Regulatory Obstacles to Mortgage Credit

Testimony before the Senate Committee on Banking, Housing, and Urban Affairs

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Good morning, Chairman Shelby, Ranking Member Brown, and members of the committee. My name is Julia Gordon, and I direct the Housing and Consumer Finance team at the Center for American Progress, a nonpartisan think tank dedicated to improving the lives of Americans through progressive ideas and action. Thank you so much for convening this hearing on the critical topic of access to mortgage credit.

Historically, the housing sector has led recoveries following economic downturns. Recovery from the Great Recession, however, has played out differently – in significant part because unlike most downturns, this recession was triggered by the housing sector itself. Driven by a highly leveraged, largely unregulated superstructure in the private capital markets, risky and abusive mortgages replaced previously stable, well-underwritten, long-term, fixed rate products and created a precipitous asset bubble. This system was driven by misaligned incentives up and down the securitization chain and abetted by regulators asleep at the wheel. Predictably,[1] as soon as housing prices started to level off, these new loans began to fail *en masse*, causing failures throughout the private securitization market that ultimately threatened the global financial system and required the largest taxpayer bailout in America's history.

Fallout from the mortgage crisis has been extensive throughout the system and continues to hamstring the housing market. Foreclosures due to toxic mortgage products damaged the real economy, spiking unemployment and causing massive home price declines, the combination of which then triggered a new wave of foreclosures even on homes with properly underwritten mortgages. Tens of millions of families suffered job loss, foreclosure, or other financial insecurity, in many cases ending up with damaged credit and ravaged savings and retirement accounts. Much of the American public lost confidence in the financial system, especially banks and mortgage lenders.

On the business side, hundreds of banks and mortgage companies failed,[2] and those that survived pulled back from the mortgage business or limited their lending to households with very high credit scores and ample wealth. Today, access to credit is tighter than it was pre-housing boom, mortgage

volumes are down precipitously, homeownership shares have fallen to their lowest level in two decades, and rental costs are soaring relative to incomes. Many neighborhoods have not yet turned around and continue to struggle with foreclosures, vacant homes, and blight, especially communities of color.

In the wake of the crisis, Congress and the American public supported comprehensive financial reform legislation to help realign incentives and strengthen oversight to prevent future crashes of this nature and size. That legislation, the Dodd-Frank Act, addressed a slew of issues, including but not limited to new rules of the road for the mortgage market, and also established a new independent regulator, the Consumer Financial Protection Bureau. This legislation makes it extremely unlikely that we will once again see a proliferation of the dangerous, poorly underwritten mortgages that led us to this pass.

Yet today, just a few years after the crisis, the mortgage industry has returned to Congress to ask for a rollback of these crucial financial reforms. Lenders blame Dodd-Frank for tight access to credit, and they promise that if only Congress would undo financial reform, the doors would swing open. The problem, however, is that this route to opening the doors would open them to the same pernicious, predatory practices that brought the economy to its knees less than seven years ago. Above all, removing these reforms would undermine the most critical component of recovery, which is to restore public trust in the system.

The truth is that there are likely many reasons for tight lending practices. The same voices asking for regulatory rollbacks have previously told both Congress and regulatory agencies that access to credit will open if a variety of other factors are addressed: aggressive buyback policies and steep risk-based pricing pursued by Fannie Mae and Freddie Mac in the wake of the crisis; FHA's insufficiently nuanced "Compare Ratio"; the Basel III capital requirements; and the high cost and complex requirements of servicing troubled mortgages. Fortunately, these problems lend themselves to policy changes that can help both mortgage lenders and homebuyers in a "win-win" situation, in contrast to the regulatory rollbacks that trade away consumer protection for lender profits.

In this testimony, I first provide a reminder of the problems in the pre-crisis mortgage market and then sketch out the dimensions of the current credit crunch. Next, I examine some of the proposed regulatory reforms and demonstrate how they could hurt rather than help today's homebuyers.

- The CLEAR Relief Act would undermine core lending rules for more than half of all mortgage originations and restore incentives to make "exploding" adjustable rate mortgages.
- The Mortgage Choice Act would make mortgages more expensive by re-opening the door to upselling practices driven by kickbacks and commissions.
- The Preserving Access to Manufactured Housing Act would sanction offering a largely lower-wealth and rural population more expensive mortgages with fewer consumer protections than are available to households purchasing site-built homes.

Finally, I provide a set of alternate, effective recommendations to increase access to responsible, sustainable mortgage credit.

I. Background: A trip down memory lane to the pre-crisis mortgage market

A misalignment of incentives lies at the heart of the foreclosure crisis. A toxic combination of Wall Street appetite for risk and stakeholders up the entire mortgage origination chain making more money for originating worse loans drove home prices to unsustainable levels. In the capital markets, investors aggressively poured money into the mortgage-backed-securitization machine in search of yield, while "financial innovations" aimed at managing risk actually spread that risk throughout the system. Subprime mortgage products proliferated and were sold to consumers who could have qualified for more stable and affordable products. Homeowners lost existing equity to aggressive lenders and brokers milking these transactions for fees. So-called "Alt-A" mortgages with features previously used judiciously in a narrow market were broadly marketed and layered with increasing numbers of risk factors, virtually assuring their failure.

At the height of the housing bubble, independent mortgage brokers originated the vast majority of subprime loans, receiving their compensation from lenders immediately upon brokering the loan. Those lenders then sold the loan into the secondary market within weeks, where it was bundled together with other mortgages and sliced and diced into mortgage-backed securities (MBS). The facilitators of this process – the investment bankers, lawyers, and ratings agencies involved – were all paid their fees regardless of the performance of the MBS. Those securities were then sold to investors. At the same time, even more derivative products were layered on top of them, with credit default swaps at the top of the pyramid – what Warren Buffet identified as early as 2003 as "financial weapons of mass destruction."[3]

Most of the subprime and so-called Alt-A mortgage products layered a variety of risks to create loans that were essentially designed to fail. One of the worst products, the hybrid adjustable rate mortgages also known as 2-28s or 3-27s because they would have 2 or 3 years of a fixed rate before the rate would explode, would often be locked in by prepayment penalties as high as four percent of the mortgage amount, so to refinance, these penalties would be paid from the proceeds of the new loan, and the loan balance would grow with each refinancing. Other mortgages, the "pay option" variety, offered consumers an opportunity to pay even less per month than their interest payments alone, which resulted in loan balances that rose rather than declined over time. While these designed-to-fail products stripped away much of the economic benefit of homeownership, it was at least possible – and extremely lucrative for brokers, lenders and investors – to continue refinancing as long as home prices kept rising. Once home prices declined, however, failure was virtually inevitable.

In addition to the exploding rates and prepayment penalties, other risky features included a failure to escrow for taxes and insurance (which often was a part of deceptively marketing a "lower monthly payment"), little or no documentation of income, and underwriting only to the very low initial teaser rates. In many cases, mortgage brokers were paid more to steer borrowers into higher-rate loans with riskier features through lender-paid yield-spread premiums, and they generally received the highest lender payment when that increased rate was locked in with a prepayment penalty.[4]

The predatory lending practices and toxic products characteristic of that period had only one function: to enrich mortgage brokers, lenders, and investors. These were not true "affordability" products

designed to help renters become homeowners; in fact, the overwhelming majority of subprime mortgages made from 1998 through 2006 went to borrowers who already owned their own homes – 60 percent were refinances, and 30 percent were for families who were moving from one home to another.[5] Far from expanding homeownership to people who otherwise could not afford it, subprime lending actually resulted in a net reduction in homeownership.[6] Homeownership rates in the US peaked in 2004, well before the housing bubble had fully inflated or burst.[7]

Similarly, the damage to the market was largely wreaked by the mortgages themselves and the system for selling them, not by borrowers who were overreaching or not ready for homeownership. The average subprime loan amount (which includes loans made in high-priced housing markets like California) was a modest $205,700.[8] What's more, most borrowers who received predatory loans qualified for better, more sustainable loans. A study for the Wall Street Journal found that of the subprime loans originated in 2006 that were packaged into securities and sold to investors, 61 percent "went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms."[9] Even those borrowers who did not qualify for prime loans could have received sustainable, thirty-year fixed-rate loans, for at most 50 to 80 basis points above the introductory rate on the unsustainable exploding ARM loans they were given.[10]

When the music stopped, the market crashed quickly, and the foreclosures began. At that point, it became clear that mortgage servicers had no ability or capacity to assist troubled borrowers. Congress blocked the most effective solution, which would have been to permit judicial loan modifications, and subsequently various executive and regulatory agencies worked for years on programs such as Making Home Affordable and on new servicing rules and regulations. Yet servicers to this day are unable to effectively handle a large quantity of failing mortgages.

Not surprisingly, the huge number of foreclosures triggered a much larger economic event – the Great Recession, where high unemployment rates combined with huge numbers of underwater mortgages decimated many neighborhoods and communities along with household balance sheets.

II. Why today's mortgage market needs fixing

In the wake of the financial reforms enacted after the crisis, mortgage lending is much safer than it was, and many predatory practices have either disappeared or at least are far more limited. At the same time, the national mortgage market is significantly smaller than it was, both in terms of overall volume and home sales.[11] The national homeownership rate has dropped from close to 70 percent to 64 percent. Cash investors made 29 percent of all purchases in 2013, way above their historic norm of 10 percent to 12 percent.[12] Housing starts remain depressed, and even optimistic projections for 2015 remain well below levels seen before the housing boom.[13]

A big reason for the change in the size of the market is that access to credit remains historically tight. For a conventional home purchase mortgage, the average FICO score is 754. While Federal Housing Administration credit is easier to obtain, with average credit scores for purchase-money mortgages around 680, it is still tighter than historical norms.[14] The Urban Institute estimates that approximately 1.25 million fewer purchase mortgages were made in 2013 than would have been the case had credit availability remained at pre-housing-bubble 2001 levels.[15] Consequently, more than 4 million loans have

been “missing” from the market over the last 5 years. This tight credit has disproportionately affected African American and Latino borrowers.[16]

A particularly troubling dimension of this problem is that homeownership rates for people of color have dropped particularly dramatically, with the Latino homeownership rate falling by 6 percent from its peak and the African American rate falling by 8 percent.[17] This decline in homeownership plays a significant role in the ever-increasing wealth disparities between whites and people of color.[18] Specifically, whites lost about 26 percent of their net worth during this period, while African Americans lost 50 percent and Hispanics lost 61 percent.[19]

Because the majority of families formed in America going forward will be families of color, a steep reduction in the numbers of Latinos and African Americans buying homes spells trouble for the housing market for decades to come.[20] It is also a problem that even as home prices became more affordable than they had been in years, the lack of affordable credit means many communities that lost significant wealth due to foreclosures have failed to rebuild that wealth through homeownership; as more people rent, and especially as more formerly owner-occupied homes transition to long-term rental, payments that could be contributing to rebuilding family balance sheets instead flow to investors, many of whom live outside the community.

Additionally, weakness in the housing market deprives our economy of the economic multiplier effects of a strong housing market, including additional construction jobs, consumer demand for household-related items, and local and state tax revenue. Moody’s Analytics estimates that if home construction were at a more typical level, the economy would be at full employment.[21] The stubborn persistence of negative equity also continues to depress aggregate consumer demand for all goods and services, with significant macroeconomic consequences. Homeowners with high levels of debt relative to the value of their assets have experienced larger declines in consumption than less highly leveraged homeowners, even after taking into account declines in net worth.[22]

III. Current proposals to roll back regulatory reforms will leave consumers vulnerable without increasing access to high-quality, affordable credit

Some mortgage industry players are using the tight credit environment described above as a reason to call for rolling back Dodd-Frank. In the Senate, several bills are now pending that would reverse some of the important protections of this landmark financial reform legislation. However, a time when policymakers agree that increasing homeownership is a good idea is the worst possible time to remove underlying consumer protections. In fact, the only reason that many individuals and organizations support increasing access to credit is because they are counting on the Dodd-Frank framework to keep guardrails on the market. If those guardrails are removed, the likelihood of seeing a return to predatory and unsustainable lending is extremely high.

The truth is that the Consumer Financial Protection Bureau and other agencies charged with implementing the Dodd-Frank mortgage provisions have worked hard to accommodate the needs of industry stakeholders, holding literally hundreds of meetings and using their exception authority liberally. For example, the six regulators charged with establishing “risk retention” rules made significant changes to the qualified residential mortgage definition in response to industry concerns.[23]

Indeed, mortgage trade associations have noted that the Consumer Financial Protection Bureau in particular has done a good job taking industry concerns into account.[24] In numerous rulemakings, CFPB has provided special rules taking into account all sorts of variables, including loan size, lender size, originator type, and liability concerns. A quick review demonstrates the extent to which CFPB has been responsive to these concerns. CFPB has taken the following actions, among others:

- Established a "true" safe harbor for loans meeting the qualified mortgage definition, although the statute only calls for a rebuttable presumption liability standard.[25]
- Permitted exceptions to limitations on loan originator compensation for bank loan officers as opposed to independent mortgage brokers.[26]
- Tailored the qualified mortgage points and fees cap to accommodate smaller loan sizes, allowing up to 8 percent in fees for very low balance loans.[27]
- Allowed cure periods for lenders who make unintentional clerical errors in DTI and Points/Fees calculation[28]

Nowhere has Dodd-Frank and CFPB provided more accommodation than to smaller financial institutions. Congress and the CFPB have both recognized the unique and important role that small banks play in communities across the country, and as a result, the majority of these institutions already have access to a variety of exemptions and special provisions to ensure that they have the flexibility to do high quality lending that meets the needs of their communities:

- Small banks have greater underwriting flexibility when making mortgages that are eligible for safe harbor protection, including mortgages with APRs 200 basis points higher than larger banks.[29]
- Those serving rural or underserved areas may make loans that are eligible for the qualified mortgage designation even if the loan requires a balloon payment, which is otherwise prohibited under that designation.[30]
- Community development financial institutions, housing finance agencies, small rural lenders, CHDOs and some non-profits have special carve-outs from the Ability-to-Repay rule.[31]
- Small institutions serving rural or underserved areas are exempted from maintaining escrow accounts for higher cost loans.[32]
- Small creditors who service fewer than 5,000 loans are exempt from most mortgage servicing rules.[33]
- CFPB has supervision, examination, and enforcement authority over only those financial institutions with more than $10 billion in assets.[34]
- CFPB has not yet pursued any enforcement actions against community banks.[35]
- Small businesses have the opportunity to submit early comments to the CFPB under the Small Business Regulatory Enforcement Fairness Act.[36]
- CFPB has recently proposed expanding the definition of small creditor so that roughly three quarters of creditors with less than $1 billion in assets would qualify for a variety of mortgage rule exemptions. It also proposed expanding the rural definition to be more inclusive of rural pockets in urban areas.[37]

In short, while lobbyists looking to roll back financial reform claim the rules make it impossible for smaller institutions to compete and point to the declining number of small banks in America as evidence for their case, it is clear that these institutions already benefit from special treatment across a wide

range of rules. In fact, the decline of the small banking sector predates financial reform by decades. FDIC data show that for the last twenty years, the number of small banks has declined at a rate of about 300 per year. This rate has remained essentially unchanged in the years since Dodd-Frank was passed. [38]

Nor has reform destroyed the profitability of small banks. In the fourth quarter of 2014, profits at community banks increased 27 percent compared to the previous year, despite the fact that they had to comply with the new CFPB mortgage rules.[39] FDIC data also demonstrates that by many measures, including net interest income, community banks are performing better other institutions.[40]

A primary problem for small banks is that the complexity of today's market means size matters. Large banks can benefit from the economies of scale that make markets such as residential mortgage lending more efficient, while small banks cannot.[41] A 2012 FDIC study of community banks shows that over 80 percent of the banks that exited the industry between 1984 and 2011 left to become larger banks, either through a merger with an unaffiliated bank or consolidation with another chartered bank within the same organization.[42] Only 17 percent of the banks that left the industry did so because they failed.[43]

Also, while it's inarguable that compliance costs can be more of a burden for a small institution than a large one, all banks operate under myriad rules, with Dodd-Frank being only one part of that picture, and rolling back consumer protections is not a solution to challenges posed by capacity problems. Instead, regulators and policymakers should proactively support small lenders' ability to adapt new technology and processes so that they can meet their regulatory requirements as efficiently and affordably as possible.

The CFPB's mortgage rules also appear to be having little effect on the profitability of mortgage lending more broadly. The Mortgage Banker Association's most recent survey of loan profitability among independent mortgage banks and mortgage subsidiaries of chartered banks shows that mortgage loan origination profitability has increased dramatically since the quarter *before* CFPB's mortgage rules took effect.[44] Additionally, a larger proportion of these companies are profitable than before the mortgage rules took effect, and personnel or total loan production expenses have increased only minimally during this time.[45]

Finally, some have seized on the recent interest in community bank regulatory relief to suggest that non-depository institutions should receive similar exemptions.[46] However, the business model of non-depository institutions bears little resemblance to that of small banks with known customers and strong community ties. To the contrary, non-depositories tend to have single rather than repeated interactions with customers, and many of those customers live in locations where the non-depository likely has no presence. Additionally, non-bank mortgage lenders were responsible for some of the most pernicious practices during the housing bubble. We should not return to the days when these lenders were able to avoid regulatory scrutiny or oversight, especially under the guise of helping community lenders.

Below, I take a closer look at several specific proposals pending in the Senate, examining what impact each would have on consumer protection, mortgage sustainability, and access to credit.

A. S. 812: The CLEAR Relief Act

The CLEAR Relief Act, recently introduced in the Senate, would deem any mortgage made by any bank with assets under $10 billion to qualify for "qualified mortgage" safe harbor status as long as the bank holds the mortgage in portfolio for at least 3 years.[47] This unusually broad exemption would blow a hole

through the heart of the Dodd-Frank Ability to Repay rules and shield those banks from any accountability to customers. The result of the three-year portfolio exception could easily be a new brand of hybrid adjustable rate mortgages (or "3-27s") that would be designed to fail only after the financial institution was no longer holding them in portfolio.

To understand this proposal, it is important to understand the interplay between Dodd-Frank's core Ability to Repay requirement and the subset of loans that fit into the "qualified mortgage" (QM) definition. Ability to Repay codifies a basic principle that should be common business sense but which was largely ignored during the run-up to the crisis: a lender should not make a loan unless it has reasonably determined that the borrower can afford to pay the entire loan back. To do this thorough underwriting, a lender will need "verified and documented information."[48] If a lender makes a loan that does not meet these standards, the borrower would have the basis to take legal action against the lender for a period of three years. A borrower can also assert violation of this rule as a defense to foreclosure at any time, but damages would be limited to three years' worth of finance charges and fees.

The "qualified mortgage" definition was intended to designate a category of "super-safe" mortgages – mortgages that have so few potential risks that lenders making this type of loan would receive extra protection from any potential lawsuit. While the Dodd-Frank statute established a higher threshold for legal action, the CFPB used its authority to go further than the statute to give lenders a true "safe harbor" for QM loans that are not higher-cost, which makes lenders virtually impervious to liability if they make QM loans. The QM definition excludes certain types of riskier products, such as negatively amortizing, interest-only, and balloon mortgages, requires underwriting to the maximum possible payments in the first five years of the loan, places a limit on fees that lenders can charge, since high fees generally make mortgages riskier, and excludes borrowers whose total debt-to-income exceeds a certain threshold.

As noted in the previous section of this testimony, CFPB allows loans made by small banks to qualify for the QM safe harbor even if the borrower has a higher debt-to-income ratio than specified, and for certain institutions, even if the mortgage has a balloon feature. While these banks are still subject to other components of the QM definition, because the responsible community banks were already largely engaged in safe lending, they have not had to change their practices very much at all.

The CLEAR Relief Act would expand the balloon loan exemption to much larger banks, and – even more concerning – convey safe harbor status or legal immunity on loans with virtually *any* terms or features as long as they are held in portfolio for three years by a bank with less than $10 billion in assets.

Proponents of this bill argue that because loans are held on portfolio, lenders have an incentive to insure a borrower will succeed. But history has shown otherwise. Some of the most egregious predatory lenders such as Countrywide and Washington Mutual kept a considerable number of their failed loans on their portfolios, leading to their severe financial distress.[49] And nothing prevents a portfolio loan from being predatory by charging borrowers high fees or significantly higher interest rates than they could otherwise qualify for. Furthermore, the CLEAR Relief Act's automatic granting of QM status to portfolio loans after three years gives lenders an opportunity to create loans whose price or other risk features dramatically increase after the three-year deadline.

The CLEAR Relief Act proposal also would exempt all these banks from the requirement that they require escrow accounts for borrowers in higher-cost loans. The failure to escrow was also a large contributor to bad lending, as many borrowers will fail to budget properly for large tax and insurance bills at the end of the year, and may think that their monthly payment is just "PI" (principal and interest) rather than PITI (principal, interest, taxes and insurance).

Finally, exempting institutions under $10 billion is not targeted at what anyone would think of as their local community bank. *In fact, this definition would include all but the largest 110 depository institutions in America and well over half of all mortgage loans.*[50] According to the FDIC, the average community bank has approximately $340 million in assets and fits comfortably under the current $2 billion asset threshold established for the small creditor QM definition.[51]

B. The Mortgage Choice Act

The so-called "Mortgage Choice Act" would exempt title insurance sold by a title insurance company affiliated with a lender from the "points and fees" cap in the QM definition. By permitting lenders to use affiliates to evade the fee cap, this legislation makes mortgages more expensive, which narrows rather than expands access to credit, and can easily lead to the kind of equity-stripping that harmed so many consumers in the 90s and early 2000s.

The points and fees cap in the QM definition excludes certain bona fide third party charges, including title insurance offered by non-affiliated insurance companies. However, because abuses related to affiliates abounded during the run-up to the crisis, with kickbacks and upselling rampant throughout the system, the fee cap does not exempt charges for affiliate companies, which removes the incentive for these arrangements. If this protection were removed, lenders would once again have an incentive to steer borrowers toward higher-cost insurance plans offered by affiliate companies that compensate the lender. Because borrowers rarely understand the relationship between corporate affiliates, they cannot protect themselves against inappropriate upselling based on those corporate relationships.

In testimony yesterday before the House Financial Services Committee on the same topic, Mitria Wilson from the Center for Responsible Lending observed that "anti-competitive practices put companies at a significant disadvantage if they market directly to consumers and can offer lower rates."[52] For example, one company, Entitle Direct, has only 0.1% of the market even though it offers rates that are 35 percent lower than competitors.[53] Consumers already have little choice in the title insurance market, and the Mortgage Choice Act would only constrain consumer choice by giving lenders more incentives to steer consumers to affiliated insurers.

While some states adequately regulate title insurance premiums, many states either do not regulate title insurance rates or allow insurers to set their rates and essentially notify state regulators.[54] And while the Real Estate Settlements Procedures Act, or RESPA, prohibits paying kickbacks among third-party title insurers, it does not prohibit payments to affiliated title firms.[55]

While the industry forces calling for the passage of the Mortgage Choice Act claim that the QM cap on points and fees is making it impossible for them to originate loans profitably, we know that the data indicates otherwise. As shown above, measures indicate that mortgage lending is more profitable today than it was before the CFPB's mortgage rules took effect.

Relatedly, some groups have advocated for raising the points and fees caps for all loans with a balance of less than $200,000. This change would mean that a substantial share of the mortgages would not subject to the 3% cap on points and fees to which Congress intended qualified mortgages to be subject. Responding to industry concerns, the CFPB has already used its authority to increase the allowable points and fees on smaller balance mortgages. Given what we know about the current profitability of mortgage originators, we believe this proposal is unnecessary. Rather than increase access to credit, expanding the universe of loans not subject to the 3% cap would primarily result in consumers paying more for mortgage credit.

C. S. 682: The Preserving Access to Manufactured Housing Act

The Preserving Access to Manufactured Housing Act would dramatically scale back the protections available to a consumer who takes out a loan to buy a manufactured home.[56] Specifically, it would strip away critical protections for buyers of manufactured homes, who are among the nation's most financially vulnerable consumers, by rolling back updated high-cost loan thresholds. If this proposal were to become law, a lender could charge nearly 10 percentage points higher than a prime mortgage rate without the borrower obtaining the same heightened protections that would apply in the case of a high-cost mortgage on a site-built home.

Note that while manufactured housing owners have only about one quarter of the wealth of homeowners as a whole, they typically pay far more for their home loans: more than two-thirds of manufactured home loans are currently categorized as high priced loans compared to 3 percent of site-built homes.[57] Additionally, the bill would make it easier for a manufactured home salesperson to steer a consumer into a higher cost mortgage, even when they might qualify for a more affordable loan. Earlier this month, the Center for Public Integrity and the Seattle Times reported on consumer abuses in manufactured housing finance, detailing how borrowers were misled into taking out expensive loans and how retail salespeople were encouraged to steer borrowers into affiliated loans.[58] The last thing this vulnerable population needs is cutbacks to the sorely needed protections in Dodd-Frank.

It is absolutely true that manufactured housing plays a crucial role in providing families with affordable housing, especially outside of metropolitan areas, and that affordable credit for manufactured housing is currently constrained. However, legislation that erodes consumer protections and paves the way to more expensive mortgages will harm the very consumers it is purported to help. An alternative, safer way to support the development of a robust, responsible mortgage market for manufactured housing loans is described in section "IV. B." below.

IV. Effective ways to help increase access to high-quality credit

As explained above, the proposed rollbacks of Dodd-Frank are both overly broad and insufficiently targeted to the real problems, and therefore will increase risk without necessarily increasing access to appropriate products. Increasing access to safe and sustainable credit is a critically important goal. But it is equally critical to ensure that any expansion of access not lead to the same predatory and abusive market practices that led to the crisis.

There are a number of other, safer policy changes that can increase access to credit without compromising consumer protection. In fact, there is much agreement among the many stakeholders in this system on the dials and levers that can help increase access to safe and sustainable mortgages. The following is a suggested agenda for such actions, although it is by no means exhaustive.

A. Congress should complete comprehensive reform of the housing finance system

One thread that runs throughout most policy recommendations about easing tight credit is the need to provide as much certainty as possible to market participants and stakeholders. Perhaps the largest of such uncertainties is the fate of mortgage giants Fannie Mae and Freddie Mac, which have now been under conservatorship for more than six years.

Some advocate for simply returning to the system we had before the crisis, in which Fannie and Freddie's private shareholders profited from an implicit government guarantee with minimal capital requirements. While we agree the conservatorship should not last forever, before it ends, we need to fix the misaligned incentives that led the mortgage giants to need a taxpayer bailout and we must create an explicit, priced, and paid-for government guarantee to support the long-term, fixed rate mortgage product while protecting taxpayers.

The legislation passed last year by the Senate Banking Committee, S. 1217, provided a good framework for discussion, but lacked a number of essential elements that we have recommended, particularly with respect to the access to and affordability of credit.[59] Placing the goal of access to affordable, sustainable credit at the center of the new system's purpose will provide the greatest benefit in the long run not only to families but also to lenders and investors and will also protect taxpayers from future bailouts.

We look forward to working with Congress to craft a housing finance system that can take this country into the future smoothly and successfully.

B. The Federal Housing Finance Agency should encourage Fannie and Freddie to serve more borrowers and make other changes to increase safe access to affordable credit

While comprehensive housing finance reform proceeds through the legislative process, we urge the Federal Housing Finance Agency to use its extraordinary powers of conservatorship to promote a robust, inclusive mortgage market that provides liquidity for the broadest possible range of credit needs. Given the GSEs' dominance in the secondary market, their appetite for mortgages essentially determines whether the mortgages will be made at all by the primary market.

FHFA has already taken two very important steps: providing more certainty to lenders around repurchase policies – also known as "rep and warrant" relief – and allowing the Enterprises to offer mortgages with three percent down payments as long as the borrower has private mortgage insurance. Early indications suggest these changes are making a positive difference in the marketplace. Additional steps the agency should take are the following:

- **Finalize a stronger housing goals rule:** In recent years, whole segments of the market have moved to the Federal Housing Administration or have not been served at all. In 2012, for example, the enterprises financed only 16 percent of home purchase loans that originated in

low-income and minority Census tracts, one-quarter of home purchase loans to African Americans, and under one-third of home purchase loans to Latinos.[60] Today, there are no housing goals in force at all, as FHFA has not yet issued a final rule setting goals for 2015-2017. As the agency prepares to issue this rule, we urge it to set strong single- and multifamily benchmarks, including a 27 percent goal for low-income home purchase lending; take enforcement actions that considers the performance of the overall market when the enterprises fail to meet the housing goals; establish subgoals for small multifamily properties; and create reporting requirements for single-family rental.[61]

- **Complete the long-overdue "duty to serve" rulemaking:** FHFA can use the implementation of the "duty to serve" rule required by the Housing and Economic Recovery Act of 2008 to encourage responsible innovation and give the enterprises strong incentives to serve broadly and to lead the market.[62] In particular, FHFA can make a significant contribution to greater affordability in the manufactured housing area by using the duty-to-serve rule to push the market toward more responsible practices in the area of chattel lending. The majority of manufactured housing is titled as chattel rather than real property, meaning that buyers often lack basic consumer protections.[63] Borrowers who receive chattel financing are even more vulnerable than typical manufactured housing owners, facing more expensive loans, fewer rights upon default, and legal uncertainties if they do not own the land beneath their properties.[64] In the affordable housing preservation and rural markets, we similarly believe that the enterprises can actively support these markets through new products, flexible underwriting, affirmative outreach, and other activities, including grants to and partnerships with high-performing nonprofits devoted to this work.

- **Use g-fee policies to make housing affordable to all populations in all geographies**: FHFA should return to a pricing structure that is transparent, countercyclical—or, at the very least, not pro-cyclical—and take full advantage of the enterprises' unique ability to pool risk. As we recommended in our comment letter to FHFA,[65] we think FHFA should price based on what is needed to cover expected losses and costs—including a justifiable level of capital and revenue to support its cost—and to protect the taxpayer in the event of stress scenarios, rather than on pursuing particular market shares for non-GSE entities or sectors. This means removing the adverse market fee, eliminating loan-level pricing adjustments, and keeping the base g-fee at its current level.

- **Update credit score models to include more creditworthy borrowers**: Currently, the enterprises require the use of a FICO 04 credit score in their automated underwriting systems.[66] However, newer scoring models, including both FICO 09 and VantageScore, have made some critical changes that will improve the reliability of scores and/or allow the scoring of tens of millions of consumers. These newer models no longer consider paid collection items, including medical debt collections, and give less weight to unpaid medical debts. In addition, these newer models are better able to deal with consumers with limited credit history, or thin-file consumers. For example, FICO 09 has enhancements to better assess thin-file consumers, and VantageScore claims to be able to score an additional 30 million to 35 million thin-file consumers.[67] We urge FHFA and the Enterprises to move quickly to modernize their systems.

C. As a provider of credit to so many underserved populations, FHA should continue to improve access to and affordability of credit

The Federal Housing Administration has played a crucial role in supporting our economic recovery, preventing not only even more catastrophic home price declines but also a double-dip recession. While this support came at a cost to the agency's capital ratio, a combination of strong management and improvement in the economy has put the agency on track to fully replenish its reserves over the next couple of years. Particularly, FHA has supported first-time homebuyers and buyers of color, who are poorly served by the conventional market.

Recently, FHA took a major step in increasing access to affordable credit when it reduced annual mortgage premiums, which had gotten too high in the wake of the crisis. Now, FHA should complete efforts underway to provide clarity to lenders and reduce overlays. To address lender concerns about indemnification, FHA has proposed a new system for detecting defects in loan quality and holding lenders accountable for such defects. In this proposal, FHA more clearly identifies and classifies defects in loan applications, establishes severity levels of such defects, and provides a more objective approach to analyzing appropriate cures for defects.

FHA should also complete its work on the so-called Supplemental Ratio. Right now, FHA uses the Compare Ratio tool to identify risky lenders for further scrutiny. The ratio compares the performance of loans originated by a given lender to loans originated by other lenders in the same geographic location. However, the ratio makes no allowance for the loan characteristics of a lender's book of business, and thus incents lenders to originate loans primarily to pristine borrowers. Since FHA is statutorily bound to retain the Compare Ratio, adding additional dimensions through a Supplemental Ratio will help provide a more useful and robust comparison tool that allows for lenders who desire to lend to more underserved populations or geographies.

Additionally, we believe it would be sensible for FHA to work closely with FHFA to align its policies to protect lenders, such as providing a three-year window of clean payment history for indemnification, with exceptions for fraud, data inaccuracies, and compliance with responsible lending practices.

Finally, FHA should continue to work to improve its servicing policies, both to improve loss mitigation as well as to align better with other servicing schemes to reduce unnecessary complexity and cost.

D. Housing agencies should fix servicer compensation policies to ensure that incentives are correctly aligned

The CFPB's servicing rules, along with the FHFA servicing alignment effort, provide essential procedural protections that promote better servicing outcomes for homeowners, investors, and communities. The recent proposed amendments to the CFPB rules make substantial improvements in crucial areas including transfers of servicing, bankruptcy, and access to the loss-mitigation system for subsequent hardships. They also make important strides in protecting homeowners who seek assistance following the death or divorce of a co-homeowner.

However, there are still some basic building blocks to servicing reform that are not yet in place. First, servicer compensation reform has been sidetracked and must be revived. As long as servicers profit at the expense of homeowners and investors, the system will not reliably produce healthy outcomes for the housing market and communities regardless of the rules or enforcement thereof. Regulators must come together to develop a framework to modernize and rationalize servicer compensation.

Second, with the eventual sunset of HAMP, policymakers need to find a way to require loss mitigation and to require sustainable modifications for homeowners that also benefit investors. Loss mitigation before HAMP did not always happen, and when it did, it did not always promote long-term home retention. Without rules in place, it is possible—perhaps even likely—that the system will soon forget the lessons of the crisis. To the extent that the CFPB does not or cannot mandate loss mitigation and a substantive requirement for loan modifications, Congress and other regulators should step in to ensure that such a requirement is developed.

E. Regulators should monitor Basel III implementation

Regulators must continue to monitor the implementation of the new standards to ensure that the transition does not negatively impact consumers. In particular, under the new standards, higher risk-weights are assigned to mortgage servicing rights, which may be prompting some banks to sell their mortgage servicing rights to smaller, non-bank mortgage servicers.[68] As this shift occurs, regulators must improve oversight of non-bank mortgage servicers to ensure they have the servicing capacity to handle an increased number of loans and consider whether additional changes to the standards are necessary to prevent disruption in the mortgage servicing industry.

F. Congress and regulators should support alternative mortgage channels and innovative products to reach underserved borrowers

Many communities hardest hit by the housing crisis and the economic downturn have long been either underserved or not served by traditional financial institutions that could provide safe and affordable credit. Similarly, for many borrowers, the most popular mainstream products will always be difficult to access. For this reason, we recommend taking steps to strengthen alternative mortgage channels and to experiment with safe but innovative products to reach more borrowers.

The strong need for alternative lenders in underserved communities can be attributed to years of discrimination, redlining, and market failures in which mainstream financial institutions lacked incentives to lend to projects where the aggregate social return was positive. CDFIs and HFAs, which combine deep knowledge of local communities' needs with safe, targeted products, can identify and assist potential homeowners, and CDFIs can also provide business and consumer loans, investments, and retail banking services to neighborhoods that need critical economic catalysts to overcome years of disinvestment.

Congress and regulators should consider whether there are changes to regulations such as the Community Reinvestment Act, or CRA, that can be used to strengthen these institutions. For example, changing the way that financial institutions subject to the CRA receive credit for investing in CDFIs could provide a win-win solution for banks unwilling to take risks on certain populations, especially since CDFIs and nonprofits receive special treatment in the Dodd-Frank mortgage rules to enable them to better

serve lower-income families. Similarly, sources of funding such as recent settlements between government agencies and large banks could be directed to helping alternative mortgage channels scale their operations.

Additionally, a typical mortgage product is not always accessible to some households due to the down-payment requirements or fear of placing assets in a first-loss position. Shared-equity or shared-appreciation approaches can provide a middle ground between renting and traditional homeownership. In general, these products share certain common features: owner occupancy of residential properties, initial affordability, and sharing of risk and equity or appreciation. These strategies can potentially support modest individual asset accumulation while protecting consumers against home price declines and providing more stability to the macroeconomy in times of market disruption.[69] Congress and regulators should consider how to encourage safe experimentation with alternative products.

G. Congress and agencies should support housing and credit counseling for a wide range of potential homebuyers

Whether counseling a first-time homebuyer to avoid predatory loans, negotiating a modification that will allow a distressed homeowner to stay in their home, helping a low-income family find affordable rental housing, or helping a homeless person find emergency shelter, nonprofit housing counselors are advocates for housing consumers, especially those from traditionally underserved communities such as communities of color, low- and moderate-income communities, and the elderly. A growing body of research demonstrates that those who receive housing counseling realize better outcomes than similarly situated people who do not.[70]

Recently, Congress killed a proposed FHA entitled Homeowners Armed with Knowledge, or HAWK, that would have offered reductions on the upfront and annual mortgage insurance premiums, or MIPs, to FHA borrowers who participate in a specified housing counseling curriculum. Congress should immediately restore FHA's ability to pursue this idea. Other government agencies such as the U.S. Department of Veterans Affairs and the U.S. Department of Agriculture could create the same type of program, and FHFA could work with Fannie and Freddie to create a similar incentive structure in the secondary market through preferential pricing for counseled mortgages. Borrowers could yield additional incentives if they committed to post-purchase counseling as well. Bonus points could be awarded under the goals that would incent this kind of proven, safe, and sustainable lending. Additionally, Congress should grant the Department of Housing and Urban Development's, or HUD's, Office of Housing Counseling the authority to accept funds from private entities to be distributed and used for housing counseling activities.

H. Congress should extend the Mortgage Forgiveness Debt Relief Act

When a lender forgives mortgage debt through a short sale or a principal reduction modification or even after a foreclosure, the amount that the borrower no longer owes counts as taxable income to the borrower unless it fits into an exemption in the tax code. Given the deep inappropriateness of this result for those losing their homes, Congress created a tax code exemption in 2007 entitled the Mortgage Forgiveness Debt Relief Act, or MDRA. The MDRA has been crucial to virtually every effort to assist troubled homeowners and restore the housing market to health. However, the MDRA expired in 2012, and has only been extended piecemeal by Congress – last year, it was not extended until the very last

moments of the tax year. Without this legislation, homeowners are often unwilling to do short sales, which harms the overall housing market. Plus, principal reduction is less valuable to homeowners if they must pay tax on the forgiven debt, which hampers loss-mitigation efforts. Congress must extend the MDRA at least until the end of 2016 to provide the market with some certainty, and ideally, this exemption would become permanent.[71]

I. Congress should convert the mortgage interest deduction to a credit

The federal government spends $70 billion per year on the mortgage interest deduction—more than $1 trillion over a 10-year period and more than the entire HUD budget for a year.[72] Yet the benefit of the mortgage interest deduction is heavily skewed to households in upper-income tax brackets. As taxpayers' income increases, their tax rate increases and so does the value of the deduction. In addition, the mortgage interest deduction is only available to those who are able to itemize deductions rather than take the standard deduction. According to the Tax Policy Center's analysis of 2010 data, less than one-third of taxpayers itemize their deductions, and the majority of those who itemize fall in the top income tax brackets.[73]

As part of comprehensive tax reform, we recommend replacing the current mortgage interest deduction with a tax credit. Our proposal would gradually phase out the current deduction and replace it with an 18 percent nonrefundable tax credit.[74] The effect of this change would be to provide the same benefit to all taxpayers, rather than a much larger benefit to those with higher incomes. Increasing the value of the credit to low- and moderate-income taxpayers not only increases fairness and access to homeownership but also contributes to economic growth, since it puts more money in the hands of a large number of families who typically need to spend every dollar they earn just to get by.

J. Regulators should collect better mortgage data to help identify problems and potential solutions in the market

As a free and public database, the Home Mortgage Disclosure Act, or HMDA, provides critical data to housing market participants and stakeholders, especially to nonprofits and other entities without access to expensive proprietary databases. However, the HMDA database has long suffered from some key omissions, both in terms of who is reporting data and what data are reported.

Recently, the CFPB issued a set of proposed changes to the HMDA, including changes to definitions of covered institutions and transactions, as well as the addition of proposed new fields to improve the usefulness and quality of the HMDA data. We strongly support the CFPB's efforts. In addition to its proposals, we recommend additional data enhancements that would be of great benefit to researchers and community groups in the efforts to promote fair access to credit, while also helping equip regulatory and enforcement agencies with fair lending compliance. For example, we think the CFPB should take further steps to simplify the reporting requirement to one eligibility standard, add further fields on various topics such as denials and language and race, and collect information on loan modifications and housing counseling.[75]

Conclusion

As memories of the crisis fade, policymakers face some important choices in trying to strengthen the nation's housing market. We can open the doors to a new round of predatory, unsustainable lending, or we can work to create a healthier and more equitable housing market by promoting sustainable homeownership, affordable rental housing, and stronger neighborhoods. Choosing the latter will require action by a wide array of policymakers and market participants, which can be challenging. Ultimately, however, by working together, we can create a more robust, fairer housing market that drives economic growth and promotes opportunity for America's families.

Thank you again for inviting me to testify today. I look forward to continuing to engage with you on these and other issues.

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