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TRANSCRIPT OF HEARING
ON
REAL PROPERTY FINANCE

LOS ANGELES, CALIFORNIA

NOVEMBER 12, 1974

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ASSEMBLY FINANCE
AND
INSURANCE COMMITTEE

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November 12, 1974
State Office Building, Room 1138
107 South Broadway
Los Angeles

SUBJECT: Real Property Finance

Meeting: Assembly Committee on Finance and Insurance

MEMBERS:

Honorable Alister McAlister, Chairman
Honorable Mike Antonovich
Honorable Robert G. Beverly
Honorable John V. Briggs
Honorable Robert Cline
Honorable Mike Cullen
Honorable Wadie Deddeh
Honorable Leroy F. Greene
Honorable Richard Hayden
Honorable Walter M. Ingalls
Honorable John Knox
Honorable Ernest Mobley
Honorable Louis J. Papan
Honorable Walter Powers
Honorable Paul Priolo
Honorable Leon Ralph
Honorable Newton Russell
Honorable Henry Waxman
Honorable Bob Wilson

STAFF:

Carlyle R. Brakensiek, Chief Counsel
Betty Yearwood, Secretary

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76-12-412

California Legislature

Assembly Committee on Finance and Insurance

ALISTER McALISTER
CHAIRMAN

AGENDA

November 12, 1974

Los Angeles

CALIFORNIA SAVINGS AND LOAN LEAGUE
William McKenna; McKenna, Fitting & Finch
Dr. Richard Pratt; Pratt & Associates

MORTGAGE REFINANCE COMPANY
Stanley Zimmerman

ESCROW INSTITUTE
Charles P. Conner

CALIFORNIA ESCROW ASSOCIATION
Donald Hurst

CALIFORNIA BANKERS ASSOCIATION
Richard E. Ratcliff

DEPARTMENT OF REAL ESTATE
Jack Hempel

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CHAIRMAN ALISTER McALISTER: This is the Finance and Insurance Committee of the Assembly conducting an interim study on real property financing and various problems in connection therewith.

Our first scheduled testimony today will come from various persons associated with the California Savings and Loan League.

MR. BERNARD J. MIKELL: Mr. Chairman, my name is Bernard J. Mikell, Jr., and I represent the California Savings and Loan League. I would like to simply introduce Mr. McKenna and Dr. Pratt and make a few comments about their credentials and then let them take over.

Mr. McKenna received his education at Providence College and his J. D. at Yale University. He is presently in practice in Los Angeles with the firm of McKenna and Fitting. Among his many qualifications he was Deputy Administrator under the HHFA, the predecessor of HUD under the Roosevelt Administration and was number two man in the Eisenhower administration. He has also been General Counsel for the Committee on Government Operations of the U. S. House of Representatives and was Litigation Counsel for the Federal Home Loan Bank Board and

and the Federal Savings and Loan Insurance Corporation. He also worked with the government of Brazil in setting up their housing structure, housing finance structure, and he is presently counsel for the California Savings and Loan League.

Dr. Richard Pratt is presently Professor of Finance at the University of Utah. He is a Public Interest Director on the Federal Home Loan Bank in Seattle. In 1970, he was appointed by the Federal Home Loan Bank Board in Washington to represent the public interest. He is a member of the National Advisory Commission of the Federal Home Loan Mortgage Corporation and he was a consultant to the Federal Home Loan Bank Board on the Hunt Commission which was the commission which was to study and make recommendations on restructuring the United States home financing system and he has also been a consultant to the Agency for International Development on Housing Problems in Developing Countries.

MR. WILLIAM McKENNA: Mr. Chairman and members of the committee, Dr. Pratt has prepared a basic reference paper which I hope has been distributed to the members and which is available here. I will talk in general terms from the point of view of housing and, hopefully, Dr. Pratt will get more specific and talk in detail as to the particular provisions which are contained within the notice of the committee, that is, specifically charges and interest rates, and fees called premiums or prepayment charges, the due-on-clause and late charges, but I

wanted to talk first from the viewpoint of housing because really all of these instruments, no matter how much we clarify them and no matter how much we reduce the charges to borrowers or the interest rates, it all serves no purpose unless they get some money and this is really our problem here today. This is what we are struggling with, how do we get the money on the most economical basis possible, on the most practical basis possible or the basis which serves the needs of the people of the State of California who are selling houses, buying houses, who need shelter. That really is where I would like to address myself because that is the overall problem. Unless we accomplish that, we have accomplished nothing by changing the terms of instruments that do not produce money.

I have seen and I have been told there have been continuous references here to the comparative situation in New York State and the State of California. We really, in the housing picture, have had to confront that situation since the close of the Second World War. Always it was New York that had the marvelous low interest rates, the prohibitions against exorbitant provisions in the loan instruments. We, in California, in all of that period up until the recent years were a capital-short state. New York had money coming out of its ears but New York's money came here, it built our houses, we satisfied the needs of our people. We built housing for

them and in New York the shortage of housing got worse and worse and people lived in more and more dilapidated structures. They could not put money in housing, so all of these beautiful instruments and these beautiful statutes that they devised only hurt the people of New York. We got the money from New York here in California and we built the housing here and that is the situation really that I would like to see reconstructed so that we get the money here, that we have the money to get the real estate business going again, that we can start the construction business going again, that we put the people to work who really need the work on construction, on house-building for their livelihood, that we give the real estate agents a lively real estate market, that has to be our objective and the argument over these provisions of the trust deeds must be subordinate to the major thrust, our major preface. And, of course, today particularly we have a very distressing situation. Hopefully, the last thirty days it seems that it is ameliorating some but it has been very bad. The cash flow available for housing in the thrift institutions of the State of California in September was about 3% of what it was in January. It had dropped 97% from January to September. This is the situation we have to confront. The savings--or the cash flow available for housing through the financial intermediaries in the State of California in September was about 20% of the payment down and the payment

off on mortgage loans alone. The rest of it went to the meeting of the negative deposit flow. This is the situation. We have to construct. We must get money flowing into the housing picture again and we must get it on a basis which serves the needs of the people, not a 10½% interest rate. You cannot really finance homes for the ordinary person over a 30-year period at a 10½% rate. We have got to get it down and that is our basic effort. This is what we are struggling with now and I would like to put the emphasis on starting the money flow again into housing so that we really have a viable housing business--real estate business and home construction, but we start with a background that all of the commodities in the world for which everybody can compete, its money. The sharpest people in the world want money. The biggest corporations in the world want money. The Arabs want it for their oil, the European countries want it to buy oil and we are competing with them. That is our job. We compete with everybody in the world except, perhaps, some nuns and nice people like that that have sense to remove themselves from this competition but even the number of them is reduced. Almost everybody wants money and we have gotto get it for housing and that is the problem and we cannot really take our minds away from it.

Now, how does that relate to what we are talking about here? Well, I believe that we were talking--you had some talks yesterday by way of example on the late charge provisions. What harm does it do if we let somebody stay a month or two

late in his payments. Well, back in the '30s when we first started in the direct reduction loan, the long-term amortized loan, one of the first requirements of the federal government, in addition to direct reduction on its loan payments, was that there be an opportunity to prepay the loan but then at that time the federal government mandated a very onerous provision for late charges. Today, it is a little different. We do not really, I hope, need quite the provisions that the federal government required in earlier years and which still permits but let me give you an example of what happens when one person fails to pay, make his loan payment on time and remember now it is not always the unsophisticated working man who fails to make his payment. Very often it is the calculating borrower, the professional borrower, the man who sees some other use for his money and if in terms of a one late payment on a substantial loan, that loan is rendered unsalable for a year to the Federal Home Loan Mortgage Corporation. If it is a $40,000 loan that means $40,000 is removed from the flow of funds available for housing in the State of California because one borrower failed to make his payment. Now, I say it is likely to be the sophisticated borrower who does not make his payment. The reason is that normally if it is a working man, an ordinary person, if he telephones the institution and says "I cannot make it." Then there is no payment, no late payment charge. The late payment is not imposed when somebody has a real reason for not being able to make it. It is normally the person who has a calculated reason for not making it, who is faced with the charge and the harm done

by him is that the entire unpaid principal balance of that loan is rendered unsalable to a New York purchaser, an out-of-state purchaser and those funds do not come into the housing flow of the State of California and this is a basic problem in what we talked about--the impact of failing to make a payment on a loan. If, in fact, we are going to keep the cost of financing of homes to the people of California at 70% of the prime rate because the average yield in the portfolio of the thrift institutions in this state is 7.6% and the prime is still above 10% and if we are talking about keeping the mortgage rate in the State of California substantially under the rate for triple A bonds by AT&T or the big borrowers of the county, then really we must give to the people whose job it is to get this money the means of getting it and when you put it in that way they are no more able to get this money than they are able to show to the people who are the potential sources of the money that they have paper that merits the purchase or that they can pay what they have to pay to attract the deposit and this means in direct relationship to the yield on the portfolio and to the degree that loan payments are late or prepayment charges, whatever it is. When we start talking in terms of such things as the due-on-sale clause, let us again reflect on what the impact of that is. We have constructed since 1933 a basic 30-year mortgage instrument, what we call a direct reduction loan instrument with, so far as the federal system is concerned, no subsequent payment any

larger than any earlier payment. This is the requirement and this is the result of the reforms of the hundred days of the Roosevelt administration. The direct reduction, amortized loan payment with no subsequent payment greater than any previous payment.

Put yourself in the position of a young family which wants to buy a home. That family is able to budget the maximum that is ever going to be required for the ownership of that home during the period that it occupies the home. This is the important thing. You are able to plan from the start on what it is going to cost you, X taxes, we cannot cover taxes, we cannot cover insurance but for the interest on the loan, for the reduction of principal of the monthly payment on the loan, by federal regulation, no subsequent payment can be greater over that 30-year period than any earlier payment so that the young family is able to say "This is all it is ever going to cost this family to occupy this home." Now, we change it a bit, we say, "We are going to extend that. Not only are you going to be able to occupy this home with no subsequent payment greater than any earlier payment but you are going to be able to sell that loan to the next purchaser." Immediately instead of having a loan with an average life of 8 or 10 years, the full contract period of 30 years becomes a possibility or something in between. Accordingly, the initial interest rate to that borrower must go up to reflect not just what the inflation index is going to be but it must give a safe margin to the

lender. It means that the initial cost of the loan to that home borrower must be very substantially greater than it would be if all you were giving him is a loan for the period that he occupies the house. Maybe you want to do that but the cost is going to be much higher and, in fact, what you are doing is not saving the home owner of California any money, what you are doing is transferring the cost from the present owner of that home to the subsequent borrower. You are putting the burden on the subsequent borrower into the housing market or the fellow who wants to sell his home because you make the mortgage instrument, you fix the mortgage instrument at that flat rate and somebody who comes in has to pay more to balance it out because there is no fat there. The average yield in the thrift institutions of the state is 7.6% or thereabouts, the margin for all of its overhead, all of its reserve allocations is not much more than 1%. There is no fat there.

CHAIRMAN McALISTER: Why should somebody just because they borrowed money in 1960 pay less interest over a 30-year loan than I, if I borrowed money in 1969?

MR. McKENNA: I think your point is well taken, Mr. Chairman. But if we go back again to the history of it, that is the only place we find the answer. In 1933, the federal government had to buy all of the mortgages in the country and it had to buy it because these were short-term loans which suddenly matured and there was the obligation of repaying them.

From that, we went to the opposite extreme, which was (belt fades out) that in fact no sub (belt once again fails to record) raise the interest rate in response to the market so there is a limit there on how much that can be done with it.

CHAIRMAN McALISTER: Over a period of time and with many loans, of course, ultimately you are going to be reducing the rate too, with a variable rate?

MR. McKENNA: If, in fact, the federal government has fiscal responsibility but I do not think any of us would be willing to bet his own money on that right now.

CHAIRMAN McALISTER: There are those of us, over the past generation or so we have seen inflation, but historically there has been no more inflation than deflation and you may well see a time when interest rates go down again.

MR. McKENNA: I think also if we were on the variable interest rate system there would be much greater public pressure to resist inflation, so I think you are right. If we had a variable interest rate mortgage, we would, in fact, eliminate many of these problems and we do not need prepayment charges and we do not need a due-on-sale clause if, in fact, we have a variable rate mortgage.

ASSEMBLYMAN BOB CLINE: Let me ask you relative to this latter point that you make concerning variable interest rates. Do you foresee in the instruments which you predict the variable

principal payment along with the variable interest rate, in other words, the principal payment moving inversely to the interest?

MR. McKENNA: Yes, I think that is all the federal associations could do now, Mr. Cline, but the problem is that the principal payment, the principal reduction is such a tiny amount of the initial monthly payment that there is not much to reduce there but I agree with the principle of it.

ASSEMBLYMAN CLINE: Let us say you had a variable interest rate loan and the interest rate went up and the total payment remained constant. Is it your answer to my question, that the total payment would remain constant and the amount of the reduction of the principal will decline?

MR. McKENNA: Well, yes, but the problem would be this, if we have a 30-year maximum it may be that the principal reduction becomes a negative fact of trying to crowd it into a fixed monthly payment.

ASSEMBLYMAN CLINE: So, in other words, what you are saying is you want total leeway then to vary the total amount of the payment.

MR. McKENNA: Well, obviously we would all like to keep that payment at a level amount. This is important to a young family.

ASSEMBLYMAN CLINE: Do you envision with a variable interest rate loan, the increasing of total payment as interest rates rise?

MR. McKENNA: In some instances, yes, if we are going to have a true variable interest rate loan. I think we should resist it and minimize it but we may have to do it if we are going to keep to a 30-year maximum, have the present loan-to-value ratios, and have the surge of interest rates that we have seen from time-to-time in the last few years. I do not like it but I think it will have to be.

ASSEMBLYMAN CLINE: So, you are saying it will go beyond the 30 years?

MR. McKENNA: I should think your original loan should not be made for more than 30 years but that if we have a choice of increasing the monthly payment or extending the loan beyond 30 years, we should be allowed to extend it beyond thirty years rather than to increase the monthly payments.

ASSEMBLYMAN CLINE: You think politically that is salable on a national level?

MR. McKENNA: Not at the moment. This is a very emotional issue in Washington.

ASSEMBLYMAN CLINE: I would say not in the foreseeable future.

MR. McKENNA: Well, but the net result is that we are excluding new entrance to the housing market by the present structure and we have to face that. A lot of the problem is due to the cost of constructing the home and the surge in real estate values, but the fact is that when you start talking in

terms of 10 and 11% interest rates you do preclude a very hefty percentage of the respective home owners from owning a home and you have got to get that rate down.

ASSEMBLYMAN CLINE: Nationally, what percentage of the savings and loan lending goes into single family dwellings as opposed to non-single family dwellings?

MR. McKENNA: I would only hazard a guess. I think the tax requirement, for tax eligibility is 70% but I am not certain of that. It certainly is more than two-thirds.

ASSEMBLYMAN CLINE: My final question--concerning the due-on-sale clause--there have been a number of borrowers who in order to attempt to pass on to a subsequent buyer the loan, rather than have the payment due, enter into a land contract and then the homeowner then maintains the obligation as his and the new owner pays to the original borrower the amount to cover the principal and interest. I understand that the industry has not legally challenged this and I wonder what plans you have in that regard to challenge the legality of a land sale contract?

MR. McKENNA: This really is not so much a practice now as an anticipated practice. The State Supreme Court about a month ago in the Lassen Savings case said that the due-on clause could not be exercised by a lender when the transfer was a transfer by a land sale contract rather than by a conveyance. Now, I think in my own mind this is a difference in words only.

That is what the Supreme Court held, so we anticipate and I think everybody anticipates that there will be a greater use of both sales contracts and of subordinate financing, of secondary financing if, in fact, the bare inference from the opinion is this would also so hold when there is heavy secondary financing. Now, this leads to the probability that in order to preserve the existing low-yield loan there will be wrap-around seconds at much higher rates and seconds normally have balloon payments before too long so I think really that this is going to send us in the direction of unsound financing, but all of that remains to be seen yet. I think this opinion is largely being analyzed from the viewpoint of its impact on all financing, Mr. Cline.

CHAIRMAN McALISTER: Thank you. You may proceed.

MR. McKENNA: Returning to the variable interest rate loan, under the laws of California the state-chartered lenders, in contrast with the federal, can also have short-term roll-over notes, something in the nature of a 3 or 5 year loan with a balloon payment at the end which also will permit the lender at the end of that period or some other lender to refinance at the then current interest rate. These are developments that I think we are going to have because of the surge of inflation, the uncertainty of interest rates and also because of the erosion of the provisions which make the long-term fixed interest loan, has made it a viable instrument.

CHAIRMAN McALISTER: You are saying that if you cannot have a due-on-sale clause and so in effect take advantage of the opportunity to loan money out at the higher interest rate being developed over a period of years that then you would have a series of short-term loans that would continually be becoming due over a period of several years so that you would continually refurbish your portfolio.

MR. McKENNA: This is a real possibility. There is no way around the necessity of paying current rates for your money--current short-term rates for your money. Otherwise, we have the situation we have had in the summer and early fall of this year and still have which is a very unpleasant situation, so we must be able to pay a higher rate for our savings in order to have an adequate flow of funds into housing. If we have an average yield in our portfolio as it is now of about 7.6%, new loans have to be outrageously high in order to have any perceptible influence on the average; to lift the average. On the other hand, if the average yield on the portfolio went with the money market then new lending could be at a dramatically lesser rate. This is the problem we have and the ways of achieving a solution are the variable interest rate loan, the short term roll-over loan and in the past, to a lesser degree, a due-on-sale clause which meant that instead of having a 30-year contract life to the loan, we would have a shorter actual life of perhaps eight years so that in

every eight year period we would have rolled over our portfolio.

CHAIRMAN McALISTER: Are not these other methods like the short term loan and the variable interest rate actually more equitable than the catch-as-catch-can system that is developed under the due-on-sale and prepayment penalties and this type of thing? I mean, this is kind of helter-skelter; if you sell, then there is a new loan issued to the new buyer and so you get higher interest rates but somebody else keeps their home for 30 years, 40 years, and this does not happen and these other systems that you are talking about or at least if accepted over a period of time would apply to nearly everybody.

MR. McKENNA: I think I agree with your proposition, but let me point this out, that the borrower now, or hopefully will have an option. If he likes the variable interest rate loan then he could pick that. If he prefers the short-term roll-over note, he could pick that. Now, we should also like to give him the form of loan that we have been using the past quarter century as an option, but this is not going to be a viable option, if we take away the provisions for a due-on-sale, the prepayment charges and these factors except with an exorbitant interest rate. I can understand a young family wanting to be able to budget for the time it occupies that house, the total monthly cost to it. This is an understandable proposition.

CHAIRMAN McALISTER: With a person who chose that option of knowing exactly what he was going to pay over a period of time you would want the due-on-sale clause but if a person had a variable interest rate or a short-term loan then you would not want...

MR. McKENNA: That would be my personal feeling. I would not justify a due-on-sale clause with a variable interest rate loan or a short-term roll-over note. I think what we have talked about is the essence of the problem. There is a need for what we call the nonoptional lender. Basically, in this state a savings and loan association cannot put its money anyplace, except to provide shelter for the average person. The reason for this is because you must develop these skills in the competitive money market among people who cannot use them except to get money to the homeowner. They are competing and our people are competing with the financial giants of the world and with everybody who wants money. Since the average homeowner cannot do this, we develop these skills and we develop the resources in the financial intermediary money market--the nonoptional lender, the savings and loan association--and say, "Develop your skills, get competitive, but the product of your skills, the money that you get flowing must go only to home lending." This is the only way that we can make the home financing market competitive with the Arabs, with the countries of Europe or with General Motors. We must

do it this way for these people and these experts in the savings and loan structure, whose expertise must be limited, in order to give them a chance of winning in this battle for money and to have them develop competitive instruments. They must have the means of competing with the others who want money. When we limit them to a 30-year loan with a fixed interest rate and no due-on-sale clause, the task is impossible. We will not get the money, and that is why I use New York as an example. When I was Deputy Administrator in '54 it was perfectly clear to me that New York had all of these beautiful protective devices for borrowers and they were not building houses, nor sheltering their people. We, in California, were. We were getting the money from New York and we were putting it into California home construction. This is what I would like to see start again, and this is the overpowering need. We should not talk in terms of these isolated provisions of trust deeds, but how do you put roofs over the people of the State. Hopefully, Dr. Pratt can help us relate these two.

DR. RICHARD T. PRATT: Let me say initially that it is a great pleasure to speak to this group. California has long had the national reputation of being the leader in both providing housing and housing finance and I think that you have a record that you can truly be proud of. I hope that the deliberations that your group will undertake will restore the continued record of such success.

In following up on what Bill has had to say, I thought we might get into some of the aspects of the mortgage loan and its viability as an economic instrument. I would, of course, like you to interrupt at any time, some of the points will be fairly technical, but I think they will lay a solid groundwork on how each of the aspects of the instrument works. If we take a look at the mortgage loan, which Bill has mentioned, we are really seeing sort of two difficulties that are facing us at this time. First is the overriding economic problem of borrowing short and lending long which I intend to address myself to in a few moments. Second is the current interest rate in the mortgage instrument, itself, and the various provisions of it, such as late charges, the prepayment charge, and so on.

First, I would like to say that these two things are very much interrelated. I think Bill has laid the groundwork. The mortgage is a financial instrument. It must compete with other financial instruments and it is a very large part of America's capital markets. The new funds raised through mortgage lending may be as much as three or four times the total new corporate borrowing in any year. This is the country's biggest capital market. We need to make every effort to insure that the instrument operating in that capital market is as efficient as possible. I think we need to be certain that no state isolates itself from this national market. I will give you figures which show the growing importance and dependence of California on other states in this system.

Something which I think needs to be clearly established is the fact that our mortgage lending system has operated with great efficiency. If we look at the last ten years and look at the record of savings and loan associations their net profit is something like 70 cents a year per $100 of mortgage loan. This is total compensation for facing massive interest rate risks. Anyone of us looking at what has happened to the economy in the past few years have to say that a person who undertakes to borrow short and lend for thirty years in these markets is really taking a rather substantial market position. He receives about 70 cents a year for every $100 of mortgages that he serves. The total cost of obtaining funds, servicing loans, attracting funds through savings accounts, lending, providing a return to the owners of savings and loan associations or providing for reserves in the case of mutual institutions amounts to no more than 2% per year of the mortgage balances outstanding.

Another important point is this secondary mortgage market. The state of California and the western United States, in general, depend very heavily on this market. Let me explain briefly, what it is. This is the origination of mortgage loans by an original lender, a savings and loan, a mortgage banker or others, and the sale of these loans on either local or national markets. The figures are really quite striking. If we take a look at California and the

western United States, of the estimated 3.8 million single-family loans in this part of the country, approximately 1.4 million or about 36% of the total have been supplied by funds outside of this geographic region. More than 1/3 of the mortgage credit for single-family lending is coming from outside the region.

What is the importance of these facts? Purchasers in this secondary market, whether they be federal agencies or other private financial institutions accept certain provisions in the mortgage. They anticipate being able to depend upon certain aspects of the contract. If this contract is modified or made less competitive as a financial instrument, it becomes an unattractive investment for lenders, for federal agencies, or perhaps precludes their purchasing of California mortgages, 36% of such funds coming from outside the area. Any action which would impair the salability of California's mortgages is simply denying mortgage credit to the home buyers of California. It is likely that this is going to be a more and more important source of funds. At the present time, what new mortgage lending there is, is coming mainly from federal agencies operating through the secondary market. This would be the Fanny Mae and the Ginny Mae programs, and the Federal Home Loan Mortgage Corporation's purchase of mortgages. Thus, this secondary market and the fact that we have a national instrument are factors which should be kept in mind as we discuss the mortgage.

I would like to reinforce a point Bill made. Legal prohibition that precludes something like the due-on-sale clause or a late charge, in fact, reduce the lender's option. They reduce the borrower's option. Many of these provisions assess the cost where they occur. Should a person who is punctual in his mortgage payments have to pay the burden or "carry on his back" the person who is not punctual and is inept in making his payments? Quite often these clauses assess direct user charges, as we do away with these clauses, these charges must be lumped into the interest rate. We are not charging individuals for a cost which they do not incur upon the system and for which they are not responsible. It seems a less equitable system than that which we presently have.

Let me refer now to the operational setting of a savings and loan association, and establish a base of efficiency of operation. One of the real functions, I think, that mortgage lenders and savings and loan associations especially perform is this process of intermediation or assembly funds and dispersing them in the mortgage market. They do this essentially by borrowing short and lending long. The sources of funds for these associations are few. The first is the passbook savings, which is, of course, withdrawable immediately and is subject to interest rate pressures of all types. An interest rate must be paid which will obtain those funds. The second is certificate of deposit which, while

somewhat longer, is still relatively of short duration--normally under 4 years. The certificate of deposit advances from the Federal Home Loan Bank and have an average duration of up to five years. However, the average maturity of these across the country is presently eight months.

On the other side, the mortgage lender offers loans for an average of 25 to 27 years. Now, we have talked about and will continue to talk about some options for this type of lending, such as the variable interest rate for the short-term note. A very valuable service that the savings and loan association is performing is its financial expertise. It can go to the typical homeowner and say, "Look, there is financial risk in the market. Interest rates have changed. We are willing to bear that risk, keep it from you, and provide you with a loan where you can count on the payment being a certain amount as long as you have tenure in this house. You will know what portion of your monthly payment is for principal and interest."

The price which the savings and loan has charged has been a very modest fee based on the figures, which I just gave you, to assume this interest rate risk. If we wish to shift it to the borrower, we have to ask the question: Is this really a very good thing to do, if he is able as the professional manager to bear that risk? As long as the long-term fixed interest rate mortgage has the appropriate tools associated with it, it allows such long-term fixed rate

lending. Look what happens, though, when we artifically extend the maturity of those loans or do such things as eliminate the due-on-sale. If we look at the 1965 portfolio of the Eleventh Federal Home Loan Bank District, which covers California, Nevada and Airzona, they were earning an average of $6.37 per year per $100 of mortgages held. Of course, this figure continues as long as any portion of that portfolio is on the books, thus we see that the figures from 1965 to 1973 for the portfolio held in 1965 remain at $6.37. The second line shows what has happened to the average cost of funds for these associations. When they made the loans in 1965, which is our benchmark year, the average cost of funds, plus their 1.2% operating costs amounted to $5.93. By 1973, this figure had risen to $6.93. While there was a dollar increase, there is no increased return on the portfolio. The cost or the profitability of holding that mortgage goes from a positive 44%, 44 cents per $100 in 1965 to a minus 56 cents in 1973.

ASSEMBLYMAN JOHN KNOX: May I ask a question. Is it correct that as the payments come in they are re-lending the money at the higher rate?

DR. PRATT: That is correct.

ASSEMBLYMAN KNOX: Thus, is it not correct to point out that the re-lending of money does ameliorate the situation?

DR. PRATT: Yes. It is the volume and active market with these instruments which have allowed the savings and loan association to remain in business and make a profit. You are pointing out the importance of the due-on-sale clause. A substantial source of funds is the early repayment of the loan. This source is the result of the due-on-sale clause. It is this "rolling" of the portfolio, which has allowed California associations to continue to operate. But the opposite side of the picture shows that as we slow down this ability, we force the mortgages to stay on the books and this becomes untenable. It just becomes untenable. No matter what your volume is, if you lose a little bit on each loan, you do not make it up.

ASSEMBLYMAN KNOX: I am not certain I understand how this roll-over loan works. In other words, somebody would take a loan for five years or some other time period and the institution would agree, in advance to re-lend the money at the market rate?

DR. PRATT: I intend to discuss this.

The point is that since World War II these interest rates have continually moved upward on each loan. As it stays on the books it has become an unprofitable entity. Thus, it is a fact that these loans are paid off and partly paid off as a result of the due-on-sale clause or other aspects of the contract and the clause has maintained the viability of the instrument. For instance, let me refer back to the

secondary market for just a moment. On the average, when secondary market transactions are made, it is assumed that the mortgage will have a 12-year life. This obviously assumes some early pay-offs. If you eliminate the due-on-sale clause or if you do things to discourage such pay-offs, the 12-year life is not going to exist.

I do not think we need to say much about the interest rate. There has been freedom of contract as to the level of this interest rate. Evidence shows that states which have restrictive usury laws do not have mortgage lending. There was an excellent article in the St. Louis Federal Reserve Review in the last couple of months which you might find useful, if you are interested.

There are two types of closing costs and origination fees.

First are those which represent the hard costs to the lender of putting a loan on the books. It seems appropriate that these be charged at the time that the loan is closed. They are costs associated with the origination of the mortgage loan. It seems to be a better time and place to charge them rather than spreading them over the life of the loan.

Second are those associated with origination fees and discount points. This is the market freedom. Even though there are loan disclosure requirements, such as the actual loan interest percentage rate, both the lender and borrower do have options. For some borrowers, the lender may prefer a lower contract interest rate with more initial points. For

others, the opposite may be true. This is a matter which can now be negotiated between the borrower and the lender.

We also get into some difficulties in the secondary market if there is interference with the origination of fees. As you know, HUD has set arbitrary levels at which FHA loans should be made. When these arbitrary levels are not the same as the market, the price of the mortgage changes in the secondary market. We have seen FHA mortgages carrying as much as 8 points of discount at various times to make them viable in this national secondary market. I would think that no state would want to consider any sort of legislation which might at some time preclude the marketing of their mortgages in such a market.

Prepayment charges. Why do prepayment charges exist and what role do they fill?

Let us look back at this interest rate risk for just a moment, if we might. When interest rates are rising the mortgage lender has no right to call the loan, nor has he the right normally to accelerate the interest rate on the loan. He must live with that portfolio. When interest rates fall, the borrower has every right to prepay and to re-finance at the lower interest rate, which would be to his advantage.

For example, a 25-year, $10,000 loan has a 9% interest rate. If the loan is paid off at the end of year 5 and if a prepayment charge is used, following the federal formula, the Federal Home Loan Bank Board has said that prepayment charges may not exceed 6 months' interest on the amount

prepaid, less 20% of the original balance of the loan. Thus, we have a loan balance at the end of year 5 of $9,327. We have a prepayment charge of $330, based on the formula, which I mentioned. If the borrower prepays at that time, the loan has cost him 9.53%. In other words, that is the effect of the prepayment charge. How low would rates have to be before he would be better off, that is, have a lower monthly payment, if he re-financed? Rates would only have to drop from 9% to 8.66% to make it advantageous for him to pay off the previous loan, pay the prepayment charge and negotiate a new loan. So, on the rising interest rate side where a borrower in 1965 may have gotten a loan at 6 3/4% and today rates are 10½%, nearly a 400 basis point increase, the lender has had no recourse whatsoever. He has to live with this and has been willing to do so. If interest rates were to fall we can see from this fairly typical example that they need fall only 34 basis points before the borrower would find it advantageous to re-finance. So this is a modest, a very modest, sharing of the interest rate risk.

ASSEMBLYMAN CLINE: Have you built into this re-financing rate new origination fees?

DR. PRATT: The 8.66% would have to be the effective rate, which would be a combination of the contract rate and the new origination fees. For instance, if the new contract rate were 8½%, you could have about one point or a little more and it would make it the 8.66, so the 8.66 is an effective rate and it would be a balance of the origination contract rates.

CHAIRMAN McALISTER: Dr. Pratt. When interest rates are rising, the borrower does not really have any incentive to sell or re-finance. Why have prepayment charges under those circumstances?

DR. PRATT: In that case, we would probably say that the prepayment charge was a matter of negotiation between borrower and lender at the time that it was originated, and if both parties freely understand its operation, I would see no reason to preclude it.

CHAIRMAN McALISTER: Of course, things like that are never freely negotiated. Isn't that a bit of a legalistic myth to say that any of this is freely negotiated?

DR. PRATT: I think that there are two aspects. The negotiation of individual borrowers of single family house may be limited, however, acting as a system I think the negotiation works rather thoroughly. You may have noticed in the paper yesterday that mortgage interest rates have already dropped in some instances. The system has been amazingly sensitive to competition. I think we would have to conclude that given the fact that economic changes have been rapid, readjustments have been made rather rapidly and rates have come down at the first sign of decrease in demand or any increase in supply of funds.

CHAIRMAN McALISTER: No, it does not and you can only get so much blood out of a turnip.

DR. PRATT: I think from a pure economic rationale your point has some validity.

MR. McKENNA: If, in fact, the increase in interest rates were such as we experienced from perhaps the end of the Korean war or until 1965, then there was a need for the prepayment clause because the interest rate rise was so modest that the loss of income during the replacement of the loan may have cost the institutions that much. But we are talking today in a totally different ball park and when we have this surging interest rate then obviously from an economic point of view the prepayment is not needed by the lender and there is not much economic justification for it.

ASSEMBLYMAN KNOX: I do not know why you fellows do not use the historic argument on prepayment. It dates back from the early English lenders. Now, of course, we have a more mecuric situation, but nevertheless I think that it at least has some validity. However, on a rising market, I see no justification for it at all.

MR. McKENNA: Well, it certainly is not a rapidly rising market. I might go back a bit into the history of it. The Bank Board in 1934-35 for the first time required that mortgage loans must have a prepayment privilege, which provided that the borrower must have the right to prepay. At that time, the Bank Board put in exactly the same formula which is present today. Maybe they should be reconsidering what the national formula should be? For example, if you are

buying a bond from a major corporation and it wants to call that bond, it has to pay a premium, which is a prepayment charge on that is a competitive instrument. Now they are the borrower, the big corporation, if there is a public market for that bond can go and buy it at the current rate in the public market. I really cannot say that if we are going to have this continuing surge of interest rates that we should have the present prepayment charges in there. I think that probably the Bank Board will consider a national change if we are going to have a repetition of this.

ASSEMBLYMAN CLINE: Is it customary within the industry now to eliminate a prepayment penalty when the refinancing is done with the same institution?

MR. MIKELL: In California, yes, that is true.

ASSEMBLYMAN CLINE: That applies to federal and state institutions?

DR. PRATT: Yes, as a matter of tradition it would be true for essentially all lenders. You will find wide variations in the way individual lenders apply this. Many lenders, in fact, would be very careful and very unlikely to charge a prepayment penalty in a period of rising interest rates, but it obviously does vary a good deal from institution to institution.

CHAIRMAN McALISTER: I think that this is a point that is a little troubling to some of us. There seems to be marked inconsistency at least between institutions and perhaps

as between different borrowers. We had a lady here yesterday who told us her sad story about having to pay a prepayment penalty although she understood the same institution waived the penalty for other people. I think it was the same institution that was going to carry the loan for the next purchaser and, of course, I do not know all of the facts on that, but the reported inconsistency as to the troubling thing.

DR. PRATT: Yes, I have tried to establish sort of an economic basis for it as a sharing of the interest rate risk. I think that is a very valid use of this. Certainly, I am sure this committee will have to weigh other circumstances associated with it.

The next section that we might take a look at is the late charges. I think the only comment that I would care to make at this time is that the late charge really serves two economic functions. One, the late charge should clearly cover the cost imposed by the individual who makes his payment late. I would like to reinforce that some of those costs may not be evident. The point that Bill made earlier that a history of late payments jeopardizes the sale of this mortgage in secondary markets should not be overlooked. That is an extremely important point and it may mean that $30,000 or $40,000 or whatever of mortgage credit is simply not available because this instrument became ineligible for the sale on the secondary market. Second, of course, simply the

fact that payments are late, delays the cash flow to a lending institution and that, by itself, reduces the amount of funds which might be available. Along with these direct costs it certainly is in the borrower's interest to be punctual in his payments. I believe that the late charge should reflect in increment to encourage him to be punctual. This is something which certainly is in his long-run interest. I do not think any of us would argue that we would like to see a situation which encouraged delinquency.

The impounding of tax and insurance funds is essentially not required in California any more, so I will not comment on that.

CHAIRMAN McALISTER: But on the late charge matter, has the industry done any studies or do they have any statistics which might show us what their costs are because apparently that is going to be the test in California now, it would be good for us to know what the costs are of processing, including the loss to you, of a late payment.

DR. PRATT: I did not make a study for this presentation.

CHAIRMAN McALISTER: That is what the Supreme Court of the State has said and either it is going to be finally decided through further litigation or the Legislature is going to have to establish by legislative fiat what those costs are. It would be nice to make a rational decision rather than just picking a figure out of the air.

DR. PRATT: I think that as the litigation progresses, we will have a better reference point as to what these costs are in competing institutions. This is a very active point in litigation right now.

I would like to spend some time on what I think is perhaps economically the most important element of the mortgage and that is the due-on-sale clause, which we discuss beginning on page 18.* We take a look at the operation of this, the consequences of its elimination and some of the substitutions that might occur. I have presented for your perusal at your pleasure the hypothetical effect of the due-on-sale clause, which is shown on page 19, which just compares a loan--two loans which were closed at the end of December, 1974, at essentially then current interest rates. We take a look at the subsequent sale of this property at two later points in time, assuming under one situation that no due-on-sale clause operates and under the other situation that the due-on-sale clause does operate. As you can see at the bottom of the page, the total payments received vary rather substantially. In fact, in this particular example the lender would have had to charge approximately 1% higher rate on the original loan to make up for the absence of the due-on-sale clause. That is, where this loan was a 6% loan, in the absence of the due-on-sale clause to get the same total economic return over the life of the loan it would have had to be a 7% rate.

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* SEE EXHIBIT A

In general, the due-on-sale clause, of course, operates to shorten the maturity of these loans. We have seen from previous figures that this is absolutely essential. Let us examine or ask the question what happens if this due-on-sale clause were to be eliminated? The first point we might look at is how does this affect the borrower and is it always to his advantage? This is generally considered that it will be to the advantage of the borrower. However, the advantage may be slight or nonexistent under certain circumstances. First, there has been a tremendous inflation in housing prices which makes the existing mortgage, in many cases, rather inadequate. If you would glance at page 22 of the paper you would get an indication of how the average price of a new home sold in the western United States in 1967 has changed. That home at that time sold for $26,100. By 1973, it sold for $37,200. On the next page we get an indication of how the original loan may prove quite inadequate as a financing instrument for the person buying the home. Let me run through this example with you. The original cost of the house in 1967 was $26,100. A 75% loan at that time would have provided financing of $19,575 and a monthly payment of $132.17 for principal and interest. By the end of 1973 the unpaid balance on that loan would be $17,281. Based on the price of his house in 1973, it would require $27,900 to bring that back up to a 75% loan, a level which the borrower might require at the time of purchase. A new loan on the $27,900 at 8½%

which was the rate at that time, would be $244.66 per month. The assumption of the existing loan provides only 54%, I believe it is a 46% loan to value ratio. In other words, another $10,619 of financing must be found in addition to the existing loan to bring it up to a 75% loan. What is this financing likely to look like. It is a rather substantial amount, $10,600. It is unlikely that it is going to be a long-term fully amortizing loan. Much more likely it is going to be a 5-year, 7-year loan with a balloon payment. One of the great reasons for going to the fully amortizing mortgage was to get away from the problems of balloon payments and re-financing, assuming loans of this type brings us right back into the era of large balloon payments.

I have made the kindest possible assumptions here I think concerning keeping the loan on the books, if the individual could get a 25-year second mortgage the highest rate he could pay to keep his total monthly payment the same as a new loan would be is only 9.46%. As you are well aware, second mortgages are not generally available at 9.46%, but in many cases may be at nearly twice that level. Well, what are the other options. We might have a purchase money mortgage or a contract. These are not very liquid investments. It is questionable whether we wish to encourage a proliferation of these and have a large portion of the public holding contracts or purchase money mortgages which, if they are to be sold on the market, may require a discount of 40% to 50%. In a period

of rapid inflation such as we have had, it is very questionable how often the borrower's interest may be served by elimination of the due-on-sale clause.

Let us take a look at some of the possibilities from the point of view of the lending institution. I have mentioned three possibilities that may occur. One, the association could absorb the losses. Two, switching to variable rate or short-term instruments. Three, continuing long-term lending but at a substantially higher contract rate. We have made the point before that associations are rather efficient and operate on rather small margins. This point is made again fairly effectively on page 25. Page 25 shows the average yield on the portfolio for each year from 1965 to 1973, the cost of funds, the amount available for operating expenses and income, the actual average operating expenses and the net margin on mortgages held. You can see that per $100 of mortgages held that margin was 40 cents one year, 7 cents one year, minus 1 cent another year, the average figure over the 1965 to 1973 average margin on mortgages held over cost of funds and operating expenses 21 cents per $100 of mortgages held. You just cannot remove a clause like the due-on-sale clause that may make essentially 1% difference in the interest rate over a 30-year period when you have a margin that is 1/5 of 1% on your lending. The arithmetic does not work. The savings and loan association, the lender, cannot absorb that kind of loss. It must be passed on to other borrowers. Here is where the tax and subsidy comes in. We tax new borrowers who are trying to obtain homes at this time in the market

in order to provide a subsidy to someone who may have purchased his home under a contract, we provide a subsidy perhaps to someone who sold under a contract and is essentially creating a wrap-around mortgage in which he may have a rather high rate of return. It seems like a very questionable direction for public policy.

The variable interest rate mortgage we have discussed previously. It would effectively solve this interest rate risk problem. It would take care of it. However, it does reduce the option of the borrower and the lender. I would maintain that one of the very valuable services that lenders have to sell is the assumption of this market interest rate risk and that they can assume this risk more cheaply than the average working man. Therefore, it is a good product for them. It is one product that they should have in their bag of tools, and to remove this from them does a disservice to the borrower. We should also note that the variable interest rate mortgage does exactly the same thing as the due-on-sale. The only reason anyone would object to the due-on-sale is that they now have to pay current market rates for their mortgage, under a variable interest rate mortgage they will also be paying current rates so it does not maintain that subsidy that the elimination of the due-on-sale does. It essentially provides the same aspect. The variable rate mortgage is a good tool. It is one we should have. It is not a reason for eliminating the due-on-sale clause.

ASSEMBLYMAN CLINE: The question I asked earlier was concerning the variable interest rate and the realistic adoption of a variable interest rate. Certainly at a national level, my understanding the answer to my question was it would require changes in federal legislation in order to do it. It would not?

DR. PRATT: You were talking about the changes of payment v. the change of maturity. It might be interesting to see that, for instance, on a 9%, 30-year loan of $10,000 you would have a payment of $80.46 per month. In the first year about $69 goes to reduce the principal, or an average of about $5.72 per month so if interest rates went up only ½ of 1% you would immediately go to a perpetuity if you were just trying to adjust maturities with a change of only ½ of 1%, the variable interest rate mortgage would fail or else you would have negative amortization.

ASSEMBLYMAN CLINE: I see something which looking at the effect on the industry of realistic politics, either at the national or the state level, the variable interest rate in the rising market would meet with, I would guess, widespread public disapproval. Are you offering then or is the industry in a position where attempting to put that straw man up in order to maintain its due-on-sale clause?

DR. PRATT: I do not think it is a straw man. I think the figures we have presented show that operations just could not if we have another economic period such as we have

had. If we have that sort of rising interest rate, without the due-on-sale clause mortgage lending could not have taken the form it has taken. I do not know for sure what the actual experienced alternative will be but it just could not happen. Maybe it will be the other option. I will mention of just having a higher initial rate but I doubt that the public would be very pleased with a 12% or 13% new rate today in order to cover the market risk of a 30-year loan. I do not know what the alternatives are but facing 25 and 30 year maturities with no chance of shortening them in conditions of economic uncertainty such as we have, is a very costly process.

ASSEMBLYMAN CLINE: What about taking the opposite approach towards the other extreme of developing a viable source of long-term financing available to savings and loan institutions?

DR. PRATT: I think this is clearly something that is important and is something that the industry has not sat on, average maturities and so on of liabilities have risen very rapidly. The Federal Home Loan Bank System brought out a new credit policy in 1971, which allowed long-term advances. The introduction of the certificate and the proliferation of certificates has helped. A lot more needs to be done. We should remember that all long-term lenders face this market risk and A, AA rated securities

in the last two months have been out at about 10.5%, for 20 or 25 years and even with 1½% operating costs and a margin for handling the funds we are looking at 11½% mortgage rate when we have those new use sources.

ASSEMBLYMAN CLINE: Do you anticipate with the federal government essentially being the largest single borrower in the market place today, we see a shortening of the length of term of federal debt...

DR. PRATT: That has happened at the Treasury level, however, it has not happened at the savings and loans source of funds which is the consolidated obligations of the 12th Federal Home Loan Banks. Their average two years ago, I believe was around 18 months. At the present time and through this period of very tight money the roll-overs have maintained an average of 36 months. While the federal debt may have been shortening the federal Home Loan Bank System has been doing a good job of maintaining a balanced term structure.

ASSEMBLYMAN CLINE: Do you consider that kind of roll-over, a balanced term structure for the industry?

DR. PRATT: I think further development of long-term sources of funds should be pursued very strongly. However, I do not think we should kid ourselves that there is 30-year 6% money around. That is all I am saying. Long-term money in a period of economic uncertainty is very expensive money.

ASSEMBLYMAN CLINE: The question is better to direct it to the industry, do you feel that there is any viable pressure at the federal level in order to achieve a change in the techniques of financing mortgage money.

DR. PRATT: There is a good deal of work being done at the present time in one area that is receiving a great deal of attention--the mortgage bank security which will allow the pooling of mortgages to be backed by securities, either private or having some government association with them. I think this is a very promising source of funds and one that is aggressively being pursued.

ASSEMBLYMAN CLINE: What kind of total volume are you looking at?

DR. PRATT: To make any dent in the mortgage market we would be talking perhaps $10 billion a year. It would be a very large market and there obviously are some real problems associated with bringing instruments of that size into the capital market.

MR. McKENNA: We are giving a great deal of consideration and working a great deal on a possible proposal to you people which is a development of the federal mortgage-backed bond proposal. It would be that we would be allowed to fund an agency which you would create, directors would have to be appointed, of course, by either the Governor or the Legislature or both, but we would finance it, it would take

our mortgages, it would issue tax-exempts on the basis of them and the proceeds would be used through the savings and loans to get housing going again in the State. We are working intensely on that. We would in no sense use the credit of the State. It would explicitly say that the obligations are not a moral obligation of the State. We would put up the money, we would put up the assets. The agency, the California agency and under the direction of the State would get all of its financing from us, whether or not we can construct this in a way that you would find appealing and within the interest of the State, we are still wrestling with it. On the question of whether or not we are throwing up an impossibility or a ghost here on variable interest rates, it could not be anymore different than that than it is because we are working with tremendous intensity on this. We see it as a necessary tool, an absolutely vital tool. We have been in extensive discussions in Washington with this, with the whole Federal Home Loan Bank Board, in one session for three and a half hours with the Chairman of the House Banking, with the Secretary of the Treasury personally and with the Secretary of HUD, trying to get the federal government to create a more attractive atmosphere for variable interest rate loans. There is no need for legislation either in the state level or the federal level. On the federal level we have a very limiting regulation, the Bank Board says, it is essential to change the

regulation but we cannot do it without a blessing from Congress, even though there is no necessity for legal action by Congress. This is a very difficult area. We need this tool to provide financing and there is resistance but it is resistance that I believe is emotional.

ASSEMBLYMAN CLINE: You are saying, while we do not need legislation, you are not going to do it without some expression of approval from Congress.

MR. McKENNA: We do not say that. We have this problem. That is the Federal Home Loan Bank Board.

CHAIRMAN McALISTER: That is the problem of regulation, isn't it, that you need the Home Loan Bank Board regulation to be changed?

MR. McKENNA: Our state chartered associations do not. The regulations inhibit only the federal associations but we are not permitted to compare notes and say that we are going to do a part of our lending on variable interest rates. We must compete with each other and as lawyers you would not let the industry cross that line of deciding it is going to do this in a certain percentage. We need something in the way of a mandate from some supervisor. It is a highly competitive industry and we do not do these things, we cannot get together to do them and we cannot do them in the competitive arena unless the other fellow does too. That is the dilemma.

ASSEMBLYMAN CLINE: You mean you cannot compete unless you are regulated?

MR. McKENNA: They have to tell us that we have to do a certain percentage in this form. It gets down pretty much to that. The Federal Home Loan Bank Board has got to tell the industry, a percentage of your lending must be on this basis, or we will not do it because our first objective is intense competition, each with the other. That is the situation.

CHAIRMAN McALISTER: Dr. Pratt indicated there is a serious problem with the variable interest rate if you apply it in a manner in which you extend the maturity date; what was it, how much of an interest rate increase did it require before you weren't...

DR. PRATT: One-half of one percent is all that could be tolerated. I agree that the variable rate is a vital tool but it is not the answer to all questions. The fixed rate, fixed term mortgage is a very viable and vital tool that must be preserved. If you look at the equitable way of distributing this interest rate risk I think the present instrument has a good deal to commend itself. Under the due-on-sale, the individual purchasing a house is assured of a single set payment for principal and interest essentially as long as his tenure in the home remains unchanged and S&Ls and others have found that they can live with that. At the

time a sale takes place, I do not see that we should have an implied warranty to either provide the old seller with a profit from his financing or to provide the new purchaser with a subsidized interest rate. We are at that time again at an arm's length transaction. The due-on-sale has done a good job of protecting the homeowner and his fixed payment while he is in the house and at the same time bringing in an arm's length transaction when his tenure in the home changes. His tenure in the home is never threatened by the change of payment, he can budget it, he is protected from a great deal of risk.

CHAIRMAN McALISTER: The variable interest rate is at least a partial approach at something like indexation, isn't it?

DR. PRATT: Yes, it is. The indexing problems, of course, are very substantial.

CHAIRMAN McALISTER: Of course, it is only a partial approach at it and at least in Brazil they apply it more or less across the whole economy. Let me clarify one thing. A one-half of a percent increase in the interest rate would eliminate any reduction in the principal?

DR. PRATT: Approximately ½. Let me just run over those figures again. We had a $10,000 loan originated at 9% for 30 years. It gave us a payment of $80.46 per month. My quick calculation showed that the principal reduction during the year, I think, was about $69 or $5.72 per month.

That is the first year, or $69 per year, 69/100 of 1% on a $10,000 loan. The first few years a loan amortizes, most of the amortization takes place near the end of the loan so this example, while on the first year would be quite characteristic of the first several years.

MR. McKENNA: It would be helpful if you gentlemen would give consideration to the possibility of our increasing the term beyond 30 years in the event that is the alternative from the variable interest rate to upping the payment. I think that if we were given, not necessarily the power to make an initial loan for a period of more than 30 years but rather when the interest rate goes up under a variable interest instrument that instead of what we are talking about here that with an increase in the monthly payments that we be able to extend the terms beyond 30 years, perhaps 40 years. I think that would be something that might serve the interest of the borrowers.

CHAIRMAN McALISTER: However, Dr. Pratt is saying it could end up that you would never pay off the loan.

MR. McKENNA: In many cases that would be true but even that does not bother me so much if we have negative amortization, if, in fact, we have an inflationary market and the value of the house is going up. Is that so terrible?

MR. McKENNA: I am talking like a way-out left person now but I am not that much horrified by the prospect of negative amortization.

CHAIRMAN McALISTER: Most of the people in the country are in perpetual debt. There is no question of that.

MR. McKENNA: I think we have to, if we are going to have this basic problem of rampant inflation I think we have to re-orient our thinking and maybe get exacting concepts that we have not been willing to accept before.

ASSEMBLYMAN RICHARD HAYDEN: It is my understanding that the variable interest rate is already in effect in California. If it is correct, how many savings and loan institutions are involved, and is it too early to indicate even preliminarily how successful they have been or are at this particular time, particularly in view of the economic situation?

MR. MIKELL: In California the California State chartered associations has had this power for at least a decade that I know of. As has been pointed out, the federally chartered associations cannot write variable rate notes at the present time. There is a restriction upon both associations that a loan cannot go longer than 30 years, so in practice, what has been done and there are variable rate notes and they have been written with varying degrees by different associations over the years. A loan will be written for 25 years and then the payment remains constant, in answer to Mr. Cline's question, throughout the loan. The principal amortization is reduced. This has had good customer-borrower acceptance because he knows that his payment may change but his payment remains constant and the due date may go on a little longer to 26 or 27. It is something he does not really worry about. At present, there is one shop that has written nothing but variable rate notes on its residential

loans for the last 12 years. There is another shop that I know even better that has written nothing but variable rate notes for the last four years. When the rate, the one that I know better is the one down south and when the rate for the past four years the rate has been raised twice and reduced once. When the rate is raised the borrower may pay off his loan with no charge. Out of 1,000 loans which were spot-checked on the last rate increase, which happened about six or eight months ago, three responses were received. Customer acceptance has been tremendous. The problem, of course, is customer acceptance going into the loan and here is where the problem comes. Most borrowers, just as most of us here, believe rates are going to go up so they say why should I lock myself into paying a rate which goes up as the rate goes up. I want that 30-year fixed rate term. That has been the biggest problem with acceptance of variable rate notes. One of the major associations, a billion dollar association, one of the top fifteen in the country in California has about $25,000,000 out in variable rate notes and it has been extremely difficult first to sell those and then to maintain them.

CHAIRMAN McALISTER: Are these variable rate notes the kind that would result in an increased monthly payment?

MR. MIKELL: First of all there is a problem with the standard to which this fluctuating rate is tied. Secondly, the problem is that the increase is rated differently than the decrease. As I understand it now, the lender must make a reduction when that standard is tied to bank board borrowings

and variable things which are outside the scope of just California. When it drops one-tenth of 1% the lender must drop the rate, but he cannot raise the rate until it goes up 25/100 of 1%. I am not sure if there is a prohibition against increasing the actual payment but as we all know, the Wisconsin experience was utter disaster when they waited too long and then tried to raise the rate 2½% and that was a situation that occurred within the last year.

ASSEMBLYMAN HAYDEN: This is an area of the law that you think may need some checking into for possible legislation?

MR. MIKELL: Yes. We are now dealing with your major lenders in the State, residential lenders. In direct response I think to Mr. Knox' question, more than 95% of the savings and loan assets are in residential mortgages--single family or multiple and you are taking half the market approximately, or 40% of the federal market which would be excluded from anything you did. What Mr. McKenna is saying is on a federal level we would love to have a variable rate note, make all of us do it, do not give the option to the borrower any more.

CHAIRMAN McALISTER: Do I understand though because of the 30-year limitation on your loans that on these current variable rate mortgages you are not increasing the maturity date or extending the maturity date, you are increasing the payment.

MR. MIKELL: No. Generally when they write the variable rate notes the maturity will be for 25 or 26 years.

CHAIRMAN McALISTER: Then you increase the maturity date beyond that.

MR. MIKELL: Yes. It would mean a higher initial payment because you are getting a 25-year loan amortized over 25 years vice over 30.

MR. McKENNA: We do believe that the Commissioner should re-interpret the statute to permit the term to recommence when the interest rates are adjusted and if it were so interpreted, which we think is a good interpretation, that problem would be ameliorated. I think it would also be better if you gentlemen would give consideration to permitting the term to be extended to 40 years.

ASSEMBLYMAN HAYDEN: This cannot be done administratively? Should it indeed need legislation which would make no doubt to a commissioner that he had this particular authority.

MR. McKENNA: I think that this is almost an urgent matter because we do not know where the mortgage market is going to go in the next several months, the next few years and California should have the ability to be flexible in this area. It is almost an urgent legislative matter.

CHAIRMAN McALISTER: I wonder with all the concern over debt and all the rising debt we ought to be increasing the maturity dates for the maturity, the length of term that a debt increment can last. That may be inconsistent toward variable rates too, but it does raise some difficult issues.

DR. PRATT: Let me inject my thoughts here and they may be somewhat different than my colleagues. The variable rate

is an important tool which we need. Second, if we are talking about keeping the payment the same, it is one that provides for minor adjustments, you can go to 400 years and it will not help if you get substantial interest rate changes. You could not have started lending in 1965 and kept the maturity the same under any circumstances and made the adjustments as massive as we have had. In keeping the payment the same is a tool which provides a good solution to minor and modest changes. If you have major changes and you are going to use the variable rate it will have to be associated with the ability to change the payment. I think it is one of the tools and the consumer should still have the right to a fixed rate, fixed term mortgage at the appropriate price.

MR. MIKELL: The Commissioner will be before you tomorrow. You might address the question as to whether he has the regulatory power to do that. We do not think so, we think it needs legislation.

CHAIRMAN McALISTER: Our next witness is Mr. Stanley Zimmerman of the Mortgage Refinance Company.

MR. STANLEY ZIMMERMAN: In order to try to shorten what I would talk about which has primarily to do with the report of the National Commission of Consumer Finance, I have made some excerpts from it which I will not talk about but I will just hand out to you.*

Read them at your leisure. The whole report is available but most of which it takes up is to do with the personal property

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* See Exhibit B

brokers and industrial loan companies. I have tried to express that part which has more meaning in the area in which I am speaking.

I am Stanley Zimmerman, and I am a real estate broker but I am primarily engaged in brokering necessitated borrower loans. These loans typically take the form of second mortgages, sometimes first mortgages and sometimes all inclusive and they are made at the lower of the market, or statutory maximum rate. When the market is in excess of the statutory maximum rate they just are not made at all and then in times like this necessitated borrowers do not get loans.

Among our ghetto population and our poorer people credit is rationed. That means that everything that is available in credit is used. All that legally is available is used at some sort of a reasonable rate and after that they go to wherever they might be able to find, many times in the form of paying excess prices for the goods that they are receiving beca se of rate of interest, that they pay is regulated. In the real estate loan field, those within the industry, those that are in the savings and loan associations think they are very competitive. We, that are not savings and loan associations, think they are not competitive at all. We think that there is a form of oligopsony which is in existence. Oligopsony is where there is a very limited number of buyers and that those buyers can inter-react with each other

and control prices. If you went shopping for a loan today or in any market you would find the variation in terms and price and most of the rates quoted by everybody are not the same. Partly this oligopsony comes from the fact that the state administrative agencies in approving new savings and loan charters use the convenience and advantage rule in approving new charters. I feel that this is not the thing that should be done and the National Commission on Consumer Finance assails the convenience and advantage rule in issuing charters. The answer to lower rates is competition. Competition means free access of suppliers into the market and that the way to do this is that anybody who has good character, reasonable ability to conduct a business should be able to enter that field. Traditionally, in the savings and loan and other financial institutions the reason for the convenience and advantage is given as the state of protective depositor. I feel that perhaps we should now start to organize nondeposit building and loan associations. Savings and loans are an out-growth of the old neighborhood building and loans where everybody knew each other. When you have a situation where a savings and loan is really an instrument of a holding company and stock is exchanged on the New York Stock Exchange many of their activities are in relationship to what it will do to their stock and not what it is doing to their loans. Savings and loan associations are an important part of the industry but if they were faced with a lot of competition

from nonpublic deposit building and loan associations, I think the rates would come down. These building and loan associations could be formed in local areas; they could be restricted as to what type of public deposits they could take and I advocate that they take no deposits unless they qualify under the rules of the Federal Home Loan Bank and have savings and loan insurance. Perhaps they could qualify under something similar to the Reg. A that the Securities Exchange Commission has the power pursuant to Rule 3B, which if you (1) know the people that are involved, (2) if you had a full disclosure, (3) if you are not relying upon any representations other than the representations that you have made the personal inquiry into, (4) that you have the ability to make that inquiry, (5) you are not putting all of your assets into there, and (6) you know that this has some risk factor, you should be entitled to make a deposit.

ASSEMBLYMAN KNOX: What you are really saying here is that you simply want a publicly-held corporation to be exempt from the usury limits of California because you can do that now. A corporation can be formed for the purpose of lending money and you are limited to 10%. Or, if the Commissioner says that the offering is fair and just and equitable you can sell stock to the public.

MR. ZIMMERMAN: Yes, but unless you formed it under an "S" type corporation which is very difficult to accumulate reserves, you would not be able to see to attract funds because you would have a double taxation by the time you

pay dividends. If you are in the form of what I call "a building and loan," more the old term than the new one, the payments that you make out to your depositors are tax deductible before you determine income tax. If you formed it in the form of a small corporation, you are going to have a double taxation and I think we have to look realistically at this too. It is likely that certain types of tax incentives to depositors are going to be passed by Congress or some sort of form like that. We have before Congress now a proposal that the first $500 of an individual's deposits or dividend returns or interest should be tax exempt. That is going to create a disadvantage to a corporate structure and an advantage to a deposit structure. It is for that reason that I take the form of saying let us be a deposit structure so that, one, any advantages of the large institutions could accrue to the smaller ones and, secondly, that the payment for the use of the money be prior to the determination of income which is taxable.

Gentlemen, that is generally what I want to say.

ASSEMBLYMAN KNOX: This would be under the jurisdiction of the Savings and Loan Commissioner?

MR. ZIMMERMAN: Yes.

ASSEMBLYMAN KNOX: Have you suggested it?

MR. ZIMMERMAN: Yes.

ASSEMBLYMAN KNOX: Yes, a new form or a separate form of financial institution....a substantial operation...

MR. ZIMMERMAN: No, I do not really see it as closed end. I see it as open end. I see it even as a possibility of growing into a full savings and loan association, but I see more as a community effort, small to start with.

ASSEMBLYMAN ERNEST MOBLEY: Just what is happening in the areas of the PCA and Federal Land Bank. Is this what you are talking about?

MR. ZIMMERMAN: No, I am not. First of all, I am not familiar with a PCA.

ASSEMBLYMAN MOBLEY: Production Credit Association, they are all over the state.

MR. ZIMMERMAN: No, I see this as a way to start small building and loan associations so that a mass of community effort would create the competitive forces lower rate. At the same time to give the opportunity to those that are successful to grow. I think it is wrong to approve new charters and to look into the administration of existing financial institutions in order to protect their profitability. I think that what you should be doing is increasing competition so that innovation would come about so that it would cause better products and lower rates.

CHAIRMAN McALISTER: Mr. Mobley. Are not the PCA's agricultural?

ASSEMBLYMAN MOBLEY: Yes, but they loan.

CHAIRMAN McALISTER: Thank you, Mr. Zimmerman. Mr. Charles P. Conner of the Escrow Institute.

MR. TOM KONOVALOFF: Mr. Chairman, I am Tom Konovaloff representing the Escrow Institute of California, and we appreciate the committee's time and inviting us here today and letting us talk about escrow. With me is Mr. Charles Conner, who is President of the Western Mutual Escrow Corporation, who is a spokesman for the Institute and plans to talk in those areas of escrow on home sales and loans.

MR. CHARLES CONNER: Gentlemen. The Escrow Institute of California is a trade association of 72 licensed escrow corporations that consider themselves in the independent escrow business, not connected with any title company, savings and loan, broker, or other tie. The purpose of the Escrow Institute, by its bylaws, shall be to improve the escrow profession, foster better business relationships between the members and to promote mutual benefits to its members through mutual activities and legislative, corporate, and operational matters and business development and to counteract such influences that would not promote the general welfare of the independent escrow agent. There has been quite a bit of discussion on escrow matters, and I think the best mode to go into on this is to explain how escrows operate in the State and be in a position to respond to any inquiry that you might have.

There are several definitions of what an escrow is. According to Section 17003 of the State of California Financial Code:

> "Escrow" means any transaction wherein one person, for the purpose of effecting the sale, transfer, encumbering, or leasing of real or personal property to another person, delivers any written instrument, money, evidence of title to real or personal property, or other thing of value to a third person to be held by such third person until the happening of a specified event or the performance of a prescribed condition, when it is then to be delivered by such third person to a grantee, grantor, promisee, promisor, obligee, obligor, bailee, bailor, or any agent or employee of any of the former.

That is a very restrictive term. Basically, what we in the industry call ourselves is we are hired to put it all together, serve as a central clearing house to receive funds from the buyer, the broker, the lender, to receive the documents from the seller that will convey title or from the parties to accomplish the desired results.

Our function also is to examine the preliminary title report, to determine that when all documents are recorded the escrow instructions are met. When all is ready, we complete the escrow and give the parties what they instructed us to give them.

In the State of California there are nine entities that can practice escrows. They are attorneys, so long as they are not in the actual business or make a business of escrows. Banks, state charter banks, federally chartered banks, savings and loan associations that are state chartered, federally chartered savings and loan associations, title insurance companies, title companies, real estate brokers handling their own transactions and escrow companies licensed by the Corporation Commissioner's office. Current regulutions that are

imposed upon these entities, however, differ and they vary quite a bit. The Corporation Commissioner's licensees are licensed under the laws set forth under Section 17000 through 17654 of Division 6 of the Financial Code and under the rules found in Title 10 of the Administrative Code, Chapter 9, and by special releases relative to interpretations of the Department of Corporations. These are good rules, good laws, good regulations and serve as a basis for the professional standards that are being sought by the majority of the practioners in escrow in the State of California. The banks, of course, operate escrow departments and they have indicated that in a letter dated October 9, 1970, that the Superintendent of Banks has not promulgated any regulations relating to the escrow business of state banks and trust companies and the Department of Savings and Loan by letter dated October 14, 1970. These might have changed in the meantime. "In response to your letter of October 7, please be advised that we have no statutes, rules or regulations authorizing this department to control escrow transactions and escrow holders." The real estate brokers are governed by one section in their laws that pertain to escrow and that is Section 2950 and there is one page in their regulations relating to escrows although in their reference book, volume 9, there are many references to escrow but not as it pertains to the actual conduct of their licensees. The regulations that are imposed upon the licensees of the Corporation Commissioner's office are

quite complex. My binder is about a half inch of pages that are pertinent to the rules and regulations imposed upon the Corporation Commissioner's licensees.

Qualifications--from the independent escrow operations standpoint a licensee of the Department has to have a five year experienced person at each location, stationed there permanently and have to show financial responsibility, be subjected to audits, both a CPA and their own internal audits, and the state audits. They have to be licensed by the Corporation Commissioner and bonded.

The duties of the escrow holder are extremely complex. Most of you in this room know what the duties are but the problem with the industry is that quite often the duties are viewed upon as being very minor in nature but the professional escrow officer must know real estate law, how to deal with a usury situation, must know title insurance practices, lender's practices, not only conventional but also FHA, VA, Cal Vet, second trust deed lending, personal property laws, property taxes and insurance, local ordinances relative to property inspections or local taxes, etc.

Now, historically, the escrow holder is to remain an impartial third party to receive and follow all instructions, to remain silent on items that are not his concern and to retain the confidentiality of all parties of the transaction. He cannot practice law. He cannot give advice but must walk the fine line of knowing when to remain silent and when to speak up. He must know what his duties are and what they are not.

The prohibitions on practice of law are spelled out in a State Bar Treaty that exists between the Escrow Institute of California and the State Bar, as does the California Banking Association and I believe several other entities.

The problems that face the public these days are problems that we have recognized that exist within the industry and have existed within the industry for many years. First off, there is a lack of uniformity as to standards between the north and the southern California area. This is not unique at all because even within Southern California there is a lack of uniformity between cities and even within my own company there are many differences in how we process escrows in the various counties.

The lack of standards of expertise is the biggest single problem that faces the industry. There are people who operate escrows, that handle escrows as an employee of a bank or a savings and loan title insurance company, or a real estate broker or licensed escrow company that have anywhere from five to twenty years' experience. Then, again, in other entities a person might be an escrow clerk with three months' experience and all of a sudden she is the escrow officer and then that person is responsible for all of the ongoing daily activities of handling the escrows. There are no experience requirements in other entities other than the ones licensed by the Department of Corporations. I think that one of the major problems that faces the industry also is that there appears to be many conflicts of interest. Now, there was one witness yesterday who indicated that she was

asked to go to a particular escrow company or a branch of a real estate broker. This is a trend that, be it good or bad, the buyers and sellers do not have a free choice of escrow on too many occasions.

ASSEMBLYMAN CLINE: Are you prepared as an institute to ask the State Legislature to set the standards, qualifications, or licensing?

MR. CONNER: I am sure the California Escrow Association will speak to that later on. As a matter of fact there was an attempt on this part in 1971, to come up with an escrow officer's licensing bill to try and establish some kind of uniform guidelines as to a level of expertise. But we, as an escrow institute, are not in a position to promulgate or even develop any legislative thinking along that line.

ASSEMBLYMAN CLINE: You have no suggestions along that line to make for legislative consideration?

MR. CONNER: I have some personal feelings about this. I am not sure how it could happen but I think that somewhere along the line an equalization of qualifications is an essential ingredient to the production of the public down the road. It should be done now. If it had been done now I think that the public could have a greater degree of confidence if they could go into any person holding themselves out to be an expert in the handling of escrows with the idea that they would be afforded the high degree of competence that they have a right to expect.

ASSEMBLYMAN CLINE: What I was getting at is that I want to see less government regulation. Yet, I want to see a level of responsibility within your particular industry, self regulation rather than an imposed regulation.

MR. CONNER: I think that is good too, and we have attempted to do that in the California Escrow Association, not the Escrow Institute. I do not want to take Mr. Hurst's speech away from him but they have a professional designations program that he will speak about later on and it is a real severe attempt to do just this. To increase the level of professionalism by various methods, by imposing testing on persons who are to receive the professional designations from the California Association. The only problem with that is at this point it is not mandatory. The State Bar has a method of controlling the expertise their members have, that is to admit them to the Bar and if they do not have the level of expertise they do not pass the test and, therefore, they do not get admitted to the Bar. We have not got that clout in the California Association to require that. A person just does not have to belong. The other way to do it is legislatively or by administrative remedies by each one of the commissioners. To say that this level of expertise will be maintained by all of the people practicing escrow work.

ASSEMBLYMAN CLINE: Had there been sufficient violations beyond what you would normally expect in differences of ability that would warrant the State even considering it.

MR. CONNER: I have to get into some specific case studies. I am sure that there are cases on them. I heard just a couple of weeks ago from one source that there are many cases of inequities in the handling of escrows. Of course, there are many case law items that would pertain to that. I have got some of them here.

ASSEMBLYMAN CLINE: How widespread is it, in your opinion?

MR. CONNER: I could try to find that information out for you. I do not have that information at my finger tips.

ASSEMBLYMAN CLINE: Thank you.

ASSEMBLYMAN MOBLEY: The title of your organization contains the word "institute." It connotes to me education in some form. Is that what you try to do, educate the public?

MR. CONNER: The education is not only for our own members and the professionalism in our own Institute but also assisting the public in knowing more about escrows. We have had several publications, we have had several brochures that we have distributed, indicating what escrow is all about. It is a common feeling that throughout the entire membership of the Escrow Institute that if we are able to serve the public in a better manner this will meet the objectives of the members of the organization.

ASSEMBLYMAN MOBLEY: Are members of your organization on the staffs of the various real estate schools in the State?

MR. CONNER: We have some teachers, some instructors, that either are or have been. They have been instructors or they are now members, active members of the Escrow Institute. I was an instructor myself.

ASSEMBLYMAN MOBLEY: Do they identify themselves as members of the Escrow Institute?

MR. CONNER: Not necessarily.

CHAIRMAN McALISTER: There are nine different categories that, by law, may act as an escrow agent. But your people, the escrow, professional escrow companies are the only ones that actually have standards that are set up in law, or regulation that they much comply with?

MR. CONNER: Excessive standards, yet. I am not saying that the banks and savings and loans, and title companies do not administer their escrow departments effectively. I am saying that the State has no rules or regulations, as it pertains to the real estate brokers, as compared to the ones that are placed upon us.

CHAIRMAN McALISTER: Some of these other people, in fact, would have considerable expertise and in a title insurance company we should have a lot of expertise.

MR. CONNER: Absolutely. No question about that. The anti-trust laws are dealing pretty effectively with some of the restraint of trade tactics that used to prevail in the industries where the savings and loan association would say you can have their loans, if you take their peripheral services, or ancillary services, such as insurance or escrow and

so on and so forth. So that the tools for allowing the buyers and the sellers to have the right of free choice of escrow are there. In some cases the laws may not be administered 100 percent the way that we think they should be but that is an on-going deal. We think that everything that can be done toward allowing the buyer to have the free choice of escrow would be an effective way for allowing free enterprise and the price levels to be met by the industry as required by the consumer. If there are any lock-ins of business this would tend to detract from that free choice of escrow and also therefore detract from the competitive spirit of the free enterprise system. I think that probably the other information I might have here has already been covered to a certain extent but I stand ready will and able to help in any way. The Escrow Institute wants to continue to assist wherever we can. We do not know how that might be, but we have many members who are very well qualified as to dealing with all facets of escrow and you can use the group or me as a consultant in any way, shape or form.

CHAIRMAN McALISTER: Our next witness will be Mr. Donald Hurst of the California Escrow Association.

DR. PAT HEWITT: I am Pat Hewitt and I am an attorney and the legislative advocate for the California Escrow Association. I think if I could just clarify for a couple of members of the committee who were here this morning, the difference between this association and the association that

you heard from prior to lunch. This might help you to understand the remarks that we make. The Escrow Institute is essentially an association comprised of management of some 72 independent escrow association. By independent I mean they function independently of any other institutional setting. On the other hand, the California Escrow Association, whom I represent and of which Mr. Hurst is President, is, as a matter of fact, a statewide association of various types of people who work in escrow, both employees and employers. We do cross, in terms of the setting in which we function. We function in all five settings that are regulated by State government. The independent escrow companies are regulated only by the language found in the Corporations Code. On the other hand, this association operates in savings and loan institutions, where they are regulated by that Commission; they operate in banks where they are regulated by the Superintendent of Banking; they operate in real estate offices where they come under the jurisdiction of the Department of Real Estate and when they function in title companies they are overseen by the Department of Insurance. So, with that introduction, I think Mr. Hurst has a brief statement and then we would like to receive questions from the committee. I did want to respond to a question of Mr. Cline's relating to licensing but I will wait until he reappears to do so. Mr. Don Hurst, President of the California Escrow Association.

MR. DON HURST: The Escrow Institute is a member of the California Escrow Association. We are not different of opinion, we are not two different groups going in different directions. We are part of the State Association.

One of the things I think that we are concerned with, when we listen to testimony within this session, as escrow agents, we are criticized for any kind of cost or charges that are involved in the escrow. Regardless if they are lender's charges, title charges, or termite expenses, any kind of anticipated charges the consumer usually refers to in his escrow expenses we immediately have justification in trying or rationalize in trying to explain them.

Let me give you a little background on the CEA. We are composed of 26 regional chapters throughout the state and the members of these regional associations are involved in either the processing of escrows or the supervision of the escrow personnel. We are involved with our employees, or the members of the association being involved under all five regulatory agencies. The primary goal of the association is for the education of its members and for the general improvement of escrow services to the public in general. We have just completed our 19th Annual Escrow Conference. For the last two years we have conducted seminars in various parts of the state in trying to build a better line of communication between the real estate salespeople and the escrow personnel. We have attempted very stenuously not to get involved in regulation of any fees. We were concerned a number of years ago that there could be anti-trust violations or accusations raised be an effort to standardize fees within the industry. For this reason, we have completely ignored that or tried to avoid it. We feel that the variation of fees within the state actually benefits the general public because

usually the fees are determined by the competition within the area. We certainly believe that the citizens of this state have benefited by our system of escrow procedure, since it has become apparent that even the legal professions accepted the quality of the escrow expertise to the point that generally they have not felt it necessary to be represented in each transaction when their clients were involved, in either a buy or sell. We are not going to say the attorneys are not welcome. It has become an accepted standard in most parts of the nation. We trust that we have created enough line of communication with the legal profession that our method of escrow or processing is a substantial improvement over what has taken place in other parts of the country. I would like to quote, if I could, from an article in a national realtor's newsletter in 1972. The article was entitled "A growing Number of Attorneys Refuse to Handle Closing on Single Family Houses."

> "A senior partner of a well-known real estate law firm indicated it is becoming harder and harder to find lawyers who are willing to handle closings on single family houses. The reason, he explained, is that most buyers and sellers are unwilling to pay an attorney for all the time he has to devote to a closing if it has to be done right. In our firm, as in most other law firms, we keep a record of the time spent by each member of our staff on each project because time is all we have to sell and we want to be sure we are using it to the best advantage. We recently completed a study of the time it takes to handle closing on a single family house and discovered it takes an average of 14 hours. Now, we have to charge each client according to the time any member of our staff spends on his case. Our minimum fee of putting the most inexperienced lawyer in our firm on an assignment is $50 an hour. This means that when we assign such a man to a house

closing the buyer or seller he represents will be expected to pay us approximately $700, whether the property is worth $50,000 or $10,000. Since the average buyer or seller feels that this is too much to pay we no longer accept this type of legal work."

It is a very interesting quote and it is from 1972 and it may be that the cost has gone up and we know that when we have looked at the practice of handling real estate in other parts of the nation that the cost is far greater than $700 in connection with the closing.

Chuck Conner pretty well covered some of the other areas of involvement. Knowing the scope of the hearing, and knowing that the committee wants to try and provide as much dialogue as possible rather than get into any other areas, I think I would like to welcome any questions from the committee. If we are not prepared to answer them today we certainly can come back with some answers, either in writing or to other sessions of the committee hearing.

ASSEMBLYMAN KNOX: I am just reading this chart. Who prepared that chart, the committee?

CHAIRMAN McALISTER: That is a source from the HUD/VA report.

ASSEMBLYMAN KNOX: You are under B, as I understand it. "Escrow B. Closing Fee Document Preparation and Other Closing Costs." I do not know what that is. Is that a fair statement of what you do?

MR. HURST: Yes, it is a fair statement under "Escrow Fee and Fee Closing Fee. I can explain escrow fee or document preparation, if it were necessary.

ASSEMBLYMAN KNOX: The escrow fee is for handling the money, making sure that the documents are exchanged and that the appropriate people get the check or checks, right?

MR. HURST: The escrow fee is basically the fee that we charge for the processing from one end to the other.

ASSEMBLYMAN KNOX: Do you prepare any documents beyond a simple grant deed or a closing statement?

MR. HURST: Yes, it is necessary at times to prepare deeds of trust notes, and there could be some other forms. We prefer to indicate that we are completing the form because the forms we are involved with are prepared documents that are necessary in order to insert the language of the parties involved; possibly the legal description or clarification of the terms.

ASSEMBLYMAN KNOX: But you would prepare a deed which, for example, might be a deed from one person to fifty tenants in common.

MR. HURST: Yes, sir.

DR. HEWITT: If I could also comment. They would be responsible for seeing that the instructions, both buyer's and seller's instructions, clearly reflected the understanding of both parties. Then it falls upon them, the responsibility to see that each of those items on each instruction sheet are met before the check can be transferred and the property can be transferred. This puts them in a very responsible fiduciary relationship.

ASSEMBLYMAN KNOX: Are the fees for escrow broken down? For example, you have got the escrow fee for handling the money and handling the documents. Do you charge a specific fee for the preparation of documents?

MR. HURST: In many cases, yes. A company has usually established their own basis of fees for preparation of documents.

ASSEMBLYMAN KNOX: In other words, you charge so much for a simple grant deed. You might charge more for a more complicated deed of trust or something of that nature?

MR. HURST: Usually a deed of trust there is a charge on it.

ASSEMBLYMAN KNOX: Is this pursuant to a treaty with the State Bar?

MR. HURST: Yes, sir. The treaty with the State Bar is involved with the Escrow Institute, as I said and is a member of the CEA. We have established a treaty as to documents that can be prepared. Also documents that cannot be prepared.

ASSEMBLYMAN KNOX: Your organization does not have a treaty with the State Bar?

MR. HURST: No, sir.

ASSEMBLYMAN KNOX: Do you think you should?

MR. HURST: We have just gone into negotiations with them, or conversation with them. Actually, whatever has been established with the Institute basically applies to members of the industry. There are many documents we do not prepare. There are agreements that we will not, whether it means refusing an escrow or refusing to prepare a document. This is done on a regular basis.

ASSEMBLYMAN KNOX: Do you prepare a contract of sale?

MR. HURST: No, sir. There are times when contracts very possibly have been prepared but for the most part we do not; we will be involved in the consumation of the contract. There is controversy on this now because we know of a company that is deeply involved in the preparation of contracts.

ASSEMBLYMAN KNOX: Thank you.

CHAIRMAN McALISTER: You base your fees so much per document?

MR. HURST: We base our escrow fee on the consideration, plus....

CHAIRMAN McALISTER: On the price...

MR. HURST: a charge for additional documents that may be prepared.

CHAIRMAN McALISTER: You base your fee, your basic fee upon the amount of money in the transaction?

MR. HURST: Yes.

CHAIRMAN McALISTER. There are additional charges for certain specific documents?

MR. HURST: Correct.

CHAIRMAN McALISTER: It is not based upon amount of time involved as in the example you gave by an attorney?

MR. HURST: No. It could be based on the amount of time, depending upon the arrangement. Normally, it is based upon the consideration involved.

CHAIRMAN McALISTER: Yesterday we were given some figures about the cost of escrow fees from different parts of the country; indicating that L. A. County was not broken down terribly well. It was my understanding from our discussion yesterday that it was stated that escrow fees were higher in Los Angeles County than anywhere else.

MR. HURST: I believe that he did indicate that the percentage went up from 1.58 in the state to 2.19 in Los Angeles. I believe that if the other figures were correct it would indicate that the escrow fee in Los Angeles is approximately $32 more than it is on a statewide basis, from the chart that was shown.

CHAIRMAN McALISTER: Yes, the HUD study apparently was part of my consultant's papers for this hearing. He has included a table indicating costs in Denver, which shows that Denver was much lower than California. It is interesting, it shows Denver as zero in escrow fees, Seattle is $135, and L. A. county is $148. I wonder, are you familiar with how they could come up with zero for Denver?

MR. HURST: I am not familiar with how, or what the procedure is in Denver. We could attempt to find out and get back to you with some information, but I am not really familiar with the Denver area.

DR. HEWITT: I would like to reflect the procedure that I know of in the East Coast: in Maryland and Washington where

there are no separate escrow transaction. Two attorneys simply meet around a desk with the two parties to transact business. I think that is probably just absorbed any attorney's fee. He writes the instruction and when his feeling is that the instructions have been met, the checks are exchanged.

ASSEMBLYMAN CULLEN: What was the source of the letter from the law firm, what community.

MR. HURST: The National Realtors' Newsletter.

ASSEMBLYMAN CULLEN: Where was the attorney located?

MR. HURST: I am sorry, I cannot tell you. It was a sensitive situation.

ASSEMBLYMAN CULLEN: What was the point of your presenting that as evidence?

MR. HURST: Just to indicate the fact that the way things are going, the only procedure that is going to be handled with the cost of it is by an escrow company; the amount of hours that may be involved in the processing and the cost of some other areas in processing escrow.

ASSEMBLYMAN CULLEN: I take it you are unable, based on your own experience, to tell us how many hours it takes your company.

MR. HURST: You cannot look at a number of files and take 5, 6, 10 escrows and come up with a standardization. We certainly cannot come to a conclusion if you keep doing a time study on what is involved.

ASSEMBLYMAN CULLEN: You find you are unable to measure your work product and price it out according to your payroll. You find difficulty in doing that?

MR. HURST: We have not attempted to make that type of research on a state basis.

ASSEMBLYMAN CULLEN: To give you an example. Legislators work 40 hours, some work more hours or less in a week. We are paid about $10 an hour. I take it that a 14 hour task would come out just about what you charge, $148 or $140. I believe, because I was involved in this area as a lawyer briefly, that if it is taking 14 hours for a transaction in your office you would be well advised to look around for a smart high school graduate or a new college graduate you would not have to pay $10 an hour.

But I want to make that point and if you are thinking of using that letter again, I would give it a lot of thought.

MR. HURST: I was not using it to make any point other than in a conversation.

ASSEMBLYMAN CULLEN: The other thing you mention are the various escrow laws regulated by different units of government. Now, in your escrow office or a typical escrow office that belongs to your Association, are you subject to one or more of these laws?

MR. HURST: If you are asking whether members of the Association are subject to them, yes, they are. Whether I am subject to it personally, we are talking about two different situations.

ASSEMBLYMAN CULLEN: No, I would like to take a growing escrow office that advertises its availability for escrow. Would that office be subject to regulation by a number of units of state government?

MR. HURST: Only if they are involved as a licensed escrow operator under the Department of Corporations would they be subject to those rules and regulations.

ASSEMBLYMAN CULLEN: Now that is one act. What if they are conducting other types of escrows?

MR. HURST: What do you mean "other types of escrows?"

ASSEMBLYMAN CULLEN: I understand that the escrow officers in banking transactions involving personal property are subject to some laws, real property is subject to others.

MR. HURST: The personnel who are involved with a title company, for instance, are subject to whatever rules and regulations established by the Department of Insurance.

ASSEMBLYMAN CULLEN: You mention title Company. Do you mean in escrow transactions?

MR. HURST: Yes. If the escrow is being processed through a savings and loan, the involvement is through the Savings and Loan Commissioner.

If it happened to be a realtor who was operating his own escrow, it is subject to the Department of Real Estate.

ASSEMBLYMAN CULLEN: If we come back into your office, and a realtor or various people want to use the services of your office, it is necessary for you to apply and gain a certificate of convenience from the Department of Banking, the Department of Corporations, the Department of Savings and Loan and so forth?

MR. HURST: I personally operate my business under the Department of Corporations. I have an escrow license. The personnel in my office and in management must meet the qualification that have been established by the Department of Corporations.

ASSEMBLYMAN CULLEN: Does that mean that it is possible you have to turn away business because the transaction is governed by an act administered by the Department of Banking or the Department of Insurance?

MR. HURST: No, sir.

ASSEMBLYMAN CULLEN: Is there reciprocity if you are certified by the Department of Corporations, are you also declared eligible to conduct these other escrows?

MR. HURST: The type of escrow has no bearing on the license that I hold, or the regulations that I am under. The point being a buyer and seller can come in off the street and whether I handle the escrow or whether it is handled through the savings and loan, it is only subject to the rules of our operation. The escrow is not subject to those rules.

DR. HEWITT: The institution in which the escrow officer is functioning is what causes it to fall under the jurisdiction of one of the five agencies, and the thing that is fascinating, is the fact that some of the agencies have much tougher regulations on escrow in terms of supervision, training, audits bonds, financial statements and others, so they are quite different. There is no license, there is no escrow officer's license. There is a license for various settings and performance.

ASSEMBLYMAN CULLEN: That is the whole point of my questioning. As the president of a professional association would you prefer to have escrow licensing under a single unit of government rather than five or six units of government.

MR. HURST: The rules and regulations that are established are quite different at the moment. We felt that there should be some standardization in the industry. We have attempted this on a number of occasions with the other regulatory agencies and have not been successful. It was for this reason that the California Escrow Association a couple of years ago attempted to have the bill on licensing only as a standardization of the personnel within the industry. We were not successful in doing it. I think we raised the issue of some of the inequities and the differences but we were not successful in having it passed. The personnel of the state, I think, really are interested in having a standardization.

ASSEMBLYMAN CULLEN: No, did you just say that your Association does not endorse the idea oflicensing being regulated by a single unit of government.

MR. HURST: No, I believe the Association would.

DR. HEWITT: We introduced a bill, or they introduced a bill prior to my representation of the Association two years ago, which was carried by Clare Burgener. It happened to be put together in haste and be poorly drafted but it did set up a level of training and competency and certification for people doing escrow in any setting. It did not, however, address itself to the financial responsibility of the institution in which this person was to function. It was purely and simply a licensing act.

CHAIRMAN McALISTER: As I understand it, unless you are part of a regular independent escrow company you do not have particular standards that you have to meet by law to do escrow work. Is that right?

DR. HEWITT: That is right. Because of this, this Association has been very active in setting up a certification program as a voluntary association and their activity has been met with so much approval that many of the junior colleges now include this as an AA program and will offer the certificate or training toward the certificate.

MR. HURST: I do believe that you will find that the other regulatory agencies do feel that they have rules. They are not all in the same level of performance but there are rules that are established in one man or another within those agencies.

ASSEMBLYMAN CULLEN: Is anyone involved in escrow work in California eligible for membership in your Association?

MR. HURST: Yes, I would imagine so. The only thing, if they can qualify in a regional association they are eligible to join a state association.

ASSEMBLYMAN CULLEN: In your estimation, how many belong versus those who do not?

MR. HURST: I do not know how many personnel within the State. We have approximately 2800 within the State Association.

ASSEMBLYMAN CULLEN: Does that fall into the category that you would recognize as escrow agents?

MR. HURST: Right.

ASSEMBLYMAN CULLEN: You have no idea how many are outside the Association?

MR. HURST: There is no forced requirement in order to be a part of the industry that they belong to the Association, it is strictly a voluntary thing.

ASSEMBLYMAN CULLEN: Is there any more than one type that belongs to the Association?

MR. HURST: I am not sure what you mean by one type?

ASSEMBLYMAN CULLEN: You laid out the different people who do escrow work.

MR. HURST: The regulatory agency?

ASSEMBLYMAN MOBLEY: Yes.

MR. HURST: No, we have no basis really for that conclusion.

ASSEMBLYMAN CULLEN: In other words, it would be hard to say that you represented the majority of the people who do escrow work. Is that right?

MR. HURST: Well, I do not know how many totals--since there is no license, and I do not know how many people are involved in escrow per se'. There is no other association it represents other than those within the California Escrow Association.

ASSEMBLYMAN McALISTER: Do you have many real estate agents who belong to your Association?

MR. HURST: We have some. I do not know how many. When the records come to the central or the state organization, we are not asking at the time for determination of who they may work for. Now the regionals would have to tell us that.

ASSEMBLYMAN KNOX: You do not really have to be regulated by anyone. Right? Unless you are incorporated. Could I go out and perform escrows excluding the fact that I am a member of the Bar?

MR. HURST: And hold yourself out as an escrow agent?

ASSEMBLYMAN KNOX: Yes.

MR. HURST: No. The Department of Corporations would probably stop you. If you were involved with one or another of the regulatory agencies and met the rules, fine. If you just held yourself out in handling escrows to the public the Department of Corporations, I am sure, would stop you.

ASSEMBLYMAN KNOX: You could handle any kind of an escrow business and things of that sort. If Mr. McAlister and I had a dispute as to an athletic contest between Mr. Ali and Mr. Foreman, to decide which was the better athlete in the opinion of the referee, could you hold that escrow?

MR. HURST: I undoubtedly would not.

ASSEMBLYMAN KNOX: Could you under the law?

MR. HURST: That would depend upon the terms of the contract. If it was a money bet of some nature, we would indicate no.

CHAIRMAN McALISTER: The thing about these exotic escrows, there may be some rare opportunities...

MR. HURST: We have had some exotic escrows and as I say, there have been reasons why we have turned escrows down from time to time.

CHAIRMAN McALISTER: All your escrows are not for real property sales, I mean most of them are but...

MR. HURST: That is true. Some of them even with attorneys.

CHAIRMAN McALISTER: Thank you. Mr. Richard Ratcliff of the California Bankers Association.

MR. RICHARD RATCLIFF: * Mr. Chairman and members. My name is Richard E. Ratcliff. I represent the California Bankers Association, and I have a bit of a problem here today that I think you will recognize. Dr. Pratt, in our view, gave an excellent presentation of many of the outside parameters, but the one we have to deal with, is when he is involved in the real estate financing field. My presentation was drawn up

* EDITOR'S NOTE: Mr. Ratcliff's written statement is attached hereto as Appendix C

on the basis that I would try and cover some of that material. I think, obviously, Dr. Pratt did a better job than I can do and what I will try to do is to cover the material that I think we should cover and refer to his comments the best that I can. Unfortunately, it will probably result in a kind of holding presentation, but let me try and go through it anyway.

Basically, the California Bankers Association, as some of you know, has been active in the past in dealing with some of the particular points that are involved in this hearing. For instance, AB 105 by Assemblyman Deddeh in 1973, got all the way to a conference committee between the two Houses. At that point, there was a proposed Conference Report where AB 105 was talking about a 10% limitation on late charges. The Conference Report at that point was blessed with the appearance on the scene of the Garrett case. You have heard some discussion as to what Garrett does today. We disagree with some of the discussion you have heard, but I think the point is the Garrett case has caused some new factors to be considered. The 10% at that point was unacceptable to the people involved. At that stage, various people were arguing for various things. Because of that discussion, AB 105 got hung up and died.

AB 2114 (Hayden) set out to limit prepayment penalties to six months interest on the unpaid balance less 20%. This was to be effective for a period of 7 years after which prepayment penalties could not be charged. This bill was killed in the Senate. It was killed in the process of amending the provisions of SB 200 with which you are familiar into the bill

and it became unacceptable to those of us that supported AB 2114 at that point in time.

Another bill, AB 1514 (Deddeh) was passed as Chaptered 925 in the 1973 session, which I think answers the point that was made earlier in the hearing yesterday. That has to do with impound accounts. The bill says the lender cannot require impound accounts as a condition of making the loan. Those of you who were involved in the discussion of the Committee when the bill was considered will recall a very careful discussion by everybody indicating that when there is a marginal loan application, if the lender can require an impound account, it puts him in a better position to grant the loan. If he cannot require an impound account, and the customer is not willing to voluntarily accept an impound account, at that point we said and we will repeat, at that point the lender should refuse to make the loan.

AB 1514 sets up a structure where the consumer himself will make the choice. If he wants an impound account, fine. At that point, he accepts it with a notice that indicates to him that interest will not be paid on those funds. However, if he does not want the impound account, he does not have to have it. I think it indicates that the CBA has been involved in this thing on a constructive basis for some time. You may not regard the prepayment penalties provisions of AB 2114 as being particularly what you people have in mind. You may not regard the 10% late

charge when AB 105 is what you have in mind. I think we should all understand that at the present time, there are no limitations upon these charges. The Garrett case has indicated that there is a limitation of actual cost. I disagree with the discussion of that case. I think what happened was the court was presented with a rather difficult provision to uphold in the light of the discussion before the court. The court decided that it was a penalty that was illegal under California law and the Legislature had not granted the power to lenders to impose the penalty. At that point they said that you have to fall back on liquidated damages laws. These laws talk about a reasonable attempt to anticipate what kind of damages and costs you will come up against in the even of a breach.

I think this is a different kind of a situation. Today, what I would like to do is to sketch generally the sources and flow of funds because we feel it is extremely important. I think it was indicated this morning in the S & L presentation.

CHAIRMAN McALISTER: Mr. Ratcliff, in your case you are going to have to determine what the actual damages are. You are not just going to be able to...

MR. RATCLIFF: Under the Garrett case, they ruled that provision illegal. Having ruled that provision illegal, the only thing that the parties could do was to talk about liquidated damages. I think it is totally within the Legislature's power to look at this situation and set the limit which is reasonable,

workable, and would provide both parties with some equity. I think frankly this is what we would like to see done.

There has been some discussion of the difficulty of finding costs for some of these activities, late charges, pre-payment penalties, and other such things. Speaking for the banking industry, and I think for some of the others, we do not have any kind of a unit cost accounting process in the banking industry, which would result in figures which actually reflect what the costs of any particular activity is. The problem we have is that you do that when it amounts to an extreme amount of money which would have no benefits or beneficial results to us other than perhaps some guidelines in helping the individual institutions to economize and increase their efficiency.

ASSEMBLYMAN CULLEN: Your recollections to me of the Garrett case are entirely different than I know. Yesterday in the information provided for us by the committee consultant's report, it said actual damages that set off actual damages suffered by the lessor. You are suggesting today that in that decision they said liquidated damages. I think it is clear enough. Is it actual damages or liquidated damages?

MR. RATCLIFF: My comment was misleading. What I intended to convey was my recollection, I do not have that case and I have not read it for a while but in that case they said that

the attempt of the parties to set those charges was illegal because it constituted a penalty. Having been a penalty illegal, it was thus unenforceable. At that point, what do you do with regard to the rights of the parties involved? I think you start talking actual damages; I think that is all you can do. But with regard to a lender and a borrower, who enter into an agreement, they can set a late charge provision, as a liquidated damage.

ASSEMBLYMAN CULLEN: That is your suggestion?

MR. RATCLIFF: No. I think that is what the court has said.

ASSEMBLYMAN CULLEN: Our brief here in three paragraphs uses the term "for actual damage," and it has a lot to be resolved before the committee starts thinking in terms of liquidated damages. I suppose most of the committee present here today are lawyers. Where it is difficult to ascertain actual damages, we all know the party may agree upon liquidated damages, but this court in this case may not have said that because they may not have been convinced that it is difficult for a lending institution to measure their work product and tell you what it actually costs them to process the late charges. That has never been demonstrated to this committee yet your client and the other lending institutions have found it difficult to ascertain the actual costs of processing late charges on a client's account. If it is impossible, if it is difficult, perhaps we should get into the area of liquidated damages. That is how I see it.

MR. RATCLIFF: There is a third alternative. I think the liquidated damges is one way to go. I think actual costs is one way to go in which you force the lenders into a situation where they have to come up with a cost figure, which we think is absurd, frankly.

The Legislature should look at what a late charge is, what its function is, what its impact is, and come up with some kind of a decision rendering equity.

ASSEMBLYMAN CULLEN: That is the thrust of your presentation. I merely want to call to your attention that we verified the Garrett decision set actual damages and did not allude to liquidated damages. You came before us today and said that you did not believe that the court contemplated liquidated damages, and I think there is a difference of opinion in your presentation and that of others, and our committee's brief.

CHAIRMAN McALISTER: Page 38 of our brief states that the amount could be thoroughly measured by the period of time the money was wrongfully withheld, plus administrative costs that was reasonably related to collecting and accounting for a late payment. I do not think that means that the Legislature would not have any role in it. We could determine what we find to be a reasonable administrative cost. What about this business of measuring the period of time the money was wrongfully withheld; we could have some kind of a scale for that assuming we make some kind of reasonable judgment.

MR. RATCLIFF: One of the points that I was trying to make. I do not think that the Legislature is bound by the factors set forth by the court. I think that what the court was trying to say to all of us out in the world at large is that you are going to have a late charge provision, than being aware of it being declared a penalty.

CHAIRMAN McALISTER: It would appear we would have to avoid impunity aspects.

MR. RATCLIFF: I do not think so. I think the Legislature, if it saw fit, could provide a penalty. The Legislature has permitted counties to charge a penalty for somebody who misses his property tax. The only difference is that if one of the private institutions is opposed to a public body, the function of that penalty could well be the same as the function of the late charge if the Legislature saw fit to define it in the same fashion.

CHAIRMAN McALISTER: I guess the prohibition against the penalty is written into the Constitution.

ASSEMBLYMAN KNOX: It is like saying if you don't feel like paying a traffic fine, you might land in jail. The banks could have a facility there to confine somebody for a while, a public institution can do it, why not a private institution?

CHAIRMAN McALISTER: We are talking in effect about a civil penalty. I guess it is not going to rise to the level of crime.

MR. RATCLIFF: What I would like to do is to sketch the sources of the flow of funds because of the importance to them. I would also like to discuss the importance of the secondary

market. It is one of the forces that has to be considered by the committee.

As part of that, I would like to discuss the Federal National Mortgage Association (FNMA) and the Federal Home Loan Corporation. Government National Mortgage Act (GNMA) I will not discuss. I am trying to confine my discussion to conventional mortgages as opposed to various governmental programs. As I go through, however, I will mention FHA and VA. Further, I would like to indicate how banks would generally operate in these areas. Also, I would like to reserve some time during November 22 for us to present some specific suggestions for legislation to the committee.

With regard to the sources and flow of funds, I think it is important to understand that banks have basically two in-bank sources of funds. These are commercial or checking deposits, and the savings deposits. By nature these are short-term because the depositor can retrieve them really on a very short notice period. The problem is conversion, as was indicated this morning, short-term investments into long-term funds, which are necessary for real estate lending.

The secondary market historically has been insurance companies, eastern savings banks and others who have amounts of money, which they are willing and anxious to place in long-term investments. The secondary market is one that fluctuates and

and flows and has cycles as any money market does. The in-bank sources of funds, as indicated as short-term, have unfortunately been diminishing. The problems that you all have heard about, the out-flow of savings due to federal competition, etc. have hit the banking industry also. As these funds diminish, the ability and the resources that we need to make real estate loans also diminish.

Basically, I think there are some rules of the game, and those that need funds are hard put to negotiate entirely favorable terms in the contract against those that have the funds especially in a comparative market. This is true whether you are talking about a California lender attempting to get funds or whether you are talking about a California borrower, who is attempting to get funds from a California lender. I think it is obvious that if the person has need and the other person has funds, the need very often will outweigh the ability of the person to negotiate something that is entirely favorable to him. The secondary market, in this case, your California lenders are the borrowers and we have that same problem. The market as I indicated is one that has cycles and twists to it that do not reflect the housing need that we have in California. Because of this there have been several devices developed to provide an easy entry into that market, an easy entry where you can get long-term funds out of what are basically short-term investments.

The Federal National Mortgage Association (FNMA) is a public corporation, and was created to accomplish this purpose. The Federal Home Loan Mortgage Corporation (FHLMC) basically was designed to do the same thing. It is a private corporation, set up basically by the savings and loan industry. The importance of these two devices to the committee are that both of them have standard provisions covering some fees and some provisions which are being discussed by this Committee.

The lender if utilizing these sources of funds need not use those standards unless he sells the mortgage obligation to either FNMA or FHLMC. At this point the terms of the agreement with the borrower becomes those required by FNMA or FHLMC. In addition, FHLMC has standard forms which must be used if sale of the mortgage to FHLMC is planned. These forms are generally also acceptable to FNMA. The lender uses these by going to, for instance, FNMA paying a commitment fee of 1/2 of 1%, or half a point. The commitment agreement makes the funds available for purchase of that mortgage by FNMA, when that is made by the lender. FHLMC works much in the same fashion. When banks pay FHLMC they pay a 1/2 point nonmember fee rather than a commitment fee as under FNMA.

FHA and VA programs are programs which guarantee the mortgage. They are not a source of funds, so that when you are dealing with FHA and VA loans, the lender in these cases can get a commitment from FNMA or FHLMC, go out and place the funds

under a FHA or VA program and subsequently sell that mortgage to these marketing agencies, and use the funds he realizes from the sale to make another loan. This basically is how the market is being carried on now. It is increasingly so in periods like we have now, of tight money, because we do not have the money to make the loans for our own portfolio and to hold the loans themselves. To be active in the market, you have to rely on these marketing devices as an approach into the market. Basically what they do is they sell bonds in the bond market taking those investment funds and convert those into funds which they can then place on a long-term basis on the mortgages.

Let us go briefly through how FNMA and FHLMC approach the various provisions that we are talking about here today. To give you an idea of how they treat late charges, prepayment provisions and such things: Late charges is one thing we have not talked about, that is the difficulty that the lender faces. The Code of Civil Procedure, Sec. 580 (b) sets forth the anti-deficiency legislation in California, which was enacted back in the '30's. It says in effect that since the lender has two contractural relationships with the borrower, he has to choose between them. He can sue on the note or a late payment, but if he does so, he has to waive his right to sue on the security. Or he can ignore his rights under the note and sue on the security. As a practical matter for the lender there really is not a choice. The security for the loan in all of these cases is the house itself. To sue for a payment

that is late and due, is one where it would be absurd to give up your right to subsequently sue on that security.

This presents a problem. We have got a great big mallet to enforce our rights against the other party to the contract. That great big mallet is foreclosure. It is expensive; it is time-consuming; and it is rather frightening in all of its aspects to everybody involved. We do not like to use foreclosure; it is kind of a last resort. The problem we have is that there is no effective way that we can collect from the delinquent borrower on his delinquencies without going to a foreclosure proceeding which is ridiculous. In our view, late charge is something that should reach the threshold of pain, if you can use that term, which gets into the penalty concept of a late charge. It is something which the borrower should be aware that he has this obligation and he has to meet it. I think that Mr. McKenna this morning indicated another reason why late charges are important to the lender and that is the problem of the mortgage being poisoned, if you will, when a person defaults on a payment when the lender tries to sell that mortgage in the secondary market and gets additional funds to lend here in California.

Basically, FHA which as you know is a federal program, has a provision on late charges that 2% of the payment due, including impound accounts which are required under federal law, is the measure of the late charge. VA loans is 4%. FNMA, the provision is 4%, but there, it is only on the payment due, but only on the principal and interest excluding

any impound accounts. FHLMC is the same as FNMA. In the conventional secondary market, apart from FNMA and FHLMC--for instance, if the bank should attempt to sell mortgages to an insurance company. At that point, they are going to look at and see what the general market is. They review the bank's practices with regard to some of these provisions. If they are satisfactory, they will then enter into negotiations to buy the mortgage. If they are not satisfactory, then those funds do not become available. This is the problem that the lender generally has. We have to somehow have these provisions in such a form that they will be familiar and acceptable to that secondary mortgage.

With regard to late charges, we have gone through this argument on late charges for some period of time. Four or five years ago, we used to oppose people who wanted to impose a limitation on late charges of 10%. Then we came in with a bill and suggested that 10% was equitable. There were others who opposed that. The bill has obviously never passed through or we would not be talking about it as we are today.

With AB 105 in Joint Conference Committee, we agreed to a late charge limitation and I understand all these are limitations maximums. We agreed to 6%, and we would like to say that we think that this makes sense. The county provision with regard to a missed payment of county property taxes is really very close in terms of what it is trying to accomplish. I can give you a personal example. I missed my property payment a few years ago; because I do not have an impound account, and in the process, the penalty that I had to pay was 6%. If you take that

penalty of 6%, if it is a December payment and you annualize it, it comes out about 11%. A December payment is something like 24%. There is a new redemption situation in the law, which after those periods you go to a lien being imposed and you are talking about a 1% per month or 12% a year penalty on these funds. It seems to me that 6% makes some sense.

The purpose of the prepayment was pretty well discussed this morning. Let me just go into the FHA, VA regulations, and say there shall be no prepayment provision. But in this siutation the seller is going to have to pay points, so that you have in effect almost an automatic assumption process. But the seller, when he goes to sell the property is going to have to pay points, which we will get into in a few moments, but basically reflect the difference between the market rate and the rate limitation imposed by the federal agency.

FNMA equally says no prepayment provisions, but they also say that if the loan is on a FHLMC form acceptable to them, at that point the prepayment provision of FHLMC comes unenforceable as long as FNMA holds that mortgage. If they should turn around and sell that mortgage themselves, a secondary mortgage, to raise funds for them to use in the housing finance field, at that point it would become enforceable. This means that if FNMA feels that for their purpose, they do not need a prepayment provision. But they fully recognize that they have to go out and sell it on a secondary market. They are going to have some kind of a prepayment provision to make that salable.

The FHLMC prepayment provision is one which I think is worthy of looking at. Basically, as you will recall in SB 200, Senator Gregorio's bill, the basic structure was, in all of these we deduct 20% on the balance, an automatic reduction of the penalty every year of 20% over a period set up in such a way that after 5 years there is no prepayment provision. FHLMC does it a little differently. They, too, have a 5 year period of operation. They say a prepayment occurs in the first 3 years, the borrower must pay an amount which shall not be less than the maximum amount allowed by the FHLBB regulations or such lesser percentage as is the maximum permissible under applicable law. There you get into the problem of the ruling with regard to the Federal Savings and Loans being able to charge six months interest on the excess of the 20% of the original balance of the loan. But if you are talking about a 10% loan, this six months' interest on the first three years talks about a 5% charge. If the prepayment occurs during the fourth and fifth years of obligation, the charge shall then be 3%. After the fifth year, there is no charge. This only applies if refinanced by the holder of the note. We feel that for purposes of trying to meet the general demand, to make sure that we do not disturb the flow of funds, the FHLMC pattern makes some sense. I think that this comes about because in the tight money market now, increasingly FNMA and FHLMC become the vehicles for what lending is going on. We feel that utilizing these things protects access to the secondary market that we feel is vital. Beyond that

you are finding increasingly, certainly among banks, that the lenders are making their loans on the FHLMC form preparing to sell those. That being the case, we think that the FHLMC provisions, perhaps with some adjustments, makes some sense in terms of the committee review of the things that we have been talking about.

CHAIRMAN McALISTER: In essence as I understand that, on the FHLMC pattern there is no prepayment penalty except where the mortgage or deed of trust is sold to another lender.

MR. RATCLIFF: It is effective, if it is refinanced by someone other than the holder of the note; if it is another entity doing the refinancing, then the prepayment charge becomes effective. I think that for present purposes, it may be a little narrow, that restriction. But I think that the FHLMC approach of 5 and 3 is something that incorporates the 5-year period of SB 200, and also the declining tendency, although states it rather than have a straight line decline.

CHAIRMAN McALISTER. This gets around the problem that the savings and loan people were talking about this morning, saying they need this ability to sell if they get out-of-state money, an equity kind of a problem?

MR. RATCLIFF: I hesitate to answer that in the guise of what the savings and loan industry needs. On the banking industry's viewpoint, we think so, yes. There is some differences of opinion in approach between the banks and the savings and loans.

CHAIRMAN McALISTER: Your money is not all going out in terms of long-term loans like...

MR. RATCLIFF: That is absolutely correct.

CHAIRMAN McALISTER: If that solution addresses itself to that problem, it would be essentially a solution to either industry...

MR. RATCLIFF: The purpose we have in suggesting that the committee look at this provision, is that in our minds by adopting something along the lines of the marketing device designed to get to the secondary market for lenders here that you are not jeopardizing the acceptance of these mortgages when the time comes to sell them in that secondary market.

This one further point presents a problem that this committee is going to have to wrestle with if they decide to do anything in this area. That is the mortgage loan brokers, for instance, have the provisions of AB 2114, which was the bill we were proposing for us, which the Legislature said, "No, we are not going to give to you," and they turned around and gave it to the mortgage loan brokers.

We think that anybody in the business of real estate lending should be working under the same kind of overall limitations. I think it should be true whether it is a mortgage loan broker, or any other type of lender. This would include individuals because we think that the attempt and things that the committee is looking at is to protect the consumer from some

of these provisions that some people feel are onerous. That being the case, I do not think it makes any difference who imposes the provision.

The due-on-sale clauses was an excellent discussion in terms of what it is and how it works and why it is there from this morning's discussions. FHA and VA have no due-on-sale provision. FNMA has no due-on-sale provision, (but again FHLMC, 4 is used.) It is suspended during the time that FNMA holds that mortgage. If they subsequently sell it, then it is reactivated. FHLMC has a uniform note, in which it contains the following provision, which we think makes a lot of sense. "If all, or any part of the property or any interest therein, is sold or transferred by the borrower without the lender's prior written consent excluding (a) the creation of a lien or encumbrance subordinate to this deed of trust, (b) the creation of the purchase money secured interest for household appliances, (c) a transfer by devise, descent, or by operation of law upon the death of a joint tenant, or (d) the grant of any leasehold interest of three years or less, not containing an option to purchase," presents again a familiar provision to the secondary market. It presents a provision which is currently being used, and we think that the subdivision (c) talks about any transfer by devise or descent, that it takes care a lot of the problems that Senator Gregorio was talking about in terms of exercising a due-on-sale clause against a poor widow etc. I think a lot of those problems diminish or disappear under this kind of a provision.

Again, under the conventional secondary market, it depends on the market's review of the institution's policies. If they are acceptable, they will buy the mortgages; if they are not acceptable, they will put their money elsewhere.

FHLMC has an interesting statement in their Services Guide. They believe that the right of acceleration upon transfer of ownership an invaluable tool of any mortgage investor and insuring that only credit worthy mortgages are responsible for making payments. The lender makes the loan, sells the loan to FHLMC or FNMA and then the key services the loan. In their manual to the service, they tell him to use his best efforts to determine the sale or transfer mortgage property; or any other event giving rise to the right of acceleration. They go on to indicate that they treat assumptions a little bit differently than other people.

Tucker v. Lassen is one that ends up possibly promoting the use of a contract of sale, as opposed to an outright conveyance of your interest, as the means to handle property transactions. We have not completed our analysis of this. We see a lot of problems with that device as applied to the consumer. I will just give you one. If a loan on a piece of property which subsequently is sold under a contract of sale, possession is transferred. The borrower under the loan no longer has possession. He is under the contract of sale to sell it to a subsequent buyer. If he defaults, the lender's only right is to foreclose.

We foreclose, and the relatively innocent subsequent purchaser loses his house. His only rights at that point are against the person he brought it from who may or may not be able to make him whole. I think this kind of thing presents many problems.

CHAIRMAN McALISTER: Why do you call this last person relatively innocent? You are assuming that the person who sold to him misrepresented the status.

MR. RATCLIFF: No, I think he can be either innocent or less than innocent. I do not think it really makes any difference because the rights that he has are against the person that sold him the property whereas the person who sold him the property is in effect saying when your contract of sale is fulfilled, I will be able to convey the title of that property. But when that time comes, that title may not be any longer under his power. It may have been reclaimed by the lender in the foreclosure proceedings.

CHAIRMAN McALISTER: But that only happens if default occurs.

MR. RATCLIFF: That is right. If our lender, the seller under this situation, makes the payments everything is fine. If the institution and the subsequent purchaser agree on an assumption of some sort with the substitution of parties, then there are no problems. It is the ones in between that could cause the problems, which in our view could make the contract of sale work under some circumstances and cause terrible problems under others. We are just indicating there are some problems with it.

Assumption clauses and fees are part of the hearing notice, and FHA and VA have no due-on-sale, thus you almost automatically

fall into the assumption situation. FNMA is much the same. FHLMC, however, is different, and FHLMC basically permits the lender, the servicer, to use his judgment as to whether to approve an assumption or not. As you recall, they do have a due-on-sale provision, so it is up to the lender servicer. The lender servicer can approve an assumption under the following conditions:

1. If there is a cash equity of at least 5% of the new purchase price;

2. the property is to be owner-occupied;

3. the monthly first, plus junior mortgage payment, if any, plus escrow impound accounts do not exceed 25% of the base pay of the primary wage earner;

4. the provision I just read to you, plus all other monthly payments on all installments debts having remaining terms of more than 7 months do not exceed 33 1/3% of the monthly base pay of the primary wage earner.

The next one is not really applicable, and the final one is that there are no other changes in the terms of the loan.

The reason for mentioning this will appear when you look at SB 200 in the Tucker case. We should go back to the La Salla case, talking about the junior encumbrance situation. The court said because there was no substantial impairment of the lender's security, the lender could not accelerate when a junior encumbrance appeared on the title.

The *La Salla* case talked about impairment to the security, and the next time I saw that concept was in SB 200. Subsequently, again it was talked about in the California Supreme Court in the *Tucker* case.

We take strong exception to the discussion of impairment of security in the lender's situation, as if the lender's only concern is with the condition of his security. The lender has extended financing to a particular borrower based on his promise to pay as agreed; and the evaluation of his ability and willingness to pay the payments that he has agreed to do under the contract. If you will recall the conditions that FHLMC has for assumptions, you will recall that they are talking about basically creditworthiness and the ability of the lender--the borrower--to make the payments under the assumption. In addition, both FNMA and FHLMC talk about credit reports, and they talk about the obligation of the lender servicer to pass on any credit reports. The basic point is that both of these institutions understand what goes on in the making of a loan, and there are several factors obviously. But one of them that we feel is extremely important is the evaluation of the borrowers' ability and willingness to pay. We feel that the security is there, when you are talking about foreclosure. But in the meantime, of far more importance to the borrower, is his ability and willingness to make the payments, he is obligated to make under the note.

We feel that the FHLMC approach is one that is far superior to the approach of SB 200. The FHLMC has a 1% assumption fee, and we feel that this also makes some sense.

In my attempt to prepare for this meeting, there was a great deal of confusion in my mind as to what was intended and what was meant by points. As I understand it, there are two basic areas where points that come into the conversation when you talk about real estate financing. One is the discussion of points with regard to FHA and VA loans. This is where the subsequent person gets an FHA or VA loan, subsequently he goes to sell the property. At that point, as the seller, he has to pay the difference between the going market rate and the FHA rate in that particular loan. This is true on a brand new loan obligation also, say in the tract situation the seller in that case, is paying the difference between the interest rates on those funds.

The problem arises because FHA and VA both are designed to get the buyer into the house, to help him through the maze and the difficulties of the market in his particular situation. Once he is in the house and goes to sell it, apparently the assumption is, that at that point he has some money and then he should pay the difference to the lender who has used market rate funds in advancing the house. He should compensate the difference between the limited amount of the loan and the market rate, which presently exists.

Basically other than FHA and VA, the use of points is with reference to charges, which are computed on the basis of percentage of some amount, whether it is the unpaid balance, the original balance, or what have you. These also are regarded

as points. Banks generally do talk about points and the FHA and VA loans and do charge the seller those points. However, when you get to the situation in terms of loan fees, for instance, which is loan origination fees, those points which are most often used in addition, the banks look at it as if the loan origination fee is the fee that covers the lender's cost of obtaining the block of funds from a secondary market, and its cost of processing the loan. Thus, in terms of your hearing notice, it would cover appraisal fees, photo fees, and many of those miscellaneous fees, in our view.

Now FHA and VA loans fees, loan origination fees, are limited to 1% of the amount of the loan. The report I have on that is that depending on the lender, they think that cover their costs, or they think it is below a figure, which covers their costs. The FNMA, FHLMC, and the secondary market leave these fees to the lenders, and our feeling is the loan fee of 2% would be a proper one, in other words, a charge of two points. If you take FNMA and FHLMC, if the lender is utilizing these, if you figure that the FHA/VA 10% loan fee covers our costs, then when the lender utilizes FNMA or FHLMC, the 1/2% commitment fee or nonmember fee is taking up an addition 1/2% leaving in some cases a 1/2%, which would go presumably into the lender's profit. When he sells to these people, he then becomes a servicer on the loan. He is no longer participating in the profit other than the charges that he is permitted to charge to FNMA or FHLMC for the servicing of that loan, which varies between 1/4 and 3/8 of a point.

You have the 1% cost factor in terms of the commitment fee, plus the 1% of our costs. It is for these reasons we suggest that a very minimum really, a 2% loan fee, assuming you want to limit this fee, the idea being that this seems to be what we can live with. It seems to be what covers the costs undergoing the conventional secondary market, which is probably the most expensive process for the lender to do.

This loan fee would include such things as appraisals, photo fees, and miscellaneous fees. Title fees, real estate broker fees, escrow charges, etc, are not normally fees charged by the bank. The extent that these costs incurred by the bank, we feel we should pass them on to the borrower on an out-of-pocket basis. When escrow services of a bank are utilized, we think that at that point the bank escrow operation should be regarded within the realm of the independent escrows; what they need to make a profit, what they need to carry out their business, are something that other people should be able to live with.

Let me just very briefly indicate that under late charges banks are presently charging somewhere between 4 and 6%. Prepayment penalties again vary greatly, but probably a 6 month interest on the original balance, less 20% seems to be not unusual. Many banks at the present time are going to a shorter period of time. There are several banks for instance that have currently adopted either the FHLMC approach of the five, three, five-year period, or taking a 5, 4, 3, 2, 1 approach, but generally this seems to be the way to which things are going.

One item of interest is that one statewide bank has no prepayment charge. They instituted a prepayment charge and subsequently they raised it to the FHLMC or something similar to the FHLMC provision. The reason they did that is because they found they were unable to compete in the secondary market for the obtaining of funds, and thus they had to impose a prepayment charge just in order to make those funds flow from other sources. This was mentioned to a degree this morning, and something that I have been trying to emphasize.

Due-on-sale provisions, I think, are generally uniform and are almost always included in the notes. The unusual situation is where the note does not include such in the provision, although there are notes which do not have due-on-sale provisions. Assumptions, the fees vary from a flat charge of--and I do not know what the minimum figure would be, but I would guess it to be somewhere in the neighborhood of $11, perhaps a little less, to 1% of the unpaid balance. We think that 1% of the unpaid balance is a figure that makes some sense. It is not in our view unreasonable, and it seems to be something that FHLMC provides thus again protecting the secondary market and the flow of those funds. It is something the committee might want to consider. Loan fees also vary, but again 2% makes some sense. Finders' fees, incidentally, are not utilized by banks at all.

The bank's attempt to deal with the secondary market generally predated FNMA and FHLMC, and those provisions that we

that we do have currently enable us to operate in that secondary market. The FNMA and FHLMC provisions are providing a trend within the industry to go to lesser charges and lesser fees, which is happening just because they found they do not have to charge these higher rates. The FNMA and FHLMC entry to the secondary markets especially at the present time is about the only source of funds that seem to be workable and flowing with any kind of degree of continuance.

One item that this whole discussion should include is the attempt by us to take a normal money situation, which there may not be such a thing, but to try and give you an indication of one of the problems that we have in terms of raising funds for real estate lending if you assume that you can take $100,000. Take half of it from the two basic sources that banks have, commercial or checking accounts, and savings accounts, the Federal Reserves requires that we establish reserves. For commercial accounts, 15%; for savings accounts, 20%; thus, right off the bat, $17,500 has to be deducted from that $100,000 in order to get down to the lendable fund, which at that point would be $82,500 But assume for a minute forgetting that FNMA and FHLMC have limitations that have been raised to $550,000, in terms of the size of any one mortgage. Forgetting that aspect for a moment, assume a 10.5% annual rate of interest on this loan. Roughly, 8% of that is going to go to pay interest in deposits, including FDIC insurance and other costs, servicing the loan, etc., which leaves the bank something in the neighborhood of 2½%, or if you take 2½% of $82,500, it is something like $2,062.50 annual return

before taxes that the lender has to play with. Now, these figures represent nothing more really than an attempt to show you the general breakdown of what kind of economics we are talking about. A 2½% return on the capital is one that would cause the normal investor to think about it a little bit, but this is the kind of structure that we are looking at in the real estate lending business. Again, this assumes the normal lending situation, and it also assumes the charges, fees, etc. It returns nothing more than the incidental revenue to the bank, and I would like to explain that our feeling is that the late charges, prepayment provisions, assumption fees, and the rest of it should be regarded as covering the lender's cost, covering the lender's expense of doing business, etc. as allocated, but they should not be looked at as items of revenue.

We feel that this kind of a structure causes all kinds of problems. Assume for a moment rather than a "normal" money situation, a tight money situation. The Federal Reserve--one of the things that they can do in fighting inflation is to increase reserve requirements for banks. Take the 15 of the 20% reserve requirement and boost them. Now, we have to spend money to buy government bonds in which those reserve funds are invested. Any expenditure comes out of that 2.5% return, but again when the federal policies of selling bonds in lots of a thousand dollars drains away potential savings, as has happened in the past, then funds do not go into the savings aspect of banks or savings and loans. At that stage the reserve requirements become even more difficult because you do not have the basic funds to pull out.

The discussion was intended to illustrate a couple of points; (1) the importance of the secondary market, both conventional and that part of the market which has been captured by the market agencies, FNMA and FHLMC; (2) any legislative action that the committee might anticipate really must not restrict the flow of these funds, because the whole housing economy is dependent upon that flow. We feel there are some ways to accomplish what I consider to be the ends of the committee in terms of revising some of the laws surrounding some of these provisions, to permit that flow of funds be retained; at the same time to accomplish something to prevent the application of unreasonable provisions and one of the things for instance in the Garrett case, and other cases that have come up involving some of these charges, are that the court marvel unfortunately from the consumer's view perhaps fortunately tends to take a fact situation which is difficult to justify, one that the results unduly argue large late charge provisions. Then in the process of attempting to justify it, the institution involved loses. In other words the court comes to the right result in the process, comes up with some reasoning, and some reasoning and rules of thought that we think are unduly and hinges on other provisions.

The California Bankers Association would like to see some legislation based upon an analysis and an evaluation of some of the testimony that you heard today and some that you are going to hear tomorrow, and come up with legislation, which will put a lot of these things to rest based upon an intelligent, reasonable approach to it, which above all protects the flow of funds to the secondary market.

At this point, I would like to offer to attempt to answer any questions that anybody has.

CHAIRMAN McALISTER: Regarding your 2 or 2½% profit, would you calculate profits on net worth rather than on deposits? As you came up to 2 and 2½% on the basis of these $100,000 deposits, you are making money on other people's money.

MR. RATCLIFF: Yes, that is probably true. The point I was trying to make is that the costs that we have are such that when somebody charges you a 10½% interest rate on a loan, I imagine your reaction would be to think that is high. What we are trying to show is that with the cost of money, and with the costs of the various other aspects of the business, that in our view the return to the lender is not that great, that there are other places where that money can be placed where the return would be greater. So we feel that we are part of the market, and there is a lot of discussion about the savings and loan, the banks and who is bigger and better, and who does it in the greatest fashion. I think both of us are part of the market and should remain a part of the market. The problem that we all face is increasing pressures, increasing concern by many people and an apparent inability over the past years to convince the Legislature that there are ways to accomplish some limitations which really should have the effect in our view of relieving some of the pressures anyway.

CHAIRMAN McALISTER: Our next witness is Mr. Jack Hempel of the Department of Real Estate.

* MR. JACK HEMPEL: Mr. Chairman, my name is Jack Hempel. I am Chief Deputy Director of the Department of Real Estate, and Commissioner McCarthy has asked me to thank the committee for giving the Department the opportunity to be present and to respond to any questions that you may have concerning the jurisdiction or the expertise of this Department.

The topics listed in the meeting notice are not regulated by the Department of Real Estate, except for some of the charges in connection with hard money loans under what is customarily referred to as the Necessitous Borrowers Act. These matters were most recently addressed by the Legislature in connection with SB 304 and SB 310 of the 1973 Session.

Both bills were supported by the Department of Real Estate. These amendments tightened up the activities of some of the larger mortgage brokers via Article 7 of the Real Estate Law with respect to regulatory provisions applying to real estate licensees in certain mortgage loan transactions.

We assume the above information has been catalogued by the committee, and that your current interest lies primarily in the area of settlement costs directly related to the purchasing and selling of residential properties in today's real estate market.

In that regard we understand several of the matters which the committee might feel are within our area of expertise, although

* See exhibit D

not in our regulatory jurisdiction, have to do with the following:

First, the effect of real estate brokerage commissions on real estate transactions and the question of these fees in relation to services rendered.

Now, commissions are a matter of negotiation between agent and principal. Although there are rates, 6%, typical in the trade, many licensees deviate from this figure. In Sacramento, for example, I have seen TV commercials within the last three or four months from a prominent firm of real estate brokers advertising that their full service commissions on house sales are $800 plus 1% of the selling price. I do not know whether there have been any surveys as to how many licensees deviate from the norm, but it has long been customary for large transactions to typically result in a negotiated commission at somewhat less than that figure. Representatives from the industry could comment on this, I am sure, and I believe they will be testifying before your committee tomorrow.

The state antitrust laws prohibit the fixing of commissions for services, and the California Association of Realtors many years ago entered into a consent decree, which resulted in the withdrawal from circulation of any recommended rates. It would be our observation that the fact that most licensees charge 6% on residential sales is more a standard of reasonableness than of design. It is true in most fields that activities below a certain rate are not economically feasible. This is probably why my TV repair experience has been relatively similar as to

the cost per visit from the three different repairmen who visited my own home during the last several years. It probably also explains why the markups for the sale of consumer goods based on inventory, turnover and the like are relatively stable. We understand big ticket appliances customarily sell at a 40 to 50% markup, whereas small appliances sell at the 25 to 30% level. Similarly, the discount new car auto sales are usually at $200 to $300 over invoice. I know of none who deal for $50 to $100. The net-net under that sort of situation just would not be there for them to stay in business.

In the typical real estate transaction, to get back on target, the commission is shared by four real estate licensees. The listing is secured by a salesman who is probably an employee in a real estate firm. The property is sold by another office with whom the listing office cooperates or through the multiple listing service. The same sort of division of the selling agent's share of the commission takes place in that office between the salesman and his broker. Without this network of communications, there would probably be fewer real estate transactions. Mulitple listing services have thrived because they help get the broadest possible exposure for properties which are available for sale, and it is true that concept where the multiple broker and salesmen involvement usually comes into play. If one considers the vast majority of every real estate licensee's time which is spent in work other than getting a signature on a dotted line, the actual remuneration to each licensee involved in the transaction would be best understood.

Now to get into some specifics on that, I would like to mention that a portion of all licensee's fees is set aside for education and research in real estate at the institutions of higher learning in California. We have found three of these research projects which contain segments relating to the income of licensees. A copy of each of these has been delivered to the committee for such analysis as might seem appropriate. Although each of these was directed originally to something only collateral to the pure question of income, the factors which were reviewed seem to point toward an average income for a full-time licensee in the real estate business at somewhere between the $10,000 and $20,000 per annum level. Even a 1974 survey by the organized real estate industry, within whose ranks the most active licensees are probably found and who, therefore, might be expected to have a substantially higher income level, 69% of those surveyed, and this was a 1974 survey, who were salesmen responded that their earnings were $20,000 or less, 23% of that group were under $10,000, 25% reported they earned from ten to $15,000, 21% from 15 to 20, and 31% checked over the $20,000 spot.

We were told also that the question which might arise, from the committee, would deal with the question of whether or not a large number of licensees in the state is not a factor which runs counter to the possiblity for reductions in real estate commission rates. We hardly think so. If there is an over population of real estate licensees, every competitive economic test we have ever seen supports the suggestion that the greater the competition the more price cutting might be expected.

To give you an idea of numbers, as of July 1, 1974, the department had 291,381 real estate licensees. Of these, 146,435 were real estate salesmen. Of this group 90,000 were active and over 56,000 inactive. There were 73,000 real estate broker licensees on that date, 62,000 of whom were active and 10,000 inactive. These numbers are large, but I think it is interesting that a percentage has varied only nominally for the past 35 years. A review of the department record shows that the ratio of licensee to population has run something from 90 to 125 since the late 1930's.

CHAIRMAN McALISTER: You indicated 219,000 real estate agents. What was the figure on brokers?

MR. HEMPEL: 72,000 brokers and 146,000 salesmen. 219,000 was the total figure. 67,000 of those are inactive. We have an inactive status under the law that provides for a separate fee and they are identifiable.

CHAIRMAN McALISTER: That means there are over 2/3 of 219,000 that are active?

MR. HEMPEL: Yes, sir. This inactive status has been statutorily provided just for the past 17 or 18 years out of our more than 50 years of license law enforcement history, and it shows as you have just observed that 2/3 of these numbers are participating on the economic scene. The other third are active.

CHAIRMAN McALISTER: I had no idea that there were that many people in this industry. With the total, counting active and inactive, it would be just over one out of every 100 people in the state.

MR. HEMPEL: I have been with the Department for 20 years, but prior to 1940, I was in the real estate business for a number of years. When I first got my license in 1940 there were six million people in the state, and they had 60,000 licensees, so you see the ratio has not changed much.

The one interesting observation is that in 1950 when the first requirement that separated salesmen from brokers was adopted by the Legislature, in order to get a broker's license you had to show two years' experience as a real estate salesman, as well as taking a more comprehensive examination. From that time to this, the ratio of brokers to salesmen has gradually changed. At that time there were more brokers than salesmen for the simple reason it was relatively the same type of hurdles to get over to get into the business.

Today, if you notice from the figures that I just gave that there are two salesmen for every broker. Another reason for that is that we have educational requirements for real estate broker licenses, which have been growing. Beginning January 1, 1975, a real estate broker applicant will have had to complete six college level, 3-unit courses in or collateral to real estate. It is presently four courses and this is getting to be a meaningful educational requirement for a real estate brokerage which attempts to recognize the trend toward professionalization out in the industry and the needs of the consumer in the vastly more complicated real estate situation that exists today than it did 40 or 50 years ago.

We heard the last gentleman refer to FNMA, GNMC and FHLMC and those terms did not even exist in the real estate field 30 years ago. We have delivered copies of the Department's long-range professionalization plan to the consultant to the Committee, so that can give you a picture of the road that has been travelled to date. In trying to upgrade the standards for real estate broker's license, and also to show where the legislature may continue to see an interest in raising these standards.

We believe that a limitation is one which says that the entrance level jobs should be generally available to the person who can show a general level of competence; and that the real estate broker, who is under the law responsible for his real estate salesmen, is responsible for the funds his firm handles, should be required to know a good deal about real estate. Those courses, by the way, include real estate law, real estate practice, real estate appraisal, real estate finance, either accounting, or real estate economics, which is course number 5 and any of the group of electives for course number 6. I mention that, too, because I heard some of the testimony earlier today about escrow handling. I might add a word or two in supplement as I complete this little sheet here.

We believe that if there is to be a limitation on participation in the real estate field, getting back to the question of big numbers, and to what extent that has on the

relationship of commission charges. We believe that the only type of limitation that would be appropriate would be the type that exists today. There should be a competency requirement for entrance into the field, and there should be a substantial requirement for knowledge and experience before you are allowed to employ others in the field and be responsible for entrepreneur. That exists today, and we would like to carry it even further in the years to come.

We do not believe that entry into the real estate business or in any other field, should be artifically restricted. Our citizens should have a right to a job and we are quite satisfied that we have the finest real estate examination in the United States. I have just returned from a real estate license law official's meeting where some nice things were said to us by the real estate administrators and commission members from other states. Half a dozen states utilize our examination for that matter and give them to their licensees, and it is developed into limited reciprocity for us with them.

It is the commissioner's desire that I attempt to respond on his behalf to any questions that you might have formulated. If I do not have the answer at hand, we will try to get it back to you before you have the final meeting of this committee that it has scheduled at this time.

In that regard, based on some comments about escrow handling, I heard earlier today there are a number of jurisdictions involved. I want you to know that the Department of Real Estate has surveyed all of its realtors in the process.

It began two years ago; we have four-year licenses. So all real estate broker licenses were renewed for the last two years, we have included a questionnaire to determine how many of them were handling escrows, and to this date we have had a return of 23,000 of these questionnaires. Of that group, 250 of them handled 12 or more escrows per year. We assume that anything less than that is purely a casual operation, and I am sure a 12 escrow office could not survive on that basis. Somewhere between 1% and 2% of real estate licenses handle escrows as a regular function.

They are allowed to do so under an exemption from the Financial Code, which allows them to handle escrows coincidental with their own transations. Those are the only kind they do handle. We have separate regulations to deal with the handling of trust funds which go into considerable detail as to who can handle these. They can be handled only by a real estate broker, or salesman on his behalf, or if a nonlicensee is handling him on behalf of the broker, is required to secure a fidelity bond. Also, every broker, who handles these 12 or more is subject to an audit. We automatically schedule them for an audit and we have audited all 250 of those, and we have run into just two cases that resulted in a need for some discipline. One was a commingling case that is the type of thing that an audit would hopefully guard against, and the other had to do with records that were just so poor that they did not meet the other requirements of the regulations. But, it seems that real estate brokers to what limited extent they are in the escrow field, appear to be functioning adequately.

CHAIRMAN McALISTER: Should the Department of Real Estate take a more active role or posture on various issues relating to the real estate industry, such as the due-on-sale clause, late charges, and the other things we have been talking about here.

MR. HEMPEL: That is almost a philosophical question. We are funded, and the Real Estate Commissioner has the statutory responsibility to do certain things. When we go beyond that, for instance, take surveys, we run surveys on situations and when a question arises on an appropriate item to be budgeted for whatever costs there might be to do something outside the jurisdiction. The experience that is available within the Department of Real Estate, as a result of observing the real estate scene rather closely, and having hundreds of people involved in one or the other phase of that suggests that the Department of Real Estate should be involved in commenting on various aspects that are directly related to real estate transactions.

But that expertise has its limits, too, and unless we maintain careful records as they are related to these other aspects, such as late charges, due-on-sale clauses, and the like, at whatever expense is involved, the question arises how intelligently we could comment on their impact on the real estate scene.

CHAIRMAN McALISTER: You mentioned the thrust towards greater professionalization of high standards that your Department has been attempting to maintain. I believe in 1971 or 1972 Assemblyman Ralph had a bill that challenged that concept.

MR. HEMPEL: It did when it was introduced, but subsequently with an amendment, the bill was an educational advancement bill, part of this package. I think that was the one that made course numbers 3 and 4 mandatory. This has been a gradual step. I refer to 6 now, it is now 4 and a few years before that, it was 2. By accepting an amendment which I think was wise that Mr. Ralph suggested that private schools that would give courses that measured up to the quality and level of the college courses that were given at that time should be included. He suggested that amendment, we accepted it, and he supported the bill, and it was signed by the Governor.

That concept has been continued into our course number 5 and 6. This plan for professionalization does not suggest that just an endless array of courses should be added. We feel that if you review the plan, we feel that it constitutes the basic package of real estate subjects would be a major, if in fact, general education were plugged under.

CHAIRMAN McALISTER: Thank you very much, Mr. Hempel.

This completes our formal agenda for today. We will adjourn, and we will reconvene tomorrow in San Diego at 9:30 am at the San Diego Gas and Electric Company auditorium.

The meeting is adjourned until tomorrow morning.

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EXHIBIT A

THE MORTGAGE LOAN

Prepared For

CALIFORNIA LEGISLATURE

ASSEMBLY COMMITTEE

ON

FINANCE AND INSURANCE

Alister McAlister
Chairman

ON BEHALF OF THE

CALIFORNIA SAVINGS AND LOAN LEAGUE

By

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INTRODUCTION

The residential mortgage, in California as well as the rest of the nation, has remained essentially unchanged since the major revisions which followed the depression of the 1930's. The present completely amortising mortgage has served society well since then. Now, however, the viability of the mortgage instrument is again coming into question, but the problems of today seem to be centered in two new areas: 1) the difficulties associated with making long-term fixed rate loans in periods of extended inflation and escalating interest rates, and, 2) the increase in legal attacks and legislative limitations on the mortgage instrument which reduce its competitive standing among financial instruments. Although substantial attention has been given to the problems of financial intermediaries in general (much of the President's Commission on Financial Structure and Regulation dealt with short-term borrowing and long-term lending), these new problems have for the most part been neglected. Yet their consequences for the mortgage instrument as it has functioned for nearly four decades could be far-reaching; and a balanced, thoughtful rethinking of issues associated with the mortgage instrument will be required of state and national legislators who must deal with the questions concerning the mortgage instrument, courts which must rule on rights of various parties, and, finally, the consumer who must ultimately obtain mortgage credit. A similar response, free from past inertia, will be required of the nation's mortgage lenders.

In this vital process of reevaluation, several important points should be kept in mind:

1) Lenders, legislators and the courts should clearly differentiate

between legal and economic issues. Many of the present legal attacks are based on financial issues masquerading as issues in property law and consumer protection. In many cases mortgage lending institutions have defended various clauses based on legal and property rights, when the real importance of such clauses is in maintaining the competitive viability of the mortgage instrument in attracting capital. Lenders need not be ashamed of provisions in mortgage contracts which are designed to provide economic remuneration to the lender or lessen his financial risk. Many of these provisions tend to assess the cost of special services to those requiring such services and allow an overall lower mortgage rate to the bulk of borrowers. The price of eliminating contract provisions of this type must ultimately be a higher price for mortgage funds.

2) Legislators, courts and consumer groups should understand that only a modest portion of the cost of mortgage credit is accounted for by the mortgage lender's operating costs and profits. Too often those attacking the mortgage instrument have looked at the gross rate of interest on such a mortgage and have arrived at the mistaken idea that this amount represents net revenue to the mortgage lender. On the contrary, mortgage lenders operate on exceptionally thin profit margins. During the period from 1963 to 1972, savings and loan associations had only one year in which their after-tax profits amounted to as much as one percent of their mortgages outstanding. The average net profit after taxes during this period amounted to seven-tenths of one percent of mortgages outstanding, or $0.70[1] per year for each hundred dollars of mortgage balances. Moreover, savings and loan associations

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[1]Mortgage loans at year end divided by net income after taxes for all savings and loan associations. Savings and Loan Fact Book 1974,p.95,104. United States League of Savings Associations, 1974

have also been successful in controlling their operating costs, an additional component of the cost of mortgage credit. Total annual operating costs of associations have varied from 1.2% to 1.3% of mortgage loans held during the past decade. In comparison the consumer price index rose from 94.5 to 148.3 over an essentially similar period. Associations' record of cost control over a decade of inflation indicates the increased efficiency with which mortgage funds have been supplied. In total, the mortgage lender requires less than 2% for his services of assembling funds, servicing mortgages and assuming the risks of financial loss.

3) Restrictions imposed on the mortgage instrument by any state will reduce the ability of local lenders to obtain mortgage credit through the sale of loans in the national secondary market. The secondary mortgage market funnels capital from areas of surplus to areas requiring mortgage funds. The private secondary market is composed of private loan originators selling whole loans or participations to private investors, often in geographical areas remote from the origination of the loan. The federal secondary market is composed of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. These agencies purchase mortgages with funds obtained from the sale of federal agency obligations and from other sources.

The state of California, and the Western United States in general, depend heavily on secondary markets to provide mortgage funds to home buyers. Of the estimated 3.8 million single family homeowner mortgages existing in the West, 1.4 million, or 36% of the total, were held by lenders outside the region.[2] With over one-third of the single family mortgage credit supplied in the West coming from outside that area, it is important that no

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[2] "Mortgage Banker", Mortgage Bankers Association of America, Nov., 1974, p.52.

restrictions be placed on the mortgage instrument which would impair its salability.

The secondary loan purchaser, whether public or private, has certain understandings concerning the investment which he is purchasing. Loans are normally purchased based on an assumed life of 12 years. If maturities of California loans are lengthened as a result of a legally imposed change in the due on sale clause, the California loan will become an inferior product of questionable salability on national markets. The loan purchaser expects timely payment of principal and interest. A weakening of late charge requirements may jeopardize such timeliness and impair the market acceptance of the mortgage. A private sale of loans may be made on a basis which anticipates the sharing of prepayment charges, but a loan not providing for prepayment charges may be unattractive in the secondary market. Any modification of the mortgage which compromises its salability in national markets reduces the availability of mortgage credit to the citizens of California.

4) Legal prohibitions of various clauses found in the mortgage contract reduce the borrower's, as well as the lender's, options in mortgage credit negotiations. Historically, the borrower has been free to negotiate all the terms of the mortgage--interest rates, origination fees, prepayment charges, etc. Eliminating any of these elements removes a possible option which the borrower might have preferred. Because savings association mortgage lending operates with thin profit margins and a high level of operating efficiency, changes in the mortgage instrument which appear to reduce the cost of borrowing must be made up in an offsetting cost increase in some other aspect of the mortgage. If non-interest rate items are eliminated, a higher contract rate

on the mortgage will result. A large number of borrowers might prefer a lower interest rate with provision for a due on sale clause, or a prepayment charge or a late charge to an alternative contract, omitting one or more of these but bearing a higher contract interest rate.

THE PROBLEM OF BORROWING SHORT AND LENDING LONG

California savings and loan associations (the state's largest mortgage lenders) obtain their funds from short-term sources and invest them in long-term real estate loans. Their funds are acquired from three primary sources. The first is passbook savings, which as of March 31, 1974, represented 31%[3] of the liabilities of state chartered California associations. These passbook balances are subject to immediate withdrawal and are, therefore, very sensitive to changing interest rates. The second source of funds for associations is savings certificates earning interest higher than the normal passbook rate. These certificates provided 49%[4] of total liabilities as of March 31, 1974. Although savings certificates are of a fixed maturity, this period is relatively short in relationship to the maturity of mortgage loans. Nearly all certificate accounts range in maturity from three months to four years, with the largest amount of two years maturity or less. The third significant source of outside capital for associations is borrowing from the Federal Home Loan Bank system, a credit system established by the Federal Government to provide back-up financing for savings and loan associations. For state chartered California Associations, advances were 8.9% of liabilities as of March 31, 1974.[5] Some Federal Home Loan Bank advances are available in maturities of five years or greater, but approximately

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[3] California Savings and Loan Commissioner

[4] Ibid.

[5] Ibid.

half of the advances to California associations were less than one year maturity as of March 31, 1974. The short-term nature of savings and loan associations' liabilities is not inadvertent: historically, short-term interest rates have been lower than long-term rates, making the process of borrowing short and lending long profitable.

Although associations are funded by liabilities with very short maturities, their assets have greater maturities than those of any other financial institution. As of June, 1974, the national average contract maturity on mortgages for newly built homes was 27.7 years, while average maturity for existing homes was 25 years. Contract maturities have consistently been above 25 years in recent years.[6] In a period when interest rates remain unchanged, borrowing short and lending long provides a substantial service to the public and is also profitable to associations, since short-term rates have usually been below long-term rates. But the upward movement of interest rates over time causes severe earning problems for savings and loan associations and other financial institutions which borrow short and lend long. And in fact, interest rates associated with savings and loan associations have generally been increasing in the postwar period. Table 1 traces the mortgage portfolio held in 1965 through 1973. As the table shows, the interest income per $100 of mortgages in 1965 was $6.37. Inasmuch as the interest rate is fixed for the mortgage loan, the $6.37 per year figure continues throughout the life of the loan. During this same period of time, however, the association must pay the current (and flexible) market rate for funds and must meet its operating expenses. The second line of the table shows the average cost of funds plus expenses

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[6] Federal Home Loan Bank Board Journal, October, 1974, p. 37.

TABLE 1

EFFECT ON INCOME FROM BORROWING SHORT AND LENDING LONG
(Based on loan portfolio held 1965)

	1965	1966	1967	1968	1969	1970	1971	1972	1973
Interest Income[a] Per $100 of Mortgages	$6.37	$6.37	$6.37	$6.37	$6.37	$6.37	$6.37	$6.37	$6.37
Average Cost of[b] Funds plus Operating Expenses of 1.2%	5.93	6.23	6.39	6.30	6.43	6.82	6.80	6.76	6.93
Net Income per $100 of Mortgages	.44	.14	-.02	.07	-.06	-.45	-.43	-.39	-.56

[a] Interest income represents interest earned on mortgages held in the portfolio during 1965 as a percent of those mortgages, based on figures for associations in the 11th Federal Home Loan Bank Board District. Source-Federal Home Loan Bank Board Journal, December, 1973, p. 34, and September, 1974, p. 36.

[b] Operating expenses as a percent of mortgages nationally for all associations have varied between 1.22% and 1.3% in the period 1969-1973. See 1974 Savings and Loan Fact Book, p.104 and p.95. The lower figure of 1.2% is consistent with the Brigham and Petit results for the Los Angeles area, corrected for non-mortgage assets. See: Study of the Savings and Loan Industry, Irwin Friend, p.1018. Average cost of funds is based on figures for the 11th Federal Home Loan Bank Board District. See FHLBB Journal, Dec, 1973, p.33.

of 1.2%. The net of these two figures is the net income per $100 of mortgage made in 1965. Thus in the first year the portfolio generated $0.44 of net income per $100 of mortgage. The original income level is eroded because the cost of funds increases while the rate of return on the mortgage remains fixed. Indeed, by the year 1973, the mortgage was imposing a net drain on the association of $0.56 per $100 of mortgage. Over longer periods of time, of course, this problem of lending long and borrowing short could be increased.

This borrow short-lend long problem has forced mortgage lenders to incorporate provisions in their contracts which limit their risk exposure.

ISSUES IN THE MORTGAGE LOAN

The mortgage agreement between the lender and the borrower consists of several major provisions which determine the financial responsibility the borrower undertakes in return for the loan. These are: 1) payment of the stated interest rate on the mortgage loan, 2) payment of closing costs and origination fees, 3) timely payment of principal and interest on the mortgage until maturity, or until an act occurs which, by mutual agreement, accelerates the loan, 4) payment of late charges in the event of late payments, 5) the payment of prepayment charges in the event of early repayment of the loan, 6) the payment of a pro rata share of the property tax and property insurance on a monthly basis. These elements work together to constitute a viable instrument allowing the ordinary citizen to borrow sums of money for very long time periods. A brief synopsis of each of the important aspects of the mortgage loan is given in Table 2.

Although the provisions of a mortgage loan are well established in

TABLE 2

IMPORTANT ASPECTS OF THE MORTGAGE LOAN

PROVISION IN MORTGAGE INSTRUMENT	EFFECT
Due on Sale Clause	Provides a means of adjusting loan rates upon a borrower's transfer of property, thereby enabling new borrowers to obtain loans without wholly subsidizing holders of old loans. Allows long term fixed rate mortgages.
Prepayment Charge	Provides sharing of the costs associated with falling interest rates between borrower and lender.
Interest Rate	Provides basic return to lender. Represents a return for lending risk. Reflects local and national economic conditions.
Origination Fees	Covers out-of-pocket costs of mortgage lender for appraisal, etc.
Late Payment Charge	Assesses cost of delinquent accounts to those generating costs. Provides an incentive to the borrower to maintain his loan in current status.
Impound of Tax and Insurance Funds	Requiring of impounds for most mortgage loans is no longer allowed under California law.

tradition and practice, they have recently come under close scrutiny by consumer groups, courts and state legislators. Probably all the elements of the mortgage loan have, at one time or another, been at issue in various consumer suits against mortgage lending institutions. Each aspect of the mortgage loan will be examined in some detail in the following pages, with an attempt to show how they operate, what their economic impact is on the borrower and lender, and some of the implications of modifying each aspect of the mortgage contract.

THE INTEREST RATE

The stated interest rate is normally not a legal issue in mortgage lending, although it may occasionally be a matter of litigation in instances where the borrower alleges that the lender has charged an interest rate in violation of the state's usury laws. But on a broader scale, the nominal interest rate on mortgages remains a matter of continuing concern. There are numerous state usury laws limiting mortgage rates. These laws reflect the belief that a restrictive usury law will result in the availability of low-cost mortgage funds. Unduly restrictive usury laws actually tend to deny mortgage credit to the state's citizens. When market rates rise above levels set by local usury laws, local availability of funds tends to dry up as institutions find it more profitable to invest outside the area. While not a major item of consumer litigation at this time, public interest can be best served by removing usury laws and relying on market competition and rigid disclosure regulations to assure both mortgage availability and the lowest possible credit costs.

Table 3 shows how interest rates and maturities combine to determine the monthly payment required per $1,000 of mortgage balance. Two aspects of

TABLE 3

THE EFFECT OF INTEREST RATE AND
MATURITY ON MONTHLY PAYMENT
(Assumes a $1,000 Loan)

INTEREST RATE	MATURITY					
	5 YEARS	10 YEARS	15 YEARS	20 YEARS	25 YEARS	30 YEARS
6%	$19.33	$11.10	$8.44	$7.16	$6.44	$6.00
7%	19.80	11.61	8.99	7.75	7.07	6.65
8%	20.29	12.13	9.56	8.36	7.72	7.34
9%	20.76	12.67	10.14	9.00	8.39	8.05
10%	21.25	13.22	10.75	9.65	9.09	8.79
11%	21.74	13.79	11.37	10.32	9.80	9.52
12%	22.24	14.35	12.00	11.01	10.53	10.29
13%	22.75	14.93	12.65	11.72	11.28	11.06
14%	23.27	15.53	13.32	12.44	12.04	11.85
15%	23.79	16.13	14.00	13.17	12.81	12.64

this relationship should be given careful consideration before a greater portion of the total cost of the mortgage loan is lumped into the contract interest rates. First, as mortgage interest rates are pushed higher, each equal increment in the interest rate causes a more than equal increase in the monthly payment required. For example, an increase in rates from 6% to 7% on a 30 year loan increases the monthly payment $0.65. An increase from 9% to 10% increases the payment $0.69. Second, at higher interest rates an extension of loan maturity lowers the monthly payment less than a similar maturity change at lower rates. A 7% loan of 30 years maturity has a monthly payment $0.42 lower than a 25 year loan. At an interest rate of 10% the difference is reduced to $0.30.

CLOSING COSTS AND ORIGINATION FEES

The mortgage borrower is normally charged certain fees at the time of the origination of the loan. These fees normally range from 1% to 1.5% and may be either deducted from the face amount of the loan or added as a cash cost. A $20,000 loan with origination and closing costs of 1.5 points would result in a disbursement of funds in the amount of $19,700 to the borrower. During the year 1973, loan origination fee income for state chartered California savings and loan associations amounted to 3.6% of the total revenue.[7] The amount of loan origination fee income is largely dependent upon loan volume during the period in question.

Conceptually, closing costs and origination fees can be divided into two separate categories: 1) charges for out-of-pocket expenses incurred by the lending institution in the actual origination of the mortgage, and 2) payments to the lender for the purpose of increasing the mortgage yield above the nominal contract rate.

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[7] Statement of Condition, California Department of Savings and Loans.

The portion of origination fees which are associated with hard costs of the mortgage origination are charged for such items as title insurance, appraisals and other functions which help consumate the transaction. These charges essentially represent user-imposed costs on the association and so should be properly charged to the buyer for the services performed.

Table 4 shows the effect of origination fee, maturity, interest rate and prepayment on the effective yield of a mortgage loan. Several factors are evident from the table: 1) origination fees have a greater effect on realized interest rates at higher contract interest rates, 2) the effect of origination fees is higher on loans of shorter maturity, 3) the effect of origination fees is higher on a loan that is prepaid relatively early.

The present regulations of the Federal Reserve Board (regulation Z) require that the actual percentage rate on a loan be shown, thus the effect of origination fees is not hidden from the consumer in the loan origination process. Given the existence of rigid disclosure regulations, there is no reason to prohibit or limit such fees on mortgage loans. As long as the consumer is unambiguously informed of the true rate of interest on his loan, and the true cost of credit, mortgage lenders should be allowed to offer the various mixes of interest rates and origination fees which seem to best serve their market.

PREPAYMENT CHARGES

Most residential mortgage loans include a charge for early prepayment of the loan balance. The most common pattern for prepayment charges nationally is that provided by the regulations of the Federal Home Loan Bank Board: a Federally chartered association may impose a prepayment charge equal to 6 months interest on the amount of principal prepaid less 20% of

TABLE 4

EFFECT OF ORIGINATION
FEES AND LOAN PREPAYMENT
ON EFFECTIVE MORTGAGE LOAN
INTEREST RATE*
(Origination Fee of 1%)

	Loan of 25 Years Maturity Prepaid in				Loan of 30 Years Maturity Prepaid in			
Contract Rate On Loan	5 Years	10 Years	15 Years	No Pre-Payment	5 Years	10 Years	15 Years	No Pre-Payment
6.25%	6.50%	6.40%	6.38%	6.36%	6.50%	6.40%	6.37%	6.35%
6.50	6.75	6.65	6.63	6.61	6.65	6.75	6.62	6.60
6.75	7.00	6.91	6.88	6.86	7.00	6.90	6.87	6.85
7.00	7.25	7.16	7.13	7.12	7.25	7.15	7.12	7.10
7.25	7.50	7.41	7.38	7.37	7.50	7.40	7.37	7.36
7.50	7.75	7.66	7.63	7.62	7.75	7.65	7.63	7.61
7.75	8.01	7.91	7.88	7.87	8.00	7.91	7.88	7.86
8.00	8.26	8.16	8.13	8.12	8.25	8.16	8.13	8.11
8.25	8.51	8.41	8.39	8.37	9.51	8.41	8.38	8.36
8.50	8.76	8.66	8.64	8.62	8.76	8.66	8.63	8.61
8.75	9.01	8.92	8.89	8.88	9.01	8.91	8.88	8.87
9.00	9.26	9.17	9.14	9.13	9.26	9.16	9.13	9.12
9.25	9.51	9.42	9.39	9.38	9.51	9.41	9.39	9.37
9.50	9.76	9.67	9.64	9.63	9.76	9.67	9.64	9.62
9.75	10.02	9.92	9.89	9.88	10.01	9.92	9.89	9.87
10.00	10.27	10.17	10.15	10.13	10.26	10.17	10.14	10.12
10.25	10.52	10.42	10.40	10.39	10.52	10.42	10.39	10.38
10.50	10.77	10.68	10.65	10.64	10.77	10.67	10.64	10.63
10.75	11.02	10.93	10.90	10.89	11.02	10.92	10.90	10.88
11.00	11.27	11.18	11.15	11.14	11.27	11.17	11.15	11.13
11.25	11.52	11.43	11.40	11.39	11.52	11.43	11.40	11.38
11.50	11.77	11.68	11.66	11.64	11.77	11.68	11.65	11.64
11.75	12.03	11.93	11.91	11.90	12.02	11.93	11.90	11.89
12.00	12.28	12.18	12.16	12.15	12.27	12.18	12.15	12.14
12.25	12.53	12.44	12.41	12.40	12.53	12.43	12.41	12.39

*As a general rule of thumb, origination fees have the following impact on mortgage loan interest rates. Assuming a loan of 25 to 30 years maturity.

1. Each 1% of origination fees increases the effective interest cost approximately 25 basis points assuming total prepayment at the end of 5 years.

2. Each 1% of origination fee increases the effective interest cost approximately 15 basis points assuming total prepayment at the end of 10 years.

3. Each 1% of origination fee increases the effective interest cost approximately 12 to 15 basis points assuming payoff after the tenth year.

the original balance of the mortgage. While no such regulation exists for state chartered California associations, the Federal pattern has gained substantial local acceptance.

The economic rationale for imposing prepayment charges is to protect the mortgage lender from refinancing in periods of declining interest rates. During periods of rising interest rates, the mortgage lender can neither increase the interest rate nor call the mortgage loan and reinvest at more favorable rates; but during periods of declining interest rates, the borrower is free to prepay the mortgage loan and refinance at a lower rate except as constrained by the prepayment charge. Thus prepayment charges help to equalize interest rate risk. The actual impact of the prepayment charge is shown in Table 5. The table provides information on the prepayment of a 25 year loan of 9% interest and original balance of $10,000. For example, if the loan is prepaid after five years, the amount prepaid is $9,327.00, the prepayment charge is $330, the effective cost of the loan to the borrower over the five year period is 9.53%, and the borrower would find it profitable to refinance if he can obtain mortgage credit at 8.66% or below. A prepayment penalty provides only minimal protection to the mortgage lender in the early years of the loan, or conversely, the benefit to be gained by the borrower from refinancing is not severely compromised by the existence of the prepayment penalty. At the five year date, interest rates need drop only 34 basis points to make it profitable for the borrower to repay the loan, pay the prepayment penalty, and obtain new financing. If the loan is prepaid at a later point, the dollar prepayment charge is smaller and the effective cost of credit to the borrower is lower; however, the incentive to refinance is also lower.

TABLE 5

PREPAYMENT CHARGE*
25 Year Loan
9% Interest Rate on $10,000 Loan

YEAR OF PREPAYMENT	AMOUNT PREPAID	PREPAYMENT CHARGE	COST OF LOAN OVER PERIOD HELD	REFINANCING RATE AT WHICH BORROWER HAS AN ADVANTAGE FROM PREPAYMENT
5	$ 9327.00	$330.00	9.53%	8.66%
10	$ 8274.00	$282.00	9.19%	8.43%
15	$ 6625.00	$208.00	9.08%	8.28%
20	$ 4043.00	$ 92.00	9.02%	8.04%

* Assumes maximum prepayment charge allowed by Federally chartered savings and loan associations. Prepayment charge is 6 months interest on the amount prepaid less 20% of the original loan balance.

LATE CHARGES

Mortgage lenders impose a charge for monthly installment payments which are overdue. Often the institution allows a grace period, in some cases up to 15 days, before a late charge is imposed. There are several reasons for the imposition of a charge on delinquent payments. First, the handling of delinquent payments imposes a cost on the lending institution. Delinquent accounts take the specialized attention of staff and generate increased costs of servicing. Second, it encourages the borrower to remain punctual in his loan payments. Laxness on the part of the lending institution encourages delinquency on the part of the borrower and may ultimately result in the borrower losing his property through foreclosure. Finally, late charges are important in maintaining the cash flow of the lending institution and this provides additional mortgage funds. The largest single source of lendable funds for California savings and loan associations comes from the repayment of existing loans.

An appropriate late charge should be sufficient to fully recover the additional cost imposed by the late account. In addition, the late charge should be sufficient to motivate the borrower to maintain his loan in a current status.

THE IMPOUNDING OF TAX AND INSURANCE FUNDS

Nationally, most mortgage lenders require the payment of a pro rata portion of the borrower's yearly property tax and property insurance. Except for certain classes of mortgage loans, such a requirement is not allowed in the state of California. The impounding of tax and insurance funds assures that the lender's interest in the property is protected from tax liens and

the destruction through fire and other causes. Inasmuch as impounding of tax and insurance accounts is not permitted in California, this issue is likely to disappear as a matter of concern to lenders, borrowers and legislators. Interestingly, however, California experience indicates that borrowers generally prefer to include tax and insurance payments with their regular installments even where not required.

THE DUE ON SALE CLAUSE

One aspect of the mortgage loan deserves special attention--the due on sale clause. It is highly important to the viability of the long-term fixed rate mortgage, and it has been an attractive target for judicial or legislative attack. The following sections examine the nature of this clause and the impact of its removal. The operation of the due on sale clause requires that a mortgage be repaid upon the sale of the property. The effect of the due on sale clause has been to effectively shorten the actual realized maturity of mortgage portfolios. A lender normally uses the due on sale clause to adjust the interest rate to a level nearer that currently prevailing in local mortgage markets. This has the effect of maintaining the financial viability of the mortgage portfolio, which may have been eroded by increasing interest rates. Table 6 provides a comparison of two hypothetical mortgages, one subject to a due on sale clause, the other not having the due on sale clause. Both are assumed to be closed December 31, 1964,[8] and the property subsequently sold December 31, 1968, and again December 31, 1971. Loans closed December 31, 1964, are assumed to be at an interest rate of 6%, essentially the national mortgage rate existing at that point in time. Upon

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[8]The cost of funds for associations lending in the 11th district as of 1965 was 4.73% at the time the property was sold. By 1968 the cost of lendable funds had increased to 5.10%, by 1971 to 5.6%. The exercise of the due on sale clause allows the lender to keep pace with the rising cost of funds. See Federal Home Loan Bank Board Journal, January, 1974, p.49.

TABLE 6

HYPOTHETICAL EFFECT OF DUE ON SALE CLAUSE

LOAN WITH DUE ON SALE CLAUSE	LOAN WITHOUT DUE ON SALE CLAUSE
Loan Closed December 31, 1964	Loan Closed December 31, 1964
Amount of Loan $10,000	Amount of Loan $10,000
Interest Rate 6% Mat. 25 years	Interest Rate 6% Mat. 25 years
Initial Monthly Payment $64.43	Initial Monthly Payment $64.43
1964-1968	1964-1968
48 Monthly Payments @ $64.43	48 Monthly Payments @ $64.43
Property Sold December 31, 1968	Property Sold December 31, 1968
Due on Sale Invoked	No Due on Sale Clause
New Loan Amt. $9,219.34 Rate-7%	Old Loan Remains
1969-1971	1969-1971
36 Monthly Payments of $69.93	36 Monthly Payments of $64.43
Property Sold December 31, 1971	Property Sold December 31, 1971
Due on Sale Invoked	No Due on Sale Clause
New Loan Amt. $8,474 Rate 7.75%	Old Loan Remains
1972-1989	1972-1989
216 Monthly Payments of $73.74	216 Monthly Payments of $64.43
TOTAL Payments Received $21,538	TOTAL Payments Received $19,329

Loss from removal of due on sale - $2,209

sale of the property, December 31, 1968, the loan having the due on sale clause is called, and the interest rate raised to the current rate of 7% existing in 1968. This results in a new monthly payment of $69.93. When the property is sold December 31, 1971, the due on sale clause is again invoked, and the interest rate raised to 7.75%, again the current lending rate. By invoking the due on sale clause, the total payments received from this loan over the 25 year period amount to $21,538, whereas the total payments received from the loan not having the due on sale clause amount to $19,329. The loss from removal of the due on sale clause amounts to $2,209, approximately 22% of the original amount of the mortgage loan.

In the absence of the due on sale clause, the mortgage lender would have had to charge a rate to the original borrower of approximately 7%, instead of the actual 6% rate charged. The due on sale clause, while allowing the association to maintain its mortgage portfolio nearer current mortgage yields, also allows it to maintain lower lending rates at each point in time.

In the absence of this clause, the lender would have to be prepared to accept a maturity as long as thirty years on a majority of its loans. The due on sale clause plus other prepayments of mortgage loans have resulted in an average life of mortgage loans of 8 to 12 years. Secondary mortgage market operations generally assume an average mortgage life of 12 years.

THE CONSEQUENCES OF ELIMINATING THE DUE ON SALE CLAUSE

As the previous section demonstrated, the due on sale clause provides an effective mechanism for shortening of the average maturity of mortgage loans and sharing the market or interest rate risk between the association and its customers. The due on sale clause, by shortening maturities and

maintaining portfolio yields, helps to maintain the supply of mortgage credit at a reasonable interest rate. Elimination of the clause may not aid the potential purchaser and will increase the cost of all mortgage credit.

Effect on the Borrower

Elimination of the due on sale clause would appear to favor the potential home purchaser. But increasing home prices nullify the benefits of assuming an existing mortgage. Table 7 shows the price behavior of a western home originally purchased in 1967. As the table shows, the price has increased from $26,000 to $37,200 over the period 1967 to 1973. The annual rate of price increase over this period has been 6.08% per year, with dramatic increases in 1972 and 1973. A 75% loan originally negotiated in 1967 would provide only a 46% loan-to-price ratio by 1973. Thus the potential purchaser would have to come up with cash covering 54% of the purchase price. In the absence of such a cash down payment, the purchaser must buy on contract, obtain a purchase money mortgage from the seller, or obtain a second mortgage from an outside party. Table 8 illustrates the problem faced by the home buyer wishing to assume an existing mortgage. A buyer purchasing (in Dec. 1973) a typical house constructed, sold, and financed in 1967 could afford to pay no more than 9.46% interest on a second mortgage of 25 years term if he wishes to keep his total monthly payment at or below the payment on a new loan (Dec., 1973).[9] But a 9.5% rate is well below the rate normally charged by a second mortgage lender--second mortgage rates are often in the range of 15% to 18%. The unwary buyer may mistakenly think it advantageous to assume the current mortgage and negotiate a second mortgage at a rate substantially higher than

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[9]It is unlikely that the borrower will be able to obtain a maturity of 25 years with a junior instrument. Much of the secondary financing will incorporate substantial balloon payments which were partially responsible for the mortgage crises existing in the depression.

TABLE 7

AVERAGE SALE PRICE OF
A TYPICAL 1967 HOME IN THE WESTERN UNITED STATES[1]

YEAR	PRICE	YEARLY % CHANGE	ANNUAL % CHANGE FROM 1967
1967	26,100		
1968	27,000	3.45	3.45
1969	29,100	7.78	5.59
1970	30,000	3.09	4.75
1971	30,600	2.00	4.06
1972	32,800	7.19	4.68
1973	37,200	13.41	6.08

[1] Typical house is defined as the average house sold in 1967. Western United States includes Mountain States and Pacific Coast area.
Source: Construction Reports "Price Index of New One-family Houses Sold". June, 1974, Department of Commerce.

TABLE 8

REFINANCING VERSUS A SECOND MORTGAGE

Original Cost	1967		$26,100.00
Original Loan[1]	1967		$19,575.00
Monthly Payment[2] at 6.5% and 25 years maturity			$ 132.17
Loan Balance-end of 1973	1973		$17,281.00
Loan Required end of 1973 for 75% loan			$27,900.00
Payment required of $27,900 loan of 25 years at 8.5%[3]			$ 244.66
Additional Financing required for 75% loan if purchase money mortgage or second mortgage is used			$10,619.00
Highest rate payable on second mortgage 25 year term[4]		9.46%	

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1 75% loan-to-price ratio based on national average loan-to-price ratios of 73.6%. FHLBB Journal, March, 1970, Pg. 29.

2 Based on national average effective rates of 6.46%.

3 National average effective rate on new loans made at savings and loan associations December, 1973. FHLBB Journal, Oct. 1974.

4 This is the highest interest rate payable by the borrower on a second mortgage to keep his total monthly payment at $224.66 or less.

this break-even rate. Elimination of the due on sale clause could result in a proliferation of second mortgage instruments providing credit at a relatively high rate, with little or no net benefit to the potential home purchaser. It may also result in a large number of purchase money mortgages or real estate contracts which tend to tie up the liquidity of the home seller. These real estate contracts or purchase money mortgages are relatively high risk, low liquidity investments. The proliferation of such instruments does not seem to serve the public interest.

Effect on Mortgage Lending and The Mortgage Instrument

In evaluating the possible effects on the lender of the elimination of the due on sale clause, at least three possibilities should be examined; 1) savings and loan associations will absorb the reduction in net income without effects on other parties, 2) mortgage lenders will switch to variable interest rate mortgages as a substitute for the due on sale clause, and 3) mortgage lenders will continue to offer fixed rate mortgages, but at substantially higher interest rates.

Absorption of Losses By Savings and Loan Associations

Savings and loan associations are extremely efficient in the handling of the public's funds and receive a small margin per dollar of funds handled. Table 9 shows the relationship between the major income and expense items for savings and loan associations in the 11th Federal Home Loan Bank District, comprised of California, Arizona and Nevada. Out of each $100 of mortgages held, the association receives only about $1.46 to cover all operating expenses and provide adequate net income to the association. The entire cost of operating a savings and loan association is only about $1.25 per year per

TABLE 9

COST OF FUNDS AND INTEREST RETURN ON MORTGAGES FOR SAVINGS AND LOAN ASSOCIATIONS

YEAR	INTEREST PER $100 OF MORTGAGES[a]	AVERAGE COST PER $100 OF FUNDS[b]	AVAILABLE FOR OPERATING EXPENSES AND INCOME	OPERATING EXPENSES PER $100 OF MORTGAGES[c]	NET MARGIN[d]
1965	$6.37	$4.73	$1.64	$1.24	$0.40
1966	$6.34	$5.03	$1.31	$1.24	$0.07
1967	$6.39	$5.19	$1.20	$1.21	-$0.01
1968	$6.52	$5.10	$1.42	$1.22	$0.20
1969	$6.71	$5.23	$1.48	$1.26	$0.22
1970	$6.92	$5.62	$1.30	$1.31	-$0.01
1971	$7.13	$5.60	$1.53	$1.25	$0.28
1972	$7.21	$5.56	$1.65	$1.22	$0.43
1973	$7.34	$5.73	$1.61	$1.32	$0.28

AVERAGE NET MARGIN 1965 - 1973 = $0.21

[a]Based on figures for the 11th Federal Home Loan Bank District, FHLBB Journal, October, 1974, p.33,34.

[b]Ibid.

[c]Based on figures for all savings and loan associations. All operating costs are implicitly assigned to mortgage lending by this technique. 1974 Savings and Loan Fact Book, p.95 and 104.

[d]Net Margin will differ from net income mainly because the association has equity funds which are cost free in an accounting sense.

$100 of mortgages held. In the period shown by the table, the average margin available for the association's net income amounted to only $0.21 per $100 of mortgages held.

In the hypothetical examples presented in the previous section, the loss of the due on sale clause would have cost nearly one dollar per year per $100 of association mortgage loans outstanding. This is nearly five times the $0.21 net margin available for net income. While the hypothetical example presents only one set of circumstances, it is indicative of the impact of the due on sale clause. It is unlikely that the due on sale clause has an overall impact as low as one half of 1%. However, even this figure represents nearly twice the spread between the yield on mortgages and the cost of funds plus operating expenses. It is clear that savings and loan associations could not easily absorb the losses generated by the elimination of the due on sale clause. If it were to be eliminated, either the method of granting mortgage credit must change, or mortgage interest rates must rise.

The Substitution of Variable Interest Rate Mortgages For the Due on Sale Clause

As has been shown, the due on sale clause operates to effectively shorten the maturity of an association's mortgage loan portfolio; alternatively, it could be described as a mechanism to keep mortgage portfolio yields as close as possible to current mortgage market rates. In the absence of the due on sale clause, it is possible that associations would turn to the variable interest rate mortgage.

The variable interest rate mortgage is a mortgage whose interest rate is adjusted from time to time based on some predetermined market index or formula. This mechanism can meet the basic needs of the association in keeping its mortgage portfolio at current lending rates.

The only financially rational reason for borrowers objecting to the due on sale clause is that it eliminates the subsidy of a low interest rate which can be shared between the original borrower and the subsequent purchaser of the property. Under the variable interest rate mortgage, the purchaser of a property, having an existing mortgage loan, would be required to pay current mortgage rates. This is exactly the same condition that is imposed under the due on sale contract.

Higher Rates for Fixed Rate Mortgages

Should the due on sale clause be eliminated, the fixed rate mortgage system will be maintained at least for a portion of mortgage lending; however, current mortgage rates required at each point in time will be higher. The elimination of the due on sale clause, by extending the effective maturity of mortgage loans, would greatly increase the market risk facing the mortgage lender. This higher level of market risk would require lenders to raise the interest rate on mortgages. The restricted entry into banking activities, including mortgage lending, creates monopoly powers similar to those enjoyed by utilities. This, combined with the existence of a substantial body of mortgage loans below current market rates, in effect creates a tax and subsidy. In order for past borrowers to continue to enjoy the low interest rates, current borrowers must be charged rates sufficient to meet the cost of funds for their own mortgage plus an amount necessary to overcome the deficiency created by the below-market rate mortgages. A tax on new borrowers is created in order to fund the subsidy to existing borrowers. There seems to be no social purpose served by such an income transfer, and the unfavorable effects may be substantial. An increase in mortgage interest rates would act as a depressant on the housing industry by decreasing effective demand for new housing.

Summary

The due on sale provision, then, serves several purposes:

1) Precludes the generation of a subsidy from current borrowers to past borrowers by reducing the number of below-market interest rate mortgages.

2) Increases the availability of mortgage funds. Keeping mortgage portfolios at current competitive yields allows the attraction of additional mortgage funds in the market.

3) Reduces the proliferation of second mortgages and purchase money mortgages. These mortgages are high risk assets to the lender, and expensive to the borrower. In some cases the borrower may ultimately be worse off with a combination assumption and second mortgage than if he had obtained a new first mortgage at current interest rates.

4) Allows the continued lending of mortgage funds on a long-term fixed interest rate basis, thus shielding the borrower from the risk of interest rate changes.

5) Elimination of the due on sale clause may require mortgage lenders to use variable interest rate mortgages or short term mortgages with a large balloon payment.

Mortgage law and regulation should assure that mortgage lending institutions do not have to live with mortgage portfolios whose maturities have been unreasonably extended.

Statute and regulation should recognize the right of mortgage lenders to call or terminate the mortgage upon the sale of the property. No implied committment to future purchasers should be incorporated in the execution of a mortgage.

EXHIBIT B

INCREASED COMPETITION IS ADVOCATED TO INCREASE AVAILABILITY OF CONSUMER LOANS FOR REDUCED INTEREST RATES. by Stanley Zimmerman

EXCERPTS FROM: CONSUMER CREDIT IN THE UNITED STATES
Report of The National Commission on Consumer Finance
December 1972.

At P. 109 "Availability and market rate are so related that legally determined rates may adversely affect availability and that of course would constrict the use of rate ceilings as a policy tool benefiting all consumers."

"A highly competitive market exists when the number of sellers is so large and entry is so easy that no seller has power over price (in this study, annual percentage rate). Price is determined by the interacting forces of supply and demand."

At P. 110 "B. When a few firms possess market power in a particular market, they may charge higher than competitive market prices if it is more profitable for them to do so."

At P. 112 "Competitive conditions are a major determinant of rates and availability in the many state markets in which legal ceilings are sufficiently high to leave the market rate unaffected."

"Empirical evidence indicates that rate ceilings that impinge on market rates are also associated with substantial reductions in credit supply."

At P. 113 "In general, any kind of market imperfection-any restriction which tends to inhibit the free interactions of potential borrowers and suppliers of credit-can have a potential effect on credit availability. Such market imperfections include legal constraints, regardless of intent, as well as noncompetitive behavior of suppliers. Legal factors of most potential significance are rate ceilings, restrictions on other credit terms such as loan size and maturity, limitations on creditors' remedies, and legal constraints on the entry of new firms.

"The restrictive effect on availability can occur in two basic forms: a price effect and a nonprice rationing effect."

At P. 114 "Barriers to entry. Because the principles of free competition are based in part on ease of entry for new suppliers, any barriers to entry can lessen competition. Barriers are not limited to the commercial bank, credit union and finance company sectors studied by the Commission."

"Another significant legal barrier in consumer credit markets is that of convenience and advantage (C&A) licensing for finance companies under many state laws. By limiting licenses under strict construction of the law to offices that serve the "convenience" and "advantag of the community, states inhibit competition from new fir

"Although the intent of C&A licensing is purportedly to encourage the growth of the size of loan offices to attain economies of scale, misdirected application of the rule can lead to substantial lack of competition. Moreover, Commission studies reveal no significant economies of scale."

At P. 136 "Legal rate ceilings may reduce the price of personal loan credit to some borrowers, but when ceilings are sufficiently low to affect the observed market rate in a significant way, there is a substantial reduction in the number of borrowers included in the legal market."

"....the only truly effective way of gaining ample supplies of personal loan credit for consumers and reasonable rates too, is to increase competition while simultaneously relaxing inordinately restrictive rate ceilings."

At P. 137 "With respect to new commercial bank entry, there has been in the past an excessive concern on the part of chartering and regulatory authorities for the protection of the profitability of existing bank institutions and the presumed "needs and convenience" of the public. Too little emphasis has been given to the vigor of bank competition and relying on such competition to provide optimal performance in terms of price and availability. The economics of entry have been summarized by Donald Jacobs.

"If the rate of return is low in an area, no new bank will seek to enter. Restrictions on entry in these cases are redundant. In areas where the rate of return on capital is high, entry restrictions may impede the free flow of new capital. At best, the economic effects of entry restrictions are redundant; at worst, they are harmful.

"The presence of deposit insurance will continue to protect depositors' funds and current supervisory standards will continue to preserve the safety and soundness of commercial banks in an environment where there is liberalized entry chartering and more vigorous competition."

At P. 138 "With respect to regulations restricting entry of finance companies in the market, the Commission finds no value in "Convenience and Advantage" limitations on entry. There is ample evidence indicating that these and similar restrictions are disadvantageous to the publie and should be abolished. The Commission recommends that the only criterion for entry (license) in the finance company segment of the consumer credit market be good character, and that the right to market entry not be based on any minimum capital requirements or convenience and advantage regulations."

At P.147 "Rate ceilings in many states restrict the supply of credit and eliminate creditworthy borrowers from consumer credit markets. Some seek out less desirable alternatives, such as low quality credit sellers and illegal lenders. Furthermore, many borrowers who are not rejected pay rates of charge higher than they would be charged in workably competitive markets."

At P. 149	"The Commission recommends that policies designed to promote competition should be given the first priority, with adjustment of rate ceilings used as a complement to expand the availability of credit. As the development of workably competitive markets decreases the need for rate ceilings to combat market power in concentrated markets, such ceilings may be raised or removed."
	"Rate ceilings below those indicated in Commission studies may tend to inhibit the functioning of a competitive market and restrict the availability of consumer credit. Such states should also monitor the effect on high risk borrowers since lower rate ceilings tend to eliminate such borrowers from the legal consumer credit markets."
At P. 162	"Encouragement of competition is imporant to consumers because it provides the most efficient means of making credit available to them at reasonable prices. Put another way, competition can eliminate any monopolistic profits of credit grantors and drive from the market the least efficient creditors. If competition can be made to work,..
	"...financial responsibility, experience, character, and general fitness."
	"If the commissioner shall find...that allowing such applicant to engage in business will promote the convenience and advantage of the community..."
At P. 163	"...firms with licenses try to prevent the issue of additional licenses to potential competitors,..."
	"Restrictions on bank entry have generally been justified in the name of deposit safety. But it is difficult to see what public policy objectives are fostered by a "convenience and advantage" test for finance companies other than perhaps preserving a higher than average level of profits for banks and finance companies...
	"One can perhaps understand the opposition of bankers and some finance companies to a repeal of convenience and advantage restrictions on entry. Such an action might well jeopardize their monopolistic profits."
	"One of the most effective ways competition serves consumer interests is in the development of new products and services."
At P. 165	"...to provide for Federal chartering or licensing in an attempt to override legal impediments to effective competition in the highrisk market. Federally chartered finance companies may be able legally to ignore restrictive state laws that inhibit competition in consumer credit.
	"...efforts should be undertaken to persuade the states to remove from existing laws and regulations anticompetitive (and, by extension, anticonsumer) restrictions on entry and innovation.

EXHIBIT C

The following presentation was made before the Assembly Finance and Insurance Committee on November 12, 1974, in Los Angeles.

Mr. Chairman and Members, my name is Richard E. Ratcliff. I represent the California Bankers Association. We are here today to discuss with you the subject matter of your hearing which covers the costs associated with the financing of real property transactions.

In the past, the California Bankers Association has sponsored more than several bills, dating back some four years, covering part of the subject matter of your hearing. The most recent of these are: (1) A.B. 105 by Assemblyman Deddeh, which would limit the late charges to 10% of the payment due. This bill was not passed by the Legislature, rather, it was hung up in joint conference committee. Part of the problem was the appearance on the scene of the Garrett case.

(2) The second bill was A.B. 2114 by Assemblyman Hayden, which would have limited prepayment penalties to six months interest on the unpaid balance less 20%. This was to be effective for a period of 7 years from the date of execution of the deed of trust. The bill was amended on the floor of the Senate to be the same as the provision which is currently within S.B. 200, which is also before you in this interim study. Because of the amendment, it was not acceptable to the proponents, and thus, the bill died in the Senate.

(3) A.B. 1514 by Assemblyman Deddeh, which was passed and signed by the Governor and is Chapter 925 of the Statutes of 1973. This bill prohibits the lender from making an

impound account a condition of making the loan.

We feel that this indicates that the C.B.A. believes that reasonable, workable legislation in some areas should be adopted. We have tried, but for various reasons these measures have not been adopted.

In our testimony today, we would like to do the following: First, sketch generally the present sources and flow of funds. Second, discuss with you the importance of the secondary market as one of the forces which must be considered. Third, discuss the Federal National Mortgage Act, or Fannie Mae, and the Federal Home Loan Mortgage Corporation, Freddie Mac, their treatment of charges and some other provisions which are contained in standard notes and security agreements of these organizations. Fourth, we would like to indicate how banks generally function in these areas. Fifth, we would like to reserve some time during the November 22 hearing in San Jose to present some specific suggestions for legislation to be considered by this Committee.

Throughout my testimony, I will be talking about conventional real estate loans except where we indicate that the information available is with regard to F.H.A. and V.A. loans. Also, we are talking about residential lending, as it is our understanding that the intention of the Committee is to cover the areas of conventional, F.H.A. and V.A. lending as it applies to residential lending for consumers who are in the market for, or who are involved with, residential real estate loans and financial transactions.

I. SOURCES AND FLOW OF FUNDS

The sources and flow of funds in residential lending and residential transactions are obviously the most important parts of the entire picture. From the lender's viewpoint, if the funds are not available or are available in a restricted fashion, then his difficulties of making real estate loans are obvious.

For the first source of funds, the lender has the basic funds within the institution involved. For instance, banks have two "in-bank" sources: commercial/checking deposits and savings deposits. By nature these are short-term funds, i.e., the depositor can retrieve them either on demand or within a relatively short period of time. Real estate lending obviously involves the placing of funds on a long term basis ..... twenty to thirty years normally.

The secondary market is the other source of funds. The historical or conventional secondary market consists of insurance companies, eastern savings banks, large savings and loans, banks, or other institutions and even individuals which have the ability and the desire to commit their funds on a long-term basis to a lender in order that the lender can then place those funds in the real estate market and sell the mortgage obligation to that investor. It is this part of the market that we feel is extremely important.

II. THE SECONDARY MARKET

Historically, California has had housing needs far beyond our ability to generate sufficient long-term funds to meet that need. Because of this, all lenders in California that have

had any impact in this market have relied on the secondary market as a supplementary if not a primary source of needed funds. There are certain "rules of the game": those that need the funds are hard put to negotiate entirely favorable terms against those that have the funds, especially in a competitive market. This is true whether you are the California lender attempting to get eastern funds or whether you are a California borrower attempting to get funds from a California lender.

The point of this comment is that the funds are negotiated and the terms tend to be dictated by the one who has control of those funds. The person who invests the funds has to recover his costs, has to make a profit and has to, in some fashion, control the return of these funds under some kind of contractual agreement. Again, this is true whether it is a California lender (who is in the borrower's position when he goes to the secondary market) or whether it is a California borrower.

Generally, the large investors, with available long-term funds which constitute the secondary market, have been in a position to set the terms by which those funds are placed when a bank ventures forth to locate a block of funds that can be used by the bank in real estate lending. The investor reviews the lender's policy on such things as the form of the note used, the form of the mortgage or deed of trust including late charge provisions, prepayment charges, due on sale provisions, assumption policies and other provisions. Their interest is to ensure loans to creditworthy borrowers on terms that insure timely payment and a generally productive investment of their funds. If their funds

can be placed elsewhere under more productive terms, it is obviously more difficult to get those funds into the California housing market. Also, if one type of lender has more freedom to meet these demands, that particular lender has an advantage over other lenders who are not permitted to meet these demands on the same free basis. It is for this reason that we feel that lenders in California, regardless of type, whether they are bank, savings and loan, mortgage banker, or mortgage loan broker, so long as they are active in the area of supplying funds and supplying lending to those who want to purchase residential real property, all should be under the general over-all rules of the game as established by the Legislature. Credit unions and others that periodically get involved in this market, including individual sellers, we feel should be in no better position to extract a more onerous agreement than any other lender.

III. FNMA & FHLMC

Recent developments in the area have resulted in reaction to some of the difficulties in the market. There are cycles in the flow of funds that have had little to do with housing needs. Rather they are cycles that are determined by the general economic situation within the United States and, at times, the world. Federal legislation and federal activity has resulted in an easier entry into this market.

One example would be the Federal National Mortgage Act or Fannie Mae, a public corporation which was created to obtain funds either from the normal secondary market or from investment in the

bond market. The activity in the bond market converts short term investments of others into money which can then be used on a long-term basis.

Another example is the Federal Home Loan Mortgage Corporation, or Freddie Mac, which is a private corporation formed by the Federal Home Loan Bank system. The program is designed to accomplish the same ends as Fannie Mae. There is a third program, the Government National Mortgage Act, or Ginnie Mae, which is a division of H.U.D. It is another device of the same nature and is in the process of development with regard to conventional loans. They have various subsidized programs but are just beginning their conventional loan program. Because of being in a developing state, GNMA will not receive much further comment in this presentation.

Under present tight money conditions, FNMA and FHLMC have become the primary sources of funds for residential real estate lending activity by both savings and loans and banks. The problem is that the conventional secondary market does not have at all times sufficient funds available at a sufficiently reasonable cost to be able to convert those into a saleable home loan at a price that the normal borrower is able to pay. It was because of this that FNMA and FHLMC were formed and they present to us all an entry point into the market. Primarily, their source of funds under present conditions have come from the bond market, as indicated, rather than from the secondary market because there they run into the same problems that lenders from California have if they go direct. The importance of FNMA and FHLMC to this committee lies in that they have standard

provisions covering some fees and some provisions which are being discussed before the committee during this series of hearings.

The lender, if utilizing these sources of funds, need not use those standards unless he sells the mortgage obligation either to FNMA or FHLMC. At this point, the terms of the agreement with the borrower become those required by FNMA or FHLMC. In addition, FHLMC has standard forms which must be used if sale to FHLMC is contemplated. These forms generally are acceptable to FNMA. However, they have some differences in policies and approach.

The manner in which the lender uses these devices (FNMA and FHLMC) should also be discussed. With regard to FNMA, generally the lender pays a commitment fee of 1/2 of 1% or 1/2 "point" based upon the funds needed. The commitment agreement which results from this process includes provisions whereby FNMA will buy the mortgage placed by the lender from him at a certain value. FHLMC works in the same manner when banks deal with FHLMC: banks pay a 1/2 point "nonmember fee" rather than the equal FNMA type of commitment fee. However, the result is really the same.

F.H.A. and V.A. programs are programs which guarantee the payment of the loan and provide that if a qualified housing unit and a qualified borrower can be funded through FNMA or FHLMC, then these market entry devices can also be used to produce funds for real estate lending which can then be regulated under F.H.A. or V.A. programs which, of course, are subject to the federally regulated provisions of F.H.A. or V.A. These provisions regulate the mortgage and note form and become the conditions of the loan to the borrower. Included are late payment charges, prepayment charges and the like.

FNMA and FHLMC have become the most active and available fund sources for several reasons: (1) their access to bond market funds, (2) the savings outflow and federal competition for funds problems that banks and savings and loans have shared in recent months, (3) these devices convert short-term funds to long-term funds which are then available for the real estate market, and (4) the necessity that lending institutions in California have to go beyond their own in-house sources of funds.

At this point, I would like to discuss the approach that FNMA and FHLMC have to the various provisions which are included in the hearing notice preceding this meeting.

A. LATE CHARGES

Generally, a late charge is a charge to encourage the borrower to meet his legal obligations in a timely manner. It also serves to compensate the lender for his losses due to nonpayment by the borrower. This is a technical default entitling the lender to foreclose. However, C.C.P. Section 580b, the anti-deficiency legislation enacted in the 1930's, forces the lender to bring foreclosure and to sue on the security for the loan rather than for the payment due under the note, since if they do the latter, the lender would waive his rights under a deed of trust. Therefore, the lender obviously attempts to get payment without going to foreclosure because of the expense and because of the emotional impact of a foreclosure proceeding, if nothing else. Failing this, however, the lender is left only with foreclosure as the enforcement device.

<u>F.H.A.</u> provides for 2% of the payment due charge based

upon a payment including impound account amounts which are required under federal law.

V.A. loans provide for a 4% charge figured on the same basis.

FNMA has a 4% on the payment due charge, but in this case the payment due is computed by only including the principal and interest and not the impound accounts.

FHLMC has generally the same approach as FNMA.

The conventional secondary market is the remaining source of funds. These provisions vary. Generally, what has happened historically is that the sources of funds have reviewed individual lenders policies. If they find they are agreeable to the source of funds, then they make the funds available to the lender relying on the lender's expertise in evaluating the loan, placing the loan and enforcing and servicing the loan, including late charge provisions. If the late charge provision of the individual lender is not acceptable to the conventional secondary source of funds, then those funds are not made available to that lender.

I would like to make some comments on late charges. The F.H.A., V.A. programs indicate one approach to late charges. FNMA and FHLMC present another. If the lender is lending for his own portfolio there may be different problems.

The Garrett case held that a particular late charge provision was invalid as a penalty which the Legislature had not authorized. At that point, the Court decided that as that penalty was invalid the case had to be discussed in terms of actual damages to the lender because of the failure of the borrower to pay as he

was obligated under contract. The case also discusses liquidated damages as the present provisions of the code which should regulate the lender's position. Liquidated damages provisions must be reasonably related to damages to the lender in the event of non-payment.

The California Bankers Association feels that a proper approach by the Legislature would be to enact legislation setting a maximum charge. We have advocated 10% in the past. This has apparently not been acceptable in view of the Legislature's refusal to pass such a provision. We would suggest 6% at this time in view of the fact that 6% is the penalty charged by the State on late tax payments and by counties on late property tax payments. As a matter of fact, the county charge is a flat 6%. Assuming a missed December payment, annualize that payment, it comes to some 12%. The same approach taken with the April payment, if that should be missed, annualizes to a set rate of 24%. After the late charge portion of the county tax charges there is available a redemption procedure which provides, in essence, for 1% per month interest cost on the funds that are due. We feel that 6% reaches the "threshold of pain" level necessary to encourage timely payment, which is vital to all lenders, especially in view of the fact the lender cannot sue to force a late payment, he can only foreclose. Failure to adopt this approach will result in a continuing 10% late charge policy by some lenders.

At this point, I would like to refer you to the discussion earlier this morning by the savings and loan industry. At that time, they indicated that the missing of a payment on a

FHLMC or a FNMA loan results in a disallowance or disqualification of that loan for trade in the FNMA or FHLMC market. That being the case, the lender is precluded from turning those funds over and receiving more funds. This is just one of the indications of the importance, from our viewpoint, of the late charge provision. The late charge provision is especially important to us in view of the fact that, practically speaking, the lender cannot sue for payment. He can only foreclose.

B. PREPAYMENT PROVISIONS

This provision permits the lender to impose a charge on the borrower. The borrower agreed on a long term contract. Now he wants out. This provision is designed to compensate the lender for the unilateral change in the contract by the borrower. I think it is obvious that the lender in the same situation cannot go to the borrower and say, "Well, we don't like the contract anymore, and we would like to have all our money back." Thus, the prepayment provision is an attempt to cope with the lack of balance in this case between the borrower and the lender.

F.H.A. and V.A. regulations provide that no prepayment provision will be charged, but I think it is important to note the seller must pay points upon selling that property to someone else. The impact of the requirement that he pay points provides much the same kind of readjustment that the normal prepayment charge provides.

FNMA requires no prepayment provision. However, if the loan is made on a FHLMC form, which is then acceptable to FNMA, the prepayment provision of FHLMC is unenforced during the time the loan or mortgage obligation is held by FNMA. However, if they

subsequently sell it to another on the secondary market, that prepayment penalty becomes enforceable. I think it is interesting to note that FNMA uses FHLMC's provision on prepayments on condominiums and planned unit developments. There was an article in the Wall Street Journal just a short time ago that indicated that condominiums made up some 14.5% of the 1973 new starts. I think that this indicates that FNMA, while requiring no prepayment provision while they hold the loan, does understand and accept the necessity of such a payment when it comes time to sell that mortgage to a buyer in the conventional secondary market.

FHLMC presents a different approach than FNMA. They have on their standard forms a required prepayment provision. In general, what that provision provides is that, if the prepayment occurs during the first 3 years of the mortgage, the borrower must pay an amount which "shall not be less than the maximum amount allowed by Federal Home Loan Bank Board regulations or such lesser percentage as is the maximum permissible under applicable law." The maximum amount is found in Federal Home Loan Bank Board Regulations in Section 555.15, Ruling No. 74-121, February 19, 1974. In general, this provides that with regard to federal savings and loans, they cannot charge a prepayment penalty that exceeds 6 months interest on the excess of 20% of the original balance of the loan. I think it is interesting to note that this provision permits the provision to be enforceable for the duration of the loan. Assuming 6 months interest, and a 10% loan, there is a 5% prepayment charge after deducting 20% from the loan amount.

The second part of the FHLMC note provision sets forth that if prepayment should occur during the fourth or fifth years of the obli-

gation the charge shall then be 3% of the original balance. Thus, in effect what happens is a two-stage, five-year prepayment provision. The first three years shall be up to six months interest, the next two will be a 3% charge, both based on the original balance of the loan. After the fifth year there is no charge. Further, this prepayment penalty applies only if refinanced by other than the holder of the note.

The conventional secondary market varies. But generally, it is handled in the same manner as discussed under late charges. The lenders have been free to do what they wish, but in order to get funds, must conform to the demands and the needs of the conventional secondary market.

The California Bankers Association has advocated six months interest after the deduction of 20% is applied to the unpaid balance of the loan. This would prevail for 7 years. This was included in A.B. 2114 by Assemblyman Hayden in 1973, which I earlier indicated died in the Senate. It is interesting to note, however, that this particular provision was inserted over the objection of the mortgage loan brokers in S.B. 304 of 1973 and currently is in the law. This can be contrasted with the provision of S.B. 200 by Senator Gregorio, where there would be a five year provision which would diminish by 20% each year so that after 5 years there would be no more charge.

The C.B.A. feels that the FHLMC provision would be proper and workable and still provide a provision familiar to the secondary market. The provision of S.B. 200is a provision which is unfamiliar to that market and again, we feel that the secondary market is what we have to aim at in order to ensure the flow of funds.

FNMA and FHLMC have both recognized that necessity should they have to sell mortgages in that market. Further, it provides the benefits, generally speaking, of S.B. 200 by recognizing the 5-year period of existence and the declining tendency of the payments over the period of that 5 years. One further point, I earlier indicated that we feel that all lenders should be under the same limitation. The federal S & L's have their regulation which presents a problem in this regard. The same is true of the mortgage loan brokers where the provisions of our A.B. 2114 were incorporated in S.B. 304. We feel that this Committee should reconsider S.B. 304 as applied to mortgage loan brokers and should somehow attempt to deal with the federal savings and loan provision. Since the federal provision is an over-all limit as to what they can do which would be higher than the FHLMC provision which we are suggesting, competition would operate to bring federal savings and loans down to provisions of FHLMC, should it be adopted, so that they would then under the market restrictions be competitive with other lenders.

C. DUE ON SALE CLAUSES.

This provision gives the lender the right to accelerate the debt in the event the borrower sells all or part of the property. The reason for this provision is that the agreement is for a long period of time. Anticipating changes is very difficult if not impossible. If one party, the borrower, chooses to change one important provision of the contract, the term, to convey to someone else the security for the loan, then the lender should be able to call a halt and on the event of the change of ownership, enter into a new loan relationship. This is often confused with acceleration

upon default because both are the right of acceleration for the benefit of the lender.

<u>F.H.A. and V.A.</u> loans permit no due on sale provisions.

<u>FNMA</u> has no due on sale provision but again, if they are utilizing FHLMC forms in making the loan, they don't enforce it. However, a subsequent purchaser of the mortgage may enforce that provision.

I think it is important to note at this point that if there is no due on sale provision, there is no ability of the lender to accelerate the loan obligation and that obligation continues. One situation which can result is assumption. If there is no assumption, however, that borrower remains liable in addition to a new borrower who agrees to pick up the obligation for those payments. From the lender's viewpoint, this presents a difficult problem. The protection of C.C.P. Sec. 580b still exists, but to collect from the original borrower would force a waiver of the security in addition to the fact that he has sold that security to another.

At the present time, lenders view the making of a twenty or thirty year mortgage as one which probably will be prepaid within a twelve year period, thus they regard the twelve year period as one they should consider in setting interest rates and the rest. If, however, the loan is one which is subject to some kind of automatic assumption and the rate of that loan is, compared to the present market, relatively low, obviously prepayment and refinancing will not occur. In those circumstances, the lender has a loan that is going to go the full term, whether it is twenty, twenty-five or thirty years. This presents a difficult problem for the lender if he has anticipated the twelve year period which is

presently being used by most lenders.

FHLMC presents a different approach again to the due on sale. FHLMC has a uniform note which must be used if the mortgage is to be resold to FHLMC. It provides, and I would like to quote this at the present time,

> "If all or any part of the property or an interest therein is sold or transferred by the borrower without the lender's prior written consent, excluding (a) the creation of a lien or encumbrance subordinate to this deed of trust; (b) the creation of a purchased money security interest for household appliances; (c) a transfer by devise, descent or operation of law upon the death of a joint tenant; or (d) the grant of any leasehold interest of 3 years or less, not containing an option to purchase, the lender may at the lender's option declare all sums secured by this deed of trust to be immediately due and payable."

The conventional secondary market is a structure within which the lenders are left to compete in trying to meet the demands of the secondary sources of funds. As a result, they have developed due on sale clauses in much the same manner as late charges and prepayment provisions.

We would like to note at this time that subdivision (c) of the FHLMC uniform note where it excludes from the due on sale clause a transfer by devise, descent or operation of law on joint tenancy is a provision we feel takes care of many of the problems that have been indicated in testimony supporting S.B. 200. Such situations as the enforcement of due on sale clauses in the event of death of the borrower and the transfer of the property by either devise or descent to the widow. Under the FHLMC approach, there would be no enforceable due on sale clause in this case. In commenting on due on sale provisions, we feel that this provision is extremely important in view of the length of the term of the

contract and also the difficulty inherent in anticipating important changes in the underlying circumstances.

These changes may have profound affects on the borrower, his creditworthiness, and the security.....the security being the only source of funds available to the lender under the anti-deficiency legislation (C.C.P. §580b). Further, its importance is recognized by the FHLMC's Services Guide, page 516:

> "FHLMC believes that the right of acceleration upon transfer of ownership is an invaluable tool of any mortgage investor in ensuring that only creditworthy mortgagors are responsible for making payments where the right of acceleration upon transfer of ownership exists. Servicer shall use its best effort to determine the sale or transfer of mortgaged property or any other event giving rise to the right of acceleration."

The case of Tucker v. Lassen, a recent decision by the California Supreme Court, considered due on sale clauses in the context of the legislative provision against unreasonable restraints against alienation of property. The Court held that such a clause could not be enforced where the sale was in the form of an installment contract of sale of real property. It very carefully did not consider a true sale situation.

The California Bankers Association feels that the FHLMC provision offers a reasonable suggestion for California legislation, especially in view of subdivision (c) which covers all transfers by devise or descent, and excludes them from the due on sale provision.

D. ASSUMPTION CLAUSES AND FEES

This clause arises where the borrower sells the property and attempts to have his new buyer assume his benefits

and obligations under the note and deed of trust. Most instruments merge these with the due on sale and permit the lender to exercise the veto.

F.H.A. and V.A. permit assumption provision due to the fact that they don't have due on sale clauses.

FNMA likewise has no provision.

FHLMC again presents a little different structure. You will recall the FHLMC statement on the importance of the due on sale provision. They permit the lender servicer to approve an assumption if (a) cash equity of at least 5% of the new purchase price; (b) property is to be owner-occupied; (c) monthly first plus second of any mortgage payments plus escrow impound accounts do not exceed 25% of the base pay of the primary wage earner; (d) (c) above plus all other monthly payments on all installment debts having remaining terms of more than 7 months do not exceed 33-1/3% of the monthly base pay of the primary wage earner; (e) is not really applicable to our discussion here today; (f) that there be no other changes in the terms of the loan. If these conditions are not met, FHLMC will consider an assumption on a case by case basis. Note: Under this system, if the loan rate changes, the servicer-lender cannot permit an assumption. In those cases, the lender must repurchase the mortgage from FHLMC at par and make a new loan with regard to the new party.

Conventional secondary market in this area is much the same as above. Assumptions normally are only at the option of the lender. There are instruments, however, which do permit assumptions but these are normally for the lender's own portfolio and, again, it is the secondary market which dictates the nature of the provision.

In commenting on the whole area of assumptions, lenders view assumptions with extreme caution. Each lender has an experience factor which reflects the turnover rate of their loans. This factor is considered in the light of inflation, risk, and the cost of money in setting the interest rate of the loans. Incidentally, under the FNMA and FHLMC programs, the turnover rate is generally regarded as 12 years. Thus, the loan is analyzed as if it is going to last only for twelve years. If the lender did not have the veto right, then each loan would have to be regarded on the term of the note, in other words, twenty or thirty years. Inflation alone would dictate higher interest rates than presently exist.

S.B. 200 and Tucker discuss the lender-borrower relationship as if the only concern of the lender is with the condition of the security. We take strong exception to this point. The lender has agreed to financing that particular borrower based upon his promise to pay as agreed and on an evaluation of his ability and willingness to pay.

Let me for a minute go back and reread some of the FHLMC conditions for assumptions: (a) cash equity of at least 5% of the new purchase price; (b) property is to be owner-occupied; (c) monthly first plus second mortgage payments plus escrow-impound accounts do not exceed 25% of the base pay of the primary wage earner; (d) (c) above plus all other monthly payments on all other installment debts having remaining terms of more than 7 months do not exceed 33-1/3% of the monthly base pay of the primary wage earner. These provisions, plus the fact that both FNMA and FHLMC anticipate credit reports clearly indicate that they consider more than merely the security.

A further point is the "unreasonable impairment of security" test of S.B. 200, which apparently was borrowed from the court's discussion in the LaSala case which also appeared in the Tucker case. This is a situation where the lender, under their theory, is solely concerned with the condition of his security. We feel, from the lender's viewpoint, that this concept is plainly unworkable. By the terms of S.B. 200, the only application of this test would arise in a foreclosure action. If a standard is to be enacted by the Legislature, it must be an objective one, not a subjective test. The latter would lead to constant expensive and time-consuming litigation and be against the best interests of everyone involved. The problem arises since the unreasonable impairment of security test is a test which is dependent upon a subjective view of the particular situation. What is necessary is a standard which is objective and can be determined by the parties involved with a minimum of possible disagreements leading to litigation.

The California Bankers Association feels that the FHLMC approach is one that is far superior to the approach of S.B. 200. FHLMC, incidentally, permits a 1% fee upon assumption, and we feel that this is an agreeable provision.

E. "POINTS"

The next concept I would like to discuss is that of "points". This discussion differs from other areas because points, as we understand them, arise only with regard to F.H.A. and V.A. loans. F.H.A. and V.A. are not sources of funds - they are guarantee programs. They are designed to reduce the risk factor for the lender and to get funds to borrowers who are otherwise

unable to get mortgage funds in the prevailing market. Thus, they have an interest rate limitation. For instance, F.H.A. is now 9-1/2%. Having gotten the loan at the artificially low rate, when the borrower sells his property, the new buyer assumes, in the normal situation, and he then gets that same benefit. The lender, having gotten the funds from the normal market, then is permitted to charge the seller points. This is the difference between the F.H.A. or V.A. rate and the prevailing market rate expressed in a percentage of points.

F. LOAN FEES OR LOAN ORIGINATION FEES

Loan fees are very often expressed as points also, which creates some confusion with the F.H.A.-V.A. situation. In our minds, the loan fee is that which covers the lender's cost of obtaining a block of funds from the secondary market and his cost of processing the loan. Thus, it would cover appraisal fees, photo fees and all normal closing costs which would cover work done by the lender on the loan application. Credit reports are among the included costs.

F.H.A. and V.A. limit loan fees to 1% of the amount of the loan.

FNMA, FHLMC and the secondary market leave these fees to the lender. We feel that loan fees properly charged and used properly cover processing costs and commitment costs necessary to bring a loan to fruition. We feel that a loan fee of 2% of the loan is proper, that is, a chrage of two points. F.H.A. and V.A. is limited to 1% which barely covers administrative and processing costs. When using FNMA and FHLMC the breakdown is as follows: 1% for our costs plus 1/2% commitment fees or nonmember fees, resulting in a

small profit of 1/2 point which is not unreasonable since loan payments then go to others. The lender becomes only the servicer for a small fee. The servicing fee ranges betwen 1/4% and 3/8% of the interest collected on the payment as it is made through the life of the loan. The conventional secondary market breakdown is as follows: there is the 1% cost factor, plus the 1% commitment fees normally charged by sources of funds in the conventional secondary market. Under a 2% loan fee limitation, this would result in a wash for the lender.

Since each of these sources of funds should be protected, the 2% fee should be the minimum level at which any statutory maximum can be set.

Title insurance fees, real estate broker fees, escrow charges are not normally fees charged by the bank. To the extent that these costs may be incurred by the bank, we should be able to pass them on to the borrower at cost. When bank services are utilized other than as part of a loan application (e.g. escrow services) any limitation which is set should consider the private escrow services, permitting them to recover their costs plus a reasonable profit. If such a limitation is needed, then this approach should be followed in our view.

IV. NORMAL BANK PROCEDURES

These should be reviewed in order to give the Committee an idea of what is presently going on with regard to bank policies in real estate lending. To some degree this has already been covered, but I think it should be discussed directly. For banks to set these charges on a uniform basis would obviously cause anti-

trust problems. However, it is no secret within the industry what various banks do. There are differences between banks that reflect varying degrees of involvement in the real estate lending field. Other differences reflect different policies as to qualified borrowers, geographical locations, and whether they primarily lend for their own portfolio or need outside funds in order to operate.

Late charges are normally from 4% to 6%. Prepayment charges vary greatly, but six months interest on the original balance plus 20% seems to be not unusual. One statewide bank recently raised their charge to better compete with other lenders for outside funds. They raised their charge to something similar to the FHLMC provisions. It should be noted that within this area there are some banks that have a 5 year limitation on their prepayment charge, others do not. Due on sale provisions are generally uniform and are included in the note. The unusual situation is the note which does not include such a provision. Assumption fees vary from a flat charge of $100 to slightly higher than 1% of the unpaid balance. Acceleration and assumption fees are judged on individual cases. The factors considered are loan rates, creditworthiness and loan officer judgment factors. Loan fees also vary but they range from 2% to something slightly higher. Finders fees are not used by banks. Again, many of these provisions have been formulated to compete effectively on the conventional secondary market.

At this point, perhaps it would be worthwhile to discuss a major problem a real estate lender has which affects all of the things we have been discussing. This is the problem of profit and the problem of obtaining funds.

Assume that a bank wants to use in-bank sources to make a real estate loan. Assume further that you take $100,000, one-half from each of the two basic sources. In other words, $50,000 from commercial/checking account source and $50,000 from the savings account source. Under the Federal Reserve requirements, reserves must be established covering the deposit sources of the funds. With regard to the commercial aspect, it would be 15%, which results in $7,500 that must be set aside and for the savings aspect, there is a 20% reserve requirement or a reserve of $10,000. Thus, you have $17,500 which must be taken from the $100,000 and placed in government bonds to provide reserves for the deposits from whence these funds came.

This reduces the lendable funds from $100,000 to $82,500. Assume that there is a 10.5% annual rate of interest that is charged on the loan. This results in an interest payment for the year of $8,662.50. Of the 10.5% rate of interest, some 8% goes to pay interest to the depositors of the $100,000, including the depositor's interest payment, F.D.I.C. insurance and other costs to the bank including servicing of the loan under discussion. This figure comes to roughly $6,600 during the year. This leaves 2.5% out of the 10.5% or $2,062.50 as an annual return to the lender before taxes.

The foregoing assumes a "normal" lending situation. It also assumes that charges, fees, etc. return nothing more than incidental revenue to the bank.

This then presents a general picture which is not intended to reflect any particular bank or any particular transaction, but rather to reflect a problem common to bank lenders.

To place capital in the real estate lending market is very expensive to the lender because his return is not as high as people would assume. It is obvious that you can get better than a 2.5% return on many other types of investment. This is one of the real problems involved in real estate financing.

If the loan was prepared on FHLMC forms, etc., and if we forget the limitation of FHLMC and FNMA to $55,000 loans in the individual situation, the $82,500 mortgage could be sold on the FHLMC or FNMA market. The funds realized can then be utilized to make another loan. This is how to get loan funds into the California market.

If there is a tight money situation, then the Federal Reserve may increase the reserve requirement. This causes government bond prices to increase, plus the fact that out of that 2.5% return, we must go out and purchase further government bonds as the only means we have of meeting the increased reserve requirements. Further, federal policies of selling bonds in lots of $1,000 drains away potential savings or commercial deposits because of limited rates banks can pay on savings. This further operates to raise the cost levels of the market -- another complicating factor.

V. CONCLUSION

This presentation is intended to illustrate two points: (1) the importance of the secondary market, both conventional and FNMA and FHLMC; (2) that any legislative action must not restrict the flow of funds upon which the entire California housing economy is dependent. The provisions and practices

discussed can have important effects on that flow of funds.

This generally concludes the California Bankers Association presentation and I will be available and willing to attempt to answer any of your questions.

Thank you.

EXHIBIT D

STATEMENT ON BEHALF OF REAL ESTATE COMMISSIONER
ROBERT W. KARPE TO ASSEMBLY FINANCE AND INSURANCE COMMITTEE
INTERIM STUDY ON REAL ESTATE FINANCE

November 12, 1974
Los Angeles, California

My name is Jack Hempel. I am Chief Deputy Director of the Department of Real Estate. Real Estate Commissioner Robert W. Karpe has asked me to thank the committee for giving the Department of Real Estate the opportunity to be present and to respond to questions which may arise involving either the jurisdiction or the expertise of the Department.

The meeting notice states the activities of the committee will encompass costs associated with the consummation and financing of real property transactions.

The topics listed in the meeting notice are not regulated by the Department of Real Estate, except for some of the charges in connection with hard money loans under what is customarily referred to as the Necessitous Borrowers Act. These matters were most recently addressed by the Legislature in connection with S.B. 304 and S.B. 310 of the 1973 Session -- both bills were supported by the Department of Real Estate. These amendments tightened up (on) the activities of some of the larger mortgage brokers via Article 7 of the Real Estate Law (with respect to regulatory provisions applying to real estate licensees in certain mortgage loan transactions).

We assume the above information has been catalogued by the committee, and that your current interest lies primarily in the area of settlement costs directly related (in) the purchasing and selling of residential properties in today's real estate market.

In that regard, we understand several of the matters which the committee might feel are within our area of expertise, although not in our regulatory jurisdiction, have to do with the following:

1. The effect of real estate brokerage commissions on real estate transactions and the question of these fees in relation to services rendered.

   Commissions are a matter of negotiation between agent and principal. Although there are rates (6 percent) typical in the trade, many licensees deviate from this figure. In Sacramento, for example, I have seen TV commercials within the last three or four months from a

prominent firm of Realtors advertising that their "full service" commissions on house sales are $800 plus 1 percent of the selling price. I do not know whether there have been any surveys as to how many licensees deviate from the norm, but, of course, it has long been customary for large transactions to typically result in a negotiated commission at somewhat less than that figure -- representatives from the industry could comment on this, I am sure.

State anti-trust laws prohibit the fixing of commissions for services, and I believe the California Association of Realtors -- many years ago -- entered into a consent decree which resulted in the withdrawal from circulation of any recommended rates. It would be our observation that the fact that most licensees charge 6 percent on residential sales is more a standard of reasonableness than of design. It is true in most fields that activities below a certain rate are not economically feasible. This is probably why my TV repair experience has been relatively similar as to the cost per visit from the three different repairmen who have visited my own home during the last several years. This also probably explains why the markups for the sale of consumer goods, based on inventory, turnover and the like, are relatively stable. We understand "big ticket" appliances customarily sell at a 40 to 50 percent markup, whereas small appliances sell at the 25 to 30 percent level. Similarly, discount new car auto sales are usually at $200 to $300 over invoice. I know of none who deal for, say, $50 to $100. The net-net just would not be there!

In the typical real estate transaction, the commission is shared by four real estate licensees. The listing is secured by a salesman who is probably an employee in a real estate firm. The property is sold by another office with whom the listing office cooperates or through the multiple listing service. The same sort of division of the selling agent's share of the commission takes place in that office between the salesman and his broker. Without this network of communications, there would probably be fewer real estate transactions; multiple listing services have thrived because they help get the broadest possible exposure for properties which are available for sale. If one considers the vast majority of every licensee's time which is spent in work other than getting a signature on a dotted line, the actual remuneration to each licensee involved in the transaction would be best understood.

A portion of all licensee's fees is set aside for education and research in real estate in the institutions of higher learning in California.

We have found three of these research projects which contain segments relating to the income of licensees. A copy of

each of these has been delivered to the committee for such analysis as might seem appropriate. Although each of these was directed to something collateral to the pure question of income, the factors which were reviewed seem to point toward an average income for a full-time licensee in the real estate business at somewhere between the $10,000 and $20,000 per annum level. Even a 1974 survey by the organized real estate industry (within whose ranks the most active licensees are probably found and who, therefore, might be expected to have a substantially higher income levels) 69 percent of those surveyed in 1974 who were salesmen responded that their earnings were $20,000 or less; 23% under $10,000; 25% from $10,000 to $15,000; 21% from $15,000 to $20,000; 31% over $20,000.

2. We were told that the question might arise as to whether the large number of licensees in the state is not a factor which runs counter to possibility for reductions in real estate commission rates. We hardly think so. If there is an over-population of real estate licensees, every competitive economic test we have ever seen supports the suggestion that the greater the competition the more price cutting might be expected.

   As of July 1, 1974, the Department had 219,381 real estate licensees. Of these, 146,435 (90,026 active and 56,409 inactive) were salesmen and 72,946 (62,464 active and 10,482 inactive) were brokers. These numbers are large, but the percentage has varied only nominally in the past 35 years. A review of Department records shows that the ratio of licensee to population has run something from 1 to 90 to 1 to 125 since the late 1930's.

   Further, the inactive status, which has only been statutorily provided for the past 17 or 18 years, shows us that only about two-thirds of the overall numbers are participating on the economic scene as real estate licensees. The one change which has been apparent during the last two decades has been a gradual reduction in the overall number of licensees who enjoy real estate broker license status as compared to the percentage of the total licentiate who are real estate salesmen. This, we believe, is a direct by-product of the two-year salesman experience requirement which was placed into the law in 1950, supplemented by the educational requirements for real estate brokers which have been added during the last ten years -- most recently bringing the college level course requirements for real estate brokers to six real estate and real estate related courses (of three units each) to be effective January 1, 1975. We have delivered copies of the Long-Range Professionalization Plan, of which all of this is a part, to the committee.

We believe this sort of "limitation" on participation in the real estate field is that which is most economically sound and most particularly in the public interest. That is, that real estate licensees, especially those employing other real estate licensees, should be competent and knowledgeable in dealing with what is often the life savings of the average California citizen -- his participation in the ownership of his home.

We believe, too, that entry into the real estate business -- or any other field -- should not be artificially restricted. Our citizens should have a right to a job, and as long as we have a tough real estate examination for determining the competency of real estate salesman licensees, we do not believe arbitrary restrictions should be added to them. On the other hand, the broker is responsible for the activities of his salesman and as such should be expected to have a higher level of competence and knowledge in order to protect best the interests of the consumer.

Since most of the questions which might be developed by the committee as a result of testimony before it might deal with matters not apparent to us in preparing such a statement in advance -- it is the Commissioner's desire that I respond on his behalf to any questions you might have formulated; if I do not have the answer at hand, we pledge prompt research through appropriate members of our staff and a response prior to the conclusion of your deliberations.

Thank you for the opportunity to be heard.