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Transcript of Hearing on Real Property Finance, November 13, 1974

Assembly Finance and Insurance Committee

TRANSCRIPT OF HEARING

ON

REAL PROPERTY FINANCE

SAN DIEGO, CALIFORNIA

NOVEMBER 13, 1974

STATE · ASSEMBLY · CALIFORNIA
LEGISLATORUM
EST UNUSUS LEGES CONDERE

ASSEMBLY FINANCE

AND

INSURANCE COMMITTEE

557

November 13, 1974

San Diego Gas and Electric Company
Auditorium
101 Ash Street
San Diego

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

76-12-413

California Legislature

Assembly Committee on Finance and Insurance

ALISTER McALISTER
CHAIRMAN

CARLYLE R. BRAKENSIEK
CHIEF COUNSEL

BETTY YEARWOOD
COMMITTEE SECRETARY

STATE CAPITOL BUILDING
SACRAMENTO, CALIFORNIA
95814
(916) 445-9160

AGENDA

November 13, 1974

DEPARTMENT OF SAVINGS AND LOAN
Edward Barker, Ph.D., Commissioner
Saul Perlis, Chief Counsel

CALIFORNIA REAL ESTATE ASSOCIATION
Dugald Gillies

JERRY PETERS, REALTOR

BILL MITCHELL, REALTOR

CALIFORNIA INDEPENDENT MORTGAGE BANKERS ASSOCIATION
John Sykes

WESTERN HOME LOAN CORPORATION
Kenneth Green, President

CHAIRMAN ALISTER McALISTER: The meeting will come to order. This is the Assembly Finance and Insurance Committee meeting in an interim study on the question of real estate financing and related problems. We have with us today, Assemblyman Mike Cullen; Assemblyman Richard Hayden; Assemblyman John Knox and myself as well as my Consultant, Carl Brakensiek and my Committee Secretary, Betty Yearwood and my aide, Sal Bianco. I welcome all of you here and our first witness today will be Dr. Edward Barker, Commissioner of the Department of Savings and Loan. And also with him is Saul Perlis the Chief Counsel for the Department. You may proceed.

DR. EDWARD BARKER: I'm delighted that Mr. Perlis and I can be here because, as I know your committee is well aware, a considerable amount of our activities evolve around the legal and the legislative bodies, in trying to represent numerous public interests in working with the savings and loan industry. Mr. McAlister, we're here to try to do the best we can in responding to your interrogations or your concerns as we see them. I think that rather than try to make any opening statement I'd like to suggest that if you have anything you really want to start us on we'd be delighted to try and do that.

CHAIRMAN McALISTER: As you know, we're meeting to discuss and to study a number of the problems in the entire real estate industry today including the savings and loan people. One serious problem that seems to be afflicting the savings and loan industry today or at least until recently was this outflow of capital. I'm not sure what this recent decrease in prime interest rate will do or is doing to that, but I wonder if you have any comments on that.

DR. BARKER: Sure. This is commonly referred to as "disintermediation."

ASSEMBLYMAN MIKE CULLEN: Commissioner, could we have that again.

DR. BARKER: It's a financial money market term to confuse the public I suppose. Disintermediation is when you have a flow of savings from a thrift or public depository institution into other types of money market instruments or investments. For example, as has been experienced primarily by the savings and loan industry, some banks, and credit unions, the flow of savings accounts out into buying treasury notes that have been offered where the interest rate and the terms are more attractive to the depositor or the saver, than what the savings and loans, the banks, or the credit unions can offer under the laws which they operate. So that this process and problem has been going on now in kind of cyclical patterns and what is becoming more apparent is that with the shortage of savings and capital in the capital markets that more and more both governmental institutions as well as private institutions are going to this market in unprecedented amounts of demands. Thus the competition for these limited funds is pitting governmental institutions, such as the Treasury, against private corporate needs for capital as compared to kind of intradepartmental needs. Consequently, the savings flow out of the savings and loan institutions, especially in California, have almost been without precedent insofar as the magnitude of them. They've been extremely great. We've had savings and loans, for example, that the larger ones at one period of time were loosing close to a million and a half dollars a day every day they were open. This would go on for periods of thirty and sixty days almost without cessation until either the offering was closed or the money that was going out had subsided. I think one other thing the Committee would be interested in knowing about is that when the first series of these waves of disintermediation took place, it was primarily in the central larger cities where allegedly the sophisticated money moved out into more attractive offerings, away from the thrift institutions. But even in the last, we made an informal survey in our Department. For the months of August and September of this year even the smaller associations and the more rural in suburban areas of our State were feeling the disintermediation, which they had not felt back in 1973 to the degree they did in the middle part of 1974. So this is a trend that has affected all parts of the State and all of the savings and loan institutions. It hasn't been just to the large ones and it hasn't been just to the ones in the major cities. It's been pretty statewide and pretty pervasive.

CHAIRMAN McALISTER: Is this trend still continuing to the present?

DR. BARKER: It has abated for two reasons: First, the Treasury relented at one point a few months ago and went back to a ten thousand dollar certificate instrument instead of a one thousand dollar. This automatically meant that many of the smaller

savers could not qualify, although their last offering, in the month of October, was one thousand dollars. Fortunately, or unfortunately, whichever way you look at it, a considerable amount of that was taken as it hit the market so only roughly three hundred million was subscribed by small depositors instead of the original issue I think was well up in the billions.
Only about three hundred million of those subscribed by the small saver/depositors, so the effect was not as great, Mr. McAlister, as had been predicted. There has been a leveling out, and in some cases now there have been several weeks where most associations are what we call in the black, meaning that there has been more deposits served than there have been withdrawals. However, it would be sanguine on anyones part if they assumed that this meant that there was a directional trend around. Some experts are predicting that in January, although I understand it has now been postponed, if the Americans had been allowed to buy gold there would have been another real disintermediation period of some savings institutions. I understand that, if I'm not mistaken, Secretary of the Treasury Simon has postponed it or tried to postpone that from becoming effective. So I would say off hand that temporarily and in the real short runs savings and loans are stabilized.

CHAIRMAN McALISTER: Well there is entirely something of a trend toward lower prime rates from what I have been observing. Hasn't it done something like two points in the last couple of months?

DR. BARKER: Yes, that's true sir. The prime rate may or may not affect the long-term interest rate. At any given time it does not. However, if prime rate were to continue to seek lower levels and continued at those lower levels for a longer period of time, then it would have an effect upon the longer term money market rates. But at any given time when the prime drops that doesn't necessarily mean that the long-term money market rates drop with it in any sort of a positive correlation.

CHAIRMAN McALISTER: Some proposals that they made, I understand, would permit the S & L's to pay higher rates to their depositors in order to compete with these other sources or other competitive organizations. Do you have any feelings on that?

DR. BARKER: Yes, I have mixed feelings on that. From the depositor's point of view, it would be fine and also it would probably mean, in one way of looking at it, that there might not be as much disintermediation. However, Mr. McAlister, if the savings and loan institutions are compelled to pay higher rates, to keep savings or to attract new funds, there is no way they are going to be able to lower their mortgage rates, because the cost of money will even become higher to them than it is now.

CHAIRMAN McALISTER: They pay higher rates and more money at the same time in order to get more money so that they have to charge more money in turn when they loan money.

DR. BARKER: It's a vicious cycle. Might I indicate one other part to the Committee's consideration. I am now going to have to talk in averages rather than in specifics on this point of any institution. I would say on the average that the savings and loan associations in California, be they federally chartered or State licensed, have had a change in their liability deposit racial mix. Now, what do I mean by that? Well, about the start of 1973 or in the middle of '73, the typical deposit liability of the typical savings and loan in California showed that about twenty to twenty-five percent of its deposits were in four-year certificates at seven and a half percent, whereas about seventy-five to eighty percent of their deposit liabilities were in passbook accounts at around five and a quarter, five and a half percent. So under those conditions savings and loan associations were able to obviously offer lower mortgage rates to the borrower because their cost of money on the average was well below six percent. However, the trend has been almost reversing itself in that respect. Today we find that most associations in the State of California, in an effort to retain their savings against the competitive structure, the money markets, have emphasized and gone to the four year, seven and a half percent certificate. So today in many associations at least sixty or seventy percent of their deposit liabilities are in the seven and a half percent accounts rather than in the five and a half, five and a quarter percent accounts. So we had almost a reversal in the mix.

CHAIRMAN McALISTER: The seven and a half percent accounts are four-year.

DR. BARKER: That's right.

CHAIRMAN McALISTER: Do I recall that several months ago when the Citicorp holding company issued the so-called floating rate notes that you asked the Attorney General to intervene or or consider intervening on the grounds that they were engaged in the unlawful practice of banking?

DR. BARKER: According to our legal position?

CHAIRMAN McALISTER: Yes. Could you bring us up to date on that matter?

DR. BARKER: I'd ask Mr. Perlis to.

MR. SAUL PERLIS: Well, there is some controversy on that subject within the State government and the matter was eventually referred to the Governor and there has been no action taken. The only action that's taken at the United States Congress level where they have a bill (I'm not certain if it's been signed) which has been processed and would put control of these notes under the Federal Reserve. Clearly, they like to regulate them.

CHAIRMAN McALISTER: That's a pending bill?

DR. BARKER: I think it's been passed, or at least it's out of Committee ready to be passed.

MR. PERLIS: I think they agreed on the terminology of the statutes has gone through both Houses. I'm not quite certain whether the President signed it or not.

CHAIRMAN McAlister: What would the bill have done?

MR. PERLIS: The bill placed under the Federal Reserve Board the right to regulate the issuance of such notes.

CHAIRMAN McALISTER: Okay. But of course if that hasn't passed yet I guess its likely to go over to the next Session because it has . . . .

MR. PERLIS: No. I believe it passed. The President may or may not have signed it.

CHAIRMAN McALISTER: I guess that's an issue that's going to be passed on to the new Governor.

MR. PERLIS: That would be one of the issues, yes sir.

DR. BARKER: Might I add, Mr. McAlister, that at the time that we were quite concerned about these Citicorp notes, the Department of Corporations made an opinion that they could see no way they could legally prevent their sale in the State of California.

CHAIRMAN McALISTER: Do you still feel that those notes did cause the adverse effect on the S & L's that you feared?

DR. BARKER: I think that to some degree it did. I'd point out that maybe more important was the psychological impact to the public that there were other areas of activity where they can invest their savings that might be more advantageous to them than putting them into a time deposit or a bank of a savings and loan account.

CHAIRMAN McALISTER: Has your Department said anything other than you're concerned with the Citicorp issuance of, to assist the S & L's in halting the outflow of funds?

MR. PERLIS: The interest rate structure is all controlled by the federal government and we have no power to regulate interest rates.

CHAIRMAN McALISTER: That brings another question. Are the interest rates that the State-chartered S & L's may pay regulated by the federal government?

MR. PERLIS: Federal Home Loan Bank Board.

CHAIRMAN McALISTER: So that's entirely federal and not under the control of the State.

MR. PERLIS: That is correct.

ASSEMBLYMAN CULLEN: The State officials met with the Secretary of Business and Transportation during the Citicorp crisis about what the savings and loan were concerned with. I think Crocker Bank also floated a similar issue and almost concurrently, Chairman McAlister's Committee put out a resolution, subsequently adopted by the Assembly, directing a study with recommendations as to remedial action to be submitted to the Legislature in early January. Can you touch on the status of that study?

MR. PERLIS: I believe I can. I don't really know where the study stands but I know we replied to the Business and Transportation Agency and gave them the complete documentation on what we had done as far as requesting action and stating that our position was still the same. We felt that something should be done. I cannot tell you what the study accomplished. I do not know what the results are.

ASSEMBLYMAN CULLEN: That was represented to me by the President of Great Western Savings and Loan, who felt something should be done. We have a problem. The Legislature is prepared to do something. What do you want the Legislature to do? The President of Great Western didn't know. Frank Walton left that meeting with a number of savings and loan people feeling that if your industry is so concerned with all the talent and knowledge in this field, you could come up with some definitive recommendations for legislation or the alternative. Now that you've found yourself back in the competitive world, maybe you ought to start competing.

That is very blunt. But if this report merely comes in describing the problem, I for one would recommend to the Chairman that we just file it in the wastebasket, because we're not the only reservoir of knowledge. As a matter of fact, we're not even a reservoir of knowledge in this complicated financial field. We depend upon you folks who have made it a life's work.

DR. BARKER: This is complicated by the fact that the Federal Home Loan Bank Board has a dual jurisdiction over all savings and loan institutions in the State of California. In essence, the Federal Home Loan Bank Board in Washington set all the governing laws regarding the insurance of accounts, whether the savings and loan is a State license savings and loan or it is a federally chartered savings and loan operating in the State of California. The insurance of accounts is established by the Federal Home Loan Bank Board, and other such laws and regulations regarding mergers, branching, and other things. While we have similar laws for State license, the area where we have no authority is in the area regarding interest rates.

ASSEMBLYMAN CULLEN: If I may respond to that. Years ago I listened to our esteemed colleague John Knox at a dinner in South San Francisco, where he said that government doesn't manufacture solutions. We're in a position to provide tools so that the general public will have something to apply to the problem and come up with a solution. And for me to hear testimony saying that you're strapped because this is the law . . . this is State law . . . this is the federal law, really doesn't address the problem because we're in the lawmaking business. If it's desirable we will unmake this

State law. If it's desirable we will approach the California delegation and try to unmake or change the federal law.

MR. PERLIS: You're talking about floating notes that are sold throughout the country. And the Federal Reserve, if they have the regulatory power, might cure some of the problems. Now, the second problem is whether there is anything that should be passed in the State Legislature addressed to that fact. I am not certain on that point because I don't know how far this federal statute will go towards curtailing the problem.

CHAIRMAN McALISTER: Well, of course, we don't know how the Federal or Reserve Board is going to speculate. Getting them power is one thing and knowing what they'll do is something quite different

DR. BARKER: Quite clearly. No question about that.

CHAIRMAN McALISTER: There is a great difference of opinion on this issue. Some people are unhappy with the floating rate notes and they let the S & L's take their chances and this is a very competitive market for money.

DR. BARKER: It's a controversial issue, Mr. McAlister. There's no question about it. The reason we wanted to see an injunction or a stoppage was so there would be time in which it could be studied and so that good legislation could be promoted. Unfortunately, we couldn't achieve that.

CHAIRMAN McALISTER: Let me ask this. I think that perhaps Mr. Cullen really had in mind that while you may not have much power, what would you do if you did have the power?

DR. BARKER: My first suggestion would be to get the Treasury of the United States out of the savings market and back into the money market.

CHAIRMAN McALISTER: So you wouldn't let them issue small denomination instruments.

DR. BARKER: At high interest rates. Here is one arm of the federal government, the Federal Reserves, the Federal Home Loan Bank Board, they're saying to savings and loans and to banks through federal law which dominates over the state, you can only offer a certain rate to attract savings. Another arm of the federal government, the Treasury, is deliberately issuing a savings instrument at a higher competitive rate, with even more advantageous features than the rate allowed to be offered by the banks, savings and loans, credit unions, or any other private financial institution. So my first point would be, and I certainly concur with you Mr. Cullen, we should be coming up with ideas. I did not realize the nature of what you were anxious to have us do here this morning. I would say to you, the first things I would strongly urge would be to bare pressure upon the Administration and Washington by the California delegation by all of us and to get the Treasury out of the savings markets. Then the flows into the savings and loans, the banks, and into other institutions that do the financing of residential housing would be in a position where pressure could be brought to bare for them to offer mortgage rates, competitive but at the same time logical, to the needs of the public. As it stands now, the S & L's in many cases are seeing their costs rising, their ability to acquire funds rising, and they feel compelled to maintain a margin. In so doing it automatically pushes mortgage rates up.

CHAIRMAN McALISTER: What proportion of the S & L's deposits consist of individual deposits under ten thousand dollars?

DR. BARKER: Well, I don't have those figures with me but I'd guess a considerable number.

CHAIRMAN McALISTER: Do you think it would be more than half?

DR. BARKER: Oh, yes. Easily more than half.

ASSEMBLYMAN JOHN KNOX: Can a savings and loan institution make a loan to a bank?

MR. PERLIS: Yes, I guess it could.

ASSEMBLYMAN KNOX: I just heard recently some very large amounts of money have been transferred from savings and loans to banks at substantial rates of interest. Were you aware of any of those loans?

MR. PERLIS: No. Are you sure they were loan transactions?

ASSEMBLYMAN KNOX: That's what I heard.

MR. PERLIS: They're not deposit transactions because of course they can deposit money in a bank.

ASSEMBLYMAN KNOX: I heard they were transactions which involved the bank paying interest to the savings and loan. Now, whether it's a deposit or whether it's a loan, I don't know.

MR. PERLIS: I don't know the answer to that.

ASSEMBLYMAN KNOX: Would your department have any ability to regulate that, for example, if money were being withdrawn from the home building market or home loan market, in order to assist some bank's cash position? Would you be in a position to stop the savings and loan institution from doing that?

MR. PERLIS: I think we would because the Financial Code specifies the type of loan transactions that the savings and loan can engage in.

ASSEMBLYMAN KNOX: But they can deposit money or, in effect, lend money to a bank?

MR. PERLIS: They can deposit money, yes.

ASSEMBLYMAN KNOX: They can't lend money to a bank?

MR. PERLIS: Not unless it's secured by real property.

ASSEMBLYMAN KNOX: In the normal course of your examination of savings and loans, would the nature of the deposit come to your attention?

DR. BARKER: Oh yes.

ASSEMBLYMAN KNOX: Are you aware of any deposits by savings and loans and banks that had unusual interest rates in the prime rate plus area?

DR. BARKER: The exams on savings and loans are on an average of once every fourteen months. So activities do go on between examination periods in fluctuating manners. I would have to frankly go to our records of our most recent examinations of savings and loans to see if there was any real major trend of that sort of activity. To my knowledge there is not, although there could be some sporadic times when a savings and loan might do exactly what your question is saying. I have heard of some instances where they might, for a few days or a week or so, get into that sort of a situation.

ASSEMBLYMAN KNOX: Would you consider this something that you should stop?

DR. BARKER: Yes indeed. I assure you that we are trying to put every bit of pressure we can on the savings and loans. Whenever they have excess assets, those should go into the housing market.

CHAIRMAN McALISTER: Where would they engage in the transaction such as Assemblyman Knox has mentioned?

DR. BARKER: To have a higher rate of return to them.

ASSEMBLYMAN KNOX: I got some rather definite indications that at least one savings and loan institution made a very substantial rate of interest. It's a deposit or a loan, I'm certain of that. And, it withdrew assets from that savings and loan that would be available to the housing market presumably, and put it in a bank at a high rate of interest. And I just don't think that's what these institutions were created for. I was concerned as to what your department is doing about it, if in fact that's true.

DR. BARKER: If we found that to be a practice, we would go to those savings and loans with the idea in mind of ascertaining why they felt they had to do that.

ASSEMBLYMAN KNOX: Thank you.

DR. BARKER: I would also say that our examination does reveal many things in our examination process looking at it from a management point of view when we find such practices we call it to the attention of the management via a letter requiring their compliance.

ASSEMBLYMAN KNOX: But this is a written regulation of your department.

DR. BARKER: We have written regulations regarding what they can invest their assets in.

MR. PERLIS: That's right. The statute actually provides for the deposit situation and the loan transactions are spelled out in the Financial Code as to what they can lend to . . . .

ASSEMBLYMAN KNOX: But I assume that the deposit situation contemplates a normal demand bank deposit because the savings and loan have to put their money someplace. They have to have it available to pay off a depositor that wants to withdraw his funds or to make his loan appropriate . . . .

DR. BARKER: It's entirely conceivable a bank might, for example, Mr. Knox, offer a savings and loan a privilege or an arrangement where they could theoretically have a demand deposit position. But they could also have it on a basis where they could transfer it into that demand deposit while still leaving the funds with the bank in some other form that would bear interest to the savings and loan.

ASSEMBLYMAN RICHARD HAYDEN: Yesterday our testimony brought forth some possible areas that I think perhaps you could clarify today. Basically, I was concerned with this whole area of parity. It is my understanding that the Commissioner has been given emergency powers by the Legislature to act after the federal government has acted, but that these regulations that you establish administratively go out of effect one hundred days after the legislative session ends. I'm basically concerned about enacting statutes that specifically implement those regulations because there would be nothing at that point until the new Commissioner came in and you went through the same process again. I wonder if you could comment on that, particularly because it has to do with the question of a variable interest rate on mortgages which appears to be one of those things which is being done by State chartered institutions that leak in several instances? Could you generally comment in that particular area? What legislation, if any, would you suggest is needed, or is it sufficient as it is?

DR. BARKER: This Legislature enacted a statute a couple of years ago, because of the fact that we have the two systems in California which are very competitive. The Federal Savings and Loans and the State License very often (either Congress or the Federal Home Loan Bank Board) enacted legislation and, of course, it took them much longer for our Legislature to enact similar legislation. So we do have this ability to issue what is called a parity regulation at the end of the next legislative session, giving the Legislature the opportunity to either come up with a statute or if you reject it then the regulation ceases to exist and that's the end of that.

ASSEMBLYMAN HAYDEN: Is that in our new two-year session a technical question?

DR. BARKER: Well, this statute was passed before the two-year session went into effect.

ASSEMBLYMAN HAYDEN: So that in itself might be something that needed clarification.

DR. BARKER: Sixty-one days after the end of the combined session we consider this a single session as I understand it.

ASSEMBLYMAN HAYDEN: Right.

DR. BARKER: So actually it could last for two years.

CHAIRMAN McALISTER: If you pass a regulation today then that would be good until sixty-one days after the end of the 1976 session.

DR. BARKER: We've discussed that subject and I think that's the conclusion we've reached. Although normally, before we go into that situation we more or less determine that it is legislation that either ourselves or someone is going to introduce in the Legislature and not wait. In other words we don't really issue these regulations on the basis that they're going to stay for two years or even one year unless we feel that legislation should be enacted and we go into the Legislature with it; or the industry that might do that. Now with reference to the variable rate mortgage, there is a civil code statute section, authorizing a variable rate mortgage and laying out certain conditions that have been in effect for several years. We have issued regulations with reference to them. The mortgage has never really been used to any great extent in this State. If the variable rate mortgage is enacted by the Federal Home Loan Bank Board, I think that it will probably take a statute of Congress. We have two things that I think would bother us. One is the peg. That has been the principal problem as to what do you peg it to. Our regulations peg it to a Federal Home Loan Bank directive that comes out every six months, establishing the average cost of money. Now there is criticism of that. It's not the worlds greatest system, but it is one problem. The second problem is on a variable rate mortgage. If you do vary your rates, and you're obviously going to cut down on the principal payments, what does that do to your loan maturity? If you don't change the monthly payment, you'll have a loan that might then run out many years beyond the loan maturity specified. If you change the loan payment, the borrower of course is hurt.

ASSEMBLYMAN HAYDEN: Now how would you suggest, or are you ready to suggest what we in the Legislature might do to clarify change. I'm not quite sure of the words that I want to use. I don't know whether it would be appropriate if the lengths of the loan be statutorily changed.

DR. BARKER: On the peg I really have no suggestion. I really don't know the answer on that at all and, insofar as the loan maturity I think there is going to have to be some legislation that will permit a modification of loan term to a certain extent in the event that the variable rate mortgage does win acceptance. Now what exactly, I don't know because I really didn't expect to have this question and we didn't attend the hearings that you held the last couple of days. I think it's going to take some study. We kicked it around quite a bit several years ago within the department when Preston Martin was Commissioner because he was quite interested in the variable rate concept. I think one concept we had was to maybe not permit an extension of the maturity more than, say beyond twenty-five percent of the original term. That was just flat and arbitrary but it's one way to approach it.

ASSEMBLYMAN HAYDEN: You are prohibited statutorily now however, in that particular area. So we would need legislation if we went that particular route.

DR. BARKER: I think we would need some legislative enactment.

CHAIRMAN McALISTER: Maturity of loans. Oh, I see.

DR. BARKER: So what you have happening is you have to escalate your interest rates, which you're paying less on the principal and that means your term, your payments are going to stretch out just that much longer if you leave the payment the same.

CHAIRMAN McALISTER: That's a rather troubling aspect to this. I can see some real equity arguments in favor of the variable rate. The rates keep going up -- you're in effect, under the common present system. You are asking newer borrowers to subsidize older borrowers. But on the other hand this maturity problem, when you have rapid and substantial rises in the rate, becomes almost an impossible thing. It was pointed out yesterday that you could reach the point where you had a negative flow here. In other words you were not paying off any of the interest or principal.

MR. PERLIS: We did some calculations in the department at the time this subject was rather pressing. Actually if you don't change the payment, a loan could run to a infinity. But it's not likely to.

DR. BARKER: May I add one other thing on this point, Mr. McAlister? There have been some other proposals and variable rates that, as now proposed, are also attracting the attention of people. One proposal would be a negotiable period. In other words that no mortgage would last for more than five years at a stipulated fixed rate and then at the end of that five years it would be subject to negotiation again between the borrower and the lender. Another proposal is called the flexible payment plan in which, especially for young marrieds, the amount paid, at, say for the first five years, would be at a lower payment and then after five years or whatever the stipulated time is, the payments would be increased. This would give young marrieds an opportunity to try and acquire housing that now may be shut away from them. We're quite concerned about this.

CHAIRMAN McALISTER: I brought some insurance on that plan once and when the time came for the rates to go up I let the insurance drop. But, maybe the variable interest rate concept is only part of a larger ballgame. It's kind of like in the indexing concept. Maybe it really doesn't work too well unless you do this to a lot of other features in the economy. The extended maturity date, if you have substantial rises in the interest rate, doesn't seem to me that it's going to work. If they are not substantial then it could work quite well.

MR. PERLIS: Well, one of the concepts on that is we don't have such things as an interest rate that always goes up.

CHAIRMAN McALISTER: No.

MR. PERLIS: There are always drops and I think the kind of a feeling is that it averages out. I think that's the way which it is normally explained.

CHAIRMAN McALISTER: Historically we've had as much deflation as inflation. It's just that we've lived in a period here of a generation or so where the inflation seems to exceed the deflation, but that's not the historical record at all. If you have a generation like that, your longer term may not count too much.

Let's turn to the prepayment penalty and sale area. This is a very controversial area, as I'm sure you gentlemen are aware. In the savings and loan industry people tend to oppose restrictions on the existing practices basically on the grounds that they fear restrictions in these areas would make it more difficult for them to accumulate capital and make their margin of profit even smaller and would make it more difficult to market their loans, etc. Do you have any comments on these areas? What the impact would be on the savings and loan industry, for instance, if we were to greatly restrict the use of prepayment penalties or the due on sale clause?

MR. PERLIS: Well, obviously there would be some economic detriment. I don't know the exact amount if I personally would be in a position to evaluate. I think you have the cost of entering into a loan which of course is the prepayment penalty feature. I can't say the dollar amounts, but of course it's all these various things which go to build up the proper picture of a savings and loan. At the same time, this is one of the things that's always caused -- you have the consumer problem and we have numbers of complaints by people who have prepayment penalty clauses invoked against them. We try to work them out where we can, but it's not always very easy to do so. With reference to the due on sale clause, I think that's a very difficult one to answer. I think if the due on sale clause was outlawed it would in effect lock the association into a loan where interest rates may be less.

CHAIRMAN McALISTER: Would the consequence of that be that they would charge somewhat higher interest rates on the average?

MR. PERLIS: This is controversial. I mean there are arguments to be made on both sides of this picture.

CHAIRMAN McALISTER: If there is some kind of a loss to them on this, would they not have to make an effort to adjust to that in some way?

MR. PERLIS: That is true. But query, where would they make the adjustment?

CHAIRMAN McALISTER: One possibility would be to just generally raise interest rates.

MR. PERLIS: On the new loans?

CHAIRMAN McALISTER: Yes.

DR. BARKER: Might I add that there's another peculiar feature in the money markets that is not normally explained and I think has an indirect impact on this problem of prepayment penalties and due on sale clauses, etc. I'm sure when I make this remark it will seem like it has no relationship, but I'll try it anyway. Looking at one of the other financial intermediaries who is in construction financing, I use the word construction financing not residential housing, you will find that ostensibly on the surface, it appears as if the interest rate they charge on this financing, is less than the savings and loan. If you look only at the interest rate it might well be. However, they usually have an arrangement in their financing where they take an equity position. Now the concept of an equity position in a residential housing is something that has never been explored particularly. It's always assumed that the Savings and Loan Association, having been the bulwark of financing of residential housing, that the owner got full title back with no impingements or entanglements against it, once he paid off the mortgage or cleared the trust deed. Now, all I'm saying here is that if more and more of our housing goes in the direction that I think it's going, we're going to see the disappearance of the single family residence to a great extent. Seeing the disappearance of the single family residence could well mean that other financial intermediaries, like life insurance companies and banks can finance complexes and tracts rather than individual housing. In the case of life insurance it would be coming more and more into the market again, particularly where they can extract these equity positions that they do and their contracts. Thus, from a due on sale clause or from a prepayment penalty aspect, these are things that don't affect that type of residential construction financing as compared to the savings and loan that doesn't have that capability or uniqueness.

CHAIRMAN McALISTER: Of course, some of these sources of funds that you mentioned, like the insurance company's, are subject to the usury laws, aren't they?

DR. BARKER: Well, they take an equity position just as an amateur. I'm not an attorney. I don't see how that would affect the usury law, Mr. McAlister.

CHAIRMAN McALISTER: Well, they can only charge so much interest. We have a ten percent interest limit.

DR. BARKER: Yes, that is correct. But sometimes they actually charge a lower rate of interest than the savings and loan does, because they take an equity position in consideration. Now I would suggest to the Committee that I think down the line more and more of our housing needs are going to be resolved in these more communal-type developments. I'm convinced of it. If that is the case, I think in the future the housing needs and the financing of them in the State of California are going to be other than savings and loan associations that are going to be involved in that financing, Mr. McAlister.

ASSEMBLYMAN KNOX: May I ask a question on that point. Is that Ventura case still the law where a lender takes an equity position that he also shares the liabilities if they turn up?

MR. PERLIS: Yes. Yes, that's still the law but I think it . . . .

ASSEMBLYMAN KNOX: Does it apply to the insurance companies to take an equity position . . . .

MR. PERLIS: Anybody will say that becomes actively involved. I mean the Ventura case really involved considerably more than a lenders action. They really became involved in the construction, the design, the whole thing. As far as I know it's still the law.

ASSEMBLYMAN KNOX: If any lender wants to get that last pound of flesh and not only get his interest, his prepayment penalty, his late payment penalty and his due on sale penalty, and in addition he wants a piece of the action, he also shares the liabilities. Is that still the law in California?

MR. PERLIS: As far as I know it is, unless somebody has come up with a case which I haven't read recently.

DR. BARKER: I hope, Mr. Knox, you weren't thinking that I was suggesting that savings and loans get into the equity position.

ASSEMBLYMAN KNOX: Was this a bank or an S & L in Ventura? I can't remember. It was an S & L, wasn't it?

MR. PERLIS: It was not an S & L. It was not an equity position case actually, but a development of a piece of land which associations can engage -- more like a joint venture.

ASSEMBLYMAN KNOX: That's what the court held, in effect.

MR. PERLIS: That's right, in effect.

CHAIRMAN McALISTER: The material prepared by our consultant indicates that bonuses, points, warrants, options and rights to covert the lenders loan into the corporate stock of a borrower, probably are deemed interest and must be considered in evaluating whether the usury law has been violated. Also, the contingent interests such as an agreement to be compensated at a rate of interest less than ten percent, but to also receive a percentage of the borrower's profits, may be usurious, depending on the base rate used and the amount of risk assumed by the lender. So we do have some usury problems, at least lurking in the background here. Gentlemen, what are your feelings about the usury laws? While I know they don't apply to the S & L's, they will apply to some of these other entities if what they do is construed to be interest and it would exceed the ten percent. Are our usury laws outdated as some feel?

MR. PERLIS: Well, as a lawyer I can't answer that because, for over twenty years of my experiences, I've only been with either a bank or a savings and loan, and both are exempted from usury statutes. So I'm certainly not up-to-date on the usury laws. I am sure your counsel has spent more time and effort on that than anything I've done. It would be difficult to answer that.

DR. BARKER: The only way I would answer that, Mr. McAlister, would be from studying the money markets and disregarding the legal technical aspects of what you raised. It is my opinion that the capital needs of our economics system will be so great in the next ten years that I don't see any decrease in long-term interest rates in the future. Now, I'm talking about in the long run. I'm not talking about any seasonal adjustments or six months or short-term. If my prediction is correct, then I would say to you that the usury law might be uneconomical in that respect, if it were only ten percent, because it well could be that we could be at fifteen percent rates by '76, which I think is very likely.

CHAIRMAN McALISTER: Any other questions? Thank you gentlemen. It's been very enlightening.

DR. BARKER: Thank you.

CHAIRMAN McALISTER: I appreciate your coming. Now Mr. Doug Gillies of the California Real Estate Association.

MR. GILLIES TESTIMONY WAS ORAL AND IN WRITTEN FORM.
FOR BREVITY, HIS WRITTEN TESTIMONY WHICH IMMEDIATELY
FOLLOWS.

STATEMENT ON

COSTS ASSOCIATED WITH REAL PROPERTY FINANCING TRANSACTIONS

to the

ASSEMBLY COMMITTEE ON FINANCE AND INSURANCE

San Diego, November 13, 1974

by

Dugald Gillies, Vice President,
Governmental Relations

CALIFORNIA ASSOCIATION OF REALTORS

Mr. Chairman and Gentlemen:

My name is Dugald Gillies, Vice President for Governmental Relations of the California Association of Realtors (formerly the California Real Estate Association), an organization of 73,000 Californians who are directly engaged in serving the public in real property sale transactions.

Because on a daily basis our members work with buyers and sellers of real property, we think we can reflect to you what the problems and frustrations are, the impact of costs incident to those transactions, and the extent of inhibition of property transfers as a result of those costs or practices.

We shall confine our recommendations and discussions to those real property transactions dealing with homes---and for that purpose would select the definition for which there is ample precedent in California law of residential property of four units or less.[1] We have limited this discussion to consideration of housing because that is the area to which most legislation has been directed, is the area affecting the largest number of consumers and the one in which problems most frequently arise, and because buyers and sellers in most other situations tend to be more sophisticated and, therefore, more able to negotiate for themselves.

Shelter is a necessity. The interest of government in assisting its citizenry to achieve the goal of decent, safe and sanitary housing is well expressed in federal law and is reiterated in state law in the mandate that general plans contain a housing element which "shall make adequate provision for the housing needs of all economic segments of the community"[2] and further expressed in the guidelines for that plan element adopted under authority of law which set a further goal of promoting and insuring "the provision

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[1] See, for example, Civil Code 1916.5 (variable interest): "...real property containing four or fewer residential units or on which four or fewer residential units are to be constructed."; or Code of Civil Procedure 580b (deficiency judgements).

[2] Government Code 65302.

of selection by location, type, price, and tenure."[3]

Shelter costs from 25% to 33% of the income of essentially every California family and, therefore, the costs or impediments to the acquisition of housing must also be the concern of government.

Home ownership is a basic method of providing shelter---over 3,600,000 California families own their homes. But the percentage of homeowners which was long on the rise is now beginning to slip because an increasing portion of our population are literally priced out of the housing market. It is generally considered today that more than half of all Californians could not afford to buy a home.

There are three elements of cost which are critical in the decision to acquire a residential property:

(1) The monthly cost which includes the amortization of principal (and during the first years of a typical home contract today this can amount to less than five percent of the monthly payments), interest and impounds for property taxes and insurance.

(2) The initial cash requirement which includes the down-payment, loan fees or points (to which is related assumption fees and the whole question of acceleration), transfer taxes imposed

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[3] Health and Safety Code 37041 and "General Plan Guidelines" IV-8 (1973), Council on Intergovernmental Relations.

by government (plus fees amounting to thousands of dollars per unit in some areas on new construction in the form of "bedroom" taxes, sewer and water connection charges, etc.), title insurance, pest control services (inspection and mandated work), charges for appraisal and escrow, real estate commissions (although these are not mandated nor present in every transaction), the pro rata of taxes and insurance accrued, initial hazard insurance premiums, a host of miscellaneous fees connected with lending which we will examine later, and a group of fees imposed by government for recording, appraisal (FHA), reports on use, occupancy and zoning, mandated inspections, and the like.

(3) The price of the house, although this is translated to a monthly cost and an initial cash requirement and it should be parenthetically noted is affected, again, by government action.

But it is not just the element of homeownership which must be your concern in this hearing. The mobility of our population is a factor closely associated with this situation. There are up to 750,000 property transfers affecting owner-occupied homes in California per year. These transfers occur by reason of change of job, an increase or decrease in family size, marriage and family formation, children, death, dissolution, health, changes in economic circumstances and a host of other reasons.

It is the public policy and in the interest of this state to facilitate those property transfers as expressed in the Constitution[4] and on the long-standing statutory prohibition against unreasonable restraints on transfer[5].

Thus, it is not just the buyer of a home who has a stake in this transaction, but the seller as well. Obviously, he will try to recoup all of <u>his</u> costs arising from the sale---and many costs are ascribed to the seller today---so that both parties have a stake no matter which pays these costs. Some federal agencies such as the Veterans Administration require that many of the basic costs involved in the transaction be entirely paid by the seller while FHA sharply limits the costs which may be assumed by the buyer, thus shifting effectively the bulk of them to the seller.

The seller also has an interest in protecting his equity which has been produced as the result of his investment, his labor and his care of the property. This is a legitimate interest and the erosion of this equity by mandating many of the costs of the transaction on the seller---costs which he cannot escape if he wants to sell---represents a substantial consumer burden. The seller is as much a consumer as the buyer and, obviously, there are just as many of them. The state has statutorily stated a policy that home

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[4]Article I, Section 1.

[5]Civil Code 711: conditions restraining alienation, when repugnant to the interest created, are void.

owner equities "must be protected and conserved".[6]

Beyond this, the vendor of the home needs to preserve as much of his equity flowing from the transaction as possible since in normal circumstances he will be purchasing another home for which his entire equity may be required, or which in any circumstance the application of his equity would reduce the amount of borrowing and, therefore, the effective price of the home primarily translated into the monthly payments.

It is extremely significant that the protection of the equity of the seller which is impacted not only by the costs shifted to him but by the price achieved in the sale is dependent upon the availability of financing to the buyer. When an assumption of his loan by the buyer or new financing is not forthcoming, except at much higher interest rates, for example, the seller has the alternative of reducing his selling price and absorbing the loss in equity to persuade the buyer to complete the purchase or of rejecting the sale and retaining the property. This concept is accepted by those appraising property.[7] This is confirmed, also,

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[6]Health and Safety Code 37003.

[7]37 The Real Estate Appraiser 24 (1971): "It is said that valuation of older existing residences is best accomplished by using the market comparison approach...Each (comparable) sale considered is a past transaction. Value, however, is tied up in futures. Past sales cannot indicate present value unless it can be demonstrated that in the mortgage money market, the (continued)

in the very definition of "fair market value" which includes the premise that the property transfers for cash---when in actuality on residential property very few cash transactions occur.

From testimony of Realtors active in the residential market, in today's conditions of mortgage availability and pricing, as many as 20% of transactions which have been consummated by agreement by buyer and seller "drop out" because satisfactory financing within the means of the parties cannot be arranged.

The question should be asked: As a general principle, should government intervene or regulate the costs or other factors in this residential property transfer transaction?

First it should be observed that all factors influencing the cost of a real property transaction are not the subject of your hearing. You are not attempting to deal with the price of the house or the land, with pest control costs, with insurance protection costs and a number of other very significant factors. We do not urge that you expand the list to include these items since we have no indication that it would be appropriate or feasible for

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[7](continued) same availability in payment terms continues to prevail. If during the interval between a past sale and date of appraisal, the competitive forces in the fixed income money markets have changed, making money scarcer and more expensive, ratios will probably decrease and mortgage payment rates rise...Casual study of residential real estate over the past two years plainly supports the assertion that market activity and levels are thoroughly dependent on availability and terms of mortgage financing."

government to attempt to regulate these particular costs.

We presume that it was the conclusion of your committee, as it would be our own, that in those areas of cost in the home transfer situation in which there is adequate competition and an essentially free market that there is no reason for government to attempt to intrude. Conceivably there would be a constitutional question of government authority in such circumstances and there are, of course, a series of court decisions respecting attempts in many fields to engage in price fixing which have been held invalid. Beyond this, there is the real question of the effectiveness of government by some arbitrary means substituting the judgement of government officials for the judgement of the marketplace which raise real questions. Without elaboration, we believe, for example, that the experience of New York City with rent control has been sufficiently documented to prove that those attempts were counterproductive.

On the other hand, government <u>is</u> now involved in the real estate sales transaction and, in fact, regulates many facets of it. It, for example, contributes to or assists many participants in portions of that transaction through the insurance of lenders' risks on many loans, through the purchase of loans from lenders, from the creation of availability of funds in substantial quantities for loans (as, for example, the Federal Reserve system and the

Federal Home Loan Bank Board).

Additionally, by statute in California government effectively limits competition through creation of a semi-monopoly situation in which a limited number of charters for financial institutions are made available based on a determination by state regulatory agencies of the "need" to serve the public.

The California Association of Realtors believes, in general, that there should be no government price control in the absence of an emergency or a grave abuse and this would go towards such areas of intervention as establishing the price of housing itself, establishing the basic price of money, or specifically the establishment of real estate commissions (a subject with which we will deal later in this statement).

On the other hand, CAR believes that <u>some</u> limited regulation is desirable and is indicated on the basis of precedent and need where government has otherwise entered the field. Franklin Harding, then the executive vice president of the California Savings and Loan League, was quoted several years ago in testimony before a Congressional committee as saying: "But the fact remains, neither all lenders nor all borrowers are perfect, and a few of each are perfect stinkers."[8]

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[8] May, 1971.

It should be understood in this context that state law has attempted to provide specific remedies for and protections for lenders in real property loan transactions (as an example) through rather extensive statutory devices and that, conversely, the borrowers should be entitled to similar consideration---and, of course, there is precedent for such consumer-oriented law based on many factors.

We will deal with each of these situations in specifics.

Acceleration:

Related to the issue of acceleration is the question of assumption fees and we will deal with them together.

Acceleration is a hot subject now with much attention focused on it since the October 10 decision of the California Supreme Court in Tucker v. Lassen S&L Association[9].

In actuality, it has periodically been a hot subject in the sense that acceleration has been used to effectively deny many Californians the opportunity to transfer property---to sell or buy a home---(an opportunity frequently based on vital personal necessity) on about a two or three-year cycle since 1966: every tight money market.

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[9] ____ C 3d ____.

And today we are experiencing the worst of those. Property in many, many cases is unsaleable because of interest rates and the shortage of money and while the shortage of money itself does not create a presumption of a restraint on alienation, a practice by lending institutions to accelerate loans which produces that shortage of money may well be such a restraint, in our view.[10]

The parties to a transfer are further being severely disadvantaged through a loss of their equity in substantial magnitude. This is contrary to expressed legislative policy on protecting the homeowner's equity.[11]

Acceleration is the practice, based on contract, by which the lender requires the payment of the entire remaining balance of principal and interest in one lump sum upon the conveyance of any interest in title to the property (voluntary or involuntary).[12]

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[10]See footnote 5.

[11]See footnote 6.

[12]A typical acceleration or due-on sale or encumbrance clause as quoted in Tucker, supra, reads: "To protect the security of this deed of trust, trustor (borrower) agrees: ...that if the trustor shall sell, convey, or alienate, or further encumber said property, or any part thereof, or any interest therein, or shall be divested of his title or any interest therein in any manner or way, whether voluntary or involuntary, all obligations secured hereby, irrespective of the maturity date expressed in any note evidencing the same, at the option of the Beneficiary (the nominee of the lender) and without demand or notice, shall immediately become due and payable." Parenthetic material added.

The so-called "due-on sale" clauses were essentially unknown in real property financing prior to 1930 and when introduced first took their purpose in protecting the security of the lender against moral risks such as waste or poor credit.[13]

Such a narrow and perfectly legitimate purpose would, of course, indicate that acceleration would be waived where there was no threat to the lender's security. But in recent years acceleration has been threatened or has occurred on the occasion of essentially every transfer of property, whenever interest rates are higher than those in effect at the time of the loan's original negotiation "openly to secure economic advantages created by changing interest rates."[14]

In fact, one of the counsel for the California Savings and Loan League proposed in a law review dissertation that "the types of conditions to such a waiver which lenders normally prescribe are one or more of the following: satisfaction with the buyer's credit standing; expressed assumption of the loan by the buyer; payment of a waiver fee; an increase in the interest rate to reflect the current interest rate for such a loan; a reduction of principal; and

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[13]Bonanno, Jack F., "Due-on Sale and Prepayment Clauses in Real Estate Financing in California in Times of Fluctuating Interest Rates---Legal Issues and Alternatives", 6 USFLR, 267, at pp. 271 and 275.

[14]Id. Also see, Cherry v. Home Savings and Loan, 276 CA 2d 574 (disapproved where inconsistent with Tucker, supra, by the later Supreme Court action).

the giving of some type of additional security for the loan".[15]

The California courts have begun to erode this absolute power of acceleration by lenders as a restraint on alienation, but in very limited circumstances. The first significant case was La Sala v. American Savings and Loan.[16] In brief, in that case the court determined that acceleration could not be used when the borrower executed a junior encumbrance on the property as a means to increase the current interest rate, unless the lender's security was impaired. The court observed: "In any event, a restraint on alienation cannot be found reasonable merely because it is commercially beneficial to the restrainor. Otherwise one could justify any restraint on alienation upon the ground that the lender could exact a valuable consideration in return for its waiver, and that sensible lenders find such devices profitable."

In October, the Tucker[17] case extends that prohibition against automatic acceleration in the absence of a showing of impairment of security, specifically in a transaction occurring in the form of a land sale contract where the seller retains a substantial equity in the property. It appears that the criteria of Tucker extends to other devices such as the all-inclusive deed of trust, the lease

[15]Kolbor, Bernard, "The Due on Sale Clause in California", 44 L. A. Bar Bulletin 64 (1968).

[16]5 C 3d 864 (1971).

[17]Supra.

option and conceivably even the outright sale where the seller takes back a second deed of trust as part of the purchase price where the condition of the retention of a substantial equity by the seller is met.

Frankly and parenthetically it would help to secure immediate clarification of the application of Tucker to such situations as the all-inclusive deed of trust and purchase money second mortgage since we have evidence during the weeks since Tucker that some lenders are threatening acceleration in those cases despite the court's action.

But these beg the larger question: Should not a homeowner have the right to convey his property subject to an existing first trust deed to be assumed by the buyer, where no impairment of security of the lender is involved, in even an outright sale situation? We believe he should.

The court in Tucker did not decide that question directly, but indicated that "such consideration must await a case involving the attempted exercise of a 'due-on' clause upon outright sale by the trustor."[18]

That was a primary function of SB 200 (Gregorio) of the 1973-74

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[18] See footnote 7 of Tucker, supra.

session which was before your committee and was referred to interim and presumably is one of the bases of this hearing.

While the courts in this state have previously upheld the acceleration device as not an unreasonable restraint on alienation, and as an interpretation of existing constitutional and statutory law[19], they have now as previously indicated shown an interest in reexamining that issue, particularly on the basis of a plethora of critical commentary[20]. It should be emphasized, however, that the court even in the past has been interpreting statute and that it is the legitimate function of the Legislature to change the policy of that statute where conditions indicate.

In our belief, conditions now indicate such a change.

Consider the following:

(1) The Legislature has statutorily enunciated the policy of protecting the homeowner's equity[21] since the Coast Bank case.

(2) In a relatively recent and expanding device, the owner who becomes the seller after say five years from his initial purchase,

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[19]See, for example, Coast Bank v. Minderhout, 61 C 2d 311 (1964).

[20]For list of such commentaries see footnote 7, Tucker, supra.

[21]See footnote 6.

paid at the time of his purchase points and other charges (discussed later) as consideration for a 30-year contract. While these do not represent prepaid interest (and the distinction is important), they are an equivalent to interest for the entire term. The currently typical two points plus $50 on a conventional loan is the equivalent of one quarter of one percent interest prepaid, whereas the not unusual six points is the equivalent of three-fourths of one percent prepaid---or well over one percent for a 30-year term when compounded considering its prepaid nature. If the loan is accelerated after five years (and it could be one year), the unearned benefit to the lender is apparent.

(3) Because of the factors in the point above and the reasonable expectation of both parties to a real property loan that they are committed for a 30-year term, the owner, therefore, should be able to convey that right unless the security of the lender is impaired.

(4) The inhibition against acceleration should not be limited in its operation (as extended by the courts to this time) only to those sellers who can afford, through a contract of sale or similar device, to retain substantial equity interest, but should be extended by the Legislature to the less affluent members of our society who are to a greater degree the victims of the restraints on alienation or, alternatively, the exactions of lenders which occur through

threat of the use of the acceleration device.

(5) The buyer of property is in no better position to pay additional interest or points than a continuing owner of existing property, but the lender using a device designed to protect his security is exacting these higher charges because of the occurrence of a transfer of title---which frequently occurs from circumstances beyond the control of the seller.

(6) Modest mortgage borrowers are generally unable to bargain (even if they are aware) on acceleration provisions when they are presented with notes and deeds of trust with "boiler plate" provisions which represent or approach contracts of adhesion. Any bargaining is generally confined to interest and points.

(7) If lenders require periodic adjustment of their loan portfolios, as they contend, they should give serious consideration to adjusting their initial loans to the variable interest formula authorized by statute and regulations of the Savings and Loan Commissioner[22] which has been essentially ignored since its enactment.

The California Association of Realtors recommends strongly the enactment of a measure similar to SB 200. We would prefer that the measure apply only to real property secured loans on residential properties of four units or less---the type of property which is not

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[22]Civil Code 1916.5 (1970); 10 Cal. Adm. Code 240, et seq.

subject to a deficiency judgement[23] and thus is the type of loan in which the lender has depended on the security provided by the property itself. It should be emphasized, also, that the assumption of a mortgage debt by the buyer does not release the seller who was the original grantor or mortgagor from his liability to the lender for the mortgage debt[24].

There are many facets of SB 200. The primary thrust of the acceleration provisions was to prohibit the use of the due on sale clause in the case of an outright sale where the new buyer agreed to assume the loan and paid an assumption fee of not to exceed one percent of the outstanding principal balance or $100, whichever was greater. Additionally, it provided protection in a series of involuntary transfers.

The exception provided in SB 200 parallels that in the recent court cases in that it would permit acceleration in those circumstances in which the lender could show that his security was impaired. The court in Tucker illustrated the types of impairment of security which could permit acceleration---and it should be emphasized that they would be very much the exception, rather than the rule.

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[23]Code of Civil Procedure 580b.

[24]See, Biddel v. Brizzolara, 64 C 354; Case v. Egan, 57 CA 453; Heard v. Tuohy, 133 C 55.

We are prepared to discuss the details of SB 200 with the committee should it wish, or to work with the committee and its staff or with others concerned in refinement of the language of SB 200 including the method of establishing impairment of security.

But today's conditions emphasize the need for an extension by the Legislature of this limitation on the use of acceleration. Hopefully and expectantly today's money market conditions will ease, but the credit crunch will return again in its cycle and the continuing need for this legislation will remain.

In fact, further inaction by the Legislature could have an opposite effect. In a recent law review commentary[25] it is stated: "On the other hand, California's unwillingness to enact any form of legislation regulating the use of the due on sale clause may well lead one to conclude that the California Supreme Court has correctly assessed the public policy of the state to be one of not interfering with the exercise of the clause. Indeed, when the Legislature finally did enact a statute in 1971 dealing with the due on sale clause, it merely provided that a clause accelerating the due date of an obligation upon the sale or other transfer of certain kinds of residential property subject to an encumbrance would not be valid unless printed in its entirety in both the note

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[25]Bonanno, supra.

and the security instrument."[26]

Prepayment Penalties:

The prepayment of all or part of a loan by the borrower is frequently a matter of necessity for him. The homeowner is not an artificial entity having continuous existence, is not in the business of dealing with financing and able to balance one transaction against another, and by virtue of a host of contingencies may well be forced to prepay a loan.

The most common and frequent of these, of course, is when the owner sells his home. In the previous section we have discussed the desirability in many circumstances of continuing the existence of that loan through an assumption by the buyer of that property.

Frequently, however, this is not possible since the buyer will require additional financing or will have his own credit arrangements with a different institutional lender.

It is true, of course, that if the current interest rate is lower on new loans than that on the existing loan the buyer would not wish to assume the existing loan.[27]

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[26]Civil Code 2924.5 (1971).

[27]An alternative available to lenders is the variable interest contract discussed in the previous section.

The comparatively rare attempt in the past to prohibit prepayment or to make no specific provision for it in real property security transactions has been basically solved with the passage in 1974 of AB 3500 (Deddeh)[28]. That measure prohibits a lock-in and applies to original principal obligations of $100,000 or less with a few stated exceptions.

A similar prohibition against lock-ins in contracts of sale was enacted in 1968.[29]

In specific terms, however, a problem still remains with the so-called prepayment penalty which can be excessive. Actually, only a few lenders have been guilty of extracting excessive charges, but these can be similarly inhibiting to a transfer of property, as well as a device to extract funds from the equity of the seller which should be protected and available for the reasons stated in the previous section.

A typical clause in a note and deed of trust would stipulate a penalty of an amount equivalent to six months' advance interest on the unpaid balance as to any payment which exceeded 20 percent of the

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[28]Civil Code 2954.9, operative as to contracts executed after January 1, 1975.

[29]Civil Code 2985.6, operative as to contracts executed after January 1, 1969.

original principal amount of the loan.[30]

But the amount of penalties vary materially. For example, in a survey of savings and loan practices in 1970[31] one institution charged two percent of the original amount of the loan, another six months' interest on the original amount of the loan, but the formula for the majority would fall within the proposals in SB 200 (Gregorio) which provided a maximum of six months' interest on the unpaid balance with two important exceptions mentioned later.

Frequently lenders have exacted a prepayment penalty even when they have accelerated the loan.[32]

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[30]A typical clause as cited in Lazzareschi Investment Company v. San Francisco Federal S&L, 22 CA 3d 303 (1971) reads: "Privilege is reserved to make additional payments on the principal of this indebtedness at any time without penalty, except that as to any payment made which exceeds 20 percentum of the original principal amount of this loan during any successive 12 months' period beginning with the date of this promissory note, the undersigned agree to pay, as consideration for the acceptance of such prepayment, six months' advance interest on that part of the aggregate amount of all prepayments in excess of such 20 percentum. The privilege of paying amounts not in excess of such 20 percentum of the original principal sum without consideration shall be noncumulative, if not exercised. The undersigned agree that such six months' advance interest shall be due and payable whether such payment is voluntary or involuntary, including any prepayment effected by the exercise of any acceleration clause provided for herein." (Underlining added.)

[31]Dupuy, Reg, "Savings and Loan Practices", California Real Estate Magazine, September 1970, at page 26.

[32]This practice was held valid in Hellbaum v. Lytton S&L Association, 274 CA 2d 456 (1969), and was also the circumstance in Tucker, supra.

FHA and VA permit no prepayment penalty. New York permits no penalty after three years from the date of the loan.[33]

The California Association of Realtors believes that a limited prepayment penalty is a desirable device effective during the early years of the loan. In effect, it permits the lender to recoup costs which are not totally recompensed at the time the loan is made and which cannot be recouped if the loan is terminated at too early a date.

Historically, this was the reason cited for the prepayment penalty and has been the traditional reason for sustaining it.[34] Significantly, however, the fact that lenders increasingly charge points or loan fees for making a new loan or accepting an assumption reduces the validity of the original purpose of the prepayment penalty. We support the terms of SB 200 which is one of the subjects of this hearing. That bill would prohibit a prepayment penalty after five years from execution of the note; permit prepayment of 20 percent of the obligation in any one year without penalty, cumulatively, and limit any prepayment penalty which was authorized during the first five years to an amount not to exceed six months' interest on the

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[33]NY Gen. Obligation Law, 5-501(3)(b), which by its terms does not "apply to the extent such provisions are inconsistent with any federal law or regulation".

[34]See Bonanno, supra, at page 295.

unpaid principal balance.

This fee represents a significant amount. For example, the permitted prepayment fee on a $25,000 loan at 10 percent (certainly not an unusual loan today) would be $1,000, <u>but some lenders are charging more</u>. Some, as indicated above, also levy prepayment fees based on the original loan amount even after the loan has been in existence for ten or fifteen years.

Again, the prepayment clause approaches a contract of adhesion. The borrower, if he is aware of it, has essentially no option but to accept it for he bargains on interest and points.

The facets of SB 200 which have been most controversial have been the limitation of any penalty to the first five years of the contract and the <u>cumulative</u> permission to pay off 20 percent per year (or to deduct 20 percent cumulatively) before computation of the penalty.

Actually, these are not unique conditions. Many institutional lenders in California today use contracts which embody one or both of these principles, although the formulas vary from case to case.

We support both of those facets of SB 200. After the contract has been in existence for a reasonable term---and five years would seem to be totally reasonable for these purposes---the lender has certainly recouped his initial costs. The 20 percent deduction is a device to scale the penalty downward during that first five-year term.

An attack was made (not under California Association of Realtors' sponsorship) on the prepayment penalty as a liquidated damage provision and thus void or uncollectable under California statutory restraints on liquidated damages.[35] The court in Meyers v. Home S&L Association[36] held under the provisions of the statute that the clause was not of a type contemplated by the liquidated damage provision. Significantly, however, the court said: "The bulk of plaintiff's arguments regarding the social and economic undesirable aspects of a loan transaction involving such a prepayment clause is more appropriately addressed to the Legislature than the courts and is not persuasive or controlling of our decision herein."

Obviously, the remedy is legislative by statute and that is what we request.

In a companion action, Meyers v. Beverly Hills Federal S&L Association[37], the United States Court of Appeals held that "Federal law preempts the field of prepayments of real estate loans to

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[35]Civil Code 1670-1671.

[36]38 CA 3d 544 (1974).

[37]499 F 2d 1145 (1974).

federally-chartered savings and loan associations, so that any California law in the area is inapplicable to federal savings and loan associations operating within California." The federal rule specified by the Federal Home Loan Bank Board regulations[38] limits the penalty to a maximum of an amount equivalent to six months' advance interest on the amount prepaid during any 12-month period which exceeds 20 percent of the original principal amount of the loan.

Thus, the federal rule which is preempted is equivalent to the proposal in SB 200 with the two important distinctions separately discussed: namely, denial of a penalty after five years and the accumulative 20 percent feature.

It should be observed, of course, that the federal rule is permissive and maximum, but apparently the state may not substitute some other rule less than that maximum and enforce it for federally-chartered institutions.

The argument is made, therefore, that state institutions must be parallel. The New York experience, however, indicates that that approach has not been followed in that jurisdiction.

It is important to observe, of course, that there has been

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[38]12 C.F.R. 545.6-12(b).

opposition to the imposition of any rule in California. Certainly the federal rule applicable to all lenders in this state would be preferable to no rule at all, for penalties are being exacted in excess of an equivalent to the federal rule.

We urge adoption of legislation equivalent to SB 200, but are again prepared to discuss with the committee in depth, or with others interested, alternatives to the specifics of that proposal.

Late Charges:

While late charges are not a cost associated with transfers of real property, they are an important factor in real estate financing and one which, in our view, should be regulated.

A late charge serves a legitimate function. It tends to produce promptness of payment which is socially desirable and certainly something which the lender should expect, and to reimburse the lender for his costs arising from the lateness of the payment. These costs would include the loss of the use of the money for the period for which it was late and the costs incident to the collection itself, including the costs of notices, accounting, and conceivably a personal contact. On the other hand, in the past at least, there have been punitive charges levied for late payment which, in our belief, were, or are, unconscionable particularly when used as a device to produce additional revenue for the lender rather then the legitimate device of compensating him for his costs. In 1972 we were able to document cases in which late charges amounted to 20 percent of the monthly payment, to one percent per day of the monthly payment, or two percent of the total unpaid balance.

Then, in 1972 the courts[39] held that a clause specifying an arbitrary late charge constituted, in fact, liquidated damages which were statutorily void.[40] In that case, the late charge was equivalent to one percent of the original amount of the note.

Some lenders, however, had characterized their late charges as additional interest, but in 1973 the courts again concluded that such a device (in that case an increase of interest at a rate of two percent per annum for the period for which the payment was late) constituted liquidated damages and was thus void.[41]

The court observed in this latter action that liquidated damages could be validly assessed if the exact amount of damage which could be validly anticipated by the parties was extremely difficult or impractical to fix. They said: "Although we conclude on the record

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[39] Clermont v. Secured Investment Corporation, 25 CA 3d 766 (1972).

[40] Civil Code 1670-1671.

[41] Garrett v. Coast and Southern Federal S&L, 9 C 3d 731 (1973).

before us that defendant failed in its burden of establishing extreme difficulty in anticipating and fixing damages for the breach of an installment payment, it is possible that on a proper showing defendant might have been able to establish the impracticability of prospectively fixing its actual damages resulting from a default in an installment payment."

It is the belief of the California Association of Realtors that because in many situations the amount of damages is small, and the amount of penalty is small, that it is impractical from purely a cost standpoint, if not otherwise, to fix the actual damages in a particular situation. We might be talking about $1.50 or $5.00 on a particular payment and the computation of the damage figure alone would cost in excess of the amount to be collected. Thus, we believe that a statutory formula which would establish permitted charges by fixing maximums should be enacted.

Bills to accomplish this purpose have been introduced at each session for the past five or six years.

As a matter of fact, the California Law Revision Commission in its general study of liquidated damages proposed[42] the validation of a stipulated contract late payment charge if it did not exceed limits outlined in that legislation. Their study of that matter

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[42] In SB 1532 (Stevens) 1974.

in published form is available.[43] The Commission withdrew the bill, however, before its first hearing and is currently reviewing the situation ostensibly with the purpose of submitting new legislation in 1975.

Obviously, CAR will wish to see the specific proposals evolved by the Law Revision Commission.

Although general legislation setting one rule to be followed by all lenders on real property secured contracts has consistently failed in the Legislature, SB 304 was enacted in 1973 relating to transactions negotiated by real estate licensees who are termed in that connection "mortgage loan brokers". The formula[44] limits the penalty to ten percent of that portion of the installment due representing principal and interest, but permitting a minimum charge of $5.00 and contains other important language with respect to multiple penalties, grace period and other factors.

Although the liquidated damage decisions are not new, they in essence have not been effective, to our understanding. The amounts are so small as to again constitute a sum of such magnitude as to be unworthy of litigation. A new class action would be perhaps the only solution with its time delays, costs and imperfections.

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[43] 11 California Law Revision Commission 1201.

[44] Business and Professions Code 10242.5.

We believe a statutory formula to be preferable.

At this time, subject to a review of the Law Revision Commission recommendations, we would recommend the establishment of a formula either applicable to loans on residential property of four units or less or loans with an installment of less than $500 per month (which was the Law Revision Commission approach) of a maximum of ten percent of that portion of the installment representing principal and interest with a minimum of $5.00 and a 10-day grace period provided.

Miscellaneous Finance Charges:

While conceptually the compensation paid to the lender for a loan is thought to be the interest paid for the use of that money for the term in which the loan is in effect, in actuality the lender today collects from the parties of a real property sale transaction many other fees either as reimbursement for costs incurred or as an enhancement of the basic compensation represented by interest.

Thus, although lenders at one time included a factor for all of their administrative overhead and costs within the interest component on the loan, that is no longer true.

The major additional lender fees are those termed "points" or otherwise and variously called loan fees, loan initiation fees, or discount fees. They are sometimes paid by the buyer, sometimes by the seller and sometimes divided between them.

The California Association of Realtors agrees that the lender must be compensated for his costs in setting up the loan and the other administrative work which must be accomplished. Beyond this, of course, interest reflects the cost of the money to the lender from whatever source, some factor for his general overhead and the continuous servicing and processing of the loan during its term, and a margin for profit.

We agree that there is logic in the separation from the interest component of initial loan costs through the device of a loan fee or points and that a combination of interest and points is appropriate as compensation for borrowing.

We will comment specifically on usury below, but aside from that consideration do not advocate further controls on the basic cost of money.

It is the host of miscellaneous fees beyond interest and points which have introduced a new element to the real property transaction in recent years.

For example, in a typical transaction you will now find a photo fee, an appraisal fee, a tax service fee (to check the status of tax payments on the property), a warehouse fee (in some transactions--a payment for money held after commitment but before loan), a document fee (for the preparation of the loan documents and associated documents themselves, including the truth-in-lending disclosure document), a drawing fee which is a variation of the document fee, a fee for a credit report, an inspection fee and perhaps others. They are apparently limited only by the imagination of the lender. And many of them come as a surprise to the buyer and seller in the transaction. They well may total several hundreds of dollars in addition to the points and interest.

To some extent truth-in-lending attempted to deal with this problem by requiring the specification of one overall figure: the annual percentage rate, which was calculated to include many of these costs. Truth-in-lending, however, has perhaps produced as much or more confusion in lending as it has truth.

We do not have specific recommendations to the committee on this point, but would suggest an examination of this question to see if some simplification can be evolved and the evolution of some reasonable relationship of this host of added charges to the purposes of the loan fee (points) in the first instance and to the interest charged.

The Federal Reserve Board, for example, estimated in mid-1970 that when average contract interest rates were 8.29% that fees and charges amounted to an equivalent of an additional 1.11%.[45] It is apparent that costs have risen since that time.

Usury:

Usury is the lending of money at exorbitant rates of interest. In response to usurious practices most states, including California, have enacted laws governing interest rates.

The first California statute was adopted as an initiative in 1919.[46]

In 1934 a new section was added to the Constitution on usury which, in part, supplanted, to the extent inconsistent with, the provisions of the initiative statute.[47] That section reads in part: "No person...shall by charging any fee, bonus, commission, discount or other compensation receive from a borrower more than ten percent per annum upon any loan or forebearance of any money, goods, or other things in action..." Exempt from the constitutional provision, however, are banks, savings and loan associations, credit unions and other similar regulated institutional lenders. Thus, the

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[45]As quoted in Bonanno, supra, at page 269.

[46]Stats. of 1919, p. lxxxiii, set forth in West's Annotated California Civil Cide, Section 1916-1, et seq.

[47]Art. XX, Sec. 22.

exempt institutions are not limited in the amount of interest or other compensation which they can charge.

But, nonetheless, usury has an important limiting effect on the residential mortgage market in today's conditions for it does affect loans made by insurance companies, retirement funds (apparently other than public retirement funds), other similar institutional sources and private individuals. While these sources of mortgage money may not appear prominently in the marketplace, they have actually been responsible for hundreds of millions of dollars of mortgage loans in California which are normally placed through and serviced by financial institutions who are themselves exempt or real estate licensees under the Mortgage Loan Brokers Law.[48]

Because in today's money market these persons are limited to receiving ten percent (with some limited exceptions on which I will not elaborate unless the committee wishes such elaboration), they have significantly withdrawn from the residential mortgage market which has contributed to the chilling effect of the total entire situation where many exempt financial institutions unaffected by the Usury Law are without funds to provide an adequate magnitude to handle the needs of property transfers today.

Obviously, any basic change in usury limitations, since they

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[48]Business and Professions Code 10240, et seq.

reside in the Constitution and an initiative statute, can only be changed by the people at an election. The California Association of Realtors would not suggest and would not favor elimination of usury limitations---and, frankly, it is, in all probability, politically impossible in any event.

The proposed Uniform Consumer Credit Code[49] proposes a maximum interest rate of 36 percent on the theory that realism is necessary and that necessitous borrowers should not be driven out of the legitimate regulated lending market into the hands of loan sharks. Parenthetically, CAR does not agree with the limits proposed in that Uniform Act.

The California modification of the Uniform Act has been presented to the Legislature in each of the past three sessions[50]. That proposal, or further modifications of it, will be considered at hearings of the Senate Judiciary Committee next week. The bill, as proposed, however, does not deal with the basic question of the constitutionally-imposed limitation on usury.

Most states have some type of usury limitation, generally in statute rather than in constitution, and many of them have modified

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[49]National Conference of Commissioners on Uniform State Laws (1968).

[50]The latest, SB 3 (Song) 1973.

usury limits in recent years. A new approach has been to set a floating rate limit, as has recently been adopted by Delaware, as an example, establishing the limit at four percent in excess of the Federal Reserve Board discount rate for banks. We do not have a specific proposal to make to you and time exists in the sense that no proposal could be submitted to the voters until the election in June, 1976, in any event, but we intend to continually review the matter with the possibility of presenting a proposal during the next year and would hope that your committee would also review it.

There are some ancillary problems in the usury field. In August of this year when the FHA interest rate went to 9.5% plus one point charged to the buyer and five, six or seven points charged to the seller, the question was raised as to whether the combination of these factors constituted a violation of the Usury Law. As previously mentioned, one point normally translates to the equivalent of one-eighth percent of interest. Some mortgage bankers handling loans for nonexempt institutional lenders withdrew from the market on FHA loans. Since conventional loans at the time were going at 10.5% plus two points, obviously those same lenders were barred from the conventional market.

The real question which arose was whether points paid by the seller to a transaction (and this is the importance of distinguishing points from interest) constituted a violation of the Usury Law. The position of CAR is that they do not since they are not "received from a borrower" in the language of the constitutional limitation. The question has been posed of the Attorney General and his opinion is due shortly.

Some statutory clarification of this point in early 1975 may be essential.

Title and Escrow Charges:

Obviously, title and escrow charges represent costs chargeable to either seller or buyer in a transfer of real property. The costs, particularly for title charges, are rooted in the system of recording titles in this state and are, thus, not susceptible easily to change.

We are unaware of any proposals which may have been made to your committee and which are, thus, under review at this hearing for regulation or change in these charges or practices.

The Title Insurance Law was extensively rewritten in 1973, operative only on the first of January this year,[51] conferring upon the Insurance Commissioner certain review and adjustment powers with respect to title insurance rates and escrow charges of controlled escrow companies (of title entities). This law has had little time to operate and the results or impact have not yet clearly emerged.

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[51] SB 1293 (Zenovich) 1973; Chapter 1130, Stats. of 1973.

We would believe some time for evaluation might be required.

The Insurance Commissioner, under his authority stemming from the Title Insurance Law, promulgated a new series of inhibitions on title entities earlier this year[52] ostensibly to increase competition in the title industry. The effect of that bulletin will probably be to curb abusive rebate practices, a goal with which CAR totally agrees, although we have some disagreements with the detail of some of those inhibitions on which we are engaged in dialogue with the Commissioner's office. Again, the impact as it might be measured in the costs of title insurance have not yet become apparent.

The escrow business is extremely competitive. Escrows are held in California by title entities, independent escrow companies licensed by the Department of Corporations under the Escrow Law[53], banks, savings and loan institutions, attorneys and real estate brokers (when in conjunction with a real property transaction in which they are otherwise engaged). We know of no proposals to regulate escrow rates in view of this competition, nor of any demonstrated need for it.

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[52] Bulletin 74-2, Insurance Commissioner, January 1974, "Title Rebates".

[53] Financial Code 17000, et seq.

Real Estate Commissions:

Your agenda lists among the items to be considered in this analysis of the costs of real property financing transactions the item of real estate commissions. We are unaware of any proposals which have been advanced to your committee or to the Legislature to define, regulate or otherwise proscribe the compensation paid to a real estate licensee for the services performed in a real property sale transaction. Thus, it is difficult for us to address any particular facet of the question.

For background, however, let me make these comments to the committee.

There is no standard for real estate commissions in California. There are no suggested commission schedules and there is no uniformity in commission charges. By consent decree entered into by the California Real Estate Association, the predecessor to the California Association of Realtors, with the Department of Justice[54], our association and (now) all local boards of Realtors are precluded from even suggesting commissions or from surveying existing commission practices.

Commissions do vary, however, with the type of transaction.

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Six percent is frequently mentioned as a prevalent commission on residential sales, while ten percent would reportedly be more common on sales of vacant land. On the other hand, on large industrial or commercial transactions the commission is subject to negotiation and can involve a sliding scale dependent on the eventual amount of the sale.

But even in the residential field competition and variation does exist. A brokerage firm in Fairfield, California, advertises a three percent commission, others advertise their services for a flat fee. For example, a broker here in San Diego and at least one in Sacramento provide services for a flat $800, while another advertises $800 plus one percent.

All of these compensation factors are contingent upon the consummation of a sale. If there is no sale, no commission is paid. The real estate licensee will frequently perform essentially all his functions and consume equal resources in an effort to conclude a sale, but because of factors beyond his and the principal's control the sale will not be consummated and no commission will be paid. We referred earlier in our testimony to current financing conditions which have produced a "drop out" rate of up to 20 percent in some circumstances. Additionally, there are a group of licensees termed "real estate counselors"[55] who provide a service to buyers or

[55]Within the infrastructure of the National Association of Realtors there exists the American Society of Real Estate Counselors.

sellers at a stipulated and negotiated fee regardless of whether a sale is consummated or not. There is little indication, however, of the acceptance of this concept by buyers or sellers in the residential real property market. There has been no evidenced willingness, to this point in time, of public acceptance of a contract for payment of a real estate counseling fee which is not contingent upon an actual transfer of the property.

Key elements in earning a commission, as cited by a recent California court decision[56], are the existence of a written contract of agency with the real estate licensee and the exercise of due diligence by that licensee in effecting the sale.

The essential service, the performance of which requires a real estate license, is the selling, offering for sale, leasing, offering for lease, etc. of real property.[57]

But there are many elements of service which go into the production of the sale. Not all of these services are performed by every real estate licensee. Some brokers who charge a commission of less than, say, six percent, may not perform all of them. We understand, for example, that some brokers offering services in connection with a sale for a flat fee do not provide all of these elements of service---

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[56] Blank v. Borden, (1974).

[57] Business and Professions Code 10131.1.

so that the competition which exists in the marketplace exists not only as to price, but as to the service which is performed---and, obviously, the quality of service.

Some other brokers who may, for example, charge seven percent in a residential transaction include a one-year service contract covering repairs to certain structural elements of the residence (analogous to a TV service contract).

Thus, an examination of commissions must relate to how many services are performed, and how well.

Among the services which are performed in essentially the majority of transactions (and the list is illustrative rather than exhaustive) are the following:

(1) Listing the property for sale. I have appended to this statement an example of a listing agreement. The listing process almost invariably includes an inspection of the property and a detailed inventory of its features, facilities and amenities.

(2) A check of items such as zoning, special assessments outstanding, possible relationship to geologic hazard zones under the Alquist-Priolo Act, the Coastal Zone and like jurisdictions, and obtaining a list of covenants, conditions and restrictions from the County Recorder or title company which might affect the utilization of the property.

(3) Estimating its valuation as a means of assisting the seller in setting his offering sale price. This would include a determination of recent comparable sales, the assessed valuation and replacement costs.

(4) Obtaining, where applicable, copies of mandated city or county reports on use, occupancy or zoning or like data which must be furnished by the seller to the buyer.

(5) Ascertainment of whether a pest control inspection should be made, ordering that inspection with appropriate instructions and reviewing the recommendations of that report with the principals.

(6) Submission of the listing to a multiple listing service when a broader exposure to the market is desired by the seller or the broker with its consequent costs in MLS memberships and listing fees. It should be emphasized that real estate licensees are not required to belong to multiple listing services or utilize their services.

(7) Installation of a "for sale" sign on the property.

(8) Advertising the property, typically in newspapers.

(9) Interviewing prospective buyers, qualifying them in the sense of ascertaining whether they have resources to acquire the property and a desire for the type of property listed (and, thus, screening the seller from dealing with a host of "prospects" who have no real

interest). In the typical residential sale transaction the property may be shown to an average of seven to ten different families, some on repeated occasions. This process may be expedited through utilization of prospects for purchase selected from a previously prepared list of those seeking properties of the nature advertised.

(10) Activity for an average of 45 days on a, say, 90-day listing, before an offer is made and accepted. 50 percent of residential listings normally will be sold, while efforts will continue on the remaining 50 percent without success.

(11) Conveyance of all offers to the seller and since 90 to 95 percent of those offers will be presented with conditions or a counter offer, negotiating those conditions between the prospective principals.

(12) Finding financing for the buyer. This will involve contact with lenders to ascertain the availability of financing, the qualification of the buyer for financing, and the most favorable terms available. In the typical transaction, the buyer and the lender never come face-to-face---the negotiations are concluded by the real estate licensee.

(13) Prepare escrow instructions.

(14) Follow with periodic checks to ascertain if the mutual contingencies or conditions of the escrow are satisfied and assist in

securing their satisfaction---this will normally consume an average of another 45 days.

(15) Accept and handle complaints of buyer or seller respecting the transaction which may have already been concluded.

How much does a broker licensee obtain for himself from such a transaction on which the commission might be six percent of the sale price?

Attached to my testimony is a copy of a chart titled "Budgeting the 'Company Dollar'".[58]

The first of the pie charts represents the gross income dollar which is all of the six percent in the case we are using. Of this share you will see that 33 percent is left as the "company dollar", or the share of the broker who is in business. The second pie chart "The Company Dollar" shows the distribution of this sum and indicates that the broker's own compensation which is here labeled as profit, but which actually, of course, includes the value of his own services rendered, amounts from 20 to 30 percent of this remainder.

If the gross commissions obtained by a broker (obviously from multiple transactions) are $100,000, $67,000 of that is paid to salesmen

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[58] Adams, Barnard, "Budgeting the 'Company Dollar'", _Increase Real Estate Office Profits Through Effective Administration_, California Real Estate Association, 1965.

(those associated with his own office and those of cooperating offices through multiple listing or otherwise), whereas $33,000 is left for the "company dollar". Overhead, and the various items are designated on the chart, occupy an average of 75% of this remainder, leaving for the broker's share, here designated as profit, an average of $8,250 of the gross $100,000 commission. Translated another way, this represents one-half of one percent of the sale price of the property.

So, the broker himself is netting one-half of one percent.

And let me assure you that real estate licensees in California are not making exorbitant returns from their participation in the real estate business. Attached, also, is a recent article from the California Real Estate Association magazine disclosing the results of a survey of brokers and salesmen (a sampling) who are readers of the <u>California Real Estate Magazine</u>.[59] Other data has been presented to you on Realtor compensation by the Department of Real Estate.

There are today in California roughly 62,500 active real estate brokers and over 90,000 active real estate salespersons. There <u>is</u> competition in this business.

It should be emphasized, also, that there is no compulsion to

[59] California Real Estate Magazine, October 1974.

utilize the services of a real estate licensee in the completion of a real property sales transaction. Any person may, obviously, negotiate the purchase or sale of his own property without the services of a licensee. Significant numbers of persons do so each year.

Thus, we would conclude that there is no need to regulate by statute the compensation paid in a real estate sales transaction for the services of a real estate licensee. The California Association of Realtors would oppose such regulation if proposals were advanced for it (and, as indicated earlier, we are unaware of any such proposals which may have been made to the Legislature). Beyond this, there may be a constitutional question with respect to any such proposal.[60]

Conclusion:

The costs associated with real property financing transactions are high. Those costs are preventing citizens of California from buying and selling residential property, in some cases. This is a matter of state interest.

Many of the costs, however, are not susceptible of effective state control or regulation. The marketplace, through the element

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[60]For example, authority in a licensing statute for the regulation of dry cleaning prices by the State Board of Dry Cleaners was found invalid on constitutional grounds in State Board of Dry Cleaners v. Thrift-D-Lux Cleaners, Inc., 40 C 2d 436, 254 P 2d 29.

of competition, can be expected to achieve a variation in those costs which are possible in today's economic climate.

On the other hand, there are areas in which the state or other governmental units have already statutorily lent assistance, established precedent for regulation, or have assisted one party to the transaction in his relationships with the other. Specifically, we do believe that legislation is desirable and necessary to restrict acceleration practices (and integrally and essentially simultaneously limit assumption costs), to limit prepayment penalties and late charges and we recommend the enactment of such legislation in the form outlined in our statement today.

We appreciate this opportunity to present our recommendations to the committee and stand ready to work with the committee and staff to any degree possible in this subject area.

DG:jas

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ADDRESS

PRICE

EQUITY

ROOMS BEDROOMS BATHS

GARAGE AGE LB

LT. SIZE ZONED

LEGAL

TOUR ☐ YES ☐ NO COMP N/S__________ COMPUTER

PICTURE ☐ YES ☐ NO COORD E/W__________ STYLE__________

LIV X	R/O ELEC. GAS	LENDER
DIN X	DISP DISH W	BAL. $ @ % YEARS
BRK X	FLOORS	MO. $ LN #
FAM X	FENCE SPKLR.	PI ☐ PITI ☐ TAX $ EX HO/VET
KIT X	POOL	FHA ☐ VA ☐ CONV ☐
BED X	CURBS WALKS	2ND $ @ % YEARS
X	HEAT A/C	PYMT $ MO.
X	ROOF	HOLDER ASSUM
X	EXT WALL	POSSESSION POINTS
X	INT WALL	NEW TERMS
LNDRY 220	HI SCHOOL	SEPTIC
PATIO FIRPL	JR SCHOOL	SEWER IN ☐ CONN ☐ PAID ☐
ENTRY HALL	ELEM. SCHOOL	ASSESSMENT $

OWNER PHONE

OFFICE # SALESMAN PHONE

DIRECTIONS NR. CORNER

REMARKS

TRADE COMM.

The above information is not a part of this listing agreement. It has been furnished by the seller and/or other sources, and is not guaranteed by the broker.

For and in consideration of services to be performed by____________________hereinafter called broker, I hereby employ said broker as my sole agent and grant him the exclusive right to sell and accept a deposit thereon, that said real property situated in the City of__________County of__________Legally described as:__________

__________Known as:__________

I hereby grant said broker the right to sell same for the price of $__________on the following terms $__________in cash; balance payable__________. (Commission)

This employment and sole right to sell shall continue irrevocably from the date hereof until the expiration date below and I agree to pay Broker__________per cent of the selling price or any other price acceptable to me as and for the compensation of said Broker hereunder in the event of a sale or exchange of said real property by said Broker or any other, including myself, while this contract is in force or should a sale or exchange be made or an agreement to sell or exchange be entered into by seller within ninety (90) days after the termination of this authorization, to or with parties with whom Broker negotiated during the term hereof, or to or with parties who became interested in said property, directly or indirectly, as a result of any of the activities or efforts of Broker, or Broker's employees, including, but not limited to, the placing of a "For Sale" sign, advertising or personal referrals or contacts, unless such sale or exchange is made or agreement or exchange entered into during the term of a valid exclusive authorization to sell given by seller to a licensed real estate Broker other than Broker, seller agrees to pay to Broker the commission set forth herein, I agree to pay Broker said per cent of the listing price if I withdraw said property from sale or exchange, or otherwise prevent performance hereunder by Broker.

It is understood that said Broker is a member of the Sacramento Multiple Listing Service of the Sacramento Board of Realtors and it is further agreed said Broker may refer this listing to members of the said Service who may act in cooperation with said Broker. Payment for commission or compensation hereunder shall be made by me only to Broker.

Evidence of good merchantable title to be in the form of Policy or Title Insurance herein issued by a responsible title company to be furnished and paid for by the seller. Interest, insurances, taxes and rent to be prorated from close of escrow unless otherwise designated.

If deposits or amounts paid on account of the purchase price are forfeited, Broker shall be entitled to one-half thereof, but not to exceed the amount of the commission.

Dated at Sacramento, California, this______day of__________, 19____.

We have read and received a copy of this exclusive listing.

Expiration date:______day of__________, 19____.

In the event Broker is required to commence legal action by reason of seller's breach of or failure to perform this agreement, seller agrees to pay to Broker reasonable attorneys' fees to be determined by the Court.

X____________________Seller__________
Date Signed Phone

X____________________Seller__________
Date Signed Address

Sole Owner Yes ☐ No ☐__________ Print Seller's Name__________

In consideration of the above employment, the undersigned broker agrees to use diligence in procuring a purchaser.

"The total commission agreed to between sellers and listing Broker is____% of the sales price. Said commission shall be divided____% to listing Broker and____% to selling Broker."

__________, Broker Tel.__________Address__________

__________, Salesman Tel.__________Address__________

BKR. CODE BKR. INIT__________ DATE__________ 6/74

Increase Real Estate Office Profits
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Pub CREA 1965

BUDGETING THE "COMPANY DOLLAR"

GROSS INCOME DOLLAR

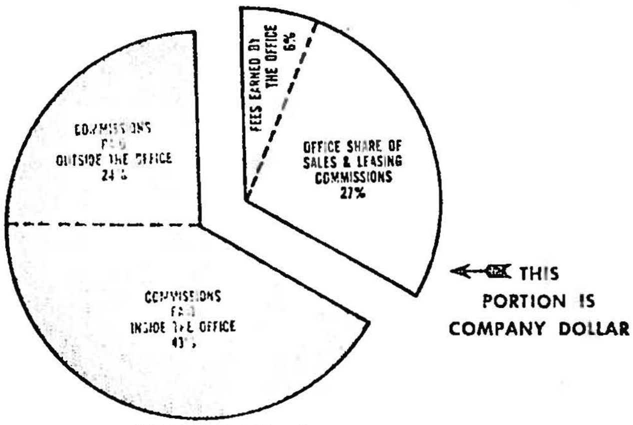

FIGURE NO. 2

THE COMPANY DOLLAR

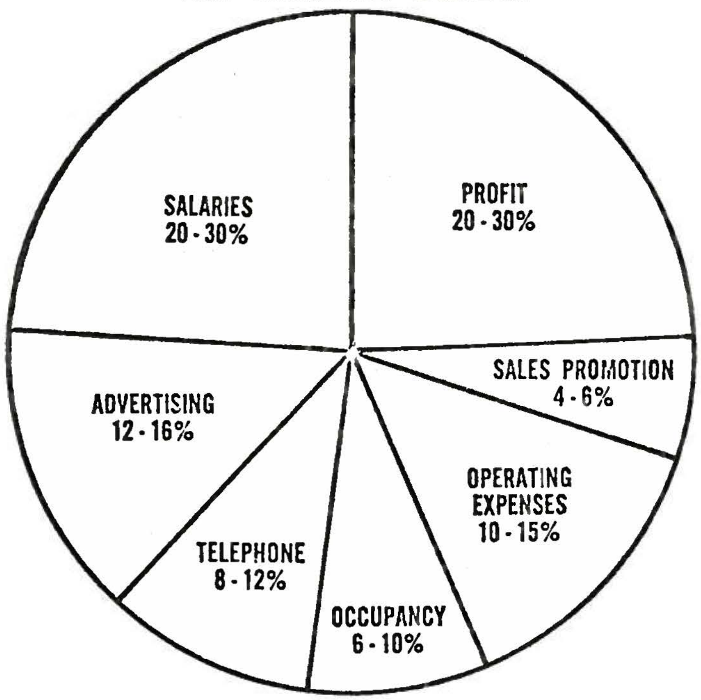

FIGURE NO. 3

By
Barnard S. Adams, Realtor

9

Survey Results Define 'Typical' CREM Reader

A middle-aged, college educated male who earns more than $20,000 per year is the "typical" Realtor reader of California Real Estate Magazine, according to a recent survey conducted by the magazine.

In an attempt to define the "typical" Realtor and Realtor-Associate, the editors of CREM sent a survey questionnaire to a random sampling of 2,000 members of California Association of Realtors in June.

A 19.5% response, divided almost equally between Realtors and Realtor-Associates, was received, and through the results, profiles of the "typical" reader were obtained.

The "typical" Realtor reader is male (77%), 50 to 65 years old (40%) with a college degree (39%). He earns over $20,000 per year (61%), and maintains an average of six bank accounts. Each bank account is in the $1,000 to $5,000 range (39%). He obtains an average of 55 property listings per year, each at an average value of $48,533. He spends an average of $5,749 per year on advertising and more than $500 per year on sales tools (57%).

The "typical" Realtor-Associate reader is also male (61%), 35 to 50 years old (37%), and has attended college (84%). He too, earns over $20,000 per year (31%) and maintains an average of four bank accounts. Each is under $1,000 (47%). He has an average of 19 property listings per year, each valued at an average of $42,563. He spends less than $500 per year on sales tools.

Realtor response to the survey was 50.5% of the total, with a 49.5% response from the Realtor-Associates.

In the Realtor group, 77% are male, while 18% are female. The question was not answered by 5%. There are more women in the Realtor-Associate category: 61%, male; 32%, female; 7%, no answer.

Other results from the survey are shown in tables on this page. Table 1 indicates the breakdown of ages of the two groups.

Table 1

AGE

	Realtors	Realtor-Associates
18 to 25 years	0%	4%
25 to 35 years	12	24
35 to 50 years	39	37
50 to 65 years	40	28
Over 65 years	9	7
	100%	100%

Table 2

INCOME LEVEL

	Realtors	Realtor-Associates
Under $10,000	4%	23%
$10,000 to $15,000	13	25
$15,000 to $20,000	18	21
Over $20,000	61	31
No answer	4	0
	100%	100%

Table 3

EDUCATION LEVEL

	Realtors	Realtor-Associates
High school	15%	10%
Some college	29	27
Two years college	16	22
College graduate	29	25
Graduate degree	10	10
No answer	1	10
	100%	100%

Table 4

USUAL BANK BALANCE

	Realtors	Realtor-Associates
Under $1,000	17%	47%
$1,000 to $5,000	39	36
$5,000 to $10,000	20	9
Over $10,000	13	8
No answer	11	0
	100%	100%

Table 5

SERVICES, PRODUCTS AS TOOLS

	Realtors	Realtor-Associates
Less than $500	40%	68%
$500 to $1,000	31	20
$1,000 to $5,000	17	5
$5,000 to $10,000	5	1
Over $10,0000	4	0
No answer	3	6
	100%	100%

The Realtors and Realtor-Associates are a highly educated, as table 2 shows. A total of 20% of the respondents, 10% in each group, have graduate degrees. At least 84% of all respondents have attended college.

They are also affluent, as table 3 indicates. Only 4% of the Realtors make less than $10,000, with 91% earning more than that. Seventy-seven percent of the Realtor-Associates earn more than $10,000 per year.

Tables 4 and 5, respectively, indicate the usual bank balances maintained and the amount spent each year on services and products as sales tools.

ASSEMBLYMAN ROBERT CLINE: Now, Mr. Gillies, you stated a couple of times that you feel that the variable interest rates proposal would be a limiting factor on the ability of the members of your Association to sell real property?

MR. GILLIES: No.

ASSEMBLYMAN CLINE: Do you feel that the variable interest rate would enhance their ability to sell real property?

MR. GILLIES: I think there would be a period of the education of the public to the variable interest device. The public is generally not aware of it. We think that if the Legislature could set one index to which the device would circulate that the public would be able to watch that index and know what is going to happen to them, etc., and it would be accepted just as all the other devices that have occurred in the new innovations in the last 40 or 50 years that mortgage financing have been accepted.

There would be a period of educational conversion. I think that at times, such as today, it would make money available at lower rates to new borrowers and, therefore, would facilitate sales because today they're charging 10½% on a conventional to help make up the 6% on loans that they made 15 or 20 years ago. They're trying to balance the portfolio at the expense of the new borrower. But if everybody moved in connection with the index, then the new borrower would pay the same as the difference between 9 and 10½ is extremely significant in the monthly payment.

ASSEMBLYMAN CLINE: What is the total volume of the real estate commissions earned by the members of your Association?

MR. GILLIES: I don't know. I will talk about commissions and what they are. If you estimate 750,000 transactions a year in the State, and I presume we don't participate in all those. We will try to produce a figure for you, if you like.

ASSEMBLYMAN CLINE: I was just doing some quick arithmetic -- 750,000 transactions, and let's take a $25,000 figure at a 6% commission; it would be about $1.1 billion in commissions earned.

MR. GILLIES: The figure might be in the range of a billion dollars. I would want to recheck that. I should emphasize, however, you don't need to use a realtor, a real estate broker to engage in the sale of real property. There are many sales that are consummated without broker negotiations.

ASSEMBLYMAN CLINE: Now, I certainly would agree to that. You mentioned that there was a 20% dropout of sales that are based on unacceptable lending provisions. What part of that 20% dropout do you feel is a real dropout based on the unavailability of money versus the unacceptability of terms in which that money is being offered.

MR. GILLIES: Well, I'm told there is always a dropout, and that the normal dropout with the people that I talked to is about 6% -- one of the parties wouldn't be able to qualify for financing, etc. After you've got an accepted offer -- that 6% of those transactions will drop out. The dropout rate is down to 20%. I think the 14% differential is entirely due to conditions in the financial market.

ASSEMBLYMAN CLINE: What kind of a dropout has been experienced when the mortgage rates were between 5½% and 7½% for example?

MR. GILLIES: I would assume that would be the 6% figure, I just mentioned, as compared to the 20% figure today.

ASSEMBLYMAN HAYDEN: If the California Real Estate Association has reached that particular point and your comment regarding the taping of the index -- the Commissioner, as you recall, Mr. Perlis, indicated that they were not at this point, ready to make any suggestions, but the existing situation on the federal level was certainly unsatisfactory, or it created problems, and that sort of thing. What I'm really concerned about is that I don't really know how the Legislature can make that determination without having some real guidance and direction from those who are involved directly in the field so that eventually we're going to have to get some.

MR. GILLIES: I think we would probably be prepared to propose legislation and we would consult with the industries involved prior to doing so.

ASSEMBLYMAN HAYDEN: For the next session -- are you talking about next month?

MR. GILLIES: Yes . . . to eliminate the maximum terms of the loan where the rate formula wasn't utilized. To retain the maximum 30-year term for the initial loan, but to permit an extension of that term through application of the variable rate formula, but not to such a point where amortization would be totally eliminated. In other words, some variation permitted. Now understand, of course, that if you're talking about a period of years, as the loan term is paid off -- let's say, you had an initial 30-year loan; say, you paid it down to 25 years before a rise in interest occurred. Then you could go back up to 30 years without violating the statute, in effect a novation for a new 30-year loan. That would have to be clarified in the law, but if you got to the point where amortization was eliminated, we don't believe that would be socially desirable. I don't believe the feds would accept that anyway. We discussed this with some of the federal people just this past weekend.

CHAIRMAN McALISTER: Mr. Gillies, although variable rate is the concept to me, I am troubled by the quickness by which we could reach the point where amortization would be eliminated, at least from the testimony yesterday a ½% rise in interest rates if it happened immediately before there was any payoff would reach the point where there was no further amortization. And, of course, it takes quite a few years before you paid off very much principal. Most of that comes near the end of the loan period.

MR. GILLIES: Unfortunately, Mr. McAlister, the example yesterday was a frightening one, and it dealt with today's conditions, I think you began with a 9½% loan or a 10% loan, etc. Obviously when you get into a loan in those magnitudes, the initial amortization -- the initial amount of the payment going into principal is less than 5% of the monthly payment normally. It's a very small amount.

CHAIRMAN McALISTER: Mr. Gillies. I have a few questions. Who does the broker act as an agent for?

MR. GILLIES: Whoever employs him and that's generally the seller in a residential transaction.

CHAIRMAN McALISTER: Any time you try to regulate businesses that also have federal implications, or federal regulations it seems that you do run into some of these problems of preemption or preemption type problems and you mentioned the question of federal preemption regarding prepayment penalties. If the State passes tougher or more restrictive regulation of prepayment penalties than the federal government would enact, and if this would be applicable only to state S & L's and not to federal chartered S & L's, would there not be a competitive disadvantage between the two?

MR. GILLIES: You might be creating a competitive advantage for the State S & L's, in certain market conditions. I can only say to you that of course, it would be a factor of competition, but New York has done it and it hasn't run the federal S & L's out of New York.

CHAIRMAN McALISTER: Along a similar line, yesterday we heard testimony from members of the savings and loan industry to the effect that on many occasions they sold their mortgage or deed of trust instruments to out-of-state financial institutions and we didn't have opportunities for due on sale and prepayment penalties that they would then have some difficulty in negotiating these instruments. Do you see a problem there?

MR. GILLIES: It's conceivable that there is a problem there, Mr. Chairman, but interestingly I think Mr. Ratcliff's testimony was that the Freddy Mack instrument, for example, contained the essential elements of SB 200 on prepayment. Federal

S & L's who want to sell their mortgages through Freddy Mack are going to have to conform to that. The federal regulation on federally chartered S & L's, as far as prepayment is concerned, is a maximum only. They may have no prepayment penalty if they desire or they may have one of any lesser magnitude. They may not exceed the limit set and obviously the federally chartered S & L that wants to market its paper with Freddy Mack is conforming to the Freddy Mack forum which in essence is in SB 200. At the maximum of five years and a decreasing scale of penalty from six months interest downward.

CHAIRMAN McALISTER: Didn't he say with regard to one of the other federal type agencies though, maybe it was Fanny Mae, that there was some kind of a system whereby if you negotiated the instrument out-of-state that there was a kind of resurrection or renewal of the due on sale.

MR. GILLIES: Well, his point was with Fanny Mae when owned it they will not allow you to exercise or to charge the prepayment penalty if prepayment occurs. But if Fanny Mae sells it then the provision that's legally in the estimate is resurrected.

CHAIRMAN McALISTER: Our next witness in Mr. Jerry Peters, a realtor.

MR. JERRY PETERS: Good morning. My comments will not be as all encompassing as Mr. Gillies. He covered a great variety of topics and very well. My situation or what I would like to talk about is work in more of the gut level of the real estate business. I deal with buyers and with sellers. There has been, as Mr. Gillies mentioned, a larger percentage of people dropping out of the market. Much of that is attributable to the higher rates because they cannot afford the higher payments or psychologically they refuse to pay that higher payment. Another aspect is that they refuse, also, to pay the higher point charges. I found it very common where these points tended to really lower the ceiling in terms of the ability of a buyer to purchase property -- where they had X dollars in cash for a downpayment anticipating a normal type of money market -- then when they obligated themselves to purchase a piece of property found that the cash they had earmarked for certain purposes wasn't adequate. It seems that there is a great variation between lending institutions on these points on the front end in acquiring a loan and there's also a great variation in the interest rates that these lending institutions do charge. My second comment will be on the assumption fees that various institutions charge. It seems there is a variation there. It will go anywhere from one point plus to a couple of hundred dollars to no points and fifty dollars or just the fee for a credit investigation. It seems the lenders are increasing their yield from a low yield of say eight and a half percent to a current yield of ten percent. On top of that charging their one point, two points or whatever it is to assume this loan plus a total new documentation fee.

ASSEMBLYMAN KNOX: Are they asking for title insurance, too?

MR. PETERS: No. They are not asking for title insurance.

ASSEMBLYMAN KNOX: But all the documentation, assumption fees.

MR. PETERS: Yes. One case in particular where the seller was on the verge of bankruptcy, for example, there was no chance of even negotiating anything lower than a current yield for the new buyer who happened to be a very strong buyer. There was also the points. It seems as if they are, in many cases, being very usurious as such in terms of the yield that they are getting. It seems to be a real conflict here where a loan is committed, a year previously, for a thirty-year term at a particular interest rate. For some odd reason the seller is forced to sell, then the seller does sell and the buyer wishes to assume that loan and pays down to the loan, then he gets these various charges charged to him. It's expensive.

ASSEMBLYMAN KNOX: Is there a loss in sales as a result of this?

MR. PETERS: Oh, yes, definitely.

ASSEMBLYMAN KNOX: Have you been in the real estate business long enough to know when it was a buyers market for money?

MR. PETERS: I've been in the business approximately five years.

ASSEMBLYMAN KNOX: So it's been essentially a sellers market for many years.

MR. PETERS: Yes. It's been a sellers market. Occasionally, it's been a buyers market for a very brief time span. At that point in time we didn't have prepayment penalties or we did have prepayment penalties but since it was a buyers market, interest rates were lower so we have what they called interest reduction fees.

ASSEMBLYMAN KNOX: Would you favor legislation that would drastically limit the type of fees that could be charged under these circumstances -- limiting acceleration clause, prepayment penalties, etc. -- provide for freer assumption of deeds of trust by a qualified buyer, and possibly also restrict real estate commissions.

MR. PETERS: Real estate commissions. I of course would be defensive on that point because various firms have various economies at scale. As Mr. Gillies mentioned, you have quite a range of fees charged and some fees, even in small firms are negotiated. In terms of loan fees I would suggest legislation to the point where they should be justifiable in some sense. When you have an assumption occasionally or when you have a selling in a tight money market, the buyer will try to shop around for better financing, of course. In a tight money market he won't be able to find it. So, he's stuck to going back to the existing lender. The existing lender, in many cases, will not increase the loan. We'll want an increase to a current rate or even a higher-than-market interest rate. This has happened. So the poor buyer is literally locked into a situation where he has to pay points and an interest rate above the market, simply because other lending institutions don't have money . . . .

ASSEMBLYMAN KNOX: We're a legislative committee and we're wondering what you suggest we do about that?

MR. PETERS: My suggestion would be a fee to be justifiable in terms of their costs. So the current buyer today isn't subsidizing the loans of yesterday, so to speak. I don't wish to deny the lenders, of course, the right to earn a return on their investment, but it isn't really their investment, it's the investment of the depositors. The depositors return is limited by statute and yet the return to the lending institution, at present, really is not.

ASSEMBLYMAN CULLEN: You've raised a point that troubles me. Why should a new buyer today going up and down the street and surveying the cost of money, be entitled to the money market of five years ago. Say, he's buying a GI loan at five and a half percent or six percent. Where is the equity for him to complain of the fact that the same lender on today's money market is eight percent? Now we'd be happy to loan you the money on this home by virtue of assuming this mortgage, but we are not going to loan it to you at rates of five years ago. Isn't that what you said?

MR. PETERS: No, not at all. As Mr. Gillies said when a person gets a loan on a particular property or borrows money, he enters into a contract for say, thirty years. He pays his points for the privilege of borrowing that money plus he shows the lender a yield of X percent per year. Why is it then that this loan is not, say, assumable by a buyer for . . . .

ASSEMBLYMAN CULLEN: Even though the interest might change?

MR. PETERS: Provided the buyer meets the qualifications that the lender will set upon a borrower of this nature.

ASSEMBLYMAN CULLEN: At the same interest?

MR. PETERS: Well, yes, at the same interest.

ASSEMBLYMAN CULLEN: All right. That's my point. What makes the buyer so special that he can come along five years later and register a complaint because the lender said no?

MR. PETERS: What jeopardizes the lenders position in terms of the contract he entered five years ago.

ASSEMBLYMAN CULLEN: Yes, well, you know a contract bilaterally is two people. In that contract it says, should you ever sell this property to another party it will be expected that you will satisfy your obligation to us, which may be twenty thousand dollars.

MR. PETERS: Doesn't that seem somewhat unilateral because the lender himself can sell his paper as such. Yet the buyer cannot sell the obligation.

ASSEMBLYMAN CULLEN: With respect to performance, it's agreed upon, at the time of the contract if the homeowner decided to dispose of the house which is the security for the loan. No, we don't want you moving this security around. We won't permit you to move this security around. You have to pay off the value of the home. Now, the way this is done is that the new buyer seeks out a loan, and he would like to go to the first lender and say he would like to leave it with you. Because you have a nice reputation and I certainly like this low interest rate of five years ago. What's wrong with the lender saying, fine, we'd just as soon lend to you on the same basis that we're lending to everyone else today. And the guy says, oh, no, I want you to loan to me on the same basis as five years ago?

MR. PETERS: Well, that is a very valid point. But my point in terms of assumption really, it would be, I think, beneficial, in terms of the home buyer and the home seller to allow loans as such to be assumed at whatever the existing interest rate was. My point, really, on the assumption, initially, was that in some cases lenders are allowing loans to be assumed. Some at the current rate, some above the current rate, because the buyer has no other direction to go in terms of a source of money.

ASSEMBLYMAN CULLEN: I'll grant you that and it seems to me that if the Legislature were to enact legislation requiring five and a half percent loans, to go on indefinitely or at least to the end of the life of the first loan, you'd really be putting lending institutions out of business. Because when they make the loan, they know as we've been told that the average turnover . . . .

MR. PETERS: Turnaround is twelve years, or six, whatever.

ASSEMBLYMAN CULLEN: And in turn if the Legislature were to mandate that the average turnover will be twenty five years, I think we'd have to go into a new line of business.

MR. PETERS: Very valid on that. But yet again, you do have the institutions that do charge, for example, when you have a 9% loan that is being assumed, the lender will say fine. You may assume it for two points for $50 at a 10½% interest rate when the prime in residential loans is actually 10%. This is my major concern here. In fact, when they are, so to speak, tapping the buyer for a point plus documentation fee, when in fact they're not doing documentation, appraisals and everything else, they should offer this loan at maybe a quarter of a point below prime. This would be reasonable. They're increasing their yield and in many cases replacing a stronger buyer with a weaker buyer. Their security is much improved. This is a point we should really investigate.

The other point I wish to bring up is the fact of prepayment penalties. It seems that when you charge a fee on the acquisition of some financing and then a very high fee in many cases on the payment of the loan, when you dispose of a piece of property, it, in effect, is making it an extreme hardship in the case of a seller, when he in turn wishes to take that equity and reinvest it in another property. This is something where we should have a time limit, as Mr. Gillies suggested, say possibly a five year period, that the prepayment penalty is in effect, or have the prepayment penalty graduated over a period of years to where after the normal turnaround period, the prepayment is not in effect.

ASSEMBLYMAN CLINE: Mr. Peters, have you experienced any loss of your ability to sell property based on the prepayment penalty?

MR. PETERS: Yes, I have. One instance was where a particular seller -- well, we had an interest reduction fee. The interest on a current loan was somewhere in the mid 8% range, and this was about a year ago. The rate at that time, a year and a half ago, was at 7½, 7¼, something of that nature. The seller was in a particular squeeze where really this interest rate (he hadn't owned the property for that long a period of time) and this interest reduction fee that they did charge would have literally eroded his total gain, and there really would be no benefit in him selling.

ASSEMBLYMAN CLINE: What did he finally do?

MR. PETERS: Hung onto the property. He didn't sell. He literally cancelled out of the sale.

ASSEMBLYMAN CLINE: It was more advantageous for him to hold on to the property?

MR. PETERS: Right.

ASSEMBLYMAN CLINE: In other words, then your only complaint was that you didn't get your share? Am I correct?

MR. PETERS: Well, I subsequently sold the property to another party.

ASSEMBLYMAN CLINE: And what happened?

MR. PETERS: The price was adjusted upward. So, in other words, the buyer had to pay more because of this situation.

ASSEMBLYMAN CLINE: What difference did it make to you?

MR. PETERS: Well, it doesn't make any difference to me, as such, except that I was under the impression this committee was here to find out how possible buyers would be able to afford properties more readily to make the housing market possibly more fluid than what it is.

ASSEMBLYMAN CLINE: So your taking a more altruistic approach to the problem. In your own economic livelihood?

MR. PETERS: My economic livelihood hasn't suffered greatly at all.

ASSEMBLYMAN CLINE: Well, do you think it has diminished the ability of other buyers to purchase property because the seller has to make a prepayment penalty?

MR. PETERS: In many cases we've lost sales because the seller has insisted on a price increase to the equivalent of the prepayment penalty and the buyer has refused to pay it.

ASSEMBLYMAN CLINE: Now, when you're faced with a situation such as that, where there is an objection to prepayment penalty, what percentage of the cases are you able to resolve the problem as opposed to having your sale drop out?

MR. PETERS: In many cases we can resolve the problem by going to the existing lender. In some cases, the existing lender is so high above the current market that it's not economically feasible to request that he increase the loan to what the buyer wishes. What I mean by high in terms of cost is points and interest.

ASSEMBLYMAN CLINE: What percentage of your business do you think is affected by that?

MR. PETERS: I would say more recently somewhere between the ten and fifteen percent range of my total business volume.

ASSEMBLYMAN CLINE: And what do you estimate is the average range of the residential property which you're selling?

MR. PETERS: Fifty thousand.

ASSEMBLYMAN CLINE: The average range is fifty thousand?

MR. PETERS. Yes. The median would be about fifty.

ASSEMBLYMAN CLINE: Mr. Chairman, there's something which was said earlier I wanted to ask and perhaps it could be made a part of the record. One of our witnesses yesterday, Mr. Bernie Mikell, has suggested that the change mix of the portfolios of the lendable funds, which are available, coming from say, certificates of deposit, or deposits, demand deposits or borrowing or equity on the basis of association, has changed. I think it might be valuable for the Committee to have for its record perhaps a ten year moving average of the changes in the sources of financing of states savings and loan institutions from the varying sources which are available to them for lendable funds. Could we make a request or perhaps Mr. Mikell could consent to develop some sort of information such as that. He has indicated that he would do so. Thank you.

CHAIRMAN McALISTER: Okay. Thank you Mr. Peters.

MR. PETERS: Thank you, sir.

CHAIRMAN McALISTER: Mr. Bill Mitchell, Realtor.

MR. BILL MITCHELL: I'm Bill Mitchell and I'm a real estate broker in La Jolla, California. Actually I started out on this fight back in 1970. I wrote a letter in 1970 to Congressman Rosenthal, who was then the Chairman of the Consumer Banking Committee on the federal level. He was the representative from New York, I believe, at the time, when he was investigating Christmas Clubs. I asked him to include in his investigation the very subjects that we are talking about today. I have a copy of the letter here. He wrote back to me and told me he would. And never heard another word about it. That was in 1970. I later cornered then Assemblyman Stull, in person, told him the plight of my observations since I've been in the real estate business and he was so interested that he asked me to send him a letter and mark it personal so he'd be sure to get it; which I did and very promptly got a reply at which time he said he was turning it over the Federal Investigating Committee and Banking. Never heard another word about it. Never saw anything in the newspapers or anything. I also sent a copy of the letter to Congressman Wilson at that time, in 1970. I finally just gave it up pretty much in frustration, feeling that I'm another citizen who is unheard and then later I took a course at UCSD -- a business course where the Professor happened to bring this up. I was asking him the question, "why is it that these things seem to be slanted in favor of the savings and loans", this is my opinion. He said, "because executives of the savings and loans write the legislation for savings and loans". He said, "that's why you didn't get anyplace". So, I just joined the crowd and sat back and didn't say anymore. Then suddenly, just recently, Assemblyman Craven sent me a copy of the letter stating that this hearing was going to be held and I jumped on the telephone immediately and asked to be heard. So now I feel like I am being heard, I think. It's kind of a touchy situation when we come out against savings and loans because being a real estate broker we rely on savings and loans and I have a lot of friends in the savings and loan business. If they hear about me talking here, there's probably going to be some resentment, but at this point I don't care. It has nothing to do with, as Robert Cline keeps bringing up, our commission or not. I've been in the real estate business for sixteen and a half years and I'm literally sick of the unfair advantage the savings and loans take over the public. I've watched this for all these years -- since 1958 -- of innocent, in my opinion, innocent and ignorant buyers paying fees that I think are unreasonable and unnecessary. I'm sorry that Mike

Cullen walked out because I wanted to challenge him on the question that he asked of Jerry Peters just before me. Well, it will come up in my presentation here so I -- maybe he'll be back by then. But my premise is that savings and loan associations are not committing illegal acts, to my knowledge. But they rather are taking advantage of the unknowing and ignorant public. There are no laws regulating savings and loans as you said, the usury laws don't apply to them and that's a big question mark in my opinion, as there are regulating ordinary loan brokers. It's apparently assumed that savings and loan associations are moral and they wouldn't take advantage of the public. They are a great moral institution for the good of the public. It seems to be the general attitude of the public and people in general. They think that they are just next to God. I contend that they do take advantage of the public whenever possible. They have an undue advantage over the public because they have the public off balance; the public is not knowledgable; even though we advise them as brokers whenever they sell a home and they acquire a loan. Most people who sell their homes feel that in this kind of a market, the way it's been rising, they sell it for a great amount of profit. Ever since I've been in the business, people have almost always sold their house for a little bit more than what they paid for it. They feel like they are making out like bandits. So, thousands of dollars are exchanging hands. Therefore, a few hundred dollars charged by a savings and loan is somewhat negligible, compared to what they are receiving. So they'll often times just go along like a cow being led to slaughter because they figure what's a few hundred dollars here or a few hundred dollars there. The same thing happens with termite companies, which is another fight I've been on. We may have to get another committee meeting. When I first entered real estate over sixteen years ago, it was common practice to charge fifty dollars to a hundred dollars to transfer a loan. And, incidentally, somebody asked if Jerry Peters had ever experienced a loose money market. When I first came in, you could borrow from a savings and loan at 5 3/4% and 6%, and we used to fight for 5 3/4% when they were asking 6%. It is common to charge a full point in transferring the loan. All they do is transfer it from one name to another name, and that could amount to -- like one transaction I had here a couple of years ago in La Jolla that I thought was very, very unfair and I went to bat for my client in this transaction. It made no difference in the money that I was going to receive because I was going to make the sale anyway. Sometimes we step beyond what we are required to do and fight for a buyer, and in this case, I sold this man a house while it was under construction and he got a brand new loan. And I will mention the name of the company -- it was the Home Savings and Loan of Los Angeles, and he got a brand new loan from them for $75,000, and it cost him at that time one point because the money was fairly loose at that time. Six months later, the man found himself in financial trouble, where he had to sell the house. He called me and asked me to sell it, so we sold it -- it was actually five months. We sold it a month later, which was a total of six months, and they said, we want a full point for your man to assume the loan, which meant another $750.

I've known sometimes, and I know that this institution has done it as well as other lending institutions that not only do they charge the full point to transfer the loan, but they actually attempt and some of them have actually completed it. I have never allowed them to do it because I just raise hell when they try it. That is, they also charged the seller the prepayment penalty at the same time, and I think that is immoral. It's not illegal for them to do it, but they try it. And if the broker screams and hollers, they oftentimes won't. At that time, I called up the President of the Home Savings and Loan in Los Angeles, and I told him what I thought of the whole situation. I said when money gets loose again, you may not find us giving you loans. In other words, it was an absolute threat that I brought to them, and he finally said, well, in this case, only in this case, and because you give us a lot of business, we'll waive the fee. But why should I have had to do that? If I hadn't done that, the buyer would have paid it, and the seller would have paid.

I can give a lot of other examples, too, but I don't want to take all day. You can talk to almost any escrow officer or any real estate broker and they'll tell you these things are going on constantly. I assume that most people, maybe it doesn't bug them -- I guess philosophical it really does -- it just gets to the core. I don't like to see that sort of thing going on.

Another situation on these prepayment penalties that I think is highly unfair, and on my own home I fought to the end recently, this happened to me with Central Federal Savings and

Loan. I'll name the names. I don't care if they want to try to sue me. Because I can document it, I can pull it out of my files and show exactly where they did it. At least four, maybe five occasioned where Central Federal Savings and Loan lent money on a house at eighty percent of the purchase price, then maybe three, four, maybe five years later, the same person says (I mean the buyers) the seller, says, okay, I want to sell my house. So we say, all right. We put it on the market at the current market value which is obviously higher because of our inflationary tendancies, and the lender says, so we get it sold, and we sell it cash to the loan; in other words, twenty percent down and we're asking for a new eighty percent loan. The lender comes up with a seventy percent commitment. So, consequently we can go anywhere else in town and get an eighty percent commitment. At the time when, the first couple of times this happened to me, I asked the manager of the branch at that time if they were trying to force the prepayment penalty. Oh, no he said, absolutely nothing like that. We wouldn't do that. And I said, well, why won't you lend eighty percent. He said, because we don't think that the house has gone up that much in value. But yet any other lending institution in the area would lend eighty percent of the purchase price of cash the loan, it was not an inflated value. We had a buyer ready, willing, and able to buy. And then I asked the question of the same branch manager if this same house were sitting next door and it was either free and clear or it had a loan with an S & L. Then I came to you and asked you for an eighty percent loan on it, would you give it to me then? And he said, no doubt.

And I said, well, then you're admitting to me that you are forcing the prepayment penalty. Oh no, nothing like that, he said. And I said, then, what are you doing? And I got no answer. So then, on about the fifth transaction I stopped going to them for my first loans, with the idea in mind that when my customer comes to me four or five years later and asks me to sell his house that I'm going to be confronted with a problem. So I avoided that lending institution as much as possible. On my own home, this happened, last year, 1973, and my house had gone up in value and I was able to get an eighty percent loan from anywhere else. And this was in the spring of 1973. The interest rates are seven and seven and a quarter at the time. So it was relatively a loose money market. And I sold my house. Sold it twice in two weeks. So that indicated that the value was in fact the value that it said. The first person wanted, I think he wanted two weeks to think -- to arrange the financing and I wanted to give him ten days and he looked for another house. And I said fine. My house is on the market one more week. Sold it at the same price to another individual which indicated that that was in fact the market value for the house. Central Federal Savings said, we'll lend seventy percent. They're pulling the same thing on me and I said wait a minute. So I finally, I coward to them and I said well, all right, but then I just won't give you any more loans in the future. I could see it causes problems later. And, in other words, as Robert Cline keeps indicating, he makes me feel like we're worried about our commission. Why sure. Anybody is worried about it but in these cases, we don't have to go to bat for buyers. We don't have to make sure the buyer gets a good loan now, so that later when we go to sell the house that he's going to come out better. But we do that. We try to do the best for the buyer that we possibly can find on the market. But in that case my wife took up the fight and she called up the head office of Central Federal Savings, and she told them that I was in the real estate business and brought a lot of loans and we think it's unfair when we can produce eighty percent loans elsewhere. And she presented her case pretty well and they said, well we have never waived a prepayment penalty in our entire history. Now this is what they said, I don't know whether that's true or not. They consented to waive half the prepayment penalty. So I gave it to her for spending money. Either that or get a good job -- but I'm just pointing that as another example of how they take advantage, unfair-advantage of the public. In most cases they have the seller over the barrel because he either asks the unable buyer to come up with more cash down, when this seventy percent loan commitment comes up, or he allows the buyer to go elsewhere to obtain a loan and he pays the prepayment penalty. Or he doesn't sell the house. And again, Mr. Cline wanted to know the percentage of times that we lose on that. I would say the percentage is ten or fifteen percent. A heck of a lot of money went to the lending institution when I didn't feel they deserved it. Because people are over the barrel. They have to sell their house. There was a poll taken one time at an annual sales conference by CIA and they were making the point that most people who sell their houses put their houses on the market because they must sell their house. They took a poll in the audience that day and it turned out ninety-five percent of the people who had recently had a transaction gave the reason why the people sold the house, and in most cases it was because they had to sell for some reason. Either financial; the house is too darned crowded for the number of kids they've got; or they're rambling around in the house and all the kids have left home; and they're pretty much in a position where they can't handle it or maybe they're retired and they can't handle the taxes any more. So they sell because they have to sell. And in this case these people are forced into prepayment penalties. They get the prepayment penalty and then they put it out of the higher interest rate to boot. I've got a transaction presently going. I didn't even think of it until we were sitting here and I was listening to the others speak. But, it happens to be on a four unit apartment building and when I went over to negotiate the price on it, the seller was very much influenced on much he would take by the fact that he has a fourteen hundred dollar prepayment penalty to pay. So our counter proposal was that he would sell at this price provided the buyer goes through La Jolla Savings and Loan. So I called La Jolla Federal Savings and Loan and I asked what kind of a loan they would make on this and they said we'll go sixty percent of our appraised value which means usually sixty percent of the purchase price. I've got seventy-five and eighty percent commitments from elsewhere. Home Savings and Loan -- our old friend again, will go eighty percent on it. Home Federal will go seventy-five percent. I think World Savings will go seventy-five percent. There's a lot of them that are just completely out of money so they won't lend at all. But the point that I am making here is why should this man be forced to pay fourteen hundred dollars. I'm going to make the sale anyway. So it makes no difference how much commission I'm going to make or whether I'm going to make the sale or not make the sale. But, I think it's unfair. Why should they be entitled to a fourteen hundred dollar prepayment penalty when in fact they won't lend the money. They're forcing him to go elsewhere. The buyer cannot come up with more than twenty to twenty-five percent down. She can't come up with forty percent down and not many buyers can. And the seller in this case cannot carry a second trust deed because he's in the process of purchasing another property; and he needs all the cash he can get in order to do it, otherwise he won't sell. So if it turned out that this was the only loan available at sixty percent, the deal would be off. And this would be one of the few percents where we would lose the sale. Again I was going to point out at this point that their security is not impaired and it's no threat to the lender in a situation like this.

Another subject that I've known -- now I haven't seen this happening in quite a long time, but I suspect that it must be floating around, but this happened to be Home Federal Savings and Loan. When I used to have a real estate company in Newport Beach and I've actually worked in the Orange County area; the Santa Barbara County area; I've worked the Los Angeles County and San Diego County and this seems to be the general trend among lenders, up to this point what I've talked about. In all of those counties they will just pull every little thing they can do to squeeze that extra dollar out of the people. And most people don't know when they sit down and read their contracts from the savings and loan just what they're reading and they're not attorneys. And you say, well ignorance is no excuse for the law. That's something I've been challenging for years and I'll stand alone on it and challenge it. I think ignorance is an excuse of the law in some cases. And I think that in a case like this when a person doesn't know, and he can't afford to hire an attorney for every step that he makes in life, that again, he shouldn't be taken advantage of when they stick all these little clauses in there where the lender can take advantage of them. And the point that I was making earlier is that there are no laws regulating these people and that's why I think there should be a law. There should be laws in all these fields regulating savings and loans. I don't think they should be considered to be moral anymore than any other person in existence or any other loan broker. I think that they should be required to be regulated by law so that they can't take advantage because they will. They're human beings too. But this was an example that came up with Home Federal Savings and Loan where they charged interest from the time the note was drawn in escrow. I didn't even notice this until my buyer called me and the escrow was to close in sixty days. They were charging her interest when she hadn't even borrowed the money yet. She signed the note in escrow and they always draw up the note in advance and it came out, I think, her charge, and I think this was back when houses were selling for ten thousand to twenty-five thousand dollars, which was a big sale in those days to me. This cost to the woman I think was seventy-five dollars and she was scraping up every penny to buy this house. We had figured them down to within five dollars of what her expenses would be when she purchased the house. This seventy-five dollars just threw her out of kilter. The only reason that they waived it was because I called up the president and I just raised hell again with him and I told him that if you expect to come into the Orange County area and make loans, you better not start pulling things like this on the public. Because I don't like it and I'll spread it among everyone of my real estate colleagues to boycott you. He finally said, I'll call you back later. He called me back in two hours and said well, in this case we've changed our policy -- in this case. He should have changed it in all cases. Now I don't know whether they still do that, I doubt that they are now. I don't see how they could get away with it very long. Sometimes the escrows may go ninety days and it would amount to a heck of a lot more money.

Okay, getting into the part where Mike Cullen asked the question, "why does a borrower or buyer think that he has the right to assume a loan at the old five-year-old interest rates?" I think he has every right to do it. Based on the fact that when that seller bought that money, the lender bought the money at a lower rate and it hasn't cost him another cent for that money that he committed for thirty years, five years previously. If he lent it at one percent or if he lent it at six percent, he committed that for thirty years and I don't give a darn what the contract says, they have the right to recall the loan and all that, or force payment if the property is sold. I think that law should be changed. I think they should be forbidden to do that. Because they bought the money cheap and they're going to sell it high. And not only do they sell it high, if a person bought it at six percent -- they sell it at ten and a half, which is the current rate right now, they also charge a point to assume the damn thing. And this is what's so disgusting to me. I don't think they have a right to do that and I think that I'll stand up until the last dog is shot on that particular issue. When they buy money low it should be allowed to be transferred. I think that is something that is the prerogative of the seller. That's part of the selling feature of his home. When he borrowed money at six percent five years ago and then he has a house for sale now, this is part of the selling feature. I have a loan on my house of six percent. I contracted for thirty years and nothing tickled me more than this case that was brought up earlier about Tucker vs. Lassen on October 10. It put a lot of smiles on people's faces when that happened because maybe that's going to be the precedent that we need. Maybe that will follow over into trust deeds as well as contracts of sale.

ASSEMBLYMAN CLINE: Do you feel then that the prevailing interest rates should then move with the interest rate that exists on that loan and that property should then move with that property?

MR. MITCHELL: Absolutely.

ASSEMBLYMAN CLINE: Even if it's higher?

MR. MITCHELL: Yes. I think it should be outlawed. They are sure they have the contract that states that they can do this.

ASSEMBLYMAN CLINE: Are you going to take away the sellers right in a down market to refinance a loan at a lower rate on that existing piece of property which is committed for 30 years?

MR. MITCHELL: Well, no, he could pay it off and at that time he could pay his prepayment penalty unless legislation comes in where they limit it to 5 years.

ASSEMBLYMAN CLINE: In other words, you want to give the seller an advantage over the association, over the lender. You want to say, okay, he can assume a low rate, and the lender has no recourse to up that interest rate, but if the interest rate happens to be high on that existing loan, and prevailing market rates go down, then unilaterally the buyer has the right not to assume the loan if he chooses.

MR. MITCHELL: That's right.

ASSEMBLYMAN CLINE: However, why should it be one way for the borrower and not for the lender.

MR. MITCHELL: That's what I'm saying now. It's one way now in favor of the lender and not for the borrower, and this I'll point out just from what you said there. In a down market, if somebody borrows today at 10½% and next year the interest rates drop to 8½%, a lot of the lending institutions will allow you to buy the interest rate down on your very loan. You could pay a point, for instance, and get it reduced to 9½% or pay 2 points and get it reduced to 8½%. Psychologically it makes a lot of borrowers feel better when they do that. But they have to pay for it. So what I'm contending here is to make it a two-way street like you're talking about and what I would like to see is if the lender has the right to receive payment when he reduces the interest rate, then why shouldn't he pay the seller or the borrower when they increase the interest rate. That would be a two-way street. Right now, they have the right to charge the lender.

ASSEMBLYMAN CLINE: Wouldn't you agree that the amount of money that is lent is dependent upon the price that the lender has to pay for that money?

MR. MITCHELL: That's right. You weren't in here earlier when I was bringing this very point up. I was answering Mike Cullen's question to Jerry Peters, where you wondered what right the buyer has, to assume a loan at the five-years-ago interest rate. I think he has every right to do it. Because the lender paid low for that money when he lent it out five years ago at six percent, and then on today's market, just because the interest rates have gone up, it doesn't cost him any more for that money. In fact, he's making money again, because he's already contracted for thirty years and charged his point.

ASSEMBLYMAN CLINE: The cost of administering that money may have risen rather sharply.

MR. MITCHELL: Well, if the seller didn't sell his house....

ASSEMBLYMAN CLINE: If you're still processing. Let's say you get the existing loan at 5½% and you have a margin of, let's say, as a lender of 1%, as your margin in that, after that loan is already on the books, you are estimating it's going to cost you over the life of the loan based on, let's say, the current market for hired help, supplies, postage, a whole range of other things, you estimate a certain cost of administering that loan. Over that period of time, you may have seen some dramatic rises, say in 10 or 15 years in the cost of administering that loan. So you might actually be losing money on that loan that you originally had just because of inflation.

MR. MITCHELL: Then I would say it was poor administration. Because you have the person selling that loan for 30 years, he should take those things into consideration. He's got a lot of other loans that are going to pay off because the person may get a windfall, or he may decide he wants to accelerate the payoff on his loan. He's going to pay it off and they will get money back for that and they will be lending it back out at higher rates.

ASSEMBLYMAN CLINE: You're asking us then to place a restriction on or more seriously regulate a regulated industry than is currently the case.

MR. MITCHELL: Yes, absolutely. I don't think it is regulated enough. I think they are allowed to get away with murder.

ASSEMBLYMAN CLINE: Do you think that state-wide governmental regulation on this would increase the supply of money.

MR. MITCHELL: Yes. It would increase, because money would be there existing and it would increase the chances of people being able to buy their homes for themselves, and the seller to be able to sell. In essence, it wouldn't create any more money in existence that isn't in existence now. But it would allow the flow for the use of it to transfer hands.

ASSEMBLYMAN CLINE: This would be accomplishing just the opposite. Because the money flow would not continue. They'll lock up that money. You won't have the dramatic turnover.

MR. MITCHELL: No, you would have the turnover. This is what I'm saying. It's on the books, you'd have a book turnover. But you wouldn't have actual cash money turnover, is what I'm getting at. And in essence, that would be the same, well just like money in banking, they say 80 percent of the economy is created out of thin air, and it's because checks are passed on from one person to the other to use for purchasing and it is actually not cash. But it transfers hands.

ASSEMBLYMAN CLINE: ...cash or the equivalent.

MR. MITCHELL: That's right. But what I'm getting at here is you are transferring money but only on the books. In this case you are saying, John Doe is going to sell his house and Bill Williams is going to buy it and the same money ....

ASSEMBLYMAN CLINE: Well, you are selling a future interest in a money flow, because you actually have an asset because that loan and the obligation to repay that loan creates the flow of the money.

MR. MITCHELL: I'm not sure we're talking along the same lines, here. The thing that I'm getting at is that the flow of the sale will take place because of the ability to transfer the money. If you wanted to use it in the sense of money, and actually take the greenback representation that the buyer is paying the seller money but he's paying it to him by assuming a loan. Taking over his obligation.

ASSEMBLYMAN CLINE: Well, if he increased the second mortgage market in order to make up that difference, assuming the price of the real estate, the fair market value or the cash value of the real estate rises with inflation of building costs, population pressure, etc. Now the amount of money to pay down to that existing loan may not be there for that average borrower across the market.

MR. MITCHELL: That's right, but it enables the owner then, the seller in that case, to carry some of the financing himself, or you could get a hard money second.

ASSEMBLYMAN CLINE: Well, that would end up costing you more money than refinancing. It would actually end up costing the borrower more money.

MR. MITCHELL: Well, if that were the case, you would have the alternative to go ahead and get a new loan and pay the prepayment penalty on this one, or pay the current rate.

ASSEMBLYMAN CLINE: You still have the opportunity to pay.

MR. MITCHELL: You have the opportunity but you have to pay the penalty, the prepayment penalty.

MR. CLINE: Not under Tucker vs. Lassen.

MR. MITCHELL: That only applies to contracts of sale.

MR. CLINE: Sure.

MR. MITCHELL: Well most attorneys will scare the living daylights out of your buyers on purchasing on contract of sale. Any experience that I have had on that line where we suggest contract of sales as a real estate broker should never, in fact, be allowed to draw a contract of sale. We usually ask an attorney to take care of this situation. And I haven't met an attorney yet who doesn't set the seller and the buyer down and say, "do you realize what you are doing?" And when they get through with them they walk out without making any transaction under that comparison.

ASSEMBLYMAN CLINE: We could as a Legislature, draft all sorts of real estate regulations concerning that. There could be a whole brand new market opened up.

MR. MITCHELL: Well, that's another whole subject, but the point that I'm trying to make here is that I don't feel that a lending institution should have a one-way street. You are indicating that the other way would be one-way, but I'm saying, no, it will be two ways. If they can charge the seller to reduce interest rates then the seller should be paid when they raise interest rates, or the borrower should be paid when they raise interest rates; and it should be a two-say street. And I think that when money has been bought at a certain figure, a person should be allowed to turn around and sell it at a certain figure.

ASSEMBLYMAN CLINE: Well, I'm not convinced as someone is charged with responsibility of evaluating and making a decision that you would actually increase the supply of money in the market place for those lendable funds for the real estate transaction. By taking your point of view or by taking the opposite point of view, perhaps somewhere in between there is an acceptable place.

MR. MITCHELL: I guess if maybe I say it this way, because I don't think I am getting my point across. I don't feel like you are hearing what I am saying. What I am saying is in essence, increase the flow of money, the reason you want the flow of money is the ability to buy. Otherwise, you don't need the money. So if you have the ability to buy, then you don't require as much money. In other words, by allowing the loan to remain at the same interest rate you are enabling buyers to buy and sellers to sell and that's the whole story. The whole reason for why you have the demand on money is so buyers can buy and sellers can sell.

ASSEMBLYMAN CLINE: We've got a particular problem. There are lending institutions who will lend on a combination -- if I understand their market correctly, and I'm trying to understand their position as well as your position. They lend on a combination of things. One is the underlying value of the property and that's the security for the note. It may not be the total reason for the note because the credit of the borrower is vitally important. In other words, they don't want to have to get REO and turn that over and sell it.

MR. MITCHELL: What is REO?

ASSEMBLYMAN CLINE: Real estate owned, within the association. They don't want to have to repossess that property because that is costly. It wipes out profits in their note if they have to service it in that regard. So if the credit of the borrower is important in the transaction, then the change of borrowers and the change of persons obligated to repay that note changes. Then the entire prospect of repayment may change. You would have to say "okay, that borrower is acceptable to the lender," then maybe we could justify your position.

MR. MITCHELL: This, I thought I could go on without saying but that's a good point. That's one of my points on this. I believe that the person should be of the equivalent risk or better that assumes the loan. I would go along with that. One thing I was going to ask here regarding President Ford coming out and speaking very soon in Las Vegas regarding this very issue requiring lenders to keep the interest rate at the same amount when a person assumes. Have you heard anything to that effect? This is supposed to be one of the counter recessionary measures. I was asked that but nobody seems to know.

I have finally reached the point in my notes here of the questions you asked. I said a person should be allowed to sell his property to whomever qualifies at the interest rate that the loan was originally committed to, and I think provided he qualifies at equal or better risk. If he does not sell the house, then the loan stays the same and the lender does not gain. In other words, if he decides not to sell and keeps his house, the lender just rides right out to the end of the 30 years at that interest rate. And if he didn't figure when he lent that money the administrative costs and didn't project the rise in administrative costs, then he was a poor administrator.

ASSEMBLYMAN CLINE: But don't you think one of the factors in lending money at that particular rate is in fact the turnover of money?

MR. MITCHELL: Well, they must base it on that because they assume that most houses, most loans are paid off on an average of five years. Somebody else said six years.

ASSEMBLYMAN CLINE: If that were the case, you'd get a lower interest rate by doing that. I've got opinions on that. I didn't mean to interrupt your testimony.

MR. MITCHELL: I wanted to point out too that I think that some savings and loans are in existence who really do care about the public. An example of that happens to be San Diego Federal Savings and I don't own any stock in it. I've had them state to me when I took my loan there on my house that I bought a year ago when I sold the other one and had to pay off with Central Federal. I asked them that question before I ever took the loan out. I said, in four or five years if I sell my house and it's at a higher value and I want to get a new loan, are you going to pull the same kind of thing on me to force me to accelerate the loan? And they verbally answered that if I could show where I could borrow the money at eight percent from any other lender, at these terms, then they would waive the prepayment penalty. And I said I thought that was fair. That's the way you ought to do it. You shouldn't try to force people into it. I felt that they had a pretty good attitude and I thought it should be mentioned here. There are probably other savings and loans that would do the same thing but they seem to be in the minority. They actually do care about public relations and the public's feelings. Also, this is a minor thing but I get annoyed by it and I know a lot of other brokers do and I'm sure maybe the public does, but they don't go through the real estate transaction as often as we do. There are some lending institutions that say when you go to them, I want you to get a loan commitment and they come up with a pretty good loan commitment and then say that they expect you to run the escrow here. And it's almost like it's extortion. If you don't run the escrow there, they imply you won't get the loan. This is something I think there should be some legislation on. They shouldn't be allowed to dictate where a person goes to escrow. Sometimes there are circumstances where we might borrow from a savings and loan in downtown San Diego and the broker does an awful lot of servicing if he's a good broker and does a lot of handcarrying of papers to expedite the transaction. And if he has to run around downtown San Diego or clear out to La Jolla or happens to be in the North County, it cuts down his ability to serve his buyer and his seller to the fullest extent. I don't feel that they should be allowed to hang that over your head. I think some legislation should be put on it.

I wanted to point out that Mr. Gillies, representing the CREA, in some cases I agree with and in some cases I don't. I don't think that CREA reflects the general population necessarily of real estate brokers and salesmen. For one thing, the representatives that go to the state conventions where these things are decided on are not elected by the members of the realty boards. In most cases they are appointed. I was a state director one year and I was appointed by the president. And that didn't mean that the people wanted me. I just went because I thought it was kind of an honorary thing to get. I went up there and voted on these things. But then CREA dictates a lot of things that I don't feel, and in a lot of cases are the majority feeling about certain issues.

One of the issues I want to take exception to is this variable interest rate. I think that in a stable economy that's fine. But when you have a rising economy, it can be disasterous. When I was in England last year and I sat and watched a television interview of people in the street who were just ready to panic when they had a sudden increase in their interest rates. I think they went from six or seven percent up to ten and eleven percent. They were interviewing just ordinary common working people. They were in a panic. They said they didn't know how they were going to pay their loan on their houses. They were just going to have to lose the house because they could not pay the payments that were required. Then others said they were buying their houses but were not building any equity. Now the interest is more than what the payments are. There were other people that were interviewed and they said that they had been saving for a number of years. A young couple, saving for a number of years and were just about to buy a home and because of the variable interest rate were unable to purchase. So anyway, I wanted to point out that because it frightened me when Mr. Gillies said that he's representing the real estate brokers of California, I think if you took a poll, you might find a little bit different issue and I wanted to caution you. I think that there is a handful of people in CREA who decide on these things and they say that they are representing all the real estate brokers in the State of California. I don't think that that is necessarily true.

CHAIRMAN McALISTER: We are well aware that the variable interest rate is a very controversial issue. However, I think that one of the premises of it is that if you're going to squeeze the S & L's in some respects, then there may have to be some other area where they make up what they lose.

MR. MITCHELL: The variable interest rate scares me so much I'd rather see you leave everything exactly as it is and I'll keep screaming and writing to Congressman Rosenthal and Senator Stull, than to go into that. That really frightens me. When I saw the reaction of the English people -- they were just at a near panic when this happened. I would hate to see our economy come like the English economy. I just heard last night on the news that their gas is now a dollar fifty-three a gallon, gasoline just went to that.

CHAIRMAN McALISTER: It just went to two sixty-six in Israel.

MR. MITCHELL: Is that right? That's war prices.

CHAIRMAN McALISTER: It went up from sixty cents to two sixty-six in one day.

MR. MITCHELL: The other question is why shouldn't the usury laws apply to savings and loans. I don't understand why they are excepted from that. They are allowed to charge eleven and twelve percent and a loan broker or private individual wouldn't dare. He'd be locked up. It would be considered a crime.

CHAIRMAN McALISTER: You are going to hear shortly from some representatives of the loan brokers who will probably tell you that the usury laws should not apply to them either on the premise that you are drying up investment money with the usury laws in the first place. So, which way should we go?

MR. MITCHELL: I was hoping that this committee would listen to all sides and come up with a good answer to what we can do to this situation. I finally do feel I got to really voice my opinion. I'm finished but have this question. How long has this investigating committee been in action and what prompted it to be formed?

CHAIRMAN McALISTER: This is a regular committee in the Assembly. The Finance and Insurance Committee has had bills on these subjects over a considerable period of time, but especially this last year. It was felt that we ought to have a study because interest on these matters has been rising and there was not a concensus of the Committee during the last session as to what should be done and we hoped that these hearings could help us to reach a concensus. So we scheduled two days of hearings in Los Angeles on Monday and Tuesday, and a day here in San Diego and we are going to have still another day in San Jose on the 22nd of November.

MR. MITCHELL: The reason I asked the question is because I still have the question in my mind as to when I wrote to my congressman, assemblyman and senators and they say that they are doing something about it and I never hear another word. You wonder why didn't it go to a committee like this in the first place.

CHAIRMAN McALISTER: Well, there is of course no assurance that any particular legislation in any direction will emerge from our deliberations. These have been issues that have vexed the legislative process for several years now and it has been a difficult one for any concensus to be attained. But, at least this is an in-depth substantial hearing and we've gotten a good cross section of opinion. It certainly has helped me to learn about the issues and I'm sure that would be true of the other members as well.

MR. MITCHELL: I have a good feeling about it because I do feel that maybe the statements of the professor at UCSD was maybe not completely true when he said that executives of savings and loans are the people who write the legislation for -- to regulate savings and loans. I feel now that maybe the legislators are really doing it. They are listening to both sides.

CHAIRMAN McALISTER: Their legislation is a product of many factors and pressures and conflicting opinions and the savings and loans are certainly among those who have an input but people like you also have an input and I can assure you we'll do our best on an impartial and fair basis.

MR. MITCHELL: Very good. Thank you very much.

CHAIRMAN McALISTER: All right. Mr. John Sykes of the California Independent Mortgage Bankers' Association was unable to be with us here today and therefore, the only remaining witness we have on our agenda is Mr. Kenneth Green, President of the Western Home Loan Corporation.

MR. KENNETH GREEN: Mr. Chairman and Committee Members, I have presented with you a copy of what I am going to read. It's very short and it spells out primarily what I think is a discriminatory piece of legislation that exists after the Constitution was enacted.

I would like to ask "How does the general public gain any advantages, protection, or liberties through the limitation of interest rates as established in the State Constitution?"

My industry, home loan brokerage, and the mortgage business as a whole, has suffered a great set back because of the ten percent interest rate limitation placed on real estate loans as set up in our constitution.

However, through legislation certain businesses have been exempted from the protective blanket of the Constitution; namely, banks, savings and loans, and thrift companies.

As the economy struggles to establish its levels, through whatever pressures, the cost of money has shot past ten percent. Because of the most recent ebb in the money market, banks have through the exemption been lending money to the public and the building industry at levels up to sixteen percent. Savings and loans have as a general practice been lending money at eleven to twelve percent to all home buyers (the general public), and thrift companies still make real estate loans to the public at an APR of 18.69.

Where is the protection to the public when the limit as set by the constitution can be ignored by a few under the umbrella of newer legislation?

Where is the advantage to the public when many who are in the business are discriminated against by a one-sided law. Competition is completely eliminated by a biased piece of legislation which offers a special right to only a few -- banks, savings and loans, and thrift companies.

Where is the liberty to the public when he cannot choose with whom he can do business. Through newer legislation certain institutions may do business and others may not.

A great disservice and unfair condition exists when one specific group may do as they please while another is subject to great persecution by its peers.

Finally, and more specifically, my industry arranges loans to provide both money for those desiring to borrow and investments for those who would like to have their money work for them. They have been damaged by limited exemption to the California Usury Law, since the investor needs more yield when no longer invest in trust deeds offered by the general public, but instead would go to banks offering eleven to twelve percent on Certificates of Deposit.

We need to be treated equally.

I'm primarily suggesting that legislation should be enacted to exempt people like ourselves and the mortgage banking industry in general from the usury laws in California, just as banks, savings and loans and thrift company's are.

CHAIRMAN McALISTER: Thank you. Is there anyone else here who would like to address the Committee? Yes sir. Would you come forward.

MR. FRANK HARMON: My name is Frank Harmon. I'm a realtor, also a member of CAR. I have heard these hearings with a great deal of interest and I'll state this, that I'd strongly disagree with several of the gentlemen before me. I think the tendency is that we ask to regulate the other fellows business. Never our own. And I think when you invite legislation of one man's field you're asking for trouble in your own. And I think the problem is how can we induce more money into the savings market. I think if we go back and look at money as a commodity, just like wheat or water, it will seek its own level. And I think over the years the savings and loans by agreeing to these long-term contracts with no interest rate adjustment, have in effect locked themselves into a situation that they were not able to respond effectively to the change in the money market. Now in the days when things were very stable this was fine. But as was pointed out with several of the Committee members, the change of costs of doing business have escalated so rapidly, they haven't been able to compensate for them. Let's face it. Prepayment penalties and loan charges are an attempt by the savings and loans to compensate for this. Now I do not feel this committee should sponsor legislation severely restricting the savings and loans industry. I'm speaking as a realtor, and as a broker. I'm afraid that if it does do so, as so often happens with legislation, while the motive may be fine, the end result is often disastrous to the person that you are trying to help the most. I think we have to encourage the savings and loan industry with the techniques they would have today to try and adopt the flexible interest rate. For example, if we had gone back in the early 30's and these loans had been allowed to escalate over a period of time, the interest rate, on these contracts, just as everything else, the buyer is paying for. His rent has gone up, his taxes have gone up, his food has gone up. Nobody is proposing legislation to restrict those. So why is the interest rate totally exempt. Why should it not follow the cost of doing business. If it had done so over a long period of time, perhaps the savings and loans would have been in a situation where they would have had enough inflow coming in to them to where they would not have had to enact some of these other restrictions which are high cash restrictions and particularly hurt the small buyer.

I don't think there is any question about it. The man who buys a 70 thousand dollar home, generally has enough resources to where he can pay these costs. It is the young person in the 30 to 35 thousand dollar bracket that is killed by these prepayments and these loan costs. So my idea is that we try and seek a level in this business and I think that the savings and loans have the techniques and the computers today that they can find a way to adjust the interest rate. Now let's say, for example, we have a loan with the Federal Loan Bank of Berkeley. Now they've done this for many many years. They adjust the rate on an annual basis. They are involved in a very high risk situation with ranches and groves. And they have managed to do this and fairly successfully. They review their total portfolio and the cost of doing business and project what it is going to cost them the next year to do this same thing. So their's is a flexible rate and they have been able to keep a more moderate interest rate applicable. I think that if this were done on a long-term basis the savings and loans would be able to ameliorate these sudden rises in interest. This is my only fear here today. It is so easy to call for legislation to restrict the other fellow from doing something or imposing a restriction on him that five years down the road you wind up and say, "Hey, that wasn't the answer at all. All it's done is cause some other undesirable factor to occur."

CHAIRMAN McALISTER: Sir. You are in essence advocating some version of the variable interest rate.

MR. HARMON: Absolutely, sir. But by persuasion rather than legislation. I don't want you to legislate and say you must go in and have a variable rate. The savings and loans know that they are on the spot. That's one of the reasons we are having these hearings. They know there is a lot of dissatisfaction. I think the pressure of this Legislature can be heard, and tell them in effect to come up with something that is more flexible. Let's try and work together on this. Let's not stand off in one corner, let's be adversaries. Let's try and find some way we can all find this money will flow into the market. Now it can be done. Just because it hasn't been done in the past doesn't mean it can't be done in the future and I think if we are going to look to try and help the person that's buying a home, it isn't going to be accomplished by restricting one man's business over another. It rarely works and I think that if there was to be any laws passed today, I'd say let's have a law against any more laws for about a year.

ASSEMBLYMAN KNOX: Five years.

MR. HARMON: Alright, I'll take five years. But look back at the Federal Government. For four years they have been passing laws to do certain desirable social objectives. There are welfare cases for example. The results have not been what we had hoped. And that's why I say you have to go at these things very cautiously.

CHAIRMAN McALISTER: Yesterday in Los Angeles we had testimony from one of the savings and loan gentlemen who indicated some difficulty in the industry in pushing variable interest rate loans because of the competitive factor. That is, if some did more than others then this would put them out of competitive relationship with others. In fact he thought maybe we ought to somehow be pushing them this way. I don't know that represented a concensus of their thinking. He was just one person.

MR. HARMON: I personally favor as much competition as we can get. Any time businesses are regulated artificially, you reduce some area of competition. In our own business, for example, last week I was approached by a man to sell a piece of property and after we had discussed it for some time, he said, "Well you asked me for 8 percent". (This happened to be a piece of raw land) "A broker down the road told me he would take it at 6 and another one told me he would take it at 10." Now he has shopping and he was in effect telling me if I want this listing, what am I going to do? Well I don't know. I haven't made up my mind about what I'm going to do. What I am trying to say is that artificial restriction of legislation can be disasterous.

CHAIRMAN McALISTER: I listed some unimproved land of mine with a broker several times but I guess it was lower than they wanted; it never got sold. Then when I listed it for 10 percent, it magically was sold. (laughter)

MR. HARMON: I won't deny that. It can happen. Well, it's the cost of doing business. For example in this case. It happened to be a remote piece of property. It's difficult to work on. You make a judgment decision. It's not worth it to me to try this. At 10 percent it might be. It is competition.

CHAIRMAN McALISTER: Thank you Mr. Harmon. Is there anybody else here who would like to address the Committee? If not we will adjourn and the next meeting will be November 22 in San Jose.