# Federal Reserve Bank of San Francisco
# June 16, 2006
## Nontraditional Mortgages: Understanding the Market, Products, and Issues

Good morning Governor Olson and members of this committee. For the record, my name is Chuck Cross and I am the Director of the Division of Consumer Services for the Washington Department of Financial Institutions. My division is responsible for the regulation of mortgage companies, finance companies, check cashers and sellers, payday lenders, money transmitters and currency exchangers. I am here in three capacities this morning: as a state representative, as a representative of the Conference of State Bank Supervisors (CSBS) and as a representative of the American Association of Residential Mortgage Regulators (AARMR).

### State Supervision of the Mortgage Industry:

The bulk of mortgage regulation in this country falls to the state regulatory agencies that I represent. Under our jurisdiction are 440,000 state licensees comprised of 100,000 companies, 60,000 branches, and 280,000 individuals. Mortgage lenders and brokers are subject to our regular examinations, investigations and enforcement actions including fines, suspensions, revocation of licenses, and criminal prosecution.

The state laws we enforce provide licensing standards, a consistent regulatory presence and an effective deterrent to bad practices through meaningful enforcement. The two largest predatory lending cases in history were brought in 2002 and 2006 by states through the combined efforts of state attorneys generals and mortgage and banking regulators. These high profile cases and countless other enforcement actions would not have happened without state authorities.

If you haven't heard, CSBS and AARMR are nearing the implementation of a national licensing system for mortgage companies and loan originators. The goals of the system are to provide uniformity in the application process and to develop a comprehensive licensing and supervisory repository available to regulators, the industry and the public.

### Nontraditional Mortgage Product Guidance:

CSBS and AARMR support the proposed interagency guidance on nontraditional mortgage products which addresses innovations in mortgage lending that have surfaced in recent years. These innovations, while beneficial to many financial institutions and consumers, could potentially lead to safety and soundness issues and create confusion among consumers who do not understand the unique risks associated with these products. We agree with the proposed guidance that lenders who choose to underwrite nontraditional products with less stringent income and asset verification requirements must be governed by clear policy guidelines, coupled with other mitigating factors, such as lower loan-to-value and debt-to-income ratios and higher credit scores.

We are concerned, however, that while the use of more comprehensive debt service qualification standards appears prudent on the surface, these qualification standards would essentially require that borrowers qualify under the most stringent scenario with information that may not accurately reflect future circumstances. If the analysis is not meaningful, lenders risk denying credit to qualified borrowers or granting credit to unqualified borrowers. Additionally, the use of more comprehensive debt service qualification standards, unless also required of non-bank lenders, could place insured financial institutions and their affiliates at a competitive disadvantage.

Therefore, CSBS and AARMR are working to develop guidance for our non-bank licensees offering nontraditional mortgage products. The guidance will be designed for state-licensed mortgage lenders and brokers who were not covered by the federal guidance issued in December 2005.

**Disclosure:**

We believe that an entirely new disclosure process is necessary to help consumers keep pace with an ever expanding array of mortgage related products. The disclosure process in the United States does not work. The current system only protects those who accurately complete the forms. With the extraordinary volume and complexity of disclosures, consumers do not and cannot read or understand them.

We therefore recommend a marketplace where disclosures:
- ✓ Are tailored to the exact characteristics of the loan in question
- ✓ Are sufficiently detailed to permit consumers redress if there are variances in the final loan offering
- ✓ Involve models that are standardized between institutions so consumers can compare product offerings
- ✓ Are “front” loaded in the transaction process and required the first time a discussion is made regarding loan terms
- ✓ Have not more than three or four key summary items highlighted to reduce the potential for information overload

I would like to end my comments with a few observations based on my years as the Enforcement Chief for a state regulatory agency:

1. First, I cannot overstress the importance of requiring lenders to be honest and forthright about prepayment penalties. In the recent Ameriquest case, borrowers found themselves with three year prepayment penalties on loans that were designed to be refinanced in two years, yet we found no problem with the written disclosures.
2. Second, piggy back or simultaneous second mortgages can be very damaging to consumers especially when sold at the closing table.

3. Third, do not allow apples and oranges comparisons of monthly payments. Many an effective predatory lending scheme is based upon payment amount deception. When a borrower is led to believe that their payment includes taxes and insurance when it does not, they are about to close on a loan that is full of undisclosed elements. Elements that would probably be exposed if the truth of the payment were known.
4. Fourth, low or no doc loans have little place in the mortgage marketplace. This does not mean that they have no place, but when limited doc loans equal or surpass a lender's full doc portfolio, something's not right and you should be looking for fraud.
5. Fifth, if we are stuck with the Truth in Lending disclosure then at least acknowledge that a fully indexed amortization tells the borrower little about the future of the loan. I encourage you to consider a worst case scenario for all disclosures.
6. Sixth, frequently borrowers misunderstand the amortizing nature of their loan even in traditional mortgage products. Even regulators can find it difficult to examine the payment history of a loan. Routinely we find significant errors that have already caused consumer harm. I hope you understand that mortgage servicing may be the predatory wave of the future.
7. And finally, consumer demand has not driven the innovation of products in this market. Consumers buy what they are sold . . . period. The products you are considering here today were not requested by consumers or structured by consumers. That being said, we have a saying in Washington State: products don't harm people, people harm people. A payment option ARM sold to a sophisticated consumer could be the perfect financing solution. Sold to the average consumer, it could be a ticket to foreclosure.