Statement of

Douglas G. Duncan, PhD

Senior Vice President of Research and Business Development, and Chief Economist

Mortgage Bankers Association

Washington, DC

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

Hearing on

"Preserving the American Dream: Predatory Lending Practices and Home Foreclosures"

February 7, 2007

Chairman Dodd, Ranking Member Shelby and Members of the Committee, my name is Doug Duncan and I am the Mortgage Bankers Association's (MBA's) Chief Economist and Senior Vice President of Research and Business Development.[1] Thank you for the opportunity to testify before you today as your review and consider the issues of predatory lending and foreclosures.

Before I begin, let me say, that we all share the same commitment – to come up with solutions to better protect consumers from abusive lending. When abusive lending happens, it is a stain on the mortgage industry just as it is a burden on our families and communities. The real estate finance industry has provided homeownership opportunities across this nation and has been a driving force in establishing communities, creating financial stability and wealth for consumers and fueling the overall economy. Our industry has helped our country reach a near 70 percent homeownership rate – to the benefit of us all – and MBA is committed to finding solutions to help weed out bad actors and, where appropriate, bring them to justice.

MBA believes there are three things the government can do to help to protect consumers. First, make financial education a priority in this nation, empowering consumers with knowledge and giving them the tools they need to make good decisions and protect themselves. Second, is to simplify and make more transparent the mortgage process so that consumers may better understand the details of the transaction and facilitate shopping more efficiently from lender to lender. Third, is to enact a strong and balanced uniform national standard for mortgage lending with increased consumer protections.

The mortgage industry has been extremely innovative in developing products and financing tools that create homeownership opportunities, expand affordability and facilitate greater consumer choice. Recently, however, there have been claims that these very products and financing tools are themselves in some way bad for consumers and have driven foreclosure rates to a state of crisis. Some advocacy organizations seek new, rigid underwriting standards and the imposition of "suitability" requirements. MBA is concerned that these approaches, which might look reasonable at first, will simply stifle innovation and take good financing options out of the hands of homeowners limiting consumer choice. The effect will be to undermine our mutual goal of putting Americans in homes and keeping them there.

---

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the Nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field.

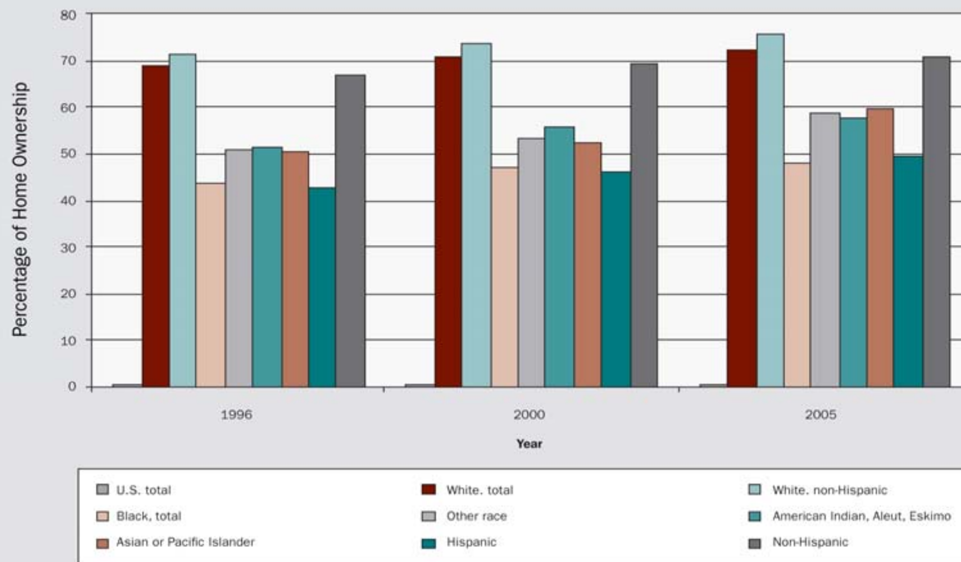
There is no doubt that when homes are lost to foreclosure, the process can have a devastating affect on consumers and communities. Please do not forget, foreclosures are extremely costly to lenders as well. We have evidence that current foreclosure rates are within normal ranges. Foreclosures are driven primarily by loss of employment, illness and other life events, and not by mortgage products.

MBA respectfully asks policy makers to continue to rely on sober judgment and sound research in assessing the scope of the problem when considering legislative approaches that will affect this key area of the nation's economy. While there likely are a small number of bad actors in our industry, there are many, many more stories of lenders who have helped borrowers achieve their homeownership dreams.

Our industry has considerable data that we will continue to make available and we urge government experts to carefully review it and to resist the urge to create policy based on headlines and anecdote. The mortgage market has performed well for consumers and for the larger economy and any policy that is not based on sound facts has the potential to undermine these benefits – particularly for those previously underserved borrowers who have so greatly benefited from recent innovations.

I. TODAY'S MORTGAGE MARKET

Homeownership is near its highest level in history – nearly 70 percent overall. Homeownership rates rose roughly 3.5 percentage points in the U.S. between 1989 and 2001. Looking at recent years, in 2001, the overall homeownership rate was 67.8 percent. In 2006, it was 68.9 percent. For African-Americans, the rate in 2001 was 47.7 percent, and in 2006 it grew to 48.2 percent (although it was 49.1 percent in 2004). For Hispanics, the rate in 2001 was 47.3 percent and in 2006 it was 49.5 percent.



As a result of these increases in homeownership, across all demographics, Americans are building tremendous wealth by increasing their home equity through their monthly payments and through the impressive rate of home price appreciation seen in recent years. According to the Federal Reserve Board's (FRB) Flow of Funds data, the value of residential real estate assets owned by households has increased from $10.3 trillion in 1999 to $22.4 trillion as of the first quarter of 2006, and aggregate homeowners' equity now exceeds $10 trillion. According to the FRB's 2004 Survey of Consumer Finances, the median net worth for homeowners was $184,000. For renters, it was $4,000.

More than a third of all homeowners own their home free and clear of any lien. Of the remaining two-thirds of homeowners who do have mortgages, three-quarters have fixed rate mortgages. Only one quarter of these borrowers, or about a sixth of all homeowners, have adjustable rate mortgages (ARMs).

Homeowning Household Distribution
By Mortgage Type

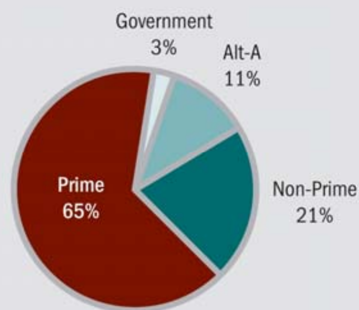
Household Mortgage Type	Percent	Percent of Those with a Mortgage
No Mortgage	**34.6**	
Fixed Rate	49.2	75.2
Adjustable Rate	**16.2**	**24.8**
Jumbo	.3.9	6.0
Conforming	12.3	18.8
Total	**100.0**	**100.0**

Source: American Housing Survey; Mortgage Bankers Association

According to MBA's Mortgage Originations Survey, in the first half of 2006, 62 percent of the dollar volumes of loans originated were prime loans, 16 percent were Alt. A, and 19 percent were non-prime, with government loans accounting for the remaining 3 percent.

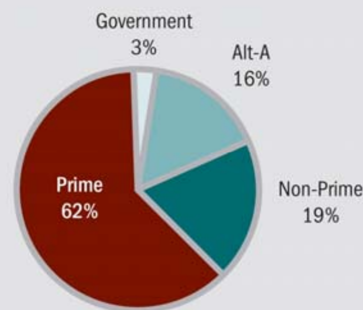
Mortgage Originations by Loan Type

First Half of 2005



By dollar volume

First Half of 2006

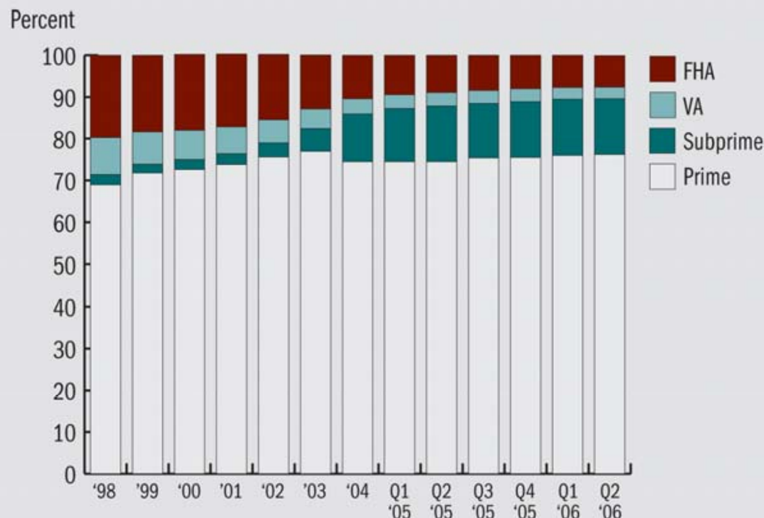


By dollar volume

Source: MBA's Mortgage Origination Survey

Estimates from MBA's National Delinquency Survey indicate that the number of nonprime loans has increased more than 6.5 times over the last five years (Q3 2001 to Q3 2006).

Based on first half 2006 data, nearly half of non-prime borrowers, or 45 percent, utilize nonprime loans to buy homes. One in four of these purchases was by a first-time homebuyer. Also, notably, over the last several years the average difference between the interest rates of prime loans and non-prime loans has decreased markedly.



II. MORTGAGE PRODUCT INNOVATION – Creating Access and Affordability

As we have indicated, the mortgage industry takes pride in its innovations in developing mortgage products. Innovation in combination with the liquidity provided by the secondary market has dramatically expanded the opportunity for consumers to become homeowners, particularly for traditionally underserved borrowers.

Over the past several decades, as mortgage lenders have sought to adapt to changing market conditions and changing consumer preferences, mortgage products have developed beyond the 30-year, fixed-rate, amortizing mortgage. In fact, in the early 1980s, in response to prohibitively high interest rates, the ARM began to gain wide acceptance.

In addition to ARMs, some lenders at the forefront of responding to consumer demand for product diversity, particularly in high cost markets, began to offer interest-only and payment-option mortgages. Mortgage lenders have successfully offered such products for decades, through different market cycles, without a threat to their safety and soundness. It is therefore prudent to look to the practices of lenders regarding nontraditional mortgage products but not to impose prescriptive requirements that would force them to change proven standards, disadvantaging institutions from effectively participating in this market.

Over the last decade, hybrid ARMs, where the initial interest rate is fixed for a period of time and then adjusts annually, also have gained wide acceptance. Borrowers now can take advantage of hundreds of different financing options based on their individual needs and circumstances. They can also choose among thousands of mortgage originators. MBA supports the opportunity for consumers to make their own choices. They are in the best position to choose which mortgage option is best for them and their families.

A. Nontraditional Mortgage Products

"Nontraditional mortgage products" refer to financing options which have been developed to increase flexibility and affordability and otherwise meet the needs of homebuyers who have been purchasing homes in an environment where real estate prices have increased faster than borrowers' incomes. Other homeowners have used these products to tap their homes' increased equity for a variety of needs including home improvements and renovations, paying down other forms of debt, as well as education and healthcare needs. While these products have often been characterized as "new," some of them actually predate long term fixed-rate mortgages. Nontraditional mortgage products include fixed- and adjustable-rate loans that permit interest only (IO) payments and payment-option loans including option ARMs.

MBA strongly believes that the market's success in making these "nontraditional" products available is a positive development. Although these products have been used to finance a relatively small portion of the nation's housing, they have offered and continue to offer new, useful choices for borrowers.

Notably, however, while nontraditional products have offered borrowers a variety of options, many of these products are not prevalent in the nonprime market. Payment-option loans are typically not available in the nonprime sector. In fact, according to Fitch Ratings, no nonprime loans carried a negative amortization feature in 2005. The IO share in the prime sector was 44 percent of dollar volumes, while it was 25 percent of dollar volumes in the nonprime sector. According to Standard & Poors, nonprime IO borrowers tend to have larger loans, typically indicating higher incomes, and better credit scores than nonprime borrowers who choose other products.

To be sure, as with all mortgage products, nontraditional mortgages must be underwritten by lenders in a safe and sound manner and their risks must be appropriately managed. As with other products, loan originators must provide consumers necessary information on a product's terms so a borrower can determine whether the product matches his or her needs.

Reports by MBA members and other data reviewed by MBA indicate that interest-only and payment-option mortgage borrowers also generally have good credit scores and relatively low loan-to-value (LTV) ratios. These products also tend to be most prevalent in higher cost areas of the country where there is a greater need for affordability products. For example, California, a particularly high cost state, has always had a high

ARM share. As the risk of a loan or its features increase - mortgage lenders take appropriate steps to offset the risk by requiring other features like higher credit scores to ensure a borrowers credit worthiness.

Interest-Only and Payment-Option Mortgages:

Interest-only and payment-option mortgages are two different products. Each is treated differently by lenders in terms of credit policy, underwriting standards and risk management.

An interest-only mortgage is commonly a loan under which a borrower is permitted to make interest-only payments for a certain period of time, after which the borrower is required to make principal payments as well. The interest rate may be fixed or adjustable during the interest-only period and may be fixed or adjustable after amortizing payments are required. Borrowers are typically allowed at their option to make principal payments during the interest-only period.

A payment-option mortgage is a loan for which a borrower typically has an option each month to make one of four payments: an amortizing payment based on a 15-year repayment schedule; an amortizing payment based on a 30-year repayment schedule; an interest-only payment; or a minimum payment based on a start rate which is below the fully-indexed accrual interest rate.

Where the minimum payment is insufficient to pay all of the interest due at the accrual interest rate, negative amortization occurs. Negative amortization means that the principal balance owed by the borrower increases. Typically, the minimum payment is fixed for 12 months, after which it adjusts annually based on the fully-indexed rate. Payment increases are usually limited to 7.5 percent in any one year. The amount of negative amortization may range from 10-25 percent of the original mortgage amount; if this limit is reached, the loan is recast, requiring payments that will amortize the outstanding balance over the remaining term of the mortgage.

B. ARMs and Hybrid ARMs

ARMs, including hybrid ARMs, are tried and true credit options. While some have asserted that they should be treated as nontraditional products, they are not covered by either the federal or state guidance for good reasons detailed in our recent letter to members of this committee. (For a fuller description of the guidance, please refer to page 10). They significantly differ from interest-only and payment-option products. ARMs, first developed in the 1970s, permit borrowers to lower their payments if they are willing to assume the risk of interest rate changes. Hybrid ARMs, introduced in the mid-1990s, combine the benefits of fixed rate mortgages and adjustable mortgages and allow borrowers to opt for a lower initial interest rate and lower monthly payments, which are fixed for a period of two to ten years (including 2-28 ARMs and ARMs with longer fixed payment periods). After the fixed payment period ends, the hybrid ARM converts

to an adjustable rate mortgage with the interest rate and payments adjusting periodically (usually yearly) based on interest rate changes in the capital markets.

ARMs, including hybrid ARMs, are not simply refinancing tools; these mortgages are affordable financing options that have helped millions of borrowers achieve the dream of homeownership. Hybrid ARMs offer a lower monthly payment during the fixed payment period than a fixed rate mortgage. Nearly half, or 45 percent, of non-prime loans are purchase loans, with 25 percent of non-prime purchase mortgages originated for first-time homebuyers indicating that a significant portion of the recent gains in homeownership are likely attributable to hybrid ARMs. In the first half of 2006, 67 percent of new subprime loans were ARMs.

Hybrid ARMs are frequently underwritten using more flexible guidelines based on reasonable repayment expectations, allowing many more borrowers to qualify for these loans. Flexible underwriting for hybrid ARMs is appropriate. Relatively few hybrid ARMs experience any adjustment at all; hybrid ARMs are usually refinanced very early in their terms. Data from Fitch Ratings indicate that of the prime loans originated in 2003, only 44 percent remained outstanding as of the second quarter of 2006. For subprime loans originated in 2003, only 22 percent remain outstanding as of that time.

If ARMs and hybrid ARMs were underwritten to the fully-indexed rate, as some advocacy organizations assert, many hybrid ARM borrowers simply will not qualify for mortgages to buy homes or to get needed credit. For many borrowers, the choice is not between an ARM and a fixed rate mortgage to finance the property they want; it is an ARM or no mortgage at all.

Hybrid ARMs are not "exploding mortgages." Payment increases are generally much smaller than alleged and by virtue of borrowers moving or refinancing, frequently never come due. The rates and payments under hybrid ARMs do not normally increase by 40-50 percent, after the option period has expired, as has been alleged. In fact, whether there are any payment increases depends on the structure of the ARM and what happens to interest rates during the fixed period of the loan. Data from lenders demonstrate that today, on average, the change between the average start rate and the average fully indexed rate under these mortgages is generally no more than 2-3 percentage points. To protect borrowers from unmanageable payment increases, lenders structure hybrid ARMs so that there is a cap on the periodic adjustment. Also, as indicated, most subprime borrowers do not remain in their mortgages for more than three years. In any event, the potential increase in payments for borrowers later in the life of a hybrid ARM pales by comparison to the initial up-front savings to these borrowers.

C. Federal and State Nontraditional Guidance

On September 29, 2006, the federal financial regulators--the Board of Governors of the Federal Reserve (FRB), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC) and the

National Credit Union Administration (NCUA)—jointly issued Final Guidance on Nontraditional Mortgage Products (the Guidance).[2] Key aspects of the guidance are the same as the proposed guidance issued for comment by the regulators nearly nine months ago, with a few significant clarifications.

The Guidance is intended to address risks posed to federally regulated financial institutions by the growing use of mortgage products that allow borrowers to defer payments of principal and, sometimes, interest. The guidance specifically covers interest only (IO) and payment-option adjustable rate mortgages (Option ARMs). It specifically excludes HELOCs and reverse mortgages.

The guidance applies to federally regulated institutions including federally chartered banks, S&Ls and credit unions but it has a "trickle down" effect since it requires such institutions to monitor the quality of third party originations so they reflect the institutions' lending standards and compliance with laws and regulations.

The Guidance addresses three sets of concerns: (1) Loan Terms and Underwriting Standards; (2) Portfolio and Risk Management Practices; and (3) Consumer Protection Issues.

On November 14, 2006, Conference of State Bank Supervisors (CSBS) and American Association of Residential Mortgage Regulators (AARMR) encouraged the states to adopt guidance which generally tracked the Federal Guidance and, to this end, both organizations published their template as CSBS/AARMR Guidance. This guidance is based on the Federal Guidance, and only modified or deleted those provisions dealing with risk management that were inapplicable to non-depository institutions.

In their press announcement, the organizations noted that consistent guidance "will allow the opportunity to gauge the impact on the mortgage market and consumer behavior." As of this date, 23 states and the District of Columbia have adopted or begun the process of adopting the CSBS/AARMR guidance.

Mortgage lenders have been subject to a patchwork of lending requirements, in areas other than nontraditional products, emanating from the federal, state and even local governments. These diverse standards, while well-intentioned, have lessened competition, increased regulatory costs and, thereby, increased costs to the consumer. Restrictions that vary from locality to locality lessen the number of entrants that are willing to learn and comply with particular requirements. Increased regulatory risks and compliance costs for those who do compete translate into increased costs for consumers.

For this reason, MBA particularly appreciates the efforts of the regulators to develop guidance that is consistent among federal and state regulated institutions. Consistency of guidance better serves consumers, increases competition and lowers costs.

---

[2] 71 Federal Register 58609 (October 4, 2006)
http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20060929/attachment1.pdf

Recently, pressure has been exerted by some advocacy organizations to extend the Federal Guidance to ARM products, including hybrid ARMs, notwithstanding that neither the Federal Guidance nor the CSBS/AARMR Guidance encompass them.

MBA strongly believes that the federal and state guidance should not be expanded to go beyond nontraditional products (IO and Payment Option ARMS). Further, it should not be expanded to include hybrid ARMs or other traditional products. Again, the effect of such expansion will only serve to limit borrowers' options and increase costs.

As of yet, no regulatory action has been undertaken to expand the Federal Guidance. We understand, however, that the federal regulators are carefully considering this matter and we trust that before any additions are made to the guidance the public, industry, advocacy organizations and others would be afforded a full and fair opportunity for comment.

1. Underwriting Standards

The establishment of underwriting standards is the responsibility of lenders and mortgage investors who are constantly refining credit policies in response to risk analysis, market conditions, and consumer behavior. Certainly, the experience of many such institutions, which have offered a range of products for decades, has demonstrated an ability to develop safe and sound underwriting standards.

Mortgage lenders that successfully offer nontraditional products have used credit reports, credit scores, and sophisticated modeling to ensure that the non-amortizing features of nontraditional loans are mitigated with features that reduce risk.

While MBA and its members agree that borrowers should not be underwritten at teaser rates that are substantially below the fully-indexed accrual rate and are in effect for just the first few months of the mortgage, MBA has not favored the establishment of rigid, overly broad, underwriting standards that require analysis of borrowers' ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. We have commented that such an approach is far too prescriptive and forces lenders to apply credit policies that disadvantage products in a manner which is inconsistent with their risks.

The nontraditional guidance expects that interest-only and payment option mortgages be underwritten to the fully indexed rate, a result that will limit the availability of these products. The extension of this requirement to hybrid ARMs will have a similar effect. Moreover, under an approach requiring underwriting to the fully indexed rate, a 10/1 hybrid ARM with a 20-year amortization starting in year eleven would be disadvantaged against a 3/1 hybrid ARM with a 27-year amortization starting in year four despite the fact that most lenders would consider the 10/1 hybrid ARM a lower risk product.

A key risk factor of any hybrid mortgage is the initial length of time during which the interest rate is fixed, where an interest-only payment is required or the fact that the loan

does not amortize. An overly broad standard may require lenders to invert this risk analysis and treat loans with a longer fixed rate or payment timeframe as higher risk than those with shorter timeframes.

2. Portfolio and Risk Management Practices

MBA and its' members share the view embodied in the guidance that lenders should pay particular attention to those products in their portfolios that may carry higher risks and change credit policies and risk management practices when performance problems arise or risk analysis indicates there may be a problem.

There is also agreement with the requirement that mortgage lenders should have appropriate controls in place for the types of mortgage products they originate.

Day-in day-out, lending institutions work internally and with their regulators to ensure that their loan loss reserves are adequate given the risks in their portfolios.

3. Borrower Information Concerning Nontraditional Products

MBA and its members strongly believe that the features of mortgage products offered to consumers should be fairly represented so that consumers can decide for themselves which product makes the most sense given their personal financial position. As indicated, many consumers understand the array of products and have used them appropriately to their advantage.

Because there is no single, uniform, mandated disclosure for nontraditional products, lenders have developed their own disclosures to inform borrowers about the characteristics of these products. Many mortgage lenders have been originating these products for a considerable amount of time and have significant experience with them. This experience has informed the development of disclosures.

Lenders also provide borrowers the range of information and disclosures mandated under the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA), including the Consumer Handbook on Adjustable-Rate Mortgages (CHARM) booklet.

MBA has reviewed the disclosures developed by several MBA members who originate significant volumes of nontraditional mortgages and have found them to be quite detailed and comprehensive in providing consumers the information they need to fully understand the mortgage product they are considering.

Mortgage lenders that successfully offer these products constantly review the performance of these loans. They make changes as warranted to credit policies and other practices, including disclosures, to improve performance and to facilitate customer understanding.

MBA's comments on the Proposed Federal Guidance and the Proposed Illustrations of Consumer Information on Nontraditional Products published contemporaneously with the federal nontraditional product guidance strongly urges that the regulators use the existing authorities under TILA to improve disclosures for nontraditional products nationwide.

Notwithstanding that the regulators determined that new information as set forth in the Guidance was needed now, to ensure that consumers get the information they need about nontraditional mortgages, MBA urges that the regulators regard the new disclosure illustrations as a temporary approach. MBA recommends that the regulators direct their energies toward a much more comprehensive approach to improving the mortgage disclosure process for consumers and make these disclosures applicable to all mortgage lenders.

Consumers today confront a pile of disclosures when they apply for and close on a mortgage. Sadly, every new layer of disclosure simply increases the likelihood that the consumer will merely initial all of them without even a cursory reading. For this reason, disclosures do not need to be added; they need to be combined, streamlined and made much more user friendly.

Efforts at improvement should include all disclosures required by federal law. Because RESPA and TILA apply to regulated and unregulated entities, such an approach is the best means of assuring that virtually all consumers receive high quality information and that a level playing field of disclosure requirements is established for all industry originators. These efforts should also consider the plethora of state disclosures.

In the meantime, MBA and its members are currently implementing the Guidance. Notably, however, MBA members have long established underwriting standards, risk management and appropriate consumer protections for these and all mortgage products.

MBA strongly believes that sound underwriting, risk management and consumer information are essential to the public interest. At the same time, we also believe that it is essential to assure the legislative and regulatory environment serves and does not choke innovation in the industry and reduce credit options for borrowers. Such an environment allows lenders to provide borrowers the widest array of credit options to purchase, maintain and, as needed, draw equity from their homes to meet the demands of their lives.

D. Financing Tools

The following valuable financing options allow consumers to make their mortgage more affordable:

Prepayment Penalties

A prepayment penalty in connection with a mortgage allows a borrower to choose a lower rate and lower monthly payments in return for agreeing not to refinance within a set period unless he or she pays a fee. A lower rate can be offered because the presence of a prepayment penalty assures a more reliable income stream for investors in pools of such mortgages and, consequently, better pricing for securities and consumers themselves.

MBA has long been committed to transparency and informed consumer choice and, in that vein, believes that prepayment penalties should always be optional and result from true consumer choice. Accordingly, MBA would support a requirement as part of a uniform lending standard that originators provide borrowers with a choice of a loan rate with and without a prepayment penalty, if available.

Yield Spread Premiums

Yield spread premiums represent the value of any difference in rate between the rate the customer pays a mortgage broker and the current par (going) rate accepted by secondary market investors. Unlike prepayment penalties that reduce the interest rate, yield spread premiums increase the rate to receive credit back on the transaction to pay for closing and origination costs. As (HUD) recognized in considering the legality of yield spread premiums, these payments offer borrowers the option of choosing to defray origination costs by selecting a higher rate and therefore, higher monthly payments instead of paying them up front. MBA favors their disclosure to borrowers but also believes they are important options that should remain available.

E. Lenders Rely on Accurate Appraisals

Lenders have every incentive to ensure that property appraisals are accurate because they bear the risk of loss. The lender relies on the appraisal as a true reflection of the value of a property and agrees to lend a particular amount to a borrower based on the appraisal. To assure the veracity of the appraisal and the fair dealing of appraisers, MBA supports the proper licensing of appraisers. Further, lenders have developed and utilized automated valuation models (AVMs) which are objective programs that provide accurate valuations of a particular property. Lenders represent and warrant to investors that the appraisal is accurate. If it is discovered to be inaccurate, a lender can be forced to buy the loan back.

III. THE PRIMARY REASON FOR DEFAULTS ARE FAMILY AND ECONOMIC DIFFICULTIES – NOT PRODUCT CHOICES

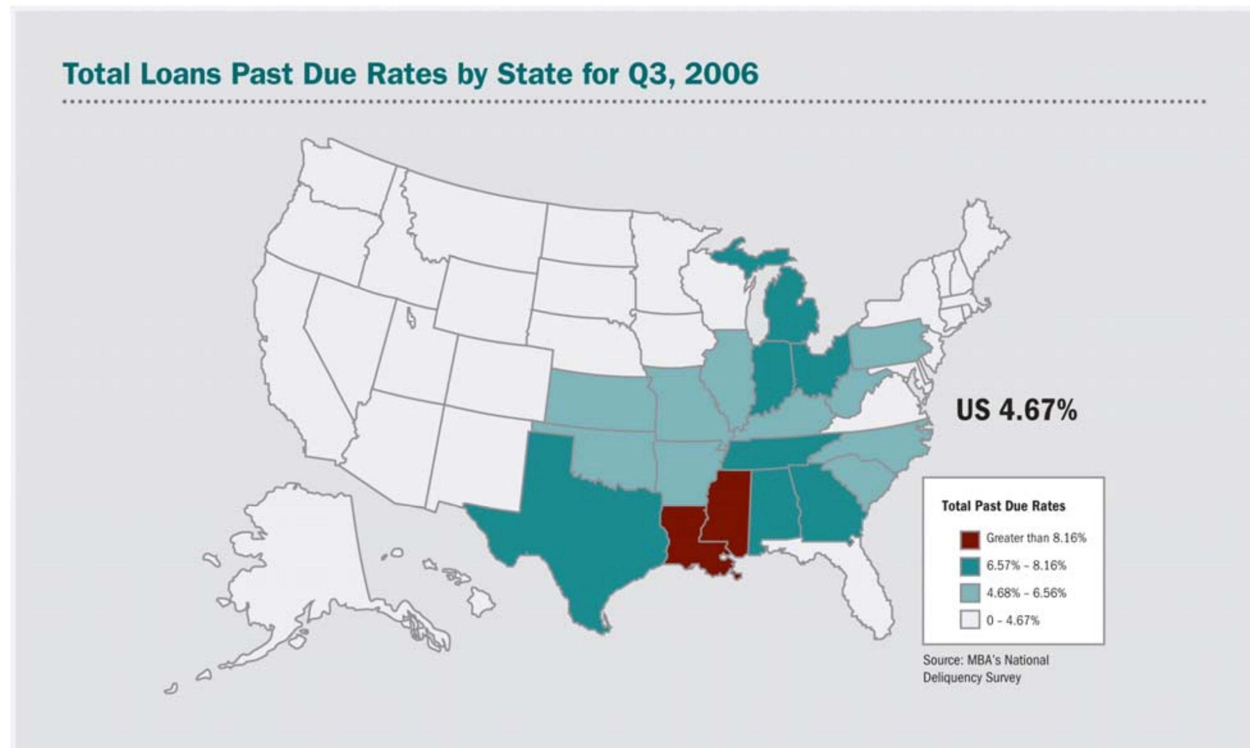
There is no evidence that product choices by borrowers are determinative of defaults or foreclosures. Different products have different default rates but the product choice does not cause the default. Data consistently demonstrate that delinquencies among all borrowers are a function of a variety of factors including, first and foremost, economic

difficulties caused by job losses. According to Freddie Mac, based on a sample of loans in Workout Prospector®, from 1999 to 2005, the following are the reasons for delinquency:

Reasons for Delinquency

Variations in delinquencies from state-to-state reflect differences in the level of unemployment:

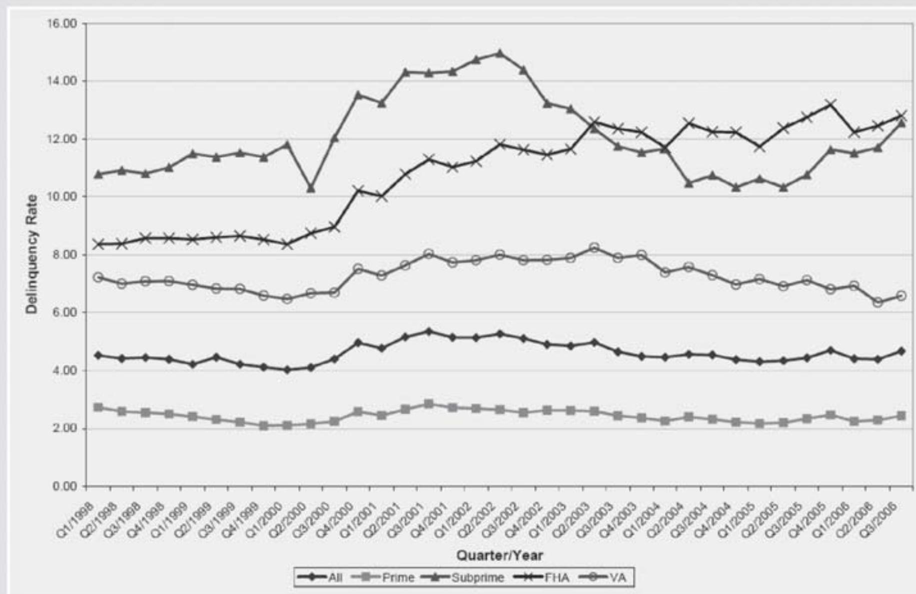
Unemployment or curtailment of Income	41.5%
Illness or Death in Family	22.8%
Excessive Obligation	10.4%
Marital Difficulties	8.4%
Extreme Hardship	3.3%
Property Problem or Casualty Loss	2.1%
Inability to sell or rent property	1.6%
Employment Transfer or Military Service	0.9%
All Other Reasons	9.0%



Assertions that delinquency rates are at crisis levels and a greater percentage of borrowers are losing their homes are not supported by data. In fact, delinquency and

foreclosure rates, including nonprime borrowers, have remained relatively low with some increases over the last year.

Total Delinquency Rate by Loan Type



Source: MBA's National Delinquency Survey

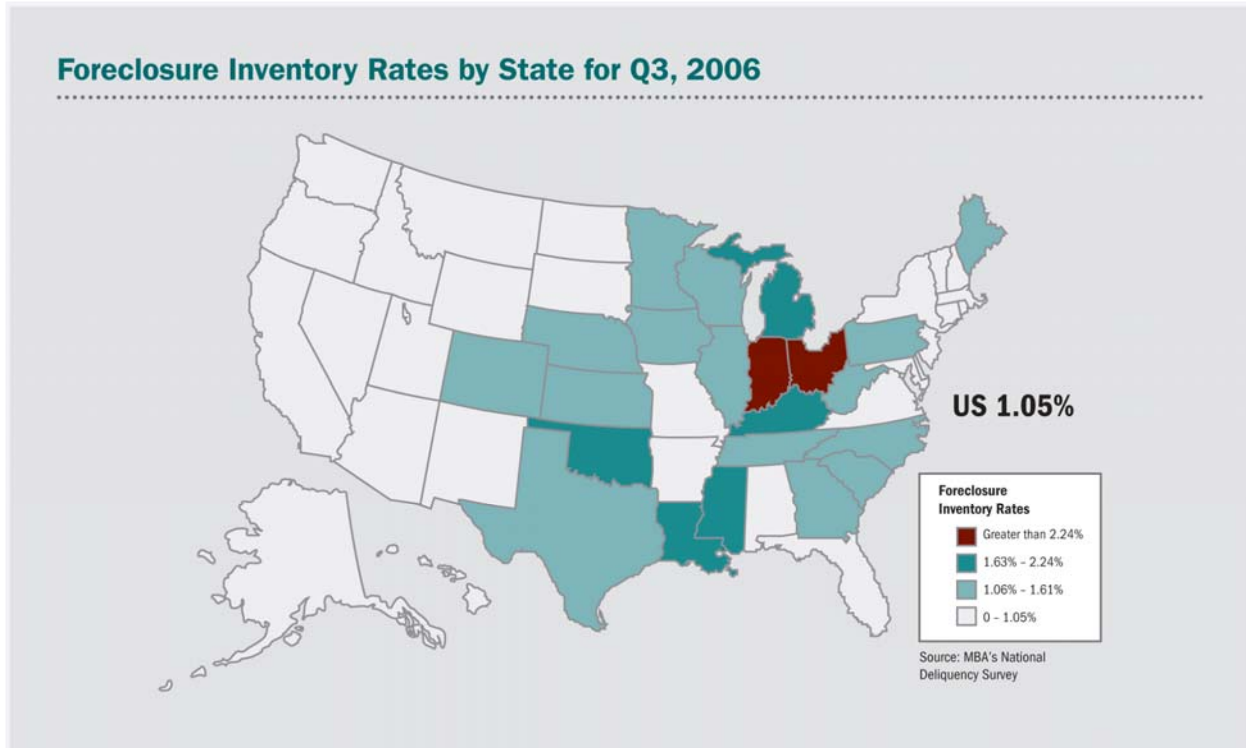
All ARM loans had higher delinquency rates as compared to the second quarter of 2006. In the third quarter of 2006, the delinquency rates for fixed rate mortgage loans (FRMs) were either unchanged or declined. The delinquency rate for prime ARMs was 3.06 percent, for prime FRM loans was 2.10 percent, for non-prime FRM loans increased 36 basis points to 9.59 percent, and the delinquency rate for non-prime ARMs was 13.22 percent. In the third quarter of 2006, the delinquency rate for non-prime loans was 12.56 percent, up from 11.70 percent.[3]

MBA's third quarter 2006 National Delinquency Survey (NDS) found that the percentage of loans in the foreclosure process was 1.05 percent, an increase of six basis points from the second quarter of 2006, while the seasonally adjusted rate of loans entering the foreclosure process was 0.46 percent, three basis points higher than the previous quarter. The foreclosure inventory rate for subprime loans in the third quarter of 2006 was 3.86 percent, up from 3.56 percent in the second quarter. The foreclosure inventory rate for prime FRMs increased to 0.36 percent from 0.34 percent, for prime

---

[3] These figures are based on MBA data. MBA defines "delinquency" as having one or more payments overdue. The loans in foreclosure are approximately a third of these numbers and the borrowers actually losing their homes are approximately a fourth of that group.

ARMs from 0.56 percent to 0.70 percent, for non-prime ARMs from 3.88 percent to 4.68 percent. The foreclosure inventory rate decreased for subprime FRM loans from 3.05 percent to 3.00 percent.



In its most recent data, MBA is seeing increases in delinquencies and foreclosures for nonprime loans, particularly nonprime ARMs. Because of technology induced cost reduction and efficiency gains by the industry as well as the appetites of borrowers for credit, the share of outstanding loans that are non-prime has been increasing for the last several years. The higher average delinquency and foreclosure rates among these loans mean the overall statistics for total outstanding mortgages are unlikely to fall as low as in the past.

It is important to note that non-prime loans have always had higher delinquency and foreclosure rates and lenders factor in these risks when lending to non-prime borrowers. Given the fact that nonprime borrowers have weaker credit profiles, this is not surprising. Foreclosures also can be accelerated by slow housing markets that limit borrowers' ability to quickly sell in order to cover their losses. MBA data has indicated that over the last several quarters a number of factors, including the aging of the portfolio, increasing short-term interest rates and high energy prices, have been putting upward pressure on delinquency rates. However, healthy economic growth and vibrant labor markets have offset these pressures.

Nevertheless, for each borrower whose loan goes into default and is foreclosed, the experience is a traumatic one, and it is not surprising that counsel for such borrowers would assert every claim available to permit their clients to hold onto their homes.

However, policymakers need to understand that keeping the homeowner in their home paying on their mortgage is the best outcome for both the lender and the borrower.

IV. FORECLOSURE PREVENTION AND SERVICING PRACTICES

Mortgage servicers want to preserve homeownership and, in fact, have economic incentives to get borrowers back on their feet as quickly as possible and avoid foreclosure. Delinquencies and foreclosures are costly both from a hard and soft dollar perspective. Significant staff must be dedicated to handling delinquencies and foreclosures. Servicers also must advance principal and interest payments to investors and pay taxes and insurance premiums even though such payments are not received from the borrower. If the loan becomes seriously delinquent, servicers must hire foreclosure attorneys and sometimes pay for property preservation. All these costs can be a significant drain on capital. In the event of foreclosure, noteholders take significant losses on the loans. A 2003 Federal Reserve study notes that, "estimated losses on foreclosures range from 30 percent to 60 percent of the outstanding loan balance because of legal fees, foregone interest, and property expenses." [4] From a pure economic basis alone servicers do not desire foreclosures.

It is important to note that servicer profits derive from receiving the servicing fee for administering the loans. Although the servicing fee is small, usually amounting to one fourth of one percent of the loan balance, when a loan is delinquent, that fee is not earned. When a loan is extinguished through foreclosure, the servicing asset represented on the balance sheet is also extinguished. Large numbers of foreclosures are detrimental to a servicer's earnings and net worth. Thus, long-standing claims that lenders purposely put borrowers into products they cannot afford in order to take the property through foreclosure is simply unfounded.

In reality, everyone loses in a foreclosure – the borrower, the local community, the mortgage insurer, investors and the servicer. Servicers do not have an incentive to intentionally cause foreclosures, because profitability rests in keeping loans current and, as such, the interests of borrowers and lenders are mostly aligned.

A. Loss Mitigation Tools

Recognizing the significant downside to foreclosures and with a strong desire to assist their borrowers, servicers have, over the last fifteen years, made deliberate and significant strides to provide workout alternatives to foreclosure. These alternatives include both home retention options, such as forbearance, repayment plans and modifications, and home relinquishment options when the borrower can no longer support the debt. Of course, servicers strive to provide home retention solutions whenever possible. The following is a brief overview of the home retention options used by servicers:

---

[4] Foreclosing on Opportunity: State Laws and Mortgage Credit, Karen M. Pence, Board of Governors of the Federal Reserve System, May 13, 2003.

- **Informal Forbearance Plans:** These plans provide short-term postponements or reductions in payments with a typical duration of three months, followed by repayment of the arrearage over time.

- **Special Forbearance Plans:** These plans are longer-term forbearance plans that typically combine a period of postponed or reduced payments followed by repayment of the arrearage over an extended time frame. There is usually a cap on the amount of PITI (principle, interest, taxes and insurance) payments that can be deferred. The industry average is 12 – 18 months PITI. Extensions are handled on a case-by-case basis.

- **Loan Modification:** Modifications result in permanent changes to one or more of the original loan terms, such as the interest rate and/or duration of the loan. A modification is a very effective work out vehicle, because it provides an immediate resolution to the delinquency by taking the amount of arrearage and adding it to the balance of the modified loan (e.g. "capitalize the arrearage") and re-amortizing the payments. The duration of the loan can also be extended to reduce monthly payments.

- **Delinquent Refinance:** Although less common, borrowers that are less than three months behind may be able to refinance to lower rates and capitalize the arrearage.

- **Partial Claims:** FHA borrowers have an added tool called a partial claim. HUD will accept a junior loan that is comprised of the amount of arrearage. This junior loan bears no interest and is repayable upon pay-off of the first mortgage. The servicer "advances" the amount of the arrearage to the borrower's account and makes a "partial" claim to HUD for the amount of the advance.

Other non-home retention loss mitigation alternatives are useful when borrowers have no viable means to cure their financial situation. These options offer several benefits that should not be discounted. First, they avoid foreclosure which can severely impact the borrower's credit. Second, the servicer generally does not seek repayment of the deficiency, which is the difference between the value received for the property and the amount of the debt owed. Third, borrowers are often assisted with moving expenses. These options are most often used when home prices decline below the amount of outstanding debt:

- **Pre-Foreclosure Sale (PFS) or Short Sale:** Proceeds from a third party sale of the borrower's home are accepted as satisfaction for the mortgage, even though they represent less than the amount owed.

- **Deed-in-Lieu of Foreclosure (DIL)**: The borrower voluntarily deeds the property to the servicer as satisfaction for the mortgage even though the value of the property is less than the amount owed.

The success of these loss mitigation programs is a reality in terms of keeping borrowers in their homes. Mortgage lenders work hard at devising ways to reach consumers at an early enough point to work out a feasible approach in light of a consumer's situation.

B. Servicer Practices

Before borrowers ever reach the point of being seriously delinquent, servicers attempt to cure the delinquency. Experience has shown that early intervention is the key to curing delinquencies. As a result, servicers make significant attempts to contact borrowers early in the delinquency or even before a delinquency occurs. In fact, prime lenders have adopted some techniques from subprime lenders that have proven effective, including: providing welcome calls to new customers ensuring that they have important contact information; initiating reminder calls prior to the expiration of the grace period for at-risk borrowers; using automation to determine when a borrower's failure to make a payment is outside of their normal pay-behavior; and prioritizing out-bound assistance calls to the highest risk delinquent borrowers first. This allows servicing staff to focus their resources where they are most needed. These techniques have proven to be beneficial for consumers. In addition to personal contact, servicers send numerous notices to borrowers informing them of their delinquency, offering loss mitigation and providing helpful information on how to avoid foreclosure.   Property preservation personnel in some cases also leave discrete information at the property address.[5]

Some servicers are also using telecommunication tools to streamline contact with delinquent borrowers. Through automation, the delinquency status of in-bound callers can be determined very quickly and calls routed automatically to workout staff thus by-passing the company's standard customer service line. The process is seamless to the consumer and avoids wait times. Other companies provide dedicated toll-free numbers that go directly to the loss mitigation teams trained to address more complex borrower needs.

Servicers have also developed websites that allow borrowers to access loss mitigation information, obtain and submit required documents and in some cases, apply for loss mitigation on line.

---

[5] The following are the notices/solicitations typically provided by servicers: a payment reminder that payment is past due (from 2-16th) (this is typically for high risk borrowers); late charge notice notifying the customer that payment is past due and late charge has been assessed; monthly account statement reflecting either the current and/or total amount past due; notice of availability of counseling and state/local payment assistance programs at 45 days (Federal Law); mail "How to Save Your Home" pamphlet at 60 days (Federal Law for FHA loans); mail internally created documents on how to save the home for non-FHA loans; separate letters soliciting for loss mitigation; multiple calls each month to solicit alternative collection/loss mitigation. Additional notifications are sent pursuant to state statutory requirements or preconditions to foreclosure including the breach (or demand letter); letter announcing acceleration of the debt; service of process notices, and foreclosure sale date.

Unfortunately, despite all this technology and effort, over half of borrowers in foreclosure proceedings have had no contact with their servicer.[6] This lack of contact is one of the biggest challenges servicers face in trying to cure delinquencies.

One situation that MBA believes contributes to this low contact rate is a provision in the Fair Debt Collection Practices Act (FDCPA). Under FDCPA, a lender who purchases servicing on a delinquent loan is required to announce itself as a "debt collector" prior to discussions with that customer. A servicer who purchases current servicing that subsequently becomes delinquent, however, is not required to make this announcement. This so-called "mini Miranda warning" effectively drives borrowers away by creating a misleading and conflicting message with loss mitigation efforts (especially when servicers request financial information from the borrower for purposes of structuring the loss mitigation plan). Servicers that purchase delinquent servicing should be treated like other servicers and not have to provide this statement. It is counterproductive.

Even with these obstacles, servicers are not just throwing in the towel. They are proactive in exploring new options that bring borrowers to the table - ways that create approachable environments for borrowers who might be embarrassed or not trusting of the lender. This includes teaming up with non-profit and for-profit agencies to assist in *locating* borrowers and providing homeownership counseling.

One such effort is a joint venture between NeighborWorks America, the Homeownership Preservation Foundation (HPF), the Ad Council and approximately 17 nationwide servicers, insurance companies and other industry representatives. The partnership is funding a nationwide campaign to inform and educate homeowners about the availability of foreclosure prevention counseling. The partnership links the HPF's 1-888-995-HOPE toll-free hotline, which offers free telephonic foreclosure prevention counseling with NeighborWorks' network of "on the ground" organizations that provide face-to-face homeownership counseling services when telephone counseling is not enough. With the assistance of the Ad Council, the partnership will fund a nationwide public service campaign aimed at encouraging homeowners to contact 1-888-995-HOPE to receive foreclosure prevention counseling. Counselors will work with borrowers and their servicers, even those that are not part of the partnership, to execute loss mitigation arrangements. The hope is that homeowners who are hesitant to call their servicers will be more likely to contact a non-profit organization to discuss alternatives.

This recent joint venture is modeled after Chicago's Homeownership Preservation Initiative (HOPI) that encourages homeowners facing foreclosure to call the city of Chicago's 311 hotline to be linked to non-profit credit counseling agencies. The HOPI program and the subsequent national partnership has resulted in increased communication strategies by servicers and the industry's ability to inform non-

[6] Foreclosure Avoidance Research, Freddie Mac, 2005.

profits across the country about servicers' creative and flexible loss mitigation options that are generally available to borrowers in danger of foreclosure.

The paradigm has shifted from a decade ago. Borrowers need to know that lenders can help. A direct call to the lender or to a reputable housing counselor can save a borrower's home. We hope to facilitate that message whenever possible.

C. Concerns with Mandatory Forbearance

MBA understands that the Committee is exploring other ways to reduce foreclosures. Let me assure you that the mortgage banking industry is willing and eager to embrace new opportunities, but MBA implores you to keep in mind that those alternatives must be simple, cost effective for all parties and have reasonable probabilities of success.

Of significant concern are recent press stories suggesting a statutorily mandated forbearance period. The length and trigger of such a forbearance period is unknown at this time, but MBA is very concerned that such a proposal would prevent or delay lenders from taking important statutorily required steps, such as sending breach letters, accelerating the debt, or initiating foreclosure. Forbearance, while well intentioned, may have unintended results when applied across the board, and will certainly delay already lengthy foreclosure time frames.

First and foremost, it is unclear that mandatory forbearance will increase the number of cures over current volumes. Historically there is very little success with curing loans where the property is abandoned, converted to rental properties but no longer profitable, damaged or subject to code violations, or where the borrower simply no longer has the means to support the loan at any level or to perform a short sale . Delaying the inevitable foreclosure only add costs for borrowers and lenders in these cases. There is simply no way to cure these delinquencies and therefore going to foreclosure is really the only solution.

Second, holding off foreclosure, when it is really the only path, often results in the deterioration of properties and ultimately affects entire neighborhoods. Crime increases and other property values are impacted. Servicers must have discretion to move to foreclosure according to state time frames that have been established and vetted over many years.

Third, any mandated forbearance period, by its very nature, will increase the number of loans that move into the severely delinquent loan category (90 or more days delinquent) and remain there. Under risk-based capital rules, loans that are 90 days or more past due are subject to a 100 percent risk weighting (as compared to loans that are current or below 90 days delinquent, which carry a 50 percent risk weighting). A broad application of a forbearance period could affect financial institution's capital requirements and rankings.

Fourth, there is significant time already built into the delinquency and foreclosure process for borrowers to cure their problems. Cases are generally not referred to a foreclosure attorney until the loan is 90 days past due. Servicers must then prepare and refer the file to a foreclosure attorney. The foreclosure attorney must prepare the petition for foreclosure and file it with the appropriate court or begin the statutorily prescribed notices that pre-condition non-judicial foreclosure. Service of process and hearings follow. This is not a quick process. In New York, for example, it takes approximately 12 months from the petition filing date to reach foreclosure sale. In Pennsylvania, it takes approximately 10 months. Foreclosure timelines are shorter in non-judicial states and those processes have been developed and vetted by the state legislatures over many decades. It is important to stress that servicers continue to solicit borrowers for loss mitigation even when the loan is "in foreclosure." In fact, servicers will execute a viable loss mitigation arrangement up to the foreclosure sale date. Some states also offer redemption periods that allow a borrower to tender payment to the servicer after the foreclosure sale is complete and get the property back. Diligent borrowers have sufficient time already to clear up a delinquency if other financial factors are present (including loss mitigation).

Fifth, foreclosure delays can result in negative tax consequences for borrowers. Accrued interest, taxes, insurance premiums, foreclosure costs and other incurred fees continue to mount the longer the loan is delinquent. These amounts become part of the borrower's total indebtedness. Under the Internal Revenue Code, if the lender "writes off" the borrower's debt following foreclosure, a borrower who is solvent and has recourse liability under the tax code is considered to be enriched by the amount of the "debt forgiven" and is taxed on that amount as if it were ordinary income. Any forbearance period that delays the foreclosure sale will increase the borrower's debt and exacerbate the negative tax consequences for borrowers. As a result, forbearance for all borrowers, even those that cannot resolve their delinquency by any means, is not a sound alternative.

Sixth, a mandatory forbearance law may unintentionally harm the borrower's ability to recover. Servicers know that the longer the borrower remains delinquent, the less likely he or she will be able to cure the delinquency. A mandatory forbearance law that gives no discretion to the lender and encourages borrowers to remain delinquent will harm borrowers' chances of recovery.

It is also important to remember that foreclosures take longer in judicial foreclosure states. A 2003 Federal Reserve Board working paper notes that, on average, foreclosures in judicial foreclosure states take 148 days longer than non-judicial foreclosure states. Because it takes longer for foreclosures to be handled in the judicial states, their inventories at the end of each period tend to be higher. [7]

The mortgage industry has been responsive to its customers and has an interest in preserving homeownership. MBA urges this Committee not to impose an artificial

[7] Karen Pence, 2003, "Foreclosing on Opportunity: State Laws and Mortgage Credit." Federal Reserve Working Paper #2003-16.

forbearance period without consideration of the concerns above, and without consideration of the fact that loss mitigation is prevalent and effective.

V. THE IMPOSITION OF A SUITABILITY STANDARD HURTS THOSE IT IS MEANT TO HELP

As indicated, the data does not show that unsuitable products or predatory lending are the cause of delinquencies and foreclosures. The foreclosure problem is based on economic difficulties that confront borrowers.

Notwithstanding, a number of advocacy organizations have urged that a "suitability standard" be imposed on mortgage lenders as a means of making the lender responsible for assuring the borrower is in the right loan to prevent foreclosure later. These organizations assert that a "suitability standard" applies to securities brokers and that there is no reason why a similar standard should not be imposed on mortgage lenders. MBA disagrees.

While a specific proposal for a "suitability standard" for the mortgage industry is not yet fully formed, a variety of approaches have been suggested. Most would simultaneously require more rigid, prescribed underwriting standards, a duty of fair dealing at the inception of the loan, a subjective evaluation by the lender whether a product is best suited for that borrower, the establishment of a fiduciary obligation by the lender to the borrower and a private right of action to redress any violations. Some suggest that a regulator be empowered to specify the parameters of the requirement.

While many of points might sound good at first, on closer examination of the facts, they each raise very significant concerns for consumers. MBA published a paper within the last two weeks which MBA offers for inclusion in the record exploring many of these issues.[8]

In general, the paper explains why the imposition of a "suitability standard" on the mortgage lending industry risks unintended, negative consequences for consumers that would turn back the clock on hard won fair lending and homeownership gains. Congress should resist pressure to enact a suitability standard for the mortgage lending industry and, instead, should turn its attention to the creation of a uniform national lending standard. A uniform national standard would be the best approach to improve financial literacy, simplify disclosures to consumers in the mortgage process, and establish clear, objective standards to stop lending abuses without impeding the market's vitality and its ability to innovate to benefit consumers.

---

[8] MBA Policy Paper Series, Policy Paper 2007-1, "Suitability, Don't Turn Back the Clock on Fair Lending and Homeownership Gains."

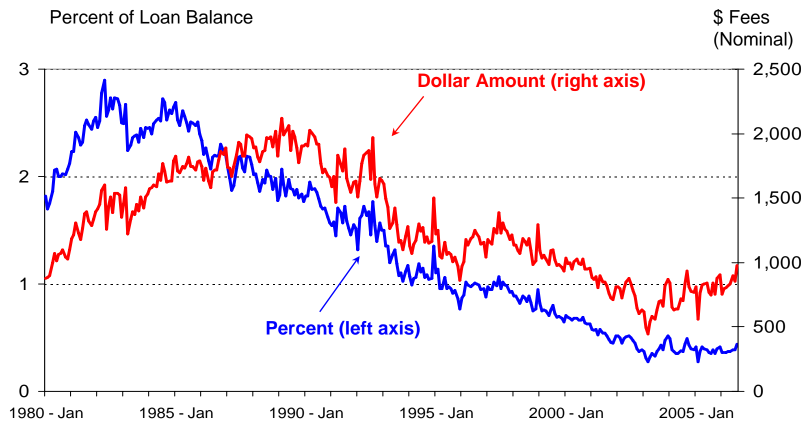
A. Rigid Hard Wired Underwriting Standards Deny Credit Options to Borrowers

The most recent data provided by the mortgage lending industry under the Home Mortgage Disclosure Act (HMDA), on loans made in 2004 and 2005, demonstrate the greatest and widest availability of mortgage finance in our nation's history, which in turn has made possible record homeownership rates. The data show that borrowers in virtually every area of the nation, of every race and ethnicity, and at every income level receive an unparalleled array of credit opportunities.

MBA believes it important to remember how we got to this point. The confluence of several factors has contributed to the growth in credit opportunities for prime and nonprime borrowers over the last 15 years. These factors include increased competition from an unparalleled number of loan originators including mortgage companies, banks, credit unions and mortgage brokers. They also include innovations in the mortgage market, resulting in the range of mortgage products available today including fixed-rate products and adjustable rate products as well as "nontraditional." [9]

Most importantly, the past 15 years has been marked by dramatic changes in the mortgage origination process made possible by technology. Computerization has enabled a much greater understanding of default risk and the development of objective underwriting criteria. It has also permitted the embodiment of these criteria in automated underwriting tools and the growth of risk-based pricing. As shown in the chart below, according to the Federal Housing Finance Board's data from their Monthly Interest Rate Survey, the costs of originating a mortgage have declined tremendously both measured as a percentage of the loan balance and in nominal dollars.

[9] Under the Federal Regulators' Nontraditional Guidance, nontraditional products include mortgages that may involve the deferral of principal and/or interest including interest only and payment-option mortgages. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609 (Oct. 4, 2006).



Risk-based pricing, in turn, has permitted the development of a market to serve the needs of nonprime borrowers "who have difficulty in meeting the underwriting criteria of 'prime' lenders because of blemished credit histories or other aspects of their profile."[10]

Rigid new underwriting standards, no matter how well intentioned – even as innocuous as requiring a particular debt-to-income ratio, to ensure a borrower's ability to repay, for example – will result in denying some borrowers' credit who would otherwise qualify in today's market. Some of these borrowers will even be denied homeownership although they would qualify today. The magic of today's market is that the widest range of borrowers can get the widest spectrum of loans.

Similarly, while it might sound reasonable to require that all borrowers contending for a hybrid adjustable rate mortgage (ARM) - that allow lower fixed payments for an initial period and higher payments after that--be qualified at the fully indexed rate, such an approach will lock some borrowers out of the home of their dreams and deprive them of lower payments. It would also have the consequence of failing to allow these borrowers an opportunity to repair their credit so they can refinance into a lower priced prime loan before the rate adjusts. Moreover, ARMs, which have lower initial mortgage payments, and the potential for payment reductions if interest rates decline, allow borrowers to allocate more of their cash flow to other uses. For example, a borrower who saves on their mortgage payment can put more funds towards financial investments, potentially diversifying their overall portfolio.

[10] Remarks by Governor Edward M. Gramlich at the Federal Reserve Bank of Philadelphia, Community and Consumer Affairs Department Conference on Predatory Lending, Philadelphia, Pennsylvania (December 6, 2000).

It is important to be clear that in many cases the alternative to a flexibly underwritten adjustable nonprime mortgage product is not a fixed rate loan for many borrowers, but rather no loan at all at least for the property the borrower wants. All borrowers simply do not qualify for a fixed rate loan to finance the home because the payments are initially higher.

Some insist that the borrower like the one described who can not meet fixed ratios should be denied credit if they don't satisfy a particular test. Such a result is unnecessary in today's financing world. Also, respectfully, MBA wonders if that opportunity should be withheld from 87% of borrowers, including those who qualified for non-prime loans who are making their payments and achieving the dream of homeownership.

Today borrowers at virtually all points on the credit spectrum qualify for loans. The imposition of new rigid standards would change that and not for the good.

B. The Imposition of a Suitability Standard Risks Unintended Consequences

While certainly not intended to promote or authorize discrimination or reignite redlining, MBA is extremely concerned that the injection of subjective standards into the mortgage process would conflict with and potentially threaten fair lending, community reinvestment and homeownership gains particularly for first time homeowners and minorities.

The reason this would happen is not because anyone has bad motives but because new subjectivity would be injected into the market, the risks would increase markedly, driving many to be much more cautious or even to withdraw from the market. Lessened competition and increased risks will decrease financing options and increase costs.

Since the 1990's, the denial rates of African-American loan applicants, though still greater than white borrowers, have declined considerably. In 1992, the denial rate for conventional home purchase loans for African-American borrowers was 36 percent and in 2004 it was 24.7 percent. While there has been some increase in the institutions covered by HMDA over these years, the number of applications nearly quadrupled over this period.[11]

Although all homeownership has increased since the 1990s, the percentage increase in African-American homeownership has been greater than among whites and the national average. The African-American homeownership rate has increased almost six percentage points since 1994, while the overall rate has increased nearly five percentage points. If a subjective suitability standard is imposed, in the first instance, lenders will be required to assure that a loan is suited for the borrower. If such a standard is imposed, a lender facing a mortgage applicant who is a member of a

---

[11] 1992 and 2004 HMDA data.

protected class, and for whom a loan product may be "unsuitable," might deny the borrower credit options to conform to the suitability requirement and, at the same time, violate the letter and spirit of fair lending and community investment requirements. Conversely, if credit is extended, the lender risks violating a suitability requirement.

Either way, by injecting ***subjective*** standards into the process, there will be much greater caution by lenders and less competition in the market as lenders shy away from these risks. There is real concern that subjectivity and even caution will disproportionately affect first-time homeowners, minorities and those with less wealth where suitability and fair lending concerns intersect.

Even if the facts suggest that a lender is in compliance with both fair lending rules and a suitability requirement, borrowers who go into default are likely to claim that the loan was "unsuitable." This new cause of action will also drive lenders out of markets, lessening the availability of credit and driving up costs for consumers. It would seem that only the lawyers will benefit.

Although as indicated, advocacy organizations point to the securities industry as a model for a suitability standard, on examination, the industries are not analogous. Their business models differ and so do the policy imperatives that govern them.

While federal policy has been to encourage mortgage lenders to make credit available to as many borrowers as possible, by contrast those responsible for regulation of the securities industry have not made expansion of investment opportunities to underserved persons or neighborhoods a major policy initiative. The consequence of the suitability requirement for a securities firm is that overly cautious broker-dealers will lose out on commissions. The consequence of a suitability requirement for mortgage lenders is that overly cautious lenders may violate the letter of federal anti-discrimination laws and the spirit of community reinvestment laws.

As far as the business models are concerned, securities broker-dealers function as intermediaries between their customer and the market to invest their customers' money; broker-dealers hold themselves out as investment consultants. Mortgage lenders, on the other hand, represent their companies and investors whose money they put at risk to make loans to borrowers; they do not function as agents or fiduciaries and they do not hold themselves out as such to borrowers. Consumers select their securities advisor on a long-term basis, but regularly shop among mortgage lenders when seeking a mortgage.

It is noteworthy that survey data indicates that an intrusion by lenders into the borrower's personal decisions is unwelcome by the borrower whom a suitability standard would be designed to protect. One recent study found that 88 percent of respondents would prefer to "decide for themselves whether or not a mortgage product is right for them, rather than leaving that responsibility to the mortgage lender."[12]

Also notably, borrowers subject to a pilot program in the City of Chicago that imposes mandatory financial counseling only for borrowers in specific ZIP codes have filed a law suit alleging that the program amounts to "state-sanctioned redlining."[13] Governor Blagojevich suspended this law on Friday, January 19, recognizing that it was hurting the people it was designed to protect, according to The Chicago-Sun Times.[14]

Lenders can and do offer valuable information to consumers. Lenders help consumers understand what mortgage products are available and for what mortgages they may qualify. For this reason, it pays for consumers to see lenders early in the home buying process, not only to determine what property they can afford, but also to consider their financing choices in relation to their particular situations, including their incomes, credit and plans to stay in their homes. Nevertheless, lenders cannot serve as agents and fiduciaries for borrowers as well as for their companies.

Despite the wide range of market innovations, some borrowers have obtained loans with terms that negatively impact their ability to repay. Let us assure you, the fundamental goal that borrowers only obtain loans they can repay is shared by consumers, advocacy organizations, regulators and mortgage lenders alike. For this reason, the mortgage lending industry has a great stake in striving, along with advocacy organizations, legislators and regulators, to make the lending process as understandable and abuse-free as possible and more work is needed toward this goal. However, imposing a suitability standard is not an appropriate solution and would run the risk of turning back the clock on innovations that have greatly expanded home ownership opportunities.

Congress, therefore, should resist pressure to enact a suitability standard which would harm consumers. Retaining the current "arms length" transaction model in the mortgage lending industry works best.

VI. STEPS CONGRESS CAN TAKE TO PROTECT CONSUMERS

There are at least three things Congress can do to help consumers become better informed through the mortgage process, protect themselves and help them make the best choice for themselves.

First, considerable resources should be committed to improving borrower education to raise the level of financial literacy, including incorporating this issue into general educational programs and increasing access to transaction-specific borrower counseling. It would be a worthy undertaking to conduct a review of total government

---

[12] *See* American Financial Services Association Press Release, "Borrowers, Not Lenders, Should Decide Appropriateness of Mortgage Products, Finds Survey," (Nov. 20, 2006).

[13] *See* Mary Umberger, "Home Buyer Counseling Challenged," Chicago Tribune, Nov. 2, 2006.

[14] *See* Lisa Donovan, "Gov Halts Mortgage Counseling," Chicago Sun-Times, January 21, 2007.

efforts in the area of financial literacy to see what is working is what is not. This study could also include the amount of resources expended for this purpose. MBA believes that better financial education would empower all borrowers to shop effectively among the array of competitors in the marketplace.

Second, simplification of the mortgage process and all necessary consumer information would make it much easier for an empowered consumer to navigate the market, and such improvements are long overdue. Consumers today face a pile of disclosures when they apply for and close on a mortgage. Efforts at improvement need to streamline the existing mandated disclosures and information, and must be comprehensive and well considered. A successful effort would result in much more effective information on the benefits, costs and features of the loan options presented by lenders. It would also go a long way to help borrowers shop for mortgages among lenders with an ability to make an apples-to-apples comparison.

Third, uniform lending standards that are clear and objective, but do not unduly restrict the market, would improve on the standards established under HOEPA to stop lending abuses. These standards must be national in scope to enhance competition in all markets for all borrowers, especially nonprime. Such standards will allow all borrowers to benefit from greater choices, competition and lower prices that a fair and fully functioning market brings. MBA would support the expansion of the types to loans to be covered in a uniform national standard to include purchase money loans and open-ended lines of credit.

MBA supports the framework for a national standard that includes the following principles and components.

Broad Principles of a National Standard:

- Uniform National Standard. A national law should recognize a national mortgage market by including broad preemption that facilitates competition and market efficiencies leading to low cost mortgage lending. It should apply to all lenders creating uniformity in the market. It should not change the current regulatory oversight, preemption or enforcement regime of those regulated by the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the National Credit Union Administration (NCUA), the Federal Reserve Board (FRB) and the Federal Deposit Insurance Corporation (FDIC).
- Protect Financing Options. The innovation of lenders to make mortgage credit more widely available through a variety of products and financing tools should be protected. Unduly limiting or outlawing finance options could put homeownership out of borrowers' reach, particularly underserved borrowers.
- Risk-based Pricing. Lenders' ability to efficiently price loans based on the risk of non-payment presented by a borrower has revolutionized and expanded the availability of mortgage credit. Through risk-based pricing, mortgage credit is more widely available to borrowers, especially to traditionally underserved

communities. A national standard should recognize and protect the benefits of risk-based pricing.

- A Suitability Standard Should Not Be Imposed. Certain groups have suggested imposing a suitability standard on mortgage lenders. Lenders already make a "suitability" determination through assessing affordability when underwriting a consumer's ability to repay a loan. A suitability standard beyond that threatens progress made in fair lending as well as the availability and affordability of credit to homeowners by reintroducing a subjective determination into a loan officer's work. Further, the imposition of a suitability standard exposes lenders to significant liability and will increase the cost of mortgage credit since it could affect the mortgage-backed security marketplace.
- Objective Standards. The provisions of any national standard passed by Congress should include clear, objective standards so that consumers understand their rights and protections and lenders understand compliance requirements.
- Added Consumer Protections: MBA supports increased protections for consumers in a national standard.

Components of a National Standard:

A. HOEPA Triggers:

- Reasonable High Cost Loan Triggers. Almost no lenders will make loans that meet the HOEPA high cost loan triggers because of the significant liability that attaches. Investors will not buy high cost loans because of the liability, which dried up liquidity for these loans. The triggers, therefore, act as a de facto usury ceiling in that lenders won't make loans above the triggers. Therefore, the APR and point and fee triggers should be maintained at their current levels so that legitimate lending is not cut off. MBA would support the setting of triggers at a reasonable level to help assure that mortgage credit continues to be available to credit-worthy borrowers.
- Point and Fee Definition Should Not Be Overly Broad. A national standard should maintain the items included in HOEPA for making the point and fee calculation. Neither prepayment penalties, nor yield spread premiums should be included in the definition because doing so would threaten the use of these finance options and because the value of those items is already reflected in the interest rate and APR. Thus, including those items in a points and fees test would result in double counting. Lowering the point and fee trigger by excessively expanding the point and fee definition will invariably cut off legitimate credit to our neediest borrowers.

B. HOEPA Protections:

- Refinancing a Loan Should Provide a Benefit to a Borrower. Existing loans should not be refinanced into a high cost mortgage loan unless doing so provides

a benefit to a borrower. A national standard should allow regulators to establish objective safe harbors for determining when the benefit threshold is met.

- No Asset Based Lending. Evaluating a borrower's ability to repay a loan is fundamental to a lender in underwriting a mortgage application. A lender has every incentive to ensure a loan is properly underwritten since the lender takes the risk of loss on a defaulting loan and, through agreements with investors, can be forced to repurchase a loan from the secondary market. A borrower's ability to repay a high cost loan should not be solely based on the collateral value of the property.
- Assignee Liability. MBA supports the maintenance of the existing assignee liability regime provided in the Truth in Lending Act (TILA) and HOEPA.

C. Consumer Protections for All Loans:

- Prepayment Penalties Should Be Limited to Three Years. Prepayment penalties reflect an agreement between the lender and borrower whereby the borrower agrees to stay in a mortgage for a period of time in exchange for a lower rate or a significant reduction in fees. If a prepayment penalty is offered, it should be limited to three years and clearly disclosed to the borrower. The borrower should also be offered a loan without a prepayment penalty.
- Yield Spread Premiums Are a Valuable Financing Option. A yield spread premium (YSP) is a very good mortgage financing option that allows borrowers to pay closing costs through the rate. The inability to use yield spread premiums could bar creditworthy borrowers from homeownership. Where RESPA requires it, MBA would support improved YSP disclosures.
- Borrowers Should be Given Choice to State Income. Stated income loans are important to certain borrowers, especially in the emerging markets, because documenting their income in connection with a mortgage application can be difficult. Further, interested borrowers should be given the option of choosing a stated income loan versus a fully documented income loan if the borrower so chooses and if the lender has disclosed any cost difference.
- Home Improvement Contracts. Lenders should disburse loan proceeds to the borrower or jointly to the borrower and the contractor, or through a third-party escrow agent. Lenders must not disburse loan proceeds until the payment is approved in writing by the borrower, the contractor has signed a certificate of completion or the contract, and the property has been made available to the lender for inspection.

D. Standards for All Loans:

- Right to Cure. A national standard should permit lenders reasonable time to "cure" any unintended errors in the mortgage transaction without incurring any further or punitive liability.
- Accurate Appraisals. When formal valuation methods are required, lenders must evaluate properties through real estate appraisal professionals and/or through automated valuation models. Participants to the transaction must be careful not

to either pressure or be pressured. Lenders must ensure that the appraiser is licensed as required by law and make a good faith effort to ensure the appraiser is in good standing.

Finally, while any increases in delinquencies and foreclosures are an important concern, prohibition of particular products is not a solution – because they are not the cause. Many borrowers have used a range of products effectively to realize their dream of homeownership and otherwise satisfy the financial demands that we all face.

Conclusion

MBA has been long committed to fighting predatory lending and we would welcome the opportunity to work with members of Congress and staff to develop policies that weed out bad actors and allow the mortgage industry to continue to serve borrowers. Financial literacy, mortgage simplification and a uniform national standard are steps Congress can take to address abusive lending.

MBA wants to underscore the importance of innovation in making credit opportunities available to consumers. The products and financing tools are not predatory – they help borrowers get into homes. MBA believes that borrower choice should be protected and that consumers are in the best position to make good choices for themselves. The imposition of a suitability standard risks undermining our hard won gains in the areas of homeownership and reaching underserved borrowers. It will take away consumer choice as well as access to and affordability of mortgage credit. It will lead to counterproductive results – hurting the very borrowers it's intended to help.

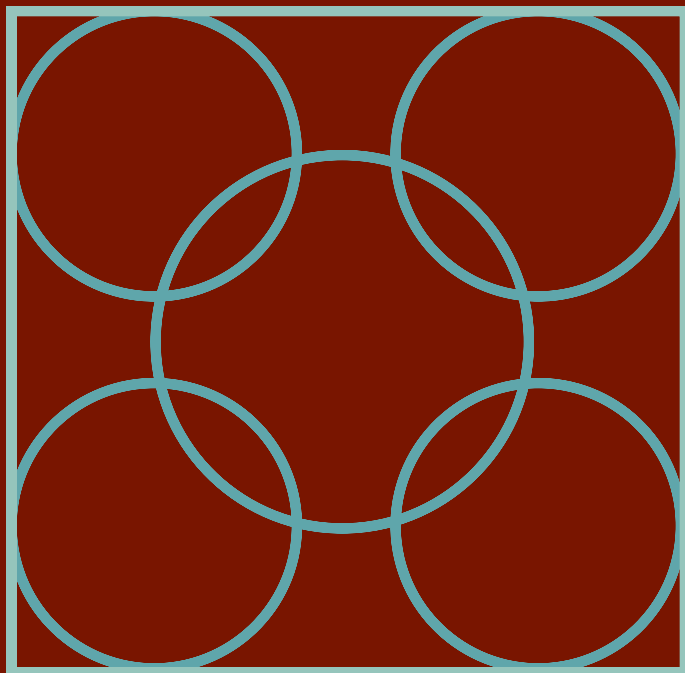
Lenders and consumers alike have every incentive to keep borrowers in homes. Foreclosure is a loss for everyone. Currently, foreclosures are within normal ranges and are caused in large measure by life events like job loss, divorce and illness. Lenders work very hard to offset foreclosure and work with delinquent borrowers to try to keep them in their homes.

MBA looks forward to continuing to work with this Committee and the whole Congress to address challenges in the housing market and we stand ready to assist you however we can.

Thank you.

S P E C I A L   R E P O R T

MBA Policy Paper Series
Policy Paper 2007-1



Suitability — Don't Turn Back the Clock on Fair Lending and Homeownership Gains

MORTGAGE BANKERS ASSOCIATION®
Investing in communities

Overview

This policy paper, published by the Mortgage Bankers Association (MBA),[1] explains why the imposition of a "suitability standard" on the mortgage lending industry risks unintended, negative consequences for consumers that would turn back the clock on hard won fair lending and homeownership gains. The policy paper concludes that Congress should resist pressure to enact a suitability standard for the mortgage lending industry and, instead, should turn its attention to the creation of a uniform national lending standard, to improving financial literacy, to simplifying disclosures to consumers in the mortgage process, and to establishing clear, objective restrictions to stop lending abuses without impeding the market's vitality and its ability to innovate to benefit consumers.

1 The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web Site: www.mortgagebankers.org.

Executive Summary

The most recent data provided by the mortgage lending industry under the Home Mortgage Disclosure Act (HMDA) on loans made in 2004 and 2005 demonstrate the greatest and widest availability of mortgage finance in our nation's history, which in turn has made possible record homeownership rates. The data show that borrowers in virtually every area of the nation, of every race and ethnicity, and at every income level receive an unparalleled array of credit opportunities.

Over the last fifteen years, the confluence of objective mortgage lending criteria, automated underwriting, risk-based pricing, a robust secondary market and nonprime lending are all responsible for the increased availability and affordability of mortgage credit and homeownership, with the greatest gains achieved for minority and first-time homeowners.

These achievements have occurred against a backdrop of hard won fair lending and anti-redlining laws. Under the Fair Housing Act and the Equal Credit Opportunity Act (ECOA), lenders may not deny mortgage credit to borrowers because of their race, gender, religion, national origin and membership in other protected classes. The Community Reinvestment Act (CRA) and the Home Mortgage Disclosure Act (HMDA) seek to stem redlining of under served areas and broaden the availability of credit to borrowers who have not had access to the credit markets.

In light of the mortgage lending industry's achievements in democratizing credit, the debate no longer concerns whether credit is sufficiently available to borrowers. Rather, the debate now has turned to whether the loans particular borrowers receive are in their best financial interests. Because of claims of lending abuses and foreclosures, some consumer advocacy organizations have recently suggested that a "suitability standard" should be imposed on the mortgage lending industry. These advocacy organizations point out that a "suitability standard" applies to the securities industry and that experience should serve as a model for the mortgage lending industry.

While a specific proposal for a suitability standard for the mortgage industry is not yet fully formed, a variety of approaches have been suggested. Most would simultaneously require more rigid, prescribed underwriting standards, a duty of fair dealing at the inception of the loan, a subjective evaluation by the lender whether a product is best suited for that borrower, the establishment of a fiduciary obligation by the lender to the borrower and a private right of action to redress any violations. Some suggest that a regulator be empowered to specify the parameters of the requirement.

However, if rigid, prescribed underwriting standards were imposed, some borrowers will be unnecessarily denied needed credit. If a subjective suitability standard is imposed, a lender facing a mortgage applicant who is a member of a protected class and for whom a loan product may be "unsuitable" might deny the borrower credit to conform to the suitability requirement and, at the same time, violate the letter and spirit of fair lending and community investment requirements. If credit is extended, the lender risks violating the suitability requirement. Even if the facts suggest that a lender is in compliance with both fair lending rules and a suitability requirement, borrowers who go into default are likely to claim that the loan was "unsuitable."

Faced with contradictory legal requirements, some lenders and secondary market participants will understandably be reluctant to expose themselves to severe legal and reputational risks — lessening competition, rationing credit and increasing prices. Other lenders and secondary market participants, who choose to remain in the market, may be expected to increase their prices to reflect the costs resulting from increased risks including the risk that their collateral (the property securing the loan), will not be available to satisfy the debt because of suitability claims. Other compliance costs, including systems and training costs, will increase prices further for consumers.

A suitability standard would not provide benefits to consumers that outweigh these risks and costs to consumers, lenders and other market participants. Suitability attempts to control the product choices of borrowers to prevent defaults. However, the primary reasons for mortgage defaults are "life events," including job losses and family crises, not product choices. Furthermore, there is no public or private concensus on what is a socially optimal level of foreclosure against which the success of a policy choice can be objectively measured.

The securities industry is not analogous to the mortgage lending industry and imposition of a suitability standard on the mortgage lending industry is not appropriate. The policy imperatives of the two industries differ and so do their business models. The fair lending and community investment imperatives apply only to the mortgage lending industry.

Securities broker-dealers function as intermediaries between their customer and the market to invest their customers' money; broker-dealers hold themselves out as investment consultants. Mortgage lenders, on the other hand, represent their companies and investors whose money they put at risk to make loans to borrowers; they do not function as agents or fiduciaries and they do not hold themselves out as such to borrowers. Consumers select their securities advisor on a long-term basis, but regularly shop among lenders when seeking a mortgage.

Lenders can and do offer valuable information to consumers. Lenders help consumers understand what mortgage products are available and for what mortgages they may qualify. For this reason, it pays for consumers to see lenders early in the home buying process not only to determine what property they can afford, but also to consider their financing choices in relation to their particular situations, including their incomes, credit and plans to stay in their homes. Nevertheless, lenders cannot serve as agents and fiduciaries for borrowers as well as for their companies.

It is not clear that the suitability standard is working well in the securities industry. In fact, NASD[2] has expressed concern about the magnitude of claims brought against brokers based upon suitability.

Despite the wide range of market innovations, some borrowers have obtained loans with terms that negatively impact their ability to repay. The fundamental goal that borrowers only obtain loans they can repay is shared by consumers, advocacy organizations, regulators and mortgage lenders alike. For this reason, the mortgage lending industry has a great stake in striving, along with advocacy organizations, legislators and regulators, to make the lending process as understandable and abuse-free as possible and more work is needed toward this goal. However, imposing a suitability standard is not an appropriate solution and would run the risk of turning back the clock on innovations that have greatly expanded home ownership opportunities.

Congress, therefore, should resist pressure to enact a suitability standard which would harm consumers. Retaining the current "arms length" model in the mortgage lending industry works best. Rather than upsetting this model, Congress, federal regulators, industry and consumer organizations should turn their attention to working to create a uniform national lending standard, improving financial literacy and licensing, simplifying the mortgage process, streamlining disclosures, and establishing clear, objective restrictions to stop lending abuses without destroying the market's ability to innovate for the benefit of consumers.

2 Previously known as the National Association of Securities Dealers, Inc., it is now known only as "NASD."

Table of Contents

Introduction 11

Today's Mortgage Market 12

Objective Lending Criteria, Automation and Risk-based Pricing Extending Credit to More Borrowers 15

Fair Lending and Antipredatory Laws 16

Advocacy for Suitability Standard 17

Proposals With Unintended Negative Consequences 19

Subjective Suitability Requirements Risk Undermining Fair Lending, Community Investment and Homeownership Gains 20

A Suitablity Standard Is Not Worth the Risks of Limited Borrower Choices and Increased Borrower Cost 22

The Primary Reasons for Defaults Are Family and Economic Difficulties. Not Product Choices 24

The Suitability Standard in the Securities Industry 27

The Securities Industry is Not Analogous to the Mortgage Lending Industry 28

It is Not Clear that the Suitability Standard is Working Well in the Securities Industry 31

Retaining the Current "Arms Length" Model in the Mortgage Lending Industry Works Best for Consumers 32

Conclusion 34

Suitability — Don't Turn Back the Clock on Fair Lending and Homeownership Gains

Introduction

Predatory lending abuses have been a major public policy concern at least since the mid-1990s. Congress enacted the Homeownership and Equity Protection Act (HOEPA) in 1994 and several states enacted laws to address this issue beginning with North Carolina in 1999. There are now 30 diverse state laws and 17 local laws on this subject.

During 2006, however, some consumer advocacy organizations, expressing the view that existing laws and regulations offer insufficient protection to consumers, began focusing their efforts on the possibility of imposing a suitability standard on the mortgage lending industry.[3] These advocacy organizations assert that lenders should be assigned an additional affirmative duty of determining the suitability of mortgage loans for prospective borrowers.[4] Their rationale is that beyond the insufficiency of current protections there is a persistent information asymmetry between lender and borrower concerning mortgage products. They assert that this point necessitates assigning the lender a fiduciary responsibility to serve the borrower. Asserting that suitability works in the securities industry, these advocacy organizations contend that it could also be applied to the mortgage lending industry.

While a specific proposal for suitability is not yet fully formed, a variety of approaches have been

3 See, e.g., *Calculated Risk: Assessing Non-Traditional Mortgage Products: Hearing Before the S. Subcommittee On Housing & Transportation, S. Comm. on Banking, Housing & Urban Affairs,* 109th Cong. (Sept. 20, 2006) (statement of Michael D. Calhoun on behalf of the Center for Responsible Lending); Remarks of Allen Fishbein at the Women in Housing and Finance Conference (Nov. 29, 2006).

4 See, e.g., Kathleen C. Engel and Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending,* 80 Tex. L. Rev. 1255 (May 2006); Daniel S. Ehrenberg, *If the Loan Doesn't Fit, Don't Take It: Applying the Suitability Doctrine to the Mortgage Industry to Eliminate Predatory Lending,* 10-WTR J. Affordable Housing and Community Dev. L. 117 (Winter 2001).

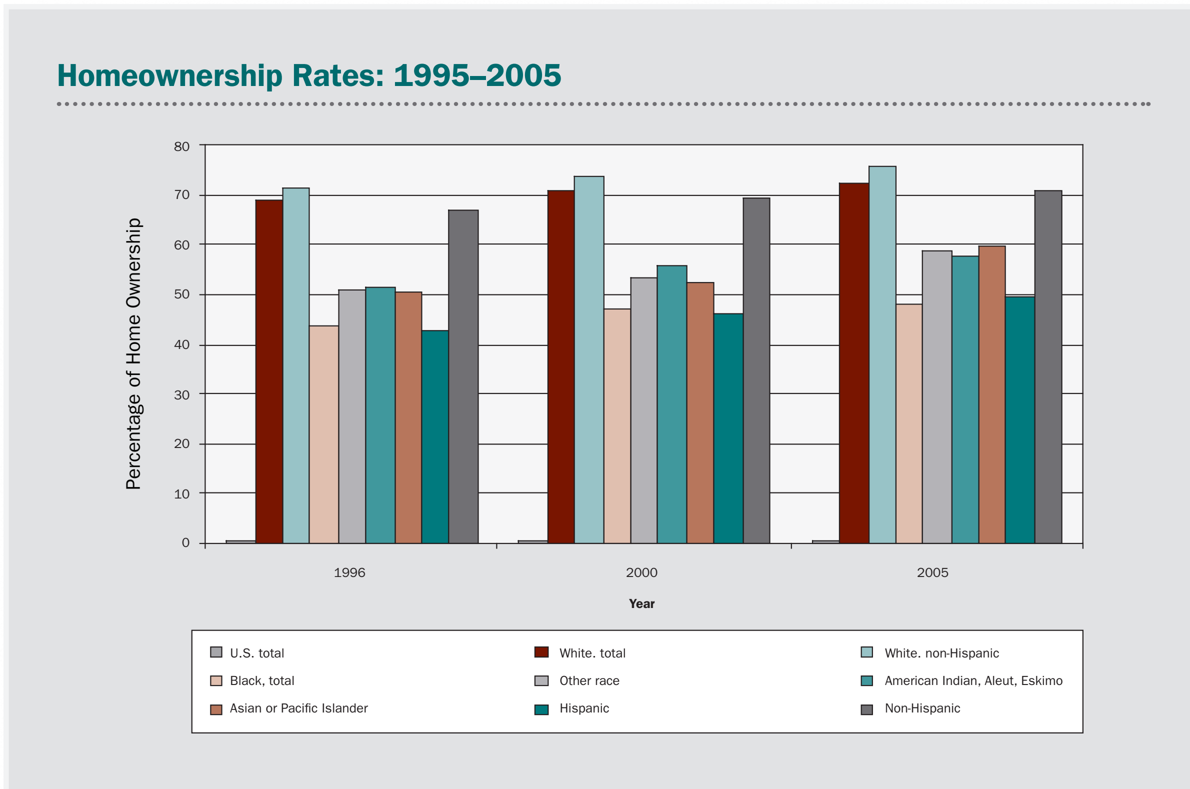
suggested. Most would simultaneously require more rigid underwriting, a duty of fair dealing at the inception of the loan, a subjective evaluation by the lender whether a product is best for that borrower, the establishment of a fiduciary obligation by the lender to the borrower, and a private right of action to redress any violations.

The following analysis explores these ideas and concludes that current proposals for imposition of a suitability standard on the mortgage lending industry risk unintended, negative consequences for consumers.

Today's Mortgage Market

The most recent data provided by the mortgage lending industry under the Home Mortgage Disclosure Act (HMDA) on loans made in 2004 and 2005 demonstrate the greatest and widest availability of mortgage finance in our nation's history, which in turn has made possible record homeownership rates. The data show that borrowers in virtually every area of the nation, of every race and ethnicity, and at every income level receive an unparalleled array of credit opportunities.

Homeownership is near its highest level in history. Homeownership rates rose roughly 3.5 percentage points in the U.S. between 1989 and 2001. Looking at recent years, in 2001, the overall homeownership rate was 67.8 percent. In 2005, it was 68.9 percent. For African-Americans, the rate in 2001 was 47.7 percent, and in 2005 it grew to 48.2 percent (although it was 49.1 percent in 2004). For Hispanics, the rate in 2001 was 47.3 percent and in 2005 it was 49.5 percent.



As a result of these increases in homeownership, across all demographics, Americans are building tremendous wealth by building equity through their monthly payments and through the impressive rate of home price appreciation we have seen in recent years. According to the Federal Reserve's Flow of Funds data, the value of residential real estate assets owned by households has increased from $10.3 trillion in 1999 to $22.4 trillion as of the first quarter of 2006, and aggregate homeowners' equity now exceeds $10 trillion. According to the Fed's 2004 Survey of Consumer Finances, the median net worth for homeowners was $184,000. For renters, it was $4,000.

More than a third of all homeowners, approximately 34 percent, own their home free and clear. Of the remaining two-thirds of homeowners who do have mortgages, three-quarters of these homeowners, or half of all homeowners, have fixed rate mortgages. Only one quarter of these borrowers, or about a sixth of all homeowners, have adjustable rate mortgages (ARMs).

Homeowning Household Distribution
By Mortgage Type

Household Mortgage Type	Percent	Percent of Those with a Mortgage
No Mortgage	**34.6**	
Fixed Rate	49.2	75.2
Adjustable Rate	**16.2**	**24.8**
Jumbo	.3.9	6.0
Conforming	12.3	18.8
Total	**100.0**	**100.0**

Source: American Housing Survey; Mortgage Bankers Association

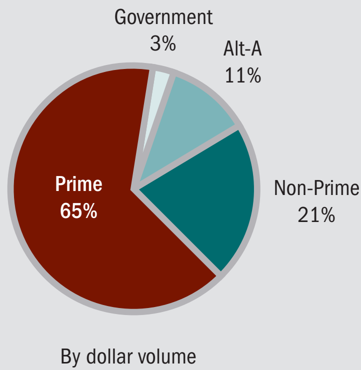
According to MBA's Mortgage Originations Survey, in the first half of 2006, 62 percent of the dollar volumes of loans originated were prime loans, 16 percent were Alt A, 19 percent were nonprime,[5] with government loans accounting for the remaining 3 percent. Recently, cash out refinances have accounted for about 75 percent of refinances.

5 Notably, while nontraditional products have offered borrowers a variety of options, many of these products are not prevalent in the nonprime market. Payment-option loans are typically not available in the nonprime sector. In fact, according to Fitch, no nonprime loans carried a negative amortization feature in 2005. *Mortgage Principles and Interest,* August, 2006, p.6, Fitch Ratings. The interest only, or IO, share in the prime sector was 44 percent, while it was 25 percent in the nonprime sector. According to Standard & Poors, nonprime IO borrowers tend to have larger loans, typically indicating higher incomes, and significantly better credit scores than nonprime borrowers who choose other products. *Trends In U.S. Residential Mortgage Products: Subprime Sector Second Quarter 2006,* Standard & Poors, 2006.

Reports by MBA members and other data reviewed by MBA indicate that interest-only and payment-option mortgage borrowers generally have higher credit scores and lower loan-to-value (LTV) ratios. These products tend to most prevalent in higher cost areas of the country such as California.

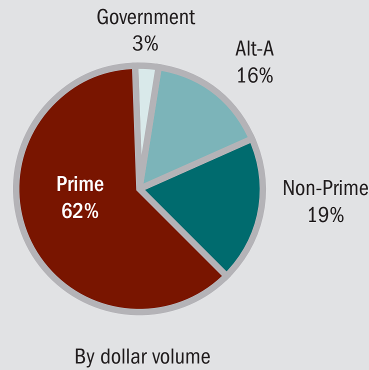
Mortgage Originations by Loan Type

First Half of 2005



By dollar volume

First Half of 2006

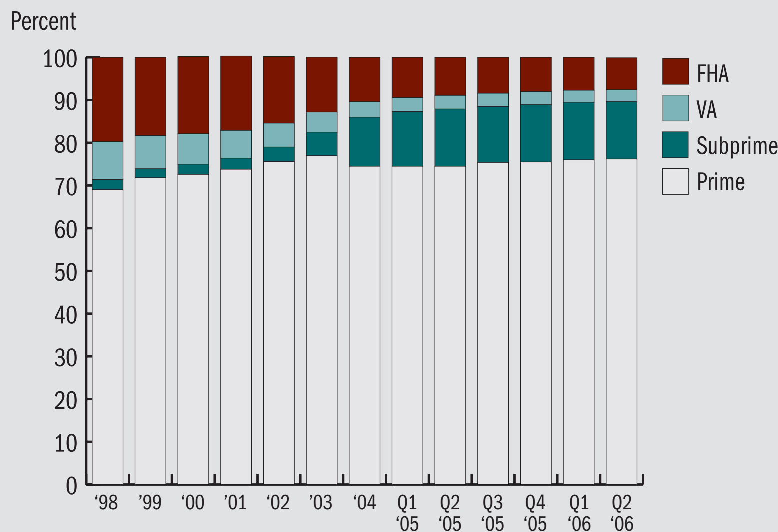


By dollar volume

Source: MBA's Mortgage Origination Survey

Estimates from MBA's National Delinquency Survey indicate that the number of nonprime loans has increased more than 6.5 times over the last five years. (Q3 2001 to Q3 2006). Contrary to the perceptions of some, based on first half 2006 data, nearly half the borrowers, or 45 percent, utilizing nonprime loans do so to buy homes. One in four of these purchases was by first-time homebuyers. Also, notably, over the last several years the average difference between the interest rates of prime loans and nonprime loans has decreased markedly from three to two percent.

Outstanding Loans by Loan Type: 1998–Present



Source: MBA's National Delinquency Survey

Objective Lending Criteria, Automation and Risk-based Pricing Extending Credit to More Borrowers

The confluence of several factors has contributed to the growth in credit opportunities for prime and nonprime borrowers over the last 15 years. These factors include increased competition from an unparalleled number of loan originators including mortgage companies, banks, credit unions and mortgage brokers. They also include innovations in the mortgage market, resulting in the range of mortgage products available today including fixed-rate products and adjustable rate products as well as the "nontraditional."[6]

Most importantly, the past 15 years has been marked by dramatic changes in the mortgage origination process made possible by technology. Computerization has enabled a much greater understanding of default risk and the development of objective underwriting criteria. It has also permitted the embodiment of these criteria in automated underwriting tools and the improvement of risk-based pricing.

Risk-based pricing, in turn, has permitted the development of a market to serve the needs of nonprime borrowers "who have difficulty in meeting the underwriting criteria of 'prime' lenders because of blemished credit histories or other aspects of their profile."[7]

Since the rise of the nonprime market, home lending to minority borrowers, particularly African-American and Hispanic borrowers, has risen significantly.[8] Notably, the use of automated systems in the prime and nonprime markets has not only extended credit but made its availability "color blind."

Fifteen years ago, in 1992, when a consumer went to a loan officer, the loan officer considered a credit report, a property appraisal, employment information, asset information and similar risk related information to determine whether a borrower qualified for a mortgage loan. Notwithstanding that the Fair Housing Act and ECOA pertained, there is evidence that some loan personnel, sometimes unconsciously, denied credit to borrowers from protected classes more frequently than they denied credit to majority borrowers, even though the borrowers had similar risk profiles.

A 1992 study by the Federal Reserve Bank of Boston[9] that engendered enormous controversy found that African-American borrowers with similar credit information as white borrowers were more likely to be denied mortgage loans than their white counterparts. While a subseuqent study by the FDIC reversed the study's conclusion, there remains evidence that there may have been disparate treatment by loan officers. Also, in 1992, there was virtually no risk-based pricing and no real nonprime market. Borrowers either qualified for what then was a prime mortgage loan or they were locked out of homeownership and remained renters.

---

6 Under the Federal Regulators' Nontraditional Guidance, nontraditional products include mortgages that may involve the deferral of principal and/or interest, including interest-only and payment-option mortgages. *Interagency Guidance on Nontraditional Mortgage Product Risks,* 71 Fed. Reg. 58,609 (Oct. 4, 2006).

7 Remarks by Governor Edward M. Gramlich at the Federal Reserve Bank of Philadelphia's Community and Consumer Affairs Department Conference on Predatory Lending, Philadelphia, Pennsylvania (December 6, 2000).

8 See Department of Justice, Fair Lending Enforcement Program (Jan. 2001) stating that home mortgage loans to African-American and Hispanic borrowers increased by 72 percent and 87 percent, respectively, in the years 1993 to 1998. Conventional mortgages to minorities also increased significantly during this time. Gramlich, supra note 7.

9 Alicia H. Munnell, Lynn E. Browne, James McEneaney, and Geoffrey M.B. Tootell, *Mortgage Lending in Boston: Interpreting HMDA Data,* Federal Reserve Bank of Boston, Working Paper WP-92-7, October 1992.

Beginning in the mid-1990s, credit scoring and sharper underwriting tools were developed using computer technology. Statistical evaluations of defaults and other risks permitted validation of these new systems.

Today, loans are priced based on risk — borrowers pay a rate that conforms to the risk presented by their credit, the amount of down payment or equity they bring to the transaction and other relevant risk related factors.

While a lender and its employees are called upon to exercise judgment in the mortgage process, including in instances where a borrower's application is referred from an automated underwriting system, there is a greater degree of objectivity in the mortgage process than ever previously existed. The increase in objectivity and the advent of risk based pricing has coincided with a reduction in denial rates of African-American loan applicants.

Since the 1990s, the denial rates of African-American loan applicants, though still greater than white borrowers, have declined considerably. In 1992, the denial rate for conventional home purchase loans for African-American borrowers was 36 percent and in 2004 it was 24.7 percent. While there has been some increase in the institutions covered by HMDA over these years, the number of applications nearly quadrupled over this period.[10]

Although all homeownership has increased since the 1990s, the percentage increase in African-American homeownership has been greater than among whites and the national average. The African-American homeownership rate has increased almost six percentage points since 1994, while the overall rate has increased nearly five percentage points. (Note that both rates fell from 2004 to 2005.)

The chart on page 12 illustrates increases in the homeownership rate during the period when objective lending criteria, automated systems and risk-based pricing were introduced.

Fair Lending and Antipredatory Laws

All of the mortgage lending industry's achievements in bringing credit to borrowers have occurred against a backdrop of legal requirements. These requirements seek to assure the availability of credit to all borrowers without regard to race, religion, gender, age or membership in other protected classes and to stem redlining of under served areas and broaden the availability of credit to borrowers who have not had access to the credit markets.

The Fair Housing Act[11] makes it unlawful for any lender to discriminate in its "residential real estate-related" activities against any person because of race, color, religion, gender, handicap, familial status, or national origin.

---

10 1992 and 2004 HMDA data.

11 Title VIII of the Civil Rights Act of 1968, as amended, 42 U.S.C. §§ 3601 et seq.

The Equal Credit Opportunity Act (ECOA) prohibits discrimination with respect to any aspect of a credit transaction on the basis of race, color, religion, national origin, gender, marital status, age, receipt of income from public assistance programs, and good faith exercise of any rights under the Consumer Credit Protection Act.[12] ECOA applies to all stages of the credit transaction, from application to closing.

The Community Reinvestment Act of 1977 (CRA)[13] requires that each federal financial supervisory agency assess the record of each covered depository institution in helping to meet the credit needs of its entire community, including low- and moderate-income (LMI) neighborhoods, consistent with safe and sound operations, and that such record be taken into account when deciding whether to approve an application by the institution for a deposit facility. CRA does not require any specific percentage or lending ratio, but instead encourages institutions to lend in LMI neighborhoods in addition to higher-income neighborhoods.

HMDA[14] is a disclosure law. While it does not prohibit any specific activity of lenders, it requires the public reporting of lenders' loan activities for the purposes of increasing investment in metropolitan areas and enforcing the fair housing laws. Under HMDA, financial institutions must report data regarding loan originations, applications, and loan purchases, as well as requests under a pre-approval program if the pre-approval request is denied or results in the origination of a home purchase loan. HMDA requires lenders to report the ethnicity, race, gender, and gross income of mortgage applicants and borrowers, information regarding the pricing of higher cost loans, whether the loan is subject to HOEPA, and the type of purchaser for mortgage loans that they sell.

Advocacy for a Suitability Standard

In light of the mortgage lending industry's achievements in democratizing credit, the debate no longer concerns whether credit is sufficiently available to borrowers. Rather, the debate now has turned to whether the loans particular borrowers receive are in their best financial interests. Most recently, because of claims of lending abuses and foreclosures, some consumer advocacy organizations have recently suggested that a "suitability standard" should be imposed on the mortgage lending industry, making the industry responsible for assuring the suitability of products for borrowers. These advocacy organizations point out that a "suitability standard" applies to the securities industry and that experience should serve as a model for the mortgage lending industry.

While a specific proposal for suitability is not yet fully formed, there are a variety of approaches. Most would simultaneously require more rigid, prescribed underwriting, a duty of fair dealing at the inception of the loan, a subjective evaluation by the lender whether a product is best for that borrower, the establishment of a fiduciary obligation by the lender to the borrower and a private judicial remedy for violations. Some suggest that a regulator be empowered to specify the parameters of the requirement.[15]

Some of the proposals in the nature of rigid, uniformly prescribed underwriting standards to assure a

12 15 U.S.C. §§ 1691 et seq.

13 12 U.S.C. §§ 2901 et seq.

14 12 U.S.C. §§ 2801 et seq.

15 See, e.g., Engel & McCoy, supra note 4.

borrower's ability to repay might require a rigid minimum debt-to-income ratio or similar standard that would require that a lender may not extend a loan to the borrower unless the borrower meets the test. Another suggestion would require that all adjustable rate mortgages be underwritten to a fully indexed rate. Still others would require that the borrower gain a "net tangible benefit" from the loan transaction.

Subjective standards are proposed to include an obligation on the part of the lender to assure that a loan is the "best product to meet the borrower's needs." Many advocacy organizations have also urged that a mortgage lender should be legally required to act as a fiduciary with respect to borrowers. Most recently, Ohio considered and ultimately rejected a proposal to impose a fiduciary duty on lenders and mortgage brokers.[16]

Similarly, and often as a substitute for a broader fiduciary duty, a handful of states have enacted legislation that imposes on lenders and/or mortgage brokers an explicit duty of good faith and fair dealing.[17] In August 2006, the National Consumer Law Center (NCLC) recommended the imposition of a "duty of good faith and fair dealing" to address "irresponsible underwriting, unsuitable loans, and steering" in the nonprime[18] market.[19] Likewise, in September 2006, advocacy organizations suggested that Congress adopt a duty of good faith and fair dealing applicable to the "non-traditional, hybrid adjustable rate and nonprime market."[20] In both proposals, the duty would include a vaguely worded suitability requirement, specify underwriting standards for determining a borrower's ability to repay a loan based on the "maximum payments" possible under a loan, and prohibit steering.

In addition, effective January 1, 2007, the Ohio mortgage broker licensing and usury law requires lenders and mortgage brokers to make "reasonable efforts" to obtain financing that is "advantageous" to the borrower in terms of rates, charges and repayment terms without providing any guidance as to what standards apply or what constitutes compliance.[21]

Advocacy organizations also have indicated that they would want to require that the lender should, as a matter of law, have a fiduciary responsibility to determine, based on largely subjective criteria, that a particular loan product is properly matched to the needs of a particular borrower. The lender's judgment of suitability would be reviewable in the courts through a private right of action. This approach is described as modeled on the responsibilities that broker-dealers have in the securities industry.

---

16 See, e.g., § 1322.081 of both the House and Senate versions of Ohio Senate Bill 185. The Senate version states that a broker and lender "shall be a fiduciary of the buyer and shall use their best efforts to further the interest of the buyer." Ohio S.B. 185, 126th Gen. Ass. (2006).

17 See N.C. Gen. Stat. § 53-243.11(8); Ohio Rev. Code § 1322.081.

18 Nonprime lending can perhaps be most simply described as "lending with elevated credit risk." Based on a number of carefully weighted factors, including, but not limited to, credit score, loan-to-value ratio, income and assets, and attributes of the property itself, nonprime loans are given to loan applicants who have a weaker credit history or demonstrate less of a capacity to repay the loan than borrowers qualifying for prime credit. The basic principle is that borrowers who do not qualify for prime loans present a greater risk of default, which justifies lenders charging higher rates and fees to compensate for the added risk associated with such loans.

19 *Home Equity Lending Market: Hearing Before the Board of Governors of the Federal Reserve System,* Docket No. OP-1253 (Aug. 15, 2006) (comments of National Consumer Law Center).

20 *Calculated Risk: Assessing Non-Traditional Mortgage Products: Hearing Before the Senate Subcommittee On Housing & Transportation, Senate Committee on Banking, Housing & Urban Affairs,* 109th Cong. (Sept. 20, 2006) (statement of Allen J. Fishbein, on behalf of Consumer Federation of America and National Consumer Law Center).

21 Ohio Rev. Code § 1322.081.

Proposals With Unintended Negative Consequences

Rigid, prescribed underwriting standards, though objective, will result in considerably more borrowers being denied credit than need to be; in fact, such standards are not needed to assure that a borrower will repay a loan.

For example, a rigid debt-to-income ratio of 45 percent might work to qualify some borrowers but it will also result in the denial of credit to those who can reasonably expect higher income in the near future. The promising medical student or law clerk may be denied a loan notwithstanding his or her future earning capability and a sound credit decision that could acknowledge this fact.

Also, if a loan must be underwritten to a fully indexed rate, even though a nonprime borrower has equity in the home and is certain to refinance prior to any adjustment, the option of lower payments under such a loan will be denied to a borrower notwithstanding that the loan may be a sound option while the borrower repairs his or her credit. It is important to note that in many cases the alternative to a flexibly underwritten ARM may not be a fixed rate loan, but rather no loan at all. The borrower simply may not qualify for a fixed rate loan to finance the home because the payments are initially higher.

Although the concept of "good faith and fair dealing" can apply during the life of the loan, imposing the requirement on the origination of the loan creates new and undefined risks. The Uniform Commercial Code (UCC) incorporates by reference the duty of good faith defined as "honesty in fact and the observance of reasonable commercial standards of fair dealing," into each contract with respect to "its performance and enforcement."[22] As explained by the NCLC, the duty of good faith is imposed on parties to an existing contract "to prohibit improper behavior in the performance and enforcement" of that contract.[23] The treatise notes, with citations to numerous lending cases, however, that the duty does not arise until the parties have reached an agreement and does not extend to contract negotiations.[24]

Implementing the "good faith and fair dealing" standard at the front end of a loan transaction as a suitability and anti-steering requirement would markedly change the relationship between the debtor and the creditor and create a large and undefined contingent liability. All of the lender's sales efforts would be judged by this subjective standard and there is no case history setting the limits of the lender's responsibility. Consequently, a borrower may successfully challenge nearly every term of a loan using this formulation.

---

22 UCC §§ 1-201(20), 1-304.

23 National Consumer Law Center, The Cost of Credit: Regulation and Legal Challenges, § 12.8 (3rd ed. & Supp.).

24 Id. at n.652.

Moreover, by making such open-ended claims justiciable as private rights of action, the proposal assures that there will in fact be extraordinary claims and costs to the lender that will be ultimately priced into all loans and thereby passed on to all borrowers. While it is hard to quantify what these increased costs will be, considering that there were more than 10 million loan transactions in 2005,[25] one can anticipate claims in the billions of dollars. Additionally, the loss of competitors that might understandably shy away from such liability will reduce competition and increase consumer costs and must be computed in the costs of such a standard.

Notably, while advocacy organizations suggest that the mortgage lending industry borrow suitability from the securities industry, there is no suggestion by any that mandatory arbitration, which is employed in the securities industry, should be imported into the mortgage market in lieu of judicial remedies.

Subjective Suitability Requirements Risk Undermining Fair Lending, Community Investment and Homeownership Gains

While certainly not intended to promote or authorize discrimination or reignite redlining, the injection of subjective underwriting standards would conflict with and potentially threaten fair lending, community reinvestment and homeownership gains.

Were a suitability standard imposed requiring "good faith and fair dealing" or that "the best product be provided to the borrower," lenders may be obligated to deny or discourage members of protected classes, such as African-Americans and the elderly, from particular types of mortgages such as those with adjustable rates. Such a denial of credit may violate existing laws and would certainly undermine fair lending gains. On the other hand, if the lender chose to ignore the standard and offer credit in a nondiscriminatory manner as the law demands, the lender may risk an enforcement action or a lawsuit for violating the suitability standard.

As an illustration, consider the following. A typical tool used to measure fair lending compliance is "matched pair testing," a process by which two testers, one in a protected class and the other of different race, gender or age but with similar risk characteristics, seek to obtain a mortgage loan. If the tester from a protected class is denied or even given less encouragement than the other tester, this is offered as evidence that the lender is discriminating against the tester's protected class.

The U.S. Department of Housing and Urban Development (HUD) funds fair lending advocacy groups to conduct such tests and uses the results to promote settlements in which the lender is encouraged to make a monetary payment and agree to adopt training and other policies to enhance availability of credit to protected classes. There is not a great deal of legal precision around these proceedings, but rather the lender is put in the position of having to decide to fight discrimination charges that may not be accurate, but would be damaging to the lender's reputation, or to settle.

25 2005 Home Mortgage Disclosure Act data cited in Robert P. Avery and Glenn Canner, "New Information Reported under HMDA and Its Application to Fair Lending Enforcement," Federal Reserve Bulletin (2005).

Applying these tests to a lender's operations under the suitability requirement, a young white tester may gain access to an ARM that an older African-American individual was denied or discouraged from by virtue of a suitability requirement. Notwithstanding, such denial may result in a prima facie claim of discriminatory treatment under the Fair Housing Act.

As indicated, the potential for legal challenges under a suitability standard are considerable. While challenges to "suitability" will certainly occur when a loan goes bad or becomes uncomfortable, claims of discrimination can be expected whenever a borrower belonging to a protected class is denied or is discouraged from applying for a loan. Additionally, the potential for reputational risk based on claims of discrimination or predatory lending is enormous.

To avoid legal or reputational difficulties, some lenders understandably will restrict the amount of credit they make available in under served markets. The result would be to increase the price and thereby restrict the availability of credit, turning back the clock on the gains brought by CRA, HMDA, and the market innovations which have been developed by the mortgage lending industry.[26]

As Federal Reserve staff pointed out in the report accompanying the release of the 2004 HMDA data, even the misuse of HMDA data on a lender's pricing of loans risks reputational harm and disinvestment.[27] These concerns greatly increase in this context where lenders will face both reputational risks and the risks of suitability and fair lending suits at the same time.

It is noteworthy that survey data indicates that an intrusion by lenders into the borrower's personal decisions is unwelcome by the borrower whom a suitability standard would be designed to protect. One recent study found that 88 percent of respondents would prefer to "decide for themselves whether or not a mortgage product is right for them, rather than leaving that responsibility to the mortgage lender."[28]

Also notably, borrowers subject to a pilot program in the City of Chicago that imposes mandatory financial counseling only for borrowers in specific ZIP codes have filed a law suit alleging that the program amounts to "state-sanctioned redlining."[29]

To be clear, the lending industry does not support government efforts to deny credit to any borrowers whatsoever. However, if Congress or a state legislature decides that certain types of loans are unsuitable for particular classes of borrowers, it should provide clear prohibitions that do not require lenders to substitute their judgment for a borrower's. In addition, lenders acting pursuant to the legislative mandate should be granted immunity from legal challenge under fair lending or other laws as long as their actions are in compliance with the legislative directive.

---

26 See, e.g., *Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit: Hearing Before the Subcommittee on Housing and Community Opportunity, Subcommittee on Financial Institutions and Consumer Credit,* 106th Cong. (Nov. 5, 2003) (statement of Micah S. Green on behalf of the Bond Market Association noting a quarter percentage point increase in lending rates as market participants withdrew from the market).

27 Robert P. Avery and Glenn Canner, *New Information Reported under HMDA and Its Application to Fair Lending Enforcement,* Federal Reserve Bulletin (2005) at 393.

28 See American Financial Services Association Press Release, *Borrowers, Not Lenders, Should Decide Appropriateness of Mortgage Products, Finds Survey,* (Nov. 20, 2006).

29 See Mary Umberger, *Home Buyer Counseling Challenged,* Chicago Tribune, Nov. 2, 2006.

A Suitablity Standard Is Not Worth the Risks of Limited Borrower Choices and Increased Borrower Cost

For those lenders who remain in the market, after the imposition of a suitability standard, the new risks to the lender and to the secondary market will increase compliance costs and consequently the costs of credit.

Several factors determine the particular mortgage interest rate that a particular borrower receives. The first and most important is the 10-year Treasury note rate,[30] which in large measure has become the benchmark for the 30-year fixed mortgage.[31] Mortgages typically trade at a spread above Treasury rates because the lender bears both the credit risk (the risk that a borrower may default) and prepayment risk (the risk to the investor that the borrower may refinance or move, thereby paying the loan off ahead of its stated maturity). Lenders incur expenses in originating a loan which may only be defrayed by pricing prepayment risk into the loan.

The second factor, therefore, in the mortgage price is the premium over the Treasury rate to account for a borrower's expected credit and prepayment risk. Nonprime borrowers tend to have both a greater level of credit risk, i.e., higher expected levels of delinquency and default as a result of their prior credit problems, and greater prepayment risk. The reason for the greater prepayment risk is that nonprime borrowers frequently refinance their loan if their credit improves and they qualify for a lower rate. Objective risk factors, including credit scores and other items from a borrower's credit report such as payment history on prior mortgages, loan-to-value ratios, debt-to-income ratios, and other underwriting variables, are powerful predictors both of a borrower's likelihood to pay on their loan and to prepay.

A third factor in the price is the amount of administrative and other expenses associated with the loan. Loan applications that take additional time for an originator to complete are more costly. Additionally, small loans are more expensive to originate because the fixed costs are spread over a smaller balance. Nonprime loans tend to be significantly smaller on average relative to prime loans. Compliance costs are also a key part of the administrative expenses associated with the loan. These costs include insurance and legal work, training employees and systems related costs.

Typically, the price of a loan is arrived at using a statistical model which may be embedded in an automated underwriting system (AUS). The use of automated underwriting for most borrowers allows lenders to concentrate their attention on helping borrowers with unique credit histories or other characteristics qualify for financing.

30 The 10-year Treasury rate reflects the risk-free credit of the United State government. The 10-year rate also cannot be called; investors can expect to receive the stated interest rate on their investment for the full 10 years.

31 In fact, lenders use a variety of indices to determine their cost of funds and to help price their loans, including the LIBOR/swap index.

If borrowers are in effect granted a new "suitability" defense to foreclosure actions by law, costs will increase and credit options will narrow. The ability to foreclose is an essential element of the mortgage cost, a factor that makes mortgage credit cheaper than almost any other form of credit because the lender has the security of the collateral real estate backing the loan.[32]

If the ability to realize on the lender's security interest is impaired, the lender will have to charge higher rates to the disadvantage of the vast majority of borrowers who pay their loans on time. The final factor in the determination of a borrower's mortgage rate depends on the borrower. Borrowers who aggressively shop among several lenders are likely to get a better rate than borrowers who visit only one lender or mortgage broker. These borrowers make the competitive marketplace work for them and help wring out any excesses in pricing through their efforts. There are more than 10,000 mortgage lenders competing for business in the American market.[33]

Assessing the impact of new requirements imposed by various state anti-predatory lending laws in 2004, the United States Government Accountability Office (GAO)[34] noted that state laws that included assignee liability provisions inflicted the negative, unintended consequence of discouraging legitimate market activity, restriction of availability of loans, and increase in costs of the loans that were available.[35] Specifically, the report noted that "if secondary market participants are not willing to risk having to assume liability for violations committed by originators, they may pull out of the market altogether, reducing the availability and increasing the costs of legitimate nonprime credit. Finally, if states' predatory lending laws have different terms and provisions regarding assignee responsibilities, the secondary market as a whole could become less efficient and liquid, further increasing rates on legitimate nonprime mortgages."[36]

---

32 Significant sums are lost by lenders when loans go into foreclosure. The estimated losses on... foreclosures range from 30 percent to 60 percent of the outstanding loan balance because of legal fees, foregone interest, and property expenses. See Karen Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit,* Federal Reserve Working Paper (2003).

33 Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *Higher-Priced Home Lending and the 2005 HMDA Data,* Federal Reserve Bulletin (2006) at A123. This report, accompanying the release of the HMDA data, points out that nearly 8,850 lenders are covered by the law and that this accounts for an estimated 80 percent of home lending nationwide. Additionally, mortgage brokers are not covered by HMDA.

34 Then known as the "General Accounting Office."

35 General Accounting Office Report to the Chairman and Ranking Minority Member, Special Committee on Aging, U.S. Senate at 84.

36 Id.

The Primary Reasons for Defaults Are Family and Economic Difficulties Not Product Choices

There is no evidence that product choices by borrowers are determinative of defaults or foreclosures. Different products have different default rates but the product choice does not cause the default. Data consistently demonstrate that delinquencies among all borrowers are a function of a variety of factors including, first and foremost, economic difficulties caused by job losses. According to Freddie Mac, based on a sample of loans in Workout Prospector,® 1999-2005, the following are the reasons for delinquency:

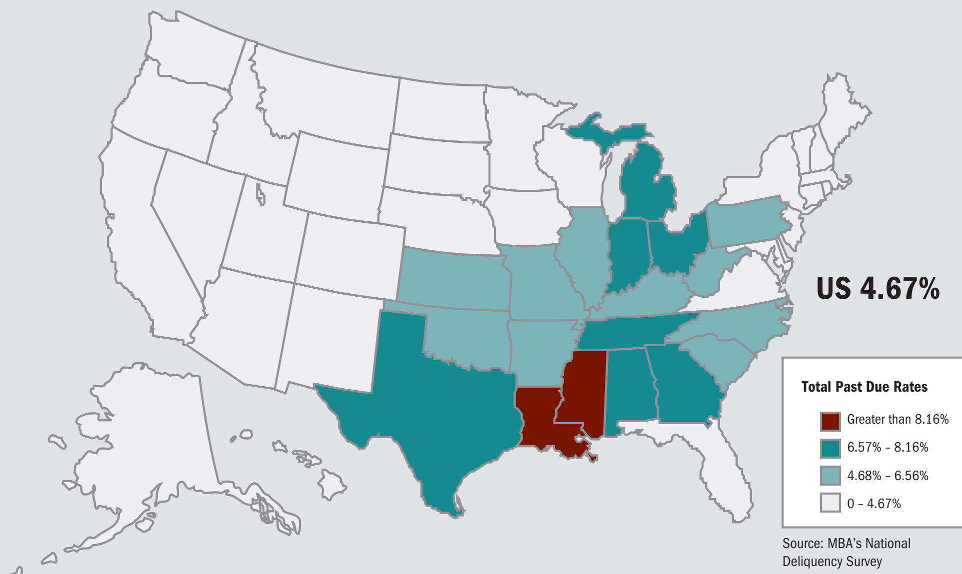
Reasons for Delinquency

Reason	Share
Unemployment or curtailment of Income	41.5%
Illness or Death in Family	22.8%
Excessive Obligation	10.4%
Martial Difficulties	8.4%
Extreme Hardship	3.3%
Property Problem or Casualty Loss	2.1%
Inability to sell or rent property	1.6%
Employment Transfer or Military Service	0.9%
All Other Reasons	9.0%

Source: Freddie Mac

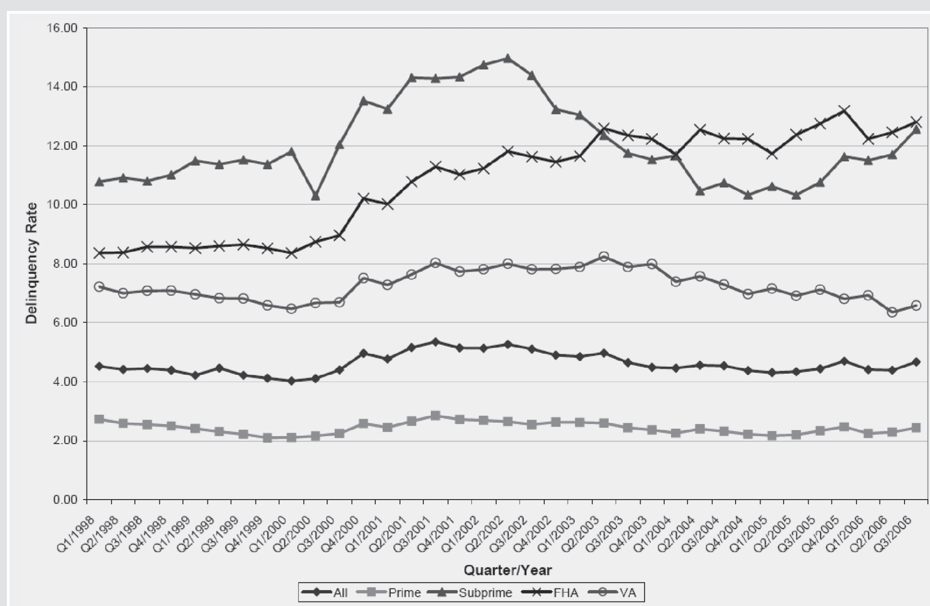
Variations in delinquencies from state-to-state reflect differences in the level of unemployment.

Total Loans Past Due Rates by State for Q3, 2006



Assertions that delinquency rates are at crisis levels and that a greater percentage of borrowers are losing their homes are not supported by data. In fact, delinquency and foreclosure rates, including among nonprime borrowers, have remained relatively low with some increases over the last year.

Total Delinquency Rate by Loan Type



Source: MBA's National Delinquency Survey

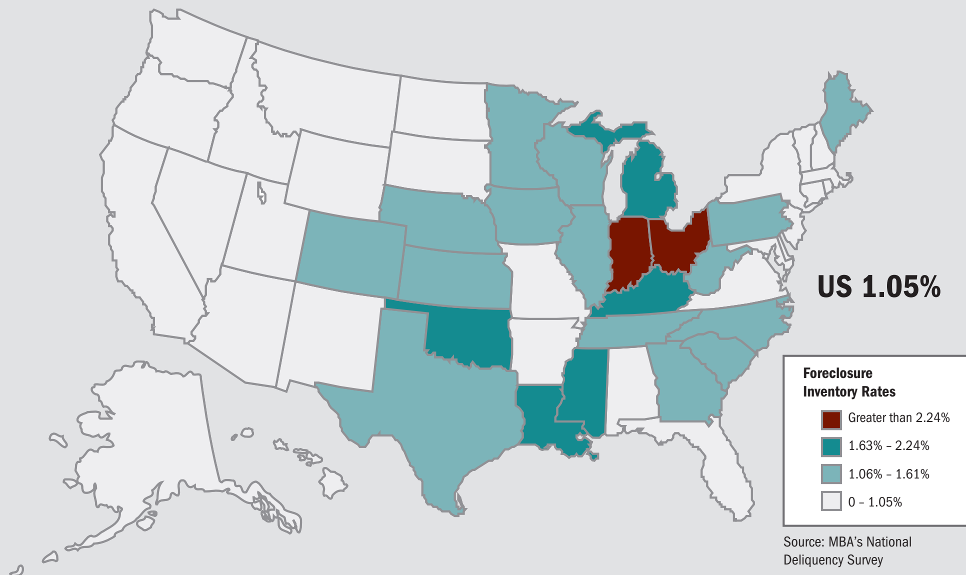
All ARM loans had higher delinquency rates compared to the second quarter of 2006. In the third quarter of 2006, the delinquency rates for fixed rate mortgage loans (FRMs) were either unchanged or declined. The delinquency rate for prime ARMs was 3.06 percent, for prime FRM loans was 2.10 percent, for nonprime FRM loans increased 36 basis points to 9.59 percent, and the delinquency rate for nonprime ARMs was 13.22 percent. In the third quarter of 2006, the delinquency rate for nonprime loans was 12.56 percent, up from 11.70 percent.[37]

MBA's third quarter 2006 National Delinquency Survey (NDS) found that the percentage of loans in the foreclosure process was 1.05 percent, an increase of only six basis points from the second quarter of 2006, while the seasonally adjusted rate of loans entering the foreclosure process was 0.46 percent, three basis points higher than the previous quarter. The foreclosure inventory rate for subprime loans in the third quarter of 2006 was 3.86 percent, up from 3.56 percent in the second quarter. The foreclosure inventory rate for prime FRMs increased to 0.36 percent from 0.34 percent, for prime ARMs from 0.56 percent to 0.70 percent, for nonprime ARMs from 3.88 percent to 4.68 percent. The foreclosure inventory rate decreased for subprime FRM loans from 3.05 percent to 3.00 percent.

---

37 These figures are based on MBA data. MBA defines "delinquency" as having one or more payments overdue. The loans in foreclosure are approximately a third of these numbers, and borrowers actually losing their homes are approximately one-fourth of that group.

Foreclosure Inventory Rates by State for Q3, 2006



Source: MBA's National Deliquency Survey

In its most recent data, MBA is seeing increases in delinquencies and foreclosures for nonprime loans, particularly nonprime ARMs. Because of efforts by the industry and the appetites of borrowers for credit, the share of outstanding loans that are nonprime has been increasing for the last several years. The higher average delinquency and foreclosure rates among these loans mean the overall statistics for total outstanding mortgages are unlikely to fall as low as in the past.

It is important to note that nonprime loans have always had higher delinquency and foreclosure rates and lenders factor in these risks when lending to nonprime borrowers. Given the fact that nonprime borrowers have weaker credit profiles, this is not surprising. Foreclosures also can be accelerated by slow housing markets that limit borrowers' ability to quickly sell in order to cover their losses. MBA data has indicated that over the last several quarters a number of factors, including the aging of the portfolio, increasing short-term interest rates and high energy prices, have been putting upward pressure on delinquency rates. However, healthy economic growth and vibrant labor markets have offset these pressures.

Nevertheless, for each borrower whose loan goes into default and is foreclosed, the experience is a traumatic one, and it is not surprising that counsel for such borrowers would assert every claim available to permit their clients to hold onto their homes. In this context, it is likely that claims of unsuitability will make their way onto the list of defenses advanced by borrowers to head off foreclosure. If the experience of the securities industry is a guide, whenever the market declines, claims of unsuitability of recommended investments spike.

The Suitability Standard in the Securities Industry

Neither the Securities Exchange Act of 1934 nor the U.S. Securities and Exchange Commission's (SEC) implementing regulations impose an express duty on market professionals to ensure that a securities transaction is suitable for a customer. The SEC relies upon two key legal theories — agency law and the so-called "shingle theory" — to impute a suitability requirement under the anti-fraud provisions of the federal securities laws to securities market professionals. In other words, the SEC does not have a suitability rule as such. The SEC incorporates the suitability concept into the anti-fraud provisions of the Securities Exchange Act of 1934[38] and SEC Rule 10b-5.[39] Essentially, suitability was imputed into 10b-5 along with other violations alleging fraud, such as false or misleading statements of fact, excessive markups, boiler room operations, or control or domination of the market.[40] As a theory grounded in fraud, there must be a showing of *scienter* — that is, intentional knowing or reckless conduct by the market professional — for a claim of unsuitability to be established.[41]

Under the agency theory, the SEC takes the view that a securities market professional acts as an agent on behalf of the customer.[42] Consistent with this theory, the market professional, as part of his or her duty of care and loyalty as agent for the customer, is expected to only recommend securities that are suitable to the customer's financial means and investing goals. The case law consistently supports this idea.[43]

The key factor in this theory is that an agency relationship results when a market professional *recommends* a transaction.[44] Also, the "shingle theory" postulates that the act of holding oneself out as a securities market professional implies that one will deal fairly with the investing public.[45] The very point of holding oneself out as someone who offers investment opinions on a fee basis is to cultivate a relationship with a client based on a high degree of trust and confidence, in return for the duty to act in the best interests of that client.[46] Because securities market professionals possess greater skill and knowledge about the securities markets when they recommend a securities transaction to customers, the customer reasonably relies on the professional's skill and knowledge in agreeing to engage in the recommended transaction. The market professional has a responsibility only to recommend transactions that are suitable for the customer.

The case law is consistent, however, in holding that where the securities market professional merely

38 15 U.S.C. § 78j (b).

39 See Clark v. John Lamula Customers, Inc. [Every registered broker-dealer must be a member of a registered national securities association unless it transacts only on a stock exchange of which it is a member. 15 U.S.C. § 78o(b) (8).]

40 Lewis D. Lowenfels and Alan R. Bromberg, Suitability in Securities Transactions, 54 Business Lawyer 1557, 1581 (August 1999).

41 See, e.g., Brown v. E.F. Hutton Group, Inc. 991 F.2d 1020, 1031 (2d Cir. 1993); McDonald v. Alan Bush Brokerage Co., 863 F.2d 809, 814 (11th Cir. 1989) ("A successful cause of action under Section 10(b) or Rule 10b-5 requires that the plaintiff prove (1) a misstatement or omission (2) of a material fact (3) made with *scienter* (4) upon which the plaintiff relied (5) that proximately caused the plaintiff's loss."); Bloor v. Carro, Spanbock, Londin, Rodman & Fass, 754 F.2d 57, 61 (2d Cir. 1985).

42 Restatement (Second) of Agency § 387.

43 See, e.g., Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng, 901 F. 2d 1124, 1128 (D.C. Cir. 1990); Hanly v. S.E.C., 415 F.2d 589, 597 (2d Cir. 1969) ("a broker cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation, he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information.").

44 Unfortunately, while the NASD has made efforts to clarify the rules, there are not yet sufficient bright-line standards either in case law or in NASD, SEC, or other published guidance as to what constitutes a "recommendation," thus leaving the securities industry without certainty as to the situations in which the suitability rule applies.

45 See Kahn v. S.E.C., 297 F.2d 112, 115 (2d Cir. 1961) (Clark, J. concurring) (citing Loss, Securities Regulation 1490 (2d Ed. 1961)).

46 See, e.g., Arlene W. Hughes, 27 S.E.C. 629 (1948).

takes an order from a customer without additional action or input, there is nothing about that relationship that would create an expectation by the customer that the market professional is appealing to a relationship of trust and confidence or from a position of superior skill or knowledge about the investment decision to be made.[47] The customer has already made his or her own decision regarding the transaction. No special, heightened duties are owed in this circumstance. Rather, the professional's responsibilities commence when the order is placed and ends when the transaction is complete.[48]

The Securities Industry is Not Analogous to the Mortgage Lending Industry

While the importation of the suitability standard from the securities industry to the lending industry may at first seem reasonable, the industries are not analogous and such a standard is not appropriate for the mortgage lending industry. There are substantive differences between the functions and responsibilities of market professionals in both industries which are or would be subject to such a standard. Just as importantly, the policy imperatives applicable to the mortgage lending industry including fair lending and community investment requirements are inapplicable to the securities industry.

The Policy Imperatives Differ

While federal policy has been to encourage mortgage lenders to make credit available to as many borrowers as possible, by contrast those responsible for regulation of the securities industry have not made expansion of investment opportunities to under served persons or neighborhoods a major policy initiative. The consequence of the suitability requirement for a securities firm is that overly cautious broker-dealers will lose out on commissions. The consequence of a suitability requirement for mortgage lenders is that overly cautious lenders may violate the letter of federal anti-discrimination laws and the spirit of community reinvestment laws.

As noted, mortgage lenders have for decades been required by law to assure that they do not discriminate on the basis of race, religion, color, gender and membership in other protected classes. Lenders are required to increase availability of loans to under-served and minority populations and neighborhoods. The Fair Housing Act, ECOA and CRA encourage not only fair lending practices, but affirmative efforts to expand credit availability.

In part in response to these laws, using enhanced underwriting and loan pricing techniques, mortgage lenders have been successful in expanding the number of borrowers and neighborhoods they serve, while at the same time structuring loans that are safe enough to be attractive to buyers in the secondary market and purchasers of mortgage securities who are the principal source of mortgage credit for American home buyers.

Assuming there were modifications to fair lending and community reinvestment laws, which, to repeat,

---

47 The difference between duties for recommended transactions and mere order-taking was explained clearly in Canizaro v. Kohlmeyer & Co., 370 F. Supp. 282 (E.D. La. Feb. 6, 1974).

48 Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 337 F. Sup. 107 (N.D. Ala. April 15, 1971) ("The risk of the venture is upon the customer who profits if it succeeds and loses if it fails. When the transaction is closed in accordance with the understanding of the parties, the broker gets only his commission and interest upon advances.").

lenders do not favor, it might be possible to reconcile "suitability" requirements and these legislative mandates. However, until then, substituting a lender's judgment for a borrower's as to whether the borrower should be granted a loan that otherwise meets the lender's underwriting criteria is fraught with risk.

The Business Models Differ

Securities law requirements for determinations of suitability are predicated upon a business model under which the securities market professional acts as an agent, holding him or herself out as an expert adviser and counselor on investments to prospective investors. Securities brokers-dealers essentially function as intermediaries between the customer and the market. The public expects a securities broker-dealer to act on their behalf because of the way a broker-dealer holds himself out.

Mortgage lenders, on the other hand, are not intermediaries or agents of or fiduciaries for borrowers, do not hold themselves out in that manner and do not have a legal responsibility to represent the borrower's interests. Indeed, as noted by the NCLC, a residential mortgage transaction "is considered to be an arms length one in which the lender is entitled to its profits… and the borrower knows this."[49]

Lenders can and do offer valuable information to consumers. Lenders help consumers understand what mortgage products are available and for what mortgages they qualify. For this reason, it pays for consumers to see lenders early in the home buying process not only to determine what property they can afford but also to consider their financing choices in relation to their particular situations, including their income, credit and plans to stay in their homes. Nevertheless, lenders cannot as a legal matter serve as agents and fiduciaries for borrowers and at the same time fulfill their legal obligations to their companies.

The mortgage lender's primary duty is to those who entrust the mortgage lender with the funds used to finance the mortgage, be they depositors at a bank or purchasers of mortgages in the secondary market. Mortgage lenders are charged with performing due diligence regarding a borrower's ability to repay the loan, and secondary market investors in mortgage loans require representations and warranties from mortgage lenders that they have properly performed such due diligence on the borrowers and properties securing loans through underwriting, appraisals, title searches and other processes. Unlike the securities market professional, who takes a customer's money for investment, the mortgage lender provides money to the borrower in exchange for the legal promise of the borrower to repay the loan with interest.

Mortgage borrowers understand that the lender is not their agent. They apply for a loan from the lender who will decide whether or not to lend them the money. Mortgage borrowers shop for loans because they do not expect a mortgage lender to act on their behalf to secure the best rate and terms.[50]

Finding loans is not difficult for consumers. Advertisements in newspapers, television, and the internet offer borrowers a wide range of information on rates and terms available from mortgage lenders. Unlike the securities industry, where a customer generally does not shop among brokers or change them on a

---

49 National Consumer Law Center, The Cost of Credit: Regulation and Legal Challenges, § 12.9.3 (3rd ed. & Supp.) (quoting Sallee v. Fort Knox Nat'l Bank (In re Sallee), 286 F.3d 878 (6th Cir. 2002)).

50 This section concerns mortgage lenders, not mortgage brokers. However, the other points raised in this paper, i.e., that imposition of a suitability standard risk fair lending and homeownership gains, pertain to all mortgage originators.

regular basis, mortgage borrowers frequently shop from one lender to another looking for the best rate and terms available.

The role of the lender in many cases is to respond to the borrower's needs after the borrower decides whether to borrow and what his or her requirements demand. Order taking, which occurs in the mortgage lending industry, is exempt from the securities industry standard. To suggest that a lender should now move to the borrower's side of the transaction and effectively assume the role of a fiduciary for the borrower would radically alter the business model under which the mortgage business operates, and would assign mortgage lenders responsibilities which are at odds with their duties to mortgage investors.

Imposing a suitability standard on mortgage lenders would force them to be simultaneously responsible to the lender and the borrower, an impossible set of competing demands. If a mortgage lender had a requirement to assess suitability of the loan to the borrower, it would be as though, in the securities context, the suitability of the security for the buyer were determined not by the *buyer's* broker-dealer but rather the *seller's* broker, foisting a fiduciary duty upon the wrong party on the other side of the transaction.

Such an approach not only wreaks havoc on basic agency law, it also creates serious conflict of interest issues.[51] A suitability requirement would force the lender to assume the role of fiduciary for the borrower with the mandate to protect the borrower's interests (even at the detriment to the lender's interests) while at the same time seeking to secure a favorable return on the funds invested by the lender's shareholders and to secondary mortgage market investors.

Courts have consistently found that lenders do not have agency or fiduciary responsibilities to borrowers. Unlike a securities broker, who by definition acts on behalf of the customer's account, a lender in a loan transaction never enters into an agreement to act on behalf of the borrower. Rather, the transaction remains "at arms-length, where both parties act for themselves rather than as agents for each other."[52]

Not only is there no agency relationship, the lender and borrower are in fact counterparties in the transaction. Further, courts "are virtually unanimous in holding that the basic relationship between lenders and borrowers is an arm's-length transaction between creditors and debtors."[53] As one court stated, a fiduciary relationship would arise only if "the activities of both parties [go] beyond their operating on their own behalf and the activity is for the benefit of both."[54]

51 See, e.g., Restat. 2d of Agency, § 391 ("Unless otherwise agreed, an agent is subject to a duty to his principal not to act on behalf of an adverse party in a transaction connected with his agency without the principal's knowledge.").

52 See NCLC, The Cost of Credit, supra note 23; see also Daniel R. Fischel, *The Economics of Lender Liability,* 99 Yale L. J. 131, 146 (October, 1989).

53 Cecil J. Hunt II, *The Price of Trust: An Examination of Fiduciary Duty and the Lender-Borrower Relationship,* 29 Wake Forest L. Rev. 719 (1994) (citing, among other cases, Black Canyon Racquetball Club, Inc. v. Idaho First Nat'l Bank, 804 P.2d 900, 905 (Idaho 1991) (affirming the rule that "the relationship in a lender-borrower situation is a debtor-creditor relationship and not a fiduciary relationship.")

54 Union Planters Nat'l Bank, N.A., v. Jetton, 856 So.2d 674 (Miss. App., July 15, 2003.)

Imposition of a suitability determination requirement on lenders also would run afoul of traditional contract theory, which provides that a contracting party owes no duty to assume the position of the counterparty and decide if the contract meets the counterparty's needs. To the contrary, contracting parties are entitled to push their claims in the contract to maximize their self-interest, up to certain limits.[55] A suitability rule would turn that basic premise on its ear and require the lender to promote claims and terms contradictory to its own self-interest. This problem would be most acute where suitability may be extremely difficult to assess.

As noted, it is settled law that duties of good faith and fair dealing are already incumbent upon both parties to a contract.[56] The Restatement recites that "every contract imposes upon each party a duty of "good faith and fair dealing" in its performance and its enforcement."[57] Thus, prohibitions of fraud or material misrepresentation require no additional legal codification to enforce. The parties are covered by the implied covenants that are part of every contract.[58] The duty of "good faith and fair dealing" only arises after formation of the contract.[59] As noted, a suitability rule would essentially extend fiduciary duties to actions of contracting parties prior to the formation of the contract — the precise time when they are free to negotiate at arms length to advance their own interests.

It is Not Clear that the Suitability Standard is Working Well in the Securities Industry

The vagueness of the suitability doctrine in the securities industry has led to increased claims under the standard. NASD dispute resolution statistics reflect significant increases in claims against securities market professionals for the years 2001 to 2003, coinciding with the general stock market decline. These statistics suggest that investors who lose money are quick to claim that the recommendations of their brokers were inappropriate, even in spite of the requirement to prove scienter. There is no reason to believe that borrowers facing foreclosure would not assert similar defenses regardless of whether the loan was appropriate or not when made.

In fact, NASD has expressed concern about the magnitude of claims brought against market professionals and brokerage firms for unsuitability under NASD members' errors and omissions insurance policies. In 1998, 95 percent of the filings made with insurers under their policies were based on unsuitability claims.[60]

55 See Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12150, 1991 Del. Ch. LEXIS 215 at *76-77 (Del Ch. Dec. 30, 1991) (noting that "while contracting parties are not fiduciaries for each other, there are outer limits to the self-seeking actions they may take under a contract").

56 Restatement (Second) of Contracts § 205.

57 See also Fischel, *The Economics of Lender Liability,* 99 Yale L. J. 131 (1989) (citing to the Uniform Commercial Code § 1-203.); Easterbrook & Fischel, *Contract and Fiduciary Duty, Journal of Law & Economics,* 425, 438, vol. XXXVI (April 1993) ("Contract law includes a principle of good faith in implementation—honesty in fact under the Uniform Commercial Code, plus an obligation to avoid (some) opportunistic advantage-taking.")

58 Additionally, contract law also deals with situations where disclosure of material facts should be made, even by counterparties. For example, a person should disclose a fact if it would correct a mistake of the other party as to a basic assumption on which that party is relying in making the contract and if non-disclosure of the fact amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing. A person also should disclose a fact if the other person is entitled to know the fact because of a relation of trust and confidence between them. See Restatement (Second) of Contracts, § 161.

59 See NCLC, supra note 23 at n.652.

60 See Lowenfels and Bromberg, supra note 39.

Retaining the Current "Arms Length" Model in the Mortgage Lending Industry Works Best for Consumers

Mortgage lenders, operating within this country's sophisticated real estate finance system, respond to a number of influences in determining their ability to originate mortgages in a manner that is profitable, as well as safe and sound. The primary influence for lenders are the signals received from secondary mortgage market investors.

Lenders have no interest in originating mortgages that result in defaults, delinquencies or even late payments. For that reason, a lender's interests coincide with those of the borrower in that neither has a desire to enter into a transaction that will result in the borrower being unable to repay the loan.

A lender originating a large number of mortgages with an unacceptable level of risk will find itself facing significant price disadvantages in the secondary market. Thus, the market signals lenders when product features need to be altered. In this manner, the private market can and does correct for excessive risk even more effectively than it could be directed to do so by legal process, by virtue of suitability standard, or otherwise. A good example of this dynamic is that the market offered and then rejected loans that exceed the value of the collateral, the so-called 125 percent loans.

Despite the wide range of market innovations, some borrowers may obtain loans with terms that negatively impact their ability to repay. There is an obvious tension between the societal goal of encouraging market innovations that will expand borrowing and home ownership opportunities and the goal of protecting individual borrowers from overextending themselves. The fundamental goal that borrowers only obtain loans they can repay is shared by consumers, advocacy organizations, regulators and mortgage lenders alike. For this reason, the mortgage lending industry has a great stake in striving, along with advocacy organizations, legislators and regulators, to make the lending process as understandable and abuse-free as possible, and more work is needed toward this goal. However, imposing a suitability standard is not an appropriate solution and would run the risk of turning back the clock on innovations that have greatly expanded homeownership opportunities.

Because of the way the market works for lenders and borrowers and the challenges presented by a suitability requirement, consumers are better off if the "arms length" model of lender and borrower is retained. It will work even better if Congress, the agencies, industry and consumer organizations work to markedly improve financial literacy, licensing and disclosure requirements and enact a uniform national law with clear, objective standards to address lending abuses.

Changing interest rates and multiple refinancings have created a crop of seasoned and savvy mortgage consumers, but levels of sophistication vary among borrowers, and some borrowers need further education. Making lenders effectively responsible for a borrower's decisions does not fundamentally address the concern that some borrowers do not adequately understand the process of obtaining a loan or the loan products offered to them, it merely shifts the responsibility and burden to the lender even though the borrower, not the lender, is the best person to determine what is best for him or her.

There are at least three types of measures that would more directly respond to the problems of information adequacy and prevent predatory lending.

First, considerable resources should be committed to improving borrower education to raise the level of financial literacy, including incorporating this issue into general educational programs and increasing access to transaction-specific borrower counseling. Better financial education would empower all borrowers to shop effectively among the array of competitors in the marketplace.

Second, simplification of the mortgage process and all necessary consumer information would make it much easier for an empowered consumer to navigate the market, and such improvements are long overdue. Consumers today face a pile of disclosures when they apply for and close on a mortgage. Efforts at improvement need to streamline the existing mandated disclosures and information, and must be comprehensive and well considered. A successful effort would result in much more effective information on the benefits, costs and features of the loan options presented by lenders.

The risk-based pricing disclosure prescribed under the recent Fair and Accurate Transactions Act (FACTA) is a Congressional solution to better arming the borrower in the marketplace. Giving this solution a chance to work, along with markedly simplifying and improving the rest of the required disclosures, would meaningfully address the information asymmetry without risking hard won fair lending and homeownership gains.

Third, uniform lending standards that are clear and objective, but do not unduly restrict the market, would improve on the standards established under HOEPA to stop lending abuses. These standards must be national in scope to enhance competition in all markets for all borrowers, especially nonprime. Such standards will allow all borrowers to benefit from greater choices, competition and lower prices that a fair and fully functioning market brings.

Finally, while any increases in delinquencies and defaults are an important concern, prohibition of particular products is not a solution, certainly not to the many borrowers who have used a range of products effectively to realize their dream of homeownership and otherwise satisfy the financial demands that we all face.

Conclusion

The mortgage market works and the data demonstrate that fact. The market is serving more borrowers, who are benefiting today from innovation, unparalleled choices and competition resulting in lower prices and greater opportunities than ever before to build the wealth and wellbeing that homeownership brings. The market must be permitted to continue to do so.

While strong consumer protection is essential to the public interest, it is equally essential to assure a regulatory environment that serves and does not stem innovation in the marketplace. Such an environment would continue to allow lenders to provide borrowers the widest array of credit options to purchase, maintain and, as needed, draw equity from their homes to meet the demands of their lives. Also, while lenders must certainly assure that borrowers meet appropriate requirements, the institution of rigid requirements or subjective suitability requirements would not serve borrowers well; it would stem innovation, significantly increase lenders' costs and decrease competition which, in turn, would further increase borrowers' costs. Any new requirements in this area, therefore, must carefully consider all the consequences and balance all imperatives to truly serve the public interest.

Congress should resist pressure to enact market disincentives like a suitability standard that would harm consumers. Instead, Congress should turn its attention to the creation of a modern, workable and beneficial uniform national lending standard to help foster the market's remarkable innovations and opportunities.

Investing in communities

1919 Pennsylvania Avenue, NW
Washington, DC 20006-3404
www.mortgagebankers.org
(800) 793-6222