Reforming Mortgage Lending

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Abstract: Campen observes that an unprecedented wave of abusive and irresponsible mortgage lending played a central role in the collapse of the financial system. Wide-ranging reforms are necessary to prevent a repeat of this debacle, and Campen identifies eight key elements of a reformed system for regulating mortgage lending: responsible underwriting, appropriate incentives, understandable and timely disclosures, community reinvestment obligations, fair lending enforcement, comprehensive and uniform regulation, multiple levels of enforcement, and expanded data collection and analysis. He concludes by reviewing four current legislative and regulatory initiatives that could advance this agenda.

An unprecedented wave of abusive and irresponsible mortgage lending during the first seven years of the twenty-first century stripped wealth from millions of borrowers, led to the on-going tsunami of foreclosures, and played a central role in the collapse of the financial system.

This destructive lending was the result of a complex and interrelated set of factors, including: the growing dominance of the "originate-to-distribute" lending model aimed at providing loans for investment banks to package into securities, where actors at each of several points earned generous fees but had no financial stake in repayment of the loan; incentive structures facing individuals from front-line workers to CEOs that created strong pressures to generate high volumes of high-cost loans, and to exploit vulnerable classes of borrowers to the maximum possible extent; a fragmented regulatory system that allowed banks and savings institutions to choose among four federal regulators – who competed for clients by becoming ever more lenient – while leaving thousands of other mortgage lenders with no federal regulator at all; federal bank regulators (the OCC and the OTS) who took unprecedented actions to prevent state attorneys general from enforcing state laws against national banks and thrifts, thereby upsetting a system of dual regulation that had been in place since the Civil War; and lawmakers who rolled back existing legislation and failed to respond to newly emerging problems.

Special responsibility must be placed on the failure of the existing regulatory system. Deregulation by elimination of existing laws and regulations, non-regulation of new actors and products that cried out for coverage, and non-enforcement of the laws and regulations that remained in place all combined to allow the explosion of irresponsible and abusive mortgage lending.

Given the current state of the housing and mortgage markets, very few of the types of subprime and toxic loans that brought the system down (including: stated income, interest-only, payment option ARMs, and 2/28 or 3/27 ARMs) are currently being made. But such lending – including, inevitably, innovative variations – is sure to reemerge once the economy and mortgage market recover. In order to prevent a repeat of the recent debacle, it is essential to put in place a regulatory system to ensure that future mortgage lending will be safe for home-buyers and home-owners and will not be destabilizing to the housing market and the economy.

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Key Elements of a Reformed System for Regulating Mortgage Lending

Given the multiple causes of the problem, reforming mortgage lending requires a broad range of changes. The following key elements of a comprehensive reform emphasize protecting borrowers; if lenders are required to make only responsible loans on which borrowers can afford the monthly payments, then mortgage lending will not contribute to instability in local communities, in the housing market, in the financial system, or in the broader economy.

Responsible underwriting. Lenders must be prohibited from making loans on which borrowers do not have the documented ability to make their monthly payments. Only loans that borrowers have the ability to repay are consistent with sustainable home-ownership. Evidence suggests that most unaffordable loans were pushed on borrowers by aggressive loan originators, but even in those cases where consumers apply for loans that they cannot afford, it is the responsibility of lenders to deny those applications. Disregard for this basic rule of lending may be the single greatest cause of the mortgage crisis.

Appropriate Incentives. All actors in the mortgage process must have incentives that align their interests with the interests of borrowers and must be accountable for their actions. That is, they should receive positive compensation only when borrowers receive loans that are not only affordable but also are suitable to their needs and fairly priced. Conversely, they should face significant consequences for actions that harm borrower interests. For frontline personnel, this could be accomplished by imposing a duty of good faith and fair dealing on all loan originators plus a fiduciary duty on mortgage brokers (who borrowers now often mistakably believe have a responsibility to act in their interests), and by explicitly prohibiting yield spread premiums and steering, two common practices that reward loan originators for placing borrowers in loans that are more expensive than the best loans for which they are qualified. Appropriate incentives for Wall Street players – securitizers and investors – would be greatly advanced by assignee liability; if these actors were accountable for any abusive loans that they own, they would have a strong incentive to purchase only loans that were responsibly made. This in turn would provide appropriate incentives to lenders.

Understandable and timely disclosures – and more. Current disclosures are often too lengthy and too complex to be understood by borrowers and are often delivered too late in the process (e.g., at closing) to inform borrower decision-making. Regulations should require clear, concise, timely disclosure of loan costs and terms, highlighting particularly costly or risky features. However, some loan terms are so inherently unfair and abusive that disclosure alone is not an adequate protection; such terms should be prohibited. Examples of such inherently unfair and abusive loan features include yield spread premiums, prepayment penalties, and single payment credit insurance. Our society has decided that products such as exploding toasters, harmful drugs, dangerous toys, and tainted food are too unsafe to be offered in the marketplace, regardless of the level of disclosure. Toxic mortgage products should be similarly prohibited.

Community reinvestment obligations. One effective safeguard against abusive lending is the availability of responsible and affordable loan products. The Community Reinvestment Act gives banks an affirmative obligation to meet the credit needs in the neighborhoods where they have branch offices, and very little of the lending subject to CRA oversight was abusive. However, the growth of mortgage

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lending by banks in regions where they do not have branches, by bank affiliates, and by independent mortgage companies resulted, by the turn of the century, in only about one-third of all mortgage lending being covered by the CRA. The CRA should be modernized by extending CRA-type obligations to all lenders who account for a significant share of lending in a local area and by clarifying that CRA evaluations will be based on the quality as well as the quantify of loans to traditionally underserved borrowers and neighborhoods.

Fair Lending Enforcement. Black and Latino borrowers, and neighborhoods with high concentrations of black and Latino residents, received hugely disproportionate shares of abusive subprime loans, often as a result of targeted marketing (reverse redlining) and deliberate steering by subprime lenders. Existing fair lending laws (the Equal Credit Opportunity Act and the Fair Housing Act) prohibit discrimination on the basis of race, color, and national origin in all aspects of mortgage lending, but these laws have been generally ignored by federal regulators. Going forward, we need vigorous enforcement of fair lending laws to eliminate racial and ethnic discrimination from the mortgage market.

Comprehensive and uniform regulation. Under the current regulatory regime, parties that provide the same product or service are frequently subject to different rules and overseen by different regulators – and in some cases overseen by no federal regulator at all. As a result, lenders choose the corporate forms or charters that subject them to the least restrictive regulation, regulators compete for clients by loosening standards, and bad lending tends to drive good lending from the marketplace -- as responsible lenders are unable to compete with irresponsible lenders who aggressively market superficially attractive loan products that are in fact filled with tricks and traps that vulnerable borrowers discover only after it is too late. Instead, all parties that provide the same product or service should be subject to the same rules and regulations, enforced by the same regulator. Furthermore, this regulator should have responsibility for writing rules and regulations, for supervising lenders and other participants in the mortgage lending process, and for enforcement.

Multiple levels of enforcement. The primary responsibility for enforcement should lie with the single federal mortgage lending regulator. But the scope and diversity of the mortgage industry is so vast that no single agency can effectively respond to all abuses. Other federal agencies, such as the bank regulators, could be given back-up enforcement powers for the entities that they oversee. More important, state attorneys general should have the right to enforce federal laws and regulations within the boundaries of their states. In addition, states should be able to adopt stronger protections for their own citizens when they judge that it is appropriate to do so; that is, federal laws should provide a floor rather than a ceiling for mortgage regulation. Federal preemption of state laws and of state enforcement of federal laws should be returned to the modest role that it played before its aggressive expansion by federal bank regulators in recent years. If federal regulations are strong, then relatively few states will see the need to adopt regulations that go further. But states will still be able to operate as the laboratories of democracy by responding to emerging problems in a timely basis. Furthermore, wronged borrowers should be able to seek justice through in the courts, either as individuals or in class action lawsuits. Federal and state enforcement efforts will necessarily focus on systemically important cases, and many harmed individuals will be unable to obtain the compensation or protections that they deserve unless they have access to the civil justice system.

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Expanded data collection and analysis. With regulatory authority over mortgage lending now dispersed among multiple agencies, no single agency has the resources or the incentive to develop a data gathering and research capacity adequate to monitor the industry, evaluate the effectiveness of current regulations, or identify emerging trends and problems. In many cases, federal regulators are forced to base their analyses on data purchased from proprietary databases maintained by private companies. Instead, the new single federal mortgage regulator should develop and maintain its own database(s), includingsystematic data on loan performance, delinquencies, and foreclosures. The Home Mortgage Disclosure Act should be amended to require additional data about borrowers (e.g., age and credit score indicator), about loan originators, and about loan characteristics. The regulator should have a large enough staff of skilled researchers to conduct analyses that can inform the agency's rule-writing, supervision, and enforcement activities in a timely manner.

Current Legislative and Regulatory Initiatives

Among the legislative and regulatory measures currently under active consideration four are particularly relevant for moving toward the reformed system for regulation of mortgage lending envisioned above.

H.R. 3126, approved by the House Financial Services Committee on October 22, would establish a *Consumer Financial Protection Agency* (CFPA). The sole mission of the CFPA would be consumer protection and it would have primary responsibility for rule-writing, supervision, and enforcement of several existing laws. Its coverage would include all actors involved at all stages of the mortgage lending process. It would end the fragmentation, competition in regulatory laxity, uneven treatment, and gaps in coverage which characterize the present system of mortgage lending regulation. Its rules would operate as a floor rather than a ceiling, allowing individual states to enact stronger measures to protect their own citizens. It would have primary responsibility for enforcement of the nation's fair lending laws. It would have the ability to act promptly in response to emerging problems. And it would have a substantial research division to assemble and analyze the data needed to carry out its responsibilities. The establishment of a strong CFPA would do much to ensure fair and effective regulation of mortgage lending.

H.R. 1728, the *Mortgage Reform and Anti-Predatory Lending Act*, was approved by the House on May 7 by a vote of 300 -114; it awaits action in the Senate. The bill, which covers all mortgage lenders, mandates many important reforms, including requirements that lenders verify the borrower's ability to repay the loan and that refinance loans provide a tangible net benefit to the borrower; prohibitions on predatory features such as single-payment credit insurance, prepayment penalties on adjustable rate loans, and binding mandatory arbitration; and standards for appraisers and loan servicers. Consumer advocates praise many features of the bill, but urge the Senate to strengthen the penalties faced by violators and the accountability of Wall Street securitizers who purchase and package abusive mortgage loans and of investors in mortgage backed securities.

A Federal Reserve proposal for changes to its *Regulation Z (Truth in Lending)* would greatly improve the disclosures to consumers who apply for mortgage loans, and make them available earlier in the process. These mandated disclosures would include a comparison of the APR offered to the borrower to

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the average APR offered to borrowers with excellent credit, specify the maximum future monthly payment possible under an adjustable rate mortgage, and highlight other potentially risky loan features. Importantly, the Fed recognized that disclosure is not enough in some circumstances and proposes to prohibit brokers or loan officers from steering consumers to loans that are not in the consumers' interest but provide increased compensation to the broker or loan officer and from receiving yield spread premiums or any other payments based on a loan's interest rate or other terms. The Fed released these proposed regulations on July 23; the period of public comments will end on December 24. It is important that the final version of the regulation, expected next year, not be weakened during the comment and review process.

H.R. 1479, the *Community Reinvestment Modernization Act*, the subject of a September 16 hearing by the House Financial Services Committee, includes provisions that would extend CRA-type obligations to all mortgage lenders, whatever their corporate form or charter.

Recommended Reading

Immergluck, Dan. "Policies for Fair, Affordable, and Sustainable Mortgage Markets," pp. 197-224 of *Foreclosed: High-Risk Lending, Deregulation, and the Undermining of America's Mortgage Market,* Cornell University Press, 2009.

U.S. House of Representatives, Committee on Financial Services, Hearing on H.R. 1728, the Mortgage Reform and Anti-Predatory Lending Act of 2009, April 23, 2009. Written statements of Michael Calhoun of the Center for Responsible Lending, Margot Saunders of the National Consumer Law Center, and John Taylor of the National Community Reinvestment Coalition. All available at: www.house.gov/apps/list/hearing/financialsvcs_dem/hr041609.shtml.