

Randall S Kroszner: Protecting homeowners and sustaining home ownership

Speech by Mr Randall S Kroszner, Member of the Board of Governors of the US Federal Reserve System, at the American Securitization Forum 2008 Conference, Las Vegas, Nevada, 4 February 2008.

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The mortgage market has long been a source of strength in the U.S. economy, but it is facing significant challenges, especially in the subprime segment that serves consumers who have shorter or weaker credit records. As of November, the most recent month for which data are available, about 20 percent of subprime adjustable-rate mortgages (ARMs) were ninety or more days delinquent, twice the level one year earlier.¹ More than 171,000 foreclosures were started on these mortgages in the third quarter, up 36 percent from the previous quarter.² The significance of the problems with subprime loan performance is evident in the unusually high rate of defaults within a few months of loan origination, known as early payment defaults. In November, nearly 7 percent of subprime ARMs originated in the previous six months were already ninety or more days delinquent, twice the rate of the year before and nearly four times the rate two years earlier.³

These problems have many causes, but the role of abusive lending practices is of particular concern. Such practices have led many people into homeownership that they cannot sustain, hurting their families as well as their neighbors and communities. Practices that have hurt consumers have also undermined the confidence of investors and contributed to a virtual shutdown of the subprime market. As a result, it is difficult for many borrowers, especially those with shorter or weaker credit records, to obtain home loans.

These events have highlighted the shared interest of mortgage borrowers, their communities, lenders, and investors in protecting borrowers from abusive practices and preserving their choices. Abusive loans that strip their equity or cause them to lose their homes must not be tolerated. Protecting borrowers with responsible underwriting standards also protects the integrity and proper functioning of the mortgage market by increasing investor confidence. In other words, effective consumer protection can reduce uncertainty about the underwriting standards of, and hence, the value of, loans in mortgage-backed securities, thereby helping to revive and strengthen mortgage securities markets. In this way, effective consumer protection produces a complementary benefit for consumers by making more capital available to meet their needs. Similarly, systematic efforts to keep borrowers who may have trouble meeting their loan obligations in their homes on a sustainable basis, by providing more certainty to the market, can have the complementary benefit of ensuring the flow of capital for potential borrowers.

With these principles in mind, I will discuss current initiatives to mitigate foreclosures. Then I will spend most of my time discussing the Board's recent initiative in proposing new regulations to prevent abuse, unfairness, and deception in residential mortgage lending.

¹ Board staff calculation based on data from First American LoanPerformance.

² Board staff calculation based on data from the Mortgage Bankers Association.

³ Board staff calculation based on data from First American LoanPerformance.

Preventing unnecessary foreclosures

About one-and-a-half million adjustable-rate subprime mortgages are scheduled to have their interest rates reset this year--significantly more than in 2007--and another one-half million in 2009. While many borrowers facing reset will be able to make the higher payment, many will not. As rates reset, it is important that we take steps to protect homeowners, communities, the mortgage market, and the economy from the adverse consequences of unnecessary defaults and foreclosures.

Given the high cost of foreclosures to lenders and investors and the disruption and distress that foreclosure can cause to consumers, their families, and their communities, it is in everyone's interest to avoid foreclosures whenever other viable options exist. With large numbers of borrowers facing potential repayment problems, it is in the interest of borrowers and investors alike for the industry to develop prudent loan modification programs and other assistance to help borrowers on a systematic and sustainable basis.

The American Securitization Forum (ASF) and the Hope Now Alliance have recognized this interest and have taken leading roles in streamlining the process for refinancing and modifying subprime adjustable-rate mortgages. I have been an active proponent of such streamlined systematic approaches to reduce transactions costs and to help mitigate foreclosure risk, and I strongly encourage market participants to adopt and to implement these fast-track modification proposals as quickly as possible. The efforts by ASF and Hope Now have helped accelerate loan modifications in the last quarter, according to recently released data. I applaud these efforts but more must be done as the number of households facing resets increases. Challenges remain, for example, with respect to ongoing constraints on servicing capacity to expedite work outs. Servicers must undertake the investment to overcome the capacity challenges and provide transparent and timely measures of the results.

A systematic and prudent effort to avoid unnecessary foreclosures has many benefits. Many borrowers with subprime ARMs, for example, have been able to strengthen their credit records by making timely payments so far. It would be very unfortunate if some of these borrowers faced foreclosure when their payments increased merely because servicers lacked the capacity to reach them in time with a sustainable alternative. The solid credit history would be lost and, consequently, financing options would be reduced. Loan-by-loan modifications can help some, but they require substantial time and effort. Where appropriate, an efficient, systematic approach lets servicers reach more of these borrowers and prevent more foreclosures.

Furthermore, as noted above, standards for dealing with problem loans may help make more capital available for potential borrowers. By providing more certainty to the mortgage market, clear and consistent standards can help ensure the flow of credit to potential borrowers.

While much has been done to prevent avoidable foreclosures, more still needs to be done. For our part, the Federal Reserve has been working with financial institutions and community groups around the country to address the challenges posed by problem loans. For instance, we have been providing community coalitions, counseling agencies, fellow regulators, and others with detailed analyses identifying neighborhoods at high risk of foreclosures. In addition, all twelve of the Federal Reserve Banks have also been working with an array of stakeholders to address these challenges on the local and regional levels.

There are also efforts under way on the international level to develop responses to recent financial market turmoil. I represent the Board on the Financial Stability Forum, which has established a working group to diagnose causes of recent events and make recommendations.

The Board's proposal

I will now focus on the Board's recent proposal for stricter regulations prohibiting abusive and deceptive practices in the mortgage market under authority of the Home Ownership and Equity Protection Act (HOEPA). This proposal is intended to protect consumers and to preserve consumer choice by targeting protections to borrowers who face the most risk. The proposed regulations are designed to protect consumers from excessive layering of risk even as the practices that increase risk may change. We have sought to ensure that these standards are clear for lenders to reduce unintended consequences for consumers. Though clear, the standards are intended to be not overly prescriptive, so as to preserve access to responsible credit while amply protecting consumers. Our proposal is also comprehensive, covering most mortgage loans with certain protections and the entire subprime market with certain more specific regulations. While comprehensive, the proposal would focus protections where the risks are greatest and preserve consumers' access to responsible credit.

Our effort to produce robust, clear, and comprehensive rules was based on a rigorous analysis of available qualitative and quantitative data. We have put this proposal out for public comment until April 8 and eagerly seek suggestions to be able to craft the best possible final rule.

Comprehensive scope

Let me say more about the comprehensive scope of this proposal. It would apply stricter regulations to higher-priced mortgage loans, which we have defined broadly. We were particularly interested in ensuring that protections remain strong over time as loan products and lending practices change. Our analysis of the data suggested that the troubles in the mortgage market generally arise not from a single practice in isolation, but instead from the complex ways that risk factors and underwriting practices can affect each other, sometimes called "risk layering." Therefore, we have proposed using a loan's annual percentage rate, or APR, to determine whether the loan is covered by stricter regulations.⁴ Because the APR is closely correlated to risk, the proposed protections would cover loans with higher risks rather than single out particular risk factors or underwriting practices.

With the APR thresholds we have proposed, we expect that the new protections would cover the entire subprime mortgage market and the riskier end of the "near prime" market, the latter also known as the "alt-A" market. Covering part of the alt-A market would anticipate possible actions by lenders to avoid restrictions on subprime loans priced near the threshold. It would also address real risks to consumers in the alt-A segment. This segment grew very rapidly, and it layered risks, such as undocumented income, on top of other risks, such as nontraditional loan structures allowing borrowers to defer paying principal and interest.

Our public hearings and our analysis identified problems not just in higher-priced loans, however, but in the broader mortgage market. Thus, our proposal addresses unfair or deceptive practices for the vast majority of mortgage loans secured by a consumer's primary home. Areas targeted this broadly include broker steering, appraisal coercion, unwarranted servicing fees, and deceptive advertising. I'll touch on broker steering toward the end of my remarks.

⁴ Under the proposal, a "higher-priced mortgage loan" would have an APR that exceeds the yield on comparable Treasury securities by three or more percentage points for first-lien loans, or five or more percentage points for subordinate-lien loans.

Robust approach to affordability

Extending credit that borrowers can afford to repay is a fundamental pillar of responsible lending. Across the whole range of higher-priced mortgage loans, our proposal offers three rules that, working in combination, would help ensure that borrowers can afford their payments. First is a requirement that a lender maintain responsible underwriting practices that genuinely assess borrowers' ability to repay. This general requirement would be complemented by a specific requirement to verify borrowers' income and assets. A third rule would require lenders to escrow property taxes and homeowners insurance to help borrowers meet these obligations.

This robust approach to affordability would help ensure that the subprime market promotes sustainable homeownership. Just as important, it would also help protect consumers from abuse. When the law requires that monthly payments be affordable, then consumers are less vulnerable to abusive refinancings that strip equity. When the law imposes a responsible underwriting standard on all lenders, then irresponsible actors who would strip borrowers' equity are easier to keep out of the market. Clear lending standards have the further advantages of increasing investor confidence in the mortgage market and helping to revive the flow of credit flow to consumers with shorter or weaker credit records.

Assessment of repayment ability

Now I want to discuss the major elements of our proposed regulations for higher-priced loans in a little more depth, starting with the requirement to assess repayment ability. The regulations would prohibit a lender from engaging in a pattern or practice of making higher-priced loans based on the value of the borrower's house rather than on the borrower's ability to repay from income, or from assets other than the house. This prohibition is intentionally broad to capture all risks to loan performance and the different ways that these risks can be layered. Moreover, the proposal avoids prescribing quantitative underwriting requirements. For example, the proposal would prohibit a pattern or practice of disregarding the ratio of applicants' income to their debt, but it does not prescribe a maximum ratio because the appropriate number depends heavily on other risk factors, which vary from loan to loan.

At the same time, the proposal does offer specifics. For example, it would create a presumption that a lender had violated the regulations if it engaged in a pattern or practice of failing to underwrite at the fully-indexed rate.⁵ This presumption is derived from the subprime guidance the agencies issued last year.

It bears emphasis, however, that our proposed regulations would be more robust and comprehensive than the guidance. The regulations would apply to all mortgage lenders, including independent mortgage companies. Guidance, in contrast, does not ensure uniformity of coverage. Moreover, the regulations would be legally enforceable by supervisory and enforcement agencies. Just as important, the regulations, unlike the guidance, would be legally enforceable by consumers. Borrowers who brought timely actions could recover statutory damages for violations, above and beyond any actual damages they suffered.

The proposed requirement to assess repayment ability is intended to protect consumers from abusive practices while maintaining their access to responsible credit. We recognize that satisfying both objectives at the same time is a challenge. The proposed rule's potential for

⁵ On an adjustable-rate mortgage, the fully-indexed rate is the sum of the value of the applicable index as of loan origination and the margin specified in the loan agreement. For example, a typical 2/28 mortgage issued in 2006 might have a fully-indexed rate of 11.37. This assumes that the mortgage was linked to the six-month LIBOR, that LIBOR was at its 2006 average value of 5.37 percent, and that the mortgage had a margin of six percentage points.

consumer actions, coupled with its careful avoidance of prescribing quantitative underwriting thresholds, could raise compliance and litigation risk. In turn, this could raise the cost of credit for higher-risk borrowers or limit the availability of responsible credit. That is why we have proposed prohibiting a "pattern or practice" of disregarding repayment ability rather than attaching a risk of legal liability to every individual loan that does not perform. This approach is meant to preserve choices for borrowers with shorter or weaker credit records while protecting them from lenders who have a practice of disregarding repayment ability or are found to exhibit a pattern of unaffordable loans.

We anticipate vigorous comment on our proposed approach and have specifically solicited suggestions for its implementation.

Income verification

When we looked closely at why so many borrowers had mortgages that they struggled to repay so soon after taking out the loan, the prevalence of "stated-income" lending was a clear culprit. Substantial anecdotal evidence indicates that failing to verify income invited fraud. Moreover, when we looked at the loan-level data we saw a clear correlation between "low-doc" or "no-doc" lending and performance problems, particularly early payment defaults.

That is why we have proposed to complement a broad requirement to assess repayment ability with a specific requirement to verify the income or assets a lender relies on to make a credit decision. We recognize that stated-income lending may have a proper place when not layered on top of too many other risks. Indeed, stated income lending and "no/low-doc" lending are defining features of the alt-A market, which has long served borrowers with good credit scores who seek some underwriting flexibility. We would target the verification requirement to higher-priced loans, including the higher-priced end of the alt-A market, where the risks of stated-income lending could be layered on top of too many other risks. This targeting is intended to maintain consumer access to responsible credit.

The proposal identifies standard documents that would be acceptable, such as W-2 forms. It also allows, however, any third party documents that provide reasonably reliable evidence of income. This rule is meant to preserve consumer choice by allowing the market to identify credible nontraditional documentation of consumer income--for example, check-cashing receipts. In that regard, the proposal responds to input we gathered through the HOEPA hearing I chaired last June. Several panelists spoke of the fact that some consumers may have access to only nonstandard documents and others, such as self-employed entrepreneurs, may have some difficulty documenting their income. To help ensure that the proposal preserves access to credit for the full range of consumers, we have sought public comment on this issue.

Escrows for taxes and insurance

Another part of our proposal for higher-priced loans--a requirement to escrow taxes and insurance--would also help ensure that borrowers can afford their payments. Escrowing has become standard practice in the prime market, and the case for making it standard in the subprime market, too, appears compelling. Consumers with shorter or weaker credit histories may be less likely to appreciate the sizable burden that taxes and insurance can add to the cost of homeownership, or more vulnerable to being misled by payment quotes that leave out these amounts. Moreover, when we looked at the data, we saw in the unusually high level of early payment defaults possible evidence that the lack of escrows hurt consumers who did not have experience paying property tax and insurance bills.

We have proposed to address the problem with a requirement to escrow taxes and insurance on higher-priced loans, accompanied by a limited allowance for opt-out. We wanted the regulations to prevent irresponsible efforts to encourage borrowers to opt out. So the rule

would not permit opt-out at the closing table, but instead would require that twelve months pass before a consumer may opt out. In this respect the proposal is intended to preserve consumer choice while protecting consumers from unaffordable mortgage obligations.

Prepayment penalties

Having discussed the rules that would promote affordability, I want to say a word about our proposed rule on prepayment penalties. These penalties can take a toll on consumers who have riskier loans, and many consumers may not even be aware their loans have a penalty. Accordingly, we have proposed a ban on prepayment penalties in circumstances of a high degree of risk to the consumer, and we are also addressing transparency concerns.

The proposed rule would ban prepayment penalties where they are most likely to prevent a consumer from refinancing a loan that has a particularly burdensome payment. Specifically, a penalty would be prohibited where the borrower's debt-to-income ratio exceeds 50 percent, and a penalty would have to expire before a loan's payment could increase. The rule would also ban prepayment penalties where they are more likely to be part of a "loan flipping" scheme--specifically, where a lender or its affiliate refinances the lender's own loan.

An approach tailored to the degree of risk to the consumer appears to us to be in the best interest of consumers overall. Banning penalties altogether could cause all borrowers, including those who do not prepay, to bear the full cost of investors' prepayment risk. That result would raise questions of fairness, and it could reduce consumer choice.

We share concerns, however, that consumers often do not knowingly choose loans with penalties. We are tackling those concerns head-on. Through rigorous consumer testing, we are developing a new disclosure for prepayment penalties to improve consumer awareness and understanding. This should empower consumers to make better informed choices and improve competition.

Steering

I have so far discussed the elements of our proposal that would seek to ensure that underwriting practices and loan terms on higher-priced loans do not present unwarranted risks to consumers. There is another potential source of risk to consumers that I want to address that is related to "steering"--the risk that when they use the services of a mortgage broker, they do not appreciate the extent to which the broker's interests may diverge from the consumer's interests because of "yield spread premiums."⁶

The growth of the market for brokerage services has no doubt increased competition in the market for mortgage loans, to the benefit of consumers. Moreover, the yield spread premium, a payment from a lender to a broker based on the loan's interest rate, is sometimes the best way for a consumer to fund the cost of a broker's services. However, when a lender pays a broker for a loan that has a higher rate, that payment can create a conflict of interest between the broker and the consumer. This conflict is problematic if the consumer does not know it exists or assumes, incorrectly, that the broker is obligated to put the consumer's interests first. In such cases, the consumer cannot protect his or her own interests, and competition for loans and for brokerage services does not work effectively.

Therefore, we have proposed to prohibit a lender, for both prime and subprime loans, from paying a broker any more than the consumer had expressly agreed that the broker would

⁶ A "yield spread premium" is the present dollar value of the difference between the lowest interest rate the wholesale lender would have accepted on a particular transaction and the interest rate the broker actually obtained for the lender. This dollar amount is usually paid to the mortgage broker. It may also be applied to other loan-related costs, but the Board's proposal concerns only the amount paid to the broker.

receive. This agreement must be executed up-front, before the consumer has submitted an application and become invested in closing the deal. The combination of stricter regulation and better disclosure that we are proposing should help reduce a broker's incentive to steer a consumer to a higher rate, empower consumers to shop and negotiate among brokers, and preserve consumers' option to use the services of a broker.

Better and earlier information for consumers

Lastly, to protect consumers and promote competition, our proposed regulation would prohibit misleading mortgage advertising and require that consumers receive loan-specific disclosures early in the application process, when they can use the information to shop more effectively. We recognize, however, that we face a challenge in ensuring that disclosures for mortgage loans remain effective. We have begun a comprehensive program of rigorous consumer testing of potential improvements to current disclosures.

Conclusion

There are more elements of our comprehensive proposal that I do not have time today to discuss, such as a prohibition against coercing appraisers and restrictions on unwarranted servicing fees. We anticipate vigorous public comment on this proposal, and once we have carefully considered all the input we receive, we will move expeditiously to a final rule. As I noted at the outset, effective consumer protection can help to restore confidence in the mortgage markets and help to preserve the flow of capital to consumers who wish to purchase a home.

It is not too early to emphasize that the effectiveness of the final rule will depend critically on effective enforcement. The Federal Reserve will do its part to ensure compliance among the institutions it supervises. We also have been instrumental in launching a pilot project with other federal and state agencies to conduct consumer compliance reviews of non-depository lenders and other industry participants. I am sure we will be aided in these efforts by a new system for registering and tracking mortgage brokers recently launched by the Conference of State Bank Supervisors.

While we work to build effective consumer protections and enforcement regimes for future consumers, we will also continue our efforts, and encourage the initiatives many others are undertaking, to limit unnecessary foreclosures for consumers who are hurting now.