Randall S Kroszner: Legislative proposals on reforming mortgage practices

Testimony by Mr Randall S Kroszner, Member of the Board of Governors of the US Federal Reserve System, before the Committee on Financial Services, US House of Representatives, Washington DC, 24 October 2007.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Chairman Frank, Ranking Member Bachus, and members of the Committee, I appreciate the opportunity to appear before you today, to discuss recent problems in the subprime mortgage market, Federal Reserve actions that address these developments, and potential legislative responses. Promoting access to credit and sustainable homeownership are important objectives, and the Board believes that responsible subprime mortgage lending can help advance both goals.

Background

Subprime mortgages are loans intended for borrowers who are perceived to have higher than typical credit risk. In recent years, the subprime market has grown dramatically because of advances in credit scoring and underwriting technology, which enables lenders to charge different borrowers different prices on the basis of calculated creditworthiness. These loans are recognized by the higher prices they carry, which reflect subprime lenders' decisions to seek additional compensation for the credit risk they incur.

As the overall mortgage market has grown, many new lenders and distribution channels have developed and most of those are outside the direct jurisdiction of the federal banking agencies. A review of data provided by mortgage lenders pursuant to the Home Mortgage Disclosure Act reveals that lenders that are not subject to oversight by a federal banking agency originated just under half of the higher-priced conventional first lien mortgage loans reported in 2006.

While the expansion of the subprime mortgage market over the past decade has increased access to credit, the subprime mortgage market during recent years was also accompanied by a deterioration in underwriting standards. In some cases, abusive or fraudulent lending practices resulted in homeowners taking on mortgage obligations they could not afford, with terms they may not have fully understood. Delinquencies and foreclosures have increased. During the past two years, serious delinquencies among subprime adjustable-rate mortgages (ARMs) have increased dramatically, reaching nearly 16 percent in August, roughly triple the recent low in mid-2005. For so-called near-prime loans in alt-A securitized pools (those made to borrowers who typically have higher credit scores than subprime borrowers but still pose more risk than prime borrowers), the serious delinquency rate has also risen, to 3 percent from 1 percent only a year ago. These patterns contrast sharply with those in the prime-mortgage sector, in which less than 1 percent of loans are seriously delinquent.

Higher delinquencies have begun to show through to foreclosures. About 320,000 foreclosures were initiated in each of the first two quarters of this year (just more than half of them on subprime mortgages), up from an average of about 225,000 during the past six years. Foreclosure starts tend to be high in states with stressed economic conditions and to rise where house prices have decelerated or fallen. Adjustable-rate subprime mortgages originated in 2006 have performed the worst, with some of them defaulting after only one or two payments (or even no payment at all). Relative to earlier vintages, more of these loans carried greater risks beyond weak borrower credit histories – including very high initial cumulative loan-to-value ratios and less documentation of borrower income.

The recent increase in delinquencies and foreclosures has created personal, financial, and social distress for many homeowners and communities. We encourage servicers of securitized mortgages to reach out to financially stressed homeowners. Keeping families in their homes is a matter of great importance to the Federal Reserve. In fact, the twelve Federal Reserve Banks are working closely around the country with community and industry groups dedicated to reducing homeowners' risks of foreclosure. Each of the Reserve Bank community affairs offices provides significant leadership and technical assistance in this area.

I am also pleased to serve as the Federal Reserve's representative on the board of directors of NeighborWorks America, which has a program to encourage borrowers facing mortgage payment difficulties to seek help by making early contact with their lenders, servicers, or trusted counselors. NeighborWorks' Center for Foreclosure Prevention Center recently launched a national advertising campaign to raise awareness about its 24-hour national hotline that connects struggling borrowers with homeownership counselors. Since the launch of the campaign this past June, the daily call volume has almost doubled from 1,000 to almost 2,000 calls a day.

The Board's response to problems in the subprime market

The Federal Reserve has primary rule-writing authority for many consumer protection laws. Consumer protection laws take two complementary approaches to consumer protection: one focuses on the provision of information, and the other involves the development and enforcement of rules against abusive practices. The Board believes it is extremely important to strike the right balance by seeking to protect consumers from predatory lending practices without restricting credit from responsible lenders to borrowers with shorter or lower-rated credit histories. To achieve that balance, we coordinate with other federal and state agencies, and consult with consumer advocates, lenders, investors, and other interested parties.

Consumer protection regulations

The Board believes it is important to provide consumers with pertinent and accurate information. Clearly, information is critical to the effective functioning of markets. A core principle of economics is that markets are more competitive, and therefore more efficient, when accurate information is available to both consumers and suppliers. When information on alternatives is readily available, product offerings must meet customers' demands and offering prices must reflect those of market competitors. If consumers are well informed, they are in a better position to make decisions that are in their best interest. As a result, a significant component of the rule-writing process involves crafting disclosure requirements that provide consumers with consistent and relevant information about the terms and fees of financial products.

To be effective, disclosures must give consumers information that they can readily understand at a time when the information is relevant. To that end, the Federal Reserve will propose improvements to the rules governing the disclosure of mortgage loan terms and conditions and the timing of those disclosures. We will soon begin an extensive consumer testing process to ensure that the new disclosures we propose will be comprehensible and useful to borrowers. To further improve consumers' access to meaningful information, we are also developing proposed changes to the Truth in Lending Act (TILA) rules to address concerns about incomplete or misleading mortgage loan advertisements and solicitations, and to require lenders to provide mortgage disclosures more quickly so that consumers can get the information they need when it is most useful to them.

The Federal Reserve is keenly aware, however, that disclosure alone may not be sufficient to combat abusive practices. In addition to providing consumers with better information, the Federal Reserve plans to exercise its rulemaking authority under the Home Ownership and Equity Protection Act (HOEPA) to address unfair or deceptive mortgage lending practices. We plan to propose rules by the end of this year that would apply to subprime loans offered by all mortgage lenders. We share the concerns of Congress that certain lending practices may have led to the problems we are seeing in the subprime market today. We are looking closely at practices such as prepayment penalties, failure to offer escrow accounts for taxes and insurance, stated-income and low-documentation lending, and the failure to give adequate consideration to a borrower's ability to repay.

To ensure that any new rules will protect consumers without inappropriately reducing access to credit, the Board has obtained input from a wide variety of interested parties. I chaired a full day hearing in June that yielded valuable insight from both industry and consumer groups. The Board also solicited written comments from the public on the practices discussed at the hearing. The Board received nearly 100 comment letters, and staff is closely examining the issues raised and discussing possible remedies. Other federal and state agencies have been consulted as part of our efforts under HOEPA. We have also sought the views of our Consumer Advisory Council, which advises the Board on matters in the area of consumer financial services. The council's members represent the interests of consumers, communities, and the financial services industry.

Coordinated enforcement of consumer protection laws

Enforcement of consumer protection measures is also critical to protecting consumers from irresponsible or predatory lending. Indeed, the consumer financial services laws implemented by the Federal Reserve contain a number of substantive protections, reflecting carefully considered judgments by Congress that certain practices should be restricted or prohibited. The Federal Reserve enforces these rules through oversight of the institutions it examines for compliance with consumer protection laws and regulations.

The regulatory scheme for the mortgage industry has become extremely complex as the breadth and depth of this market has grown over the past decade and the role of nonbank mortgage lenders, particularly in the subprime market, has increased. As I mentioned previously, data collected under the Home Mortgage Disclosure Act show that independent mortgage companies made about half of higher-priced mortgages in 2006. In addition, there has been an increased presence of mortgage brokers, often independent entities who take loan applications and shop them to depository institutions or other lenders. These market developments have resulted in mortgage lending extending beyond the federal banking agencies' oversight, and this underscores the importance of collaborating with the state banking agencies and other organizations to address concerns in the subprime mortgage market.

To this end, we have launched a cooperative pilot project with other federal and state agencies to conduct reviews of non-depository lenders with significant subprime mortgage operations. The reviews will evaluate the companies' underwriting standards and senior-management oversight of risk-management strategies for ensuring compliance with consumer protection laws and regulations. Our partners in this initiative are the Office of Thrift Supervision, the Federal Trade Commission, and state agencies represented by the Conference of State Banking Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR). At the conclusion of the reviews, the agencies will analyze the results and determine whether to continue the project and, if so, how to focus future reviews.

Loss mitigation efforts

The Board also has worked with the other federal financial agencies to guide federally supervised institutions as they deal with borrower mortgage default. In April 2007, the federal financial institution agencies issued a *Statement on Working with Mortgage Borrowers*. The statement encourages federally regulated institutions to work constructively with residential borrowers at risk of default and to consider prudent workout arrangements that avoid unnecessary foreclosures. In cooperation with CSBS, the federal financial agencies issued a *Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages* in September 2007 to address subprime and other mortgage loans that have been transferred into securitization trusts. The statement calls on servicers of securitized mortgages to review the governing documents for the trusts to determine the full extent of their authority to restructure loans that are delinquent or in default or are in imminent risk of default.

To the extent possible, efforts should be made to avoid foreclosure. We encourage servicers to reach out to financially stressed homeowners, to make every effort to keep them in their homes. Lenders and servicers, for example, may be able to assist troubled borrowers by modifying the loan, deferring payments, extending the loan maturities, converting an adjustable-rate mortgage to a fixed-rate or fully-indexed loan, or capitalizing delinquent amounts. The best outcome is a loss mitigation strategy that results in a mortgage obligation that the borrower can meet in a sustained manner. The use of these and other loss-mitigation techniques is consistent with the interagency guidance that emphasizes the importance of prudent underwriting practices to help ensure that borrowers can meet the terms of their mortgage obligations and maintain homeownership.

Legislative responses

Congress is appropriately concerned about problems in the mortgage market. The Mortgage Reform and Anti-Predatory Lending Act of 2007 takes a comprehensive approach and is appropriately focused on the more problematic practices in the subprime mortgage market. We share Congress's concerns with these practices. As with regulations, it is important that new laws carefully target lending abuses without unduly restraining responsible lending. Getting this balance right is particularly critical now, as many borrowers facing rate adjustments may need to refinance into more affordable loans.

The Mortgage Reform and Anti-Predatory Lending Act of 2007 would provide greater oversight and regulation of mortgage brokers, an approach that has merit. A nationwide registration and licensing system for all mortgage loan brokers would help limit the ability of bad actors to move to a new state after having run afoul of regulators in other states. The CSBS and AARMR have a promising initiative to establish a national registry. It would be appropriate for any new legislation to ensure that all individual brokers are included in the same nationwide registry.

The Mortgage Reform and Anti-Predatory Lending Act of 2007 also addresses concerns about loans made without consideration of a borrower's ability to repay. The Board firmly believes that lenders should give due consideration to a borrower's ability to repay a loan, before the loan is extended. We and the other regulators have emphasized this several times in a variety of guidance statements on mortgage lending. This is also one of the areas we are looking at in our revisions to the HOEPA rules. In developing laws or rules to address repayment ability, the rules must be specific enough so that creditors can determine whether their practices are in compliance because legal uncertainty could have the unintended effect of reducing credit options for creditworthy subprime borrowers. At the same time, rules must be flexible enough to allow creditors to consider the pertinent factors and individual circumstances of particular consumers and to innovate prudently and fairly.

The Mortgage Reform and Anti-Predatory Lending Act of 2007 would require originators to present borrowers with loans that are appropriate to the borrower's circumstances. In the case of refinancings, the bill provides that the loan must provide a "net tangible benefit" to the borrower. As I have discussed, the Board supports the goal of ensuring that consumers do not receive unaffordable and abusive loans. However, it is critical to carefully craft such laws or rules to ensure that they do not inappropriately reduce credit availability in the mortgage market, to the detriment of consumers.

The Mortgage Reform and Anti-Predatory Lending Act of 2007 would hold securitizers and loan purchasers ("assignees") liable for the actions of mortgage originators. The securitization market is critical to increasing the resources available to fund home purchases and great care should be taken to ensure that investors in the securitization market can quickly and accurately assess and mitigate the risks, including the compliance risks, of mortgages sold in this market. Such laws should be very clearly delineated to ensure that they do not have a detrimental impact on the ability of lenders to securitize loans. Specifically, assignees must be able to conduct due diligence and determine whether an originator has complied with the law, so that they can evaluate and price for any risks.

Finally, the bill would enhance HOEPA's protections by prohibiting abusive practices, such as prohibiting the financing of single-premium credit life insurance. HOEPA's points and fees trigger would be lowered and additional fees added. These potential actions merit discussion, and we welcome the opportunity to continue to work with congressional staff on these and other provisions in new legislation.

Conclusion

The Board is engaged in several activities to assist consumers, and continues to develop rules that will improve consumer disclosures, address unfair or deceptive practices, and help consumers facing default and foreclosure. We look forward to working with Congress to enhance consumer protection laws while maintaining access to credit.