

Financial Crisis Inquiry Commission

Phil Angelides, Chairman

Sacramento Field Hearing- September 23, 2010

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Mr. Chairman and Commissioners-

Thank you for the opportunity to provide testimony today. I have been an active participant and observer of the Sacramento regional mortgage market for over 25 years. I have served in the public sector as an analyst with the California Joint Legislative Budget Committee and as Director of Single Family Programs with the California Housing Finance Agency. I have worked in the private sector as a regional manager of a number of mortgage banking companies. I have managed retail operations (working directly with consumers) and wholesale operations (working with loan brokers).

**Question #1- Your perspective on the evolution and changes in the mortgage industry and mortgage market from the late 1990's through the present and how larger trends and policy changes affected the regional mortgage market.**

The Sacramento regional market experienced an unprecedented demand for housing and mortgage products in this period from late 1990's thru 2007-2008. While there were many national factors contributing to this, the four most important changes were

1. Sustained increases in population and job growth. According to US Census information, the population in Sacramento SMSA went from 1,325,500 in 1990 to 1,796,857 in 2000 to 2,150,000 in 2008, an increase of 60%

Population in the four-county Sacramento Metropolitan Statistical Area has grown from 1.63 million persons as of July 1, 1995 to 2.15 million persons as of July 1, 2008.

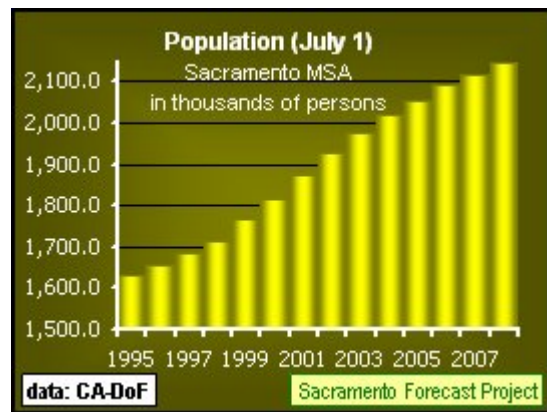


Table 1

**NET DEMAND AND SUPPLY  
HOUSING UNITS  
SACRAMENTO MSA 1989-2002**

Year	Population	Total Wage & Salary Employment	Annual Change Population	Annual Change Employment	Housing Units Permitted	Housing Units Demanded	Net Demand Annual	Pent Up Demand
1989	1,274,300	533,300	42,500	19,400	20,001	17,000	3,001	3,001
1990	1,325,500	560,000	51,200	26,700	15,262	20,480	(5,218)	(2,217)
1991	1,372,700	569,500	47,200	9,500	8,854	18,880	(10,026)	(12,243)
1992	1,403,200	557,800	30,500	-11,700	8,465	12,200	(3,735)	(15,978)
1993	1,427,500	558,300	24,300	500	7,975	9,720	(1,745)	(17,723)
1994	1,446,100	573,200	18,600	14,900	9,014	7,440	1,574	(16,149)
1995	1,457,600	590,600	11,500	17,400	7,317	4,600	2,717	(13,432)
1996	1,474,300	608,900	16,700	18,300	8,203	6,680	1,523	(11,909)
1997	1,495,900	629,000	21,600	20,100	9,255	8,640	615	(11,294)
1998	1,524,700	655,700	28,800	26,700	13,220	11,520	1,700	(9,594)
1999	1,567,900	689,800	43,200	34,100	14,074	17,280	(3,206)	(12,800)
2000	1,636,600	713,800	68,700	24,000	15,691	27,480	(11,789)	(24,589)
2001	1,664,300	736,800	27,700	23,000	17,582	11,080	6,502	(18,087)
2002	1,710,200	747,058	45,900	10,258	21,575	18,360	3,215	(14,872)
2003	1,751,200	745,600	41,000	-1,458	4,555	16,400	(11,845)	(26,717)

Note: Housing Units Demanded Calculated at 2.5 persons per household

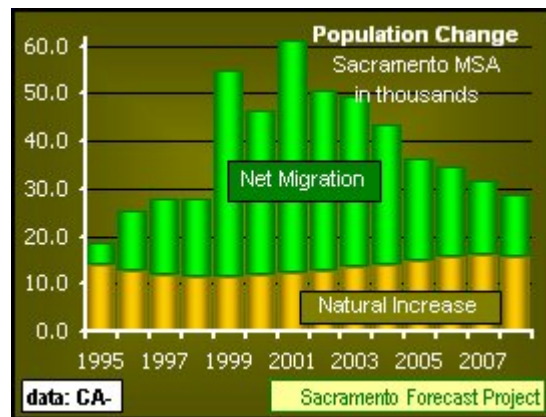
Source: Rand California via Internet Real Estate Analytics

- The large disparity of median housing prices between key San Francisco Bay area counties and Sacramento area counties boosted demand from relocating households, reverse commute households and non owner investment purchases. According to US census, The 2000 median value owner occupied home in these four counties were:

Contra Costa-\$267,800, Alameda- \$303,000, Santa Clara- \$446,000, Sacramento -\$144,200

The Bay Area spillover to more Sacramento area affordable housing impacted the traditional profile of agency and FHA/VA consumers in Sacramento and created demand for subprime, alt A and jumbo mortgage products.

The change in population jumped from an average increase of 25 thousand persons during the 1995-1998 periods to an average increase of 51 thousand persons during the 1999-2004 periods. Births, deaths and net immigration were basically stable over the whole ten year period, so the jump was the result of an increase in migration from other parts of California and the rest of the U.S; the current decline is coming from that sector now.



- Tremendous explosion nationally in the availability of mortgage capital, not only from the traditional Agency and portfolio sources but increasingly new sources of subprime, Alt A and jumbo mortgages. ALT A and subprime increased Five -fold over this period while jumbo and agency loans grew in 2003 and then returned to 2001 levels. These national mortgage changes were reflected in the Sacramento area lending patterns.

### Origination of Non-Agency Mortgage Loans

Year	Subprime	Alt A	Jumbo	Agency
2001	190	60	430	1,087
2002	231	68	576	1,898
2003	335	85	655	2,690
2004	540	200	515	1,345
2005	625	380	570	1,018
2006	600	400	480	1,040

Source: Inside Mortgage Finance (2007).

Notes: Jumbo origination includes non-agency prime. Agency origination includes conventional/conforming and FHA/VA loans. Agency Issuance GNMA, FHLMC, and FNMA. Figures are in billions of USD.

- Government sponsored programs focused on boosting the homeownership rate among under represented ethnic groups. ( Footnote #1)This led to expanded criteria around income definition, source of down payment , depth of credit and alternative credit that allow new consumers to qualify for mortgages that could not before..

Race	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	% change since '94
White (non-Hispanic)	70.0	70.9	71.7	72.0	72.6	73.2	73.8	74.3	74.5	75.4	76.0	75.8	+8.28%
Asian American	51.3	50.8	50.8	52.8	52.6	53.1	52.8	53.9	54.7	56.3	59.8	60.1	+17.15%
Native American	51.7	55.8	51.6	51.7	54.3	56.1	56.2	55.4	54.6	54.3	55.6	58.2	+12.57%
African American	42.3	42.7	44.1	44.8	45.6	46.3	47.2	47.7	47.3	48.1	49.1	48.2	+13.59%
Hispanic or Latino	41.2	42.1	42.8	43.3	44.7	45.5	46.3	47.3	48.2	46.7	48.1	49.5	+20.14%

SOURCE: US Census Bureau, 2005<sup>[6]</sup>

### Question # 2. Your views on the change in mortgage products and how those products affected the market

As background, mortgage lending has traditionally been about the 4 “C’s” – Credit, Capacity, Capital and Collateral-

- **Credit-** quantity, quality and duration of credit obligations
- **Capacity-** amount and stability of borrower income
- **Capital-** sufficient liquid funds to cover down payment, closing costs and reserves\
- **Collateral-** value and condition of property

The three traditional loan product categories with their traditional characteristics have been

- **Prime**- high credit (above 680 fico) high capacity (on going income with maximum 33/38 ratios) high capital (10-20% down payment) and high collateral (good appraisal on solid property). full documentation to support all info
- **Alt A**- reasonably high standards on 3 of 4 "C" categories –usually no doc or limited doc on income evidence.
- **Subprime**- lower standards on all 4 "C" categories –particularly credit---lower documentation and much weaker FICO credit scores (typically below 600)

If we examine the overall mortgage market changes from 1998-2006, we see a significant shift to alt A and subprime lending. Alt A and subprime went from a 14% share of a smaller market to 60% of a larger market. These loans have lower underwriting standards. In addition, the prime market was loosening underwriting as the GSE's attempted to maintain market share, meet low and moderate income lending goals and grow homeownership rates among underserved populations. Collectively, these factors contributed to a steady erosion of underwriting standards thru this period. The slippage in underwriting occurred incrementally but included these trends-

- **Credit**- the mortgage market placed a greater faith in the predictive power of the FICO scores and less on the overall credit analysis
- **Capacity**- the mortgage market shifted to the acceptance of no income doc and limited income documentation loans and greater reliance on overtime, bonuses and future earnings prospects
- **Capital**- the mortgage market shifted to acceptance of credit scoring, income growth and continuing price appreciation and reduced the requirements for down payments- average ltv's moved higher, including 100% LTV loans
- **Collateral**- mortgage market shifted to acceptance of continuing price appreciation and reliance on cheaper and faster automated or reduced property appraisal analysis methodology.

### **Question #3. Your observations of business practices within financial institutions engaged in the mortgage business and the regulation and internal risk management**

The majority of financial institutions had effective internal risk management structures. The majority of mortgage professionals treated their customers in a professional manner. Most financial institutions learned from the mortgage crisis and have instituted better risk management policies after the mortgage crisis.

**However, , the lack of effective market and management disciplines in the late 1990's through 2005 period created adverse participant incentives that harmed the consumer , undermined the viability of mortgage lending companies and threatened the stability of mortgage finance system.**

- Loan officers were often paid on “overages” – collecting additional fees for selling the consumer a higher interest rate or additional lender beneficial terms- This led to the tendency of some loan officers to maximize commission at expense of consumer interests.
- Loan officers received referrals from realtors and homebuilders for their ability to steer the consumer to close transaction as easily and quickly as possible.—this led to the tendency of some loan officers to prioritize referral interests at the expense of meeting consumer needs.
- Appraisers were hired by loan officers who had direct financial stake in the outcome of the appraisal.—Since the loan officer controlled the ordering of new appraisal orders, this led to the tendency of some loan officers to punish appraisers for not maximizing valuations and of some appraisers to maximize valuations in order to earn additional appraisal orders
- Mortgage managers were incentivized on loan production criteria-- volume, market share and or profitability—and not generally on loan quality criteria. Since, Alt A and subprime loans had higher profitability than conventional and FHA/VA, this led to the tendency of mortgage managers to encourage riskier but more profitable loans, to encourage greater volume over loan quality and to encourage loan officers to overcharge consumers.
- Underwriting personnel were incentivized on volume and post close loan performance evaluation was weak. This led to the tendency for some underwriters to move quickly through loan volumes at the expense of loan quality and for some financial institutions to be unable to detect loan performance trends
- Borrowers/consumers were incentivized by greater capital gains in a rapidly appreciating housing market. This led to a tendency of motivated borrowers/consumers to misstate critical loan information, maximize leverage through higher LTV's, and fail to carefully shop for loan terms and fees.

## **2. Incomplete and overlapping regulatory schemes contributed to uneven competitive landscape for mortgage market participants and consumers.**

The primary mortgage players were federal commercial banks, federal thrifts, state banks, and non-depository mortgage banks. These different business entities were licensed and regulated by different federal and state regulators operating under different levels of regulatory enforcement structures. Non depository entities with state licenses could offer some loan products and federally regulated banks and thrifts could offer other loan products. Consumers were unable to evaluate the credentials or reputation of market participants by licensing status. Collectively, this created an ineffective patchwork of license, regulatory and management oversight that allowed unsound financial institutions to flourish and unscrupulous loan originators to move freely thru the financial system.

## **3. Increasing distance between lender and borrower led to decrease in systemic accountability and responsibility**

While the origination to securitization vastly increased credit opportunities for the American consumer, this system led to a breakdown in the historical relationship between lender and

borrower. The development of securitization, proprietary FICO scores, automated appraisal systems, automated underwriting systems tended to “outsource” the lending decision and to dilute and reduce the accountability of the lending institution. Lenders increasingly saw borrowers as data points in a MBS prospectus. From the borrower’s side, the borrowers often did not understand where the funds were coming from. Borrowers often dealt with a loan broker first, another lender at loan closing, another lender for the first payment and another lender or two for later payments. This has led to a subversive social shift in how borrowers regard their mortgage obligations and how lending institutions regard their customers.

Footnote- #1- Steven A. Holmes, New York Times, September 30, 1999 including quote by Franklin Raines, Fannie Mae Chairman,