savings prior to it becoming a subsidiary of Wachovia last fall.

Wachovia is one of the largest financial service providers in the country with assets over $700 million—I'm sorry--$700 billion—serving over 15 million households and businesses nationwide. Since the acquisition of World and Golden West, Wachovia is pleased to be one of the largest banking companies in California now. And because we're still integrating the two companies and because World Savings had a larger mortgage business than Wachovia, I'm going to focus all of my remarks today on our experiences at World Savings and primarily with regard to our primary product, which is the option ARM.

So World Savings has been offering the option ARM for the last 25 years. And as we looked in the late '70s and early '80s and researched the opportunities that we had to do alternative mortgages, there were really two types of ARMs that we could choose to offer to consumers. One is the option ARM which we did choose and I'll explain why and how that loan works in a moment, and then the other one was a loan that does not allow for negative amortization or payment optionality.

First, let me define the product that we offer. It's an adjustable rate mortgage for which payments are fixed annually in which the borrower gets payment options each and every month. The payment options are clearly defined on the monthly billing statement, and the payment options include the full principle and interest payment, an option for customers that want to prepay their mortgage faster; we show them the payment that they would need to make in order to amortize the loan in 15 years; we give them an interest-only option; and then we give them a payment that is lower than interest only or a minimum payment rate. Each option is clearly defined on the billing statement, and a monthly basis shows the customer how their loan balance would react depending on which loan payment they choose.

UNIDENTIFIED SPEAKER: Mr. Chair, a quick question.

SENATOR MACHADO: No. We're going to hold on all questions until the end of the presentations.

MR. FIKANI: Each year we recomputed the borrower's minimum payment, and the maximum that minimum payment can increase in a given year is 7.5 percent. So if the borrower's minimum payment is a thousand dollars, the most that payment can increase in any given year is $75. That 7.5 percent payment cap is there for the first ten years of the loan.

Consumers with World, we chose this option ARM because of the 7.5 percent payment cap and the ability to accumulate negative amortization. We believed it gave the customers predictability in terms of how much their payment could increase and insured that the customer would not experience payment shock. The no-negative products that we've looked at, because there is not predictability in terms of how much percentage-wise the payment can increase, because when the loan adjust, it's based on an adjustment in the interest rate, sometimes anywhere from 1 percent every six months to up to 200, 300 percent at the point in time of adjustment in terms of some hybrid ARMs. That results in significant payment shock and ultimately puts the borrower in trouble. At World Savings, we have a vested interest in the customer's ability to repay, and we ensure that we qualify all the borrowers, as I said earlier, at the fully indexed rate because we want to ensure that they can pay that full payment if they choose to make that payment.

We're focused on a positive customer experience because we do not sell our loans into the secondary market. So when a customer takes a loan from World Savings, or now Wachovia, they will always make their payment with World Savings or Wachovia and we live with that customer month in and month out until they pay off the loan. We're looking for high customer satisfaction and loyalty in which we create customers for life. So we need to ensure that the product works for the customer as well as for us as a bank. And as proof that it does work for the customer over the last two decades, we have funded over a million and a half of these loans for over $250 billion dollars and over the last 20 years have experienced significantly lower delinquency rates than most of our major competitors, including those competitors that offered only traditional fixed-rate loans. In fact, as we look over the last 20 years, which includes performance of this loan in a lot of different real estate cycles and economic cycles, including the deep recession in Southern California in the early '90s, we cannot attribute one single delinquency, let alone a foreclosure or loss, as a result of the product.

In terms of our consumer-focus service, because we keep the customer for life and want to create customers for life, one of the things that we do is we make a welcome call to all customers within 30 days after they close their loan. We want to make sure that they understand what they applied for and the loan that they received; we want to make sure they understand the billing statement and the options that they will have month in and month out; and we want to make sure that we start off on the right foot of them understanding how to manage the loan responsibly. We then call the customers again at the anniversary date of every loan. And again, it's kind of an annual loan checkup, if you will. We want to check in and we want to make sure that the loan is still meeting the customers' needs and still performing for them. And as a portfolio lender, if it's not, sometimes we can make slight modifications to the loan or do a low-cost refinance in order to keep the customer for life and ensure that the loan performs to their benefit as well as to ours.

SENATOR MACHADO: Are you close to concluding?

MR. FIKANI: So what I would say in conclusion is that we support the federal guidelines that were issued. In looking at those federal guidelines, they reemphasize sound, principal practices that avoid predatory or abusive practices. They ensure that underwriting standards are not diluted simply for the sake of volume and ensure that lenders maintain strong compliance and risk management. And regardless of product that a lender would offer, those are just sound principles that should be applied to any loan made to any consumer.

SENATOR MACHADO: Thank you very much.

And just for the members, you're a federal thrift.

MR. FIKANI: That's correct.

SENATOR MACHADO: So you fall under the guidelines, you offer basically optional ARMs, and you maintain your own portfolio?

MR. FIKANI: That is correct.

SENATOR MACHADO: Okay. Mr. Lowenthal, with First Century—New Century—you're a little different from what Mr. Fikani talked about. Could you describe basically the outline of your company, as I did, summarize for Wachovia as a preference to your remarks?

MR. MARC LOWENTHAL: Certainly, Mr. Chairman.

Unlike Wachovia, we are governed under state law. We are state chartered throughout the 50 states in the United States. So we are not currently covered by the federal guidance. As the chairman knows, 24 states have adopted the CSBS or the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators' version of that guidance. And it's my understanding that we're here today to discuss whether California wants to adopt that guidance.

SENATOR MACHADO: I think it's testimony to see whether or not it's out, it's appropriate to look at that.

MR. LOWENTHAL: Yes, right. Well, thank you very much for having me here today. I want to commend the committee actually for its approach in terms of how it is approaching the nontraditional guidance. So far, California is really the only state that has had any hearings whatsoever on the nature of the nontraditional guidance and its applicability to the mortgage-lending industry. And frankly, I, for one, think it's refreshing that you're doing this because it will give a full airing to all of the issues.

I'd like to begin by actually taking a moment to introduce New Century to those of you that are not familiar with us. New Century is one of the largest mortgage lenders in the United States and in California. In 2006, we made over $59 billion dollars in loans, more than 30 percent of which were to Californians. We are headquartered in Irvine, California, but we originate loans across the country in all 50 states, as I mentioned. We employ more than 7,100 mortgage professionals nationwide, and 3,000 within the State of California.

Our borrowers include individuals with excellent credit and those with limited or no credit history, the self-employed, and individuals who have blemished credit histories. Increasingly, our customers include people who, because of the high price of real estate in California, need to use a higher proportion of their income to make their mortgage payments. For all of those borrowers, nontraditional mortgage products offer them flexible ways to finance their homes while keeping them affordable. Nontraditional mortgages, principal-interest-only loans now make up about 20 percent of our business.

Nontraditional products are not new. In fact, non-amortizing mortgages were created prior to amortizing mortgages in 30-year fixed rate loans which became popular after the creation of the Federal Housing Administration in 1934. Many were introduced more than two decades ago to compensate for high interest rates due to inflation and so that consumers could afford homes in high-cost areas like California. Nontraditional mortgages include an array of products and features that allow consumers to defer principal and interest payments in order to tailor their mortgage payments to fit their specific life or family needs.

These products are not just provided by the private sector. Many nonprofits, housing bond programs, and even the government-sponsored enterprises—Fannie Mae and Freddie Mac—have recognized their importance in the marketplace and offer nontraditional products. The widespread availability of nontraditional products has undeniably contributed to the nation's nearly record-high home ownership rate, the significant increase in home ownership, equity, and wealth, and a strong housing market. All of these facts need to be kept in mind as California considers whether to adopt the guidance. Clearly, the guidance offers thoughtful recommendations on a number of important issues. For instance, it calls for better disclosures that are clear and understandable to the consumer.

However, we do have concerns about the guidance. First, we're concerned that overly, an application in a rigid manner of overly prescriptive underwriting standards could limit access to proven, fair, and affordable lending products that are critical in higher-cost markets like California. Second, we are concerned that the guidance hard codes underwriting standards in a way that inhibits lenders from employing market-driven risk management practices, including the ability to customize guidelines to address the needs and risks in a particular state or market. And finally, we're concerned about the uneven application of the guidance between federal and state regulators and among different state regulators.

Much has been said recently about applying the guidance to so-called hybrid adjustable rate mortgage products—the 2/28 and 3/27 products which were discussed in earlier testimony. New Century adamantly opposes the inclusion of hybrid ARMs into the guidance. The history and features of hybrid ARMs do not warrant inclusion into the guidance and to do so would cause severe, negative consequences for consumers, the real estate market, and the economy. We estimate that if these products are made subject to the guidance, it would affect 50 percent or more of the hybrid ARMs that are underwritten today resulting in far fewer borrowers being able to qualify for the loan, thereby depressing the housing market further, cutting off home ownership to deserving families, and significantly affecting the nation's economic health.

As I mentioned, we applaud the Senate Banking, Finance & Insurance Committee for its approach on this important issue. As the committee continues to consider how the guidance should apply in California, we urge the committee to keep front of mind the positive, historical record of nontraditional loans. As demonstrated over many years, nontraditional mortgages have been valuable instruments for new and current homeowners, and their risks have been adequately managed throughout various economic and housing cycles.

Nontraditional products offer prospective and existing homeowners the ability to attain home ownership through affordable products, allow current homeowners to consolidate other financial obligations, help improve borrowers' credit impaired histories, and build financial safety nets. These products perform well in the marketplace and are adequately managed by the primary and secondary mortgage markets.

We caution California policymakers to take a careful and deliberate approach to the guidance as they determine which elements make sense for California. Unlike other states, the guidance, if adopted too strictly in California, could further exacerbate the state's already serious affordability crisis. Californians deserve a thorough and thoughtful analysis of the various elements of the guidance rather than a hasty decision to adopt it without considering its potential impact.

Importantly, we urge policymakers to refrain from including hybrid adjustable rate mortgages into the guidance. They are completely different products with different loan characteristics that nontraditional mortgages have proven themselves to be beneficial products for many prospective and existing homeowners by providing flexible, affordable access to credit.

Thank you for the opportunity to address the committee. I would be happy to answer any questions.

SENATOR MACHADO: Thank you.

We'll get the other two panel members and we'll go to the questions. Pam Canada from the NeighborWorks HomeOwnership Center.

MS. PAM CANADA: Thank you.

SENATOR MACHADO: Please use the…

MS. CANADA: Oh, thank you.

The NeighborWorks HomeOwnership Center is a 501(c)(3) nonprofit organization. We're chartered under NeighborWorks America, which you might be familiar with, as a member of the NeighborWorks Network, and we promote stable, sustainable…

SENATOR MACHADO: Can you identify yourself for the record?

MS. CANADA: Pardon me?

SENATOR MACHADO: Just say your name for the record.

MS. CANADA: Oh, I'm sorry. Pam Canada. Thank you.

We promote stable, sustainable home ownership through a comprehensive process that includes an emphasis on pre-purchase homebuyer education, flexible, responsible lending, and post-purchase counseling for homeowners. Through or pre-purchase education, prospective homebuyers learn the process and the potential risk factors of home buying in addition to successful purchase and responsible lending. Quality, responsible education provides the homebuyer with the ability to make informed choices. Informed prospective homebuyers will know if they're ready to buy, will know if they can afford to buy, and will know how to shop for a responsible lender and a suitable loan product.

We receive an average of eight requests per week from people who are having serious mortgage delinquency problems and don't know what to do about it. A year ago, it was normal to get two of these in a month. The majority of the borrowers who contact us are in what is called Combo loans. They have an adjustable rate, first mortgage, and a second mortgage that is fixed but carries a high interest rate.

One recent client, a single mother, with an income of $2,300 per month, had purchased a home with $500 down for $350,000. Using a stated income loan program, stated income is essentially no documentation—and we can talk about that further—but she used a stated income loan program. Her financing included a 7 percent option ARM, first mortgage, with an interest-only payment, equaling $1,672. A second mortgage was given to her for 11 percent with a fixed payment of $698. Her housing payment cost her 103 percent of her true income, exclusive of taxes, insurance, utilities, and the like.

Another client had purchased a home for $180,000, had put all her savings in as the down payment, so she could keep the payments affordable to her monthly income of $2,450. She got an adjustable rate mortgage with an initial rate of 2.35 percent, what is known as a teaser rate or an initial rate, that is much lower, below market, essentially, and a payment that was equal to $463 per month for the first six months, keeping her housing ratio of payment to income at a very affordable 20 percent of her true income and she was quite happy. What she didn't understand was that after six months and regularly for the next four years, her payment would be increasing 7.5 percent each time. Her payments would reach $1,300 per month and she would have negative amortization. She came to us when she was actually about 24 months into her loan and struggling to pay 60 percent of her income towards her housing expense.

In many of the cases that we see, there was an excessive amount of stated income used to qualify the borrower. Another common cause has been the option ARM loan product where a client can determine whether they will pay interest only or defer a payment completely and ARMs where the adjustment period is frequent. These quickly outpace the borrower's income, and they have no resources or limited resources to fall back on. Additionally, many members—or many lenders—excuse me—are using Combo loans to finance 100 percent or more of the value of the home. This not only maximizes the loan amount, increasing the fee to the lenders, but with the soft market in this past year, particularly in our region, it has almost eliminated the ability of the borrower to re-fi out of the nontraditional loan product in the early years of the loan because there is no equity and they are upside down. Oftentimes, I might add, there are prepayment penalties added to these and the customer is not necessarily familiar with what the ramifications of that prepayment penalty are, or they don't receive a cost benefit for the prepayment penalty which is another way to mitigate that.

A recent client that came to us for foreclosure prevention help had gotten an ARM with an initial rate of 1.5 percent that had adjusted to a fully indexed rate of 9 percent over the first 12 months. His payment went from $1,050 up to $2,414 per month, a 150 percent increase in the first year. For this family of six earning $4,800 per month, this was a nightmare with no happy ending.

Every time we get contacted by a borrower with mortgage problems, we ask them what loan terms they have, and 98 percent of the time, they do not really know and cannot accurately explain them. They are not aware of the true impact of the payments and oftentimes have been told that they could re-fi out in the future, so it didn't really matter what their loan terms were; just buy the house now; the market is moving fast—a compelling message for any family.

Most of the people who come to us say they knew they didn't get a traditional loan but thought it was the only way they could buy a home. The stated income or the teaser rate on the ARM allowed them to purchase more home than they could truly afford. The lender financed it to the max, and the market did not save them. People become delinquent because they didn't factor into their budget that they now have to pay utilities, property taxes, homeowner's insurance, along with increased credit card payments because they bought all new furniture and drapes for their home. They just didn't understand the loan they have, the payment impact, and the financial responsibilities of budgeting as a homeowner versus a renter.

Repeatedly, we see that homeowners with less than two years in the home have the most difficulty. This is due to the significant increase in the use of nontraditional loan products in the past two to three years and the borrower's lack of true understanding and planning for homeownership. It's a lack of quality pre-purchase homebuyer education, particularly for first-time homebuyers, so they can make informed choices about their home-buying decisions and a lack of accountability to the mortgage lenders that are originating nontraditional loan products in cases that are not suitable for the borrower, then selling the loans to investors or into loan pools where they now bear no liability for putting someone into financing that really made no sense. Thank you.

SENATOR MACHADO: Thank you.

Next we have Marina Schwartz.

MS. MARNA SCHWARTZ: Marna.

SENATOR MACHADO: Marna. I'm sorry.

MS. SCHWARTZ: That's okay.

Good afternoon and thank you for having this hearing. My name is Marna Schwartz and I'm a homeownership counselor at Mission Economic Development Agency in San Francisco, like Pam, a HUD-certified counseling agency.

I'm here to speak on behalf of the growing stream of borrowers who are defaulting on their nontraditional loans. The majority of the borrowers who seek homeownership counseling assistance at MEDA fit the following characteristics: Their incomes are between 50 to 80 percent of area median income; they're working-class families with stable incomes, mostly employed in service-work jobs; they're families—they have kids; they have little-to-no outstanding debt and good credit scores, 660 or above; they are Spanish speaking—we serve a Spanish-speaking population—and they're confused by the loan docs that are later given to them that are only written in

English, many of whom of these Spanish speakers are undocumented and face further vulnerability around their loan because of that; they're first-time homebuyers and they're buying in the Bay Area, which is admittedly a high-cost area, and are buying houses priced between $550,000 and $650,000.

They're coming to us and asking for help with these nontraditional loans because their loan profile is this. They have loans that are adjustable rate; they're stated loans. They're only paying interest and do not have taxes and insurance escrowed and they have a 97 percent or higher loan-to-value ratio and are charged high fees and receive a cash back at closing to help pay for the first couple months' mortgage payments so they don't experience that shock right away. Upon further investigation of their loans, 90 percent of these borrowers had their income drastically exaggerated on these stated-income loans. Most of these borrowers had used Spanish-speaking mortgage brokers or real estate agencies, not traditional banks.

These are not risky borrowers. They have stable incomes; they don't have high debt; they have good credit scores; but they are getting high-risk loans and high-cost loans. Most simply, the borrowers who are defaulting are those who cannot afford a loan that they should never have been qualified for. Specifically, their inability to pay is based on the following facts: They were given a stated loan, not because they were self-employed or because they had undocumented income but rather because their income would not support the payment that they were going to be—or the loan that they needed—to qualify for that house. The qualification for the loan was based on the minimum payment, not the fully indexed rate. They were told by their lender not to worry about the reset of interest on an adjustable rate because they were told they could refinance in less than a year. But let me give you an example of why our clients can't refinance in less than a year, can't get out of these loans.

We had a client, Alma, who purchased a home for $550,000, and she had no outstanding debt prior to the purchase of the home. The lender stated her income which was stated at $15,000 a month. Her real income was $5,000 a month, the family gross income. When two years of fixed payment expired and the interest rate reset to a 1 percent higher interest rate than was previous, not necessarily a huge jump but still very felt, she needed to refinance fast or risk defaulting on her loan. At that point, she found out that the mortgage payment was based on a false income, that she had been paying the interest, only the interest on her loan, and she had therefore no equity in the home. In fact, she had an upside down loan-to-value ratio.

Further, she found that not only was her income stated incorrectly, but it was said that she owned her own business. In fact, she did not. Although her first lender assured her that she could easily refinance, no one told her that there would be additional closing costs. She could not find a lender who would refinance her into a loan that was any better than where she was at. Although she had sublet her additional room, she will probably lose her home.

I want to be clear, it has been my experience, very few borrowers had changes in their financial situation when they default. It hasn't been a loss of income; it hasn't been a loss of a job. Rather, it is the loan that has changed on them. And in order to help them out of this loan, we tried to do loss mitigation and talk with the servicers and find a way to do a loan modification and we help them with the hardship letter to write of what has gone on. But in fact, it is not a hardship that has gone on in their own lives. It is the hardship of the loan.

In my opinion, there are serious flaws with current mortgage regulations. And if I could only have one change, I would ask that there be more regulations around stated loans, that it really be regulated, and that you really only have stated loans for people who need them, who are self-employed, who have undocumented income in other ways. I highly recommend California adapt to the regulations because this is an opportunity to hopefully make systematic changes. I would also encourage the following recommendations: Require homebuyer education by a HUD-certified counseling agency to all borrowers who are receiving nontraditional-loan products, restore sensible underwriting, strong underwriting, require accurate and accountable loan servicing with clear explanations of upcoming increases in the coupon book, letting folks know exactly what their payment is going to look like if they only pay a part of that mortgage, that PITI, eliminate incentives for lenders to steer borrowers into inappropriate and abusive loans—there is a yield-spread premium that is paid back, and that does affect which loans borrowers get into—ensure effective rights and remedies for families caught in predatory loans, including enforcement, increased monitoring and regulation of mortgage brokers, and disclosure of key documents in a language that the borrower understands. If our clients are Spanish speaking, they're receiving all their loan documents in English and they're not able to understand it. Thank you very much for your time.

SENATOR MACHADO: Thank you. The description that you just described seems more fraudulent than it does to be indicative of the practices. The question, though, that I think you both legitimately raised, and I'd like to have the panel behind also respond to, the responsibility is to assess the borrower's capability and there's a responsibility for education. One of the things that we have found in this body when we talk about trying to have mandate counseling, we have the individual borrowers coming up and saying, you shouldn't have to tell me what I need to know. But on the other hand, you also have buyers that become very emotionally involved in wanting to become a homeowner. And to the extent that may drive the deal too, where's the balance? Who should be taking that responsibility to try to sift through the emotion that's surrounding the person that has the opportunity to buy a home, that gets excited about the ability of affordability but yet you also have, I think, a legitimate question to be asked about the responsibility of those initiating the loan for disclosure and understanding. Why don't we start in the back?

MR. LOWENTHAL: Mr. Chairman, I do think that lenders bear responsibility for providing full and accurate disclosures. I think we don't want a borrower to not understand the terms of the loan that they are getting into. At least as it relates to my own mortgage company, we try very hard to put out plain English disclosures to customers so that they understand the impact of their payments, they understand the product that they're getting into, and that they're closing the loan understanding what it is that they're doing.

For instance, with respect to stated income loans, we provide them with actually two forms of disclosure. The first is when they get their good-faith estimate. We provide them with a notice that says, you applied for stated income loan. This means that we're going to rely on your stated income, what you state your income is, in order to underwrite this loan. If the income is not stated correctly, it means you could have trouble paying for this loan later on. But more importantly what it says is that if you are willing to go with a full documentation-type loan which may lower your price—and we tell them it will lower their price—that they should in fact apply for that loan and not apply for a stated-income loan. We repeat the same process at closing. We provide them with the same type of certification with a notion that they can back out at that point in time and reapply for the loan with no penalty—no harm, no foul—if you want this loan, understand what you're getting into.

But I think at some point, it boils down to the fact that the borrower has to make a choice. The lender can present the products. We can put in front of them all the disclosures. We can try to make it as clear as possible, but ultimately it's the borrower's decision whether or not they want to borrow the money.

SENATOR MACHADO: Now are those disclosures made in a sit-down situation where the person that is taking the information from the borrower and submitting the application is informing the borrower with that disclosure that you just described?

MR. LOWENTHAL: What happens in our situation is that that notice goes out with what we call the introductory package which contains the good-faith estimate, the truth-and-lending disclosures, and all the other disclosures that are provided.

SENATOR MACHADO: How much information would be in that? What size type would that be in?

MR. LOWENTHAL: Well, it's a lot of information and it's in varying size type. I mean, you know, I think that is correct. Eighty-five percent of our loans come through brokers, but we don't rely on brokers to give those disclosures. We send them directly to the borrower.

SENATOR MACHADO: But isn't the broker the one that's documenting the information from the prospective borrower that then submits the loan to you?

MR. LOWENTHAL: The broker is, but we prefer at that stage to communicate directly to the borrower and give the borrower the opportunity to come and deal directly with us if in fact in the stated income loan situation, they don't want that loan.

SENATOR MACHADO: But isn't it more likely that the discussion of the loan, the loan terms, is going to take place face to face between the borrower and the broker regardless of the amount of mail they're receiving?

MR. LOWENTHAL: Certainly, you know, it is the broker, especially in our case, that is submitting the original application and the loan materials. And presumably, you know, when we happen to offer brokers the ability to look at loan choices electronically, they can input their borrower's information and get back a loan decision. Typically, a borrower will qualify for more than one type of product. We don't know whether the broker has in fact communicated all of those offers to the borrower. So if a loan comes in as a stated income loan, that's why we've opted to send out that notice.

One of the things that we are working on is an enhanced form of disclosure that actually will set forth for the borrower all the various options that they will qualify for. That, from an operational perspective, is not an easy thing to do in terms of, you know, because sometimes borrowers can qualify for five or six or seven different loan products. So that is a challenge from an operational perspective. But in order to provide more information to the borrower in easy and understandable forms, that's something that as a company we have elected to undertake.

SENATOR MACHADO: Wachovia?

MR. FIKANI: So beyond the disclosure, since the topic of stated-income loans came up, World has been making what we call a quick-qualifier loan for the last 20 years on the option ARM product, and it's not just in terms of our responsibility in terms of full disclosure of the product, but we have responsibility in the due diligence of the underwriting process. For instance, on our stated income loans, the income has to pass a reasonability test. It has to pass a reasonability test in terms of the credit profile of the borrower, in terms of the income to type of employment, and a reasonability test to the type of assets that the client has accumulated. We also require a little more down payment on that type of loan. And you could really classify our stated income loans not as no-doc loans because the underwriter does have to carefully evaluate each application, and there are documentation requirements that may be specific to each borrower situation.

SENATOR MACHADO: Mr. Smith, since we've been talking about the broker's role in here, would you like to jump in? Your input is to the responsibility of the broker as an in between, between the lending source and the borrower?

MR. SMITH: Yes, sir. Thank you very much for that opportunity. Being a practitioner and also an approved broker with World Savings and New Century, I'm very familiar with their underwriting policies and procedures. I'd like to dovetail a little bit off the underwriting standpoint.

We in California are required to make that reasonability test also. At the point of application when we sit down and analyze an individual's financial situation, and that individual elects to go with a stated income product, it has to pass the smell test. There's no other way how to say it. It has to pass the smell test. There's other quality control the investors use once that loan file gets there. I'm not sure, but I believe salary.com might be one of the search engines that people use to verify the reasonableness of the income associated with that particular customer—how long they've been in that line of work, their assets, and their credit profile. Normally speaking, for a stated income loan to actually go through the qualifying and underwriting processes with one of these lenders here, that's past the smell test not only at their point of sale but also at the point of underwriting. There's a reason why that loan got funded. Somebody believed that income, somebody probably a little bit further down the food change than us at the point of sale. So there are checks and balances. But also there's responsibility on the borrower's side too. That borrower has to know, because they are signing on the document under penalty of perjury, what their income is, so it's a collaborative effort with respect to the income aspect.

SENATOR MACHADO: Would you two like to respond?

MS. CANADA: I guess for me it comes back again to reiterating the standard of an informed choice. Yes, certainly, the buyer, the homebuyer which, mostly we talked to, are first-time homebuyers, they're not—the word you used earlier or frequently was sophisticated buyer—and I'm not sure exactly what that means, other than, you know, we're talking to people who are not familiar with the jargon of real estate lending. They're not familiar with the market. They're not familiar with various products, and they're trusting the people they talk to, to help them, help guide them, help offer them choices. But, yes, they bear some responsibility, and the best way for them to make an informed choice is to get pre-purchase education from a quality, HUD-certified counseling agency that can tell them, face to face, through a class—we provide eight hours of workshop training in pre-purchase and post-purchase education for people so they will be sustainable, successful homeowners. And there are certainly products that are available and ready and probable…

SENATOR MACHADO: Do you think that should be an option that's made available, or do you think it should be a requirement?

MS. CANADA: I think on city-, county-, and state-run programs, it should be a requirement, and I think the state should influence and encourage responsible lenders regulated across the board to provide and require homebuyer education.

SENATOR MACHADO: Thank you.

Marna?

MS. SCHWARTZ: To that end, there are many loans that already require homebuyer education. Many of the subsidized city, state programs do require it, and so I don't see why nontraditional loan products, being as risky as they are, shouldn't fall under those same guidelines. I think that with the stated loans, especially in combination with other high-risk, be it ARM, be it hybrid products, they are something that is really difficult for borrowers to understand. And in fact sometimes the lenders are just going to trainings to keep on top of it.

In terms of whether or not stated loans become fraud or not, the lender is writing down all the information, but the borrower is ultimately signing that. So when we've taken things to district attorneys and so forth around those types of issues, you can't do anything about that because the borrower has signed on them.

SENATOR MACHADO: All right. Thank you.

Now I've got Senator Runner, Senator Correa, Senator Margett, and then Senator Cox.

SENATOR RUNNER: In terms of the issue—in fact, I was just going to ask in regards to the issue of the responsibility of an individual who purposefully misstates an income—a broker—who actually, purposely, misstates an income. What is the penalty for that, from your perspective? I mean, have you found that there's a…

MS. SCHWARTZ: We have not been successful in that.

MS. CANADA: Again, I think what often happens is the broker sells those loans to an investor or servicer in New Jersey, and so there isn't assigned liability, direct, and that what happens is the borrower then who is in trouble doesn't have easy access to justice, and they don't know what their rights are and they don't go to—in fact, there was a recent Freddy Mac survey that Roper did that showed the majority of borrowers in trouble do not go back to their lender, do not go to their servicer; they don't understand that there might be remedies.

SENATOR RUNNER: Okay. Again, from your perspective as somebody, a broker out there who purposely misstates an income…

MR. SMITH: Sir, thank you for the opportunity to answer that question. There are DRE-regulated provisions that are against the law for a mortgage broker to falsely misrepresent the material facts of a loan application and present that to a lender. That's already against the law. If anyone has done that and does not have the resources to pursue that, normally you're speaking, your regulator, whatever jurisdiction you're in or your attorney general should be referred to that case for an investigation. Loan fraud is loan fraud. There's no gray area there.

SENATOR RUNNER: Okay. Now how often has somebody been prosecuted doing that?

MR. SMITH: I don't have those statistics. I think Mr. Davi is here today. He would be probably better to answer those questions.

SENATOR RUNNER: Okay. Then one other quick question in regards to a statement that you made in regards to consumer education. I think you made the statement that you thought anybody who took a nontraditional loan should be required six to eight hours of consumer education. Is that…

MS. SCHWARTZ: That is correct.

SENATOR RUNNER: And under your definition of a nontraditional loan, are you talking about anything other than a 30-year traditional mortgage?

MS. SCHWARTZ: I think it was stated in the paper that was handed out that there is interest-only adjustable rates, hybrid 2/28s.

SENATOR RUNNER: So all ARMs, in your opinion, should have a requirement of that kind of requirement for somebody who's planning to use that particular vehicle?

MS. SCHWARTZ: Yes.

SENATOR RUNNER: Okay. Thank you.

SENATOR MACHADO: Senator Correa.

SENATOR LOU CORREA: Thank you, Mr. Chair.

I'll follow up on a couple of Senator Runner's comments here. It's been a while since I've been in business. But you're filling out a 1003 form, stated income, how is the conversation typically—there's no typical conversation—but hypothetically, do you explain to a borrower this is what it would take to buy a home; this is the kind of income you would need? Then do you ask, what is your income?

MR. SMITH: No, sir. When we take an application, specifically myself, when I take an application from an individual, we sit down and we ask all the critical information that's necessary to evaluate that person's financial status, their credit, and their resources in order to qualify for a home loan. We do not tell people—or at least I don't tell people—to back into a loan amount.

SENATOR CORREA: So you don't believe in the industry there's actually people that essentially mislead or lead, ask leading questions to these borrowers about what kind of stated income they would need to qualify?

MR. SMITH: No, sir. I don't believe—I believe…

SENATOR CORREA: You don't think that happens in the industry?

MR. SMITH: I believe that that does happen. I'm not that naïve.

SENATOR CORREA: Okay.

MR. SMITH: I would like to add one thing, though, and this would go to Mr. Runner's question but he's not here right now. This is a very, very important document that the California Association of Mortgage Brokers has created to put into the marketplace now. It's called a Consumer Protection Worksheet. This is a document that was created by our association that goes through ten critical points of any loan originator in this state to originate a loan that they should ask and open up a dialog with a consumer. It goes all the way from their personal information to the financial information, to their expectations of a loan on a home, to the various mortgage products that are out there.

SENATOR CORREA: When does this instrument actually executed?

MR. SMITH: At the point of application?

SENATOR CORREA: How many other documents were actually executed at the point of the application?

MR. SMITH: Several. If you don't get to the application from the worksheet, if you don't qualify for a loan after you've analyzed this document and you've had that open dialog with the customer, that customer may make a decision that, you know what? I'm not prepared to own a home at this time. And then we can go onto further discussion to determine if and when they are available, ready to buy a home. But once we go through those critical ten questions and it's opening up a dialog…

SENATOR CORREA: Is that in different languages or is that just in English?

MR. SMITH: Yes, sir. It's in Spanish and English.

SENATOR CORREA: Okay.

Mr. Chair, if I can. I've got a couple.

SENATOR MACHADO: Quickly, though. We've got to get to the other…

SENATOR CORREA: Just very quickly. On the issue of education, you recommend the class on education is after the loan or before the actual loan is consummated here?

MS. SCHWARTZ: We would prefer it at the pre-purchase counseling. It's much harder to work with clients who are already in default or are already in their loan.

SENATOR CORREA: Okay If I may, just one concluding statement, that it's interesting. As I listen to the underwriting criteria, because what you've got here, as I'm listening to the interest rates, the yields, and smart money versus not smart money, clearly there are some investors that keep the loans that have a different interest in terms of make sure those are performing loans. And the other brokers that actually sell the loans, the secondary market. So, you know, I'm not quite sure how we would regulate that, but I think that's a big driver in this whole argument here which is, what are you going to invest on and who's going to take the risk ultimately for those loans?

Thank you, Mr. Chair.

SENATOR MACHADO: Thank you.

Senator Margett.

SENATOR MARGETT: Senator Machado many of the questions that I had have already been asked and answered.

SENATOR MACHADO: Thank you.

Senator Cox, likewise?

SENATOR COX: Mr. Chairman, thank you. (Laughter) Not quite, sir.

You know, I'm trying to get—I appreciate the testimony of these two ladies here, but I'd like to try to get a handle on how big the problem really is. My presumption is that the income-stated application, or whatever you call that, somebody had to put the number down. And as far as I know, $15,000 is the same in Spanish as it is in Vietnamese or other things. And so there's some reason to believe that there's some continuity there. But let me just ask the folks who do these stated income, how many transactions a month do you do in your company?

MR. LOWENTHAL: We typically close somewhere around 15,000 loans per month.

SENATOR COX: That's stated income loans?

MR. LOWENTHAL: No.

SENATOR COX: I'm asking about stated income.

MR. LOWENTHAL: Our stated income volume is roughly about 40 percent of the volume that we do.

SENATOR COX: Six thousand or 4,800 a month?

MR. LOWENTHAL: Correct.

SENATOR COX: So you're doing 50,000 a year, and that's all throughout the United States?

MR. LOWENTHAL: Correct.

SENATOR COX: Okay. And let me just ask from a standpoint of defaults. Do you know how many—do you get the same percentage of defaults relative to the stated income as you do other…

MR. LOWENTHAL: Our stated-income loans perform very well. They perform comparably to the other loans that we underwrite. So we are not seeing…

SENATOR COX: Let me do this differently. I'm looking for a number. So I'm looking for a percentage.

MR. LOWENTHAL: Our delinquencies, if you look at our 60-plus delinquencies currently, they're running roughly between 8.5 to 9 percent. Now not everybody that goes 60-plus delinquent is going to stay 60-plus delinquent because of the loss mitigation efforts that we would forward. But included within that number are the delinquency numbers for stated income loans. So we are not seeing, you know, numbers, at least in the delinquency bucket, that are off the charts in terms of loan performance. We view those loans as being a reasonable risk from the lender's perspective today.

SENATOR COX: Okay. And to the ladies who are in the counseling business, how many cases do you do a month or a week?

MS. CANADA: We had—we're just running our numbers for last year. We had about 2,000 people go through our counseling, pre-purchase.

SENATOR COX: Now you haven't helped me, though, but I'm interested in how many cases that you had that were defaults that were in this stated income category?

SENATOR MACHADO: Cases like Marna described.

MS. CANADA: Oh, of that situation. Well, we haven't had one that extreme. That's pretty large. Of the eight that we get per week on an average, three of those would be stated income, and I'm kind of looking anecdotally back on the last few weeks. I don't have any pure numbers to share with you on that, on an overall average.

SENATOR COX: Your area of representation is what?

MS. CANADA: Sacramento region.

SENATOR COX: Sacramento region.

MS. CANADA: Basically Redding down to Stockton.

SENATOR COX: Okay. So you're doing about eight a week, eight a month?

MS. CANADA: Eight a week.

SENATOR COX: How many branches do you have?

MS. CANADA: Pardon me?

SENATOR COX: How many branches?

MS. CANADA: We're just one location.

SENATOR COX: Just one location?

MS. CANADA: But we cover all those areas.

SENATOR COX: Okay. So you're doing…

MS. CANADA: Correct.

SENATOR COX:all right. Forty a month, somewhere in that neighborhood?

MS. CANADA: Yes, sir.

SENATOR COX: Okay. Five hundred…

SENATOR MACHADO: Senator Cox, you're trying to get the magnitude of the stated-income defaults.

SENATOR COX: Well, I'm getting there, I think, Mr. Chairman. I may not be as quick as you…

SENATOR MACHADO: Because I would suggest, rather than trying to go through the arithmetic with the long agenda, perhaps the witnesses for the two companies could assist in providing what that, an indication of what their portfolio might be, to get a magnitude of that problem.

SENATOR COX: Mr. Chairman, I certainly would be interested in that. I also want to hear the counselors' comments because I'm not sure it's as big a problem as they think it is, and that's what I'm trying to determine because that's their business. Whether it's as big a problem as they think it is, is an entirely different situation. That's what I'm trying to determine, whether or not it's something that in fact ought to be regulated, further regulated than it is, and I've not yet, by the testimony that's been made by the opponents, I've not yet come to that conclusion.

MS. CANADA: If I can say, I don't think in my opinion, non-traditional loans serve a very valuable purpose in the marketplace when they are used with suitable clients, when they are matched as was previously talked about. Lenders can match that product to the right consumer and make a perfect marriage. It's a great loan, serves a good purpose. Where we see the difficulties and where my cohorts in Southern California have the same problem, it is when that nontraditional product is not used with a suitable client. It's not the product as well as it is the match with the product or with the consumer that's buying the home.

SENATOR COX: Thank you, Mr. Chairman.

SENATOR RUNNER: Just one comment. Maybe those that you're counseling really shouldn't be buying the home.

MS. CANADA: Maybe they shouldn't, and that's the value of the education.

SENATOR RUNNER: Yes, right.

MS. CANADA: Then they know how to regulate themselves, if you will how to understand that.

SENATOR MACHADO: Thank you very much.

I think we've got a lot of food for thought on this and I appreciate the panel. Thank you.

Next we will have a perspective from the regulations themselves. We have David Wright, associate director, Division of Banking Supervision, Federal Reserve Board; and John Ryan, executive vice-president of Conference of State Bank Supervisors.

First of all, let me thank you for taking the time to come out here to be a part of this today, and I think we're very privileged to be able to have those who work very closely on the development of those guidelines and we very much appreciate your insights and also your comments with reference to what has been said so far in terms of the perspective of the industry and the consumers would be helpful.

MR. DAVID WRIGHT: Thank you, Mr. Chairman. It's a pleasure to be here today. I'm David Wright from the Federal Reserve Board, the Division of Banking Supervision and Regulation, and I cover the risk management end of it there. I'm happy to be here to talk about the federal banking agency's guidance on nontraditional mortgages, and I'd like to give you a little bit of perspective about the rationale for why that came to be.

In 2004 and 2005, supervisors began to observe the rapid growth in these new kinds of mortgages designed to ease payments on borrowers that were facing rapidly escalating house prices in several markets across the country. Additionally, supervisors observed a general easing of underwriting standards, including increasing loan-to-value that to income ratios decrease in credit scores and more loans underwritten on a limited documentation basis, as we were just discussing here. Supervisors also observe more loans originated with simultaneous second liens designed to minimize or even eliminate down payments. Supervisors also observe that consumers may not have been receiving clear and balanced information about the risks and features of interest-only and payment-option ARMs. These products have been advertised and promoted based on their initial low monthly payments without also identifying the risks and burdens to be borne after the initial-period of benefit.

Particularly, these products and practices present unique risks to both borrowers and lenders with a potential for substantial payment increases, lack of principal amortization, and accumulation of negative amortization. Recognizing the significance of these trends and their potential consequences on the nation's housing markets, bank safety, and soundness, and consumer fairness, the chairman of the Federal Reserve and the Secretary of the Treasury convened a meeting bringing together the Federal Banking Regulatory Agencies, including the regulators of credit unions, Freddie Mac and Fannie Mae, to discuss each agency's findings, concerns, and possible solutions. As a result of these meetings, the agencies decided to issue guidance on nontraditional mortgage products in September of 2006 based on a December 2005 proposal that was issued for comment.

The guidance emphasizes the importance of developing sound underwriting standards and portfolio risk management practices. The guidance also details recommended practices for lenders—consumer disclosure—so that a borrower receives clear, balanced, and timely information when shopping for a loan or deciding which monthly payment to make. Toward that end, the guidance urges lenders to assess a borrower's ability to repay the loan at its fully adjusted payment burden, recognize that certain nontraditional mortgage loans are untested in stressed environments requiring heightened risk management, and thirdly, ensure the consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product or payment choice. The guidance is intended to apply to all nontraditional mortgage products whether originated through prime or subprime loans. The agencies have observed these products being originated in both markets.

The guidance applies to all federally regulated banks, thrifts, bank holding companies, thrift holding companies, and all their affiliates. About two-thirds of nontraditional mortgage lenders are federally regulated by at least one of the banking agencies. The remaining roughly one-third is regulated at the state level. When the guidance was under development, the banking agencies recognized that there would be gaps in coverage of the brokers and lenders subject to the guidance and that to some extent practices might migrate out of the federal banking system and still present risks to the public. This is one reason we have supported the work of the CSBS to make these issues better known to state bank commissioners with a view toward adoption of guidance on nontraditional mortgages by states that believe it is appropriate for their jurisdictions.

In closing, I should clarify that I am not here to take a position on any actions that this body may take with regard to nontraditional mortgages. As such, decisions are clearly up for the state to decide itself. Thank you for this opportunity to discuss nontraditional mortgages.

SENATOR MACHADO: So in taking on those regulations, there was a problem with the untestedness of many of these products, a risk that many borrowers may not be fully understanding what they're getting into, and there was a potential impact to the safety and soundness of the banking system?

MR. WRIGHT: Correct.

SENATOR MACHADO: Mr. Ryan.

MR. JOHN RYAN: Thank you. Good afternoon, Chairman Machado and Vice-Chairman Runner and Members of the Committee. I am John Ryan, executive vice-president for the Conference of State Bank Supervisors, which is the professional association of state bank regulators nationwide. And I'd also add, that of our members in all 50 states, 37 of them are also responsible for mortgage supervision.

I appreciate this opportunity to appear before your committee and discuss the model CSBS, AARMR, and AARMR is our mortgage regulator counterpart guidance for providers of nontraditional residential mortgage products. While I've submitted more detailed testimony to the committee in my oral remarks, I'd like to highlight three things: One, why CSBS and AARMR developed the model guidance and believe its adoption is important for consumer protection in the states; second, how changes in mortgage finance and lending necessitate more interstate and state/federal coordination and consistency and the mechanisms that state regulators are developing through CSBS toward this goal; and thirdly, that to emphasize that we believe that there's still, while this is a good first start, there still is much to be done to improve disclosures for the benefit of consumers.

First on the model guidance, over a year ago when this process began at the federal level, CSBS members who participate with our federal counterparts in many meetings concurred with federal regulators that the expanded offering of complex mortgage products to borrowers posed new risks to both consumers and lenders. Our particular concern was that some consumers did not understand the risk of the products, and the risk was not being well communicated in some cases to consumers. And I'd like to add to this, one of the reasons that we chose to do this as guidance, as well as our federal counterparts, is we do recognize it by drawing bright lines, that you can have unintended consequences. And with any action, there obviously are unattended consequences. We're trying to balance as much as possible, the benefits that clearly are provided by these products—the innovation or consumer choice—with some of the risks.

The second point is, we realized, as David has mentioned, that guidance alone at the federal level would not provide consistent consumer protection in our states. It wouldn't reach all state-regulated lenders. I think a perfect example is, the broker you have before you is touched by the guidance through his relationship with Wachovia but not through his relationship with New Century. So we wanted to make sure that the whole universe is recognizing the benefits of the guidance for consumers that we cover the whole universe. We also recognize the limitations that we have in the states to uniformly comply consistent requirements.

We also recognize that the market has significantly changed as it relates to mortgage finance and the delivery of mortgage finance. We have nationwide players in the markets, we have securitization. And those entities desire uniformity and one can understand that, an applicable law and regulation, and they are driving more uniformity at the federal level and Congress is responding to this. This has preempted our authority in certain areas. So where possible and where we see the benefit of a federal approach if we can address this in a uniform way in the states, we believe we have the opportunity to preserve more state authority going forward and avoid more preemption at the federal level.

I'd also like to add that since the time the states got together to follow up on the federal guidance and develop our own model guidance, 26 states and D.C. have approved this guidance in one form or another. Some have done it through letters to the industry; some have done it through a formal regulatory process; and some have done it as guidance. And we have posted on our website the guidance, the model guidance, how it differs from the federal guidance, and a map of all the states that have adopted this. And then from that, I'd like to add what the states are doing to facilitate more consistency and coordination among the states.

First is, is that we are working together for the first time ever, and this is the first time as an organization we have developed something like this, best practices, and modeled guidance. The best practices relates to state regulation of mortgage lenders and brokers where we have the lead in this. It also relates to working with our federal counterparts. For the first time ever, the states now have a vote in the entity called the

FFIAC, the federal banking regulators, that promulgate consistent federal regulations as well as we're working on an interagency basis with the federal regulators.

As it relates to—oh, also I would like to add that we recognize that securitization—there's centralization and nationwide players. But also as a result of that, we've also seen a proliferation, and I think this has resulted in more choice for consumers, of mortgage brokers which are purely regulated by the states. We have developed a uniform license and application for mortgage brokers for the states to adopt and are in the process of developing and will implement on January 1, 2008, a nationwide mortgage, licensing system which would allow the states to share information where administrative actions have been taken against brokers or lenders, and we'll provide more information for consumers on the brokers and lenders that are regulated by states that they do business with.

A last point I'd like to make is that on disclosures, this is a good first step. We're encouraged by the follow up that the federal banking agencies are doing now in developing illustrations that provides guidance to lenders and brokers on how disclosures might appear. We also applaud the Fed's recent update of what's called a CHARM book. It's an acronym which is our Consumer Handbook for ARMs. But bottom line, this is still a very confusing process for consumers, and I think there's something that we as states, in terms of the more common-sense approach sometimes, we bring to this being closer to consumers, can bring together with the federal regulators to make this a more understandable process.

SENATOR MACHADO: I think you're very generous for complimenting with a common-sense approach. (Laughter) Thank you very much.

David, I've heard that there's been some talk about expanding the guidance to include hybrid ARMs, the 2/28s, those products of that such. Is that a consideration that's taking place, and what is the likeliness of that happening?

MR. WRIGHT: Right now, the Federal Banking Agencies are collecting facts around the 2/28 mortgages so that we better understand exactly what might be needed. The Senate Banking Committee has urged us to take a further look into this as well. And so right now, we're in the fact-gathering mode. I would not even attempt to estimate a probability as to what's going to go. Again, we are still trying to understand, you know, the full scope of this issue. And certainly, if we think that there's a real need to put additional guidance out that something will do or if we think the issues around 2/28s fall largely under broader risk management guidance that already exists for banking organizations, we can take that route. So one of the two will probably prevail in the end.

SENATOR MACHADO: In the vernacular, guidance become de-facto regulations?

MR. WRIGHT: No. I don't think so. We're very careful about distinguishing between what is guidance that it's something laid out and more flexible principal based and what is regulation, something that a bank must do. The guidance is basically very effective, though I think supervisors are out there, and these are very strong expectations. However, we have found that in particular instances or in particular settings, things that were written down did not really anticipate changes and practices, innovations, so that following the letter of a rule could actually become counterproductive and have some of the unintended consequences that John Ryan was speaking to. So guidance is implemented more flexibly, but I think the ultimate intent of what we're looking for in nontraditional mortgages will come through in the way we supervise institutions. That doesn't mean it's going to be done softly, but it will be done in a flexible manner that takes into account the realities of the business setting.

SENATOR MACHADO: So where does accountability come in, in terms of looking at compliance with guidance or substantial compliance with guidances?

MR. WRIGHT: Well, the first accountability is for the banking organizations themselves to read, understand the guidance, and set forth policies and procedures that take into account any remedial actions they have to take on their current practices. They also have an accountability to make sure that their compliance functions, their audit functions are fully ready to take in some kind of testing around whether or not their policies are effective, and then ultimately the banking organizations are accountable for making sure that there's follow through with the guidance at the banking organizations.

SENATOR MACHADO: Mr. Ryan, you said that some states have adopted them in terms of regulations, and others have just adopted it as guidance. What differences do you see at the state level in terms of how this affects the industry?

MR. RYAN: Well, I think in both cases the states are trying to maintain the spirit of guidance which is that there are fundamental principles that they believe the industry should be following. But a violation of regulation, even a technical violation, can result in penalties and things like that, and guidance is different in that regard. We are hopeful that the enforcement and the accountability is, one, that the industry recognizes that this is an opportunity to make some changes and that there's some self-enforcing aspects of this because I do believe that if this isn't successful, that we'll see more at the federal level in terms of regulation and legislation. They could have more significant consequences on the industry. And then secondly, there are aspects of the guidance that are based on federal regulation that are already applicable to this universe, so some of those violations could already be enforceable.

SENATOR MACHADO: But that would go directly to the soundness of the industry and not so much to the behavioral practices with respect to informing the potential borrower and making sure there's an understanding of the product?

MR. RYAN: No. I would say beyond, that the federal regulation does fill in some gray area. But as it relates to consumer protections and disclosure, there are also state laws, here in states like California, unfair and deceptive practices, there are other things that really do exist out there that as regulators we could pull together to take action against some that we believe are misleading consumers deliberately or defrauding in the case in some of the issues that come up. And in states when we think this is important where the state is the lead regulator on licenses, they have been aggressive in taking enforcement actions for revoking licenses which is a different regulatory model.

SENATOR MACHADO: Thank you.

Senator Runner, do you have question?

SENATOR RUNNER: Yes. Being the new guy here, I just have a couple; maybe you can help me, with the terms in the industry. The issue of guidance, now I understand regulatory; I understand penalty and for not following regulation. What is—is there a penalty for not following guidance; and how then is guidance enforced?

SENATOR MACHADO: That was the questions that I asked. (Laughter)

SENATOR RUNNER: No. I just didn't quite get the answer. (Laughter)

MR. WRIGHT: That's a very good question. It can be a little bit confusing. So for federal banking regulators, guidance lays out our supervisory expectations of the banking organization, and we will go in and examine around those expectations and see if they're being followed. If they are not being followed and there is not a good explanation as to why they are not being followed, given the particular setting or exceptions, then it will affect our overall assessment of, for example, in this case, the risk management and compliance of the organizations. This can result in a downgrade of the organization's rating; it can have negative consequences on their flexibility in pursuing acquisitions, and it's, importantly, for senior management. It goes to the board, perhaps even for something…

SENATOR RUNNER: So in essence, by not following the guidance, there is an evaluation and it does have effect within their ability to perform their business?

MR. WRIGHT: Absolutely.

SENATOR RUNNER: Okay. Now let me ask you this: In terms of the acceptance of those issues or the implementing of those guidance issues—for instance, when it is picked up for like, you know, Freddie Mac or Fannie Mae, at that point then, does that then help then become more of an enforceable, regulated issue by way of how those particular agencies would then adopt a standard?

MR. WRIGHT: I can't speak to the office OFHEO, which is the regulator for Freddie and Fannie. I can't speak to exactly how they implement these types of things, but they are putting together similar regulations or guidance around that, but I would echo the comments made by others. The vast majority of nontraditional mortgage originations are going into the private securitization market, meaning, Wall Street, investors, foreign investors. It's a very diversified pool. The risks are being layered and distributed in a way tailored to people's risk appetite out in the market. So Freddie Mac and Fannie Mae have some portion of the definition of nontraditional mortgages, but the vast majority is coming through…

SENATOR RUNNER: Let me ask you, Is that true? I mean, I'm just trying to think Freddie Mac and Fannie Mae, for instance, ARMs. That's a product, isn't that, a product that they would have?

MR. WRIGHT: They have the vast majority of conventional ARMs. The vast majority are not nontraditional products.

SENATOR RUNNER: Okay. Let's go down this path because I tried to clarify that a little bit earlier. So again, your definition of nontraditional—or let me go back. Your definition of traditional is much more expanded than the typical 30-year loan.

MR. WRIGHT: Yes. I think the term of art, and there's boundaries here—not everyone fully agrees.

SENATOR RUNNER: Right.

MR. WRIGHT: But what we are looking at in the Federal Banking Agency guidance is, first of all, a loan that isn't fully amortized.

SENATOR RUNNER: Okay.

MR. WRIGHT: Interest only, payment-option ARM, simultaneous second liens.

SENATOR RUNNER: Okay.

MR. WRIGHT: These are mainly the products that are not standard government, you know, qualified, conventional mortgages.

SENATOR RUNNER: Okay. I think, from at least from your testimony compared to the testimony previously, it would seem to me that some people had a more, a broader definition than what is a nontraditional loan.

MR. WRIGHT: Yes, and that may be the case.

SENATOR RUNNER: Okay.

MR. WRIGHT: If some people include all adjustable-rate mortgages—and some of those have been confusing to consumers, and that's why we have our CHARM booklets.

SENATOR RUNNER: Okay. Good. Thank you.

SENATOR MACHADO: All right. Well, thank you very much. It's been very helpful.

Our next panel will be a Regulatory Perspective from California. We have Preston DuFauchard; we have Jeff Davi and Michael Kelley.

I've asked each of them to answer two questions. One, Does your organization believe that the CSBS guidance should be applied to your members? And if so, do you anticipate any problems or challenges in complying with it? And I also want to know if you have the statutory authority to be able to implement the CSBS guidance without any action by the legislature.

MR. PRESTON DuFAUCHARD: Good afternoon, Mr. Chairman and Members of the Senate Banking, Finance & Insurance Committee. My name is Preston DuFauchard. I'm the commissioner for the California Department of Corporations. I was appointed to this position just over six months ago. Thank you for inviting me to attend this hearing. Joining me today are a couple of people from my staff—Louisa Brody and Timothy LaBass. Louisa Brody is deputy commissioner in charge of the department's Financial Services Division, and that division is responsible for licensing in the regulation of licensees under the California Residential Mortgage Lender law and the California Finance Lenders law, among others. Tim LaBass is deputy commissioner with the Department of Office of Law and Legislation.

We were asked to address two questions, as the chair just noted, first, whether the department is authorized to implement and enforce the guidance on nontraditional mortgage risk, product risks, as developed by the Conference of Bank Supervisors and the American Association of Residential Mortgage Regulators. And the second question is whether the department foresees any challenges to implementing and enforcing the guidance. The short answer to each of these questions is yes, and I'll expand on them very briefly.

First of all, as to the authority, the laws administered by the department provide the commissioner with broad authority to adopt guidelines for those licensed lenders making mortgage loans in California. For example, a financial lenders' law specifically provides that the commissioner may make general rules and regulations for enforcement of this division in addition to and within the general purposes of this division, and the Residential Mortgage Lending Act has a similar although less explicit provision. So these provisions do authorize the department to adopt some form of regulation that would require the department licensees to follow the guidance that has previously been testified to, and the process for adopting that would be governed by the California Administrative Procedures Act which sets forth sort of the process for our department and other departments in adopting these guidelines. Given the various public notice and formal approval requirements, it takes, in our experience, anywhere from six months to a year to adopt that guidance.

In our annual rulemaking calendar, the Department of Corporations has to prepare by January 30 of each year. We have actually listed the guidance as potential rulemaking in this year, 2007. So let me talk about the challenges to implementation. And I should discuss in that vein external challenges to the department's legal authority and internal challenges of implementation. As far as external challenges to the department's legal authority are concerned, we are aware of no source of such a challenge, but we do face internal challenges of implementing the guidance. The largest challenge is a function of the scope of the guidance. Much of it concerns itself with institutional risk management. The federal regulatory agencies that adopted the guidance are agencies concerned with systemic risks posed by nontraditional mortgage products, that is, they monitor the risks these loans have on individual member banks, risks posed to the banking system as a whole, and risks to investors who purchase mortgage-backed securities in the marketplace. And I think Mr. Ryan, who just testified, disclosed some of the ways that they've identified these risks to their institutions. Even in the way these federal agencies set out the guidance proposals, they suggest institutional risk management measures before discussing consumer protection measures. As such, the guidance these federal regulators have adopted get at the problems associated with nontraditional mortgages from slightly a different angle than the examination procedures used by the Department of Corporations when we examine our licensees.

The lending laws the department enforces, tend to place the interest of the consumers and fair competition ahead of the institutional and risk management systems of any particular company. Accordingly, the department examinations of its lenders tends to place little emphasis on safety and soundness of loan portfolios and institutional risk processes. Instead, the examinations that we conduct concern ourselves with fairness and transparency of the lending practices—for example, making sure that the lenders are not overcharging borrowers in calculating allowable fees. To be sure that proposed guidance contains prescriptions for consumer protections—and we agree that consumers should understand the risks of these products to present more fully—but the guidance goes much further than the consumer protection measures. The guidance concerns sound underwriting practices and risk management procedures. Accordingly, the examination and enforcement of the full set of guidelines from our perspective may be a bigger pill than the Department of Corporations can swallow with existing resources. Adoption of any form of regulation, of course, creates the expectation that it will be enforced, and so the department would need additional training to develop skills and resources to analyze and enforce underwriting criteria that risk management procedures of its licensees may follow.

Unlike my colleagues from the Department of Financial Institutions, we don't have a staff of bank examiners to assess the safety and soundness of loans made by our licensees. For these reasons, we're assessing how to implement the consumer provisions of the guidance and be flexible on the other provisions.

That concludes my remarks, and I want to thank the chair and the committee for inviting me to participate in this hearing.

SENATOR MACHADO: Thank you very much.

Mr. Kelley, do you prefer to go next?

MR. JEFF DAVI: Davi.

SENATOR MACHADO: Davi. I'm sorry.

MR. DAVI: Okay. Senator, thank you. Mr. Chair, thank you. I'm Jeff Davi, a real estate commissioner, and I appreciate the opportunity to address the issue of nontraditional mortgages products and consumer protection today.

I've brought with me two members of my staff—my chief deputy, John Liberator; and Tom Pool, as well from our legislative and publications section. As commissioner and a one-time practicing broker, I have a broad perspective on mortgage lending and the abuses that can occur and the problems entailed in regulating mortgage broker transactions. I know my time is brief. So instead of providing a description of the department's programs, its regulatory authority, and the available consumer publications, I've brought for each of you a folder, materials that contain, among many things, my written testimony, information about the DRE, and pertinent consumer publications.

The committee's asked that I respond to two specific issues, including whether the DRE, which licenses real estate brokers who conduct business as mortgage brokers, has the authority to implement and enforce the guidance issue jointly by the Conference of State Banks Supervisors and the American Association and Residential Mortgage Lenders regarding the origination of nontraditional mortgage programs. The short answer is that I believe the DRE currently does have the statutory authority to implement the guidance, at least to the extent the guidance is applicable to real estate brokers through broker loans. However, I also believe a careful and measured approach for implementation of guidance, as it relates to real estate brokers, is necessary to ensure the desired outcome of the consumer education has achieved. In this regard, I think it would be helpful to provide some background.

The real estate law allows brokers to conduct a wide variety of activities, including the listing and sale of real property and mortgage brokering. In fact, over the past decade or so, mortgage brokers have become a significant player in arranging mortgage loans in California. The great majority of mortgage brokers act as retail channels for banks, thrifts, and mortgage bankers. Mortgage brokers, as was testified earlier today by Mr. Smith, generally do not have any latitude regarding the underwriting guidelines of the loans they arrange and have little leeway regarding the rates charged to the borrower. Mortgage brokers typically act as a conduit for lenders. Their role is generally limited to originating loans on behalf of lenders, and ensuring the loan product offered by the lender is packaged pursuant to the guidelines required by that lender with whom the broker's affiliated or associated.

As such, I believe most of the guidance is not applicable to the real estate brokers. The guidance does not provide guidelines for lenders who accept third-party originations, and I believe the guidelines set forth for third-party originations are appropriate. There's one portion of guidance, however, that I believe is applicable to the mortgage brokers, and that is, the timely delivery of lender-required, nontraditional disclosures, and how the products are marketed. With respect to marketing and advertising, existing law requires that real estate brokers disclose all material facts about a product in the ad or material used to solicit borrowers.

In the folder I've provided you, you will find the pertinent advertising laws and regulations. In brief, any promotion of a nontraditional mortgage must include the material facts of the product, so the ad or promotional material is not misleading. This would include disclosures of the possibility of negative amortization, frequency of payment or rate, adjustments, and the amount of the balloon payment if the program is not fully amortized. This is also true of any verbal discussions a broker has with a borrower.

The department has made significant efforts to educate brokers about their responsibilities owed to borrowers, especially when arranging nontraditional mortgages. These efforts include a publication of the real estate law book and materials on the mortgage loan advertising requirements, a mortgage loan bulletin, and a book on mortgage brokering in California and routine participation and industry educational seminars. We've also made an extensive effort to educate borrowers in this regard. I would urge you to take the time to review the published consumer booklet using the services of a mortgage broker which is the white multiple-page booklet inside your handout. On pages 11, 12, and 13, it educates a borrower on what questions to ask to ensure understanding of the loan terms.

SENATOR MACHADO: Could summarize the rest of it so we can get through?

MR. DAVI: Okay.

SENATOR MACHADO: That's a lot of pages.

MR. DAVI: I have lots to give you.

There's one issue that I'd like to raise with respect to the requirements of nontraditional mortgage disclosure with the guidance. It states many have argued that lenders should not be responsible for overseeing the marketing and borrowing disclosures of practicing third parties. However, the guidance makes it clear that expects the lender should have systems of controls of establishing and maintaining relationship with third parties because reliance of third-party relationships can significantly increase the institution's risk of that profile. The guidance goes on to state that lender oversight to third party should involve the monitoring quality originations so that it reflects the lender's standard. Presumably this would include giving consumers—lenders—nontraditional mortgage disclosure that raises the issue with respect to broker loans.

I think we can all agree that the sooner the consumer is notified as to the terms of these loans, the better off they are. In concluding, one of the concerns we would have is, that when you have a broker, initially you meet with a client over a loan, the specific lender in mind may not have been selected, so the information provided may be provided at that point and then duplicated by the exact lender once the lender is selected later on in the process. So I would just be concerned whether there could be a duplication of a very, paper-written transactions to begin with, which could also foster the lack of a consumer to read these documents and go through them. So we need to be aware of that as we do it.

SENATOR MACHADO: Thank you very much.

MR. DAVI: I'll conclude there at your request.

SENATOR MACHADO: Thank you very much, Mr. Davi.

Mr. Kelley.

MR. MICHAEL KELLEY: Mr. Chairman, Members. My name is Michael Kelley, and I'm the commissioner of the Department of Financial Institutions and I too have two of my key staff members here to assist me in offering any information you have. I have with me my senior deputy and chief examiner, Craig Carlson, and also the deputy commissioner of credit unions, Beth Dooley.

For the hearing, you asked me to address two issues. The first issue is whether or not we believe that the department's licensees are subject to the federal guideline; and secondly, what authority and how do we expect to enforce the guidance. So the answer to the first question is simple, and it is, yes. We do believe our licensees are subject to the guidelines, and that's because the department's licensees, the banks and the credit unions, their insuring entities were party to the federal agreement, and the bank side is the FDIC, Federal Deposit Insurance Corporation, and on the credit union side is the NCUA, which is the National Credit Union Administration. And so as a result of those two entities being party to it, we believe that that is sufficient authority to allow us to hold our licensees subject to the guidance. The one group of licensees that is not specifically mentioned is the 18 privately insured and state-chartered credit unions. With regard to those private-lien-insured credit unions, the department has also instructed them, along with all of our licensees, to adhere to the guidance.

Now the question of, Do we expect any challenges, I'm fortunate that I believe I have a very good working relationship with my licensees and their representatives. But, no, I do not expect any challenge to our authorities to direct our licensees to adhere to this policy. Quite specifically, if the licensees were to challenge me, I believe that the Financial Institutions Code, Section 215, which covers banks, and Financial Institutions Code 14201, which covers the credit unions, provide sufficient authority for me to direct the licensees to enforce the provisions of the guidance. But as Commissioner DuFauchard has noted, those provisions require the passage of a regulation which in and of itself could be a very lengthy process. It could take anywhere from two to six or eight months. So rather than rely on a process that was very lengthy, I also have some backup authority that I believe is appropriate that allowed me to immediately to utilize the authority on the books to enforce it. And that authority is embodied in a broad concept that the legislature has given the commissioner, and that is, to ensure the safety and the soundness of financial institutions, and specifically, in Financial Code Section 1912, 14204, and 14205. So under those broad authorities, my examiners can apply and look at the principles and opine on them in terms of whether or not the institution is following it.

Now just quickly, I'll talk about some of the steps that we've taken to make sure that our licensees understand that we intend for them to follow the guidance. The first thing I did is the department announced our expectations in our January bulletin. We have a monthly bulletin we send to all licensees, and very prominently in the beginning was the announcement that we expected them to adhere to the guidance and advise them to read and familiarize themselves with the guidance and carefully scrutinize their risk-management processes, policies, and procedures in this area. In the same bulletin, the department noted that the federal regulatory agencies announced a publication—and I think the individual from CSBS mentioned it—where it's a consumer booklet, *Interest-Only Mortgage Payments and Options ARMS, Are They for You?* And what we also provided for to our licensees is information on where they can get it, links on our web page, we were trying to do everything we could to ensure that our licensees had a resource that they could pass onto their customers to help them make informed decisions about this product. We have it on our web page; and if any of you desire through your staff, we will make the information available, to you to let you look at it yourself. But it's a very important consumer document that we wanted to make sure that our licensees knew about and availed themselves to.

The second thing the department did is, we requested all of our licensees to provide some information in terms of how prevalent is this product, or are these products, and their product line. And we just are beginning to get back some of the information. But what that information is designed to do is hopefully provide us a picture of how prevalent is it and how are they managing it. So that is in the works, and we are getting that information and I'll be glad to share that with you as more information comes in.

And the third thing we did, which I think is the most important, is we provided direction via what we call an examination bulletin or, for our examiners, were those people who are out in the field who are actually looking at the loans and giving them guidance on what we expect them to do in terms of reviewing the loans that they come across that represent these nontraditional products. Previously, it was asked, you know, what do we do if we find it? Under our general authority, it can become an issue of concern that is documented in the examination which then could ultimately lead to a different rating or, you know, a memorandum of understanding in terms of them changing or shoring up some of the things that they're doing.

So in closing, I'd say that, you know, DFI were in a much better position to enforce what is there; we have done what we think is appropriate in terms of consumer protections and advising our licensees to adhere to it. And not only did we advise them to it, we believe we have the authority that the legislature has given us to make sure that they're doing it in the appropriate fashion. So it's my closing comments. And if you have any more detailed questions, as I said, I have my two experts in the area that will help in addressing any of your specific questions or concerns.

SENATOR MACHADO: Thank you, Mr. Kelley.

Question for DOC and DRE. Do you plan to introduce to pursue regulations this year?

MR. DuFAUCHARD: We're trying to figure out what the best way of doing that is. As noted before, I think by Mr. Ryan, 26 states have announced that they intend to adopt a guidance in some form or another. Most of the states that have announced they intend to adopt the guidance are regulators that are in Mr. Kelley's shoes, in some sense. They are state bank regulators which are federally insured. Other iterations of that have been an endorsement of the guidance. I don't really know what that means from a regulatory standpoint.

SENATOR MACHADO: Well, but from the standpoint of what a portion of the guidelines that would deal with consumer protection.

MR. DuFAUCHARD: Another way of doing that would be to say that this guidance is something that represents the best practice around these products, and we would expect our licensees to, and at examination time, we would look to see whether our licensees will report on these types of things, specifically on the consumer protection areas, yes.

SENATOR MACHADO: But you're talking about guidance, so you would be able to do this without regulation, not going through the administrative law process?

MR. DuFAUCHARD: I'm trying to figure out exactly. If we can be flexible and say this is the best practices, then we would expect to do this in form of an order, if you will.

SENATOR MACHADO: So when do you think you'll have some direction within your department on this?

MR. DuFAUCHARD: I'll need to rely on my general counsel to help me with how to structure it. We had actually put it on our regulatory calendar, but I wasn't sure exactly. As I said, I was sensitive to the staffing needs.

SENATOR MACHADO: Other questions you've asked is whether or not you're going to do this and how to do this. When do you think you would have that answer?

MR. DuFAUCHARD: I don't have it today but…

SENATOR MACHADO: I understand that.

MR. DuFAUCHARD: …to have that pretty soon. Senator, I would think within the next month, I could have that answer to that.

SENATOR MACHADO: Okay. If you could communicate with our staff, I would appreciate it. That's one of the questions I think we're deciding, trying to look at, is how best to pursue this. And if you have the authority and you're going to take the initiative to be able to do this in a way that's going to be effective, then we don't need to encumber the process.

MR. DuFAUCHARD: I understand.

MR. DAVI: If I can follow up the question. We don't have plans to adopt any regulations in this regard. We do feel we have the ability on the guidance side with the authority for those applications to a mortgage brokerage. However, it seems to me, that as we're all going through this, there may be some situations where the departments might want to get together and the best way to implement these guidance issues.

SENATOR MACHADO: But aren't some of your licensees a little more independent than those that would come under Mr. Kelley and even so those of Mr. DuFauchard.

MR. DAVI: When you say independent, you mean…

SENATOR MACHADO: I mean, they're over here. They're the ones—they're not within an agency; they're operating as a broker.

MR. DAVI: Correct.

SENATOR MACHADO: And oftentimes, there's not a bright line between them acting as a real estate licensee and a broker.

MR. DAVI: There is no…

SENATOR MACHADO: That's right.

MR. DAVI: That's right.

SENATOR MACHADO: Do you think that gets clouded in terms of who I am and what I'm doing?

MR. DAVI: Well, the license allows them to do either of those things. So it's definitely…

SENATOR MACHADO: Do you think there's some inherent conflict there if I'm trying to sell a house and also deliver a package to finance that house?

MR. DAVI: I don't believe there's an inherent conflict. I believe that the law allows disclosure in those situations, and that's the law that I regulate. It does allow…

SENATOR MACHADO: But I think, from the testimony we've heard today, that there seems to be some problems or some need for more emphasis on consumer education as to the acceptability, and what we have heard—and not only have I heard here today but I've heard elsewhere where you have had some aggressive tactics taken to qualify that oftentimes after that qualification people are extremely disappointed. But there usually is no ability to recover the commissions associated with the transaction.

MR. DAVI: I understand that.

SENATOR MACHADO: Has your department taken a look to see what there is, any conflicts between your real estate licensees and the brokers and the carrying out their business and to what extent that impacts the consumer?

MR. DAVI: We haven't looked at the conflicts. We've gone ahead and taken disciplinary action against those licensees that we found participating in those types of activities.

SENATOR MACHADO: How did you find that?

MR. DAVI: They were typically discovered in an audit or they're discovered by a complaint, and we get between 7,000 and 8,000 complaints a year that we look through about all the licensees and determine, to set up cases, and then go ahead and take disciplinary action.

SENATOR MACHADO: Of the 137,000 brokers that you have, how many audits do you perform a year?

MR. DAVI: In the area of—this is a ballpark—1,600 audits, and we have about 7,000 to 8,000 cases established overall.

SENATOR MACHADO: Are those cases strictly brokers or they're across the board?

MR. DAVI: They're not distinguished between the two, Senator, so they're all away across the board, all of those licenses.

SENATOR MACHADO: Okay. What I'm hearing is some hedging on the department wanting to have some guidance to the broker's side of this for the consumer protection aspect of this, and I'm also concerned that the department seems to be unconcerned about a bright line between the function of the real estate licensee and a broker.

MR. DAVI: That's not what I'm trying to say, so I apologize for misleading you. We are willing to and we feel we have the authority to put in place the guidance now and we are doing that. My point was, if we're going to talk about regulations, then perhaps there should be a little more discussion among both departments, Department of Financial Institutions, as to the best of those guidelines to adopt and make any regulations if we decide to go that route. I'm all for that, and I want to continue to prep the consumer. But I just want to make sure that we address the mortgage brokers that are being the conduits, channel more appropriately versus those mortgage lenders that are producing the products.

SENATOR MACHADO: I concur with that. My question goes back to you. Because of the nature of the products and the complexity that the borrower faces in trying to understand that, do you think there should be a right line between the real estate licensee and the broker in the carrying out those transactions?

MR. DAVI: There is a line, but you understand, the law allows both to occur.

SENATOR MACHADO: Well, I know the law allows a lot of things to happen, but that does not necessarily mean that law is appropriate today.

MR. DAVI: Well, it does work. It does work well in many cases. It's the cases where you have the situations that Senator Correa talked about, where the person in the quick-qualifier type of loan and he's got a loan broker that's egging them on; I mean if you want to buy this house, you've got to have this kind of income—those are the bad brokers out there. I don't know that that means the ability for a licensed real estate broker to do both needs to be changed in law. That's what I'm trying to say. I think that we've got to get the bad brokers out of business and we've got to stop them from hurting the consumers. But it doesn't mean we change the law necessarily to do that line, that fine line. That's all I'm saying.

SENATOR MACHADO: Senator Runner.

SENATOR RUNNER: Thank you.

I'm going to follow up on—we began earlier, one of the other panels—in regards to, particularly the concerns in regards to income stated loans and then the concern that many had, or some had, I should say, in regards to the fact that they were done fraudulently. Actually, almost, and sometimes with the person who is making the loan, sometimes without that individual's even knowledge being done by the broker themselves in regards to misstating incomes, those kind of issues. So my question is, and I'm not sure exactly in terms of who actually is responsible for prosecuting those, whether it's—is it Mr. Davi or Mr. Kelley?—in regards to the Department of Financial Institutions. But anyhow, when that is done—let me ask you this: How many prosecutions have there been for fraudulently misstating an individual's income?

MR. DAVI: I can't specifically say how many that that occurrence has occurred, but the Department of Real Estate, when licensees are involved in misrepresentation of fraud, what that would be, our ultimate penalty would be revocation of their license. And then we do turn that file over to the district attorney, and we encourage the district attorney to prosecute.

SENATOR RUNNER: And you don't have any idea how many those are?

MR. DAVI: I was trying to see if I can gather that up before I got up here because I knew I was going to be asked. I don't have a number, whether it's one or it's ten or it's 100. I venture to say this, sometimes the district attorneys will tell us. They have other cases that are life-concerning things that they prosecute; and sometimes matters that just don't get prosecuted. So it's really up to that jurisdiction to prosecute someone for fraud and put them in jail potentially which is allowable, which is allowable punishment. But we end up revoking a license from the Department of Real Estate.

SENATOR RUNNER: Could you get me that number? Could you get the committee that number, how many have actually had prosecutions or…

MR. DAVI: It's beyond our department's scope. We'll be asking, of our cases that we've closed, how many have gone on to be prosecuted and convicted of some kind of…

SENATOR RUNNER: Well, why don't you start with telling us how many licenses have been revoked at that point? Maybe we can find out from there. No, no, no. In regards to the specific, in regards to the issue of fraudulently stating an income.

MR. DAVI: I'd have to do some research on that and get back to you.

SENATOR RUNNER: Right. So if you can get that to us, that would be helpful. And again, I don't know from the other perspectives here, from the Department of Corporations or the commissioner, you know, the commissioner of Financial Institutions, if you also participate in that, in regards to that role.

MR. KELLEY: Our licensees would have the ability to make stated income loans. We haven't, I'm not aware of any complaints that I've received. Typically that would come from the lender, and the lender would have available resources, that is, if the misstatement is to the lender…

SENATOR RUNNER: What's the lender's motivation for making that complaint?

MR. KELLEY: The lender would have no motivation. That's what I'm saying. They would have the adequate resources and they would fund the loan. And if the borrower defaults, obviously, they would have all the available resources to address that issue.

SENATOR RUNNER: I was just going to say, and help me understand this point then, if the lender is the one who have to file the complaint, what is the lender's motivation for filing the complaint against somebody who's misstating someone's income?

MR. DuFAUCHARD: Absolutely no motivation. They would have adequate resources through the normal foreclosure process because it's a—and similarly, I'm not aware of any consumer…

SENATOR RUNNER: So in essence, there's no penalty out there for the broker who knowingly misstates somebody's income in order for a loan qualification?

MR. DuFAUCHARD: There must be federal law that says you cannot lie on and—I used to work for a bank.

SENATOR RUNNER: My point is that there is a law. The point is, is there any prosecution? Is there anybody who actually is prosecuted or gets in trouble for doing that?

MR. DuFAUCHARD: I'm not aware of it.

SENATOR RUNNER: Okay.

SENATOR MACHADO: Could you take it back to your staff and then come back to the committee with what…

MR. DuFAUCHARD: Absolutely. I will take it back.

SENATOR RUNNER: Again, if part of this discussion is about the implementing of additional guidance, then I'm kind of frustrated that we already have some actual statute that we've already indicated that some of these practices are illegal. But yet we don't have any enforcement of the current statute. So at that point, what good does it have to do additional guidance?

MR. KELLEY: Mr. Chairman, I'll just add from the standpoint of DFI, in our particular case and as it doesn't relate to the mortgage brokers is, the example given. But when our licensees and our examiners sit down and we go through things, and if we find that something is misstated and we believe it was fraudulently misstated in an application, we would turn that over to the attorney general and the attorney general would then seek prosecution.

SENATOR RUNNER: Can you tell us how many of those you've turned over to the attorney general?

MR. KELLEY: We will look through or records to see, you know, in our exams how many situations have occurred where we've had to turn something over. But in my brief tenure there, all the things we've talked about, in my group of licensees, it doesn't appear to happen very much, if at all.

SENATOR RUNNER: Again, you can understand what my concern is. We've heard earlier that that is a major concern in regards to the abuse of income-stated loans. And so if that's a major point of the abuse in regards to the fraudulent aspect, then it seems to me there ought to be an equal concern in regards to how it is that we prosecute or how it is that we deal with that fraud.

SENATOR MACHADO: I think in fairness to the three departments, the Department of Finance has the staffing and the requirement for safety and soundness, a routine audit system that goes through all the financial institutions underneath their jurisdiction, as where the other two departments may not be fully staffed. I know last year we worked with the Department of Corporations to try to get more enforcement personnel to be able to take on some of that and the Department of Real Estate likewise to be able to do it. So it's a worthwhile topic to see. It would be helpful for the committee to know to what extent you can, can't, and where you think some of the voids are also.

Senator Correa.

SENATOR CORREA: Thank you, Mr. Chair. I just wanted to also follow up Mr. Runner to make sure we get the figures on the—I guess those that have been actually prosecuted, successful prosecutions, and what the penalties are. All of us that are licensed get that annual, or I should say, monthly. Is it monthly?

UNIDENTIFIED SPEAKER: It's a quarterly newsletter.

SENATOR CORREA: A quarterly newsletter, a list of individuals that have had their license removed. It looks like a lot of them. But when you look here, that you've got broker salespersons, a total of about half a million people that are licensed right now. I would imagine percentage-wise, very, very few actually get to the point where they actually lose their license. And many of them, as you know, can actually regain their license. So I'd love to look at those figures.

Mr. Chair, as I'm thinking here about your question about the inherent conflict of interest between a person doing a loan and essentially the broker of sales, so to speak, on the deal, I'm not quite sure that's really the issue because you can also have collusion between the broker and salesperson to give each other the deals and that's the way you generate the business. Anyway, I look forward to looking at that information.

MR. DAVI: I preface with the material I have. One of the issues is we don't separate mortgage brokerage loan fraud versus fraud in another form of real estate transaction because the license allows for all those things to occur. So I'm going to go back and try to figure out the best way to give you what you need, but the numbers that I've been giving you today reflect all the licensees.

SENATOR MACHADO: I would be good to have a bright light.

SENATOR CORREA: Mr. Chair, just as I listen to this whole discussion today, just very quickly, it's an interesting area because in many ways you're trying to save people from themselves when they're trying to fall in love with that beautiful house and they want to qualify. Yet, that doesn't absolve certain individuals and their profession from being clear in representing to that individual who's getting the loan, what their ability is to repay that loan. You know, I've heard people come to me and say, so and so broker told me, and I almost quote verbatim this individual told me, Should I buy the house? A broker told me it's a brand new house, deep discount, you know, 20 percent. They're not moving the houses. They're going to qualify me an adjustable and they promised me in one year I can refinance into a fixed rate and it will be much less expensive. I mean, it just doesn't make sense but you've got professionals that are actually licensed in this area making those false representations, and I don't know how you prove in a court of law or procedure-wise in front of one of your regulatory bodies, how do you prove, you know, that those words were actually, you know, stated by that broker or that salesperson? And that's what I'm trying to figure out. How do you grapple with that specific issue?

You know, when you talk about disclosure, you've got reams and reams of documents, and I challenge even the most competent attorney here who's read through all that stuff when you go to buy a house. You don't; you don't; you can't.

SENATOR MACHADO: Thank you. Thank you very much for the panel.

Next, we'll have the Perspective of the Regulated Community. They will come up and tell us how they're going to concur with all the comments previously made and we should have no problems.

Mr. Ross that would be greatly appreciated. Mr. Ross, since you first spoke, you can commence.

MR. JON ROSS: Good afternoon. I'm John Ross on behalf of the California Mortgage Bankers Association. Mortgage Bankers are lenders who make home loans. They make them from their own funds, typically funds they borrow from another bank, and predominantly, they're loans and then sold in the secondary market. And with the funds they get back, they make more loans. That's what distinguishes a mortgage bank from a bank-bank that may have deposits that they use to fund loans or a broker who doesn't use their own money but arranges a loan that's made by someone else, just too sort of set the table a little bit.

Very, very briefly, just to put the market in perspective, Senator Machado, when you and I first started talking about these issues, we were talking about liquidity problems in the market and the ability to get mortgage money in here. We have a market now that's increasingly liquid because of the development of secondary market players.

SENATOR MACHADO: You're telling people how long we've been around here.

MR. ROSS: Well, it's the gray hair that gives me away. (Laughter) It's an increasingly flexible market. You now have multiple, secondary market players who buy different types of loans, looking out for different kinds of products, and it's increasingly competitive and all that. I think it leads to generally the lower prices we've seen in the mortgage market over the last five to ten years.

The one other change in the market, I'd like to comment on before getting into the specifics of the guidances, is that unlike, say, ten years ago, there's a vast majority of the product that comes in through mortgage brokers, through folks like Mr. Smith. That's different. I'd say it's close to half the loans coming to a mortgage bank to a broker. That broker takes on a different role but also provides the customer a choice. The broker takes on a fiduciary obligation. He's there to consult with the borrower and help them through the process. The borrower can also go straight to a lender and take on a lot of that responsibility for making these evaluations themselves, but that's a phenomena that's, you know, we've seen over the last decade.

On the guidance specifically, we've talked to our membership. I think our membership accepts that it's coming and is prepared to adapt. I think the concerns overwhelmingly are that there be uniform application between state and federally licensed entities, that there be uniformity to the extent possible between various state licensees—Department of Real Estate, Department of Corporations, Department of Financial Institutions—and to the extent possible, as someone mentioned earlier, uniformity between the states because we're in a national market and a variety of obligations here across state lines can make the process more expensive.

One thing I'd like to respond to or at least comment on that Commissioner DuFauchard brought up, and I think it's a good point that I hadn't thought about a lot until he said it today, our licensees typically operate under the Residential Mortgage Lending Act, and that law, when it was set up, was set up to emphasize consumer protection and fairness in the market but not necessarily to protect the investors, the secondary market investors. To get this license, you have to be HUD-certified and be doing business with Fannie and Freddie and other large institutions. I think the judgment of the legislature then—it was correct—was we don't have a safety and soundness concern about them. We'll let the federal government, we'll let OFHEO and others ensure that they are sound so there isn't an emphasis placed on our law on the underwriting practices of mortgage bankers because in part those are derivative of what Fannie and Freddie and others tell us to do. So I think the commissioner's point is right, that in adapting the guidance at least in the area of the market, the consumer protections and others obviously have applicability. We need to think through how you have guidance and encourage it without creating an expectation that the department now has to begin analyzing the underwriting practices of mortgage lenders from a safety and soundness perspective which I don't think anybody ever contemplated when we did that law.

SENATOR MACHADO: Thank you.

Mr. Hines. Let's just work around the table.

MR. GREG HINES: Mr. Chair and Members of the Committee, I want to start out today by thanking you for the opportunity to be here. I think this is a great forum, and the fact that we're speaking on nontraditional mortgage products in this way before going forward with any regulatory legislative action speaks well for the state.

My name is Greg Hines. I'm the director of Government Affairs for the California Association of Mortgage Brokers. Since its inception in 1990, CAMB has promoted the highest standards of professional and ethical conduct, among which are expert knowledge and accountability, fair dealing, and service to the consumer in our community. The association provides education, legislative and regulatory representation, and public relations for up to over 4,000 membership of mortgage brokers and affiliated service providers across California.

Nontraditional mortgage products are the driving force for home ownership today. It was innovation within the mortgage-lending industry that led to the development of nontraditional mortgage products and allowed lenders and consumers to work together to combat significantly rising home prices, the thing that we've all seen, especially here in California. However, with innovation come new issues and complications. While these nontraditional mortgage products offer the opportunity of lower monthly payments compared to traditional mortgages, they also come with increased financial risk, consumer responsibility, and more opportunities for the occurrence of abusive lending practices. Included in the regulatory agency guidelines for recommendations related to the updating of loan disclosures, we at CAMB wholeheartedly agree with the federal and CSBS/AARMR government goals to educate the consumer in efforts to curb predatory lending and believe that our members are already practicing much of the prescribed recommendations. CAMB believes it is important to update mortgage informational brochures and key mortgage disclosures to address nontraditional mortgages and made the requirements of those disclosures uniform for all loan originators. Furthermore, we believe any changes need to be consumer tested in order to determine the effectiveness of those changes.

Updating brochures and other educational materials and writing the material in a way the average consumer can understand will help increase consumer knowledge of all mortgages in the marketplace. At the federal level, government-required information booklets that have been described earlier by testimony from the federal agencies, like *Buying Your Home: Settlement Costs, Helpful Information* and the *CHARM* booklet need to be updated better to succinctly explain the potential risks and benefits of these types of loans. Consumer education is a vital tool to protect from unscrupulous lending practices, and this information should be available to all consumers, no matter where they come from or where they are buying their home.

Current government-required mortgage disclosures that are designed to ensure consumers are well informed are based on mortgage market without the presence of nontraditional mortgage products. Interest-only and payment Option adjustable rate mortgage rate mortgages with their payment variability based on consumer choice has made government disclosures ineffective in truly disclosing the financial terms, benefits, and risks of a particular loan. Government-required mortgage disclosures, like the Good Faith Estimate, the Truth in Lending Statement, and California's own Mortgage Loan Disclosure Statements need to be updated to provide consumers with a clear perspective of their loan, the actual costs, benefits, and long-term financial risks of a loan under different financial scenarios, including a worst-case scenario.

While efforts to reform and revise current disclosures is a necessary step, we firmly believe that a government must renew its focus on providing sufficient resources to enforce existing abusive lending laws. Most of the abusive lending practices that occur today are already illegal under current federal and state laws, and increasing enforcement efforts amongst the state and federal regulatory agencies will have a dramatic effect on curbing abusive lending practices in the mortgage industry. We can continue to do what's right for the consumer through education, updating disclosures and other information, and continuing to teach and practice high ethical standards. But in the end, these efforts will make little difference if adequate resources and energies are not provided to assist the commissioners in their efforts to stop the bad actors. Mortgage industry, consumer groups, and government in their daily interaction in the marketplace can and should help government agencies target new abusive lending practices as they are identified and help identify bad actors within the industry.

Above all else, it is imperative that we all work together to improve consumer education related to the various mortgage products available in the marketplace. To further this goal, and as Mr. Smith pointed out earlier in testimony, CAMB has developed for its membership a *Consumer Education & Protection Worksheet* geared to assist the loan originator in ensuring the consumer is educated on the major types of mortgage loans and, in particular, the loan the consumer has selected. An educated and informed consumer is the most effective weapon to combat abusive lending practices. CAMB truly believes that this will serve as a solid foundation for…

SENATOR MACHADO: Are we getting to the end?

MR. HINES: Hmm?

SENATOR MACHADO: Are we getting to the end?

MR. HINES: I'm wrapping up. We truly believe that this…

SENATOR MACHADO: Can I summarize it basically saying that you would accept the guidelines for a greater consumer protection?

MR. HINES: Yes. We would, to the fact that they can be applied by the DRE.

SENATOR MACHADO: Thank you.

Mr. Governar.

MR. SCOTT GOVENAR: Mr. Chair, Committee Members, Scott Govenar on behalf of the California Financial Services Association. CFSA is comprised of state-regulated non-depository consumer finance lenders regulated by the Department of Corporations. CFSA members are affiliated with large, national lenders as well as small family-owned lenders who do auto loans. CFSA, because of their affiliation with large banks, already comply with the federal guidelines, many members. And we would support as an organization having the state apply those guidelines as well in terms of the relevant provisions as non-depository institutions. We believe there are sound consumer protection components in those and enforcement of the guidelines as well as state law is beneficial to our members because we do want to weed out the bad actors.

We do agree with Mr. Ross and others that we think consistency is important and that if we go through the regulatory approach, that the guidelines are consistent with federal law, and if the federal law does change with the guidelines, change, rather, this will be a better way to ensure consistency versus, say, putting something in statute, which would be outdated soon. We'd be happy to help with the Department of Corporations and others in preparing these.

SENATOR MACHADO: Thank you very much. I appreciate that.

Mr. Eckert.

MR. GEORGE ECKERT: Good afternoon, Chairman Machado, Members of the Committee, Ladies and Gentlemen. My name is George Eckert. I'm a licensed real estate broker, part owner of the Money Brokers, Incorporated, and a Sacramento-based mortgage loan brokerage. I make my living making mortgage loans. I'm chairman of a legislative committee of the California Mortgage Association. I'm appearing on their behalf. I've previously submitted a copy of my remarks to the secretary.

The California Mortgage Association is a trade association with more than 400 members, most of whom are DRE-licensees engaged in the business of private mortgage finance. Our borrowing clients are typically credit challenged, income impaired, or otherwise unable to qualify for even subprime loans. What most of our borrowers have in common is equity and a need for money in a hurry. Our loans are funded almost exclusively by private lenders, not Fannie Mae, Freddie Mac, or some big Wall Street syndicate. Most often, these lenders are our friends, our neighbors, and our business associates. We offer an alternative to traditional investments, such as CDs, stocks, bonds, and mutual funds to investors seeking a higher yield with relatively low risk of a real estate, secured investment.

Our typical investor is an older individual who modest savings, retired, or saving for retirement, with little tolerance for risk. This investor profile requires us to ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of the borrower's repayment capacity, one of the stated goals of the interagency guidance. Loan-to-value ratios are lower than for traditional and most subprime loans, typically, 70 percent or less providing a cushion for market downturns. Credit scores, while considered, are given less weight than a common-sense analysis of the borrower's willingness and ability to pay.

In our industry, if you put an investor in a loan that pays on time and offers a nice return, you might get a thank you and maybe a referral to a friend or neighbor. But that same investor in a loan that results in a foreclosure or a loss will tell everyone who will listen that you're the scourge of the earth, and then he'll sick his lawyers on you and eat you for lunch. Long-term survival in the private mortgage finance industry requires prudent underwriting, first and foremost. We don't need any interagency guidance to tell us that.

Typical terms for loans originated by CMA members include interest-only payments, balloon payments, and prepayment penalties. A full disclosure of all these terms is made pursuant to existing laws, such as truth and lending, Reg Z, RESPA, as well as pertinent provisions as California's financial code and real estate laws and regulations. Fixed rates are the norm with ARMs, and separate/step-rate loans are not uncommon. Our members don't originate loans with low teaser rates or negative amortization because our investors wouldn't buy them. With our members' loans, what you see is truly what you get. CMA supports full disclosure of every material loan term as long as such disclosure is meaningful and does not become cumulatively overwhelming for the borrower. To prevent disclosure overload throughout the loan process, and especially loan closing, we would support coordination of any new disclosures or existing disclosures required by state and federal law. The streamlining of all relevant disclosure forms to eliminate duplication and minimize overload would be ideal. Model forms that provide lenders with a safe harbor, if used properly, would be preferred to a do-it-yourself approach with uncertain legal effect.

As an industry, we've been meeting the needs of borrowers and lenders for more than 30 years. We've responded to the challenges of increased regulatory oversight. We increased competition in an ever-changing market for our products. We have survived market run-ups and downturns. We believe our industry provides valuable services to an underserved client base. We'd encourage this committee and the regulators to seriously consider the potential impact of any proposed legislation or regulations in our ability to continue to serve the needs of California's borrowers and private lenders. Thank you for your time and for your attention.

SENATOR MACHADO: Thank you. And in your market, you're dealing basically with the lender and the borrower, no secondary market?

MR. ECKERT: Lender and the borrower, no secondary market. We make the loans; we service the loans; we live with the loans from the day it is originated till the day it pays off.

SENATOR MACHADO: And your reputation is based on the ability to make all parties to the contract fulfill their obligations?

MR. ECKERT: Absolutely. I would also state that in the last ten years, we've only had two properties go all the way through the foreclosure sale, and we have a portfolio right now of over 200 loans. At any given time in the past ten years, we've had approximately that many.

SENATOR MACHADO: Okay.

Senator Correa.

SENATOR CORREA: Very quickly. What's the typical interest rate?

MR. ECKERT: Right now, our interest rates run between 10.5 and 11.5 percent.

SENATOR CORREA: And points up front?

MR. ECKERT: Well…

SENATOR CORREA: Average.

MR. ECKERT: Owner occupied loans probably 4 to 5 (percent). Speculative development-type loans, as high as 10 (percent).

SENATOR CORREA: It's a wonderful country. Thank you, sir.

MR. ECKERT: Thank you.

SENATOR MACHADO: Any other questions? Thank you very much.

Next we have Consumer Perspectives with Paul Leonard, Kevin Stein, who is scheduled to be up here. He is ill today. So, Paul, I do appreciate your perspective on this and your patience for the hearing.

MR. PAUL LEONARD: Thank you for the opportunity to testify today and for holding these hearings on such critically important matters. My name is Paul Leonard, and I'm here representing the Center for Responsible Lending, a national nonprofit, nonpartisan research and public policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. We've recently opened an office here in California to complement our offices in North Carolina and Washington, D.C. We're affiliated with Self-Help which is one of the nation's largest community development financial institutions and which has provided more than $4 billion in financing to almost 45,000 homeowners, small business owners, and nonprofits across the country.

I want to summarize my somewhat lengthy testimony, given the lateness of the day. I really want to make four points.

First, we put out an analysis last month called *Losing Ground* that looked at the foreclosures in the sub prime mortgage market. We found that California families are losing their homes because of risky loan products and loose underwriting in the sub prime market. Much of that has been discussed today. Just to give you a sense, we project that of the loans that were originated in 2006, of the sub prime loans—they were originally in 2006—one in five of those loans will end in foreclosure.

Further, these loans and the sub prime market as a whole will have a particularly damaging impact on communities of color where there's likely, where there is a likely reliance on high concentration of foreclosures. They're more concentrated in California's urban neighborhoods. Kevin Stein, who was not able to appear today, put out a report last month also, the *California Reinvestment Coalition*. They found that most large cities in California, more than half of African American and Latino purchased borrowers received sub prime loans in 2005, which is the most recent federal HMDA data that's available.

The second key point is that the federal interagency guidance, we believe, is a good first step to restoring sound lending principles in mortgage lending. However, it is critically important that the guidance should cover all California lenders and brokers. What hasn't been stated today, and I think it's been glossed over, is that sub prime borrowers, the sub prime loans are overwhelmingly made by non-depository lenders. Seventy percent of all sub prime originations in California in 2005 were offered by the state-chartered, non-depository lending institutions. It's critically important to provide the guidance's protections to all borrowers, not just prime borrowers, and it's important that the California regulatory agencies are charged with and move forward in quickly implementing the guidance. Moreover, it's important that the regulators have the authority that they need to enforce the guidance, as has been mentioned earlier.

The third point is that we believe that California's guidance should explicitly cover sub prime 2/28 and 3/27 hybrid adjustable rate mortgages which include many of the same risks as other loan types directly addressed by the federal guidance. This is the dominant product in the sub prime market as it's been for the last few years. Initial fixed rate is typically, deeply discounted, teaser rate, followed by a large rate adjustment often on the order of 50 percent, as Mr. Smith mentioned earlier, and it can lead to a significantly higher payment just two years down the line. These loans are frequently called exploding ARMs. In most cases, lenders are qualifying—sub prime lenders are qualifying borrowers for these loans based only on the initial discounted payment and even then assuming that borrowers are going to pay somewhere between 40 and up to 55 percent of their income, of their pretax income, for those initial payments. When they reach their reset date, they have little capacity to absorb the payment shock and are forced to either refinance if the market has gone up or increasingly, as the market has flattened out and interest rates have gone up, to default and move into the foreclosure process. These hybrid ARMs made up 81 percent of the sub prime sector securitization in the first half of 2006. And as discussed more in my testimony, there are the details of how these 2/28s is laid out more clearly in my longer testimony.

The steep payment shocks on these 2/28s and 3/27s represent precisely the sort of the deferral of interest that was intended when the nontraditional mortgage guidance was defined, we believe. And we're not the only ones. Federal Reserve Board governor, Susan Bies, reached a similar conclusion recently stating, let's face it. A teaser loan really is a negative amortization loan because you don't pay interest upfront.

As was mentioned earlier, other federal policymakers and regulators are also pushing to have the sub prime hybrid ARMs covered by the guidance. That includes federal deposit insurance corporation chair Sheila Bair and six U.S. senators on a bipartisan basis, wrote to each of the regulators requesting that the 2/28s be covered by the guidance. There's no reason for California to wait for the federal regulators to provide adequate protections to the sub prime borrows here in California. California regulators again should act swiftly to include the sub prime ARMs in the guidance covering non-depository mortgage lenders and brokers.

Finally, we don't believe that the guidance goes far enough. We think additional changes are needed to ensure that home ownership is not only attainable but also sustainable for sub prime borrowers. Lenders' and brokers' failure to account for the payment shock is compounded by the failure to escrow property taxes and hazard insurance. National data indicates that only one of four sub prime borrowers actually has an impoundment account. And again, when you're not automatically paying for property taxes and hazard insurance, the ability to come up with those big lump sums often forces refinances which drain equity from borrowers who already have limited equity to start out with. We recommend that all lenders be required to establish escrow or impoundment accounts on sub prime mortgages to pay for property taxes and hazard insurance.

The final point I wanted to touch on today was around the issue around stated incomes. These have obviously been growing dramatically over the last several years originally intended to be for certain kinds of borrowers for whom had irregular flows of incomes or had income that was hard to verify. It now represents Fitch, one of the underwriting agencies, says represents more than 50 percent of the sub prime sector. The Mortgage Asset Research Institute recently found that over 90 percent of stated income borrowers exaggerated their income by 5 percent or more and almost 60 percent exaggerated their income by over 50 percent. The report goes on to note, that when these loans were introduced, they made sense, given the relatively strict requirements borrowers had to meet before qualifying. However, competitive pressures have caused many lenders to loosen these requirements to a point that makes many risk managers squirm.

Consider also the frank acknowledgements by the chief executive of Ownit Mortgage Solutions. It was quoted in a New York *Times* article just this week which was a state-licensed, non-bank mortgage lender which recently filed for bankruptcy protection after investors asked it to buy back well over $100 million worth of bad loans that were early payment defaults. Ownit's chief executive, Bill Dallas, acknowledges that standards were lowered, but he placed the blame at the feet of investors and Wall Street saying that they encouraged Ownit and other sub prime lenders to make riskier loans to keep the pipeline of mortgages' securities well supplied. His quote was, "The market is paying me to do a no-income verification loan more than it is paying me to do the full documentation loans," he said. "What would you do?"

I think these points out a major problem that was raised by Mr. Smith earlier this morning which is the incentives of the system that we are working in now. Mr. Smith earlier mentioned that mortgage brokers don't have incentives and are paid flat commissions for the types of mortgages that they're offering. That couldn't be further from the truth. You can look at a broker rate sheet and see all the variations that are available with different prices and yield spread premiums which lenders pay to brokers based on higher interest rates that they bring in.

In conclusion, many have portrayed the nontraditional and the 2/28 sub prime loans as affordability products, implying that these features and other techniques are used to achieve monthly payments that are affordable for a borrower with a given amount of income. This ill-conceived notion of affordability is dangerously short-sided if borrowers can't sustain payment after adjustment and results in loans that leave borrowers worse off financially than they would be, had they never owned a home. It stands on its head the traditional American experience of home ownership is a path to greater long-term financial security. We would urge the California regulators to make it clear that these abusive and destructive lending practices such as these won't be tolerated. Thank you.

SENATOR MACHADO: Thank you very much.

I guess the question comes back around those. You have individuals that get involved to the point where they want the home, and they may themselves may not want to recognize the risk that's there. What responsibility do we have beyond just trying to make them aware of what the difficulties are and what would be, you think, the reaction would be, if you put in full indexing underwriting principles that would require rejection of many of these loans and these individuals not being able to pursue that dream and what would be the ripple impact to the economy?

MR. LEONARD: Well, you know, again, I think the goal is to have affordable, sustainable sub prime financing for borrowers who have less-than-perfect credit. There's no question about that. But putting homeowners who are not going to be able to stay in their homes into financing that's short term, that's based on the collateral and not on their income and their ability to repay the loan through variable business cycles and real estate cycles is not doing homeowners any favors and I think that we're going to see that. We've already seen a dramatic increase in foreclosures here in California, and I hope that our projections don't come to fruition. But if they do, we're going to see a much larger resulting array of foreclosures than we have seen yet which is not, again, is not doing any sub prime borrowers any favors.

SENATOR MACHADO: Senator Correa.

SENATOR CORREA: Thank you, Mr. Chair. I concur with your comments and I guess I will just not be repetitive so I'll restate in different form…

SENATOR MACHADO: That's fine. Mr. Runner took the same liberty. (Laughter)

SENATOR CORREA: You know, you're looking here at market risk. I mean, to what point do I go out of my way to tell that buyer, hey, you know, the market's going down, not up; therefore, you shouldn't buy? I looked at one of the lenders out here. Hey, you shouldn't lend. I think it's a market risk, buyer/seller—the borrower meaning—the borrower wants to do the loan; the seller, meaning the investor, wants to do that loan as well.

One thing I would say, though—again, I'm coming back to the issue of a fraud which is, that you as a lender or the borrower make that decision based on a good representation of what you're getting yourself into. And that's, I think, what I'm trying to figure out here. Are you, as the individual who actually made the loan or invested in that loan on the stated income, how represented was that stated income?

MR. LEONARD: Well, I'm struck that the notion of stated income has spread as much as it had. The other issue that we work on is payday loans. And in payday loans, another controversial subject, which I won't go into…

SENATOR MACHADO: Thank you.

MR. LEONARD: …but I will say--

SENATOR MACHADO: That's another day.

MR. LEONARD: --that for a payday loan, you have to actually produce a pay stub in order to get a payday loan, a $300 loan for two weeks. And the notion that we are now making the largest financial transactions available on the statement of income to a broad swath of borrowers seems like there's something that has gone wrong in the system.

One of the fundamental notions of this, not to sort of violate the idea that individuals aren't responsible for their own decision, but evaluation of—the lender's evaluation of the ability to repay a loan is a fundamental principle of how lending has operated in this country for a very long period of time, and that is the responsibility and part of that is verifying that the borrower has the income that they say that they have.

SENATOR CORREA: To the chair, just to follow up, it would be very interesting to see what happens if the doomsday scenario has actually come to fruition because, as you know, now the finance sector is coming up with the 50-year mortgages.

MR. LEONARD: Absolutely.

SENATOR CORREA: You know, you refinance on a 50 year. So what? You know, you lose today but God knows where you're you'll be in 50 years.

MR. LEONARD: Right.

SENATOR CORREA: It'll be interesting to see where it goes.

MR. LEONARD: But at the same time, I mean, I think this widely acknowledged, that the sub prime market in particular is widely acknowledged to have gone too far in loosening standards, and a number of large players in the marketplace right now are facing some serious financial difficulties as the investors, the secondary market investors, are being more careful about pushing back bad loans to the originators. There is a correction going on. But while this correction plays itself out, millions of borrowers are already in loans that they're not going to be able to sustain.

SENATOR MACHADO: Thank you very much. I think those are very good comments. Thank you.

Now open for public discussion. Please state your name for the record, please.

MR. STEVE CRISTOVIAC: Good afternoon. My name is Steve Cristoviac with the Mortgage Brokers Association for Responsible Lending. I'd like to go over a couple of highlighted problems that I've seen as a mortgage broker in the industry.

Number one, if you can see, would be stated income loans. I'd like to go into that further but you have heard a lot.

Number two is negatively amortized loans. One point that I would like to point out is that back in 2003 less than 1 percent of all loans originated in the Bay Area—it was .8—were negatively amortized. In 2005, 30 percent. Residential home appraisals currently are ordered by the mortgage broker. There's an immense amount of pressure for appraisers to hit a predetermined value that hurts both the consumer and the lender. It allows people to obtain homes but it should be protecting both parties and it's not currently. The industry currently is set up to offer higher fees and higher interest-rate loans to the less educated. The language in which the terms are currently negotiated are not required to be put down on the documents of what they're assigned. Consumers right now choose certain loan products because they will win a trip or a prize. I'm speaking right now to also the insurance board. That is illegal insurance. It's illegal for an insurance agent or broker to rebate any commission to the consumer because it might lead to steering of a product that is not safe for that consumer to obtain—for instance, if one person wants to get term insurance and I could steer them towards whole life insurance by rebating some of my commission. The same is true with possibly someone who might be right for a 30-year mortgage. I could then steer them towards a negatively amortized loan, make a huge commission because those commissions are easily hideable, and I can steer them by telling them, go ahead and win a seven-day cruise to Hawaii. Please do that.

Enforcement, I don't know of enforcement.

Current employment environment, certainly, under the Department of Corporations, for instance, Ditech, the actual bank—the lender, Ditech—is licensed, not the individuals. You can have an 18-year-old high school dropout be educating and guiding you towards the most financially important…

SENATOR MACHADO: _______.

MR. CRISTOVIAC: Thank you very much, Senator, and they could talk like I am right now.

Lastly is prepayment penalties. Paul Leonard was speaking about two-year exploding ARMs. The dangerous part about these two-year loans is that, or two-year fixes or three-year fixes, they come associated with a two-year prepay and a three-year prepay. In other words—and the prepayment penalties are generally six months of interest—so those prepayment penalties can be $15,000, $20,000, $25,000 here in California. So really, the dangerous part is that the prepayment penalty is associated with that exact amount of fixed term. A great solution would be to allow consumers to shop around six months before the term of the fixed period goes up. In other words, make maximum the amount that the prepayment penalty could be, would be 1.5 years on a two-year fix or 2.5 years on a three-year fix. I would actually suggest half the fixed term.

There's a lot of other problems, not anything with such immense problems as in the mortgage industry, nothing that I could say in two minutes. But hopefully, I can get some invitations back to your offices and speak to some assistants.

SENATOR MACHADO: Well, thank you very much. I also appreciate the background information you've given to the first page. It will be helpful to the committee.

MR. CRISTOVIAC: Thank you, Senator.

SENATOR MACHADO: Is there any other public comment? Well, I want to thank all the participants today. It's been very helpful.

Yes, sir. Mr. Smith.

MR. SMITH: ______________.

SENATOR MACHADO: There's a trap door there, so brevity is going to be necessary. (Laughter)

MR. SMITH: Thank you very much for the last couple of minutes.

One of the things that I do want to address on behalf of our association and on behalf of the members that were here to convene this meeting today, this hearing today, I applaud you on your visual acuity with respect to this issue because it is a large issue. One of the things that I want to close with is extremely important—and we all know this but it needs to be said in a public forum—there is a difference between legislative product and creating a subset of renters in California. We need to be very mindful of the decisions that we make and not create a subset of people here and take away the American Dream of homeownership. That's my final statement.

SENATOR MACHADO: Well, thank you, and I think that's a concern of all of us in trying to find the proper balance so that people can be made aware of the decisions, of the ramifications of their decisions, and also hold the industry accountable so they're forthright in what they're presenting. I think we saw some examples today of perhaps some need for more scrutiny. I think there's also some demonstration today of broad acceptance of the guidance that's being proposed at the federal level as to an applicability at the state level. So again, I want to thank everybody for their participation today. It's been very long but I think it's been very helpful. With that, this meeting's adjourned.

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