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CALIFORNIA STATE SENATE BANKING, FINANCE & INSURANCE COMMITTEE

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES
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STOCKTON, CALIFORNIA

California's Central Valley is primarily an agricultural region, with predominately blue collar jobs. Median income is $51,374, compared to state wide median income of $55,734. The housing boom in the Valley was fueled by the exodus of blue collar and middle management workers from the San Francisco Bay Area. These workers were attracted by the ability to buy larger homes on larger lots than they could afford in the Bay Area, with what was then attractive financing. Low gas prices made the idea of commuting back and forth to the Bay Area each day seem reasonable.

California’s Central Valley has been ground zero for foreclosures in both California and the nation. Foreclosure filings were reported on 72,285 California properties in July, the highest total nationwide, and a figure that converts to one in every 182 California properties. Foreclosure filings were highest in the Central Valley – one in every 73 households in Merced, and one in every 82 households in both Stockton and Modesto. The July foreclosure rates in Merced, Stockton, and Modesto were number 2, 3, and 4, among all cities nationally.

Stockton, and other cities in the Central Valley, have been hard hit by foreclosures, because of a combination of factors which came together simultaneously. Home prices increased significantly, in an area where incomes were stagnant. Lenders relaxed their underwriting standards dramatically, and often required no money down, with no income verification, even when making loans to people with less than stellar credit. Lenders and mortgage brokers encouraged borrowers to purchase homes with mortgages the borrowers could not afford in the long-term, based on the assumption that the borrowers could refinance out of those mortgages before the payments increased to unaffordable levels. Many borrowers obtained loans whose interest rates were scheduled to reset to two or three times the initial introductory payment, a level that was clearly unsustainable for these borrowers in the long term. The secondary market expressed a voracious appetite for mortgage loans, particularly those considered subprime. Virtually all market participants, including borrowers, mortgage brokers, lenders, credit rating agencies, and investors, believed that home prices would continue to rise indefinitely.

When home prices leveled off, many borrowers were left with little or no equity in their homes, and mortgages whose payments they could not afford. A significant number of borrowers who found themselves unable to afford their mortgage payments were surprised to realize that the neighborhood lender who initially made their loan no longer held the mortgage; instead, the loan had been sold on the secondary market to an anonymous investor, and was being serviced by a company who owed a fiduciary duty to the investor, not the borrower. Servicers who collected the payments on these loans were bound by that fiduciary duty to maximize the value of the mortgage asset at all costs, which often meant foreclosure, in lieu of a loan modification or other forbearance plan. A significant number of lenders and mortgage servicers were simply ill-equipped to work with borrowers having trouble making their payments, because their business models were based on payments collection, and not loss mitigation.

The mortgage market has changed substantially from the market in which our parents and many of us purchased our first homes. Loans originated and serviced by the neighborhood bank or savings and loan are a thing of the past. Instead, mortgage loans are originated by lenders throughout the world, bought and sold by and between financial institutions and institutional investors, bundled and sold by investment banks to investors in the secondary market, then bundled and sold again, and again, to still other secondary market investors. Involvement of multiple investors, and lenders' ability to shed the liability associated with mortgage assets by selling them, has resulted the development of a vast array of mortgage products that neither lenders, nor borrowers, nor even regulators fully understood.

As State Senator from the 5th Senate District, I represent Stockton, Manteca, Tracy, and other hard-hit Central Valley cities. I have served as Chair of the California State Senate Banking, Finance & Insurance Committee since December 2006, and have been involved in mortgage issues during each of my 14 years in the California Legislature.

In January 2007, my committee was the first in the country to hold hearings on the federal Interagency Guidance on Nontraditional Mortgage Product Risks. We also held hearings in March and August 2007, and in January 2008, to review steps we could take to address dangerous subprime lending practices, and investigate whether foreclosure avoidance plans which had been initiated at the state and federal levels were working. During that same time period, I participated in five town hall forums in my District, including one with Treasury Secretary Henry Paulson, in which borrowers could seek assistance from housing counselors, mortgage brokers, and mortgage lenders.

Collaborative initiatives between California and the federal government are critical for ensuring that mortgage brokering and mortgage lending in California, going forward, are performed responsibly. Uneven application of rules regarding lending practices encourages regulatory arbitrage, a practice in which lenders choose their regulator, in order to minimize the amount of regulatory oversight to which they are subject.

There is great risk in California enacting laws to regulate our state lending licensees, and in doing so creating an unlevel playing field between state and federal lenders. Doing so will harm consumers in multiple ways. Not only will the state drive consumers to federally-regulated lenders who are subject to fewer restrictions, but we will send a message to the secondary markets that their capital is unwanted. Capricious actions by well-meaning states, particularly by a state as large as California, can dry up liquidity for years. New York's recent experience provides an excellent example of how this can happen. Very recently, both Fannie Mae and Freddie Mac indicated they would not purchase or guarantee loans that meet the definition of a subprime loan, pursuant to a recently enacted New York law. Thus, lenders in New York who are subject to that law will have few, if any, sources of liquidity with which to make those loans.

The California Legislature does, however, have an important role to play in this crisis, and has passed several pieces of legislation. In 2007, I authored two measures to help reform lending practices in California. Both were enacted into law. SB 385 extended the federal nontraditional and subprime lending guidance to state-regulated lenders and brokers, and SB 223 prohibited anyone with an interest in a real estate transaction from improperly influencing, or attempting to improperly influence, a real estate appraiser, in connection with that transaction. A similar appraisal provision of Regulation Z, which was recently enacted by the Federal Reserve Board, is not effective until October 2009. The changes enacted by SB 223, were effective a full two years earlier, in October 2007.

In 2008, I co-authored SB 1137, which required lenders to contact borrowers before filing a notice of default, in order to improve communication between lenders and borrowers, and help save some borrower's homes. SB 1137 was signed into law in July 2008. I also authored SB 1240 and SB 1737, which enact comprehensive mortgage broker reform in California, and SB 1055, a federal tax conformity bill that provides needed tax relief to borrowers whose lenders have forgiven mortgage debt in connection with a foreclosure, short sale, or deed in lieu of foreclosure. Many of the changes enacted by SB 1240 piggyback on the portions of HR 3221 pertaining to a national mortgage licensing registry. SB 1055, SB 1240, and SB 1737 are awaiting the Governor's signature.

Since 2007, the California Senate Banking, Finance & Insurance Committee has supported legislation that treats state- and federally-regulated lenders equally, and that protects consumers, while allowing for the free flow of credit from the secondary market. The Committee has resisted measures that would apply only to state-regulated lenders, or that would seek to modify existing mortgage contracts. Modifying mortgage contracts legislatively would send signals of uncertainty into the investor market, causing interest rates to increase and limiting the availability of capital.

Unfortunately, we are not past the worst of the foreclosures. In spite of the commitment of ten state-regulated lenders to work proactively with borrowers to help these borrowers avoid foreclosure, and establishment of the HOPE NOW Alliance, a similar effort that also includes federally-regulated lenders, borrowers in trouble continue to get the runaround from their lenders when they contact the lenders seeking forbearance. I am personally aware of several families in my District whose efforts to obtain workout arrangements from their lenders have been spurned. Hundreds of hard-working, dedicated housing counselors have also run into brick walls, when advocating on behalf of their clients. Everyone agrees that foreclosure is a last resort that should be avoided at all costs, but the lending industry simply has been unable – and, at times, unwilling -- to meet the demand for loan modifications and forbearance plans.

Foreclosures are also likely to continue increasing, because of the large number of negatively-amortizing, payment option adjustable rate loans made to Valley residents. Many of these loans were issued to borrowers who have been paying only the minimum amount each month, and whose mortgage contracts will soon require them to begin paying down their loans, according to a fully-amortizing rate schedule. Unable to refinance due to minimal equity and tight underwriting standards, and unable to afford fully-amortizing payments at which they were not underwritten, many of the borrowers with payment-option ARMs are likely to become the next wave of foreclosures. Rising unemployment rates, coupled with recessionary economic conditions that have lowered the incomes of many Californians, will exacerbate the problem.

The Central Valley is likely to lag the state in recovering from the foreclosure crisis. Some local industry professionals, who have experienced several real estate cycles, predict that real estate prices in the hardest hit areas of the Central Valley are likely to take at least two years before they hit bottom, and even longer before they begin to recover. Other areas of the Central Valley have already begun to see signs of recovery. However, most of the inventory that is beginning to move consists of real-estate owned properties, which are being sold at artificially low levels, in order to attract buyer interest. Until the mix of properties on the market returns to a more traditional ratio, in which most of the For Sale signs are sales by owner, rather than by bank, Central Valley housing prices will continue to be depressed.

Recovery within the Central Valley will also be hampered by the high cost of fuel. Many of the residents of the Central Valley are commuters, who must drive to jobs in the Bay Area. With fuel costs at historic highs, these homeowners are even harder pressed to make ends meet. For these Central Valley residents, saving enough money to make a down-payment, in an underwriting environment which now requires at least a 10% down payment, will be an impossibility. This, in turn, will restrict the number of potential buyers of homes for sale, and keep home prices depressed.

The effects of foreclosure are greatest on the individuals whose lose their homes, but extend far beyond these individuals to neighborhoods, cities, the state, and even the international economy. Homeowners who lose a home to foreclosure lose equity, and experience damaged credit, damaged psyches, damaged community reputations, and damaged images at work. Many will never again be able to own a home. Neighborhoods with foreclosures experience significant declines in property values, which often means that homeowners who are making their mortgage payments are losing equity. Many of these homeowners also end up upside down in their mortgages, owing more on their mortgages than their homes are worth, and unable to sell their homes as a result.

Individuals who rely on the real estate business (realtors, construction workers, and contractors, and others), and on businesses that rely on a healthy housing market (salespeople in home improvement stores, furniture stores, landscaping businesses, and others), lose their jobs when foreclosures hit a community. Businesses that rely on a healthy housing market, and many financial services businesses, go bankrupt. The collapse of IndyMac Bank, a very large lender in the Alt A market, is reflective of how foreclosures can bring down even large, previously well-capitalized businesses.

Business failures and widespread foreclosures also impact the domestic and international investment community. Stocks, particularly those in the financial sector, have plummeted, taking many individual's retirement savings with them. The credit crunch that is currently gripping the United States is a direct result of investors fearing the worst about mortgage-backed securities. When foreclosures increased dramatically, many investors who held mortgage-backed securities and collateralized debt obligations fled from a market to which they had eagerly gravitated mere months before. Liquidity for mortgages vanished almost overnight. The cost of credit rose. Even borrowers with good credit and 20% down now have trouble obtaining loans. International investors are seeking investments outside of the United States. The foreclosure crisis has spread to a point where no single person is unaffected.

Although the provisions of recently-enacted House Resolution 3221 may have a positive impact on Central Valley communities going forward, the actions of our local leaders and our state legislature are likely to have a greater near-term impact.

Since this crisis began, the federal government response has been too slow. In mid-2005, all five federal banking regulators (the Office of the Comptroller of the Currency, Federal Reserve Board, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration) reviewed data from the largest residential mortgage lenders in the country, looking for trends and current practices. The agencies' review found indications of loosening in underwriting standards, some instances of borrowers not being qualified based on fully amortizing payments, an increase in piggyback loans, and an increase in the use of credit scores in lieu of income and asset verification. The layering of these activities on top of subprime and nontraditional mortgages added additional credit risk. The survey also found concentrations of subprime and nontraditional products in areas experiencing the most rapid home price appreciation.

Yet, despite these sobering findings, the five federal banking agencies waited until December 2005 to issue *proposed* guidance on nontraditional mortgage product lending risks. These agencies did not finalize the nontraditional guidance until September 2006, and initially failed to extend the guidance to the types of products most responsible for the first wave of foreclosures (subprime hybrid ARMs). Final guidance on subprime hybrid ARMs was not published until twenty-one months *after* the publication of proposed nontraditional guidance. Over this nearly two-year period, underwriting standards weakened to the point that anyone could get a loan, with or without income verification, and regardless of whether they could afford the loan over time. Mortgage loan disclosures became meaningless. Borrowers did not understand their loans, and believed they could refinance out of mortgages they clearly could not afford over the long-term, because their mortgage brokers and lenders assured them the housing market would continue its upward spiral.

As the subprime implosion grew, the Federal Reserve Board publicly stated that the nontraditional and subprime guidance documents were sufficient, and that amendments to Regulation Z were unnecessary. I commend your Committee and the leadership of your Chair, Representative Frank, in this regard. It is doubtful the Federal Reserve Board would have acted to amend Regulation Z, absent pressure from your Committee and the Senate Finance Committee. Yet, even under pressure from your Committee, the Federal Reserve Board's action was far too late. The Board began looking into revising Regulation Z in mid 2007, but took over a year – until July 2008 – to issue final changes to those regulations. Those changes will not go into effect until October 2009, at the earliest.

To conclude, I would like to review the actions my Committee has taken to address the foreclosure crisis.

The Committee I chair was the first in the nation to begin looking at the issues of nontraditional and subprime lending. We held our first hearing in January of 2007, to review the nontraditional guidance, and followed up with hearings in March and August of 2007, to review the subprime guidance and develop a strategy for helping stem the rising tide of foreclosures statewide.

In large part due to our August informational hearing, our state regulators, particularly our state Department of Corporations (DOC), spearheaded an initiative among state-licensed lenders to work with borrowers having trouble affording their loans. Also at the urging of the Committee, our DOC commissioner began collecting comprehensive loan servicing data from our state licensees. DOC initiated its effort before HOPE NOW, and has been a leader in the area of proactive mortgage lender regulation in California.

In 2007, I authored two measures to help reform lending practices in California, and in 2008, I followed up with five more pieces of mortgage legislation, to reform mortgage brokering practices, provide mortgage forgiveness tax relief, and enact escrow reform. I urge this Committee to give the changes enacted by Congress and the California Legislature, and the changes made to Regulation Z, a chance to work.

Without greater forbearance by the lending industry for problem loans, I believe there is little the federal government or state can do for those unable to afford their loans. At the margin, some will be helped, but in general, the market will have to absorb the shock, reset, and then go forward. We risk creating a moral hazard with government intervention to step in and save those who would otherwise lose their homes. Rewarding risky behavior will only perpetuate the problem. The work of your Committee is not yet done, but should be focused in the short-term on ensuring that the legislation we have already enacted is implemented in a way that maximizes its effectiveness.