Excerpts from Testimony of North Dakota Commissioner of Financial Institutions Timothy J. Karsky before the U.S. Senate Committee on Banking, Housing and Urban Affairs on "The Condition of the Banking Industry: Part II"
June 5, 2008

State Initiatives to Improve Supervision of the Residential Mortgage Industry

While state supervisors are leery of a complete overhaul of the banking system, we have long recognized the need for changes to the residential mortgage system. As a result, CSBS has been working diligently to improve cooperation and coordination among state regulators and between state and federal authorities. Much progress has been made towards enhancing supervision of the residential mortgage industry as federal and state regulators have engaged in an unprecedented number of cooperative initiatives and agreements to ensure seamless supervision of the industry. The numerous initiatives detailed below provide a model of financial regulation in a federalist system of government.

State and federal financial regulators have developed—and continue to develop—guidelines, best practices, and regulations to prevent abusive lending practices in the mortgage industry. Congress and state legislatures have passed or are debating legislative initiatives designed to change industry standards and protect consumers. An array of market participants—regulators, attorneys general, and servicers, among them—are engaged in loan modification strategies to help homeowners avoid foreclosure.

We congratulate this Committee on the recent passage of the S.A.F.E. Mortgage Licensing Act of 2008. As we have outlined for this Committee in previous testimony, the states have adopted numerous initiatives to enhance the supervision of the mortgage industry. As recognized in the bill passed by this committee, the cornerstone of these initiatives is the development of the Nationwide Mortgage Licensing System.

CSBS-AARMR Nationwide Mortgage Licensing System

The CSBS-AARMR Nationwide Mortgage Licensing System (NMLS) went live, as scheduled, on January 2, 2008. This system is more than a database. It serves as the foundation of modern mortgage regulation by providing transparency for regulators, the industry, investors, and consumers. Seven inaugural participating states started using the system on January 2, and eighteen states will be on the system by the end of the year. To date, 42 state agencies representing mortgage regulators in 40 states have signed the Statement of Intent, indicating their commitment to participate in the NMLS. Eventually, we expect all 50 states to transition onto the System. I have attached, as Exhibit A, a map which indicates when states will begin using the NMLS.

In the first five months of operation, the NMLS:

- Is currently managing over 4,800 companies;
- Is currently managing over 3,100 branches; and
- Is currently managing over 23,000 individuals.

The NMLS creates a single record for every state-licensed mortgage company, branch, and individual that is shared by all participating states. This single record allows companies and individuals to be tracked across state lines and over any period of time. Additionally, consumers and the industry will eventually be able to check on the license status and history of the companies and individuals with which they wish to do business.

The NMLS provides profound benefits to consumers, state supervisory agencies, and the mortgage industry. Consumers will have access to a central repository of licensing and publicly adjudicated enforcement actions. Each state regulatory agency will retain its authority to license and supervise, but the NMLS eliminates unnecessary duplication and implements consistent standards and requirements across state lines. Honest mortgage bankers and brokers will benefit from the removal of fraudulent and incompetent operators, and from having one central point of contact for submitting and updating license applications.

The NMLS is part of an extensive effort to improve regulatory expectations, supervision and enforcement of the mortgage industry. We appreciate this Committee's recognition of this powerful tool and the revolutionary impact it will have on the supervision of the mortgage industry.

CSBS is pleased that we have been able to initiate many programs in collaboration or consultation with our Federal counterparts.

Pilot Programs with Federal Regulatory Agencies

Late in 2007, CSBS, the Federal Reserve System (Fed), the Office of Thrift Supervision (OTS), and the Federal Trade Commission (FTC) engaged in a pilot program. Under this program, state examiners have joined examiners from the Fed, OTS, and FTC to conduct simultaneous examinations of mortgage companies whose separate charters cross federal and state jurisdiction. While the examinations are in their final stages and are not yet complete, we have already learned a great deal from the process. This pilot is truly the model for coordinated state-federal supervision.

Uniform Standards for Testing and Education

CSBS and AARMR are spearheading a cooperative project with the mortgage industry called the Mortgage Industry Nationwide Uniform Testing and Education Standards (MINUTES). The project involves regulatory representatives from five states (Louisiana, North Carolina, Oregon, Pennsylvania, and South Carolina) cooperating on a task force with representatives from three mortgage industry associations (Mortgage Bankers Association, American Financial Services Association, and National Association of Professional Mortgage Women).

The initiative, begun in early 2007, provides model language establishing uniform standards for mortgage professional testing and education, and streamlines the process for licensees to comply with these standards. MINUTES will ensure that licensed mortgage providers and their loan originators are held to the same standards and expectations, regardless of the state in which they make loans. Once implemented, MINUTES will provide an Internet portal connecting state approved educators with mortgage professionals and then connecting testing and education satisfaction with the NMLS for a seamless interface of licensing and continuing education requirements. Users of the NMLS will be able to identify mortgage professionals who have successfully passed a test and are current on their education requirements for each state in which they are licensed to conduct business.

CSBS-AARMR Guidance on Nontraditional Mortgage Product Risks

In October 2006, the federal financial agencies issued the *Interagency Guidance on Nontraditional Mortgage Product Risks* which applies to all banks and their subsidiaries, bank holding companies and their non-bank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions. Recognizing that the interagency guidance did not apply to those mortgage providers not affiliated with a bank holding company or an insured financial institution, CSBS and AARMR developed parallel guidance in November 2006 to apply to state-supervised residential mortgage brokers and lenders. 45 states plus the

District of Columbia have adopted the guidelines developed by CSBS and AARMR. [1] Ultimately, we expect all 50 states to adopt the guidance.

CSBS-AARMR-NACCA Statement on Subprime Mortgage Lending

The federal financial agencies also issued the *Interagency Statement on Subprime Mortgage Lending*. Like the *Interagency Guidance on Nontraditional Mortgage Product Risks*, the Subprime Statement applies only to mortgage providers associated with an insured depository institution. Therefore, CSBS, AARMR, and the National Association of Consumer Credit Administrators (NACCA)[2] developed a parallel statement that is applicable to all mortgage providers.

Released in July 2007, the Subprime Statement has been adopted by 40 states and the District of Columbia. [3] Again, we expect all 50 states to adopt the Statement to encourage seamless and consistent supervision of the mortgage industry.

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

AARMR-CSBS Model Examination Guidelines

In addition, CSBS and AARMR developed state Model Examination Guidelines (MEGs) for field implementation of the *Guidance on Nontraditional Mortgage Product Risks* and the *Statement on Subprime Mortgage Lending*.

[1] To track state adoption of the CSBS-AARMR *Guidance on Nontraditional Mortgage Product Risks*, go to http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/NTM_State_Implement.htm.
[2] The National Association of Consumer Credit Administrators represents the officials of the states and territories of the United States of America and of the Dominion of Canada, or their associates, who, by law, are vested with authority and duty to administer laws which require regulation or supervision of consumer credit agencies in the United States of America and the Dominion of Canada.
[3] To track state adoption of the CSBS-AARMR-NACCA *Statement on Subprime Mortgage Lending*, go to http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/Sub_prime_State_Impl.htm.

Released on July 31, 2007, the MEGs enhance consumer protection by providing state regulators with a uniform set of examination tools for conducting examinations of subprime lenders and mortgage brokers. In addition, the MEGs were designed to provide consistent and uniform guidelines for use by lender and broker in-house compliance and audit departments to enable them to conduct their own review of their subprime lending practices. These enhanced regulatory guidelines present a new and evolving approach to mortgage supervision.

To prepare state examiners, as well as industry compliance personnel for an approach designed specifically for subprime lending platforms, CSBS and AARMR released a comprehensive Internet based MEGs User School on March 1, 2008. This school was developed to give both regulators and industry the tools needed to comprehensively examine the institution under the MEGs.

AARMR-CSBS Reverse Mortgage Examination Guidelines (RMEGs)

On December 8, 2008, AARMR and CSBS announced the release of a comprehensive set of examination guidelines designed specifically for reviewing the business practices and operations of lenders and brokers selling reverse mortgage loans to seniors. CSBS and AARMR expect that the Reverse Mortgage Examination Guidelines or RMEGs will begin to be used by state mortgage regulators in early 2009.

A reverse mortgage loan is a loan secured by a lien on residential real estate in which the homeowner is not required to make payments on the loan until the homeowner ceases to reside in the property. Typically, a reverse mortgage loan is eligible for homeowners at least 62 years of age.

State regulators have expressed concern that the complexity of reverse mortgage loan transactions coupled with aggressive marketing campaigns put homeowners and the financial institutions making the loans at risk. Further, state regulators believe that the substantial real estate equity held by senior homeowners makes these consumers more vulnerable to "equity stripping" scams or other fraud and abuse, such as the simultaneous sale of unsuitable investments or deceptive sales practices.

When sold to the right person for the right reason, these products can be very beneficial. However, reverse mortgage loans are not suitable for every senior homeowner or every situation. And even when made correctly, reverse mortgages present future risk to the financial institution. That risk must be understood by management and planned for appropriately.

This project demonstrates yet again that the States take the lead when it comes to consumer protection in regulating the mortgage industry. Reverse mortgages are an area of emerging risk for consumers and the States are aggressively getting ahead of the curve, just as the States were ahead of the curve on consumer protection when we began building the Nationwide Mortgage Licensing System five years ago.

The RMEGs are a comprehensive set of guidelines covering all aspects of operations from policies and procedures to marketing, underwriting, quality control and servicing of a reverse mortgage portfolio. The RMEGs take a two-pronged approach of regulatory compliance and sound management practices to achieve the dual goal of consumer protection and institutional stability.

<u>Nationwide Cooperative Protocol and Agreement for Mortgage Supervision</u>

In December of last year, CSBS and AARMR launched a Nationwide Protocol and Agreement for Mortgage Supervision to assist state mortgage regulators by outlining a basic framework for the coordination and supervision of Multi-State Mortgage Entities (those institutions conducting business in two or more states). The goals of this initiative are to protect consumers; to ensure the safety and soundness of the institutions; to identify and prevent mortgage fraud; to supervise in a seamless, flexible and risk-focused manner; to minimize regulatory burden and expense; and to foster consistency, coordination and communication among state regulators.

To date, thirty states have signed the agreement with an additional six states indicating a commitment to join. CSBS and AARMR expect all state regulators to sign the protocol and agreement in 2008.

CSBS contends that an enhanced regulatory regime for the residential mortgage industry is absolutely necessary to ensure legitimate lending practices, provide adequate consumer protections, and to once again instill both consumer and investor confidence in the housing market. The vast majority of mortgage bankers, brokers, and lenders are honest, law-abiding mortgage providers. And many of the problems we are experiencing are not the result of “bad actors” but rather bad assumptions by the architects of our modern mortgage finance system. Enhanced supervision and industry practices can successfully weed out both the bad actors and address the bad assumptions. If regulators and the industry don’t address both causes we will only have the veneer of reform and we risk repeating our mistakes.

One lesson we should learn from this crisis is that consolidation and nationalization of supervision and preemption of applicable state law is not the answer. For those who were listening, the states provided plenty of warning signs of the problems to come. The flurry of state predatory lending laws and laws to create new regulatory structures for lenders and mortgage brokers that banks and the capital markets were funding were indicators that things were not right in our mortgage lending industry. To respond to this lesson by eliminating the early warning signs that the states provide seems incongruous. Just as checks and balances are a vital part of our democratic government, they serve an equally important role in our financial regulatory structure. The United States boasts one of the most powerful and dynamic economies in the world because of those checks and balances, not despite them.

Most importantly, it serves the consumer interest that the states continue to have a role in financial regulation. While CSBS recognizes that the mortgage market is a nationwide industry that ultimately has international implications, local economies and individual homeowners are most affected by mortgage market fluctuations. State regulators must remain active participants in mortgage supervision because of our knowledge of local economies, and our ability to react quickly and decisively to protect consumers. To that end, the states, through CSBS and AARMR, are working to improve mortgage supervision through enhanced cooperation and coordination with one another and our federal regulatory counterparts.