December 21, 2007

Dear Governor Gregoire,

We are pleased to submit the recommendations of the Governor’s Task Force for Homeowner Security. With some limited exceptions noted in the report, the Task Force members strongly support the recommendations in the report. The recommendations in the report reflect the thoughtful and unified consensus of the Task Force members. The Task Force designed the recommendations to address current market conditions, including the increase in residential foreclosures, and to establish systems, standards and processes that will serve to minimize the scope and impact of any similar future mortgage market disruptions.

Since you announced the creation of the Task Force on September 17, 2007, we conducted 6 formal meetings of the Task Force and numerous subcommittee meetings. We heard from individuals and organizations outside of the Task Force membership in the form of oral presentations and written comment, and relied upon the strong base of knowledge of Task Force members and their organizations, and the staff of the Washington State Department of Financial Institutions. We have identified both immediate and long-term actions we can take to address the issues that you charged us with, along with additional issues raised at Task Force meetings. Our recommendations include:

- Increased Public Awareness
- Counseling assistance for borrowers at risk of foreclosure and for first time home buyers
- Lender and servicer best practices for borrowers at risk of foreclosure
- Lender and loan originator best practices and disclosures at loan initiation
- Consumer education and financial literacy
- Improved notice to consumers facing foreclosure
- Standards and borrower protections for nontraditional mortgage product risks and subprime mortgage lending, and
- Legislation to reduce mortgage fraud and mortgage rescue scams

Since the Task Force started its work the national mortgage lending market has continued to deteriorate. While Washington State has been relatively insulated from the impact of the national market, with foreclosures in our state remaining low relative to the rest of the nation, we are not immune from market realities. We urge you and other leaders to give a high priority to the recommendations in our report to minimize foreclosure activity in Washington State and, where possible, look to the future by taking action now to address identified areas of concern.

We commend you for your foresight in assembling the talented and dedicated group of individuals that comprise the Task Force and for asking us to focus on these important issues. On behalf of all of the members of the Governor’s Task Force for Homeowner Security, thank you for the opportunity to serve the people of Washington State.

Sincerely,

/s/

Carol K. Nelson
Chair
Washington State Task Force for Homeowner Security

/s/ Carol Nelson, Chair
CEO
Cascade Bank

/s/ Dwayne Aberle
President and CEO
Security State Bank

/s/ Michaela Albon
Senior Vice President and
General Counsel for Home Loans
Washington Mutual

/s/ Fred Corbit
Attorney
Northwest Justice Project

/s/ Tom Echols
Regional Director of
Government Affairs
HSBC – North America

/s/ Arturo Gonzalez
Director of Homeownership Center
El Centro de la Raza

/s/ Kim Herman
Executive Director
Washington State Housing Finance Commission

/s/ Scott Jarvis
Director
Department of Financial Institutions

/s/ James Kelly
President
Urban League of Metropolitan Seattle

/s/ David Main
Main Street Builders, Second Vice President,
Master Builders Association of King & Snohomish Counties

/s/ Tricia McKay
Executive Director
Medina Foundation

/s/ Richard Mitchell
General Counsel
Office of the Governor

/s/ Sharon Nelson
Chair of the Board
Consumers Union
* Representing her own views

/s/ Gary Oakland
President and CEO
Boeing Employees Credit Union

/s/ Don Riley
Executive Vice President of
Business Opportunities
Windermere Services Company

/s/ Aiko Schaefer
Director
Statewide Poverty Action Network

/s/ Adam Stein
Mortgage Broker Commissioner
American Brokerage, LLC
Washington Task Force For Homeowner Security

Final Report

Prepared for Governor Chris Gregoire
December 21, 2007
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Section One

Developing workable solutions to address Washington’s mortgage crisis and methods of cultivating a more stable environment for all Washington homeowners.
Governor’s Task Force for Homeowner Security

Introduction, Mission and History

On September 17, 2007, Governor Gregoire announced the creation of a task force (Task Force) to evaluate instability in the national subprime mortgage market and to make recommendations to minimize the impact of this national trend in Washington.

The Governor recognized that the Washington economy was strong and that the state was not yet seeing foreclosures and defaults at the same rate as other states. This presented an opportunity to work on solutions before this national problem hit Washington as severely as it impacted the rest of the country.

The 17 member Task Force, chaired by the Chief Executive Officer of Cascade Bank, Carol Nelson, was comprised of knowledgeable and compassionate people from the financial industry, construction and real estate industries, non-profit organizations, consumer groups, and government.

The group was initially charged with evaluating and providing recommendations on:

- The extent of the problem and impact in Washington for current and new home buyers;
- Ways to facilitate sensible refinancing options from responsible lenders for homeowners in default or at risk of default;
- Consumer education to those in foreclosure or at risk of foreclosure;
- Consumer education to potential new home buyers; and
- Reforms to Washington lending practices, as needed.

Based on the Governor’s directive, the Task Force outlined its mission as follows:

“The mission of the Task Force for Homeowner Security is to evaluate instability in the national mortgage market and recommend actions to take that minimize the impact of this trend in Washington.”

The Task Force met for the first time on October 8, 2007. Subsequent meetings of the full Task Force were held on October 26, November 9, 16, and 30, and December 14, 2007, with four subcommittees meeting to address specific issues and develop recommendations for the full Task Force. The Task Force ultimately produced 24 recommendations under 9 subject categories. These recommendations were approved and adopted by the Task Force at its December 14, 2007, meeting.
Members of the Task Force

Chair: Carol Nelson, CEO, Cascade Bank

Members:

- Dwayne Aberle, President and CEO, Security State Bank
- Michaela Albon, Senior Vice President and General Counsel for Home Loans, Washington Mutual
- Fred Corbit, Attorney, Northwest Justice Project
- Tom Echols, Regional Director of Government Affairs, HSBC – North America
- Arturo Gonzalez, Director of Homeownership Center, El Centro de la Raza
- Kim Herman, Executive Director, Washington State Housing Finance Commission
- Scott Jarvis, Director, Washington Department of Financial Institutions (DFI)
- James Kelly, President, Urban League of Metropolitan Seattle
- David Main, Main Street Builders, Second Vice President, Master Builders Association of King and Snohomish Counties
- Tricia McKay, Executive Director, Medina Foundation
- Richard Mitchell, General Counsel, Office of the Governor
- Sharon Nelson, Chair of the Board, Consumers Union
- Gary Oakland, President and CEO, Boeing Employees Credit Union
- Don Riley, Executive Vice President of Business Opportunities, Windermere Services Company
- Aiko Schaefer, Director, Statewide Poverty Action Network
- Adam Stein, Mortgage Broker Commissioner, American Brokerage, LLC

Alternates:

- Carolyn Adams, Washington Mutual
- Aaron Bresko, Boeing Employees Credit Union
- Allison Butcher, Master Builders Association
- Scott Cameron, Cameron Real Estate Group LLC
- Karen Carlson, Washington State Housing Finance Commission
- Eric Dunn, Northwest Justice Project
- Dee Taylor, Washington State Housing Finance Commission
- Linda Taylor, Urban League of Metropolitan Seattle
Best Practices for Lenders & Servicers

Michaela Albon
Tom Echols
Kim Herman
Scott Jarvis
Carol Nelson
Don Riley
Aiko Schaefer
Linda Taylor

Best Practices for Originators

Dwayne Aberle
Michaela Albon
Tom Echols
Kim Herman
Scott Jarvis
Carol Nelson
Gary Oakland
Don Riley
Aiko Schaefer
Adam Stein

Consumer Education & Counseling

Michaela Albon
Tom Echols
Kim Herman
Scott Jarvis
Carol Nelson
Gary Oakland
Linda Taylor

Financial Literacy Report

Jeff Caden*
Scott Jarvis
James Kelly
Gary Oakland

*Executive Director, Washington Homeownership Center, invited participant
Executive Summary Of Recommendations

I. Public Awareness and Outreach Campaigns

1. The Task Force recommends a strong, clear and consistent state-wide consumer education and outreach program. This includes expanding statewide public awareness and outreach campaigns to educate borrowers about the importance of understanding the terms of their mortgage loans and encouraging them to contact their lender if they are facing an adjustable rate mortgage (ARM) reset or are having trouble making their mortgage payments.

2. The Task Force recommends encouraging private, non-profit and public sector entities from a broad range of lending and housing related industries to employ available resources to support public awareness and outreach.

II. Counseling Assistance for Borrowers at Risk of Foreclosure and First-Time Home Buyers

3. The Task Force recommends that the State provide financial resources to the Washington State Housing Finance Commission for qualified in-state housing counseling agencies to increase education and counseling capacity for mortgage default and foreclosure counseling, and first-time home buyer education.

4. The Task Force recommends providing grants or loans to assist qualifying low- and moderate-income homeowners, who are delinquent on their mortgage payments, to bring their loan current to be eligible to refinance into a different loan product.

5. The Task Force recommends providing appropriate tax credits, incentives, or other mechanisms to financial institutions or other mortgage originators that contribute financial resources to recognized charitable non-profit financial literacy, consumer education and Washington State Housing Finance Commission qualified housing counseling agencies.

III. Lender and Loan Servicers Best Practices Toward Borrowers at Risk of Foreclosure

6. The Task Force recommends the adoption of best practices for lenders and loan servicers that contain, at a minimum, these elements:
   - Early identification and notice.
   - Loan modifications or workouts.
   - Identification of mortgage fraud.
   - Ongoing borrower education on loan products.
Executive Summary Of Recommendations (continued)

IV. Lender and Loan Originator Best Practices at Loan Origination

7. The Task Force recommends a single page disclosure summary of the key terms and conditions of a mortgage. The disclosure summary should be signed by the loan originator and the borrower and provided to the borrower no later than three days following the loan application and reviewed at closing. This disclosure summary would reduce misunderstandings at the time of closing and thereafter, and confirm for the originator or lender that this important information has been accurately provided to the buyer before they proceed with the loan.

V. Consumer Education and Financial Literacy

8. The Task Force recommends that the State fund the expansion of financial literacy through established networks in the workplace, community organizations, state and local government agencies, our state’s K-12, community college and higher education systems, and other organizations.

9. The Task Force recommends the incorporation of financial literacy in our K-12 schools as part of our Washington Assessment of Student Learning (WASL) curriculum.

10. The Task Force recommends using available state government information resources to provide a centralized location for consumers to obtain financial literacy and counseling information, including the linking of all state Web sites with financial education information from a single designated location.

11. The Task Force recommends forming and utilizing partnerships with local private sector resources, community coalitions such as the Washington Asset Building Coalition and government to promote financial literacy.

12. The Task Force recommends increasing private and public sector funding for financial literacy from a variety of local, state, federal and private sources.

13. The Task Force recommends that Washington demonstrate leadership by developing, in concert with public, private and education sector partners, a standard, national definition of financial literacy to be used across all segments, along with nationally standardized, qualitative and quantitative measures to evaluate the short and long-term impact of financial education programs.


15. The Task Force recommends encouraging federal regulators to classify substantive financial literacy outreach efforts as “innovative” and “responsive” for the federal Community Reinvestment Act purposes.
Executive Summary Of Recommendations (continued)

VI. Improved Notice to Consumers Facing Foreclosure

16. The Task Force recommends amendments to Washington’s Deed of Trust statute (Title 61 RCW) to improve the foreclosure notice provided to homeowners.

VII. Standards and Borrower Protections for Nontraditional Mortgage Product Risks and Subprime Mortgage Lending

17. The Task Force recommends authorizing the Department of Financial Institutions to adopt by rule the standards and provisions in the Guidance on Nontraditional Mortgage Products Risks issued by Conference of State Bank Supervisors and American Association of Residential Mortgage Regulators.

18. The Task Force recommends authorizing the Department of Financial Institutions to adopt by rule the standards and protections in the Statement on Subprime Lending issued by the Conference of State Bank Supervisors, the American Association of Residential Mortgage Regulators, and the National Association of Consumer Credit Administrators.

VIII. Other Standards and Borrower Protections for Mortgage Products

19. The Task Force recommends prohibiting by law the practice of encouraging (“steering”) borrowers to accept a higher-cost loan when they qualify for a more affordable loan.

20. The Task Force recommends prohibiting assessments of prepayment penalties on payment option ARMs beginning at least 60 days prior to the first scheduled recast of the loan. The Department of Financial Institutions should be authorized to adopt rules to establish additional consumer protections as necessary.

21. The Task Force recommends that the State prohibit loan products with negative amortization for subprime borrowers.

22. The Task Force recommends that the State pass legislation that: i) identifies the disclosures that mortgage brokers must make to their customers; and ii) clearly articulates duties that mortgage brokers owe to their customers.

IX. Preventing Mortgage Fraud and Foreclosure Rescue Scams

23. The Task Force recommends legislation to define and enact into law the felony crime of mortgage fraud, together with adopting appropriate penalties.

24. The Task Force recommends legislation designed to reduce the proliferation of foreclosure rescue scams that prey upon homeowners at risk of foreclosure.
Overview of State and National Market Conditions

Washington State finds itself in an enviable position relative to the present nationwide problem affecting the capital markets, the mortgage industry and homeowners. The most respected of national surveys – the Mortgage Bankers Association® National Delinquency Survey – just released its 3rd quarter 2007 results showing Washington near the bottom in total past due loans of all types and in the category of seriously delinquent loans (i.e., loans over 90 days past due or pending foreclosure). This represents a ranking among the states, in terms of all loan types of 46th and 48th, respectively. Based upon an estimate derived from the Mortgage Bankers Association® National Delinquency Survey, by end of the 3rd quarter 2007 there were only about 45,000 loans of all types in Washington that were past due, with an estimate of only about 17,000 (or 1.12%) seriously delinquent. When compared with nationwide estimates of nearly 3.3 million loans in default in the 3rd quarter 2007, Washington represented only an estimated 1.4% of the total number of outstanding defaults. Moreover, the picture in the most risky of loan categories – subprime ARM loans – was likewise in marked contrast to the nationwide problem. For 3rd quarter 2007, the same survey estimates indicate a total of about 11,300 subprime ARM loans past due in Washington (less than 13%), compared with about 725,000 nationwide (nearly 20%). Of these, about 6,200 subprime ARM loans in Washington were seriously delinquent (7.1%), compared with a nationwide estimate of over 575,000 loans (15.6%).

It is a fair assumption that Washington’s relatively low numbers and percentage of delinquencies and pending foreclosures are due to an overall strong state economy and job market. However, Washington is not insulated from the same forces that affect the rest of the nation. Currently, we are facing a global credit crunch that will necessarily impact the local economies of Washington to some degree. We have not seen the end of the subprime ARM delinquency crisis, because the interest rates on a large percentage of these riskier loans are due to “reset” in the next 6 months.

Washington appears to be a place of relative calm in the present national turmoil over the residential mortgage market. However, subprime ARM borrowers who are most at risk remain vulnerable to higher, potentially unaffordable interest rate “resets.” All Washington residents, including potential first time home buyers and new or returning borrowers with less than “platinum” qualifications, are at risk of being affected by the present credit crunch.

The Governor’s Task Force Report addresses this dilemma with the goal to assess the nature and scope of the mortgage problem as it affects Washington, and make recommendations that will help Washington residents overcome some of the more glaring risks in the months ahead. In addition, the Task Force recommendations contain specific proposals intended to solve problems in the mortgage industry that are cyclical in nature and, if left unaddressed, would only manifest themselves again under future, recurring conditions.
Task Force Recommendations

I. Public Awareness and Outreach Campaigns

The Task Force recognizes that educated consumers are more likely to seek help and work with their lenders early to avoid foreclosure. Additionally, informed borrowers are less likely to enter into loans they cannot pay or become victims of foreclosure rescue scams if they are already in trouble and facing foreclosure.

1. The Task Force recommends a strong, clear and consistent state-wide consumer education and outreach program. This includes expanding statewide public awareness and outreach campaigns to educate borrowers about the importance of understanding the terms of their mortgage loans and encouraging them to contact their lender if they are facing an adjustable rate mortgage (ARM) reset or are having trouble making their mortgage payments.

The Task Force suggests the education have two components. First, financial literacy about housing finance is needed on a long-term basis to continue to raise the public's level of education so individuals can understand the terms of their mortgage. Second, and more immediately, borrowers must be provided information about alternatives to losing their homes to foreclosure. If this education is to make a lasting difference, there must be long-term financial support. Any educational programs developed should not “reinvent the wheel” and ideally should be integrated with and reinforce those of other local and national agencies such as The Home Ownership Preservation Foundation, NeighborWorks and the national Ad Council’s foreclosure campaign.

2. The Task Force recommends encouraging private, non-profit and public sector entities from a broad range of lending and housing related industries to employ available resources to support public awareness and outreach.

A variety of resources is essential to effectively reach affected borrowers and connect them with the appropriate assistance. Partnerships of private, non-profit and public sector entities will reach more consumers more efficiently and offer borrowers improved opportunities to connect with suitable resources and potential solutions.
II. Counseling Assistance for Borrowers at Risk of Foreclosure and First-Time Home Buyers

Purchasing a home is a rite of passage and the dream of most non-homeowners. Besides the intangible benefits of security and stability, homeownership builds equity, and is probably the single biggest financial commitment one will ever make.

Each foreclosure of a residential mortgage is a personal, social, and financial tragedy for the household facing foreclosure. The loss of the home represents the loss of a family’s shelter and its most precious financial resource. Foreclosure also has a destabilizing effect on the neighborhood where the home is located.

3. The Task Force recommends that the State provide financial resources to the Washington State Housing Finance Commission for qualified in-state housing counseling agencies to increase education and counseling capacity for mortgage default and foreclosure counseling, and first-time home buyer education.

State funds should provide sufficient counseling capacity to help Washington homeowners for as long as the need exists.

First time home buyer counseling could also be funded by providing indirect tax incentives to encourage Washington financial institutions to fund private non-profit agencies that provide home loan counseling to first-time home buyers and default or foreclosure counseling.

4. The Task Force recommends providing grants or loans to assist qualifying low- and moderate-income homeowners, who are delinquent on their mortgage payments, to bring their loan current to be eligible to refinance into a different loan product.

A program should be created and funded to offer grants or loans to deserving, low- and moderate-income homeowners. The grants or loans would be available to homeowners who are delinquent on their mortgage payments and at risk of foreclosure because they cannot cure their defaults by refinancing their homes on their own. Once cured of their defaults, these deserving borrowers would then be in a position to receive suitable refinancing from institutional sources at more affordable rates.

5. The Task Force recommends providing appropriate tax credits, incentives or other mechanisms to financial institutions or other mortgage originators that contribute financial resources to recognized charitable non-profit financial literacy, consumer education, and Washington State Housing Finance Commission qualified housing counseling agencies.

Washington should consider appropriate tax credits, incentives or other mechanisms to encourage financial institutions and other mortgage originators to voluntarily fund charitable non-profit financial literacy, consumer counseling and Washington State Housing Finance Commission qualified housing counseling agencies.
Task Force Recommendations

III. Lender and Loan Servicers Best Practices
Toward Borrowers at Risk of Foreclosure

Preventing foreclosure serves the interests of homeowners, communities, lenders, and investors. Lenders and loan servicers who engage at-risk borrowers early and offer a range of alternatives increase the likelihood of finding solutions to the borrower’s financial difficulties. Borrowers who know the range of options available to them are more likely to make efforts to use those options. Lenders and loan servicers who agree to standardized best practices are increasing the chances of preserving homeownership and that serves everyone involved in the mortgage loan process. Even if homeownership cannot be preserved, a controlled deliberate process of loss mitigation may limit the financial damage to all the parties.

6. The Task Force recommends the adoption of best practices for lenders and loan servicers that contain, at a minimum, these elements:

**Early identification and notice.** Lenders and loan servicers should identify and begin contacting at-risk borrowers as early as six months, but no later than 120 days before an adjustable rate mortgage loan is due to reset. Notices should encourage borrowers to engage immediately with the lender or loan servicer to explore other options. The notices should contain general information about the changing loan rates and mortgage payments, provide information about other loan products the borrower may qualify for, provide information about sources for financial literacy, and include contact information for third-party counseling resources. All contact with borrowers should be timely and informative. Borrowers should not have difficulty in reaching lender or loan servicer representatives who have authority to make decisions about alternative loan products.

**Loan modifications or workouts.** If a lender or loan servicer determines a borrower cannot make payments they should work with the borrower to find realistic and sustainable potential solutions, on a case-by-case basis. When considering alternatives to the borrower’s current loan product, lenders and loan servicers should offer qualifying borrowers non-adjustable rate loan products. All reasonable loss mitigation options should be considered, including short sales, forbearance plans, loan modifications, deeds in lieu of foreclosure, relocation assistance, refinancings, and shared appreciation structures.
Identification of mortgage fraud. Lenders and servicers who identify mortgage fraud by any person or entity involved in the lending process should report that information to the appropriate law enforcement and regulatory agencies.

Ongoing borrower education on loan products. There is a range of loan products currently held by borrowers. Many of those products have terms or conditions that may significantly change during the life of the product. Lenders and loan servicers should take steps now to make sure borrowers understand the terms and how they may change. A combination of lender and loan servicer notices and public advertising campaigns may help accomplish this goal. Lenders and loan servicers should consider using this opportunity to obtain current credit information as a means to re-qualify the borrower into a stable and better priced loan product.
Task Force Recommendations

IV. Lender and Loan Originator Best Practices at Loan Origination

Any consumer who has ever shopped for a mortgage or closed on a house knows how complicated the process is. The stack of paperwork that must be signed and understood during the process is very intimidating. Much of this paperwork represents disclosures which are intended to inform the borrower about the costs of the mortgage. Many times these disclosures are lengthy and difficult to read. As a result, the typical borrower may not be adequately informed about the true cost and terms of their mortgage transaction.

Some mortgage products may be even more difficult to understand because many of these products have terms that change over the course of the loan. For example, a borrower may have an adjustable rate mortgage, which typically starts out with an interest rate that is lower than the rate on a comparable fixed-rate mortgage. But after the introductory period—often two or three years for subprime borrowers—the interest rate goes up, which can result in payments that increase by hundreds of dollars each month.

7. The Task Force recommends a single page disclosure summary of the key terms and conditions of a mortgage. The disclosure should be signed by the loan originator and the borrower and provided to the borrower no later than three days following the loan application and reviewed at closing. This disclosure would reduce misunderstandings at the time of closing and thereafter, and confirm for the originator or lender that this important information has been accurately provided to the buyer before they proceed with the loan.

Legislation is needed that gives the Department of Financial Institutions the authority to create a standard residential mortgage disclosure summary form. The disclosure summary should include these elements:

A single page disclosure summary with all material terms should be provided to loan applicants. Lenders and loan originators should be required to provide borrowers with a summary of the material terms of their loan before they agree to enter into a loan transaction. The document must be one page, be written in language easy to understand, and should summarize the key loan features.

The disclosure summary should be given to the borrower no later than three days following loan application and reviewed at closing. The timing of the disclosure summary is crucial. Disclosure should be made by the originator or lender within three business days of the originator or lender taking a loan application from a borrower. This ensures that the borrower has all the pertinent information about the loan before proceeding with the transaction. The disclosure summary must be re-issued each time significant terms of the loan change.
Task Force Recommendations

IV. Lender and Loan Originator Best Practices at Loan Origination (continued)

The disclosure summary must contain in simple terms the key elements and terms of the loan.

a. General rates and term of the loan. The disclosure summary should state the interest rate, terms, and fees for the loan.

b. Adjustable terms. The disclosure summary should state whether the loan has any provisions that might cause consumers to experience increases in their payments. The disclosure summary should state potential increases in the payment, including how a new payment is calculated when the introductory fixed rate expires.

c. Prepayment penalties. The disclosure summary should state whether there are prepayment penalties, how they are calculated, and how long they apply.

d. Balloon payments. The disclosure summary should state whether the loan has balloon payments, in what year the balloon payment occurs and how much it is expected to be.

e. Stated income loans. The disclosure should state whether there is a price added or premium charged because the loan is based on reduced documentation, or the stated income of the borrower.

f. Taxes and insurance. The disclosure summary should state whether taxes and insurance are included in the monthly payment or whether the borrower will have to pay taxes and insurance outside of the mortgage payment.

g. Yield Spread Premium. The disclosure summary should state whether a “yield spread premium” will be paid to the broker. The broker must disclose that fee and the affect that fee could have on the interest rate or other terms of the loan.
Task Force Recommendations

V. Consumer Education and Financial Literacy

“In this era of volatile financial markets, job uncertainty, rising debt, and declining savings rates, the ability to manage personal finances is becoming as important as the ability to read and write. The financial stability of families—and by extension, of communities and the nation itself—is at issue.”

Ted Beck,
National Endowment for Financial Education

Washington should be a leader in financial education, not a follower, in order to maintain a strong and vibrant economy. Task Force members and local and national leaders all recognize that financial education is key in creating and sustaining informed consumers who make sound financial decisions. Consumers must be informed before their lack of financial education puts them, and our economy, at risk.

Recommendations 8 through 15 are focused on increasing the state’s capacity to meet the need for financial literacy at all levels.

8. The Task Force recommends that the state fund the expansion of financial literacy, through established networks in the workplace, community organizations, state and local government agencies, our state’s K-12, community college and higher education systems, and other organizations.

The Task Force urges Washington’s K-12 and higher education communities to implement a financial literacy component that compliments the many existing public and private financial literacy programs proven to increase consumer awareness and knowledge. There are some states that require students to take a personal finance course to graduate.

Money Savvy Generation\(^1\) research indicates, of six American children:
- 5 of these kids will be left behind in the global economy
- 4 will never be able to manage a household budget
- 3 won’t know how to save for retirement
- 2 won’t learn to balance a checkbook
- 1 will likely declare bankruptcy during his/her lifetime\(^2\)

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\(^1\) Money Savvy Generation is a private organization which develops innovative products to help parents, educators and others teach children the skills of basic personal finance.

\(^2\) This information was taken from a presentation made by Money Savvy Generation CEO and Founder Susan Beacham to attendees of the October 30, 2007 National Financial Education Network Summit.
Task Force Recommendations

V. Consumer Education and Financial Literacy (continued)

9. The Task Force recommends the incorporation of financial literacy in our K-12 schools as part of the Washington Assessment of Student Learning (WASL) curriculum.

According to Money Savvy Generation³:
- 81% of the nation’s parents want solid personal finance courses taught in the children’s schools
- 61% of parents surveyed believe that parents and schools share the responsibility for financial education.
- 74% of parents feel unprepared to teach their kids about personal finance.
These statistics clearly identify a need for financial education at all ages, including children, their parents and educators.

10. The Task Force recommends utilizing available state government information resources to provide a centralized location for consumers to obtain financial literacy and counseling information, including the linking of all state Web sites with financial education information from a single designated location.

A centralized location is convenient for consumers and is important for the dissemination of financial literacy information. Without a readily available and easy to find mechanism to retrieve qualified financial education assistance, Washington residents are left at risk of using inaccurate or misleading information.

11. The Task Force recommends forming and utilizing partnerships with local private sector resources, community coalitions such as the Washington Asset Building Coalition⁴ and government to promote financial literacy.

Working together, organizations can form a synergy that utilizes the existing programs that many of these organizations have in place. By doing so, it standardizes and strengthens financial literacy programs. Under this model, resource and financial responsibilities are shared making the programs more sustainable.

12. The Task Force recommends increasing private and public sector funding for financial literacy from a variety of local, state, federal and private sources.

Organizations currently working to educate and assist consumers are overwhelmed and have little or no way to offer fully funded services to those in need. Continued reliance on these strained financial and personnel resources prevents opportunities for increased education of Washington residents.

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³ Money Savvy Generation is a private organization which develops innovative products to help parents, educators and others teach children the skills of basic personal finance.

⁴ The Washington Asset Building Coalition (WABC) came together in October, 2006 to expand asset building across the state. More than 50 organizations are involved and helped gain $2.8 million from the Legislature for 2007-09.
Task Force Recommendations

V. Consumer Education and Financial Literacy (continued)

13. The Task Force recommends that Washington demonstrate leadership by developing, in concert with public, private and education sector partners, a standard, national definition of financial literacy to be used across all segments, along with nationally standardized, qualitative and quantitative measures to evaluate the short and long-term impact of financial education programs.

Students and adults need access to the right information and an opportunity to receive financial literacy education to understand finances. As Federal Reserve Board Chairman Ben S. Bernanke has said:

“In today’s complex financial markets, financial education is central to helping consumers make better decision for themselves and their families.”


The Financial Literacy Public-Private Partnership (FLPPP) is a state-wide public and private partnership that sets the agenda for financial literacy. Their goals include:

- Increase financial literacy training opportunities for educators and students
- Increase awareness and support of financial literacy education by showing relevance to State standards
- Act as a clearinghouse for evaluating curricula in terms of effectiveness and relevance to State standards
- Maximize the number of teachers and students receiving training
- Create statewide recognition of the advantages of financial literacy training
- Establish a measurement tool for program evaluation (JUMP$TART survey)
- Incorporate financial literacy into WASL prep for math

15. The Task Force recommends encouraging federal regulators to classify substantive financial literacy outreach efforts as “innovative” and “responsive” for the federal Community Reinvestment Act purposes.

Financial institutions that provide specialized credit products and services for low income communities should be recognized under the federal Community Reinvestment Act (CRA). Additional CRA awards should be given to financial institutions that help organizations teach financial literacy.
Task Force Recommendations

VI. Improved Notice to Consumers Facing Foreclosure

When the foreclosure process is imminent it is critical that the borrower receive timely and adequate notice of the foreclosure process. This provides the borrower with notice of the serious nature of their situation, informs them of resources available to assist them, and cautions them about foreclosure rescue scams.

16. The Task Force recommends amendments to Washington’s Deed of Trust statute, Title 61 RCW, that include, at a minimum, the following:

The written notice of default provided to the borrower, required under RCW 61.24.030(7), should be improved by requiring a prominent written statement at the start of the notice advising the borrower of the need to protect his or her interest in the property. The written statement should also incorporate information directing the borrower to suitable and qualified third party sources of information and counseling. The written statement should make it clear to the borrower that the notice of default is the first step in a process that could result in the loss of the home and should not be ignored. Finally, the written statement should caution the borrower to be wary of unknown third parties offering help.
Task Force Recommendations

VII. Standards and Borrower Protections for Nontraditional Mortgage Product Risks and Subprime Mortgage Lending

The Task Force believes that certain types of loan products carry significant risk and that additional controls should apply to the marketing, origination and servicing of these loans. These nontraditional and subprime loans, including interest-only loans, payment option ARMs, and loans with short-term teaser rates are of particular concern because payments on these loans can increase significantly when the loans reset.

17. The Task Force recommends authorizing the Department of Financial Institutions to adopt by rule the standards and provisions in the Guidance on Nontraditional Mortgage Products Risks issued by the Conference of State Bank Supervisors and American Association of Residential Mortgage Regulators.

On October 4, 2006, the federal financial institution regulatory agencies published final guidance on nontraditional mortgage product risks. Nontraditional mortgage products include interest-only mortgages, payment option adjustable rate mortgages, and other products that have negative amortization. Working with the state regulators, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) issued parallel guidance (see Addendum pages 66-76) to cover state-licensed mortgage entities not subject to the federal interagency guidance as a means of promoting consistent regulation in the mortgage market. Among other things, the guidance sets standards for management to ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower’s ability to repay, recognizing the impact of payments that suddenly increase for borrowers with low credit scores or high debt-to-income ratios, and the importance of ensuring the borrowers understand the costs, terms, features, and risks of their loan.

18. The Task Force recommends authorizing the Department of Financial Institutions to adopt by rule the standards and protections in the Statement on Subprime Lending issued by the Conference of State Bank Supervisors, the American Association of Residential Mortgage Regulators, and the National Association of Consumer Credit Administrators.

On June 29, 2007, the federal financial institution regulatory agencies published a final guidance and publicly released the Statement on Subprime Mortgage Lending (Subprime Statement). The subprime statement covers hybrid adjustable rate mortgages with very low initial fixed rates for 2 or 3 years followed by an adjustable rate period of 27 or 28 years.

Working with the state regulators, the Conference of State Bank Supervisors (CSBS), the American Association of Residential Mortgage Regulators (AARMR), and the National Association of Consumer Credit Administrators (NACCA) issued parallel guidance (see Addendum, pages 77-85) to cover state-licensed mortgage entities not subject to the federal interagency guidance as a means of promoting consistent regulation in the mortgage market.
Task Force Recommendations

VII. Standards and Borrower Protections for Nontraditional Mortgage Product Risks and Subprime Mortgage Lending (continued)

Among other things, the Statement provides that lenders and mortgage brokers should not make loans based predominantly on the liquidation value of the home, should not induce a borrower to repeatedly refinance a loan in order to charge high points and fees, should not loan to borrowers who do not demonstrate the ability to repay, and should provide information that enables the consumer to understand the material terms, cost, and risks of the loan product prior to making the loan.
Task Force Recommendations

VIII. Other Standards and Borrower Protections for Mortgage Products

19. The Task Force recommends prohibiting by law the practice of encouraging ("steering") borrowers to accept a higher-cost loan when they qualify for a more affordable loan.

Lending advocates have long alleged that minority and poor borrowers are often steered into subprime loans that carry excessively high interest rates and steep prepayment penalties. But the growing use of subprime loans by people with higher credit scores suggests that such problems exist among a much wider swath of borrowers than previously thought. According to a recent study by the Wall Street Journal over half of homeowners with subprime mortgages could have qualified for a prime loan with a lower interest rate. Recently proposed federal legislation would allow certain federal banking agencies to adopt regulations that would prohibit mortgage originators from steering any consumer from a prime loan to a subprime loan.

20. The Task Force recommends prohibiting assessments of prepayment penalties on payment option adjustable rate mortgages beginning 60 days prior to the reset of the interest rate and payment amount. DFI should be authorized to adopt rules to establish additional consumer protections as necessary.

In recent years, many borrowers took out adjustable-rate mortgages that offered a low rate for the first few years and then "reset" to a higher rate. In many cases those borrowers suffer when their payments increase dramatically. A prepayment penalty that extends beyond the reset period traps the borrower and makes it very difficult for them to refinance their loan.

21. The Task Force recommends that the state prohibit loan products with negative amortization for subprime borrowers.

Several products used to fund subprime loans are structured so that the monthly payments do not cover the amount of interest due each month. Therefore the principal balance increases each month. At the end of the loan term in this negative or non-amortizing loan, the borrower owes more than the amount originally borrowed. For many subprime borrowers who can not pay what they currently owe, this increase puts the loan further out of reach.

22. The Task Force recommends that the State pass legislation that: i) identifies the disclosures that mortgage brokers must make to their customers; and ii) clearly articulates duties that mortgage brokers owe to their customers.

The Task Force believes it is critical that consumers understand their relationship with a loan originator and the nature of the duties owed to them. RCW 19.146.005 should be clarified to include the duty of good faith, honesty and fair dealing.
IX. Preventing Mortgage Fraud and Foreclosure Rescue Scams

*Mortgage fraud is one of the fastest growing white collar crimes of this decade. It is a trend quickly sweeping through the country and can impact the financial health of families, property values, communities, and industry reputations. Mortgage fraud generally relates to a mortgage transaction involving a purposeful misrepresentation of various factors in the mortgage process.*

23. The Task Force recommends legislation to define and enact into law the felony crime of mortgage fraud, together with adopting appropriate penalties.

Combating mortgage fraud is a priority because mortgage lending and the housing market have a significant overall effect on the nation's economy. A typical mortgage fraud case involves misrepresentations made during the lending process. Mortgage fraud should be defined to include using deceptive practices, misleading lenders or borrowers, obtaining property by fraud, or making deliberate misrepresentations. Having a specific “mortgage fraud” crime defined as a Class B felony will encourage county prosecutors to charge perpetrators of mortgage fraud.

24. The Task Force recommends legislation designed to reduce the proliferation of foreclosure rescue scams that prey upon homeowners at risk of foreclosure.

Foreclosure rescue scams are sweeping the country and costing people their homes. These scams involve thieves who steal people's homes and equity after promising to help save the home from foreclosure. Because the homeowner is in financial distress, they are particularly vulnerable to fraud and exploitation. In one of the more typical foreclosure rescue scams, the homeowner surrenders the title to his or her house thinking he or she will become a renter and buy the house back over a few years. The scam artist skims the equity out of the home and walks away with all the homeowner's equity. In other cases, homeowners sign documents, not realizing they have signed over ownership of their home.

The Task Force recognizes that fraudsters and scam artists leave many victims without remedies. The legislature and other policy makers should endeavor to adequately fund prosecutor's offices and legal services for the indigent to achieve the appropriate deterrent effect.
Conclusion

The Task Force is pleased to submit these recommendations to the Governor. We encourage the Governor, and other leaders, to give these recommendations a high priority. It is our belief that the recommendations will minimize foreclosure distress in our state and resolve problems in the mortgage industry that, if left unaddressed, could recur in the future.

In addition, we acknowledge that the issues related to the mortgage industry alone do not reflect the challenges in the broader financial services industry. We encourage the Governor to also exercise leadership in exploring affordable and fair financial services for Washington residents.
Section Two:

Historical information and background regarding the subprime mortgage market and specifics about the regulatory environment in Washington and at the Federal level.
Just 25 years ago, residential mortgage lending was a lot different than it is today. What you saw then was predominantly “brick-and-mortar” bank lending – conventional, FHA and VA. Finance companies were nearly the only “subprime” and home equity lenders. Conventional lending was predominantly “conforming” loans approved by Fannie Mae and Freddie Mac. FHA-insured loans were the typical way that first-time home buyers, with little down-payment, were able to afford a home. FHA permitted a 3% down payment, albeit, with strict requirements. For active military personnel, veterans and their dependents, VA-guaranteed loans permitted a 0% down payment with strict requirements. Adjustable rate mortgages (ARMs) were practically unheard of.

Back then, banks held on to their loans and servicing more than today. While Fannie Mae and Freddie Mac were the predominant secondary market sources, the relatively small private secondary market was mostly insurance companies.

However, the market was at a near stand-still because retail mortgage loan rates had risen to an all-time high approaching 21%.
But Today Is Different

The Consumer Demand Side. Residential mortgage lending today is different than it was 25 years ago. Today, mortgage brokers service the demand side – dominating retail mortgage lending with 58% ($1.7 Trillion) of all originations in 2006. In addition, mortgage brokers directly access wholesale markets, often bypassing banks.

The Wall Street Supply Side. On the other hand, Wall Street controls the supply side, dominating the wholesale and secondary market. In July 1983, the collateralized mortgage obligation (CMO) was first introduced by Lehman Brothers, ushering in mortgage lending’s “Age of Wall Street.” Loans are now often “committed” for sale to the secondary market before they are even closed. Wall Street and major bank holding companies directly compete with Fannie Mae and Freddie Mac.

The Commoditization of Mortgage Lending. Wall Street’s influence has created or expanded the underwriting of products which allow mortgage loans to be bought and sold as a commodity. “Subprime” lending is a staple within the U.S. mortgage market. Most lenders make home equity loans, not just finance companies. ARM loans are now common. Private sector low- or zero-down lending has surpassed FHA and VA lending. “Stated-income” and “no doc” loans for self-employed persons became common in the last 10 years.

The Wall Street Macro-Business Model. The Wall Street-style risk-based capital business model has replaced traditional mortgage lending. Nationwide and regional banks are doing more wholesale lending. Branch bank lending concentrates more on originating fee income, not holding on to loans. Banks sell most of their fixed rate loans and portfolio their ARMs. Sale of servicing is very common. Banks are frequently self-insuring their risk of default rather than requiring PMI.

5 Based on the August 2007 release of the Mortgage Brokers 2006 Report, prepared by Wholesale Access Research & Consulting, Inc., and sponsored by the nation’s largest wholesale lenders.

6 While there are estimates that “subprime” lending is as high as 25% of total originations, it is preferable to rely upon the figure of 14% as shown in the Mortgage Bankers Association® Delinquency Survey for 2nd QTR 2007. While this is based upon only 44 million loans reported to MBA (which may not be the total number of loans serviced), it is an accurate measure of what is truly “subprime” among the 44 million loans surveyed.
What Is Subprime Lending?

“Subprime” mortgage lending does not refer to any specific products per se. However, “subprime” borrowers are often sold higher risk products. “Subprime” borrowers will almost always be charged higher interest rates than “prime” borrowers.

“Prime” and “Subprime”. A “subprime” borrower is a consumer whose credit score is less favorable than that of “prime” borrowers. In the midst of confusing information about the industry, it is better to define “subprime” by, first, illustrating what “prime” lending is and then generally applying the label “subprime” to all other mortgage loans. Certainly, a “prime” credit risk is generally perceived as someone whose mortgage would be acceptable to Fannie Mae’s purchasing guidelines as a “conforming” loan (except for Fannie Mae’s exclusion for “jumbo” loans above a certain loan amount). Factors in judging a “prime” borrower are:

- **Acceptable FICO Score.** The FICO Risk Score range is 300* to 850. The median FICO score in the U.S. is 723. The average FICO score in the U.S. is 678. The average FICO score in Washington State is 690. A “prime” borrower would, in combination with other acceptable factors, have a FICO score above the median.

- **Acceptable Debt-to-Income (DTI) Ratios.** The front-end ratio is the percentage of total housing costs (rent for renters, and PITI, hazard insurance, and HOA dues for homeowners) to gross income. The back-end ratio is the percentage of total monthly and other debts (including housing costs) to gross income. A “prime” borrower would typically have front-end and back-end ratios, respectively, no greater than 28/36.

- **Acceptable Combined Loan-to-Value (CLTV) Ratio.** A “prime” borrower would typically have a combined loan-to-value (CLTV) ratio of 90% or less (i.e., 10% or more down payment or equity) and a total front-end debt-to-income ratio of 36% or less.

- **Other Factors.** Examples of other factors in judging a “prime” borrower include such matters as concerns raised on the face of the property appraisal.

If a borrower has an excellent FICO Score and CLTV ratio but a higher DTI ratio, or if the borrower is self-employed and relying on “stated” (rather than verified) income, he or she may qualify with some lenders for what is known as alternative “A” (or Alt “A”) loan rates. Alt “A” may also be applied to borrowers with peculiar miscellaneous factors, such as concerns about the appraisal. But, generally, unless one has an acceptable FICO score, DTI ratios, CLTV ratio and other factors, one is automatically a candidate for a “subprime” loan.

* Correction made April 04, 2008
What Are the Current Market Conditions?

Overall Nationwide Market Conditions

According to the respected Mortgage Bankers Association® Delinquency Survey, as of September 30, 2007, about 5,990,000 out of 45,417,215 loans reported in the survey (or about 13.2%) were “subprime.” And about 2.6 million of all reporting mortgage loans, or 5.8%, were past due. Of these, 1.34 million loans, or about 2.95%, were seriously delinquent (i.e., 90+ days or more past due or in foreclosure).

And of the 5,990,000 million subprime mortgages nationwide reported to Mortgage Bankers Association®, nearly 1 million (about 16.7%) were past due. And of these, over 680,000 (over 11.8%) were seriously delinquent or in foreclosure.

This represents a continued upward trend from past quarters. While the situation may continue to accelerate, it is important to keep matters in perspective. The statistics above indicate that past due and seriously delinquent subprime loans represented only 2.2% and 1.5%, respectively, of all reporting loans nationwide.

National Trend in Default/Foreclosure

Historic Trend: 2002-2007. Some types of mortgage loans are riskier, depending on general economic and employment conditions in the U.S. Coming out of a general recession beginning in 1st QTR 2003, default and foreclosure rates in the riskier “subprime” category trended downward until 4th QTR 2005. But while default and foreclosure rates for fixed-rate subprime loans evened out and have remained relatively constant since 4th QTR 2005, the most risky of loans for both lenders and borrowers – subprime ARM loans – experienced a dramatic rise in combined default and foreclosure rate throughout 2006 and continuing into 2007.

For additional information on the historic trends in delinquencies and foreclosures, including 2006 data analyses, see Appendices attached, at Page 52.

Where Will It End? Industry analysts expect combined default rates to drift higher through at least May 2008. And this prediction may even be an underestimate. Huge numbers of subprime ARM loans were issued in 2005. Many will be burdened by big rate increases in the next 12 months.

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7 Some servicers may not report some or all of their information to Mortgage Bankers Association®. Therefore, while the MBA National Delinquency Survey is well-respected, it may not be 100% accurate.

The chart above, compiled from data published in the Mortgage Bankers Association® Delinquency Survey, shows the national trend in serious delinquencies and foreclosures for all loan types from 1st QTR 2002 through 3rd QTR 2007. Now, with the release on December 6, 2007 by the Mortgage Bankers Association® of its 3rd QTR 2007 Delinquency Survey (for the period ending September 30, 2007), we can see a further upward trend in serious delinquencies and pending foreclosures nationwide, particularly for subprime ARM loans. Based upon those loans which are reported to the Mortgage Bankers Association® (about 80% of the estimated national total), the 3rd QTR 2007 national data shows a continued national rise in serious delinquencies and foreclosures, particularly with subprime ARM loans:

NATIONWIDE DELINQUENCIES AS OF SEPTEMBER 30, 2007

<table>
<thead>
<tr>
<th>ALL LOANS</th>
<th>ALL PAST DUE*</th>
<th>SERIOUSLY DELINQUENT*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>MBA Reported</td>
<td>Adjusted Est.***</td>
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<tr>
<td>All Loans</td>
<td>45,417,215</td>
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<td>Subprime ARM</td>
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<td>Subprime Fixed</td>
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<td>Prime ARM</td>
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<td>Prime Fixed</td>
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<td>FHA</td>
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<td>417,683</td>
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<tr>
<td>VA</td>
<td>1,112,903</td>
<td>76,456</td>
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</tbody>
</table>

* 30 Days or More Past Due. ** 90+ Days Past Due or Foreclosure Pending.

***ASSUMPTION: Total nationwide loans reporting to MBA (both current & delinquent) were 45,417,215. Based upon the assumption that this represents 80% of the estimated national total (as estimated by Mortgage Bankers Association®), the adjusted estimate would be 56,770,000.
Where Does Washington Stand?

In contrast to the picture nationwide, Washington State is substantially below the national delinquency rates for all types of loans – both for serious delinquent loans and all past due loans. However, the delinquency rates, especially in the area of subprime ARM loans, should be monitored closely, even in Washington State. For all past due subprime ARM loans, Washington had a delinquency rate by 3rd QTR 2007 of 12.91% (compared with 19.59% nationwide). For seriously delinquent loans (i.e., loans 90+days past due or in foreclosure), the Washington delinquency rate on subprime ARM loans was 7.10% (compared with 15.63% nationwide). Moreover, even FHA loans in Washington (with their stricter underwriting standards) had a delinquency rate for the period of 8.46% (compared with 13.52% nationwide). With these trends likely to get worse before they get better – particularly as the interest rates on many subprime ARM loans reset – Washingtonians should remain watchful.

**WASHINGTON STATE DELINQUENCIES AS OF SEPTEMBER 30, 2007**

<table>
<thead>
<tr>
<th></th>
<th>ALL LOANS</th>
<th>ALL PAST DUE*</th>
<th>SERIOUSLY DELINQUENT**</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>MBA Reported Only</td>
<td>MBA Reported</td>
<td>Adjusted Est.***</td>
</tr>
<tr>
<td>All Loans</td>
<td>1,204,416</td>
<td>36,012</td>
<td>45,015</td>
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<tr>
<td>Subprime ARM</td>
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<td>11,326 est.</td>
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<td>Subprime Fixed</td>
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<td>Prime ARM</td>
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<td>Prime Fixed</td>
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<tr>
<td>VA</td>
<td>37,556</td>
<td>1,821</td>
<td>2,276</td>
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</tbody>
</table>

*30 Days or More Past Due. **90+ Days Past Due or Foreclosure Pending.

***ASSUMPTION: Total Washington State loans reporting to MBA (both current & delinquent) were 1,204,416. Based upon the assumption that this represents 80% of the estimated total, the adjusted estimate would be 1,505,550.

Nonetheless, according to the 3rd QTR 2007 MBA Delinquency Survey, Washington State – in comparison with all other states – ranked near the bottom in terms of delinquencies and pending foreclosures. When measuring total loans past due by state, Mississippi was highest with 10.6% total past due loans; while Washington State (ranked 46th in this category among the states), had only 2.99% in total past due loans. Of the seriously delinquent loan (90+ days past due or pending foreclosure), Ohio ranked highest with 5.44% total past due; while Washington State (ranked 48th) had only 1.12% in overall past due loans. Even in the riskier area of subprime ARM loans, Washington State ranked near the bottom. Mississippi had the highest percentage of total past due subprime ARM loans (at 30.16%), while Washington State (ranked 46th among the states) had 12.91% total past due subprime ARM loans. And in the category of seriously delinquent subprime ARM loans, Washington State ranked 48th among the states, with only 7.1% compared with highest ranking OHIO, at 25.67%.
Where Does Washington Stand? (continued)

In terms of actual numbers (see assumptions above), Washington State had an estimated number of total past due loans in all categories for 3rd QTR 2007 of about 45,000, nearly 17,000 loans seriously delinquent. In the area of subprime ARM loans, Washington State had an estimated 11,326 loans past due, with an estimated 6,229 seriously delinquent. This significantly varies from the magnitude of the problem nationwide and in practically all other states. Washington remains in much better condition than the rest of the country.

The Task Force has analyzed subprime loan volume data for select Standard Metropolitan Statistical Areas in Washington State based upon the most recent available data. These data are included in Appendices, attached, at Pages 58-65.
Causes of the Present Problem

Relaxation of Credit Standards

Of the five principle factors that lay behind the changes in the residential mortgage lending market in the last 25 years, only one – relaxation of credit standards – might possibly be viewed by some observers as a cause of the present mortgage situation. The positive, direct effects of information technology have far outweighed certain unintended, indirect consequences. Likewise, the positive effect of an increase in the supply of mortgage money and the consequent growth in demand for mortgage products has, by and large, stimulated home ownership and greatly improved the financial well-being of most Americans.

Twenty five years ago a lot of doors were closed in this country – including Washington State – to large numbers of would-be homeowners. Today, however, the largest percentage of households ever – about 69%\(^9\) – are homeowners.

The general economic stimulation that initiated this phenomenon was a major achievement for federal government policy. Moreover, relaxation of credit standards per se has not been a cause of the present “subprime” and “foreclosure” situation. Rather, it has been the relaxation of credit standards without consistent, adequate safeguards which bears some of the responsibility.

Lack of Adequate Underwriting

A major cause of the present mortgage situation has been the lack of adequate safeguards. Some examples of the inappropriate underwriting standards include:

**Overuse of “Little or Nothing Down”**. Historically, sound underwriting practice was to require a minimum down payment for two reasons: (1) as a hedge for the mortgage holder against market deflation in the event of default, and (2) as a disincentive to the borrower going into default in the first place. Accordingly, the recent phenomenon of “low down” and “nothing down” arrangements has a built-in higher risk for which lenders nationwide should have taken appropriate precautions to safeguard against a down-turn in local home prices. In 2003 alone, 28% of first-time home buyers purchased a home with no down payment, according to National Association of Realtors. When the final statistics are compiled, this percentage is likely to be much higher.

**Overuse of “No Upfront Verifications”**. While “low doc,” “no doc” and “no income verification” loans were designed to ease underwriting standards for deserving self-employed persons, the practice eventually grew into widespread abuse through loan officers, underwriters and hundreds of individuals committing outright mortgage fraud.

\(^9\) 2005 U.S. Census Bureau (68.9%). Washington State homeownership was 67.6% in 2005 (U.S. Census Bureau).
Causes of the Present Problem (continued)

Over-Acceptance of “High Debt-to-Income Ratios”. During 2006, underwriting standards on subprime loans became progressively worse with each successive month, with debt-to-income ratios rising from 46% in May to 47% in June.\(^\text{10}\)

Reliance on Teaser Interest Rates. One of the practices was underwriting borrowers at a “teaser” discounted interest rate on an adjustable rate mortgage (ARM), not on the rate at which the loan would, soon after the loan closed, adjust to – often leaving the borrower with an inability to afford the new payment.

Shoddy Appraisals. As the volume of originations got so big, property appraisals were often shoddy and over-inflated, and many lenders and/or funders did not properly review or question them.

Lax Lending by Builder Affiliates. In an effort to sell newly constructed houses, lender affiliates of builders often engaged in lax underwriting by permitting combinations of the above.

Predatory Lending Tactics

Risky Products. In many cases, the loan products themselves might have been inherently too risky for many borrowers. This is particularly true of loans products that were originally designed for certain borrowers with higher risk tolerance, but which were then marketed to other types of borrowers with an inability to manage or absorb higher risk.

Case Study – Option ARM Loans. One example of over-marketing a loan product that was perfectly well-suited for some borrowers under the right market conditions is the Option ARM loan. An "option ARM" is a loan where the borrower has the option of making either a specified minimum payment, an interest-only payment, or a 15-year or 30-year fixed rate payment in a given month. Option ARMs became popular in the last few years because they were usually offered with a very low initial “teaser” interest rate and a low minimum payment, which permitted borrowers to qualify for a much larger loan than would otherwise be possible. However, rather than underwriting a loan applicant’s suitability for an Option ARM at the fully-indexed rate, borrowers were placed into these loans based on their ability to pay only the “teaser” rate. Moreover, while Option ARMs were best suited to people in fields with sporadic income, such as some self-employed people or those in a highly seasonal business, they were often marketed to anyone with a desire to take advantage of its low minimum-payment. In addition, they were often marketed to people with such high debt-to-income ratios that they could never afford payments at a fully-indexed interest rate. Moreover, the Option ARM has the potential for negative amortization, in which the loan will not pay off within the 15- or 30-year term. As with any loan with potential negative amortization, the increased loan balance will reduce or eliminate the borrower's equity in the

\(^\text{10}\) Mortgage Bankers Association®. Note: The traditional “prime” standard of 28% front-end and 36% back-end ratios had become increasingly rare due to the “credit orientation” of society in general.
Causes of the Present Problem (continued)

financed property, or if the value of the property declines, increase the chance that the borrower won't be able to sell the property for an amount that will repay the loan.

Up-Pricing “Prime” Borrowers. Many homeowners whose credit scores entitled them to a “prime” rate mortgage loan were sold “subprime” rate loan products. In some cases, this was the result of affinity fraud through ethnic, religious or other social relationships common to the borrower and the loan officer. However, this could not have occurred in such numbers without negligent or complicit underwriting standards.

Wall Street’s Role
Globalization of the capital markets and unprecedented liquidity brought eager investors who found their way to the secondary market. Knowing this, private equity firms and hedge funds – looking for ever-higher yields – encouraged riskier subprime loans. Investor assessment of risk was often corrupted by inconsistent standards among originating lenders. But with no liability as loan assignees, private equity firms and hedge funds had no incentive to engage in sounder underwriting. Wall Street relied on risk-taking models previously foreign to mortgage lending, ignoring the fundamental 3 C’s of credit – creditworthiness, capacity and collateral. As Wall Street made money easy, non-institutional lenders and mortgage brokers – whose only stake was fees – were encouraged to make even riskier loans.
State and Federal Regulatory Roles

Residential Mortgage Regulation

Underlying Features of Residential Mortgage Regulation. Federal agencies often have different missions which can lead to competing agendas – in part reflecting intense competition and occasional animosity among the different types of financial institutions which they each serve. Laws and regulations – both federal and state – have not kept pace with the explosive growth and innovation in the residential lending industry. The result of federal-state conflict, federal inter-agency tension, and the pace of innovation in the private sector has become a tangled web of rulemaking, supervision and enforcement.

Federal vs. State Regulation. Actual jurisdiction to supervise and enforce residential lending compliance policy lies chiefly with only 5 federal agencies, each with its own “turf” over often-competing industries. With the Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS) and National Credit Union Administration (NCUA) asserting sole jurisdiction over federally chartered operating subsidiaries (and even “exclusive agents”), the OCC, OTS and NCUA have predominant influence over residential lending compliance in the U.S. Washington State (like the majority of other states) is equipped to perform the bulk of regulation of residential lending compliance laws and regulations, since Washington State routinely enforces the 13 major federal statutes and/or regulations in this area, plus 8 state licensing and enforcement statutes of its own. In contrast to the 12 federal agencies regulating this field, Washington State enforces federal and state policy through only 4 state agencies: Attorney General’s Office (AGO), the Department of Financial Institutions (DFI), Department of Licensing (DOL), and Office of Insurance Commissioner (OIC). When the enforcement power of Department of Housing & Urban Development (HUD) and the Federal Trade Commission (FTC) are added to the equation, coupled with the indirect supervision of the Federal Financial Institutions Examination Council (FFIEC) and the indirect enforcement authority of the Department of Justice (DOJ) over anti-discrimination prosecutions, it appears as if the federal agencies have a near “lock” on residential lending supervision and enforcement.

Also, beginning in 1997, the OCC and OTS declared that state regulators cannot regulate, examine or investigate national banks, federal thrifts, their operating subsidiaries, and (in the case of Federal thrifts) their “exclusive agents.” A huge concentration of the national market, including the largest federally chartered banks and thrifts, has, with the help of this new federal policy, been given a “safe harbor” from state consumer protection regulation and enforcement. Federal banking regulators claim that these banks, thrifts and their operating subsidiaries are preempted from state regulation and have recently won narrow but important victories in the courts. See Wachovia v. Watters (U.S. Supreme Court – 2007). Since 1999, financial services holding companies have entered the market through relationships between their thousands of respective agents and federal thrift charter affiliates, also claiming federal preemption for their independent agents.
State and Federal Regulatory Roles (continued)

The “Tangled Web” of Regulation

Major Laws – Regulations


- **Washington State.** Consumer Loan Act (Ch. 31.04 RCW), Consumer Protection Act (Ch. 19.86 RCW), Escrow Agent Registration Act (Ch. 18.44 RCW), Mortgage Broker Practices Act (Ch. 19.146 RCW), Mortgage Loan Servicing (Ch. 19.148 RCW), Real Estate Brokers Act (Ch. 18.85 RCW), Title Insurers (Ch. 48.29 RCW), Certified Real Estate Appraiser Act (Ch. 18.140 RCW).

Major Agencies

- **Federal.** Department of Justice (DOJ), Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board (FRB), Federal Financial Institutions Examination Council (FFIEC), Federal Trade Commission (FTC), Department of Housing & Urban Development (HUD), National Credit Union Administration (NCUA), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS).

- **State.** Attorney General’s Office (AGO), the Department of Financial Institutions (DFI), Department of Licensing (DOL) and Office of Insurance Commissioner (OIC).
State and Federal Regulatory Roles (continued)
State and Federal Regulatory Roles (continued)

Washington Mortgage Regulation

Regulation of State-Chartered Financial Institutions. The Department of Financial Institutions regulates state-chartered commercial banks (Title 30 RCW), savings banks (Title 32 RCW) and credit unions (Ch. 31.12 RCW). All of the institutions originate and/or fund some residential mortgage loans directly and/or through mortgage brokers. As of June 30, 2007, the overall delinquency rate for Washington State-chartered commercial and savings banks (by number of loans) was less than one-half of 1% (0.42%), and the delinquency rate for Washington State-chartered credit unions was only one-half of 1% (0.5%). This compares with 0.93% delinquency rate in Washington State for all reported loans and a 2.47% nationwide as of June 30, 2007.

Licensing and Regulation of Mortgage Brokers and Loan Originators. The Department of Financial Institutions licenses, examines and regulates mortgage brokers and individual loan originators working for mortgage brokers under the Mortgage Broker Practices Act (MBPA, Ch. 19.146 RCW) for their compliance with federal and state consumer protection laws and regulations. With recent amendments to the MBPA initiated by Washington Association of Mortgage Brokers (WAMB) and authored by the Department of Financial Institutions, we have 15,300 applicants for the Loan Originator license. With 70% of loans nationwide being originated by mortgage brokers, this is the area where the Department of Financial Institutions has the most authority and opportunity to make a difference in helping to solve the subprime problem.

Licensing and Regulation of Some Mortgage Lenders. Even if a non-bank mortgage lender is exempt from mortgage broker licensing, the lender is still subject to the jurisdiction of the Department of Financial Institutions for prohibited practices set forth in the MBPA unless it is an operating subsidiary of a national bank or federal thrift. The Department of Financial Institutions conducts investigations and administratively prosecutes these exempt mortgage lenders who commit consumer protection violations. In addition, the Department of Financial Institutions licenses, examines and regulates consumer loan companies under the Consumer Loan Act (Ch. 31.04 RCW). These companies obtain a license from the Department of Financial Institutions for the privilege of making loans above 12% -- which means that these consumer loan companies almost always make subprime loans. However, because several consumer loan companies that were once the Department of Financial Institutions’ licensees are national bank or federal thrift operating subsidiaries, they are no longer subject to the Department of Financial Institutions’ examination and enforcement jurisdiction because of federal preemption.
Section Three

The following comments reflect the views of individual members of the Task Force.

The following text is added to the report by the Task Force members who support additional reforms, including the strengthening of the accountability of lenders and mortgage brokers to their customers:

The Task Force has taken significant steps to recognize important ways that lenders and mortgage brokers can provide responsible and fair mortgages. Many of these are listed in the Best Practices sections (III and IV) of the report, as well as in the adoption of guidance on nontraditional and sub-prime mortgages section (VII). Many of our colleagues on the Task Force and throughout the industry voluntarily exercise good lending practices, yet we believe all loan originators should adhere to the same basic standards.

Therefore, we recommend state policymakers should, within the limits of Constitutional law, promulgate regulatory reforms that require sound underwriting practices and full disclosure, eliminate harmful loan products, and enable borrowers to defend against their homes being taken by illegal and unethical practices.

A fundamental component of reform is to require that lenders and mortgage brokers have fiduciary responsibility to their customers. Homeowners have suffered from misplacing their trust in the hands of the minority of mortgage brokers and lenders whose interest is maximizing their profits without regard to the consequences to their customers. As a result, some homeowners who qualified for traditional low cost mortgages have been sold expensive sub prime loan products because of the much larger fees they generated for the brokers. Other homeowners have actually lost their homes through various financing schemes perpetuated by disreputable brokers willing to profit from the homeowner’s loss.

While most brokers and lenders watch out for the interests of their customers, unfortunately those that do not may attempt to shield themselves from customer complaints because their duty to customers is limited under Washington law. (See, Mortgage Brokers in Washington and the Limits of Imposing Fiduciary Duty, prepared by the Department of Financial Institutions and dated November 15, 2007. See Addendum Pages 86-88.) Accordingly, because brokers market their services with the claim that they have products that are in the best interest of homeowners and home buyers, all independent mortgage brokers should have a duty to their customers. More specifically, this duty to Washington homeowners and home buyers should be a fiduciary duty as is the case in California, or the duty should be clearly specified by statues as it is in Minnesota.

Finally, it is important to note that making it clear that mortgage brokers have a duty to their customers, as is already the case for real estate agents and lawyers, is a tool that can provide increased homeowner security without increased taxes.

Fred Corbit
Kim Herman
David Main
Tricia McKay
Sharon Nelson
Aiko Schaefer
Member Comments continued

The following draft legislation is being submitted by the Washington State Housing Finance Commission. This bill is an example of legislation relevant to Task Force recommendation 4 of subsection 2 (see pages 8 and 13).

BILL REQUEST - CODE REVISER'S OFFICE

BILL REQ. #:  H-3961.1/08
ATTY/TYPIST:  BP:cro

BRIEF DESCRIPTION: Creating a smart homeownership choices program.

AN ACT Relating to a smart homeownership choices program; adding new sections to chapter 43.320 RCW; and making an appropriation.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

NEW SECTION. Sec. 1) A new section is added to chapter 43.320 RCW to read as follows:
(1) The smart homeownership choices program is created in the department to prevent predatory lending, prevent foreclosures, and provide prepurchase and postpurchase homeownership education and counseling to low and moderate-income households as defined in RCW 84.14.010.
(2) The Washington state housing finance commission shall administer the program with moneys from the account created in section 2 of this act pursuant to an interagency agreement with the department. The commission may request funds from the department as needed to implement and operate the program.
(3)(a) The Washington state housing finance commission shall provide grants to nonprofit organizations and governmental entities that have experience providing prehomeownership and posthomeownership education and counseling to low and moderate-income persons for the
purpose of preventing predatory lending, preventing foreclosures, and promoting responsible and successful homeownership activities in their local communities. A priority for grants must be given to organizations and governmental entities serving minority and multilingual communities. Moneys may also be used by the commission, under terms and conditions to be determined by the commission, to assist homeowners who are delinquent on their mortgage payments to bring their mortgage payments current in order to become eligible to refinance into a different loan product. Moneys may also be used for outreach activities to raise awareness of this program. Not more than four percent of the total appropriation for this program may be used for administrative expenses of the department and the commission.

(b) Amounts appropriated from the state general fund for deposit into the account created in section 2 of this act may only be used to serve low-income households as defined in RCW 84.14.010. Contributions for the program from private and other nonstate sources may be used to serve both low and moderate-income households as defined in RCW 84.14.010.

(4) The Washington state housing finance commission must provide an annual report to the legislature at the end of each fiscal year of program operation. The report must include performance measures, including measures to gauge program efficiency and effectiveness and customer satisfaction. The report must also include information including: The total number of households served; the percentage of program participants who successfully purchased homes; information on the terms of financing obtained by program participant homebuyers; information about participant homebuyers who receive housing finance assistance from the federal or state government or the commission; the number of program participants that elected not to purchase homes; the number of program participants seeking help to resolve mortgage delinquency; the number of program participants that successfully avoided foreclosure; and the number of program participants who refinanced a home, including information on the terms of both the new loan product and the product out of which the homeowner refinanced.
NEW SECTION. Sec. 2) A new section is added to chapter 43.320 RCW to read as follows:

The smart homeownership choices program account is created in the custody of the state treasurer. All receipts from the amounts appropriated for the smart homeownership choices program created in section 1 of this act and all receipts from private contributions and other sources that are specifically designated for the program must be deposited into the account. Expenditures from the account may be used solely for the purpose of preventing predatory lending, preventing foreclosures, and providing homeownership education and counseling through the smart homeownership choices program as described in section 1 of this act. Only the director of the department of financial institutions or the director's designee may authorize expenditures from the account. The account is subject to allotment procedures under chapter 43.88 RCW, but an appropriation is not required for expenditures.

NEW SECTION. Sec. 3) The sum of one million six hundred thousand dollars is appropriated for the fiscal year ending June 30, 2008, from the general fund solely for deposit in the smart homeownership choices program account created in section 2 of this act for the purposes of this act.
Section Four

Appendices: The final pieces
Appendices

This appendix contains supplemental graphs and tables, as follows:

Current Delinquency Data

The following current delinquency data is offered here -- a second time in the report -- on a single sheet, in an effort to make the information easier to locate and use.

NATIONWIDE DELINQUENCIES AS OF SEPTEMBER 30, 2007

<table>
<thead>
<tr>
<th></th>
<th>ALL PAST DUE*</th>
<th>SERIOUSLY DELINQUENT*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>MBA Reported</td>
<td>Adjusted Est.***</td>
</tr>
<tr>
<td>All Loans</td>
<td>45,417,215</td>
<td>2,638,740</td>
</tr>
<tr>
<td>Subprime ARM</td>
<td>2,959,267</td>
<td>579,720</td>
</tr>
<tr>
<td>Subprime Fixed</td>
<td>2,751,751</td>
<td>351,399</td>
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<tr>
<td>Prime ARM</td>
<td>6,346,076</td>
<td>334,438</td>
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<tr>
<td>Prime Fixed</td>
<td>27,559,715</td>
<td>738,600</td>
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<tr>
<td>FHA</td>
<td>3,089,370</td>
<td>417,883</td>
</tr>
<tr>
<td>VA</td>
<td>1,112,903</td>
<td>76,456</td>
</tr>
</tbody>
</table>

* 30 Days or More Past Due. ** 90+ Days Past Due or Foreclosure Pending.
***ASSUMPTION: Total nationwide loans reporting to MBA (both current & delinquent) were 45,417,215. Based upon the assumption that this represents 80% of the estimated national total (as estimated by Mortgage Bankers Association®), the adjusted estimate would be 56,770,000.

Where Does Washington Stand?

In contrast to the picture nationwide, Washington State is substantially below the national delinquency rates for all types of loans – both for serious delinquent loans and all past due loans. However, the delinquency rates, especially in the area of subprime ARM loans, should be monitored closely, even in Washington State. For all past due subprime ARM loans, Washington had a delinquency rate by 3rd QTR 2007 of 12.91% (compared with 19.59% nationwide). For seriously delinquent loans (i.e., loans 90+days past due or in foreclosure), the Washington delinquency rate on subprime ARM loans was 7.10% (compared with 15.63% nationwide). Moreover, even FHA loans in Washington (with their stricter underwriting standards) had a delinquency rate for the period of 8.46% (compared with 13.52% nationwide). With these trends likely to get worse before they get better – particularly as the interest rates on many subprime ARM loans reset – Washingtonians should remain watchful.

WASHINGTON STATE DELINQUENCY AS OF SEPTEMBER 30, 2007

<table>
<thead>
<tr>
<th></th>
<th>ALL PAST DUE*</th>
<th>SERIOUSLY DELINQUENT**</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>MBA Reported</td>
<td>Adjusted Est.***</td>
</tr>
<tr>
<td>All Loans</td>
<td>1,204,416</td>
<td>36,012</td>
</tr>
<tr>
<td>Subprime ARM</td>
<td>70,186</td>
<td>9,061</td>
</tr>
<tr>
<td>Subprime Fixed</td>
<td>50,072</td>
<td>4,136</td>
</tr>
<tr>
<td>Prime ARM</td>
<td>208,636</td>
<td>5,758</td>
</tr>
<tr>
<td>Prime Fixed</td>
<td>777,619</td>
<td>10,576</td>
</tr>
<tr>
<td>FHA</td>
<td>48,824</td>
<td>4,131</td>
</tr>
<tr>
<td>VA</td>
<td>37,556</td>
<td>1,821</td>
</tr>
</tbody>
</table>

* 30 Days or More Past Due. ** 90+ Days Past Due or Foreclosure Pending.
***ASSUMPTION: Total Washington State loans reporting to MBA (both current & delinquent) were 1,204,416. Based upon the assumption that this represents 80% of the estimated total, the adjusted estimate would be 1,505,550.
Current Delinquency Data (continued)

Nonetheless, according to the 3rd QTR 2007 MBA Delinquency Survey, Washington State – in comparison with all other states – ranked near the bottom in terms of delinquencies and pending foreclosures. When measuring total loans past due by state, Mississippi was highest with 10.6% total past due loans; while Washington State (ranked 46th in this category among the states), had only 2.99% in total past due loans. Of the seriously delinquent loan (90+ days past due or pending foreclosure), Ohio ranked highest with 5.44% total past due; while Washington State (ranked 48th) had only 1.12% in overall past due loans. Even in the riskier area of subprime ARM loans, Washington State ranked near the bottom. Mississippi had the highest percentage of total past due subprime ARM loans (at 30.16%), while Washington State (ranked 46th among the states) had 12.91% total past due subprime ARM loans. And in the category of seriously delinquent subprime ARM loans, Washington State ranked 48th among the states, with only 7.1% compared with highest ranking OHIO, at 25.67%.

In terms of actual numbers (see assumptions above), Washington State had an estimated number of total past due loans in all categories for 3rd QTR 2007 of about 45,000, nearly 17,000 loans seriously delinquent. In the area of subprime ARM loans, Washington State had an estimated 11,326 loans past due, with an estimated 6,229 seriously delinquent. This is significantly at variance with the magnitude of the problem nationwide and in practically all other states.

The Department of Financial Institutions has analyzed subprime loan volume data for select Standard Metropolitan Statistical Areas in Washington State based upon the most recent available data. These data are included in Appendices, attached, at Pages 58-65.
Historical Delinquency Data

Source: FDIC
Historical Delinquency Data (continued)

Conventional Subprime Mortgage Delinquencies, Washington

Source: FDIC
Historical Delinquency Data (continued)

Source: FDIC
Historical Delinquency Data (continued)

Source: FDIC
Historical Delinquency Data (continued)

Source: FDIC
Source: FDIC
HMDA-Reported Higher-Priced Loan Data

**NUMBER OF HMDA-REPORTED HIGHER-PRICED* LOANS IN WASHINGTON STATE (2006)**

* A Higher-Priced loan is one in which the loan's rate spread exceeds a threshold set by the Federal Reserve Board in regulation C, the regulations that implement the Home Mortgage Disclosure Act (HMDA). For first-lien loans, the threshold is three percentage points above the Treasury security of comparable maturity. For second-lien loans the threshold is five percentage points above the Treasury security of comparable maturity.

**HMDA-REPORTED HIGHER-PRICED* LOANS AS A PERCENTAGE OF TOTAL OF HMDA-REPORTED MORTGAGES IN WASHINGTON STATE (2006)**

* A Higher-Priced loan is one in which the loan's rate spread exceeds a threshold set by the Federal Reserve Board in regulation C, the regulations that implement the Home Mortgage Disclosure Act (HMDA). For first-lien loans, the threshold is three percentage points above the Treasury security of comparable maturity. For second-lien loans the threshold is five percentage points above the Treasury security of comparable maturity.
HMDA-REPORTED HIGHER-PRICED* LOANS AS A PERCENTAGE OF TOTAL HMDA-REPORTED MORTGAGE LOANS ORIGINATED IN WASHINGTON STATE (2006)

* A Higher-Priced loan is one in which the loan's rate spread exceeds a threshold set by the Federal Reserve Board in regulation C, the regulations that implement the Home Mortgage Disclosure Act (HMDA). For first-lien loans, the threshold is three percentage points above the Treasury security of comparable maturity. For second-lien loans the threshold is five percentage points above the Treasury security of comparable maturity.

HMDA-REPORTED HIGHER-PRICED* LOAN VOLUME IN WASHINGTON STATE (2006) (IN MILLIONS)

* A Higher-Priced loan is one in which the loan's rate spread exceeds a threshold set by the Federal Reserve Board in regulation C, the regulations that implement the Home Mortgage Disclosure Act (HMDA). For first-lien loans, the threshold is three percentage points above the Treasury security of comparable maturity. For second-lien loans the threshold is five percentage points above the Treasury security of comparable maturity.
Higher-Priced Loan Origination Profiles: WA Cities

**Higher-Priced* Loan Origination Profile for Washington State 2006**

**Bellingham**

- Loans Originated: 1,769
- % of Total Mortgages: 17.7%
- High-Rate Loan Volume (millions): $294
- % of Total Mortgage Volume: 10.2%

* A Higher-Priced loan is one in which the loan’s rate spread exceeds a threshold set by the Federal Reserve Board in regulation c of the regulations that implement the Home Mortgage Disclosure Act (HMDA). For first-lien loans, the threshold is three percentage points above the Treasury security of comparable maturity. For second-lien loans, the threshold is five percentage points above the Treasury security of comparable maturity.

**Higher-Priced* Loan Origination Profile for Washington State 2006**

**Bremerton - Silverdale**

- Loans Originated: 3,239
- % of Total Mortgages: 22.3%
- High-Rate Loan Volume (millions): $475
- % of Total Mortgage Volume: 19.7%

* A Higher-Priced loan is one in which the loan’s rate spread exceeds a threshold set by the Federal Reserve Board in regulation c of the regulations that implement the Home Mortgage Disclosure Act (HMDA). For first-lien loans, the threshold is three percentage points above the Treasury security of comparable maturity. For second-lien loans, the threshold is five percentage points above the Treasury security of comparable maturity.
Higher-Priced Loan Origination Profiles: WA Cities

Higher-Priced* Loan Origination Profile for Washington State 2006
Kennewick - Richland

Kennewick-Richland
Loans Originated: 2,489
% of Total Mortgages: 24.9%
High-Rate Loan Volume (millions): $229
% of Total Mortgage Volume: 19.4%

* A Higher-Priced loan is one in which the loan's rate spread exceeds a threshold set by the Federal Reserve Board in regulation c, the regulations that implement the Home Mortgage Disclosure Act (HMDA). For first-lien loans, the threshold is three percentage points above the Treasury security of comparable maturity. For second-lien loans, the threshold is five percentage points above Treasury security of comparable maturity.

Higher-Priced* Loan Origination Profile for Washington State 2006
Longview

Longview
Loans Originated: 1,845
% of Total Mortgages: 30.1%
High-Rate Loan Volume (millions): $210
% of Total Mortgage Volume: 27.2%

* A Higher-Priced loan is one in which the loan's rate spread exceeds a threshold set by the Federal Reserve Board in regulation c, the regulations that implement the Home Mortgage Disclosure Act (HMDA). For first-lien loans, the threshold is three percentage points above the Treasury security of comparable maturity. For second-lien loans, the threshold is five percentage points above Treasury security of comparable maturity.
Higher-Priced Loan Origination Profiles: WA Cities

**Higher-Priced* Loan Origination Profile for Washington State 2006**

**Olympia**

- Loans Originated: 3,660
- % of Total Mortgages: 24.7%
- High-Rate Loan Volume (millions): $856
- % of Total Mortgage Volume: 20.7%

* A Higher-Priced loan is one in which the loan’s rate spread exceeds a threshold set by the Federal Reserve Board in Regulation C, the regulations that implement the Home Mortgage Disclosure Act (HMDA). For first-lien loans, the threshold is three percentage points above the Treasury security of comparable maturity. For second-lien loans the threshold is five percentage points above Treasury security of comparable maturity.

**Higher-Priced* Loan Origination Profile for Washington State 2006**

**Seattle - Bellevue - Everett**

- Loans Originated: 54,649
- % of Total Mortgages: 21.6%
- High-Rate Loan Volume (millions): $7,872
- % of Total Mortgage Volume: 17.3%

* A Higher-Priced loan is one in which the loan’s rate spread exceeds a threshold set by the Federal Reserve Board in Regulation C, the regulations that implement the Home Mortgage Disclosure Act (HMDA). For first-lien loans, the threshold is three percentage points above the Treasury security of comparable maturity. For second-lien loans the threshold is five percentage points above Treasury security of comparable maturity.
Higher-Priced Loan Origination Profiles: WA Cities

Higher-Priced* Loan Origination Profile for Washington State 2006
Spokane

* A Higher-Priced loan is one in which the loan’s rate spread exceeds a threshold set by the Federal Reserve Board in regulation c, the regulations that implement the Home Mortgage Disclosure Act (HMDA). For first-lien loans, the threshold is three percentage points above the Treasury security of comparable maturity. For second-lien loans, the threshold is five percentage points above the Treasury security of comparable maturity.

Higher-Priced* Loan Origination Profile for Washington State 2006
Tacoma

* A Higher-Priced loan is one in which the loan’s rate spread exceeds a threshold set by the Federal Reserve Board in regulation c, the regulations that implement the Home Mortgage Disclosure Act (HMDA). For first-lien loans, the threshold is three percentage points above the Treasury security of comparable maturity. For second-lien loans, the threshold is five percentage points above the Treasury security of comparable maturity.
Higher-Priced Loan Origination Profiles: WA Cities

Higher-Priced* Loan Origination Profile for Washington State 2006
Mount Vernon - Anacortes

Mount Vernon - Anacortes
Loans Originated: 1,465
% of Total Mortgages: 26.1%
High-Rate Loan Volume (millions): $236
% of Total Mortgage Volume: 21.2%

* A Higher-Priced loan is one in which the loan’s rate spread exceeds a threshold set by the Federal Reserve Board in regulation c, the regulations that implement the Home Mortgage Disclosure Act (HMDA). For first-lien loans, the threshold is three percentage points above the Treasury security of comparable maturity. For second-lien loans the threshold is five percentage points above Treasury security of comparable maturity.

Higher-Priced* Loan Origination Profile for Washington State 2006
Wenatchee

Wenatchee
Loans Originated: 1,334
% of Total Mortgages: 22.1%
High-Rate Loan Volume (millions): $167
% of Total Mortgage Volume: 18.8%

* A Higher-Priced loan is one in which the loan’s rate spread exceeds a threshold set by the Federal Reserve Board in regulation c, the regulations that implement the Home Mortgage Disclosure Act (HMDA). For first-lien loans, the threshold is three percentage points above the Treasury security of comparable maturity. For second-lien loans the threshold is five percentage points above Treasury security of comparable maturity.
Higher-Priced Loan Origination Profiles: WA Cities

Higher-Priced* Loan Origination Profile for Washington State 2006
Yakima

Yakima
Loans Originated: 2,272
% of Total Mortgages: 29.6%
High-Rate Loan Volume (millions): $219
% of Total Mortgage Volume: 23.8%

* A Higher-Priced loan is one in which the loan's rate spread exceeds a threshold set by the Federal Reserve Board in regulation c, the regulations that implement the Home Mortgage Disclosure Act (HMDA). For first-lien loans, the threshold is three percentage points above the Treasury security of comparable maturity. For second-lien loans the threshold is five percentage points above Treasury security of comparable maturity.
Addendum

Conference Of State Bank Supervisors
American Association Of Residential Mortgage Regulators
Guidance on Nontraditional Mortgage Product Risks

I. Introduction

On October 4, 2006, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) (collectively, the Agencies) published final guidance in the Federal Register (Volume 71, Number 192, Page 58609-58618) on nontraditional mortgage product risks ("interagency guidance"). The interagency guidance applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

Recognizing that the interagency guidance does not cover a majority of loan originations, on June 7, 2006 the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) announced their intent to develop parallel guidance. Both CSBS and AARMR strongly support the purpose of the guidance adopted by the Agencies and are committed to promote uniform application of its consumer protections for all borrowers.

The following guidance will assist state regulators of mortgage brokers and mortgage companies (referred to as “providers”) not affiliated with a bank holding company or an insured financial institution to promote consistent regulation in the mortgage market and clarify how providers can offer nontraditional mortgage products in a way that clearly discloses the risks that borrowers may assume.

In order to maintain regulatory consistency, this guidance substantially mirrors the interagency guidance, except for the deletion of sections not applicable to non-depository institutions.

II. Background

The Agencies developed their guidance to address risks associated with the growing use of mortgage products that allow borrowers to defer payment of principal and, sometimes, interest. These products, referred to variously as “nontraditional,” “alternative,” or “exotic” mortgage loans (hereinafter referred to as nontraditional mortgage loans), include “interest-only” mortgages and “payment option” adjustable-rate mortgages. These products allow borrowers to exchange lower payments during an initial period for higher payments during a later amortization period.
While similar products have been available for many years, the number of institutions and providers offering them has expanded rapidly. At the same time, these products are offered to a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgages. CSBS and AARMR are concerned that some borrowers may not fully understand the risks of these products. While many of these risks exist in other adjustable-rate mortgage products, the concern of CSBS and AARMR is elevated with nontraditional products because of the lack of principal amortization and potential for negative amortization. In addition, providers are increasingly combining these loans with other features that may compound risk. These features include simultaneous second-lien mortgages and the use of reduced documentation in evaluating an applicant’s creditworthiness.

III. Text Of Final CSBS-AARMR Guidance

The text of the final CSBS-AARMR Guidance on Nontraditional Mortgage Product Risks follows:

CSBS-AARMR Guidance On Nontraditional Mortgage Product Risks

Residential mortgage lending has traditionally been a conservatively managed business with low delinquencies and losses and reasonably stable underwriting standards. In the past few years consumer demand has been growing, particularly in high priced real estate markets, for closed-end residential mortgage loan products that allow borrowers to defer repayment of principal and, sometimes, interest. These mortgage products, herein referred to as nontraditional mortgage loans, include such products as “interest-only” mortgages where a borrower pays no loan principal for the first few years of the loan and “payment option” adjustable-rate mortgages (ARMs) where a borrower has flexible payment options with the potential for negative amortization.¹

While some providers have offered nontraditional mortgages for many years with appropriate risk management, the market for these products and the number of providers offering them has expanded rapidly. Nontraditional mortgage loan products are now offered by more lenders to a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgage loans and may not fully understand the associated risks.

Many of these nontraditional mortgage loans are underwritten with less stringent income and asset verification requirements (“reduced documentation”) and are increasingly combined with simultaneous second-lien loans.² Such risk layering, combined with the broader marketing of nontraditional mortgage loans, exposes providers to increased risk relative to traditional mortgage loans.

¹ Interest-only and payment option ARMs are variations of conventional ARMs, hybrid ARMs, and fixed rate products. Refer to the Appendix for additional information on interest-only and payment option ARM loans. This guidance does not apply to reverse mortgages; home equity lines of credit (“HELOCs”), other than as discussed in the Simultaneous Second-Lien Loans section; or fully amortizing residential mortgage loan products.

² Refer to the Appendix for additional information on reduced documentation and simultaneous second-lien loans.
Given the potential for heightened risk levels, management should carefully consider and appropriately mitigate exposures created by these loans. To manage the risks associated with nontraditional mortgage loans, management should:

- Ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower’s repayment capacity; and
- Ensure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product choice.

The Washington State Department of Financial Institutions expects providers to effectively assess and manage the risks associated with nontraditional mortgage loan products.

Providers should use this guidance to ensure that risk management practices adequately address these risks. The Washington State Department of Financial Institutions will carefully scrutinize risk management processes, policies, and procedures in this area. Providers that do not adequately manage these risks will be asked to take remedial action.

The focus of this guidance is on the higher risk elements of certain nontraditional mortgage products, not the product type itself. Providers with sound underwriting, and adequate risk management will not be subject to criticism merely for offering such products.

**Loan Terms and Underwriting Standards**

When a provider offers nontraditional mortgage loan products, underwriting standards should address the effect of a substantial payment increase on the borrower’s capacity to repay when loan amortization begins.

Central to prudent lending is the internal discipline to maintain sound loan terms and underwriting standards despite competitive pressures. Providers are strongly cautioned against ceding underwriting standards to third parties that have different business objectives, risk tolerances, and core competencies. Loan terms should be based on a disciplined analysis of potential exposures and compensating factors to ensure risk levels remain manageable.

**Qualifying Borrowers** — Payments on nontraditional loans can increase significantly when the loans begin to amortize. Commonly referred to as payment shock, this increase is of particular concern for payment option ARMs where the borrower makes minimum payments that may result in negative amortization. Some providers manage the potential for excessive negative amortization and payment shock by structuring the initial terms to limit the spread between the introductory interest rate and the fully indexed rate. Nevertheless, a provider’s qualifying standards should recognize the potential impact of payment shock, especially for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores. Recognizing that a provider’s underwriting criteria are based on multiple factors, a provider should consider these factors jointly in the qualification process and may develop a range of reasonable tolerances for each factor. However, the criteria should be based upon prudent and appropriate underwriting standards, considering both the borrower’s characteristics and the product’s attributes.
For all nontraditional mortgage loan products, a provider’s analysis of a borrower’s repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate,\(^3\) assuming a fully amortizing repayment schedule.\(^4\) In addition, for products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision.\(^5\)

Furthermore, the analysis of repayment capacity should avoid over-reliance on credit scores as a substitute for income verification in the underwriting process. The higher a loan’s credit risk, either from loan features or borrower characteristics, the more important it is to verify the borrower’s income, assets, and outstanding liabilities.

**Collateral-Dependent Loans** — Providers should avoid the use of loan terms and underwriting practices that may heighten the need for a borrower to rely on the sale or refinancing of the property once amortization begins. Loans to individuals who do not demonstrate the capacity to repay, as structured, from sources other than the collateral pledged may be unfair and abusive.\(^6\) Providers that originate collateral-dependent mortgage loans may be subject to criticism and corrective action.

**Risk Layering** — Providers that originate or purchase mortgage loans that combine nontraditional features, such as interest only loans with reduced documentation or a simultaneous second-lien loan, face increased risk. When features are layered, a provider should demonstrate that mitigating factors support the underwriting decision and the borrower’s repayment capacity. Mitigating factors could include higher credit scores, lower LTV and DTI ratios, significant liquid assets, mortgage insurance or other credit enhancements. While higher pricing is often used to address elevated risk levels, it does not replace the need for sound underwriting.

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3 The fully indexed rate equals the index rate prevailing at origination plus the margin that will apply after the expiration of an introductory interest rate. The index rate is a published interest rate to which the interest rate on an ARM is tied. Some commonly used indices include the 1-Year Constant Maturity Treasury Rate (CMT), the 6-Month London Interbank Offered Rate (LIBOR), the 11th District Cost of Funds (COFI), and the Moving Treasury Average (MTA), a 12-month moving average of the monthly average yields of U.S. Treasury securities adjusted to a constant maturity of one year. The margin is the number of percentage points a lender adds to the index value to calculate the ARM interest rate at each adjustment period. In different interest rate scenarios, the fully indexed rate for an ARM loan based on a lagging index (e.g., MTA rate) may be significantly different from the rate on a comparable 30-year fixed-rate product. In these cases, a credible market rate should be used to qualify the borrower and determine repayment capacity.

4 The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a loan with a 5-year interest only period and a 30-year term would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

5 The balance that may accrue from the negative amortization provision does not necessarily equate to the full negative amortization cap for a particular loan. The spread between the introductory or “teaser” rate and the accrual rate will determine whether or not a loan balance has the potential to reach the negative amortization cap before the end of the initial payment period (usually five years). For example, a loan with a 115 percent negative amortization cap but a small spread between the introductory rate and the accrual rate may only reach a 109 percent maximum loan balance before the end of the initial payment period, even if only minimum payments are made. The borrower could be qualified based on this lower maximum loan balance.

6 A loan will not be determined to be “collateral-dependent” solely through the use of reduced documentation.
**Reduced Documentation** — Providers increasingly rely on reduced documentation, particularly unverified income, to qualify borrowers for nontraditional mortgage loans. Because these practices essentially substitute assumptions and unverified information for analysis of a borrower’s repayment capacity and general creditworthiness, they should be used with caution. As the level of credit risk increases, it is expected that a provider will more diligently verify and document a borrower’s income and debt reduction capacity. Clear policies should govern the use of reduced documentation. For example, stated income should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. For many borrowers, providers generally should be able to readily document income using recent W-2 statements, pay stubs, or tax returns.

**Simultaneous Second-Lien Loans** — Simultaneous second-lien loans reduce owner equity and increase credit risk. Historically, as combined loan-to-value ratios rise, so do defaults. A delinquent borrower with minimal or no equity in a property may have little incentive to work with a lender to bring the loan current and avoid foreclosure. In addition, second-lien home equity lines of credit (HELOCs) typically increase borrower exposure to increasing interest rates and monthly payment burdens. Loans with minimal or no owner equity generally should not have a payment structure that allows for delayed or negative amortization without other significant risk mitigating factors.

**Introductory Interest Rates** — Many providers offer introductory interest rates set well below the fully indexed rate as a marketing tool for payment option ARM products. When developing nontraditional mortgage product terms, a provider should consider the spread between the introductory rate and the fully indexed rate. Since initial and subsequent monthly payments are based on these low introductory rates, a wide initial spread means that borrowers are more likely to experience negative amortization, severe payment shock, and an earlier-than-scheduled recasting of monthly payments. Providers should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates.

**Lending to Subprime Borrowers** — Providers of mortgage programs that target subprime borrowers through tailored marketing, underwriting standards, and risk selection should ensure that such programs do not feature terms that could become predatory or abusive. They should also recognize that risk-layering features in loans to subprime borrowers may significantly increase risks for both the provider and the borrower.

**Non-Owner-Occupied Investor Loans** — Borrowers financing non-owner-occupied investment properties should qualify for loans based on their ability to service the debt over the life of the loan. Loan terms should reflect an appropriate combined LTV ratio that considers the potential for negative amortization and maintains sufficient borrower equity over the life of the loan. Further, underwriting standards should require evidence that the borrower has sufficient cash reserves to service the loan, considering the possibility of extended periods of property vacancy and the variability of debt service requirements associated with nontraditional mortgage loan products.
Risk Management Practices

Providers should ensure that risk management practices keep pace with the growth of nontraditional mortgage products and changes in the market. Providers that originate or invest in nontraditional mortgage loans should adopt more robust risk management practices and manage these exposures in a thoughtful, systematic manner. To meet these expectations, providers should:

- Develop written policies that specify acceptable product attributes, production, sales and securitization practices, and risk management expectations; and
- Design enhanced performance measures and management reporting that provide early warning for increasing risk.

Policies — A provider’s policies for nontraditional mortgage lending activity should set acceptable levels of risk through its operating practices and policy exception tolerances. Policies should reflect appropriate limits on risk layering and should include risk management tools for risk mitigation purposes. Further, a provider should set growth and volume limits by loan type, with special attention for products and product combinations in need of heightened attention due to easing terms or rapid growth.

Concentrations — Providers with concentrations in nontraditional mortgage products should have well-developed monitoring systems and risk management practices. Further, providers should consider the effect of employee and third party incentive programs that could produce higher concentrations of nontraditional mortgage loans. Concentrations that are not effectively managed will be subject to elevated supervisory attention and potential examiner criticism to ensure timely remedial action.

Controls — A provider’s quality control, compliance, and audit procedures should focus on mortgage lending activities posing high risk. Controls to monitor compliance with underwriting standards and exceptions to those standards are especially important for nontraditional loan products. The quality control function should regularly review a sample of nontraditional mortgage loans from all origination channels and a representative sample of underwriters to confirm that policies are being followed. When control systems or operating practices are found deficient, business-line managers should be held accountable for correcting deficiencies in a timely manner.

Third-Party Originations — Providers often use third parties, such as mortgage brokers or correspondents, to originate nontraditional mortgage loans. Providers should have strong systems and controls in place for establishing and maintaining relationships with third parties, including procedures for performing due diligence. Oversight of third parties should involve monitoring the quality of originations so that they reflect the provider’s lending standards and compliance with applicable laws and regulations.

Monitoring procedures should track the quality of loans by both origination source and key borrower characteristics. This will help providers identify problems such as early payment defaults, incomplete documentation, and fraud. If appraisal, loan documentation, credit problems or consumer complaints are discovered, the provider should take immediate action. Remedial action could include more thorough application reviews, more frequent re-underwriting, or even termination of the third-party relationship.
Secondary Market Activity — The sophistication of a provider’s secondary market risk management practices should be commensurate with the nature and volume of activity. Providers with significant secondary market activities should have comprehensive, formal strategies for managing risks. Contingency planning should include how the provider will respond to reduced demand in the secondary market.

While third-party loan sales can transfer a portion of the credit risk, a provider remains exposed to reputation risk when credit losses on sold mortgage loans or securitization transactions exceed expectations. As a result, a provider may determine that it is necessary to repurchase defaulted mortgages to protect its reputation and maintain access to the markets.

Consumer Protection Issues

While nontraditional mortgage loans provide flexibility for consumers, the Washington State Department of Financial Institutions is concerned that consumers may enter into these transactions without fully understanding the product terms. Nontraditional mortgage products have been advertised and promoted based on their affordability in the near term; that is, their lower initial monthly payments compared with traditional types of mortgages. In addition to apprising consumers of the benefits of nontraditional mortgage products, providers should take appropriate steps to alert consumers to the risks of these products, including the likelihood of increased future payment obligations. This information should be provided in a timely manner — before disclosures may be required under the Truth in Lending Act or other laws — to assist the consumer in the product selection process.

Concerns and Objectives — More than traditional ARMs, mortgage products such as payment option ARMs and interest-only mortgages can carry a significant risk of payment shock and negative amortization that may not be fully understood by consumers. For example, consumer payment obligations may increase substantially at the end of an interest-only period or upon the “recast” of a payment option ARM. The magnitude of these payment increases may be affected by factors such as the expiration of promotional interest rates, increases in the interest rate index, and negative amortization. Negative amortization also results in lower levels of home equity as compared to a traditional amortizing mortgage product. When borrowers go to sell or refinance the property, they may find that negative amortization has substantially reduced or eliminated their equity in it even when the property has appreciated. The concern that consumers may not fully understand these products would be exacerbated by marketing and promotional practices that emphasize potential benefits without also providing clear and balanced information about material risks.

In light of these considerations, communications with consumers, including advertisements, oral statements, promotional materials, and monthly statements should provide clear and balanced information about the relative benefits and risks of these products, including the risk of payment shock and the risk of negative amortization. Clear, balanced, and timely communication to consumers of the risks of these products will provide consumers with useful information at crucial decision-making points, such as when they are shopping for loans or deciding which monthly payment amount to make. Such communication should help minimize potential consumer confusion and complaints, foster good customer relations, and reduce legal and other risks to the provider.
**Legal Risks** — Providers that offer nontraditional mortgage products must ensure that they do so in a manner that complies with all applicable laws and regulations. With respect to the disclosures and other information provided to consumers, applicable laws and regulations include the following:

- Truth in Lending Act (TILA) and its implementing regulation, Regulation Z.
- Section 5 of the Federal Trade Commission Act (FTC Act).

TILA and Regulation Z contain rules governing disclosures that providers must provide for closed-end mortgages in advertisements, with an application, before loan consummation, and when interest rates change. Section 5 of the FTC Act prohibits unfair or deceptive acts or practices.

Other federal laws, including the fair lending laws and the Real Estate Settlement Procedures Act (RESPA), also apply to these transactions. Moreover, the sale or securitization of a loan may not affect a provider’s potential liability for violations of TILA, RESPA, the FTC Act, or other laws in connection with its origination of the loan. State laws, including laws regarding unfair or deceptive acts or practices, may apply.

**Recommended Practices**

Recommended practices for addressing the risks raised by nontraditional mortgage products include the following:

**Communications with Consumers** — When promoting or describing nontraditional mortgage products, providers should give consumers information that is designed to help them make informed decisions when selecting and using these products. Meeting this objective requires appropriate attention to the timing, content, and clarity of information presented to consumers. Thus, providers should give consumers information at a time that will help consumers select products and choose among payment options. For example, providers should offer clear and balanced product descriptions when a consumer is shopping for a mortgage — such as when the consumer makes an inquiry to the provider about a mortgage product and receives information about nontraditional products, or when marketing relating to nontraditional mortgage products is given by the provider to the consumer — not just upon the submission of an application or at consummation.

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7. These program disclosures apply to ARM products and must be provided at the time an application is provided or before the consumer pays a nonrefundable fee, whichever is earlier.

8. Providers also should review the recommendations relating to mortgage lending practices set forth in other supervisory guidance from their respective primary regulators, as applicable, including guidance on abusive lending practices.

9. Providers also should strive to: (1) focus on information important to consumer decision making; (2) highlight key information so that it will be noticed; (3) employ a user-friendly and readily navigable format for presenting the information; and (4) use plain language, with concrete and realistic examples. Comparative tables and information describing key features of available loan products, including reduced documentation programs, also may be useful for consumers considering the nontraditional mortgage products and other loan features described in this guidance.
provision of such information would serve as an important supplement to the disclosures currently required under TILA and Regulation Z or other laws.\textsuperscript{10}

- **Promotional Materials and Product Descriptions**

Promotional Materials and other product descriptions should provide information about the costs, terms, features, and risks of nontraditional mortgages that can assist consumers in their product selection decisions, including information about the matters discussed below.

- **Payment Shock.** Providers should apprise consumers of potential increases in payment obligations for these products, including circumstances in which interest rates or negative amortization reach a contractual limit. For example, product descriptions could state the maximum monthly payment a consumer would be required to pay under a hypothetical loan example once amortizing payments are required and the interest rate and negative amortization caps have been reached.\textsuperscript{11} Such information also could describe when structural payment changes will occur (e.g., when introductory rates expire, or when amortizing payments are required), and what the new payment amount would be or how it would be calculated. As applicable, these descriptions could indicate that a higher payment may be required at other points in time due to factors such as negative amortization or increases in the interest rate index.

- **Negative Amortization.** When negative amortization is possible under the terms of a nontraditional mortgage product, consumers should be apprised of the potential for increasing principal balances and decreasing home equity, as well as other potential adverse consequences of negative amortization. For example, product descriptions should disclose the effect of negative amortization on loan balances and home equity, and could describe the potential consequences to the consumer of making minimum payments that cause the loan to negatively amortize. (One possible consequence is that it could be more difficult to refinance the loan or to obtain cash upon a sale of the home.)

- **Prepayment Penalties.** If the provider may impose a penalty in the event that the consumer prepays the mortgage, consumers should be alerted to this fact and to the need to ask the lender about the amount of any such penalty.

- **Cost of Reduced Documentation Loans.** If a provider offers both reduced and full documentation loan programs and there is a pricing premium attached to the reduced documentation program, consumers should be alerted to this fact.

\textsuperscript{10} Providers may not be able to incorporate all of the practices recommended in this guidance when advertising nontraditional mortgages through certain forms of media, such as radio, television, or billboards. Nevertheless, providers should provide clear and balanced information about the risks of these products in all forms of advertising.

\textsuperscript{11} Consumers also should be apprised of other material changes in payment obligations, such as balloon payments.
Monthly Statements on Payment Option ARMs
Monthly statements that are provided to consumers on payment option ARMs should provide information that enables consumers to make informed payment choices, including an explanation of each payment option available and the impact of that choice on loan balances. For example, the monthly payment statement should contain an explanation, as applicable, next to the minimum payment amount that making this payment would result in an increase to the consumer’s outstanding loan balance. Payment statements also could provide the consumer’s current loan balance, what portion of the consumer’s previous payment was allocated to principal and to interest, and, if applicable, the amount by which the principal balance increased. Providers should avoid leading payment option ARM borrowers to select a non-amortizing or negatively-amortizing payment (for example, through the format or content of monthly statements).

Practices to Avoid
Providers also should avoid practices that obscure significant risks to the consumer. For example, if a provider advertises or promotes a nontraditional mortgage by emphasizing the comparatively lower initial payments permitted for these loans, the provider also should give clear and comparably prominent information alerting the consumer to the risks. Such information should explain, as relevant, that these payment amounts will increase, that a balloon payment may be due, and that the loan balance will not decrease and may even increase due to the deferral of interest and/or principal payments. Similarly, providers should avoid promoting payment patterns that are structurally unlikely to occur. Such practices could raise legal and other risks for providers.

Providers also should avoid such practices as: giving consumers unwarranted assurances or predictions about the future direction of interest rates (and, consequently, the borrower’s future obligations); making one-sided representations about the cash savings or expanded buying power to be realized from nontraditional mortgage products in comparison with amortizing mortgages; suggesting that initial minimum payments in a payment option ARM will cover accrued interest (or principal and interest) charges; and making misleading claims that interest rates or payment obligations for these products are “fixed.”

Control Systems — Providers should develop and use strong control systems to monitor whether actual practices are consistent with their policies and procedures relating to nontraditional mortgage products. Providers should design control systems to address compliance and consumer information concerns as well as the risk management considerations discussed in this guidance. Lending personnel should be trained so that they are able to convey information to consumers about the product terms and risks in a timely, accurate, and balanced manner. As products evolve and new products are introduced, lending personnel should receive additional training, as necessary, to continue

12 For example, marketing materials for payment option ARMs may promote low predictable payments until the recast date. Such marketing should be avoided in circumstances in which the minimum payments are so low that negative amortization caps would be reached and higher payment obligations would be triggered before the scheduled recast, even if interest rates remain constant.
to be able to convey information to consumers in this manner. Lending personnel should be monitored to determine whether they are following these policies and procedures. Providers should review consumer complaints to identify potential compliance, reputation, and other risks. Attention should be paid to appropriate legal review and to using compensation programs that do not improperly encourage lending personnel to direct consumers to particular products.

With respect to nontraditional mortgage loans that a provider makes, purchases, or services using a third party, such as a mortgage broker, correspondent, or other intermediary, the provider should take appropriate steps to mitigate risks relating to compliance and consumer information concerns discussed in this guidance. These steps would ordinarily include, among other things, (1) conducting due diligence and establishing other criteria for entering into and maintaining relationships with such third parties, (2) establishing criteria for third-party compensation designed to avoid providing incentives for originations inconsistent with this guidance, (3) setting requirements for agreements with such third parties, (4) establishing procedures and systems to monitor compliance with applicable agreements, policies, and laws, and (5) implementing appropriate corrective actions in the event that the third party fails to comply with applicable agreements, policies, or laws.

Appendix

Interest-Only Mortgage Loan — A nontraditional mortgage on which, for a specified number of years (e.g., three or five years), the borrower is required to pay only the interest due on the loan during which time the rate may fluctuate or may be fixed. After the interest-only period, the rate may be fixed or fluctuate based on the prescribed index and payments include both principal and interest.

Payment Option ARM — A nontraditional mortgage that allows the borrower to choose from a number of different payment options. For example, each month, the borrower may choose a minimum payment option based on a “start” or introductory interest rate, an interest-only payment option based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on a 15-year or 30-year loan term, plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The interest-only option avoids negative amortization but does not provide for principal amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term.

Reduced Documentation — A loan feature that is commonly referred to as “low doc/no doc,” “no income/no asset,” “stated income” or “stated assets.” For mortgage loans with this feature, a provider sets reduced or minimal documentation standards to substantiate the borrower’s income and assets.

Simultaneous Second-Lien Loan — A lending arrangement where either a closed-end second-lien or a home equity line of credit (HELOC) is originated simultaneously with the first lien mortgage loan, typically in lieu of a higher down payment.
I. Introduction and Background

On June 29, 2007, the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) (collectively, the Agencies) publicly released the Statement on Subprime Mortgage Lending (Subprime Statement).

The Agencies developed the Subprime Statement to address emerging risks associated with certain subprime mortgage products and lending practices. In particular, the Agencies are concerned about the growing use of adjustable rate mortgage (ARM) products that provide low initial payments based on a fixed introductory rate that expires after a short period, and then adjusts to a variable rate plus a margin for the remaining term of the loan. These products could result in payment shock to the borrower. The Agencies are concerned that these products, typically offered to subprime borrowers, present heightened risks to lenders and borrowers. Often, these products have additional characteristics that increase risk. These include qualifying borrowers based on limited or no documentation of income or imposing substantial prepayment penalties or prepayment penalty periods that extend beyond the initial fixed interest rate period. In addition, borrowers may not be adequately informed of product features and risks, including their responsibility to pay taxes and insurance, which might be separate from their mortgage payments.

These products originally were extended to customers primarily as a temporary credit accommodation in anticipation of early sale of the property or in expectation of future earnings growth. However, these loans have more recently been offered to subprime borrowers as “credit repair” or “affordability” products. The Agencies are concerned that many subprime borrowers may not have sufficient financial capacity to service a higher debt load, especially if they were qualified based on a low introductory payment. The Agencies are also concerned that subprime borrowers may not fully understand the risks and consequences of obtaining this type of ARM loan. Borrowers who obtain these loans may face unaffordable monthly payments after the initial rate adjustment, difficulty in paying real estate taxes and insurance that were not escrowed, or expensive refinancing fees, any of which could cause borrowers to default and potentially lose their homes.

Like the interagency Guidance on Nontraditional Mortgage Product Risks that was published in the Federal Register on October 4, 2006 (Volume 71, Number 192, Page 58609-58618), the interagency Subprime Statement applies to all banks and their

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1 For example, ARMs known as “2/28” loans feature a fixed rate for two years and then adjust to a variable rate for the remaining 28 years. The spread between the initial fixed interest rate and the fully indexed interest rate in effect at loan origination typically ranges from 300 to 600 basis points.
subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

Recognizing that the interagency Subprime Statement does not apply to subprime loan originations of independent mortgage lenders and mortgage brokers, on June 29, 2007 the Conference of State Bank Supervisors (CSBS), the American Association of Residential Mortgage Regulators (AARMR), and the National Association of Consumer Credit Administrators (NACCA) announced their intent to develop a parallel statement. CSBS, AARMR and NACCA strongly support the purpose of the Subprime Statement and are committed to promoting uniform application of the Statement’s origination and underwriting standards for all mortgage brokers and lenders (herein referred to as providers).

The Subprime Statement identifies many important standards for subprime lending, and CSBS, AARMR, and NACCA support additional efforts to enhance subprime lending oversight. For instance, the Subprime Statement encourages depository institutions to consider a borrower’s housing-related expenses in the course of determining a borrower’s ability to repay the subprime mortgage loan. However, the Agencies did not explicitly encourage the consideration of total monthly debt obligations. Rather than create confusion or adopt a higher standard, CSBS, AARMR, and NACCA have determined to mirror the interagency statement. We will continue to work with the Agencies and our state members to improve industry-wide mortgage lending practices.

In order to promote consistent application across the states, AARMR and CSBS are developing Model Examination Guidelines (MEGs) to implement the 2006 Guidance on Nontraditional Mortgage Product Risks (NTM Guidance) and the following Statement on Subprime Mortgage Lending. These guidelines are being developed as examination standards to assist state regulators to in determining proper compliance with the NTM Guidance and the Subprime Statement. The MEGs will also be published as a public document to guide mortgage providers and their auditors in reviewing transactions covered by the NTM Guidance and the Subprime Statement.

The following statement will assist state regulators of mortgage providers not affiliated with a bank holding company or an insured financial institution in promoting consistent regulation in the mortgage market and clarify how providers can offer subprime loans in a safe and sound manner that clearly discloses the risks that borrowers may assume.

In order to maintain regulatory consistency, this statement substantially mirrors the interagency Subprime Statement, except for the removal of sections not applicable to non-depository institutions.
II. Statement On Subprime Mortgage Lending

CSBS, AARMR and NACCA developed this Statement on Subprime Mortgage Lending (Subprime Statement) to address emerging issues and questions relating to subprime mortgage lending practices. The term “subprime” refers to the credit characteristics of individual borrowers. Subprime borrowers typically have weakened credit histories that include payment delinquencies and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income (DTI) ratios, or other criteria that may encompass borrowers with incomplete credit histories. “Subprime loans” are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers. Generally subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:

- Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
- Judgment, foreclosure, repossession, or charge-off in the prior 24 months;
- Bankruptcy in the last 5 years;
- Relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood; and/or
- Debt service-to-income ratio of 50% or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

This list is illustrative rather than exhaustive and is not meant to define specific parameters for all subprime borrowers. Additionally, this definition may not match all market or institution specific subprime definitions, but should be viewed as a starting point from which the Department of Financial Institutions (DFI) will expand examination efforts.²

² “Subprime” and “subprime loans” are defined by the 2001 Interagency Expanded Guidance for Subprime Lending Programs. To promote consistency and uniformity, CSBS, AARMR and NACCA support these definitions for the purposes of this statement.
The Department of Financial Institutions is concerned that borrowers may not fully understand the risks and consequences of obtaining products that can cause payment shock. In particular, the Department of Financial Institutions is concerned with certain adjustable-rate mortgage (ARM) products typically offered to subprime borrowers that have one or more of the following characteristics:

- Low initial payments based on a fixed introductory rate that expires after a short period and then adjusts to a variable index rate plus a margin for the remaining term of the loan;
- Very high or no limits on how much the payment amount or the interest rate may increase (“payment or rate caps”) on reset dates;
- Limited or no documentation of borrowers’ income;
- Product features likely to result in frequent refinancing to maintain an affordable monthly payment; and/or
- Substantial prepayment penalties and/or prepayment penalties that extend beyond the initial fixed interest rate period.

Products with one or more of these features present substantial risks to both consumers and providers. These risks are increased if borrowers are not adequately informed of the product features and risks, including their responsibility for paying real estate taxes and insurance, which may be separate from their monthly mortgage payments. The consequences to borrowers could include: being unable to afford the monthly payments after the initial rate adjustment because of payment shock; experiencing difficulty in paying real estate taxes and insurance that were not escrowed; incurring expensive refinancing fees, frequently due to closing costs and prepayment penalties, especially if the prepayment penalty period extends beyond the rate adjustment date; and losing their homes. Consequences to providers may include unwarranted levels of credit, legal, compliance, reputation, and liquidity risks due to the elevated risks inherent in these products.

CSBS, AARMR and NACCA note that many of these concerns are addressed in existing interagency guidance. CSBS, AARMR and NACCA recognize that these guidance documents may not apply to state-supervised providers. However, CSBS, AARMR and NACCA believe these guidelines provide sound principles for mortgage lending as a

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3 Payment shock refers to a significant increase in the amount of the monthly payment that generally occurs as the interest rate adjusts to a fully indexed basis. Products with a wide spread between the initial interest rate and the fully indexed rate that do not have payment caps or periodic interest rate caps, or that contain very high caps, can produce significant payment shock.

4 As noted by Agencies in the final statement, the Subprime Statement focuses on subprime borrowers; however, the statement applies to ARM products that have one or more characteristics that can cause payment shock. Providers should look to the principles of this statement when such ARM products are offered to non-subprime borrowers.

5 For example, ARMs known as “2/28” loans feature a fixed rate for two years and then adjust to a variable rate for the remaining 28 years. The spread between the initial fixed interest rate and the fully indexed interest rate in effect at loan origination typically ranges from 300 to 600 basis points.

6 The most prominent are the 1993 Interagency Guidelines for Real Estate Lending (Real Estate Guidelines), the 1999 Interagency Guidance on Subprime Lending, and the 2001 Expanded Guidance for Subprime Lending Programs (Expanded Subprime Guidance).
reference for state-supervised providers including both Consumer Loan Companies and Mortgage Brokers.

While the 2006 CSBS-AARMR Guidance on Nontraditional Mortgage Product Risks (NTM Guidance) may not explicitly pertain to products with the characteristics addressed in this Statement, it outlines prudent underwriting and consumer protection principles that providers also should consider with regard to subprime mortgage lending. This Statement reiterates many of the principles addressed in existing guidance relating to prudent risk management practices and consumer protection laws.  

Risk Management Practices

Predatory Lending Considerations

Subprime lending is not synonymous with predatory lending, and loans with features described above are not necessarily predatory in nature. However, providers should ensure that they do not engage in the types of predatory lending practices discussed in the Expanded Subprime Guidance. Typically, predatory lending involves at least one of the following elements:

- Making loans based predominantly on the foreclosure or liquidation value of a borrower’s collateral rather than on the borrower’s ability to repay the mortgage according to its terms;
- Inducing a borrower to repeatedly refinance a loan in order to charge high points and fees each time the loan is refinanced (“loan flipping”); or
- Engaging in fraud or deception to conceal the true nature of the mortgage loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.

Loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the collateral pledged may lack sufficient consumer protection safeguards and are generally considered unsafe and unsound. Examiners are instructed to criticize such lending practices in the Report of Examination. Further, examiners are instructed to refer any loans with the aforementioned characteristics to the Department’s Division of Consumer Services for additional review.

Providers offering mortgage loans such as these face an elevated risk that their conduct will violate Section 5 of the Federal Trade Commission Act (FTC Act) or other state laws, which prohibit unfair or deceptive acts or practices.

Underwriting Standards

The 1993 interagency Real Estate Guidelines provide underwriting standards for all real estate loans and state that prudently underwritten real estate loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt.

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7 As with the Interagency Guidance on Nontraditional Mortgage Product Risks, 71 FR 58609 (October 4, 2006), the interagency Subprime Statement applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions. This statement, developed by CSBS, AARMR and NACCA, is applicable to all state-supervised mortgage providers.
Providers should refer to the 2006 NTM Guidance, which details similar criteria for qualifying borrowers for products that may result in payment shock. Prudent qualifying standards recognize the potential effect of payment shock in evaluating a borrower’s ability to service debt. A provider’s analysis of a borrower’s repayment capacity should include an evaluation of the borrower’s ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule.

One widely accepted approach in the mortgage industry is to quantify a borrower’s repayment capacity by a debt-to-income (DTI) ratio. A provider’s DTI analysis should include, among other things, an assessment of a borrower’s total monthly housing-related payments (e.g., principal, interest, taxes, and insurance, or what is commonly known as PITI) as a percentage of gross monthly income.

This assessment is particularly important if the provider relies upon reduced documentation or allows other forms of risk layering. Risk-layering features in a subprime mortgage loan may significantly increase the risks to both the provider and the borrower. Therefore, a provider should have clear policies governing the use of risk-layering features, such as reduced documentation loans or simultaneous second lien mortgages. When risk-layering features are combined with a mortgage loan, a provider should demonstrate the existence of effective mitigating factors that support the underwriting decision and the borrower’s repayment capacity.

Recognizing that loans to subprime borrowers present elevated credit risk, providers should verify and document the borrower’s income (both source and amount), assets and liabilities. Stated income and reduced documentation loans to subprime borrowers should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. Reliance on such factors also should be documented. Typically, mitigating factors arise when a borrower with favorable payment performance seeks to refinance an existing mortgage with a new loan of a similar size and with similar terms, and the borrower’s financial condition has not deteriorated. Other mitigating factors might include situations where a borrower has substantial liquid reserves or assets that demonstrate repayment capacity and can be verified and documented by the provider. However, a higher interest rate is not considered an acceptable mitigating factor.

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8 The fully indexed rate equals the index rate prevailing at origination plus the margin to be added to it after the expiration of an introductory interest rate. For example, assume that a loan with an initial fixed rate of 7% will reset to the six-month London Interbank Offered Rate (LIBOR) plus a margin of 6%. If the six-month LIBOR rate equals 5.5%, providers should qualify the borrower at 11.5% (5.5% + 6%), regardless of any interest rate caps that limit how quickly the fully indexed rate may be reached.

9 The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a “2/28” loan would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

10 A prudent practice used by the industry is to include a borrower’s total monthly debt obligations as a percentage of gross monthly income in the DTI analysis.
Workout Arrangements

On June 27, 2007, the Department of Financial Institutions issued a press release entitled Department of Financial Institutions ADVISES CONSUMERS TO PLAN FOR MORTGAGE RATE INCREASES, urging borrowers to:

- Seek information on the characteristics of their mortgage;
- Budget accordingly for the scheduled “recast” or “reset” of their loan’s interest rate;
- Contact their provider for assistance, if needed; and
- Inquire about possible solutions if payments are past due.

On June 15, 2007, the Department of Financial Institutions sent a letter to its lender licensees encouraging them to reach out to consumers to provide information on their loans and to work with consumers to avoid foreclosure. Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the provider and the borrower.

Providers should follow prudent underwriting practices in determining whether to consider a loan modification or a workout arrangement. Such arrangements can vary widely based on the borrower’s financial capacity. For example, a provider might consider modifying loan terms, including converting loans with variable rates into fixed-rate products to provide financially stressed borrowers with predictable payment requirements.

The Department of Financial Institutions will not criticize providers that pursue reasonable workout arrangements with borrowers. Further, existing supervisory guidance and applicable accounting standards do not require providers to immediately foreclose on the collateral underlying a loan when the borrower exhibits repayment difficulties. For those providers that portfolio loans, they should identify and report credit risk, maintain an adequate allowance for loan losses, and recognize credit losses in a timely manner.

Consumer Protection Principles

Fundamental consumer protection principles relevant to the underwriting and marketing of mortgage loans include:

- Approving loans based on the borrower’s ability to repay the loan according to its terms; and
- Providing information that enables consumers to understand material terms, costs, and risks of loan products at a time that will help the consumer select a product.

Communications with consumers, including advertisements, oral statements, and promotional materials, should provide clear and balanced information about the relative benefits and risks of the products. This information should be provided in a timely manner to assist consumers in the product selection process, not just upon submission of an


12 For those providers that portfolio loans, they may need to account for workout arrangements as troubled debt restructurings and should follow generally accepted accounting principles in accounting for these transactions.
application or at consummation of the loan. Providers should not use such communications
to steer consumers to these products to the exclusion of other products offered by the
provider for which the consumer may qualify.

Information provided to consumers should clearly explain the risk of payment shock and the
ramifications of prepayment penalties, balloon payments, and the lack of escrow for taxes
and insurance, as necessary. The applicability of prepayment penalties should not exceed
the initial reset period. In general, borrowers should be provided a reasonable period of
time (typically at least 60 days prior to the reset date) to refinance without penalty.

Similarly, if borrowers do not understand that their monthly mortgage payments do not
include taxes and insurance, and they have not budgeted for these essential
homeownership expenses, they may be faced with the need for significant additional funds
on short notice. Therefore, mortgage product descriptions and advertisements should
provide clear, detailed information about the costs, terms, features, and risks of the loan to
the borrower. Consumers should be informed of:

- Payment Shock. Potential payment increases, including how the new payment will
  be calculated when the introductory fixed rate expires.
- Prepayment Penalties. The existence of any prepayment penalty, how it will be
  calculated, and when it may be imposed.
- Balloon Payments. The existence of any balloon payment.
- Cost of Reduced Documentation Loans. Whether there is a pricing premium
  attached to a reduced documentation or stated income loan program.
- Responsibility for Taxes and Insurance. The requirement to make payments for real
estate taxes and insurance in addition to their loan payments, if not escrowed, and
the fact that taxes and insurance costs can be substantial.

**Control Systems**

Providers should develop strong control systems to monitor whether actual practices are
consistent with their policies and procedures. Systems should address compliance and
consumer information concerns, as well as safety and soundness, and encompass both
institution personnel and applicable third parties, such as mortgage brokers or
 correspondents.

Important controls include establishing appropriate criteria for hiring and training loan
personnel, entering into and maintaining relationships with third parties, and conducting

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13 Providers generally can address these concerns most directly by requiring borrowers to escrow funds for real estate taxes and
insurance.

14 To illustrate: a borrower earning $42,000 per year obtains a $200,000 “2/28” mortgage loan. The loan’s two-year introductory
fixed interest rate of 7% requires a principal and interest payment of $1,331. Escrowing $200 per month for taxes and insurance
results in a total monthly payment of $1,531 ($1,331 + $200), representing a 44% DTI ratio. A fully indexed interest rate of 11.5%
(based on a six-month LIBOR index rate of 5.5% plus a 6% margin) would cause the borrower’s principal and interest payment to
increase to $1,956. The adjusted total monthly payment of $2,156 ($1,956 + $200 for taxes and insurance) represents a 41%
increase in the payment amount and results in a 62% DTI ratio.
initial and ongoing due diligence on third parties. Providers also should design compensation programs that avoid providing incentives for originations inconsistent with sound underwriting and consumer protection principles, and that do not result in the steering of consumers to these products to the exclusion of other products for which the consumer may qualify.

Providers should have procedures and systems in place to monitor compliance with applicable laws and regulations, third-party agreements and internal policies. A provider’s controls also should include appropriate corrective actions in the event of failure to comply with applicable laws, regulations, third-party agreements or internal policies. In addition, providers should initiate procedures to review consumer complaints to identify potential compliance problems or other negative trends.

**Supervisory Review**

The Department of Financial Institutions will carefully review risk management and consumer compliance processes, policies, and procedures. The Department of Financial Institutions will take action against providers that exhibit predatory lending practices, violate consumer protection laws or fair lending laws, engage in unfair or deceptive acts or practices, or otherwise engage in unsafe or unsound lending practices.
MORTGAGE BROKERS IN WASHINGTON

AND

THE LIMITS OF IMPOSING FIDUCIARY DUTY

In Washington State, the relationship between a consumer borrower and a residential mortgage broker and/or residential mortgage loan originator is governed, in first instance, by statute. The Washington Mortgage Broker Practices Act, Ch. 19.146 RCW ("Act"), is the statute we turn to for ascribing duty under such a relationship.

While the Act specifically imposes a fiduciary duty for handling client funds (the trust account), there is otherwise no general fiduciary duty conferred by the Act. Rather, the Act recognizes that the nature of the relationship is generally measured by the broker agreement with the consumer but is subject otherwise to the specific requirements and prohibitions of the Act. Moreover, there is no rulemaking by the Department of Financial Institutions that imposes a general fiduciary duty upon a mortgage broker or mortgage loan originator.

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15 See RCW 19.146.050 (duty to hold client funds in trust); RCW 19.146.060 (duty to employ generally accepted accounting principles). See also State of Washington v. WWJ Corporation, 138 Wn.2d 595; 980 P.2d 1257 (1999), where the court found 250 separate good faith violations based upon violations of RCW §§ 19.146.050 and 19.146.060.

16 RCW 19.146.040 declares:

(1) Every contract between a mortgage broker, or a loan originator, and a borrower shall be in writing and shall contain the entire agreement of the parties.
(2) Any contract under this section entered by a loan originator shall be binding on the mortgage broker.
(3) A mortgage broker shall have a written correspondent or loan broker agreement with a lender before any solicitation of, or contracting with, the public.

17 See, for example, the specific prohibitions contained in RCW 19.146.0201.

18 There is at least one secondary legal resource, www.icomply.com, which draws the inference that the Department of Financial Institutions has a fiduciary rule, other than RCW 19.146.050 and RCW 19.146.060, citing WAC § 460-33A-095. This is an erroneous citation. WAC § 460-33A-095, which draws its authority solely from the Washington Securities Act, at RCW 21.20.450, refers only to the fiduciary duty of a broker-dealer in relation to mortgage-backed securities. Moreover, WAC 460-33A-095 specifically declares: "In the event a conflict arises in connection with a mortgage broker-dealer acting as an agent for both mortgage borrowers and purchasers of mortgage paper securities, every mortgage broker-dealer shall resolve the conflict in favor of the purchasers of mortgage paper securities." In other words, a broker-dealer must resolve in conflict in duty in favor of the relationship he or she has with the purchasers of mortgage-backed securities, not consumer borrowers. In addition, we cannot say, as a matter of law, that WAC 460-33A-095 presupposes a relationship of common law agency between a mortgage broker or loan originator and a consumer borrower.
There is, however, a 1964 Washington case\(^\text{19}\) that has not been generally followed and which has been recently distinguished, but which nonetheless comes close to imposing a general, common law fiduciary duty upon a mortgage broker. In *Rushing v. Stephanus*, 64 Wn.2d 607, 393 P.2d 281 (1964), defendant mortgage brokers sought review of a judgment of the King County Superior Court, which found in favor of plaintiff debtors in their action asserting fraud, *breach of fiduciary duty*, and negligence. Affirming the trial court, the Washington Supreme Court held that the mortgage brokers breached their fiduciary duty and committed fraud by failing to exercise care and diligence in obtaining a mortgage, in obtaining an interim loan, in obtaining signatures by trickery, and in charging outrageous expenses and commissions.\(^{20}\) However, the only conduct of the defendant mortgage brokers in *Rushing v. Stephanus* that is not currently protected by the explicit statutory provisions of the Act, TILA and RESPA is the court’s holding in that case that the defendant mortgage brokers violated a *duty of due care* by securing an expensive interim loan which the trial court found was totally unnecessary.\(^{21}\) Moreover, while unaddressed by the courts, it bears mention that the loans in the *Rushing v. Stephanus* case were sought by the plaintiffs for commercial purposes. As a matter of industry custom, commercial loan brokers have historically been retained by borrowers to procure financing without necessarily having established correspondent relationships with lenders. A residential mortgage loan broker, on the other hand, has been typically perceived as an independent intermediary having both a contract with the borrower and a contractual relationship with a lender.

The recent *yield spread premium* case of *Brazier v. Security Pacific Mortgage Inc.*, 245 F. Supp. 2d 1136 (W.D. Wash. 2003 – J. Thomas Zilly), in failing to find a breach of fiduciary duty by defendants, distinguishes the earlier case of *Rushing v. Stephanus*. In that case, plaintiff borrower sued defendant mortgage broker, who owned two mortgage companies, alleging violation of the RESPA and TILA. The broker moved for partial summary judgment. Judge Zilly granted partial summary judgment for plaintiff to the effect that defendants failed to disclose that defendant mortgage broker would receive a yield spread premium in exchange for plaintiff’s payment of an inflated interest rate in violation of the TILA and RESPA.\(^{22}\) However,

\(^{19}\) The case in question precedes not only the Act, but also the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA).

\(^{20}\) The facts in *Rushing v. Stephanus* were fairly egregious, even for 1964, which was prior to the protections of TILA and RESPA. In that case, plaintiffs were a sewer contractor and his wife, whose formal education did not even include a high school diploma and both were found to have a limited ability to read and understand technical language. The debtors wanted to borrow $1,800 for use in their business and mortgage brokers had them sign a stack of papers, which they suggested were a stack of duplicate loan applications. In fact, the brokers had debtors sign a loan application, a note, a mortgage and a hold-harmless agreement. No mention was ever made of commissions and expenses. The mortgage broker went about negotiating a loan and applied for $6,600, when the debtors only wanted to borrow $1,800 in the first instance.

\(^{21}\) This interim loan was arranged at a 20 per cent discount, a 10 per cent interest rate, and a penalty for a pay-off prior to maturity, despite the fact that Stephanus knew it was to be paid off with the proceeds of the $6,600 loan as soon as possible.

\(^{22}\) Judge Zilly noted in his opinion that the Act specifically incorporates TILA and RESPA disclosure requirements [RCW 19.146.030(2)], requires that a mortgage broker provide the borrower with an itemization or good faith estimate of all fees and costs the borrower is to pay in connection with a residential mortgage loan [RCW 19.146.020(6) and RCW 19.146.030]. He also noted that failure to make timely disclosures under the Act, or federal statutes such as TILA and RESPA, constitutes an unfair or deceptive act or practice in violation of the Washington Consumer Protection Act (CPA), Ch.19.86 RCW, by reason of RCW 19.146.100.
Judge Zilly, in otherwise denying the remainder of plaintiff’s motion for summary judgment, refused to find that the defendants had committed a breach of fiduciary duty, declaring:

“Plaintiff claims that mortgage brokers owe fiduciary duties of disclosure, loyalty, good faith, and due care to borrowers for whom they seek to obtain financing, citing State v. WWJ Corp., 138 Wash. 2d 595, 604, 980 P.2d 1257 (1999), and Rushing v. Stephanus, 64 Wash. 2d 607, 611, 393 P.2d 281 (1964). However, WWJ Corp. does not support Plaintiff’s position because WWJ Corp. involved a mortgage broker who was handling client funds, which is not at issue here. 138 Wash. 2d at 599. Rushing can be distinguished because it involved a breach of fiduciary duty when a mortgage broker caused plaintiffs with limited education to sign blank documents that were fraudulently misrepresented as duplicate copies of loan applications. 64 Wash. 2d at 608. Under the Washington MBPA, a mortgage broker has a duty to disclose in writing ‘all fees and costs that the borrower is required to pay in connection with obtaining a residential mortgage loan … [including] the fee or fees which inure to the benefit of the mortgage broker and other such disclosures as may be required by rule.’ RCW 19.146.030. However, no law requires a mortgage broker to negotiate for a borrower to obtain a loan at the best rate from a lender.

“The Court finds that Plaintiff has not established a fiduciary relationship between Plaintiff and Defendants. Plaintiff and Defendants entered into a contract that specifically provided that Nu-West was not Plaintiff’s agent.”

Accordingly, in light of Brazier v. Security Pacific Mortgage Inc., which properly analyzes the effects of the Act, TILA and RESPA, but distinguishes Rushing v. Stephanus and State of Washington v. WWJ Corporation, the Department of Financial Institutions is of the view that, where the broker-borrower agreement specifically makes clear that the broker is not the agent of the borrower, neither the broker nor his or her loan originator has a general fiduciary duty to the borrower except as specifically agreed to in the broker-borrower agreement and as specifically imposed by the Act.

Dated: November 15, 2007

Scott Jarvis
Director