Senate Committee on
Banking, Finance & Insurance

Michael J. Machado, Chair

Reactions to the Recent Subprime Mortgage Collapse

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State Capitol, Room 113

CHAIRMAN MICHAEL J. MACHADO: …of the Senate Committee on Banking, Finance & Insurance will come to order.

First of all, I want to thank all of you for coming. As you know, we had an informational hearing some eight weeks ago looking at the issue of subprime, and a lot has happened in the past eight weeks. Home loan defaults and foreclosures are increasing that have been forcing people out of their homes. Subprime lenders, most of them based in California, are laying off employees and shutting down their operations. Lenders that are still making loans have tightened their qualification requirements. We have seen stock prices of nearly all lenders fall, and the overall market is reflecting investor concern over subprime problems. Congress is holding hearings and trying to assign blame for what's happened, and I believe it's important to find out why this is happening so we can stop it from happening again, but just as important, to figure out what's going to happen next so we can be prepared, and that's what this hearing is about, is to try to look at what's going to happen.

I'm not interested in pointing fingers. I want to know what's next and what have been some of the deficiencies in the past that we can correct to go on forward in the future. What's going to happen to California's borrowers, to our mortgage market, to our housing market, and to the state's economy, beyond just the direct housing market? What's going to happen to the market for mortgage-backed securities and to the overall stock market? What impacts are the subprime mortgage collapse going to have, and what should we be doing to protect California from negative consequences?

Today we have assembled a variety of experts who can offer several different perspectives on those questions. I'm sorry to say that we don't have any lenders or Wall Street investment banks represented. It's not because we didn't ask. We asked every major Wall Street house and California lender to attend today, and I'm very disappointed at their unwillingness to step forward and to share their views publicly with us. So the message to those who declined our invitation, yes, your absence is noted.

I think today it's really important to take a look at the ramifications because I think the subprime market has provided housing opportunity for a lot of people who would ordinarily would not have gotten it. In an up market, a lot of deficiencies in the marketplace are easily absorbed and it provides people the opportunity to enjoy homeownership. Homeownership is almost unprecedented at about 70 percent. But at the same time, as we all know, markets that go up can come down; and when they do, they can come down in a very difficult way that causes a tremendous amount of dislocation at the very bottom of that, and that's where the homeowner is who loses their home and the family gets displaced. But interesting, because of what has developed in the market, where you have those who are outside of the traditional lending source participating in lending, you also have an extended gray of a person's, of entities that can be subject to this downturn in the market, whether it be in the secondary market, whether it can be in private lending, and then what the push back is to the rest of the economy.

So as we get started today with the panel, before I call them up, I see that Senator Cox is here, and he's my esteemed Republican colleague. Senator Cox, would you have any comments to make on this?

SENATOR DAVE COX: Mr. Chair, thank you for holding this meeting. I look forward to the testimony. Obviously we're in a very volatile situation now with, perhaps, the term *collapse* is a word relative to housing. But, you know, in the final analysis, some of the problems that we see in the marketplace are the results of people who simply didn't understand the economic principle that what you don't pay down, you will ultimately have to pay up. And if the market goes south on you, the values change. There's always a risk involved. So I look forward to hearing the testimony.

But it is a situation. There are sometimes you ask yourself, Can we save people from themselves? So I'm anxious to hear the testimony.

SENATOR MACHADO: Thank you.

We'll be joined also by Senator Scott. Do have any particular comments that you'd like to make?

SENATOR JACK SCOTT: No. I come to this with some concern, as I've read about what's been happening, but I have to confess that I've also come as someone who wants to learn a lot, and so I don't always hesitate to speak up when I don't know anything but I'm going to on this occasion.

SENATOR MACHADO: All right. Thank you.

Well, we're going to go ahead. As I was taking advantage of the fact we only had two members, and I think we could be here all afternoon giving introductory remarks from other members, what I'd like to do is call the first panel. I'd like for them all to come up. We have two microphones but we will share them.

That first panel will include Paul Leonard, director of California Office, Center for Responsible Lending; Professor Nancy Wallace from the UC Berkeley Haas School of Business; Professor Stuart Gabriel, Lusk Chair, Professor of Finance and Economics, USC Marshall School of Business; economist Doug Duncan, a senior vice-president and chief economist for Mortgage Bankers Association; Ed Smith, Jr., Chief Executive Officer of Plaza Financial Group; and Leigh Rutledge, Realtor, Dunnigan, Sierra Oaks vice-chair of the California Association of Realtors Legislative Committee.

We have the fortunate distinction to have one of the smaller hearing rooms today, but this is what keeps us cozy. And what I'd like to have each of you do is introduce yourselves, speak for about five minutes, and then we will just have a roundtable discussion and we'll start off with Paul Leonard.

MR. PAUL LEONARD: Thank you, Senator Machado, for holding this important hearing.

I came before you. I was one of the lucky folks who got to come before you on January 31. And at that point, I was arguing that we needed some tighter underwriting standards that were needed to govern the activities of the subprime mortgage market and specifically the hybrid ARM products, the 227s, 228s, and 327s, as they were structured, were fundamentally flawed products likely to produce record levels of foreclosure. Key features of those loans included a two-year fixed teaser rate followed by a very large payment shock on the range of 35, 50 percent and more of all qualified, very aggressive starting payment paying, for people paying up to 50 percent of their income for their mortgages. We produced a study, my organization, the Center for Responsible Lending, produced a study in December projecting 2.2 million foreclosures nationwide at a foreclosure rate of roughly one in five of all loans that were offered. That translates to here in California where the rates were slightly higher of about 464,000 houses foreclosed upon over the next several years.

In that hearing, the representatives of industry largely disagreed about the need for additional regulation. While they reluctantly accepted the idea of applying the federal and the Conference of State Banking Supervisors Guidance on Nontraditional Mortgages, they insisted that no additional regulations were needed covering these risky hybrid ARM products. And in fact, the representative of New Century Financial Corporation, in their testimony, said the history and features of hybrid ARMs do not warrant inclusion in the guidance and to do so would cause severe, negative consequences for consumers, the real estate market, and the economy. Sadly, I think, it now appears that those negative consequences are mounting day by day, lender by lender, not from the application of clear enforceable standards, but from the failure to have those kinds of standards in place in advance. Foreclosure problems today are just the tip of the iceberg. The problems that are caused by lenders now are being triggered by high rates of early payment defaults where mortgages that were initiating our defaulting sometimes in their first payment but clearly within the first six months of them, we would expect foreclosures to continue at high rates over the next several years, to say the least.

Some have argued that these high rates of foreclosures are okay. It's the price of doing business for risky borrowers and that even at a 20 percent rate is okay. We have 80 percent of borrowers who are homeowners and that that's going to be okay. My organization is going to be releasing a new analysis in the next day or so showing the nearly 1 million more subprime borrowers will have lost their homes from subprime mortgages than have used subprime loans to become first-time buyers. That's not homeownership; that's new home loser-ship.

Okay. What a difference a few weeks makes. We've had, as you mentioned in your opening comments, we've had the federal regulators issuing a new statement calling for application of ability to repay standards to all subprime mortgage loans. We've had Freddie Mac come out and say they're not going to buy any more loans with these improperly and dangerous underwritten loans. We've had collapse of lenders—New Century, Fremont. Those that are still in business are laying off people right and left. And while we're not in the business of affixing blame, I think there is plenty of blame to go around, from brokers, lenders, rating agencies, investors, and importantly, I think the California regulators.

I was here last week and listening to your committee, around the Budget Committee, when you were talking about the Department of Corporations and their inadequate resources. I think it's worth pointing out that that organization has 25 examiners, 25 examiners, to do examinations for more than 4,800 licensed mortgage originators under their purview. Clearly they don't have the resources to stay on top and find problems in a timely fashion.

My main message to you today is that we can't in good conscious abandon the homeowners who have been harmed by reckless subprime loans. The market is making corrections now, but these corrections will do nothing for families who have already lost their homes and those who have received exploding ARMs and will lose their homes in the future. In addition, the incentives to make damaging loans may lie dormant in the short term, but they continue to exist. And unless appropriate actions and standards are put in place, they will inevitably trigger further abuses in the future when the housing market turns up again. So I think you need to do two things.

First, we need to come up with a plan that's going to help current borrowers. The first and most important principle around that is to hold the industry accountable for their actions—lenders, servicers, investors, and trustees. They must take action at scale, not on a one-by-one basis but proactively to prevent foreclosures. Remedies could include things like converting existing loans to fixed-rate mortgages with affordable interest rates, writing down principal loan balances, and waiving prepayment penalties. The current structure of the industry, which sells most of the loans into the secondary markets, makes this a more complicated task. But I think we all need to get together and focus on helping borrowers not bailing out lenders and investors. A state role, I think, can be play a critical role in this that may have some resources to inject strategically to help borrowers in the refinance or modification process, provide some resources to make sure that borrowers have a place to go for counseling and legal services where that's appropriate. And the third policy thing that that I think is really important is that California does have on its books a foreclosure rescue scam law, but my colleagues in the legal services world have identified a number of loopholes and problems in that law that should be tightened up. Clearly people who are in vulnerable circumstances and faced with foreclosure shouldn't fall prey to foreclosure scammers who are literally looking to steal their homes.

The second big area that I believe deserves some action is creation of a stronger statutory and regulatory framework to protect future borrowers, and again, three features which I'll be prepared to discuss in more detail. First, we need to establish clear and enforceable underwriting standards for all subprime loans which are hinged upon an ability-to-pay standard, that we return back to days of fundamental, sound lending principles where lenders aren't going to make loans to borrowers, when they know, when they know, that they're not going to have a reasonable likelihood to be able to repay those loans over the life of those loans. Second, we need to strengthen originator duties, and that applies to brokers, it applies to lenders, and it applies to providing some ongoing responsibility to the secondary markets who are buying these loans in bulk and who can be argued, and your analysis argued, are actually generating the demand for these risky loans.

And finally, Senator Machado, I heard your frustration last week about the Department of Corporations. And clearly the level of resources that they have to address the scope of the lending problems is not sufficient. New Century completed an examination in August of last year which found no substantial problems with the loans that they were offered. Obviously in the last few weeks we have seen that these problems have been varied and mounting, and we need the kind of laws and regulatory enforcement that are going to prevent the interest of consumers going forward.

Thank you, and I look forward to answering your questions.

SENATOR MACHADO: Thank you much, Mr. Leonard. I know the committee is not disappointed in the fact that you've helped lay out the groundwork very clearly and some of the concerns out there.

Next we have Professor Wallace from the UC Berkeley Haas School. I know you most recently were on a local NPR program talking about subprime markets and the issues that's out there. The committee would be interested in your insights as to the use of these products, what do we see the impacts of the current downturn, and what insights you might provide us as to what we should be looking at in terms of government oversight, if any.

PROFESSOR NANCY WALLACE: Thank you very much for inviting me to this committee hearing.

SENATOR MACHADO: Pull just a little closer.

PROFESSOR WALLACE: Can you hear me now?

SENATOR MACHADO: Just pull it closer.

PROFESSOR WALLACE: I don't know if the cord reaches. Thank you very much for inviting me to this committee meeting. My comments will be very brief.

I think that we need to keep firmly in mind that this is, the subprime market is very new. It's a substantial innovation and mortgage underwriting in the United States. The rates, although high, and sometimes as we've seen recently, probably usurious, are relatively lower than they would be without the secondary mortgage market. So to take a view that something about securitization is fundamentally wrong or the access to the secondary markets and to the capital markets through the investment banking industry is somehow problematic, I think, probably should not be the primary focus of re-analysis of either the regulatory structure or how capital market flows in this country should occur because this innovation has led to enormous flows of capital and have actually reduced mortgage rates, both to the subprime market and also to the primary mortgage market.

My view of this is somewhat different, although it will echo at least some of the comments made by the first speaker. In my view of this, as with any new capital market, any innovation in mortgage contracting, people are going to get ahead of themselves in terms of how these contracts are priced, how we manage risk, how we think about risk, how we price risk, and people will get ahead of themselves in terms of pushing the envelope and exposing themselves or deceiving borrowers in the sense of how risky the mortgages that are being offered to them actually are. In viewing the underwriting structure as it exists right now in the United States, or at least in the last year, and who the major underwriters were, and originators of subprime mortgages, I do think California has an important, if not regulatory, at least, responsibility and oversight of origination practices, given that 49 percent of the top 25 subprime originators are headquartered in the State of California.

I think the other concern, in terms of looking at the testimony, both in the U.S. Senate and also recently in newspapers and professional organizations, information newsletters in this industry, the focus has been very much on the current regulatory structure through either the Office of Thrift Supervision or through the Federal Deposit, FDIC, and through the Federal Reserve Bank and the regulatory structure through the fed. What's surprising about this market and also interesting in terms of California's headquarter, heavy location of these subprime lenders, is that much of the underwriting is outside that umbrella. So these are independent corporations. They are either RTS or they are mortgage lenders. If you look at their corporate headquarters, indirectly you can get to something where there's oversight through the FDIC or the Office of Thrift Supervision, but it is only indirectly. And some of them, it's not there at all. So then the actual underwriters, the actual interface between the borrowing public and the capital markets, is an enormous web of mortgage brokers, many of which are also realtors, so they are both selling real estate and originating mortgages over the same desk to the same person where the incentives to not be clear about who you're working for and whose benefit you're originating these mortgages is not at all obvious.

I would have to echo again back to this, that I do think the Department of Corporations in California bears some responsibility in terms of this underwriting and also the licensing structure for mortgage brokers in the State of California because I don't—when you look at corporations, such as New Century, and you look at the thousands of brokers that were originating loans for them with very loose oversight, clearly, given the performance of this, of these portfolios, it does suggest that we have holes in the regulatory oversight that could be very important. Now I have not actually looked at these loans. I think we have to be careful about understanding whether it's a current cohort effect or it's the effect of house prices falling so we don't know that. We haven't looked at the data in enough detail to understand that. But at least its surface, given the information that's out there right now, there does seem to be a regulatory gap that could usually be considered and looked at in a little bit more detail in terms of understanding actually what is communicated to borrowers and whether or not truth in lending laws are followed accurately and the other federal and state regulatory structure for lending is actually being applied in the day-to-day origination of mortgages, both in the subprime market and also for the Alt-A market. Thank you very much.

SENATOR MACHADO: Thank you.

Before we proceed, I want to acknowledge a colleague from the Assembly, Ted Lieu. Ted Lieu is here because he asked to be a part of this hearing as he has an interest also as he's chair of the Assembly Policy Committee in the Assembly.

Ted, welcome.

Next we have Professor Gabriel who is from the Lusk Center for Real Estate at USC, and much of your current research has been focused on mortgage prepayment and default risk which seems somewhat timely for this topic. Welcome.

PROFESSOR STUART GABRIEL: Thank you for holding this hearing, and it's great to be here. Just a couple of pieces of summary information. Can you hear me okay? Just a couple of pieces of summary information before I begin.

I'm sure you're aware of the fact that about one in five mortgages originated in the last year was subprime. Of those, one in five was originated here in California. Twenty percent of loans originated throughout the Central Valley from Sacramento down through the Inland Empire, all the way down Highway 99, were subprime. And in that particular respect, when we look for the effects of subprime on local communities—those are the communities that we're going to look to—we're also going to look to some entering suburbs and some previously underserved areas where subprime lending has also been very significant.

Okay. All that having been said, we've done some work that relates to the subprime delinquent buyer, and we know some things about the subprime delinquent borrower. We know that they're more highly levered. That means that their loans were originated with higher debt-to-income ratios with higher loan-to-value ratios and more likely with stated income. And we know that all of those attributes were more prevalent in 2006 relative to earlier years.

With respect to the cohort of subprime loans that were originated in 2005 and 2006, Wall Street analysts believe that we're going to see losses in the range of about 10 percent on those originations, and that assumes a relatively flat house-price environment. If house prices fall, of course, all bets are off. We know that the subprime mortgages are wildly held. As Professor Wallace indicated, they're oftentimes securitized into subprime mortgage bonds. They're held in structures called CDOs—oftentimes they're held by hedge funds--and the losses will be distributed across a very large number of holders of these mortgages.

Now there was a case in past years that originating as a subprime loan was a fairly profitable business. Today it no longer seems to be a profitable business. Mr. Leonard alluded to early payment defaults, and we know that if—in the case of subprime, if a borrower misses the first payment, it's called an *early payment default.* And in that particular respect, it's possible that or likely or probable today that the loan will be put back to the originator for reimbursement. Of course, the early-payment defaults owe to a whole variety of different issues, obviously, to at least one underwriter, to the slow-house price appreciation, and also to some level of fraud amongst mortgage brokers and homebuyers and the like. But just let me give you a sense of the magnitude of these early-payment defaults. They're running at about 2 percent of pool balance in 2005. Today they're running at about 6 percent of pool balance so that they've tripled just recently over the last quarter or thereabouts.

Now when we talk to the bankruptcies that you've heard about amongst the subprime-lending sectors, these early bankruptcies were associated with lenders who did not have sufficient capital to cover those early-payment defaults. What we're additionally concerned about is the fact that many of these lenders, and the lenders that Professor Wallace was alluding to, many of these unregulated lenders rely upon credit lines that are provided by Wall Street. Of course, Wall Street investment houses have the opportunity to pull those credit lines to ask for early repayment of those credit lines, and there's various conditions associated with those credit lines so that capital can become very scarce very quickly with respect to this particular sector. And as we know, underwriting has tied into, as you know, many of the loan products that were egregious with respect to our concerns have already been pulled off the market, so the 100 percent LTV, 80/20 piggyback-type products, for all intents and purposes, are going away. What we also expect is, now with the time in underwriting, with the improved risk-based pricing, and with better qualified borrowers that these early-payment defaults are going to decline; they have to decline and they will decline sometime over the course of this year.

A few other words with respect to Wall Street, subprime lending is a big business for Wall Street. For many of the Wall Street firms that you've heard about, it's only really a small part of their overall business. So how is Wall Street hurt in this whole situation? Well, actually, though, they're hurt because fewer subprime loans are originated. Fewer subprime loans are pulled and packaged into mortgaged-backed securities or into CDO deals or whatever, and they also may be hurt to a modest degree to the extent that there are losses associated with these credit lines.

What's this mean for the housing market? Well, the housing market, of course, is in a well-evident slowdown for reasons that are only partly associated with the debacle of the subprime. We see the metrics of the housing slowdown all around us. One of those metrics, which is interesting, is an historically high number of vacant homes for sale and we see that around the country. Of course, the subprime-related defaults and foreclosures are going to exacerbate the situation. And, of course, the weakness in the housing market is going to be compounded by what we describe as the interest rate resets on the ARMs. And if you heard the commissioner of the FDIC testify before the Senate last week, she suggested that there are 1.8 million ARMs that are set to be reset this year and next year. The typical payment shock associated with the reset has been estimated at about 25 percent, 25 percent increase in monthly payment. As I mentioned previously, there has been very substantial subprime lending in underserved areas, in new housing markets, and the like in recent years, and we're going to look those areas to see some of the impacts.

Okay. With respect to foreclosure to date, interestingly enough, the foreclosure rate in California last year was only 1.2 percent, so we're far from the top of the heap here. And in fact, the state that is at the top of the heap is Colorado where last year there was a 3 percent foreclosure rate. But the lending conditions are changing in a very visible sense. The Federal Reserve Board does a quarterly survey of the senior loan officers of financial institutions. And when those loan officers were asked just this past quarter about residential mortgage lending, 16.5 percent indicated that they were scaling back residential mortgage lending relative to about 9.5 percent expansion in mortgage lending at this time last year.

Okay. So larger economic effects? Well, the problem with subprime loans per se, to the best of calculations that many have made, comprise currently less than 2 percent of all mortgage debt outstanding. So that can give you some dimension of the order of magnitude. With respect to larger effects of the housing downturn, we speak here to what we call direct and indirect effects.

And Senator Machado, you alluded to some of those direct effects in your opening remarks. Obviously, we're going to see that in construction, employment, and brokerage employment and housing starts and all the rest. The Federal Reserve Board and Chairman Bernanke has estimated that that's going to take about, the direct effects are going to take about a full percentage point off of real GDP growth this year where that's one percentage point out of about three-and-a-half percentage points, so it's a fairly significant proportionate effect. But then if you model other sorts of indirect effects, the role of moderating house-price appreciation and tied in underwriting with respect to weaker consumer spending and reduced home-equity extraction, that effect could be upwards in magnitude to a full percentage point as well with respect to real GDP growth. So there is a scenario here where the slow housing sector, again exacerbated by the subprime, can slow the economy in a very measurable sense.

To close, there are many issues here. You've heard about some of them. You'll hear about many more in the Q&A. I think the best guess at this moment—and this is a guess that you hear out of many of the macro-economic forecasting units around the country—is that borrowing unforeseen, negative economic shocks that will be evidence to labor markets and all the rest, we are not on the basis of the subprime debacle forecasting a recession. Thank you.

SENATOR MACHADO: That's a positive note to end on. (Laughter) Thank you very much.

Next we have Mr. Duncan, Senior Vice-President and Chief Economist of Mortgage Bankers Association. You've kind have been in the middle of the discussions that have been taking place back east.

MR. DOUG DUNCAN: Thank you, Senator. Yes. That's, I think, the 15-seconds of unwanted fame, how that comes down. Thank you for the invitation. It's timely and an excellent choice of subjects and the right time. I was asked to give you some data back, specific to California, so that you can put some context around the discussion. There's been a couple of good presentations on market structure, which I want to follow up just a little bit and then go to some specific data.

One of the things that I think has been lost in the current discussion is the process by which markets mature. And what we're seeing today in the death of the mono-line subprime lenders has a precursor in 1992 to 1994 in the prime mortgage space. In 1992 when we were launching a refinance boom that ended at the end of 1993 when Federal Reserve started raising rates—about, I think, 22 mono-line prime mortgage lenders issued stock and went public. By 1994, only four still remained. And what was going on was the least efficient firms in the industry were being put out in the market when profit margins fell and they couldn't control their costs.

Today we're passing the end of the third phase of life of the subprime market. If you go back prior to 1992 and 1993, spreads in that market over the prime market were about 109. When the prime market, prime companies at the end of 2003 saw those spreads, capital moved into the subprime space. And over the course of the next five years, spreads fell to 106. Then in 1998, we had long-term capital management, the Asian currency crisis, and the Russian bond default which led to a shakeout in the secondary market. And you saw the death of companies like Conseco and United Financial and those firms that were the original lenders in that space.

Subsequent to that, another flow of capital from diversified financial services firms came into that marketplace. And as of 2005-2006, spreads have fallen to about 103 relative to prime spreads. So what's happening today is that those inefficient firms, which was well described about them having loans put back to them, which exhausted their capital, are going out of business because all of the 27 firms that have failed so far have been mono-line subprime firms. But what we would argue is that what you're seeing is the emergence of a subprime market which is priced efficiently on a risk-based continuum, and it's primarily populated by diversified financial services firms. So I would say that's sort of the completion of the picture that you heard in terms of capital markets.

Let me jump—in the handout that I gave you—to a chart that that's about four from the end that comes—it's entitled *Mortgage, Serious Delinquency Rates By Loan Type*, *Fourth Quarter 2006*. It looks like this. It's about fourth from the end, and it comes from our National Delinquency Survey which has about 43.5 million loans and something on the nature of 6 million subprime loans. It's a survey that we've done quarterly since 1972 and have had quarterly releases on this data. What I do in here is in the center of that chart I show you, for subprime adjustables, subprime fixed, prime adjustables and prime fixed, what's the average serious delinquency rate for the U.S., California, and then the high five and low five states.

A couple of important points. First of all, serious delinquency is any loan that's 90 days or more past due, including those in the process of foreclosure. So in the U.S., subprime adjustables have a 9.16 percent—this is as of December 31, 2006--90-day or past due or in foreclosure percentage. California is about half of that at 5.7 percent. If you look at subprime fixed, the nation, 6.04; California, 2.48—you can read the rest or those. California is well below the average, but it's important to note that it's moving up. In the recent release, the delinquencies of foreclosures in California are on the rise.

Now the other thing you'll notice is, in the five states that are the highest, in each of those states, Mississippi and Louisiana, irrespective of Katrina, have always been very high in delinquency and foreclosure historically. But the others—Ohio, Michigan, and Indiana—all suffer the same problem, and that is, productivity gains in durable goods manufacturing have been eliminating manufacturing jobs in states with much higher than national average share of their workforce in manufacturing and in states with much higher than national average home ownership rates. So the likelihood that your job was eliminated in manufacturing and you are a homeowner was very high. And so what's happening is, all of those states have now for a couple of years have been at the top in terms of foreclosure. The point there is that, irrespective of product choice and the current structure of what's going on in the subprime arena, at the end of the day, the most important factor is what's going on in the local economy and especially in employment.

With that, if you want to jump back to the second chart, just to give you a little more context on what California looks like, I've given you two pie charts there, one of which shows the prime and subprime shares in the U.S. and in California, and the U.S. numbers do include California. So you'll see that in the U.S., of those loans outstanding, about 76 to 77 percent are prime. About just under 14 percent are subprime. In California, about 83 percent of its loans are prime, and about 14 percent are subprime. The difference is that California has very little government lending because average loan size exceed FHA and VA limits.

The second page, which says *Loans Outstanding, Composition by Product Type*, does two other things to put things in context in terms of the public discussion. One is, it makes the point that 35 percent of homeowners in the U.S. don't have a mortgage. So the first thing to clarify the discussion is, are we talking about people with mortgages, or are we talking about all homeowners? If you're talking about all homeowners, the subprime fixed component of all homeowners is about 3.8 percent; the subprime adjustable is 5.1 percent. If you look at only people with a mortgage then in the U.S., about 5.98 percent of people with a mortgage have a subprime fixed rate mortgage. About 7.9 percent have a subprime adjustable rate mortgage. That's why you hear the data that says 14 percent of all people that have a mortgage are subprime. Okay. So that's the structure of those.

Now you see with regard to California, one of the things that will lead to rises and delinquencies in foreclosure—arises in delinquencies and foreclosures in California—is California has a much higher than national share of adjustable rate mortgages. It's because it has very high house prices.

SENATOR MACHADO: Go ahead.

SENATOR COX: _____ mortgage have subprime.

MR. DUNCAN: Okay. Let me start on the left-hand side of that page. It says: No mortgage, 35 percent.

SENATOR COX: Right.

MR. DUNCAN: That's among all people that own a house, 35 percent have no mortgage.

SENATOR COX: Okay.

MR. DUNCAN: Then 39.5 percent of people who own a house have a prime fixed-rate mortgage; 10.3 percent of people that own a house have a prime adjustable-rate mortgage; 3.8 percent of people that own a house have a subprime fixed-rate mortgage. You follow where I'm going down?

UNIDENTIFIED SPEAKER: ____.

MR. DUNCAN: Okay.

SENATOR MACHADO: But that's out of the 65 percent.

MR. DUNCAN: So I'm subdividing that 65 percent.

SENATOR MACHADO: That's out of 65.

MR. DUNCAN: So you sum those that will add to 65 percent.

SENATOR COX: ________ somewhere, those with no mortgages, in relationship to subprime lenders ______?

MR. DUNCAN: No. On the right-hand side—I'm sorry.

SENATOR MACHADO: Did you get your answer?

UNIDENTIFIED SPEAKER: ________.

MR. DUNCAN: On the left-hand side of the chart, the 65 percent with a mortgage is subdivided into parts which sum to 65 percent.

SENATOR MACHADO: So 65 percent above U.S.; then the following numbers are the breakdown, but those are the components of the type of loans within that 65 percent.

SENATOR COX: Right.

MR. DUNCAN: The difference between that and the right-hand side of the chart is I've said, okay, if we're only talking about people with a mortgage. Now it divides 100 percent of those people with a mortgage, okay?

SENATOR COX: __________.

MR. DUNCAN: So the point there is that a high share—California, in terms of total loans in California, about 39 percent, have adjustable rates as compared to the U.S. where 24 percent have adjustable rates. So that's why you're going to see some rise—part of the reason you'll see some rise in delinquency and foreclosure in California in the upcoming months—because house prices have flattened out. So if you look at the next page, which has three maps of the United States, the first page in the upper left looks at the five-year average of price appreciation. There, the coloration, states in orange had 10 to 15 percent appreciation on average over that five-year period. California is one of those states.

In the upper right-hand corner, you can see the change in momentum where, from the fourth quarter of 2005 to the fourth quarter of 2006, California's rate of appreciation has now fallen into that dark blue which is 1 to 5 percent. Then in the bottom chart, it's the fourth-quarter data annualized, and what you see is California has fallen into the gray area which means no or negative price appreciation. That will contribute to rising delinquencies and foreclosures, okay?

Questions on that? That makes sense?

SENATOR COX: ___________.

MR. DUNCAN: Okay. The next, I'll go very quickly through the rest because I know you have more speakers. The next two pages, what we've tried to do is give you sense of the flow, again, with regional economic effects in place of applications from borrowers. So you can see here the difference between the pacific states, including California, and those states of Ohio, Michigan, and manufacturing states that I talked about and the product selection that borrowers are making because of the dynamics in their local housing markets, and they're substantively different. Then the next page we show across the year of 2006 the shift that borrowers made from adjustable rate products toward fixed rate products, again, adjusted for regional differences.

Now I'm not going to go through the following tables, which give you a great deal of collateral or understanding of the collateralization of the loans that have gone into the securities. But you can see there the change in underwriting criteria in the subprime space, the decline in equity required, the change and the debt-to-income ratio, and the product selection by people who are buying houses versus those who are investing in houses, and they're using two different kinds of products.

Then let me finish with the last page that shows at the top two maps of the United States and at the bottom two charts which give the current trend in delinquencies and foreclosures. And again you can see California is well below the national average. It's in the pale blue which is at or well below the national average, and you can see the upper-Midwest states with the peaks in delinquencies and foreclosures. But clearly the trend line, particularly in subprime adjustable-rate mortgages, is for increases.

One thing that is a final remark that I would keep in mind is that 2006 clearly is performing less well than 2004-2005. And a factor in that, which you may want to think about later, is the suppression of credit spreads in all markets, globally which undergirded the flow of capital into subprime. And you can see in the very last chart, you can see the comparison of loans originated in different years, and the pace at which they went into default, you will see that 2006 looks very much like 2000 which was at its time the year of a turning point in the slowdown of the housing market every year, which is the turning point, and the slowdown of the housing market will have the highest delinquency and foreclosure performance of any loan in that site or any cohort in that cycle.

SENATOR MACHADO: Thank you very much.

Next we have Ed Smith, Chief Executive Officer of Plaza Financial Group. Thank you very much. The last time you were here, you were telling us about the great service that you provided and that you take the time to know the customer and provide the product that's suitable to the customer.

MR. ED SMITH, JR.: Thank you very much. You're absolutely right, Senator, I'd like to personally thank you for inviting me back.

My presentation is unlike my esteemed panelists here, is that I actually do loans every day for a living, so I have an opportunity to sit down with customers that have this type of product on a daily basis and look into their eyes. And they ask me the question, What are we going to do? With the proliferation of, the implosion of the subprime market, you'll find a lot of customers that have 100 percent financing or high loan-to-value products, either through purchase or refinancing, are now in positions of financial peril. That being said, when we have a product or when we have a customer that walks in that's facing a payment reset and we look at the products that are available now in the marketplace that are not available today that were there two years ago or a year ago, customers are now in positions like, What do we do? And the point I'm trying to make is, we want to look at not only the problem that has existed, that's got us to here, but let's look at some solutions that will give homeowners an opportunity to maintain their homes. It's imperative that all of us that are sitting here collectively come up with an idea that will balance the capital needs in the capital markets for a performing product but also look to the needs of the consumer that's making their payments every day or that are having difficulties in making their payments every day.

What I don't want to see and what are my customer base—and many customers across this state do not want to see—is that a product is legislated away that gives them an opportunity to keep their homes or to enter into the purchase market. As he said earlier, the 100 percent AB 20 product, no-down-payment, product has gone away. That has eliminated an extremely large number of potential homeowners in this state from acquiring the American Dream, that it also has impaired many homeowners that have homes in refinancing to get a more sustainable product. So it's key that we look at solutions that will address the issues of an existing product that's out there but also curb some of the issues that we've had with lax underwriting guidelines or aggressive products that have kind of gotten us to this point. There are multitude of reasons that's got us here—from declining home values, aggressive underwriting, very aggressive product that is in the marketplace. But I really do believe on the ground level most customers and most consumers have the wrong product for their financial situation.

Like I said before—we spoke at the last hearing—it's imperative that an originator in this state takes the time to be effective on the front end of originating a loan and making sure that that customer and that consumer is matched with the right product in the marketplace. We're seeing now in my customer base many customers that are facing foreclosure or potential bankruptcies as a result of the lack of product that can refinance them into a more sustainable product. We know on the federal side that FHA reform is on its way. That's one of the products that we see would be a direct answer to subprime lending. If California could be designated as a high-cost state, if FHA reform comes to fruition, loan limits are raised, this product, from its very inception, was made to help the low- and moderate-income person to acquire a home and to maintain their homes.

These are some of the solutions that I believe we can move forward on. Also, consumer education, not only consumer education but originator education. I'm in an organization, as you know, the California Association of Mortgage Brokers, that advocates consumer education and consumer protection and we fight predatory lending, predatory lending practices. We introduced a document that I'm sure is in your packet today called the *Consumer Protection Worksheet* that guides individuals at the point of sale with the loan originator through ten-point questions that a prudent loan originator and a consumer should consider before entering into any type of loan product.

I know that Assemblymember Lieu is a strong advocate of moving consumer education and financial literacy forward, and we'd like to thank him for that. Consumer education and financial literacy is the key to one of the problems to not having a situation occur in the future. There are very, very few members that—or a few customers—that walk into my office that have a real sound financial grasp of the concept of owning a mortgage and owning a home and the responsibility that go along with that. One of the things that I think we should be able to do here is to come up with some type of solution in that at the front end of creating a loan, that there's a dialog, a documented dialog, between that originator and the consumer that has some type of connection that they understand the products that are available to them for their financial situation and that that originator is aware of all the special nuances that go along with those products, to not put that person in a position of financial peril.

The real key, the ground-level view, is when someone walks into my office, the first thing they ask me is, How much is my payment going to be? That's the bottom line. California is a high-cost state. The cost of homeownership in this state is astronomical. These products have allowed more consumers to get into homeownership opportunities. Now that that product is not performing for a myriad of reasons, as opposed to seeing who did it and why, what are we going to do about the people that have that product, we can come up with solutions to stop these things from occurring in the future, and the industry's already done that. Our industry has a history of correcting itself, as you see the market conditions correcting itself now.

Our concern and my concern is, What are we going to do about the individuals that are working every day with their families, that want to go home and they may not have their houses four months from now because daddy didn't make the payments? We need to work with the lenders, with the secondary market, with the individuals that have actually serviced these loans to come up with a viable solution to address the needs of both sides of the issue, of the interest of both parties.

I know we're going to have some questions.

SENATOR MACHADO: We will.

MR. SMITH: But I'm not as—I don't have a bunch of statistics. I'm just talking about the people I work with every day.

SENATOR MACHADO: I appreciate it very much and thank you very much, Ed. Leigh Rutledge from the realtor's perspective.

MS. LEIGH RUTLEDGE: Yes. I'm just a practitioner also. I sell houses every day, and that's why I'm here today.

I agree with a lot of what you said. I've been in this business 25 years so I've been through many, many cycles. A lot of lenders haven't been through a lot of cycles. Certainly a lot of buyers haven't. And over the last years, quite frankly, I personally have been wondering when it was going to just all explode because it couldn't possibly, the kinds of loans being made, with the market conditions, I just know from my history it just can't go on forever. So here we are.

One thing I wanted to mention is, we're talking about subprime loans, and you can answer this. My understanding of a subprime loan is strictly credit based because I know we're talking about a lot of different types of products, and that's kind of—there's a difference between, you know, a zero-down loan with somebody with stellar credit versus just credit issues. I, and before coming here today, that was my understanding. I talked to several lenders just to clarify what subprime is. Every one of them said to me that is a credit issue. Inferior credit results in a subprime loan, just for clarification about what we're talking about, for one thing.

In addition to that, we have zero down, adjustable rate loans have come up a lot here already. You know, that to me is not a subprime loan. I mean there's a lot of great adjustable products out there. There are a lot of products that aren't good. The teaser rates—it is my opinion—teaser rates that are going to adjust, you know, incredibly in the next few months. You know, they get qualified on the teaser, and six months later, it's way beyond what that buyer can possibly pay. That's another story too.

So there's a lot of nontraditional loans that are not necessarily subprime loans. You know, we've, in my business for years, you know, the last few years, if you could literally, if you could fog up a mirror, you got the loan. And that's just, you know, that's just waiting for huge trouble. And again, that's where we are. However, I was talking to another realtor the other day in the middle of a transaction and asked him.

I said, "How is this affecting you, in your business right now?"

He has a borrower, stellar credit, in the 750-range credit, but she's going in escrow on a home to close within a week, all contingencies removed, zero down, and stated income but stellar credit, and they yanked the loan. They said, that's it. You're not getting the house any more.

Okay. Was that borrower high risk? I don't know. Certainly perhaps not. Just because you're putting zero down, just because you're stated income, which a lot of independent contractor, business-owner-type people do, does make you necessarily a bad borrower. So there's a borrower—there's a buyer who won't get the home; there's a seller that won't be able to close escrow. We are in a declining market, hopefully flattening. I'm just talking about the Sacramento area, kind of flattening out this year, activity's better. However, when, you know, heading into this situation of more and more and more and more foreclosed homes, the foreclosures, and if it swings too far the other way where you have a really, really, a good borrower who cannot purchase that home, it's going to further drive down the market. You know, it's tough, and the whole picture, just the whole picture needs to be looked at carefully. So I'm just here from the man-on-the-street perspective for any questions.

SENATOR MACHADO: Thank you.

Before we open it up for questions, I see four things coming out of it. One is, if we're talking about this as being a maturation of the marketplace, then you have some displacement that occurs just because of where you happen to be within that maturity cycle. That would imply then what we're experiencing is kind of a bubble. I guess the question I would have is, Do you see any similarities with this bubble in terms of looking at past real estate cycles? And given that, and if the market itself is going to self-correct—it does seem somewhat ominous we may be looking at a 2 percent adjustment in gross domestic product—should we then be looking at going forward, new disclosures, and is government in so doing just trying to catch up on what has happened in the past and the new innovative products would may well leave us behind in terms of how you would adjust to that statutorily? Then I guess the other thing is, which was raised by Mr. Leonard is, Should we be doing something for those who have been affected by this current bubble? So I'll open that up to the panel.

Mr. Leonard?

MR. LEONARD: I think that we're actually, while I'm sure there are some well-grounded economic precedences…

SENATOR MACHADO: I want you to do it in two minutes so we can get around because I have some other members that want to ask questions.

MR. LEONARD: Absolutely. I think that in terms of whether or not this is just a maturing market, the subprime market is a relatively new market, and I don't think that the trends that have taken place here necessarily relate very well to the kinds of weak underwriting standards that have emerged in this marketplace and really put borrowers at risk. I don't know that historically the precedence from previous cycles necessarily apply. Certainly to the extent that the market has corrected some is an encouraging thing. As I had mentioned in my comments, I am somewhat skeptical that when the market turns back up, that there won't be further pressures to relax the standards once again as we saw during this cycle.

Clearly disclosure, we do need an overhaul in disclosure. That's mostly a federal issue, but the need for history around disclosures has basically resulted in adding papers to the stack. Whenever a disclosure issue comes up, we add a new disclosure and we don't take anything away. We don't make sure it's in plain English, and we don't really lay it out for the average borrower to understand what's going on. As Mr. Smith indicated, I'm sort of—I'm astounded that the perspective on the street is that borrowers have no idea what they're getting themselves into and in fact are getting into the wrong products that are just not suitable for their circumstances so much of the time. We wouldn't allow borrowers to go and buy toasters or other consumer products that have a 20 percent chance of blowing up on them. Some basic statutory consumer protections are needed to ensure that borrowers aren't being, putting their own financial health at risk.

SENATOR MACHADO: Others?

MR. DUNCAN: We would certainly agree on the disclosure issue. That's something that's been a subject of discussion for as long as I've been at the Mortgage Bankers Association which was 1992. We've actually got—because we've been unable to get federal action, that we've actually got an industry taskforce trying to figure out if we can do some kind of voluntary disclosure to help consumers so we clearly agree on that.

But a couple of things, we certainly don't agree with the forecast of 20 percent failures. There's no historical precedent and there's not basis in current data for that. In fact, what we've been trying to figure out to help the federal regulators who have asked questions on some of these products, what actually are graduation rates? Because if the subprime market exists to help people graduate from poor credit quality to good credit quality, then what's the evidence? And talking to some of our largest lenders who have portfolios of millions of loans, it appears that about 50 percent of borrowers graduate from the subprime to the prime market space. Another 25 percent graduate from subprime adjustable into subprime fixed-rate loans with better terms and about 25 percent remain in the subprime space. So the evidence of some of this would—you know, we've got lots of charts, if you want more data and charts. But one of the ones that's compelling is a review of the prepayment speeds after the first reset. So in other words, when someone takes a 228 in the 25^{th} month, they've successfully made a payment on the reset, what happens is, the probability of prepayment increases because they've demonstrated that they have the financial capacity to make the loan payments at the new terms and consequently they're shortly thereafter, within six months, the likelihood is very high that they refinance out into a prime space.

SENATOR MACHADO: Thank you.

Professor Wallace, do you want to comment?

PROFESSOR WALLACE: Just one question, I guess, with reference to some of the comments that were made by Doug Duncan in the sense of the mono-line, we've learned, doesn't work. I would have to say we're seeing—we don't really—I don't think we have a clear view that it's just the commercial banking model that works in this market. I mean, right now, RTS have a very big position in this market. We also know that there is quite a lot of vertical integration from the investment banks backed right directly into subsidiaries that are doing subprime origination. That's another model that appears to be more broken. But we also have seen serious problems and corporations, such as GMAC, which are organized to do securitization. have heavily involved themselves in subprime lending and have similar kinds of problems. So I don't think we're seeing a convergence to a model that actually works. And I think we are seeing a fairly widespread sharing of the problems. Certainly there are some extremes. New Century, Ownit—some of those are extreme, but I think we—I don't think it's really correct to say that we have a clear view of the right organizational structure of this kind of lending.

SENATOR MACHADO: Professor Gabriel.

PROFESSOR GABRIEL: So I'd like to take us all the way back to 1949 and the National Housing Act.

SENATOR MACHADO: There's a few of us that can probably go back to that. (Laughter)

PROFESSOR GABRIEL: Exactly, exactly, a few of us. You know, there's been a federal policy objective surrounding homeownership for, you know, as long as any of us, many of us have been around and all the rest. And within that objective, a fair amount of emphasis that's been placed on both the purchasers and the originators of mortgages—and this comes through the Community Reinvestment Act, it comes through the GSE Act of 1992, and it comes via data called HMDA data, Home Mortgage Disclosure Act data, which is associated with the monitoring of the originators and the purchasers.

Now in that particular respect, we have an interesting situation here, and that is, that a sizeable chunk of these subprime loans have gone to underserved communities and to households that are the targets of these homeownership initiatives and all the rest. So, you know, you asked a question about what happens with the withdrawal of subprime from those markets. I mean, even with the loss rates that we're citing, it's still quite evident that the vast majority of subprime loans are successful. They're current, they're performing well, so on and so forth, so that I'm not sure if any of us sitting at this table—I'll be interested to hear my colleague's opinions—I'm not sure if anyone's arguing that the subprime sector should go away. I don't think anyone's arguing that the subprime sector doesn't have a place in completing capital markets, so to speak.

I think what we are arguing is that we need a better understanding about the way these loans perform. We need better pricing and better underwriting of these loans, better disclosure, better consumer education. And there's a word that is being tossed around in Washington, D.C., and amongst the lending community, and the word is called *suitability*, and it's whether a suitability measure should be applied in the case of mortgage originations, in the case of a negotiation between a loan broker and an applicant in the same way that a suitability standards would apply.

SENATOR MACHADO: For the committee, now is that leading to a potential litigation for someone who does a loan that may not be suitable for a particular customer, there's a problem and then that's a basis for coming back?

PROFESSOR GABRIEL: Well, no such standard exists currently, so I'm not sure what we're talking about in a retrospective sense, but we're talking about whether lenders voluntarily would take it upon themselves to assure the suitability of the product to the borrower and that that might go some distance towards mitigating some of the bad effects that we're currently seeing.

SENATOR MACHADO: I see a head shaking over here. Professor Wallace.

PROFESSOR WALLACE: I think your point is well taken. I mean, the establishment, it's to set the bar in terms of determining culpability and origination. I'm not sure it necessarily solves the problem.

SENATOR MACHADO: I'm just trying to understand how the application and terminology would be, not necessarily passing judgment on the use or non-use of it.

MR. SMITH: I'd like to add a comment. With respect to her question about subprime loans dovetailing into your question. Subprime loans are not just necessarily credit driven. There are a multitude of factors that go into that. Not only is it credit. It's the type of income, the character of that income, property standards, property conditions. There are a lot of things that go into subprime lending. I have plenty A credit customers that takes subprime product simply because it's expedient and it works for that particular situation.

SENATOR MACHADO: Well, before we get redundant, I want to see members that have some questions too.

MR. SMITH: Sure.

SENATOR MACHADO: First, Senator Runner, then Senator Scott, Assemblymember Lieu, Lee, and—Lieu—I'm sorry—and Senator Correa, and then Senator Margett.

SENATOR GEORGE RUNNER: A couple of questions. I want to kind of go back to this thought in regards to, a little bit deeper in regards to this issue of a subprime definition focused on the product versus the borrower because, again, as we talk through that, it seems to me that's a pretty essential issue because then, if it's focused on the borrower, then we don't worry about the products on the market. We keep them there, and we focus on the issue of the borrower themselves in regards to this concept of suitability. I do have a question about that too. But is that a fair definition, that we're really not talking about products; we're talking about the borrower by definition of a subprime loan? Go ahead and speak up.

SENATOR MACHADO: Identify yourself and jump in.

MR. LEONARD: Not necessarily.

SENATOR MACHADO: Mr. Leonard, identify yourself.

MR. LEONARD: I'm sorry. Mr. Leonard. I'm sorry.

SENATOR RUNNER: Okay.

MR. LEONARD: It's not, necessarily. If I am prime credit borrower and I go to one of these mono-line subprime lenders, even with great credit, I will come out paying an interest premium because those are largely the only products that they offer. So take a New Century or an Ameriquest not offering a product to a prime borrower, they not going to turn you away if you have great credit and you happen to find your way into one of their outlets. They're not going to say, no, I'm sorry; we only offer credit to subprime borrowers; you're credit's too good; see you later. That doesn't happen. And in fact, there's a real problem that in fact a large number of borrowers who could qualify for prime credit are not receiving that, particularly among minority households.

SENATOR RUNNER: So by your definition then, it's the product that is subprime as opposed to the borrower?

MR. LEONARD: Both definitions apply and it all depends on the context. Unfortunately, that's true on a lot of these issues that we we're tackling.

SENATOR RUNNER: Okay. So if I have credit capacity and I choose to go out and borrow something quickly because I need to—I want to do it—I need to turn this around, whatever—because it is not—I guess I'm trying to get some kind of traditional loan, therefore the loan itself is subprime even though I can afford—I've got capacity, I can pay the interest, I can do all that—you would still see that as a subprime loan?

MR. LEONARD: Yes. One of the things you'll see, if you look at the data that we put in here, that goes by product type by year, is you'll see that the product of choice for investors is a stated income Alt-A product, and it's because of speed to market, that they wanted to get access to the property. We would talk about that as being a product. That serves as a certain function.

SENATOR RUNNER: And you define that as a subprime product?

MR. LEONARD: That would be—it's sort of the inflection point between prime and subprime. In the industry, it's called Alt-A, Alternative A. That's kind of the term that they use. It doesn't have full documentation. There is an interest premium. It is an interest premium.

SENATOR RUNNER: But the discussion here is about the fact that the problem that subprime lending has gone, and its effect in the market, then we're really focused on the borrower, not on the product, right? Because if I've got capacity and I have the subprime loan and I'm going to keep making those payments, my loan isn't a problem here. The only context that we're really discussing this is the context of the individual who then gets in trouble with the subprime loan which goes back to his or her capacity, correct?

SENATOR MACHADO: Senator Gabriel.

PROFESSOR GABRIEL: Mr. Gabriel here.

SENATOR MACHADO: Professor.

PROFESSOR GABRIEL: So theoretically we live in what's called a risk-based pricing world.

SENATOR RUNNER: Absolutely.

PROFESSOR GABRIEL: And what that means, of course, is that you're going to pay for your mortgage based on your understood and observed risk characteristics. The primary measure of that risk is your FICA score. So traditionally—and FICA was a Fair Issacs Company in San Rafael that does a lot of work in statistically assessing credit risk. So generally speaking, borrowers with FICA scores of less than 620 with evidence of a late payment in the last 12 months, with a bankruptcy in the last two years, or with a foreclosure in the last three years would be considered subprime borrowers.

SENATOR RUNNER: Okay, the borrower themselves.

PROFESSOR GABRIEL: Okay. Now you or I or anyone else in this room may have a FICA score well in excess of 620 but find ourselves, for whatever combination of reasons as you've heard, in the offices of subprime lender, where you might be overcharged relative to your observable credit risk.

SENATOR RUNNER: Okay. That would be me as a consumer going out and deciding where I want and who's going to loan me money. That would be my choice.

PROFESSOR GABRIEL: Yes. But if you're well-informed and if the mortgage market is working well, you should certainly be able to get a mortgage consistent with your observable credit risk.

SENATOR RUNNER: Okay. I have one more follow-up question and I've actually got to go to EQ. So let me just follow up.

This issue in regards to suitability, help me understand the idea of suitability versus underwriting. I mean, I thought that's really what we do when we talk about underwriting and looking at credit worthiness, all those other issues. I assume that that is an aspect of underwriting, and it sounds to me like suitability is just another word for it.

MR. LEONARD: Well, I think the notion is that there would be some firm standards that put additional duties on brokers or originators to make sure that borrowers are not getting into loans that are likely to be very dangerous for them.

SENATOR RUNNER: So some outside—you're going to have some criteria out there that says that you shouldn't go into this loan because, what? The market may go down in the future and that should be a problem for you; you may lose your job and you may not be able to afford this house?

MR. LEONARD: There are a variety ways of doing it. And again, this is a standard that's set up in financial investing so that, for example, for an elderly person on a fixed income having a loan, entering into a loan, in most cases, a loan that will have a payment shock in two years that requires them to pay 100 percent of their fixed elderly income is probably not a suitable product for them, and that loan shouldn't be made.

SENATOR RUNNER: Tell me the difference between underwriting that loan and saying that's a loan I'm going to make in suitability.

MR. LEONARD: Because different borrowers qualify for a range of different loans, depending on what underwriting standards are used by different lenders. The notion is that some of those loans will not be suitable for them, even if they qualify under the underwriting standards that the lender is choosing to offer. In the case of the subprime market, we've had seriously relaxed underwriting standards which have put people into loans which they didn't have a hope of being able to pay off.

PROFESSOR GABRIEL: If you're going to go down the suitability path, I think you want to think through what's the legal and financial structure of relationships in the securities industry from which this emanates because essentially, it's a structure by widows, which widows and orphans bring to an agent who is designed to act on their behalf in terms of fiduciary responsibility to invest their proceeds. That's not the same structure of relationship that exists in the mortgage industry in which you as a borrower go seeking a product and look for a company to provide you that product. So the structure of suitability is not—it emanates from a legal and transactional structure.

SENATOR MACHADO: Thank you.

Assemblymember Lieu.

ASSEMBLYMEMBER TED LIEU: Thank you, and thank you, Senator Machado and Members, for letting me be here today. The fact that we're looking at this at both a bicameral and bipartisan matter ___ how important the issue is.

I have a question for Mr. Duncan, especially your chart on *Mortgage, Serious Delinquency Rates*, if I understand your testimony, I think what you were trying to say is, look, in states like Ohio, Michigan, and Indiana, where they've had economic difficulties, they're going to have really high delinquency rates in terms of the subprime ARMs. I think your chart actually shows something very different. I think the relevant comparison, it's not between the states. It's between the loans in each state. And so we used to look at how the loans across that state performed under the economic circumstances of that state.

For instance, if you are a Mississippi resident and you had a subprime ARM, you're four times as likely to have, to be in delinquency than if you had a prime ARM. If you're an Ohio resident, you're five times more likely to be in delinquency with a subprime ARM than a prime ARM. If you then look at the lowest five states in California, those rates go higher. So if you're a California resident, you're six times more likely to be in delinquency if you've got subprime ARM than a prime ARM. If you're an Hawaii resident, you're ten times more likely to be in delinquency if you have this subprime ARM versus a prime ARM.

So to me, when I look at this and I see, that notwithstanding economic factors, you have these enormous differences and the rates are so high between those in subprime ARM and prime ARM, that the gap is so large, that it strikes me that what Senator Machado says is correct, that we might have to look at this more closely and maybe have additional disclosures or the protections because it strikes me that this subprime ARM is one of those things in tort law where you have this thing called an *inherently dangerous product*. It looks like to me that this is maybe one of those things, and I just wanted to hear your thoughts on that.

MR. DUNCAN: Yes. I think to Professor Gabriel's point about a risk-based continuum, what you're suggesting is simply that in states where the underlying economy doesn't perform as well, you see elevated levels of delinquency and foreclosure, irrespective of the product type. If the economy is better, then the entire level that that entrenched level of risks are performing at a better rate. So I don't think it does argue against original premise. I think it simply says that the underlying thing that moves the whole spectrum of risks up or down is the economy in the local marketplace.

SENATOR MACHADO: Yes. Mr. Leonard, did you want to make a comment?

MR. LEONARD: Yes, if I could. I mean, I think that premise clearly, the economy affects the levels of foreclosures. But I would agree with Assemblymember Lieu that what's going on here and the differences between prime ARM and subprime ARM fundamentally have to do with the nature of the products and the features that are built into these subprime ARMs which by definition are likely to increase delinquency and foreclosure rates. And I think your point is extremely well taken. There are a number of risk features that you find concentrated in subprime ARMs that you don't find in prime ARMs. Part of it is the time for which you start making adjustments. The adjustments come every six months, not once a year. The amount of the margin and the size of the adjustment is often quite, is much larger as well.

SENATOR MACHADO: Thank you.

Senator Correa.

SENATOR LOU CORREA: Thank you very much, Mr. Chair.

It's an interesting discussion on—I think it's policing the American Dream. As I'm thinking, as I'm hearing everybody talk, I'm thinking to myself, who gets hurt and who's actually benefiting from all this? We discussed a possible 2 percent loss of gross domestic product. When you think about the use of these products, that's probably the reason we've had an overheated economy lately and that's why Chairman Bernanke is talking about inflation. So maybe we shouldn't have had that extra 2 percent in the last few years.

The lenders, actually the investors who actually invest in subprime, which by definition is a higher risk instrument—you're getting a few basis points more in rate of return. Therefore, you know you're going to have a higher rate of default. So are we going to police or protect from themselves an institutional investor? Probably not.

The borrower, you know, you're absolutely right. The borrower comes in, is interested in the American Dream. And as long as—if you're listed as going through the roof, can you really honestly look at somebody who wants to buy a piece of the American Dream and say you shouldn't buy because my crystal ball tells me that real estate is not going to go up forever? That's a tough one. That's why again, who polices the American Dream?

I'll tell you, before I got into the legislature, my past history, I had a Series 7 license, a Series 24, a Series 8, and a Series 8 ??, which meant I could essentially run a stock brokerage firm if I wanted to, and I knew the issue of suitability. It's already practiced in the securities business, and that's why you have qualified investors, institutional investors, have private placements, which means me, unless I make $250,000 a year and worth a few million, cannot invest in those instruments. So I think conceptually you can come up with some kind of a suitability issue. I think that's important because one of my other hats was also a loan broker and also a real estate agent, and I heard somebody talk here about the issues that arise when a seller also prepares a loan. You want to do that because you want to do what's called maximizing profit. You want to make anywhere from 3 percent to 5 percent on the sale. Then you want to make anywhere from 1 percent, plus fees, plus maybe a rebate on the loan, and you can walk away $20,000, maybe more, on one transaction. Awesome. But that's not really the issue because I've seen people that don't do both also fleece, rip off borrowers. So then the issue is, How do you get to this issue of—I'll use the word again—I think it's—how do you make sure that the brokers, okay, are dealing with facts when it comes to the borrowers?

I don't want to tell my borrower, you shouldn't buy this house because I know better than you do. That's why I haven't bought real estate in the last few years which is probably why I have missed out on the big boom. But at the same time, I know there are brokers out there, for example, of somebody who can probably qualify for a good loan. Loan Number 1 wound up getting put into a Loan Number 2 because you have higher fees, higher points, higher rate; you can sell this loan in a secondary market for a higher amount. How do you police that?

I think suitability is good, like the stockbrokers do. You sit down, you interview your client, you tell them, How much do you make, How old are you, What's your timeline to retire? That's what you do, the stockbroker. Maybe you'll do that when you're making a loan, but I still don't think that gets you to the issue, which is, people that are being affected to be lied to. The perfect market, so to speak, the efficient markets, capital markets, work with the assumption being that you have good information. Where it breaks down is when you have borrowers that are effectively lied to, borrowers that are not told the truth. Again, some of these loans that you don't even make the first payment, you've got already defaults moving in that direction. That's where the issue comes in.

I guess my question to any one of you here, based on that diatribe that I just spilled out is, How do you police or how do you make sure that the broker or that loan agent gives the borrower the right information?

SENATOR MACHADO: Very quickly.

MR. DUNCAN: If you were to do one thing, if you could get every person that wanted to loan, a loan to shop at three different lenders, which our surveys show a third of all people never talk to more than their realtor and end up in a house.

SENATOR CORREA: That's where it starts.

MR. DUNCAN: There's 8,800 lenders out there to compete for the business. I've done it myself. Every time I've taken a loan, I've shopped a minimum of three and I always got better terms than the first one that was offered to me.

SENATOR MACHADO: Other comments? Very quickly.

MR. SMITH: The second issue is just basic business ethics. You need to be honest to do business in the first place. But if you want to treat people fair, treat them fair. You can't police…

SENATOR CORREA: And you know and I know through the chair, when you get a chance to make anywhere from $10,000 to $30,000 per loan. where ethics goes.

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

SENATOR BOB MARGETT: I have a question, Senator Machado. How much does suitability cost and to the transaction itself? Any idea what that would be?

MR. SMITH: I don't think that's measurable. I think it's practicality of putting a person in the right product for their circumstances.

SENATOR MARGETT: If I can just kind of segue off of what Senator Correa had to say just a moment ago. Everybody said the subprime loans are not credit driven. Okay, fine. If the guy's in the house, the guys all of a sudden faces the increase in mortgage payments and he loses the property. what happens? Is there any, any safety net for that kind of guy out there that's already to lose? What does the secondary markets say about that? Does it just say, hey, bring the auctioneer in; we're going to clear this guy out of his house?

MR. SMITH: You're going to let me to go?

SENATOR MACHADO: Sure.

MR. SMITH: Loan servicers. The homeowners, the first avenue of redress is to contact the loan servicer. Let him know that they're in trouble, the minute they find out any trouble, even before they get there. The investors that service those loans are extremely motivated to work out plans with them to keep them in the home if there's any viable way that that person can demonstrate they can participate in a loan workout program. That's the first avenue that they should do.

SENATOR MACHADO: May I jump in one second?

But in many loans in the secondary market, you're so much removals where you just have a third party that's servicing the loans and there's no relationship that traditionally would be available between a lender and borrower. What happens then?

MR. SMITH: Due diligence. In other words, if you call your loan servicer and your loan servicer does not respond to you, that consumer needs to either go to a qualified individual—visit one of our professionals—that can help them through the process to get to the right person within the loan servicer, to the right department, restructure their deal, or to do a loan workout department or lost mitigation.

SENATOR MACHADO: How sophisticated does the borrower have to be to take advantage of that?

MR. SMITH: I wouldn't say necessarily not sophisticated as opposed to be diligent. If they don't get the right answer at the first level and then make a phone call, accelerate that a little bit. Call a professional; call the person that did their loans.

SENATOR MACHADO: Thank you.

MR. SMITH: We can help you through that process.

SENATOR MACHADO: I'm sorry. Go ahead.

SENATOR MARGETT: Yes. You said "restructure the deal." How do you un-fry the egg? What do you do in restructuring your deal?

MR. SMITH: There are several methods to do that—forbearance agreements, for loan modifications, and sometimes you can actually refinance the entire transactions. There are a multitude of ways to un-fry the egg, so to speak.

SENATOR MARGETT: Well, okay. But you, we're talking about a situation, a scenario, whereby the real estate market has now gone flat. The house is not worth what the guy paid for. He's in his subprime mortgage, and now all of a sudden the numbers aren't there. He may have paid like $100,000 for his house, just using numbers, and all of a sudden the thing is worth $80,000. How do you put a deal together that takes care of a guy like that?

MR. SMITH: Quite honestly, the investor is more motivated to do a deal like that because they don't want that property either as a bad loan on the books, so that's even more leverage for the consumer to use to move forward and restructure that transaction.

SENATOR MARGETT: Going back to the lender himself.

MR. SMITH: Exactly.

SENATOR MARGETT: And saying, hey, listen, I've got to cut a deal with you. That can be done?

MR. SMITH: Yes, sir.

SENATOR MARGETT: Okay. Is there any programs out there that say, okay, fine; this house will clear the real estate market at $80,000? You have, say, a 6 percent of priors, 6 percent loan; that's going to be $6,000 a year or $500 a month using just numbers there and all of a sudden your house is now worth $80,000. You want to stay in it but you can't afford anything more. Do the payments jump up to be an 8 percent, 8 percent interest loan? Would that work and the spread there kind of help in the marketplace for this guy not to be wrenched on the deal? Do you know what I'm saying?

MR. SMITH: I understand exactly what you're saying.

SENATOR MACHADO: I'm going to ask Professor Wallace. She's been trying to jump in.

PROFESSOR WALLACE: I think you have to be careful as to who did the origination.

SENATOR MACHADO: Would you bring the mike a little closer?

PROFESSOR WALLACE: For those mortgages that were originated through a RTS or an independent, not through a portfolio lender, like a bank, the special servicer, in the case of the securitization, has a fiduciary responsibility to protect the bondholder, and they're not going to be especially predisposed to facilitating a deep workout for the borrower. That is their responsibility. Now for the portfolio lenders, like the Countrywide or the Wells Fargo Bank that's securitized under their umbrella, so the subsidiaries that are issuing the bond may say Wells Fargo. They are more motivated to do these workouts. But for the workouts that were vertical integration from the investment banking community into either independence or RTS, or mono-loan subprimes, the fiduciary responsibility of the servicer is to the bondholder. It is not to the borrower. And so it's a misrepresentation to hope for this warm treatment of subprime borrowers who are going to lose their homes. It's simply not going to happen.

SENATOR MARGETT: Okay. Well, then what are going to do? Just sit back and let this guy lose his home? Where's the program…

PROFESSOR WALLACE: I think that's why we're here today, is to try to understand the differences and the sources of this lending in that the treatment of borrowers will not be the same across these various venders.

SENATOR MACHADO: What Senator Margett brings up is very interesting because you have such a mix in the marketplace now between when you and I first probably bought our home and the relationship we had with the lender versus what you have with a secondary market, what I was alluding to earlier, the role of the servicer and the respective responsibilities.

SENATOR MARGETT: Well, I want to thank you for allowing the time, but I think we, in this legislature, have got to start looking to help this guy that got into this market, inadvertently, or, you know, he's all starry-eyed about getting a house. Maybe, like Senator Correa was saying, these guys want to, realtors want to sell the product and the loan people want to make the loans. And so all of a sudden this guy, who really kind of becomes a victim, Senator Machado, out of the whole thing when things shake up.

SENATOR MACHADO: I think you're absolutely right. This is a buildup on the hearing we had eight weeks ago.

SENATOR MARGETT: Right.

SENATOR MACHADO: To be able to try to, for us to get together and try to talk about what we should be doing. We're going to hear from our state regulators shortly too.

Senator Cox?

SENATOR COX: Senator, I hope we don't move in the direction of calling people who default on their mortgages victims, but I've heard my colleague say that. Let me call to your attention…

SENATOR MACHADO: It was your colleague. (Laughter)

SENATOR COX: Let me call your attention, let me call (laughter)…

SENATOR MARGETT: I'm a conservative Republican. I think Dave may think I'm switching parties (laughter)…

SENATOR COX: Let me presume the numbers are right that the gentleman prepared.

Mr. Duncan, I presume the numbers are right. But on Page 12, if I can just call your attention, Mr. Chairman, and just point out to you that and, by the way, I appreciated the discussion about…

SENATOR MACHADO: What are you looking at on Page 12?

SENATOR COX: The numbers here on Page 12. I'm sorry. By Mr. Duncan, it looks like this. It looks like this on Page 12.

SENATOR MACHADO: Okay. Thank you.

SENATOR COX: I appreciate the discussion about the commission. I think that's always a worthy discussion about whether or not it's a person who sells, like financial product is worth their commission or not. I think that's always a worthy discussion and certainly think the disclosure is a very important part.

But let me just call to your attention, if I may, Mr. Chairman, that the subprime has given folks the opportunity to buy a home. It really has in fact been a tool that has allowed people to purchase a home. Let me just call to your attention the first four elements that were pointed out here as hardship reasons as to why they were in foreclosure—unemployment or curtailment of income, 41.5 percent. Now I don't know how the beginning of this process you can determine whether or not that individual is in fact going to be unemployed or going to have a curtailment of income. I certainly don't know how you're going to determine whether or not somebody's going to die or have an illness in the family that is going to jeopardize their mortgage. I think you can probably have some discussion about excessive obligation. You can look at that to see whether or not they in fact are living beyond their means. The fourth one, by the way, is marital difficulties, and I can just see that now on an application that was approved by the legislature that says, tell me, by the way, how's your marital life? (Laughter) I mean, what's the possibility of your getting divorced in the next couple of—I just want to call to your attention, the first three reasons represent about 75 percent. The fourth reason represents 82 percent of all the delinquencies. And I do in fact believe that there are some risks that the borrower assumes, the lenders assume, when you in fact have a subprime opportunity. But it does in fact get people in homes, and I think we have to recognize that, and the housing market has not gone the way it, people anticipate it would go. If it had gone that way, they probably wouldn't have any difficulty, but the market always has gone down. And I don't know how you put together a disclosure form that says, by the way, if the market goes down, we're going to bail you out. I don't know how you do that. I don't think this legislature ought to be involved in that.

SENATOR MACHADO: Thank you for your statement. Now I'm going to make the prerogative. We can cap this panel and go on for another hour, but I also have two other components of this agenda that we need to get to, so I'm going to dismiss this panel. Thank you very much for the enlightenment that you've given us. If nothing else, you sparked some controversy that we'll need to be able to deal with in the future.

May I ask now to have Michael Kelley and Preston DuFauchard to come up, and give us an update from your various department's perspective as to what's happening. (Pounding gavel.) We need to go.

Mr. Kelley, welcome again.

MR. MICHAEL KELLEY: Good afternoon, Mr. Chairman.

SENATOR MACHADO: Mike, you had a chance to hear the testimony we talked about last time under the Department of Financial Institutions. You pretty much had adopted the federal guidelines. What else is going on within your department and what has happened in the last eight weeks? Any comments with respect to the testimony that was given in the previous panel?

MR. KELLEY: Well, first let me address the two issues that the committee asked me to be prepared to respond to.

The first one is, Have we taken any action against one of our licensees? The short answer is yes. That licensee is Fremont Investment Savings and Loan. And I think it's important to know, for the committee's perspective, in terms of that one institution, in terms of loans, in terms of dollar value, for subprime loans sold in the secondary market in California, Fremont represented over 90 percent. So from the standpoint of us dealing with that licensee, we believe that we have addressed a significant portion of the issue relative to our licensees. And we did do a study, officially an examination, that it started probably toward the end of last calendar year. But since our hearing, it has completed, in conjunction with the FDIC, we did issue a cease-and-desist order against Fremont and the FDIC's cease-and-desist order as public information, whereas ours isn't. But if you look at what the FDIC said, it mirrors pretty much some of the concerns that we have relative to their underwriting practices, lack of a business plan. So we believe that we have in place a framework for them to improve their operation relative to this product. And I've asked Peter Van Hoecke, my deputy, to provide even more detail relative to surveys that we did in terms of what we're finding, in terms of the number of institutions that are involved in subprime, if you care to hear that.

I sent you a letter. Hopefully, you've got a chance to look at, to get a look at how this product is used and with our licensees because in actuality, what I think is a little bit less than 28 percent of our licensees even engaged in this product. But then again, if you look at that percentage and who the primary player is, we have dealt with that player.

SENATOR MACHADO: How many that you oversee fall outside of the federal guidelines because they have no relationship with any federal agency or federal oversight?

MR. PETER VAN HOECKE: Mr. Chairman, Peter Van Hoecke, deputy commissioner for DFI.

SENATOR MACHADO: Welcome.

MR. VAN HOECKE: The only licensees that we have that would fall outside of the federal guidelines would be those credit unions that have private insurance which, I believe, they are 18.

As we noted at the last hearing, we have directed them to comply with those guidelines. However, we anticipate no problem.

SENATOR MACHADO: Thank you.

Do you have any other comments, Mr. Kelley?

MR. KELLEY: No, Mr. Chairman.

SENATOR MACHADO: Let's go through them. We'll have Mr. DuFauchard to comment, and I guess one of the things that's out there is the fact that we don't necessarily have the examiners to be able to do the type of examination of the 4,800 institutions that are in California and many of those that seem to be the ones that have fallen outside of the oversight that's prescribed from the federal regulations.

MR. PRESTON DuFAUCHARD: Good afternoon, Chairman Machado. Thank your for having me here, and I would like to comment on that specific issue. But as the background paper correctly points out, there is a severe liquidity crisis that our licensees are experiencing in the subprime marketplace; and when we got wind of this, what I asked the staff to do is to compile a list of the top 20 residential mortgage lenders and California finance lenders who provide subprime mortgages in California. And those 40 companies actually turned out to be 37, because some of them have cross licenses, are responsible for about 70 percent of the mortgage lending of our licensee population.

As far as the examinations are concerned, we have examined all of those companies within the last four years, which is our cycle for conducting examinations So they're all on schedule as far as the examinations are concerned. But let me give you a little picture of what's happened with one specific licensee, and that's New Century Financial.

While we were compiling this list, one of the things that we did was, we reached out to other state regulators across the country because the liquidity crisis not only happened in California but with other lenders as well. So we developed a plan whereby the home-state regulator would take the lead in terms of getting information from the licensee and providing that flow of information to all the other state regulators. For California, the companies included New Century, Financial of Irvine, Accredited Home Lenders, San Diego, and Ameriquest or Origin ??. Origin ?? and Ameriquest are both affiliates. The non-California companies included GMAC—which is experiencing far less problems—Four Star Financial, and Master Financial.

With respect to New Century, we've had daily conference calls with senior management of the company and all other state regulators. And in those calls, we've asked for information about mortgage loans and their pipeline and their ability to finance those loan commitments. When we first began contacting New Century, the volume of loans in their pipeline was approximately 27,000 which represented $6 billion. And as far as California's portion of that was concerned, there were roughly $2 billion in value; of that, about 5,600 loans. They had some access, although reduced access, to their credit facilities which was crippling their ability to fund their pipeline of loans.

When New Century lost all its access to its credit arrangements, the Department issued a desist-and-refrain order against New Century ordering it to stop accepting new loan applications, to fund the pipeline of loans, or to transfer those loans with the consent of borrowers to a different lender and to provide daily reports showing reduction in the pipeline. Our primary concern was that there were a substantial number of borrowers who had negotiated loans and were ready to close on a home purchase but were unable to be financed. To address that concern, we contacted the California Mortgage Bankers Association to see if any of its members were interested in looking at New Century's pipeline of loans, and we spoke with various well-financed lenders to assess their interest in the New Century pipeline and to provide relevant contact points at New Century. When making those calls to other lenders, we made clear that the pipeline loans had to meet the lenders' underwriting criteria. And in this morning's pipeline report, the national volume of loans in the New Century pipeline is approximately 430 loans and just under $117 million in value, and the portion for California is $46 million which represents about 125 loans. So that's what's taken place over the past two weeks with respect to New Century.

The conference calls with other lenders have revealed that there are liquidity problems, but those companies have continued to have sufficient funds and access to their warehouse lines that they could service the loans in their pipeline without difficulty. Some of those companies have undergone strategic transactions to enable them to have a more stable balance sheet. You may have read that accredited home lenders recently received a $200 million loan from a hedge fund at a 13 percent interest rate.

We're continuing to monitor these companies in coordination with the other state regulators. In addition, we've taken—we've talked with the administration about issuing a letter requesting our licensees discontinue accepting from subprime borrowers certain types of loan applications so that we don't know how chronic this situation is going to be. If it extends out into the summer, it would be nice if there was a limited dollar, if there's a limited volume of dollars that certain products wouldn't compete with others for refinancing and new home loan purchases.

SENATOR MACHADO: This letter is basically a letter that would set out underwriting criteria?

MR. DuFAUCHARD: It would ask that lenders discontinue accepting, for example, stated-income applications. We don't—I don't have the authority to issue an order.

SENATOR MACHADO: That would be from, for example, for all borrowers?

MR. DuFAUCHARD: For borrowers in the subprime market place.

SENATOR MACHADO: Now has the administration given you an indication when they would respond?

MR. DuFAUCHARD: No. I don't know the answer to that question. I'm hoping it's relatively soon because it's a fairly fluid situation.

SENATOR MACHADO: Now if you're just going to be looking at stated income, are there other factors that ought to be looked at in terms of the type of loans that they would accept?

MR. DuFAUCHARD: There are other factors, but I think as a state, we need to make sure we're coordinating what we're doing with other departments. For example…

SENATOR MACHADO: Departments here or departments in other states?

MR. DuFAUCHARD: Departments here in the state. For example, we need to make sure that the Cal-HFA ?? loan underwriting practices aren't severely influenced by a request we made to our lenders. Some of our lenders are partners with Cal-HFA. As a matter of fact, New Century was prior to the time we issued our desist-and-refrain order.

SENATOR MACHADO: Can you tell us the requirements for Cal-HFA?

MR. DuFAUCHARD: Yes. Housing and Finance Authority.

SENATOR MACHADO: How would their underwriting criteria be that much different than where we are with the guidelines, the federal guidelines that are out there?

MR. DuFAUCHARD: Well, for example, they may make 100 percent LTV loans available to first-time buyers. You know, I think, as a result of their activities, they can do that. They have bonds that are underwritten that they can use to assist first-time homebuyers. My point was simply that the underwriting guidelines that, or the specific product that I was looking at, wouldn't adversely influence affordable housing and first-time homebuyers.

SENATOR MARGETT: Mr. Chairman, would you just ask him to explain…

SENATOR MACHADO: Go ahead, Senator.

SENATOR MARGETT: Just explain that a little bit just for the record and for our edification, tell us about stated income, what you mean by that, and what you think everybody else means by that. The stated income loans, what I mean by that, at the January 31 hearing, there was some testimony regarding income loans where there's no objective verification of income or employment status on the part of the borrower.

SENATOR MARGETT: And that's what you mean that as well? In other words, if you ask the potential borrower, How much do you make, and they see I make $10,000 a month, you just that down and you're done with it without any verification?

MR. DuFAUCHARD: Yes.

SENATOR MARGETT: Okay. Does your agency have the ability to tell the lenders that you don't have the ability to do that kind of transaction in California?

MR. DuFAUCHARD: We're asking them to discontinue…

SENATOR MARGETT: You're asking to do it as a courtesy, or do you have authority to do that?

MR. DuFAUCHARD: We would have—we don't have the authority to ask them to do that on an order, by way of an order.

SENATOR MACHADO: You don't have any way to respond to a situation that may be urgent?

MR. DuFAUCHARD: You know…

SENATOR MACHADO: I mean, as a regulator, you're kind of, you're telling me that you can't regulate?

MR. DuFAUCHARD: I can tell you that the regulations we issue have to go through the appropriate…

SENATOR MACHADO: I understand that, but can you do something in the process and require a certain behavioral change while you proceed on regulations?

MR. DuFAUCHARD: The orders that we issue are issued on a company-by-company basis based on specific findings. If I were to issue an order prohibiting stated income loans across the board, it would be subject to challenge as an underground regulation.

SENATOR MACHADO: But even if you were to issue that across the board and then start to proceed through the normal regulation process—

MR. DuFAUCHARD: Yes.

SENATOR MACHADO: --you're saying that you're issuance of that order would be challenged and stayed?

MR. DuFAUCHARD: It would likely be successful.

SENATOR MACHADO: Likely, but you don't know until you do it?

MR. DuFAUCHARD: That's right.

SENATOR MACHADO: All right. So that stuff probably kind of disturbs me because you're the entity that those in D.C. are saying we ought to preempt because the state's not doing the job. And then to think that you'd only be looking at stated income as the criteria because you don't want to step on the toes with CAL-HFA, I would like to know what underwriting guidelines they're using for first-time homebuyers that don't go into the realm of being subprime or subprime to the extent that you could capture somebody that may not know what they're getting into as we've been talking about today. And if they do have guidelines that tout that, why you wouldn't want to impose those guidelines on the rest of your…

MR. DuFAUCHARD: _______.

SENATOR MACHADO: …that you oversee.

SENATOR MARGETT: Is it stated income transactions that create the greatest number of defaults?

MR. DuFAUCHARD: I was trying to get the—there's been press on a number of types of loan products that create the greatest amount of early defaults. Stated income loans was the one product that was mentioned in the New York *Times* article.

SENATOR MACHADO: But you also have simultaneous second liens that cause certain…

MR. DuFAUCHARD: Yes, and as well as 100 percent…

SENATOR MACHADO: I mean, I would hope as a department we could respond to something more than just a New York *Times* article.

MR. DuFAUCHARD: I'm not…

SENATOR MACHADO: Here's what I'd like to know. I would like to know what the underwriting guidelines are for Cal-HFA. And I'd like to know where you take issue with those and why you can't issue a letter to say we want to have all of our entities that we regulate to conform with that. And then I want to know who's telling you, you can't do it, and I'd like to see a timeline and I'd also like to—because I think it's totally inadequate what you're looking at in terms of saying I want a letter from the—I want permission from the governor to send a letter out saying that you can't take a stated income loan because that just seems to be one component of a variety of products.

SENATOR MARGETT: Mr. Chairman, you know, I'm not necessarily a big fan of stated income. But before I watched an agency do that, I'd want to have some hardcore statistics as, Is that really the problem? When I look on Page 12, it doesn't appear to me that that's the problem. A stated income loan doesn't necessarily fall into that category.

SENATOR MACHADO: Well, I'm not taking issue with that. But if we're looking at not trying to impinge on another agency that's making a first-time homebuyer, help assisting a first-time homebuyer, I would think at the very least, if we're looking at trying to get a handle on that, you would want to have those underwriting guidelines be what's a minimum criteria for these entities that the Department of Corporations oversees. I'm not picking on stated income. I'm looking at what is the criteria that the witness said they didn't want to step on in terms of where they were issuing that proposed letter.

SENATOR MARGETT: I heard the emphasis based upon first-time homebuyers and affordability. I heard that part. I just think we need to have all the statistics, Mr. Chairman. That's all I'm asking for.

SENATOR MACHADO: Any other questions? Do you have any other comments?

We've had this discussion in two different venues now about the Department of Corporations stepping up and being proactive with respect to looking at the implementation of the federal guidelines. You brought up two, now another standard that you're looking at, is California Housing Financial Assistance [sic], so I would like to see kind of where—I'd like to know from you where you think the Department of Corporations...

MR. DuFAUCHARD: Senator, just on that, I'm not saying that we're not implementing our rulemaking on the guide—going forward with the rulemaking on the guidance, just to be clear on that. We've actually drafted a rule, so we're moving on that, and I was trying to submit something in advance of the guidance that would react to this situation in an as-pronounced a fashion that I thought I had leeway to.

SENATOR MACHADO: I understand that. But if you're saying to this committee today that you don't want to do anything that's going to step on the underwriting capability of the California Home Finance [sic] Authority to be able to assist first-time buyers, I would think that becomes a minimum standard. And just to pick out income-stated loans, I just think, as Senator Cox has alluded to, is that it may just be an arbitrary identification without any substantiation.

Any other questions?

Thank you very—yes. Mr. Kelley.

MR. KELLEY: Mr. Chairman, I just wanted to add one thing that we're doing at DFI as it relates to Fremont, and it's in the cease-and-desist order. We've directed Fremont, whenever possible and consistent with sound lending practices, that borrowers in distress be afforded all options that will reduce their risk of foreclosure. So that's an added provision that we added in our cease and desist to facilitate that institution helping out concerns, and I know that Senator Margett at one point had asked the question of his staff because I wanted to make sure that you understood that we added that in our cease-and-desist order to our licensing.

SENATOR MACHADO: I appreciate that. I would like to ask on top of that, and perhaps you could provide that to the committee, we heard testimony from Professor Wallace that talked about the fact that those who service loans in the secondary market, to which I think some of the people you oversee entered into, they have fiduciary responsibilities to their bondholders and not to the borrower. So what role, if any, can we play in terms of making sure they're accorded everything that you stipulated in that order?

SENATOR MARGETT: Senator, may I ask a question?

SENATOR MACHADO: Yes. Senator Margett.

SENATOR MARGETT: Just one question. Let's go back to Fremont for just a second. My recollection is that they've been in and out of problems in the insurance business for sometime, lending and insurance. Are they not the ones that collapsed under a workers compensation deluge here 25 years ago? Do you recall that? I mean, they haven't got the most sanitary record out there, have they?

MR. KELLEY: Pardon me?

SENATOR MARGETT: They haven't got the greatest record out there, as far as fiscally responsibility, taking fiscal responsibility in how they run their business?

SENATOR MACHADO: It's not.

SENATOR MARGETT: What's that?

SENATOR MACHADO: You're correct, Senator Margett. I was thinking it was different. Go ahead.

SENATOR MARGETT: Well, that's all right. I'm just trying to make sure we had the right Fremont.

MR. KELLEY: Yes. It is the same entity, but what I will say is, in terms of our scheduled reviews, in terms of safety and soundness, that company had lots of capital. So from the standpoint of financial soundness…

SENATOR MARGETT: They were there, huh?

MR. KELLEY: They were there. They weathered that storm and had lots of money.

SENATOR MACHADO: Thank you very much.

We'll now open it up for public comment. Please identify yourself.

MR. STEVE KRISOVIAK ??: Thank you, Senator Machado. My name is Steve Krisoviak. I'm with the Mortgage Brokers Association for Responsible Lending, and I would like to start off—first of all, I wanted to keep my comments precise to the issue of subprime, but I need to ask, What is the precise definition of a subprime loan?

SENATOR MACHADO: You're asking the committee?

MR. KRISOVIAK: Yes. I am asking the committee.

SENATOR MACHADO: I think we've heard the definition that's dealing with the credit worthiness of the customer versus that eligible for a prime loan.

SENATOR COX: Okay. One additional thing. It's not predatory and it's not prime. It's in between.

MR. KRISOVIAK: Thank you, Senator Cox.

SENATOR COX: Okay.

MR. KRISOVIAK: When economists are taking subprime loan figures out, I don't think, just by being able to say low credit, they can't really take data out like that. So some agencies, when doing research, will say below 620 FICA scores. That's what subprime is. Another group that I've heard said the definition of subprime is 3 percent above a(n) equally traded T-bill. I've heard World Savings on two occasions in testimony saying that they are not a subprime lender, but their niche in the market is to lend out money first negatively amortized loans and, two, to borrowers with 500 FICA scores. So I'm still confused of really what exactly a subprime loan is.

Some studies and newspapers seem to suggest that subprime deals with income. Other newspaper articles seem to suggest that it deals with race. It's scary that we've had kind of a two-hour meeting, hearing today, with no precise, definite, uniform definition of subprime. Its terminology or the comment comparing apples to oranges comes to mind. But in reality it's comparing apples to oranges to limes to lemons because there's more than just two definitions. What is more scary are the more popular type of loans that go beyond the scope of subprime which is the culprit of what we will see as in the future of California real estate meltdown. The growing problem is going to be with option ARMs, also known as negatively amortized loans, also known as pick-a-pay loans.

An option ARM allows a consumer to make a minimum payment and such that, for example, on a $350,000 loan, the balance could actually be going up $1,500 every month. So usually you only get between 2.5 to 3 years to be able to make this type of a loan or by being able to take those minimum monthly payments. After two to three years when those loans reset, payments won't go up by only 40 percent. Payments won't go double. Payments will actually triple. And with the popularity of these type of loans becoming extremely popular in California in 2005, we're going to see these payments tripling at the end of this year, 2006—I'm sorry—2007, throughout 2008 and 2009. So without a proper definition of a subprime mortgage, I would like to extend this conversation to include option ARM loans which are riskier and even more popular here in California.

I'd like to go back to a comment made by an extremely popular economist not present today. The quote comes from a *Forbes* interview published this month with the chief economist from the National Association of Real Estate—or Realtors—I'm sorry. He said: I was giving a speech, and I quote, "I was giving a speech in Atlanta about two years ago. During the question-and-answer period, someone asked me something about interest-only loans. I said, they're kind of dangerous. You have to be careful. Some raised their hand said, Did you know that in Atlanta, the percent of interest-only loans in 2005 were 40 percent of the market? And Atlanta didn't even have a boom."

The economist then went onto say, "That's when I knew we were in trouble."

Today I would like to be the one in the audience raising my hand, and I would like to direct a question to the committee, to those testifying, those economists testifying today, would you be shocked to find out that 40 percent of all loans originated in the Bay Area were negatively amortized? In 2006, it was 39 percent. In 2005, it was 29 percent, and in 2003 it was less than 1 percent, so we've really seen a spike in an untested environment. This problem is not contained in the Bay Area, but the map that I've just had the Sergeant at Arms pass out shows that Salinas leads the way in the state with 40.3 percent of all originations done in 2006 were negatively, had the option of going negatively amortized, and the statewide figures hover around 30 percent for 2006.

Here are a few things that go along with option ARM loans. Tricky and often misleading sales tactics, brokers often sold high-interest rates and could come with commissions as high as 3.5 percent from the bank. So on a $500,000 loan, that could be a $17,500 commission by using a tricky sales pitch. How confusing is this sales pitch? There are at least nine different types of rates. I'll go over them. The note rate, the pay rate, the pay-rate change rate, the recast rate, the margin rate, the index rate, the annual percentage rate…

SENATOR MACHADO: Can I ask you to try to get to the point? We're all familiar with…

MR. KRISOVIAK: Negatively amortized loans, okay.

Earlier today, Smitty said that the loan products allowed, risky loan products allowed people to get into expensive California homes. I would argue these risky loan products are what caused home prices to be so expensive. And I happened to watch all three hours of the testimony by the U.S. Senate. A scary point that was raised was that in federal testimony, they said that 10 percent of all subprime loans are originated, are under the jurisdiction of federal jurisdiction.

That means that, Senator, your committee, along with the regulators that just sat before me, have jurisdiction over 90 percent of all subprimes originated. Senator Dodd also was making some comments to the…

SENATOR MACHADO: I'm going to ask you, What would you like the committee to consider?

MR. KRISOVIAK: Is this an informational hearing or a consideration on a bill?

SENATOR MACHADO: Well, it's the information, what are the things we should take. We're not interested in any more background.

MR. KRISOVIAK: Okay. The guidance doesn't go far enough that is proposed in SB 385, I believe, or 386. Senator Dodd brought up that it would have been a lot easier just to use the words *require* instead of going on and saying you should do this or you should not do that. The guidance, I would love to see the bill to be amended that is proposed so far and to take out the words *should* and *should not* and to use the words *require* and *restrict*. Also, in the federal testimony, there was a CEO of WMC. He is a top—WMC is a top five subprime lender, and they have a common practice now for subprime loans that should be adopted and actually required for all subprime loans, if not all loans. It deals with prepayment penalties. They have a policy that says that 60 days before the loan resets, the prepayment penalty expires. Generally, two-year fixed loans come with two-year prepayment penalties, or three-year fixed loans come with three-year prepayment penalties. There should be a somewhat cooling-off period between them. Thank you very much for…

SENATOR MACHADO: Thank you.

Any other public comment?

Seeing none, this has been very informative. I don't think there is any quick fix to this, but it's one that I think, even though it may be fractional in terms of the percentages, there are real people that are being affected by it, and there's also, I think a major shift that's taken place in the marketplace to those who are not covered under the federal guidelines that needs to be addressed at the state level. This committee will continue to consider the testimony to address this issue. I have a piece of legislation out there to take a look at guidelines, and this has been very helpful as we go forward. With that, this committee is now adjourned.

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