TESTIMONY OF

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NORTH CAROLINA COMMISSIONER OF BANKS

On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

"MORTGAGE MARKET TURMOIL: CAUSES AND CONSEQUENCES"

Before the

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

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Introduction

Good morning, Chairman Dodd, Ranking Member Shelby, my senator from North Carolina, Senator Dole, and other distinguished members of the Committee. My name is Joseph A. Smith, Jr., and I serve as the Commissioner of Banks for the State of North Carolina. I am pleased to testify today on behalf of the Conference of State Bank Supervisors (CSBS).

CSBS is the professional association of state officials responsible for chartering, supervising, and regulating the nation's 6,206 state-chartered commercial and savings banks, and 400 state-licensed foreign banking offices nationwide. For more than a century, CSBS has given state bank supervisors a national forum to coordinate, communicate, advocate and educate on behalf of state bank regulation.

In addition to regulating banks, 49 states plus the District of Columbia currently provide regulatory oversight of the residential mortgage industry. The one exception is Alaska, which is currently working toward a legislative solution. Under state jurisdiction are more than 90,000 mortgage companies with 63,000 branches and 280,000 loan officers and other professionals.[1]

I am particularly interested in the topic of today's hearing because North Carolina has been a leader in providing protection of residential mortgage borrowers. The North Carolina General Assembly adopted a groundbreaking anti-predatory lending law in 1999 and a companion licensing regulatory statute, the Mortgage Lending Act, in 2001. As the Commissioner of Banks, I supervised the implementation of the Mortgage Lending Act's

[1] The above numbers do not include the State of California's Department of Real Estate's approximately 480,000 licensed real estate agents who could also function as a mortgage broker under their license.

licensing provisions in 2002 and the subsequent development of examination and supervision procedures. As of the end of 2006, my office has licensed and regulated over 1,600 mortgage lending and brokerage firms and over 16,000 individual loan officers under the Mortgage Lending Act.

Mr. Chairman, I will do my best to respond to your invitation to testify today by addressing the origins of the current situation in the subprime market and the subsequent state supervisory responses. I would also like to discuss actions that are being taken by state regulators and law enforcement agencies to address the market's problems and suggested actions that may be taken by Congress.

Specifically, I will make the following four points today:

1. The mortgage market has changed dramatically over the past two decades. The majority of loans are now originated by mortgage brokers and lenders at a local level and are financed by Wall Street firms that operate at a global level. This market evolution has many positive effects for consumers and the economy, but in some cases it has also resulted in the improvident lending practices currently witnessed in some sectors of the subprime loan market.
2. States have been the first responders to this market evolution. States have led the fight to reign in abusive lending through predatory lending laws, licensing and supervision of mortgage lenders and brokers, and through enforcement of consumer protection laws. I will describe a few of these efforts later in my testimony. State regulators are working collaboratively and effectively on many fronts with each other and our federal counterparts.

My fellow state supervisors and I welcome coordination with our federal counterparts to promote responsible lending across the residential mortgage industry. Unfortunately, state efforts to curb predatory or abusive lending have been hampered by federal preemption and/or sufficient state-federal coordination. Federal law and regulations have made it harder to protect borrowers against predatory lending and to promote sound underwriting practices. This is not an excuse, but a fact. We are encouraged, however, by your Committee's interest in mortgage supervision.

3. State government agencies and not-for-profit organizations are best positioned to develop and determine proper rescue techniques to provide relief to hard-working homeowners that have a reasonable likelihood of sustaining homeownership. My message to consumers is that you can work with your mortgage servicer on your payment problems before you reach foreclosure.
4. Going forward, I believe Congress can improve the mortgage market dramatically with a few actions, such as:
    a. Establishing a predatory lending regime similar to the one adopted in my home state of North Carolina and suggested by legislation sponsored by House Financial Services Committee Chairman Barney Frank and two of my representatives, Representative Brad Miller and Representative Melvin Watt last year;
    b. Increase consumer representation when obtaining a mortgage through education, counseling, and/or improved disclosures,

especially in the subprime market. My experiences in North Carolina have indicated that the complexity of the mortgage market can make it difficult for borrowers with demonstrated credit problems to make good choices. Policymakers and regulators should simplify the process to purchase a sound loan which will promote sustainable homeownership;

c. Provide funding and support for the ongoing effort by CSBS and the American Association of Residential Mortgage Regulators (AARMR)[2] to develop a uniform licensing system for mortgage lenders and brokers; and

d. Utilize current tools to reach the subprime market through a modernized Federal Housing Administration (FHA), government-sponsored enterprises (GSEs) financing, and enforcement of consumer protection laws. The subprime market explosion came at the cost of the FHA, as it was unable to offer competitive products for responsible subprime lending. In addition, Congress should encourage the GSEs to promote affordable and sustainable homeownership across the mortgage market.

The Revolution in Residential Mortgage Lending

[2] AARMR is the national organization representing state residential mortgage regulators. AARMR's mission is to promote the exchange of information between and among the executives and employees of the various states who are charged with the responsibility for the administration and regulation of residential mortgage lending, servicing and brokering. More information about the American Association of Residential Mortgage Regulators can be found at: http://www.aarmr.org.

To better understand the current situation in the subprime market, we need to review how we got here. The changes in the residential mortgage industry over the past two decades have been dramatic and far-reaching. Over the past two decades, the market has ushered in new players, new products, and now has a bigger impact on the economy as a whole. Twenty years ago, federal and state regulated savings and loans originated most of the residential mortgages. GSEs or agencies such as Fannie Mae, Freddie Mac, and the FHA held a significant percentage of the market share and effectively set standards for the entire industry.

Advances in information and communications technology have revolutionized the mortgage market. Before the revolution, mortgages were, as a rule, made by depository institutions (generally savings and loans) that held the loans in their own portfolios. Some institutions sold mortgage loans to Fannie Mae and Freddie Mac or had them insured by the FHA, but such activity was subject to the underwriting and recourse policies of the purchasers or insurer. In these circumstances, there was a unity of risk and reward: the originating institution had to live with the loans it made. Subsequent to the savings and loan crisis in the 1980s, the origination of mortgage loans shifted primarily to mortgage brokers and mortgage lenders. Today, mortgages are "made" in a complex network, funded by capital markets, sold by an array of originators, and touched by many hands, such as servicers and securitizers.

The explosion of product choices have allowed consumers to now choose between practically any combination of fixed, adjustable, or hybrid adjustable rate and amortizing, non-amortizing, or negatively amortizing mortgages, with terms ranging anywhere from 15 to 50 years. On top of these options, risk-based pricing has allowed more consumers than

ever to qualify for home financing sooner, by trading a lower credit score or down payment for a higher rate.

The volume of loan originations has also increased over this time period. This increase in loan volume was facilitated in part by advances in technology, such as the automated underwriting systems, the increase of mortgage products available to the consumer, the evolution of the subprime market, and an expansion of the holders in the secondary market for mortgage securities, including international investors, hedge funds, and private equity funds.

The mortgage revolution has brought with it a number of good things: a vast flow of liquidity into the mortgage market, increased availability of mortgage credit, and higher rates of homeownership. It has also brought moral hazard, as the allocation of risk of a mortgage loan default became dispersed through complex contractual arrangements that began with the local mortgage broker, and ultimately ended with a Wall Street investor. This dispersal of risk created opportunities and incentives for some actors to engage in weak underwriting or fraud. As a result, there have been significant increases in fraud and foreclosures.

I am aware that some industry observers have referred to this situation as a "broker problem." Certainly, the marketing and sales practices of mortgage lenders and brokers as well as increased accountability need to be addressed. The coordinated state and federal guidance begin to address this situation. However, a mortgage broker is only as good as his or her ability to obtain funding for a loan.

Controls that were in place to govern the market have been overwhelmed by the requirements of a commission-driven origination system and a securitization machine built

for volume. Years of stellar performance created a demand for subprime mortgage securities, and the mortgage origination system responded to supply that demand. In a contest between the uncompromising innovation and marketing of capitalism and the inherent checks and balances of the mortgage market, the more aggressive tenets of capitalism were a clear winner, particularly in the subprime sector.

Market conditions have changed dramatically and rapidly in the last two years, as interest rates rose at a time of weak income growth and slowing house appreciation. Instead of tightening underwriting controls, subprime brokers and lenders loosened their underwriting and controls to maintain volume in the intensely and brutally competitive residential mortgage marketplace.

The stress test for this system has now begun. Default rates far exceed past experience, and the expectations of investors have soured. Changes in the yield curve and real estate values have reduced or eliminated refinancing as a prop to the market. A number of subprime originators have gone out of business, and the largest subprime lenders have undergone substantial market capital adjustments. Because of risk dispersion through derivatives, it is not yet clear what the extent of the damage will be. Market participants are worried—and for good reason.

Federal Preemption

The United States did not arrive at the current disarray in the residential mortgage market overnight and no single party is fully responsible for our current situation. CSBS believes the rapid and drastic changes in the industry created an environment of negligence in lending practices and increased borrower confusion. States stepped in to act as the

primary regulator in this new industry, but have been, and continue to be, hampered by federal preemption. State regulators do not eschew responsibility. It is possible regulators were too lenient as we struggled to find the appropriate balance between promoting homeownership opportunities and protecting consumers. But Congress, federal regulatory agencies, mortgage lenders and brokers, insured depository institutions, and borrowers must all accept a measure of responsibility for aiding in the creation of our current residential mortgage marketplace and for its problems.

While we are not here to point fingers, CSBS would be remiss if we did not point out that state efforts to regulate the mortgage market have been met with resistance or indifference from federal regulators and even Congress. Here are a few examples:

- The OCC and OTS have taken an aggressive position that federal law preempted state predatory lending laws, even as they apply to mortgage brokers that have originated loans on behalf of lenders and joint ventures of national banks with non-bank mortgage lenders.
- The OCC has supported the preemption of state licensing laws for state-chartered operating subsidiaries of national banks. In some cases, operating subsidiaries of national banks have refused to return calls from state regulators.
- The OCC has supported national banks' efforts to resist the enforcement of federal laws by state enforcement action, most notably by then New York Attorney General Spitzer's efforts to investigate fair lending concerns based on Home Mortgage Disclosure Act (HMDA) data.

This aggressive preemption has not been accompanied by aggressive enforcement of consumer protection, as the federal bank regulators have taken few, if any, significant consumer protection enforcement actions. While federal preemption does not excuse states from supervising non-bank mortgage lenders and brokers, it does make it more difficult, as state regulators constantly have had to combat arguments that lending laws must be uniform in order to avoid an unlevel playing field or to divert important resources to enforce state laws. Thus, it is ironic to me that state regulators are now being faulted for not acting more aggressively to interfere in transactions that gave low and moderate income borrowers a chance at homeownership, when we have been the only ones attempting to do so.

State Regulatory Responses

Despite the obstacles of preemption, as the residential mortgage industry has rapidly evolved, the states have played a more active role in its regulation and supervision. It is worth noting that the residential mortgage industry as we know it is relatively young. The evolution discussed above has taken place in the past 20 years. Therefore, state supervision of the industry is also relatively new. Conversely, state bank supervision in the United States has been in existence since the late 18th century. In North Carolina, the state has chartered and supervised banks since 1804. Obviously, state bank supervision has had centuries to evolve and improve. State mortgage supervision grows and improves each day.

The actions taken by the states in response to the evolving mortgage market have focused on protecting consumers through development of licensing and supervision of mortgage brokers and lenders, legislation, and enforcement of consumer protection laws.

The states have developed evolving and ever-improving supervision of mortgage lenders and brokers. My home state of North Carolina currently licenses 1,600 firms and over 16,000 loan officers. Each day state regulators take enforcement actions against mortgage lenders and brokers for abusive lending. I have attached, as Exhibit A, a few illustrations of the efforts by state mortgage regulators to supervise and regulate this industry.

Recognizing, however, that many mortgage lenders and brokers operate on a multi-state or nationwide basis, the states, through CSBS and AARMR, are developing cooperative initiatives and tools to more effectively regulate the marketplace.

CSBS-AARMR National Residential Mortgage Licensing System

On a national scale, CSBS has partnered with the American Association of Residential Mortgage Regulators (AARMR) to ensure that consumers are protected from fraudulent practices and receive adequate information regarding mortgage service providers. Over two years ago, CSBS and AARMR embarked on an initiative that will change the world of mortgage supervision. CSBS and AARMR are creating a national mortgage licensing system to improve the efficiency and effectiveness of the U.S. mortgage market, to fight mortgage fraud and predatory lending, to increase accountability among mortgage professionals, and to unify and streamline state licenses processes for lenders and brokers. Schedule to begin operations on January 1, 2008, this system will

create a single record for every state-licensed mortgage company, branch, and individual that will be shared by all participating states. This single record will allow companies and individuals to be tracked across state lines and over any period of time.

Last month, 29 states announced their intent to participate in the system by the end of 2009. CSBS expects several more states to announce their similar intent over the next few months. To my knowledge, no other regulator is developing or even contemplating such a system.

State mortgage regulators began discussing ways to bring more accountability and uniformity into state mortgage licensing beginning in 2003 and 2004. In January 2005 regulators began meeting on a monthly basis to create uniform license applications and began actual development of the national licensing system.

This national licensing system will also provide consumer access to a central repository of licensing and publicly adjudicated enforcement actions. This will allow homebuyers a central place to check on the license status of the mortgage broker or lender they wish to do business with, as well as a way to determine whether a state has taken enforcement action against that company or individual.

In June 2006, CSBS contracted with the National Association of Securities Dealers, Inc. (NASD) to develop this system. The NASD developed and now operates two national systems in conjunction with or for state regulators: the securities industry Central Registration Depository (CRD) ® and the financial planning and investment advisor industry Investment Adviser Registration Depository (IARD) ® system. The NASD brings significant expertise in developing and operating national licensing systems that are subject to state regulations.

The national licensing system will contain licensing information, enforcement actions, and background data for every state-licensed mortgage broker, mortgage lender, control person, branch location, and loan originator. The system will also assign a unique identifier to each company, branch, and mortgage professional that will help mitigate the frequent migration that occurs by professionals who hide by going from one company, jurisdiction, or industry to another.

Each state will continue to retain its authority to license and supervise, but the new system will eliminate unnecessary duplication and implement consistent standards and requirements across state lines. Additionally, the state agencies will be able to divert valuable resources previously used for processing applications to more supervision and enforcement.

The system will provide immediate and profound benefits to consumers, the industry, and the state supervisory agencies. Consumers will have access to key information about the providers that they trust with the most important financial transactions of their lives. Honest mortgage bankers and brokers will benefit from the creation of a system that drives out fraudulent and incompetent operators, and from having one central point of contact for submitting and updating license applications. Everyone benefits from a system that makes it easier to identify and punish the small percentage of dishonest operators in the mortgage industry.

Uniform Standards for Testing and Education

Another major initiative where states are leading is in the development of education and testing requirements for mortgage professionals. CSBS and AARMR are

spearheading a cooperative project of state regulatory agencies called the Mortgage Industry National Uniform Testing and Educations Standards (MINUTES). This initiative, begun early this year, will establish acceptable uniform standards and streamline the process for licensees to comply with these standards. MINUTES will ensure that licensed mortgage providers are held to the same standards and expectations, regardless of the state in which they make loans. To my knowledge, no federal regulatory agency currently requires specific educational or testing standards for the mortgage professionals it supervises.

CSBS-AARMR Guidance on Nontraditional Mortgage Product Risks

CSBS and AARMR also partnered together to develop guidance on nontraditional mortgage product risks. In October 2006, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) issued final Interagency Guidance on Nontraditional Mortgage Product Risks. The interagency guidance applies to all banks and their subsidiaries, bank holding companies and their non-bank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

Recognizing that the interagency guidance is important and useful, but did not apply to those mortgage providers not affiliated with a bank holding company or an insured financial institution, CSBS and AARMR developed parallel guidance. Both CSBS and AARMR strongly support the purpose of the interagency guidance and are committed

to promoting uniform application of its underwriting standards and consumer protection provisions for all borrowers. In order to maintain regulatory consistency, the guidance developed by CSBS and AARMR substantially mirrors the interagency guidance, except for the deletion of sections not applicable to non-depository institutions.

Released on November 14, 2006, the CSBS-AARMR guidance has been offered to state regulators to apply to their licensed residential mortgage brokers and lenders. The CSBS-AARMR guidance is intended to hold state-licensed mortgage providers to effectively the same standards as developed by the federal regulators.

As of today, March 22, 2007, 29 states plus the District of Columbia have adopted the guidelines developed by CSBS and AARMR. Ultimately, CSBS expects all 50 states to adopt the guidance in some form.[3] Once adopted by all 50 states, all residential mortgage lenders and brokers will be held to the same consumer protection and underwriting standards.

Proposed Interagency Statement on Subprime Mortgage Lending

CSBS and AARMR have also offered our strong endorsement of the recently proposed interagency Statement on Subprime Mortgage Lending. In conjunction with the 2006 Interagency Guidance on Nontraditional Mortgage Product Risks and the parallel CSBS-AARMR guidance, the proposed statement offers sound underwriting and consumer protection principles that institutions and all residential mortgage providers should consider when making residential mortgage loans. CSBS and AARMR are already

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[3] To track state adoption of the CSBS-AARMR guidance, go to http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/FederalAgencyGuidanceDatabase/State_Implementation.htm.

working to develop a parallel statement for state supervisors to use with state-supervised entities. Again, we expect that all 50 states will adopt the statement on subprime lending, providing state agencies with an additional supervisory tool to protect consumers, ensure sound underwriting standards, and hopefully decrease the number of foreclosures nationwide.

CSBS believes the Guidance on Nontraditional Mortgage Product Risks and the Statement on Subprime Mortgage Lending strike a fair balance between encouraging growth and free market innovation and draconian, stern restrictions.

State Predatory Lending Laws

Currently, 36 states plus the District of Columbia[4] have enacted predatory lending laws. First adopted by North Carolina in 1999, these state laws supplement the federal protections of the Home Ownership and Equity Protection Act of 1994 (HOEPA). The innovative actions taken by state legislatures have prompted significant changes in industry practices, as the largest multi-state lenders have adjusted their practices to comply with the strongest state laws. All too often, however, we are frustrated in our efforts to protect consumers by the preemption of state consumer protection laws by federal statutes. Preemption must be used for the benefit of both business and consumers.

State Enforcement of Consumer Protection Laws

In addition to the extensive regulatory and legislative efforts, states attorneys general and state regulators have cooperatively pursued unfair and deceptive practices in

[4] Source: National Conference of State Legislatures.

the mortgage market. Through settlements with Household, Ameriquest, and First Alliance Mortgage alone, state regulators have returned nearly one billion dollars to consumers. These landmark settlements further contributed to changes in industry lending practices.

But successes are sometimes better measured by actions that never reach the press. States regularly exercise their authority to routinely examine mortgage companies for compliance not only with state law, but with federal law as well. These examinations are an integral part of a balanced regulatory system. Unheralded in their everyday routine, examinations identify weaknesses that, if undetected, might be devastating to the company and its customers. State examinations act as a check on financial problems, misapplication of consumer protections, and sales practices gone astray. Examinations can also serve as an early warning system of a financial institution conducting misleading, predatory or fraudulent practices. I have attached as Exhibit B, a chart of enforcement actions taken by state regulatory agencies against mortgage providers. As an example, in 2006, states took 3,694 enforcement actions against mortgage lenders and brokers.

Proposals for Fixing the Residential Mortgage Market

The ongoing upheaval in the residential mortgage market has caused justifiable concerns among policymakers, regulators, investors, members of industry, and consumers. There is an overwhelming outcry for the regulators and Congress to “do something” to address the damage that the subprime market trauma is doing to borrowers, present and prospective, and to the economy as a whole. On the basis of five years’ worth of recent

experience regulating mortgage brokers and non-bank mortgage lenders, I have a few suggestions.

Cleaning Up the Mess

In addressing the damage to borrowers, we should consider a triage approach with the majority of staff time and energy devoted to treating those consumers for whom the treatment can preserve their home.

The same concepts should be applied to mortgage rescue. Borrowers with adequate remaining home equity, income to support a reasonable mortgage and credit capacity (generally, the so-called "alt-A" borrowers) can and should be refinanced through the operation of the market. Individuals who recently borrowed money in no-money-down loans without the income to support a fully-indexed mortgage debt are in unsustainable homeownership. Without a massive government bail-out, these mortgage loans will likely result in foreclosure. For those borrowers between the two extremes, rescue may be possible, but the form and effectiveness will depend on the individual circumstances of the borrowers. I would respectfully suggest that state government agencies and not-for-profit organizations are best positioned to develop and determine proper rescue techniques to provide relief to hard-working homeowners that have a reasonable likelihood of sustaining homeownership. Under any circumstances, I strongly encourage Congress to avoid using taxpayer funds to bail out the subprime lenders, brokers and investors that generated our current problem. The mortgage market is strong, complex, and vibrant and will be so even if many of the large subprime lenders suffer financial losses.

In addition to rescue efforts regarding borrowers, state and federal enforcement actions regarding mortgage fraud and predatory lending will continue.

Preventing a Recurrence

While I am sure it is tempting to address the prevention of future problems in the mortgage market by the appointment of one "super regulator," such temptation should be resisted. The current participants in the market include banks and other depository institutions regulated by state and federal agencies, mortgage bankers and brokers who are generally regulated by the states, securities firms, and GSE's (Fannie Mae, Freddie Mac and the Home Loan Banks), and hedge funds. Preempting or subordinating the current regulators will take years and could remove from the marketplace regulatory bodies who are active and who can be part of a long term solution. In my view, changing a few rules governing the market place and coordinating the application of currently available resources is the quickest, cheapest and most effective way to improve the market's health and prospects. A few specific suggestions in that regard are set forth below.

First, Congress should update the federal predatory lending law to incorporate the time-tested consumer protections implemented by the various states over the last decade, as embodied by legislation proposed last session in the House of Representatives by Reps. Miller, Watt and Frank. Introduced last year as H.R. 1182, the Miller-Watt-Frank bill would have created a national standard that would set sensible limits on high-cost subprime loans, while retaining the states' ability to address new abuses in the market. In addition, Congress should state clearly and unambiguously that lenders are required to consider a borrower's ability to repay a loan.

Second, we need to develop a default scheme to prevent unscrupulous subprime lenders and brokers from taking advantage of borrowers with credit problems. There is a dramatic asymmetry of knowledge, sophistication and bargaining power between borrowers and mortgage providers. Further, recent work in behavioral economics suggests that when confronted with information overload, bad choices often result. Congress should require that the default loan to a subprime borrower should be a thirty-year fixed rate loan that most consumers understand. Any other choice of subprime loan should depend on the borrower taking affirmative action to opt out of the default loan and receiving in-person independent counseling on the benefits of the transaction. Subprime lending should be a bridge to create sustainable homeownership, not a detour into a second-class, high-priced mortgage system.

Third, Congress should support the coordination of the supervision of non-bank mortgage brokers and lenders by the states. CSBS and AARMR have, in partnership with the NASD, organized a coordinated national system to license and track the activities of these enterprises. Through working on the development of the system, states and a number of industry representatives have begun a dialog that will lead to broadly consistent national standards with regard to licensing of firms and individuals. Congress can promote this system through funding the start-up of the system and by requiring states that do not wish to join the system to affirmatively opt-out of the system. Given the same kind of Congressional "encouragement" that the insurance regulatory community got in Gramm-Leach-Bliley, this system can be a valuable resource in regulating the market in the future.

Fourth, Congress already has tools at its disposal to facilitate the flow of credit to responsible subprime lending. Congress should take immediate steps to modernize FHA to

enable it to be a viable option for homeownership by borrowers with credit blemishes. Much of the growth of the subprime industry came at the expense of FHA. Clearly, Congressional concerns over the solvency of the FHA insurance fund led it to overreact and hamstrung the FHA from serving the subprime market.

In addition, Congress should encourage the GSE's to devote their primary attention to affordable housing for all Americans, particularly the subprime market. The GSEs have done wonders to increase the liquidity in the conventional mortgage market. In addition to their potential direct impact in the subprime market, the standards set by the GSEs for loans they purchase have an impact that ripples through the marketplace.

Conclusion

Ultimately, there is a trade-off between increasing the availability of credit in the mortgage market and the level of foreclosures. CSBS is concerned by this trade-off. My fellow state supervisors and I are finely tuned to the needs of the communities we serve. Like members of Congress, state supervisors are not only concerned with national trends, but with the overall economic health of our local communities. Even a relatively small number of foreclosures can be devastating to a small town.

As regulators, we must find a balance between encouraging market innovation, product choice and credit availability with consumer protection. The states will continue to improve supervision of the mortgage industry by strengthening state statutes, signing on to the CSBS-AARMR mortgage licensing system, or adopting parallel guidance for our regulated entities. Only by continuing this type of coordinated supervision on a nationwide level, can we both protect consumers and support financial services providers.

The evolution of the residential mortgage marketplace over the past two decades has dramatically affected how we supervise the industry. Innovations in the mortgage market are positive developments, but have also allowed for an increase in predatory lending and fraudulent lending practices, which have contributed to increased foreclosure rates and the turmoil we are now experiencing. As a state financial regulator, my job is first and foremost to protect the consumers of North Carolina. But I must also allow the financial service providers the opportunity to compete and flourish in the marketplace in a safe and sound manner.

My fellow state supervisors and I will continue to improve our supervision of the residential mortgage industry to improve the quality of credit available to consumers, improve standards for loan providers, ensure consumer protection provisions, and punish those who engage in predatory or abusive practices. The economy is not benefited by putting consumers in homes they cannot afford. Instead, we are working towards a marketplace with cooperative and seamless supervision that ultimately benefits both consumers and providers.

Thank you again for your invitation to come here today and for this Committee's interest in improving our mortgage market system.

Exhibit A: Examples of Actions Taken by Individual States

In addition to the cooperative efforts of state regulators through CSBS and AARMR, I have detailed a small sampling of state regulator actions in the mortgage arena. There are similarities and differences in the initiatives undertaken by the states. I believe this differentiation is a sign of health in state supervision. State regulators with a deep knowledge and understanding of local circumstances are free to tailor their supervisory framework to the unique conditions in their state.

Arizona

In January, the Arizona Department of Financial Institutions (DFI) issued the parallel Guidance for Nontraditional Mortgage Product Risks developed by CSBS and AARMR.

The DFI has led other state and federal regulators to form a mortgage fraud task force. The task force, created by Superintendent of Financial Institutions Felecia Rotellini, consists of the Arizona DFI, the Arizona Department of Real Estate, the Arizona Housing Department, the Federal Bureau of Investigation, the Department of Housing and Urban Development, the Internal Revenue Service, the Arizona State Board of Appraisers, and local law enforcement. The task force was formed to pool agency resources, to share expertise and to more effectively investigate and prosecute, both civilly and criminally, individuals engaging in mortgage fraud.

In January 2007, legislation was introduced in the Arizona legislature that would require all loan officers and originators be licensed. This legislation would also define mortgage fraud as a felony, punishable up to 10 years in prison.

The DFI has been investigating mortgage fraud and illegal lending practices since 2005. In January 2006, Superintendent Rotellini created the Regulatory Enforcement Unit to assist state examiners with their increased caseload and increased enforcement actions. Also during 2006, the DFI hired two field investigators to conduct interviews and focus on the illegal practices in the residential mortgage industry. In the past three months, the DFI has been inundated with complaints, tips, and information about predatory practices, mortgage fraud, and foreclosure rescue schemes. The DFI has been working closely with state and federal law enforcement, the professional associations that represent the mortgage and real estate industries, and journalists to heighten consumer and industry awareness, to weed out the worst actors, and to send a message that industry will be held accountable for predatory or abusive lending practices.

California

The California Department of Real Estate (DRE) licenses and regulates the activities of real estate salespersons and brokers. In order to engage in licensed activity, a salesperson must be employed and supervised by a broker. Licensed activity includes, among other things, the listing and sale of real property, property management and mortgage brokering.

At the end of fiscal year 05/06, there were 137,410 license real estate brokers and 366,734 salespersons for a total licensee population of 504,144. Licenses are generally valid for four years.

In order to become licensed as a real estate broker or salesperson in California, an individual must have completed certain pre-license educational requirements, and in most cases experience requirements for broker applicants, as well as pass a written examination.

All applicants are fingerprinted and background reports are received from both the California Department of Justice and the Federal Bureau of Investigation. Once an individual is licensed, the California Department of Justice also provides subsequent arrest notices to the DRE should one occur. Real estate licenses are issued for a period of 4 years and there are continuing education requirements which must be met for all renewals. Unless working for an exempt institution, all individuals who negotiate loans in California must be licensed as either a real estate broker or as a properly licensed salesperson who works under the supervision of a real estate broker.

The DRE has the authority to issue and discipline real estate licenses. Discipline can range from a Public Reproval, suspension, or revocation of a license. The DRE has limited authority to fine and cannot criminally prosecute cases. However, referrals to criminal enforcement agencies are made when appropriate. Less substantial violations are addressed with a corrective action letter and these are not counted in the enforcement action statistic totals.

In the area of enforcement, it should be noted that California does have a predatory lending law, which is contained in Section 4970 et seq of the Financial Code. The three licensing agencies over mortgage lending in California, the DRE, the Department of Corporations (DOC), and the Department of Financial Institutions (DFI) are jointly responsible for enforcing this law within their respective jurisdictions.

As an additional note, the DRE is in the process of adopting regulations to adopt the CSBS-AARMR Guidance on Nontraditional Mortgage Products, which mirrors the interagency guidelines.

Real estate licensees have fiduciary duties to both the lender and borrower when

negotiating loans and can be disciplined for violations of the Real Estate Law. Violations include making a misrepresentation, fraud, dishonest dealing, negligence, and criminal convictions. Failing to disclose all material facts about a loan to a borrower or misrepresenting the facts to a lender (such as knowingly misstating a borrower's income) are actionable offenses. A mortgage broker has an obligation to act in the best interest of the borrower.

Although the DRE does random audits, a majority of the audits are in response to complaints filed with the DRE. The 252 audits of mortgage brokers represent 38% of the total audits, even though mortgage brokers represent less than 15% of the licensee population. Of these 252 audits, 186 uncovered potentially actionable violations. Those violations not deemed sufficient to warrant formal disciplinary actions result in a compliance action letter. The most common violations found in the audits involved the failure to provide the proper Mortgage Loan Disclosure Statement. The second most cited violation in the audits involved lack of supervision and improper record keeping. Thirteen of the audits found trust fund shortages, totaling $295,394.

Of the 149 total disciplinary actions based on mortgage loan broker violations, the most common violation cited was failing to provide a borrower with the proper Mortgage Loan Disclosure Statement (29). As noted above, 23 actions were based, in part, on the mortgage broker making a substantial misrepresentation to the borrower. And 17 actions were based, in part, on the broker making a misrepresentation to the lender.

It is worth noting that nearly all the actions were initiated by a consumer complaint. Misrepresentations are difficult to prove without a complainant. And unless patently obvious, misrepresentations are difficult to discover in a random routine audit or

examination of records.

Since loans can be made or arranged under a real estate broker license as well as a DOC issued Residential Mortgage Lender license (RML) and a California Finance Lender license (CFL), the DRE and DOC have a Memorandum of Understanding (MOU) to cross check license applicants and disciplinary actions. This arrangement prevents a mortgage loan broker who has been disciplined by one department from obtaining a license from the other to continue operating. Last fiscal year, the Departments crossed checked over 6,000 applicants.

In addition, to lessen the burden on consumers, the DRE proactively refers complaints to the DOC when it is determined the activity was conducted under a DOC issued license and not a DRE issued broker license. Last fiscal year, the DRE referred 75 complaints to the DOC.

As noted earlier, the DRE is an administrative agency and does not have the authority to prosecute criminal or civil violations. Such violations may be pursued by local municipalities or the Attorney General (AG). Existing law allows a district attorney or the AG to bring civil actions for unfair business practices and misleading advertising.

The DRE routinely makes referrals to local law enforcement and provides technical assistance when appropriate. Last Fiscal Year, the DRE either referred or provided assistance on over 35 criminal cases. Many of the criminal referrals involved loan fraud.

Los Angeles County has also established a Real Estate Fraud Task Force of which DRE is a member. The task force meets once a month and participants include LAPD, LA Sheriff, HUD, IRS, FBI, and the Departments of Corporations and Consumer Affairs.

With respect to broker education, the DRE has already begun a series of efforts to

further ensure brokers fully understand their responsibilities to inform borrowers of the relative merits and risks of nontraditional mortgages. The DRE has recently published an article explaining that brokers have a duty to fully explain to a borrower the merits and risks of alternative mortgage programs before the point of document signing. The article also makes the point that real estate brokers have a fiduciary duty to the borrower and as such, must act in the best interest of the borrower.

With respect to marketing and advertising, existing law requires that real estate brokers disclose all material facts about a product in the ad or materials used to solicit borrowers. Any promotion of a nontraditional mortgage must include the material facts of the product so the ad or promotional material is not misleading. This would include disclosures of the possibility of negative amortization, frequency of payment or rate adjustments, and the amount of the balloon payment if the program is not fully amortized. This is also true of any verbal discussion a broker has with a borrower.

The DRE has also made an extensive effort to educate borrowers so they may make informed decisions. In this regard, the premier publication of the DRE is the consumer booklet on "Using the Services of a Mortgage Broker". This booklet educates a borrower on what questions to ask to ensure an understanding of the loan terms, especially the terms related to nontraditional mortgages. This booklet was first produced over 15 years ago and is updated periodically. The department is currently in the process of updating the booklet again so it more accurately reflects the information in the guidance.

Massachusetts

In the Commonwealth of Massachusetts, mortgage supervision has been the primary focus of the Division of Banks for well over a year.

In 2006 alone, the Massachusetts Division of Banks issued a total of 104 formal and informal enforcement actions against mortgage lenders and brokers. Included in these actions were several cease and desist orders essentially shuttering companies found to be intentionally overstating income on reduced documentation loans or engaging in other types of deceptive practices. In September 2006, the Division issued an industry letter relative to reduced documentation loans indicating that severe action will be taken should evidence of mortgage fraud be found and implemented emergency amendments to their regulations governing mortgage lenders and brokers, significantly expanding the number of existing prohibited acts and practices that constitute grounds for the issuance of cease and desist orders and license suspension or revocation.

Massachusetts was one of the first to adopt the parallel guidance on nontraditional mortgage product risks, developed by CSBS and AARMR, in the form of a regulatory bulletin. This action is essential toward ensuring a level playing field is maintained within the mortgage market and that the consumer protections within the guidance are enforced uniformly.

Finally, in an effort to develop a comprehensive strategy to address increasing foreclosure rates, the Division of Banks hosted a Mortgage Summit in November 2006. Nearly 50 individuals representing 29 government, industry, and nonprofit organizations attended the Mortgage Summit with the stated goal of seeking to address the increasing number of mortgage foreclosures across Massachusetts and to develop a statewide foreclosure prevention strategy that will put into place lasting measures to help consumers confronted with the loss of their homes.

Following the Summit, two Working Groups were established to focus on Rules and Enforcement and Consumer Education and Foreclosure Assistance. The goal of the Working Groups is to take the ideas and suggestions from the Summit and develop specific recommendations. Since January, the Working Groups have met every two weeks and set a deadline of March 31 to conclude their deliberations.

The new legislative session is also underway. Several bills dealing with mortgage foreclosures have already been introduced, including provisions which would require loan originators to be licensed and extend the Massachusetts Community Reinvestment Act to licensed mortgage lenders.

Minnesota

In December 2006, the Minnesota Department of Commerce issued the Guidance for Nontraditional Mortgage Product Risks developed by CSBS and AARMR to all state-licensed entities.

The Department's 2005 legislation, which became effective on January 1, 2006, requires licensed residential mortgage originators to conduct background checks on loan officers and prohibits a person convicted of a financial crime from serving as a loan officer without prior written consent of the Commissioner of the Department of Commerce. These requirements are very similar to Section 19 of the FDI Act.

A Department proposal presently under consideration by the Minnesota state legislature would improve and strengthen regulation of mortgage originators. The proposal, if enacted, would require the following:

1. That all licensees be a business entity with a minimum tangible net worth of $250,000 (or a surety bond or letter of credit of $100,000);

2. Require an affirmation that they are in compliance with the background check requirement;
3. Require maintenance of a perpetual roster of loan officers that would be provided to the Department on demand;
4. Require loan officers to have 16 hours of education on state and federal mortgage laws before serving;
5. Give the Department of Commerce the authority to examine licensees and charge for these exams; and
6. Make mortgage fraud a specific crime in Minnesota, which is based upon a recent law passed in Georgia.

This proposal is expected to be enacted.

The Department of Commerce has recently halted a kickback scheme and imposed enforcement penalties of more than $1 million on title insurance companies that set up sham affiliated businesses with real estate agents, mortgage originators and developers to get around state and federal laws prohibiting direct payments for referrals. The Department identified 35 affiliated business arrangements between First American and more than 600 referral partners that included real estate agents and brokers, mortgage originators, building contractors, land developers, and others.

North Carolina

Earlier this month, the North Carolina Office of the Commissioner of Banks (NCCOB) issued Guidance on Nontraditional Mortgage Product Risks (NTM guidance) developed by CSBS and AARMR. The North Carolina NTM guidance included a specific discussion of how the NTM guidance fit within the state regulatory scheme, its application

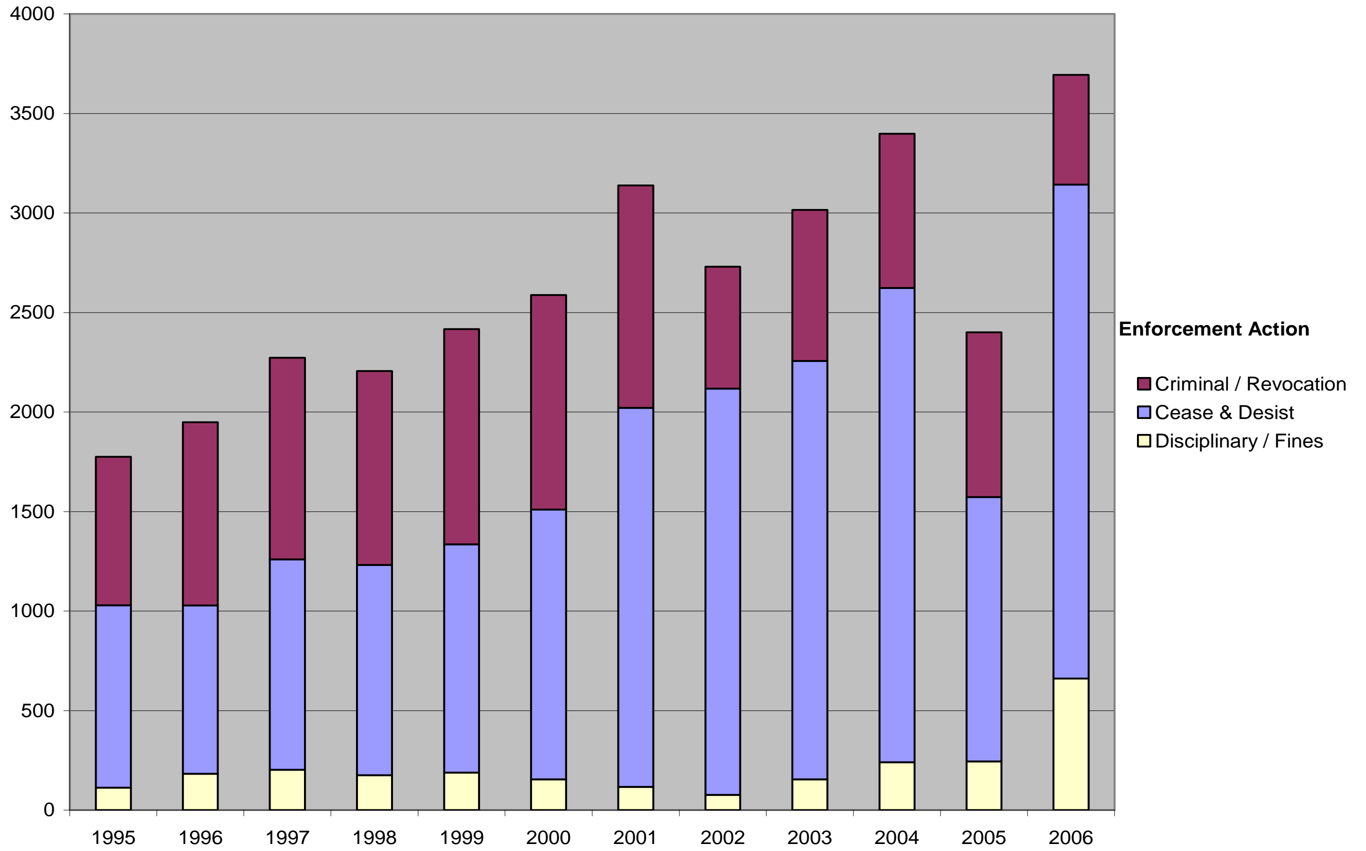
to mortgage brokers and mortgage lenders in their different roles, and provided examination procedures used by state examiners to ensure compliance.

This year, NCCOB has supported the introduction of two bills to the General Assembly to improve the mortgage market. The first bill would make mortgage fraud a felony under state law and would simplify prosecution of mortgage fraud at the state level. This legislation is modeled after the Georgia mortgage fraud law, the first of its kind. The second bill would require that all deeds of trust secured by residential property identify the name and license number of a mortgage broker, if one was involved in the transaction. This legislation is the result of a state legislative study commission on foreclosures that has met regularly over the past year.

In addition to the legislative effort on mortgage fraud, NCCOB has hired three additional staff to pursue evidence of mortgage fraud. We have trained all of our mortgage examiners on mortgage fraud (through AARMR training) and have prioritized detecting fraud in our examination process.

NCCOB has supported the development of improved standards in the mortgage brokerage business, through the encouragement of an industry-led certification program for mortgage broker firms.

Exhibit B: Enforcement Actions by State Regulatory Agencies against Mortgage Providers



Source: Mortgage Asset Research Institute