"Regulating financial services to protect and educate the public and promote economic vitality."

2005-2012 Legacy & Lessons Learned

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Washington State Department of Financial Institutions

Scott Jarvis, DFI Director, 2005-present

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Who are we?

License. Regulate. Protect. Educate. That's what we do. The Washington State Department of Financial Institutions (DFI) licenses and regulates the financial services industries – banks, credit unions, payday lenders, loan originators, mortgage brokers, financial planners, securities and more. Our staff works hard to ensure the safety and soundness of Washington financial institutions and to protect Washington residents from financial fraud. We are the "local cops on the beat" when it comes to financial regulation.

We also devote staff, time and resources to increasing the financial education of our state's residents – from kindergarten to post-retirement. We hear regularly from fraud victims "I didn't know any better." We're making sure Washington residents know better – with proven effective financial education in elementary and middle schools, presentations, video and written educational materials for high school, college, pre-homeownership, pre- and post-retirement.

With a staff of less than 200, DFI is considered a small agency. I would say "Small, but mighty."

As Washington's financial services regulator, DFI has had a significant role in reducing the effects of the national mortgage crisis and financial industry collapse on the state of Washington.

What follows are a few examples of how actions by DFI employees — this agency's most valuable resource — helped ensure the sound operations of businesses and defended Washington residents from financial abuse, deceptive practices, and even fraud — from some of the nation's largest companies.

LICENSE: Mortgage Loan Originator Licensing

Even before the major mortgage crisis hit, there were rumblings Congress might consider a national licensing system for mortgage loan originators (MLOs). As the crisis worsened, the mortgage broker community in Washington began discussing the possibility of running a bill in the legislature to make that happen. At the time, DFI licensed only 1,500 mortgage broker companies — not the thousands of individual MLOs DFI would license within a year.

For many years, the mortgage loan originator industry was largely under regulated. This led to increasing numbers of less than reputable individuals working, and fraud being perpetrated by those individuals.

Because expanding the licensing program to thousands of MLOs would have challenged the already overworked licensing and examinations staff, however, DFI did not initially support the additional authority due to a lack of capacity. The industry, represented by the Washington Association of Mortgage Brokers (WAMB) would not be dissuaded. The industry itself was not all in agreement with the idea of MLO licensing, however. Some mortgage brokers felt they would not be able to compete with the banks if the state required individual agent licensing.

The turning point occurred when then Director of Consumer Services, Chuck Cross, called an evening meeting for the industry to meet and resolve the issue. Chuck let the industry know ***DFI supported a change in the law to include MLO licensing — if the industry would agree to some form of routine examinations, as the law at the time only allowed for an examination if the Department received a complaint.*** Most of the industry agreed with this proposal.

The licensing and examination of mortgage loan originators protects the public by ensuring that individuals with criminal histories or bad credit aren't approved to provide mortgage services to the public. It also allows us the authority to revoke or suspend a license for abuses and/or illegal activity.

To implement the significant changes made in the legislation, negotiated rulemaking was needed with the mortgage broker industry. DFI convened a rules drafting panel consisting of DFI's consumer services division director, DFI staff, and five mortgage brokers from the Mortgage Broker Commission representing different segments of the mortgage broker industry regulated by DFI. Rules were developed and adopted through a multi-tier and approval process.

- The mortgage broker panel members chaired working groups (sub-panels) for licensing, examinations, enforcement, and a miscellaneous sub-panel.
- The sub-panels drafted proposals, which then went to the full panel for review.
- When approved at the full panel level, the items became final proposed rules.
- DFI conducted 11 full panel public meetings — the first of which occurred on March 30, 2006, the last on Aug. 9, 2006. All licensees were notified and invited to attend the work sessions. The final public meeting on the rules was conducted Oct. 26, 2006.
- The rules were adopted Nov. 21, 2006 and became effective Jan. 1, 2007.

In January 2007, DFI began receiving MLO applications and the separate documents required to apply including fingerprints, authentications, and the application itself. The documents came in separately and had to be matched up. This meant piecing together approximately 40,000 separate documents. The work included reviewing the results of the fingerprints, making sure each applicant had passed their test and completed their pre-licensing education, and reviewing the credit reports.

Licensing staff was determined, however, and successfully licensed nearly 13,000 MLOs.

I know how hard our staff works, but sometimes it's nice to know their efforts are noted and appreciated by our licensees: "I know you folks are slammed but my experience with DFI has been exceptional. Thank you for your work on this and for your timely responses throughout. It was/is greatly appreciated."

At the beginning of 2008, the Nationwide Mortgage Licensing System and Registry (NMLS) opened its doors as a licensing portal. Eight states joined in January with more states, including Washington, joining in April. The database, developed and owned by the Conference of State Bank Supervisors, was to be the start of a licensing system that would later be key in keeping the states in the game of mortgage regulation.

A year later, as a result of the growing mortgage crisis, Congress passed the Housing and Economic Recovery Act, which included provisions known as the Secure and Fair Enforcement and Mortgage Licensing Act of 2008 or SAFE. SAFE was signed into law by President Bush in July 2008.

Among other things, SAFE recognized the NMLS as the system for licensing MLOs nationwide. Finally, every mortgage loan originator in the United States would be subject to licensing standards and regulation, although the regulation of bank employee loan originators would be significantly more light-handed than the non-depository loan originators.

To avoid giving up authority over mortgage loan originators to the federal Housing and Urban Authority, each state was required to pass legislation implementing the federal SAFE act. Miraculously, 49 states, including Washington did so within a year. Even though it contained many of the same requirements as had already been adopted in 2006 by the Washington legislature, the number of MLOs dropped precipitously to 4,440 at the end of 2008 following implementation of SAFE. The mortgage broker industry was beginning to feel the full impact of the housing crisis.

Almost two years later to the day, President Obama signed the Dodd-Frank Act into law. It represented the most significant change in the American financial regulatory environment since the Great Depression. Under Dodd-Frank, the federal authority over MLOs shifted to the new Consumer Financial Protection Bureau (CFPB) where it resides today. ***Although the states have maintained their role as the primary regulator over MLOs, it remains to be seen how the states and the federal government can work together to continue the important role of consumer protection the states have maintained for many years.***

The MLO issue taught us that sometimes it's all about perspective: rather than seeing a shortage of staff to handle a necessary action, we should see a need to hire additional qualified staff to take the appropriate steps to keep Washington strong, safe and successful.

REGULATE: Ameriquest

In 2002, fresh off the then largest predatory lending settlement in history with Household International, state mortgage regulators were closely tuned to consumer abuse claims and indications of bait and switch practices playing out with other large lenders. Still years shy of the global financial collapse triggered by fraudulent and predatory mortgage lending, state examiners and investigators anticipated another significant case was looming.

For the prior two years consumer complaints about misrepresented loans made by Ameriquest Mortgage had been mounting. We, like regulators in other states, met repeatedly with Ameriquest management to discuss what appeared to be a worsening situation. ***Each time, company leaders argued that consumer claims were either factually inaccurate or the result of "rogue" loan officers operating outside of corporate policy and company motto of "Do The Right Thing." As the case continued, both of those claims were proven false.***

In early 2003, state regulators and attorneys general began conducting formal meetings to share complaint information about Ameriquest and compare notes on the consumer harms that were emerging. In June 2003, representatives from the states of California, Georgia, New York, Maryland, Virginia, Massachusetts, New Hampshire, Tennessee and Washington met in person to develop a strategy for investigating the complaints. The number of complaints had tripled from 2002 to 2003 in Washington and we knew from experience complaints typically are just the tip of the iceberg.

In addition to the increase in numbers, the types of complaints were very serious. Consumers complained they were subjected to high-pressure sales tactics, switched from fixed rate mortgages to adjustable rate without their consent, and that certain fees were not disclosed. Not surprisingly, loan officers were given incentives for delivering high rate, high cost loans — primarily adjustable rate mortgages (ARMs) — they could sell to unwary consumers. Additionally, Ameriquest was charging high discount points intended to be used to lower the interest rate, but never were.

Ameriquest loan officers became very adept at selling a special type of ARM loan known as a 2/28. This loan was made at a fixed payment for the first two years, but then adjusted upwards beginning in the third year. Loan officers sold these loans as fixed rate loans, hiding from borrowers the fact that the loan rate and payment would go up. Frequently, these loans would contain penalties that were not disclosed to the borrower in the form of prepayment penalties. The prepayment penalty was the final insult added to an already injured borrower, effectively making them a captive of the Ameriquest fraud machine.

As the investigation deepened, additional bad practices came to light, including fraud. In California, the Attorney General's investigators were identifying that incomes were falsified on applications. When confronted, Ameriquest defended itself by saying they themselves had been the victim of fraud by the borrowers, however, interviews of borrowers and loan officers proved these claims to be false. Investigators in all states began to closely review loan files and noticed a recurring pattern in the same types of jobs being shown again and again: computer consultants, landscapers, housekeepers — all making incomes above what would seem normal. Again, it was the type of loans - this time called "stated income" — that allowed Ameriquest loan officers to successfully deceive borrowers.

Before long, allegations of document falsification emerged as victims and former loan officers themselves began telling their stories. An email from one account executive noted "I could barely sleep last night because of what I did to a borrower." Other brokers were more aggressive, bragging "I really took that guy to the cleaners!" Loan officers were exaggerating — and in some cases completely falsifying — employment descriptions and incomes. For example, in one case, a gardener making $8 an hour was listed as being a "landscape architect" with a grossly inflated income.

In addition to changing borrowers' employment and income information to make them look like they could afford bigger loans, loan officers were ordering and reordering appraisals until they found an appraiser that would give them the inflated value they needed to make the deal work. There was substantial evidence that Ameriquest branch employees engaged in a practice of pressuring appraisers to obtain inflated loan values and/or selecting those appraisers who would willingly "give value" in exchange for steady assignments. It wasn't uncommon to find three and sometimes as many as five appraisals in the loan file, each showing a higher value.

By April of 2004, the AGs in several states, including our own, began discussing a multistate investigation. By May, interrogatories and demands for documentation were being issued by the AGs in Illinois, Iowa, Minnesota, New Mexico, Texas and Washington and by the mortgage regulators in Montana, New Hampshire, New York and Washington.

While Ameriquest began to produce information for the states, information was slow to arrive and follow up was intentionally drawn out by Ameriquest. Communications became contentious, but by December of 2004 it was clear Ameriquest had a widespread practice of using inflated appraisals, fabricating income, using deception to cover up prepayment penalties, misrepresenting the accuracy of the Good Faith Estimate, and other alarming predatory practices. The company consistently promised consumers the “lowest rate” and “the best possible rate available for their situation,” when in reality they were charging rates higher than the market norm. Despite management’s denials, Ameriquest maintained a high-pressure sales environment in their retail branches and a sharply skewed commission structure which rewarded employees producing a high monthly volume of loans. It was not uncommon for Ameriquest loan officers to make commissions in the hundreds of thousands of dollars per year by avoiding telling borrowers the actual rates and costs of the loans.

To learn the extent of management’s knowledge of – and involvement in — loan officer sales practices, state investigators demanded some 300,000 emails and reviewed them to determine what management knew about how borrowers were being treated. One particular email was significantly damning to management. It had been sent two years earlier by the General Counsel to all employees and it reprimanded, “Knock this [blank] fraud off now!” In spite of the warning, management took no further action.

From 1999 through 2005, Ameriquest made 13,495 loans to Washington residents totaling $2,706,469,252, representing about 2.5% of the loans nationwide. By 2005, a majority of states had joined the investigation and settlement discussions began in February of that year. Chuck Cross, our Director of Consumer Services at the time, was part of the negotiations team. When the negotiations stalled in May 2005, Washington led eight other states in a credible threat to file charges. This action by the more aggressive states turned the tide on the negotiations and moved the talks toward resolution.

A $325 Million multistate settlement was entered in January 2006 with ACC Capital Holdings Corporation and its subsidiaries (including our licensee Ameriquest Mortgage). As a result, thousands of Washington homeowners who received loans from 1999-2005 shared approximately $6.5 million in restitution. The company and all of its related entities closed in 2007.

Sadly, the actions of Ameriquest — along with dozens of other mortgage companies and loan originators — would soon plunge the country into the worst financial crisis since the Great Depression.

It’s important to do what you know needs to be done, even if you’re David, going after a Goliath. Sometimes, there are other Davids waiting for someone to lead the way. DFI doesn’t shy away from going after Goliath if Washington residents are at risk.

PROTECT: Countrywide

The subprime mortgage market played a significant role in making homeownership possible for many families who had less than perfect credit histories or otherwise failed to qualify for prime, conventional loans. Subprime loans, while sometimes serving a legitimate purpose, had a huge role in the mortgage market disaster that will take years to unravel.

Unfortunately, people of color were more likely than whites to get a subprime loan — and many of those borrowers could have qualified for loans with better rates and terms. The federal Fair Housing Act and the Equal Credit Opportunity Act make it unlawful to impose different terms or conditions on a loan — such as different interest rates, points or fees — based on race, color, or national origin. When a lender bases its lending decisions on one or more of the prohibited discriminatory factors covered by the Fair Housing Act, it is illegal. When a lender targets minority consumers to charge them more than they would charge a similarly situated majority consumer, it is known as "reverse redlining."

Armed with the results of the 2006 Federal Reserve Board Home Mortgage Disclosure Act (HMDA) "red flags" report identifying Countrywide Home Loans (CHL) as a possible fair lending offender, in March of 2007 DFI sent in a team of examiners to CHL's headquarters in Calabasas, California, to conduct an on-site fair lending examination.

Little did we know this was to become one of the largest fair lending examinations ever undertaken by any state mortgage regulator.

During our first visit in March of 2007, we spent six weeks onsite. We reviewed more than 200 files to test whether consumers were being treated unfairly. Later, when we discovered that Countrywide was suffering from cash flow problems, we sent our lead examiner back to the company for three weeks to monitor and report on the liquidity of the company to regulators across the country as the company teetered on collapse.

When we returned home to review the results of our examination, our team of examiners spent many hours comparing loans with similar characteristics involving consumers of various races and ethnicities. They had to find a protected class member whose transaction could be compared with those of at least four other non-protected class members with an almost identical transaction. This meant finding buyers who had many of the same characteristics including factors such as the same credit score, down payment, loan to value, maturities, general location and collateral.

Our team was able to identify possible discrepancies in the rates and fees charged to borrowers with similar loan characteristics but with different race and ethnicities, leading to the conclusion that Countrywide was discriminating against borrowers of protected classes. From comparing a sample of almost 600 loans, they were able to assert that 17 protected class borrowers received lower quality loans than other non-protected class borrowers. Overall, the examinations unit spent almost a 1,000 hours in dissecting the records of Countrywide to identify potential discrimination against Washington State protected class members.

With the findings in the exam, the enforcement unit went to work. Our enforcement chief and his assistant spent hours conducting borrower interviews, tracking people down, and gathering the necessary information for the Statement of Charges. They interviewed victims by telephone, as well as visiting people in their homes. They heard many sad stories from people who were in the process of losing their homes. One Hispanic family — of which all members spoke very little English — was tricked into adding $18,000 to their principal — ending up with a negative amortized loan with a growing principal amount each month.

In the meantime, the exam team requested additional data from Countrywide on approximately 30,000 more home loans and began analyzing the loans looking for additional possible discriminatory effects. They spent another 40 hours identifying more possible victims. The enforcement team worked separately to analyze our existing CHL complaints and dealt with consumers on an on-going basis.

On June 23, 2008 the Consumer Services Division was ready to fire the first shot over the bow by issuing a Statement of Charges. The seriousness of the allegations prompted the Governor to call a press conference to talk about the case to assure the community that we were looking at the issue.

The next two years involved more than 1,000 more hours of work on one of the most difficult cases our Consumer Services division had ever undertaken. Litigation seemed likely but in the end we entered into a settlement agreement in which Countrywide agreed to pay $650,000 to the 123 consumers. On Dec. 24, 2010, as a nice holiday surprise, Countrywide sent out checks to 123 protected class members who received between $997 and $26,176 (with an average of $5,300), most of whom knew nothing about the Division's efforts on their behalf. To say this was a Herculean effort understates the incredible work performed by the team. Within a week I had received a number of calls from check recipients thanking us for our work. One woman sobbed "You don't know what this means to me — now I can buy my kids some Christmas presents!" Hearing that was probably ***my*** best Christmas present.

Once more, we knowingly took on Goliath. We did what we knew was the right thing to do, regardless of how large the task or what any other state or federal agency was or wasn't doing. Washington led the way in investigating Countrywide for harming homeowners. Washington led the way in sanctioning Countrywide for harming homeowners. Washington led the way in getting restitution for homeowners who were harmed by Countrywide. ***We did the right thing. We did it first.***

PROTECT: The Mortgage Crisis

Did we hit bottom? Are we on our way back up? Maybe. But I doubt it. Regardless, the mortgage crisis continues to be a significant concern in Washington as well as many other markets throughout the United States. While the root causes of this crisis began several years before, all of which combined to produce a "perfect storm," I worked with DFI staff to stem the bleeding, so to speak, as much as possible here in Washington.

DFI's Proactive Leadership – The Problem of Preemption

DFI, in collaboration with the Washington Attorney General, had already shown itself to be a leader among state financial regulators in its enforcement efforts against predatory mortgage lending. However, beginning in late 2002, when DFI attempted to enforce its examination findings against national bank operating subsidiary, *National City Mortgage*, the federal government, through the Office of the Comptroller of the Currency (OCC) and later the former Office of Thrift Supervision (OTS), asserted that state-incorporated mortgage subsidiaries of national banks and federal thrifts were preempted under the National Bank Act and Home Owners Loan Act from regulation by the states or enforcement of state consumer protection laws.

And so began a protracted legal battle by DFI, the Washington Attorney General and their respective counterparts in other states, to reverse the federal position on preemption. DFI and other state regulators have, do and will continue to support the traditional role of state regulators and attorneys general in protecting state citizens from violation of state consumer protection laws.

Between 2003 and 2009, in a series of federal court of appeals and U.S. Supreme Court decisions, the OCC and OTS were successful in the assertion that operating subsidiaries of national banks and federal thrifts had a safe-harbor from state regulation and enforcement. Then, in July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was enacted by Congress, reversing the federal court decisions and restoring the authority of DFI and the Washington Attorney General. Enforcement of state licensing and consumer protection laws pertaining to operating subsidiaries of national banks and federal thrifts — including some of the largest mortgage lenders and mortgage loan servicers — was once more within DFI's purview.

It should be noted, however that during this eight-year legal battle (from 2003 until 2010) — in which DFI and the Washington Attorney General played a vigorous role among the states — we remained nearly powerless to deal with much of the mortgage lending behavior caused directly by national banks, federal thrifts, and their operating subsidiaries. ***Had there been during this time 50 state "cops" on the beat, the crisis may have been far less damaging to citizens.***

DFI's Early Response to the Mortgage Crisis

In late 2006, DFI began to hear disturbing reports of an increase in mortgage defaults — most prominently among subprime ARM loans — despite a robust Washington State economy, a "hot" real estate market, and record highs in residential construction activity. DFI also began tracking residential mortgage loan default and foreclosure data and as a result is a chief source within Washington State government for the initial compiling and interpretation of such data. Anticipating that Congress would enact nationwide standards for mortgage broker licensing and testing, DFI, which already had a fairly progressive Mortgage Broker Practices Act and Consumer Loan Act, went to the Legislature in 2007 and secured the enactment of amendments assuring that Washington continued to have one of the strictest mortgage broker and consumer lender licensing laws in the country.

DFI's Role in Public Policy to Address the Mortgage Crisis

In the late 1990's and the early 2000's, the standards lenders applied to borrowers who applied for mortgage loans changed dramatically. Lenders began offering more loans to higher risk borrowers and mortgage qualification guidelines became less stringent. Serious problems began to crop up with loans with no proof of income, known as "stated income" loans. The guidelines continued to loosen in order to produce more and more mortgages that could be sold into the securities markets. All that was required to get a loan was a decent credit score. Additionally, lenders started making "payment option" adjustable rate mortgage loans which, for many borrowers, meant a growing principal amount.

The traditional mortgage model involved a bank originating a loan to the borrower and retaining that loan. This new version of mortgage securitization began in the 1980's when government sponsored enterprises (GSEs) pooled relatively safe conventional conforming mortgages for sale to investors, in the mid-2000s, that type of securitization declined dramatically. ***Much of the money for new mortgages came from private label securitization from the sale of high-risk subprime loans, many of which turned out to be non-performing, causing a collapse in the mortgage market.***

While there are many causes for the collapse of the mortgage market, the end result was a significant increase in the number of homeowners who could no longer afford to pay their mortgage. As that occurred, the securitization market collapsed causing a significant decrease in the amount of money available to make new mortgage loans.

Home prices peaked in mid-2006, and not long after began a steep decline. Refinancing became more difficult and a significant number of homeowners began to default on their mortgages. This led to high foreclosure rates in many states, especially in California, Arizona and Florida.

While Washington homeowners were significantly better off than the rest of the country at the beginning of the crisis, ranking 48th in the number of seriously delinquent loans, Governor Gregoire had the foresight to establish a task force to evaluate the instability in the national subprime mortgage market and to seek the advice of experts in the industry to make recommendations to minimize the impact of the national trend in Washington. She wanted to work on solutions to the crisis before the national problem hit Washington as severely as it impacted the rest of the country.

I worked with the Governor to develop six principles or goals regarding how the State of Washington, as a matter of public policy, should address the housing problem:

1. Build or restore trust in the market;
2. Restrict harmful products;
3. Foster sound underwriting;
4. Promote mortgage servicing flexibility;
5. Encourage more accountability from the secondary market and capital markets; and
6. Promote financial literacy and consumer awareness.

On Sept. 17, 2007, the Governor announced the creation of the Task Force for Homeowner Security. She appointed a 17-member Task Force that was chaired by Carol Nelson, then CEO of Cascade Bank, assisted by me and my staff. The rest of the task force was comprised of members from the financial industries, the construction and real estate industries, non-profit organizations, consumer groups and government.

We were charged with evaluating and providing recommendations on:

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

- Consumer education to potential new home buyers; and
- Reforms to Washington lending practices, as needed.

The full Task Force met for the first time on Oct. 8, 2007. We met five more time with four subcommittees to address specific issues in developing recommendations for the full Task Force.

The subcommittees included:

1. Best Practices for Lenders and Servicers;
2. Best Practices for Originators;
3. Consumer Education and Counseling; and
4. Financial Literacy.

The Task Force ultimately produced 24 recommendations which were approved and adopted by the group at our final meeting in December of 2007.

DFI became the official reporter of the Task Force's outcomes and we were a key participant in the development of initiatives for the 2008 Legislative Session, including:

1. Funding and enabling homeowner counseling for at-risk homeowners and first-time homebuyers;
2. Implementing legislatively charged broad authority to conduct consumer financial literacy and outreach;
3. Adopting a one-page plain-language disclosure on all mortgage loans. The new disclosure document required all banks, credit unions and non-depositaries to comply with the federal Statement on Subprime Mortgage Lending and Guidance on Non-Traditional Mortgage Product Risks, restricting prepayment penalties, prohibiting negative amortization and "steering," and making "mortgage fraud" a felony;
4. Imposing a fiduciary duty for mortgage brokers and loan originators toward customers;
5. Authorizing expanded license and regulation of non-depositary lenders; and
6. Prohibiting foreclosure rescue scams.

As a result of the Task Force recommendations, the Governor supported SB 6272, which required DFI to implement financial literacy and education programs to support foreclosure prevention. We also worked with the Housing Finance Commission to provide additional counseling assistance for borrowers at risk of foreclosure and for first-time home buyers. The task force recommendations suggested lenders and loan servicers contact at-risk borrowers to encourage borrowers to explore refinancing options or to discuss loan modifications or workouts.

The Governor also supported HB 2770, which created a one-page disclosure document which all mortgage lenders in the State of Washington were required to provide to borrowers. This simple, easy to understand format informed borrowers of all important aspects of their loan, including the interest rate, whether the amount could change, whether there was a prepayment penalty, total fees on the loan, the yield spread premium paid to the broker, whether the loan contained a balloon payment, whether the taxes and insurance were included in the payment, and whether there was a premium for reduced documentation. No longer would Washington homebuyers have to wade through stacks of paperwork to determine what they were paying for their home. This format was later copied by the federal government in the new Good Faith Estimate.

HB 2770 also created a criminal penalty for mortgage fraud. The bill supported another of the Task Force's recommendations by creating a statutory requirement to follow the interagency guidance on nontraditional mortgage products and set limits on prepayment penalties and negative amortization – all of which played integral roles in the mortgage industry collapse and unfathomable increase in foreclosures

In 2008, DFI also was instrumental in providing technical advice regarding amendments to the Deed of Trust Act, which required greater communication between borrower and lender prior to foreclosure, requiring improved notices to protect borrowers and innocent tenants, enhancing the duties that trustees owe to borrowers, and permitting borrowers a right of action for actual damages against trustees and lenders for wrongful foreclosure. The foreclosure process isn't just about ownership, dollars owed or contracts signed – homeowners need time to develop their exit plan, and alternatives to foreclosure, if not compassion and understanding.

The Mortgage Crisis in Washington State – "Arrested Development"

In spite of DFI's efforts, we were never in a position to prevent the national mortgage crisis from hitting Washington State. DFI could only deal with the impact and aggressively undertake initiatives, as mentioned above, to help prevent the effects of the crisis from getting worse — specifically capitalizing on the impact of consumer financial education and outreach.

What began in Washington State as a spike in subprime ARM defaults, soon spread to prime ARM and so-called "option ARM" loans. Then, when the weight of these "toxic assets" finally caused a general economic meltdown, the resulting unemployment caused greater percentages of homeowners with prime fixed-rate loans to default and face foreclosure. The mortgage crisis and the collapse in construction, regardless of a robust IT and aerospace employment sector, resulted in Washington having a higher than normal unemployment rate.

But I can say with some measure of assurance that amendments to the Deed of Trust Act, beginning in 2008 and culminating in the 2011 Foreclosure Fairness Act, its

2012 amendments and legislation regarding "short sales" — particularly the Foreclosure Mediation Process to which DFI is a supporting agency to Commerce — have done much to slow and perhaps even reverse the upward trend in foreclosures. Moreover, the Washington Attorney General's national leadership in prosecuting robo-signing, assisted by the forensic investigative efforts of DFI examination teams, has played a part in preventing the percentage of foreclosures from increasing in our state.

Lessons Learned from the Mortgage Crisis

The biggest lesson learned from our experience with the mortgage crisis is that you cannot just be a regulator and an enforcer of laws: To get out in front of and help prevent problems from occurring, you must also have a public communications program emphasizing consumer awareness. Beginning with the current administration, DFI has aggressively pursued this policy.

Had there been a consumer financial literacy and outreach program a few years before the national mortgage crisis hit (especially when the bulk of subprime ARMs and option ARMs were being marketed), there might well have been an incremental positive effect on local rates of default and foreclosure.

The second lesson learned is that you cannot be too vigilant: You must anticipate potential problems in markets and business behaviors long before they materialize.

Thirdly, we have learned, like the rest of the nation, that everything is inter-connected and affects everything else, more or less.

- There is nothing at the federal level that escapes the states.
- There is hardly any regional phenomenon that does not affect the entire nation in one way or another.
- There is no policy (or absence of policy) in one part of the financial sector that does not have an effect – good or bad – in all other areas.

While the foreclosure crisis did become more significant in Washington, it is safe to say that the recommendations made by the Task Force and the resulting legislation supported by the Governor significantly reduced the impact of the crisis on Washington homeowners. It is incumbent upon DFI to seek the broadest and most flexible authority to regulate the industries over which we have jurisdiction so that we can be in a position to always fulfill our stated mission — protecting and educating the public and promoting economic vitality.

PROTECT: Bank Closures

Not long after we rang in 2009, I began to dread Friday nights. It was then that Washington joined the ranks of so many other states with financial institutions requiring closure. In the following three years, on those Friday nights DFI had to close 17 banks and one credit union.

Eight years ago, however, was a different story. The state of Washington enjoyed a good economy — everyone was making money, particularly in the real estate arena, which is the “bread and butter” of community bank lending. Banks had expanding balance sheets, strong earnings, and healthy capital positions; and many new banks were coming into the market.

Then the “Great Recession” hit, which led to those 18 failures and left many more damaged institutions. Washington banks had some of the highest concentrations in construction and commercial real estate lending in the nation. Unfortunately, with the precipitous decline in real estate values, those concentrations caused massive loan charge-offs and foreclosures, and ultimately led to the demise of many financial institutions.

This high loan demand was typically funded with non-core deposits (money from outside of a bank’s local deposits markets), creating a precarious liquidity situation. When banks got into trouble, those easy sources of funds dried up.

Some banks had weak management teams who were either incapable of reacting quickly enough to the crisis or refused to acknowledge the severity of their problems. The collapse of the housing and mortgage market added pressure to these overextended banks, and seriously impacted national banks like IndyMac and WAMU, kicking off a domino effect.

Back to those Fridays. The Governor and other local public officials in the bank’s market are notified of the pending closure. The Friday starts off as a typical day, but at the end of the workday, state and federal regulators quietly enter the bank. The regulators gather the employees together for a meeting, and announce that the bank is being closed due to a lack of capital resources. Employees are left fearful for their jobs and families’ futures. Stockholders will soon find out they have lost their investments. Boards and senior bank managements who were once the pillars of their communities are faced with the humiliation of failure. Loan customers become confused about the status of their loans, and regulators must address the public about the safety of the deposits they hold in the failed banks.

In the most recent failure, three rural communities were left without banking services. In the worst case, customers including municipal governments and commercial businesses that deal with large sums of cash would have to travel in excess of 40 miles to get to the closest community that had banking services. We worked hard over the following year to help these towns reestablish banking services. We worked with state chartered community banks to open branches, or offer other banking options (ATMs, Courier Services) to restore banking services in these remote markets. These communities were grateful to DFI for having these services restored.

The past four years proved to be trying times for Washington State's banking industry, but also a period of learning. With seasoned veterans and a lot of "trial by fire training" for new examiner recruits, our Division of Banks faced the daunting challenges of a changing banking environment.

As a result of the 2008 financial and mortgage collapse — the second largest economic recession in the last century — a whole new era began in community bank supervision. Nationally, there were nearly 400 bank failures between 2009 and 2011.

DFI worked with troubled banks and the Federal Deposit Insurance Corporation to coordinate the safe and orderly closure of those institutions — including concerted efforts to secure local purchasers and minimize consumer and public depositor losses. The first closure in 2009, Bank of Clark County, changed a number of things, and the lessons learned from that experience led to procedures which allowed a better working relationship with our federal regulatory partners whose missions differed somewhat from the responsibilities of the Washington State Department of Financial Institutions.

Our state now has healthier institutions working to develop strategies that will move them forward to profitability in a new banking environment. Institutions that were able to raise more capital will have to find safe ways to deploy that capital. Thin profit margins, increasingly remote banking services with less personal connection to the customer, and increased regulatory and compliance burdens will be challenges for community banks going forward.

The most important lessons brought to light during this trying time are that with thoughtful supervision, dogged determination, and a little optimism on our part, we now have earlier and better identification of problem or failing institutions, improved techniques to manage failing institutions, and better management of community fallout from the loss of a community bank. Washington State's financial institutions have always been closely monitored, and a partnership arrangement between the banks and the regulators has always been encouraged rather than an adversarial relationship.

Crucial support from Governor Christine Gregoire has helped the Division of Banks in continuing to recruit and train exceptional people who represent the State of Washington with strong technical expertise and professionalism. Even with serious budget deficits, Governor Gregoire joined me in recognizing the need to continue this very important mission.

Through a strong training and recruiting process, the men and women of the division were well prepared to meet the challenges presented during those troubling times. We are still able to recruit the best and the brightest college graduates and maintain an experienced staff, although retention remains an issue as state salaries have not kept pace with the financial industry and federal regulatory agencies.

PROTECT: Public Deposit Protection Commission (PDPC)

As one of Washington's smaller agencies, we are often more nimble and able to make adjustments quickly when needed. We learn quickly – both during and from our trials and tribulations — such as the January 2009 closure of Bank of Clark County. In this situation, we could see a problem (in this case with Public Deposit Protection), and we knew we couldn't fix it for this closure, but we could — and did — begin work immediately to fix it for future closures.

The Public Deposit Protection Commission (PDPC) was created in 1969 and is comprised of the State Treasurer, Governor, and Lieutenant Governor. The PDPC administers a program to ensure that public funds deposited in banks are protected if a financial institution becomes insolvent. Currently, nearly 100 public depositaries and 44 out-of-state and alien bank accounts are authorized by the PDPC.

The PDPC approves which banks can hold state and local government deposits and monitors the collateral pledged to secure uninsured public deposits. Banks are required to pledge securities for deposits exceeding the amount insured by the FDIC. PDPC-approved banks are liable (via proportional allocation) for losses on public funds due to the failure of other institutions.

Bank of Clark County's (BOCC) liquidity failure and expedited closure caused significant losses in public funds deposits, and the member banks of the PDPC had to cover those losses. Subsequently, several community banks exited the business of accepting public funds because they didn't want the risk. At the time of the BOCC failure, DFI actively worked with the State Treasurer to revamp the law to permit the Treasurer to require assurances for the continued viability of the Public Deposit Protection Program, including 100% collateralization of public funds (Substitute House Bill 2061). The law passed swiftly with bipartisan support. Today, new rules, policies, and practices strengthen protections on public deposits and reduce the liability for participating banks.

Under the current state law, the commission can request that a public depository furnish information on its financial condition, public deposits, and on the exact status of its net worth. The commission is empowered to take any action deemed advisable for the protection of public funds and to establish procedures for collection or settlement of claims arising from the failure of a public depository.

With the new legislation in place, DFI could — and did — meet regularly with the State Treasurer throughout the financial crisis to share sensitive confidential information that was critical to the Treasurer's administration of the PDPC. This action protected public deposits as well as renewed confidence in the PDPC by lowering the risk of loss to its members.

Federal government action to extend deposit insurance to transaction accounts also helped protect public funds during the crisis period. Transaction Account Guarantee (TAG) insures all bank deposits in excess of the traditional $250,000 limit for deposits guaranteed by the Federal Deposit Insurance Corp. The result is a sense of safety for companies and municipalities that want to deposit large sums of cash at banks. The program covers more than a trillion dollars worth of zero-interest deposits at large and small banks.

The TAG program was created in 2008 in the midst of market chaos stemming from the financial crisis. The program faces a Dec. 31, 2012 expiration date, absent congressional action. Groups representing community banks are aggressively pushing for an extension, arguing that termination of the program would prompt businesses and municipalities to withdraw their funds from smaller financial institutions.

Our ability to assess the situation, recognize the problem, and work with the appropriate partners to develop timely and effective legislation was critical in preventing additional public deposit losses and continued reduction in public depository participation. The public deposit losses experienced in Clark County — but not in any of the other closed institutions — clearly highlighted the importance of early communication and quick action with all involved partners.

PROTECT: Auction Rate Securities

The first indications we received of the impending auction rate securities crisis were modest enough: In March 2008, our Securities Division heard from four investors who complained that they could not get their money out of the auction rate securities their brokerage firms had sold them.

The investors said that they had originally bought the securities because their brokers had told them the securities were safe, short-term investments — like money market funds but paying a slightly better return.

In reality, auction rate securities were debt instruments, often issued by municipalities, or preferred stock issued by mutual funds. The rate the securities paid was set at frequent auctions (usually held on 7- or 28-day cycles) conducted by major brokerage firms. As we looked into the complaints, we learned that the auction rate securities market nationwide froze in February 2008 and millions of brokerage customers learned that money in investments they thought were liquid was indefinitely unavailable.

Soon, the trickle of complaints turned into a flood. We heard from a single mother who could not withdraw the money she needed to pay for her daughter's medical treatment. We heard from an elderly disabled man who was unable to get his money out to buy a house. We heard from a rancher who was facing foreclosure on part of his ranch because he could not get access to his money.

Over the next year and a half, our Securities Division would hear from more than 140 investors, who, collectively, had more than $181 million locked up in auction rate securities. These investors were not gamblers. They invested funds they intended to use for near term financial goals, such as the purchase of a new home, working capital for a business, or payment of taxes. The investors included individuals, businesses, and non-profits. By the time they called us, many of the investors were in a panic, especially as the press began to cover the auction rate securities crisis extensively.

In mid-April 2008, as the crisis built, the North American Securities Administrators Association (NASAA) formed an Auction Rate Task Force. We were one of the original members of the task force. Each task force state was assigned a brokerage firm for which it would be a lead state and we were assigned Wells Fargo. Yet again, DFI was like David, taking on a Goliath.

While the NASAA Task Force provided expertise and resources, it also required a lot of work by our Securities Division to coordinate with the other task force members.

DFI faced many challenges. At the time, our most experienced enforcement staff members were already committed to other major enforcement efforts. We had to assemble a team quickly.

Our team had to learn as much about the auction rate securities phenomenon as they could in a very short time frame. We quickly requested documents from brokerage firms involved, took statements from investors and developed an investigative plan based on the information gathered.

We developed the questions for the various categories of witnesses: salespersons, branch managers, regional managers, product managers, and trading desk employees.

Our investigative work culminated in taking testimony from 18 Wells Fargo witnesses from late August through October 2008. ***Without a high level of teamwork by our very capable staff, it would not have been possible to keep such an aggressive schedule for testimony.***

While we conducted our investigation, we continued to field many calls from distraught investors, a job that required patience and empathy. Our staff kept me informed on the scope of the problem in Washington so that I could respond to the many press inquiries DFI received. Beginning in August 2008, settlements in principle were being announced by other members of the task force in cases against broker-dealers that were underwriters of auction rate securities. These announcements kept the issue in the news.

With the information we gathered, we began drafting a statement of charges. We also began negotiations with Wells Fargo. Unfortunately, negotiations broke down.

Wells Fargo took the position that as a downstream firm, not an underwriter of auction rate securities, the auction rate securities debacle was not its fault. This ignored the fact that its representatives had given investors misinformation about auction rate securities. Most of the investors were risk-averse and needed liquidity. They would have never invested in auction rate securities if they had known that their money could be tied up indefinitely. We issued a statement of charges in November 2008.

Wells Fargo asked for a hearing. Our investigative team continued to gather and organize documents to make them available to the Attorney General's office in anticipation of the discovery process.

After the passage of some time waiting for the Office of Administrative Hearings to assign an administrative law judge, the matter came to life again once a pre-hearing conference date was set. We said that we would amend the order to identify the salespersons involved and to seek license action against the firms. In order to carry out this threat, we drafted an amended order. This brought Wells Fargo back to the table.

On Nov. 18, 2009, after a negotiating session that continued until after 3 a.m., a settlement in principle was reached. Wells Fargo agreed to repurchase the auction rate securities it had sold to its retail customers. ***Wells Fargo sold more than $3 billion worth of auction rate securities to its customers, of which more than $225 million was sold to Washington residents.***

After the settlement in principle was reached, we had to draft a template for the other NASAA jurisdictions to use as well as two consent orders to settle our own action with Wells Fargo. We then had to negotiate the language of the template with Wells Fargo's counsel. The consent order was finally returned with Wells Fargo's signatures and was entered on April 22, 2010. Wells Fargo paid a fine and our investigative costs 10 days after entry.

Our work on auction rate securities and our participation on the NASAA task force had several important benefits. ***The actions brought by Washington and the other task force states resulted in settlements with nearly 20 firms nationwide returning more than $100 billion to customers, including more than $2 billion to all eligible Auction Rate Securities investors in Washington State.***

At a time of constant talk about federal pre-emption of state securities regulatory functions, the successful efforts of Washington and the other NASAA task force members showed that state regulators are effective advocates for investors.

Task force participation had costs as well as benefits. Our auction securities effort was very resource-intensive at a time when resources available were very limited. The assignment we received as a lead state was a much more difficult one than those making the assignment knew. In fact, there were two Wells Fargo broker-dealers with customers holding auction rate securities. Only one of these broker-dealers (not the one originally assigned to DFI) was engaged in any underwriting activities relating to auction rate securities.

On balance, we did well to participate in the task force. Although the learning curve with regard to the auction rate securities business was very steep, it would have been much steeper without the help of other states who had more experience in the area.

Crises may arise at any time, regardless of what other resource commitments we have. In this case, our staff rose to the occasion. Although inexperienced, the team learned quickly, was flexible, and worked closely together without getting in each others' way. In addition to what they accomplished through formal actions, by listening to and making inquiries on behalf of customers, they provided a valuable service to citizens who suddenly found their funds were frozen and who did not know where else to turn.

EDUCATE: The Power of Partnership — Reaching the Entire State

We at DFI understand the importance of providing financial education to Washington residents of all ages, from all walks of life and from all socio-economic backgrounds – from the very young to our senior and elder populations.

DFI brought the Money Savvy Generation curriculum – with pre- and post-test, efficacy analysis, teacher training and parental involvement — to Washington elementary classrooms starting in 2004 and expanding to middle schools in 2007. ***To date, the program, solely funded by DFI, has provided proven effective financial education to more than 27,000 Washington students.***

Response from parents and teachers about the MSG program has been very positive: “The curriculum opened up communication about finances. It made [our son] more aware of how long it takes to save a specific amount of money.” “As a family we are talking about debt and savings.” ““[The best features of the program were] the banks, interviewing the parents and the great lesson slides. My students loved their pigs and worked hard to learn so they could take them home.” ““My whole team participated in the program. We all are grateful for the opportunity to share this important information with our students!”

Utilizing our Investor Protection Trust funds, we worked with Consumer University, AARP, FINRA and others to provide investor education to more than 10,000 Washington residents — from high school students and teachers to thousands of seniors near retirement and new retirees. Surveys indicated an anticipated 50% improvement at avoiding financial fraud after the AARP and FINRA workshops.

Annually, we participate in more than 50 financial education and/or foreclosure prevention outreach events. Our outreach efforts are noted, and appreciated by many partners: The Pacific Northwest Bankers Association “…we want to express our heartfelt appreciation for [DFI’s] participation in our Foreclosure Intervention Symposium….[DFI’s] dedication to distressed borrowers facing foreclosure on their homes is second to none.”; Pierce College TRIO program “This group really seemed to click with you and be receptive to the important information you offered. It is so valuable to have you as a partner!”; and Washington Business Week students “Thank you for the experience you blessed me with here at Business Week. I’ve learned that not only do I have a passion for business, but a passion for life!”

We continue to strengthen ties with other local, state and national financial education organizations to leverage the power of partnership and reach more residents each year with a greater number of resources – even as our outreach FTEs were reduced to only two communications/outreach staff due to budget cuts and overall FTE reductions.

In the fall of 2007, as we continued to investigate complaints – regarding investments, home purchase, payday loan usage and more – time and again we discovered consumers making costly mistakes or becoming victims of financial fraud simply because they didn't know any better. As the mortgage crisis and ensuing economic collapse hit our state, it became clear – more was necessary.

DFI began an Adjustable Rate Mortgage advertising campaign, warning homeowners that interest rate resets were on the horizon and to prepare for the higher monthly payments now to avoid foreclosure later. Ads ran in traditional and non-traditional news outlets, in magazines and more.

As a result of the Washington Task Force for Homeownership Security's recommendation for consumer education, DFI assembled the Washington Financial Literacy Work Group. The group was charged with identifying "current state funded efforts to support financial literacy, assess whether there are opportunities to create a centralized location of information regarding these existing state efforts, and to identify whether there are opportunities for expanding partnerships with other community entities also providing financial literacy services." The group, consisting of more than 30 Washington State financial education leaders, surveyed 749 state agencies, non-profit organizations, private sector organizations, K-12 educators, and 2-year technical and community colleges.

After numerous meetings and hours of research, the group submitted a final report summarizing the findings, 475 pages of supporting documents, and nine recommendations.

DFI took on the task of implementing of #7, the statewide clearinghouse: http://dfi.wa.gov/financial-education/ , immediately.

As the housing crisis and economic recession continued, it became clear that Washington's minority residents – particularly the Hispanic population – are especially at risk for financial fraud. In response, we enhanced our partnership with the Hispanic Affairs Commission, and formed a new liaison with the Heritage University Students in Free Enterprise (SIFE) to reach out to one of our state's most vulnerable populations. Our partnership with SIFE - a small group of student leaders from Toppenish's Heritage University, a small university in the Yakima Valley comprised of mainly Native American and Hispanic population - has become one of DFI's most successful financial education partnerships/programs.

The Hispanic Affairs Commission coordinated weekly time on statewide Hispanic radio stations for state agencies to share messages. DFI's messaging has primarily been education on foreclosure, mortgages and payday loans.

In partnering with the Heritage SIFE team, we were able to leverage Spanish-speaking residents of the Yakima Valley (SIFE students) to reach out to their neighbors with information on credit, debt, payday loans, payday lending law changes, mortgages, foreclosure prevention, Bank On efforts and more.

Since 2007, the SIFE team (consisting of an average of 60 participating students) has increased the program from 26 projects to 35, 7,605 volunteer hours devoted to programs increased to 16,165 and the phenomenal increase in impact of their outreach from 6,205 to 610,147 of Yakima Valley residents – many of them who only speak Spanish.

The Heritage SIFE team has competed in 11 regional competitions, winning them nine times. Additionally, they have competed in SIFE national competitions, placing in the top four four times and top 20 seven times – often against teams from universities and colleges many times their size.

DFI finds partnership with Heritage SIFE students most effective in reaching out to those who live and work within the Yakima Valley – particularly when reaching out to members of the Hispanic population who only speak Spanish. These students are living examples of how financial education can change lives.

I believe they tell their own story best, as they did during a national competition presentation. The hurdles they work to overcome are immense: “Nearly 50% of our children never graduate. 24% of our population lives below the poverty line, with one in 17 families surviving on food stamps as their primary source of income. And 12% one of the highest unemployment rates in the state. An average family weekly income that ranks 5th from the bottom of all large counties in the United States.” Nevertheless, these students are strong, driven and eager to succeed: “We address the deep-rooted, consistent, pernicious problems that affect our daily lives in the Yakima Valley. We focus our attention on how to apply consistent pressure and effort in a holistic way. We improve the quality of our lives through education, confidence and developing skills that are essential in a free-market economy. It is a human element, that we challenge, is the single most important factor to create change, to develop opportunities, and to allow us to achieve our potential as individuals.”

The number one lesson learned throughout the past eight years educating Washington residents is that together we CAN make a difference, that there is great power in partnerships. When like-minded individuals, organizations and agencies pull their resources and people together, we can positively affect more Washington residents. It is with that belief that DFI’s financial education & outreach team currently partners with more than 30 local, state and national partners, and continues to seek out new partnerships and ways to utilize the resources of our partners to ensure more Washington residents receive the financial education — and thereby find the financial freedom — they deserve.