“Mortgage Origination: The Impact of Recent Changes on Homeowners and Businesses.”

Before the U.S. House of Representatives Committee on Financial Services
Insurance, Housing and Community Opportunity Subcommittee

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Chairperson Biggert, Ranking Member Gutierrez, and members of the Subcommittee, thank you for inviting me to testify before you today on the subject of "Mortgage Origination: The Impact of Recent Changes on Homeowners and Businesses."

My name is Ira Rheingold, and I have been a public interest attorney for my entire adult career. I have worked in some of our nation's poorest urban and rural communities and I've witnessed the incredible resilience and optimism that mark the great strength of our nation's people. I have also seen the incredible fear and despair experienced by American families and their communities as they faced and continue to bear the brunt of the worst housing and economic crisis of our lifetime.

In the mid – 1990's through 2001, I lived and worked in Chicago, where I ran the Legal Assistance Foundation's Homeownership Preservation Project. During those years, I watched (and worked against) the unfair and deceptive practices of many actors in the mortgage industry, that slowly, but inexorably stripped away the wealth of that city's low and moderate income minority communities. Today, I am the Executive Director of the National Association of Consumer Advocates (NACA), an organization of attorneys and other advocates who represent those very same consumers and communities all across this country. At NACA, I also manage the Institute for Foreclosure Legal Assistance, a project that provides funding and training to non-profit legal organizations that help homeowners negotiate alternatives to foreclosure. In my current roles, I speak to and assist our nation's consumer advocates who, on a daily basis, meet with and represent the consumers who have been victimized by bad mortgage lending and servicing practices and see the very real-life consequences of what an out of control mortgage lending marketplace did to our communities and our nation's economy

Introduction

Before I address recent changes to rules effecting mortgage origination, I think it's essential to put any recent reforms into the context of what the mortgage making process looked like until its bubble burst and shattered our economy. The mortgage market of the late 1990s and early 2000s, in no way resembled what most of us thought we understood about buying a home or getting a loan. I have talked to thousands of consumers, who believed (or were led to believe) that the mortgage entity that originated their loan, would only profit when they timely made their monthly mortgage payment. While this may have been the case when our parents or even our grandparents bought their homes, this was not true for most of the past two decades. Instead, because of the growth of securitization as the tool to fund both prime and subprime mortgages, with all its confusing layers, multiple actors and often perverse incentives, the nature of the consumer- mortgage originator relationship, unbeknownst to the consumer, has fundamentally changed. These changed relationships and backwards incentives led us to housing market mess that we are still trying to clean up.

Securitization and the Consumer

For my purpose today, I'm going to keep this very simple. At its most basic level, securitization is a process, which involves the pooling and repackaging of cash-flow producing financial assets into securities that are then sold to investors. As securitization grew to be the dominant way that mortgage loans were funded, the role and purpose of mortgage originators (and all the other actors in the mortgage market) fundamentally changed.

For the most part, the notion of lenders keeping a loan on their books for the duration of the loan was no longer the reality. With securitization, lenders/mortgage originators generated profits, not from the payments they would receive from the borrowers over the length of the loans, but instead from the fees they collect from selling the loans to investment banks.[1] Mortgage originators essentially became manufacturers of a commodity, the American mortgage borrower. Unfortunately, most homeowners did not and don't understand their role in this transaction. This commodity was then sold to the capital markets, which in turn, chopped, spindled and mutilated this new commodity into something that could be purchased by investors from around the world.

While advocates of securitization argued that the process produced additional capital and greater access to homeownership for some consumers, they failed to recognize the fundamental shift and potential dangers it created by fundamentally changing the traditional borrower-lender relationship in the consumer marketplace. No longer was the borrower's best interest (or even their ability to repay the loan) part of the mortgage transaction calculation. Instead, the real transaction was between the mortgage originator and the investment bank, which not only set the standards for the borrower/product they wanted to buy (and then turn around and sell), but also provided the money for the originators' loans.

Under these set of circumstances, what American consumers needed was the vigorous enforcement of existing consumer protections as well a new set of consumer protections to correspond with the very different mortgage world that had now been created. Unfortunately, what the federal government gave us was the exact opposite, not only diminishing its regulation and enforcement of this market, but providing interference and protection (under the guise of preemption) for mortgage market players when states, recognizing the fundamental flaws in the system, attempted to protect their own citizens.

The mortgage market, unfairness, deception and the consumer

Understanding what mortgage originators (and all of the actors in the process) were attempting to do, i.e. creating commodities to sell, when they made a loan to a consumer helps us understand all the unfair and deceptive practices that recently flourished in the mortgage marketplace. A clear misalignment of incentives lay at the heart of the recent mortgage meltdown. [2] In the past,

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[1] Raymond Brescia. "Leverage: State Enforcement Actions in the Wake of the Robo-Sign Scandal," Albany Law School Working Paper Series No. 38, 5, December 16. 2010.

[2] For a much longer discussion of the roots of today's crisis, see Testimony of Eric Stein, Center for Responsible Lending, before the Senate Committee on Banking (Oct. 16, 2008), *available at* http://www.responsiblelending.org/pdfs/senate-testimony-10-16-08-hearing-stein-final.pdf.

the interests of borrowers and lenders were perfectly aligned: if the borrower did not pay the mortgage, the lender did not make money. But the proliferation of independent brokers and the growth of the secondary market upset this alignment of interests between lender and borrower by creating a system where each actor was compensated early in the loan transaction, often within the first month of the loan term, thereby reducing or even eliminating the incentive to worry about how the borrower would fare later on.[3]

I'd like to talk about some of those practices now, and explain why unless all these issues are sufficiently addressed, we will not be able to rebuild a fair, responsible and functional mortgage origination marketplace.

A. *The Predatory Pitch*

As the demand for product to sell to Wall Street investment banks grew (ultimately exponentially), the pitch to vulnerable homeowners (and prospective homeowners) became more targeted and more personal. Armed with financial and personal data and carefully conducted research, mortgage brokers and lenders used TV and radio advertising, mailings, telephone calls, and even home visits to reel in consumers who otherwise had no real reason to get a new home mortgage. With promises too good to be true ("refinance your home, fix your roof and lower your monthly payment") consumers were later *bait and switched* to loans far more expensive than they thought they were promised. Because the mortgage "originators" received their full compensation when they manufactured the "product/borrower" to sell onward and upward, there was little concern whether the loan was sustainable. As many of us knew, and most of us have now learned, many of those loans were completely unsustainable.

B. *The Over-Inflated Appraisal*

In a rational world, a consumer would not want to pay (or borrow) more for a home than what it was worth. In the securitization created "bizarro" mortgage world, an over-inflated house made perfect sense to the parties involved in the transaction (except for the unsuspecting consumer and the ultimate investors left holding the bag). Let's look at the parties to the transaction. We have the mortgage originator (the broker or the lender or sometimes both) whose incentive was quite obvious. Simply put, the greater the house price, the larger the loan, the greater the fee they received from the transaction. (The same can be said for the investment bank). Sometimes the incentives are a little more complicated. Take for instance a homeowner

[3] For additional background on the development of the market that led to the mortgage crisis see Testimony of Julia Gordon before the House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit (March 11, 2009) available at: http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/gordon-testimony-3-11-09-final.pdf

whose existing mortgage is already 100% of the actual value of the home. If the real house value was used, no loan could be made, no product could be created. So the house value was increased to meet the loan purchasing parameters (the underwriting guidelines) set by the investment bank and the loan was made and everyone was happy (including the "unknowing" investment bank who had another product to slice and dice and sell to someone else).

As for the appraiser who creates the fraudulent value for the home, we've seen time and again why they went along with this fraud. Simply, if they actually wanted to stay in business and continuing doing appraisals, they created the value the mortgage originator wanted.

What we had left (by the millions), were consumers who had a mortgage that was worth far more than the real value of their home.

C. Yield Spread Premiums and Prepayment Penalties

Unfortunately (for me), I have been around long enough to hear multiple and ever-shifting explanations as to why yield-spread premiums ("YSPs") were an acceptable practice and why they work for consumers. I can safely state, that none of those arguments are true in the mortgage marketplace that actually exists in our country. I do however, fully understand why they work for every mortgage market actor except, again – of course - for the consumer.

When a mortgage broker is involved in the origination of a loan, the broker's fee is one of the larger "upfront" costs. Basically the yield spread premium is a type of mortgage broker fee that includes increasing the interest rate of the loan. Essentially, mortgage brokers get paid more if they produce mortgages with an interest rate higher than what a borrower qualifies for. Yield spread premiums incentivized mortgage brokers to push loans with unnecessarily higher costs and risky loan terms. The idea is that a borrower is supposed to be able to reduce or eliminate the upfront origination costs in exchange for paying this higher interest rate.[4] However, this rarely occurs. Often borrowers pay more not only on high interest rates, but also for broker's services and other closing costs.[5] When compared to similar loans, mortgage brokers receive about $800 to $900 more in additional fees for YSP loans than those without.[6] Unless a

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[4] *See* Center for Responsible Lending and National Consumer Law Center Amicus Curiae Brief in Support of Defendant Federal Reserve Board's Opposition to Plaintiff's Motions for Temporary Restraining Order and Preliminary Injunction, *National Association of Mortgage Brokers and National Association of Independent Housing Professionals, Inc., v. Board of Governors of the Federal Reserve System*, No. 1:11-cv-00506-BAH and No. 1:11-CV-00489-BAH, 7-8, (D.D.C. March 23, 2011) citing Howell E. Jackson and Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 Stan. J. L. Bus & Fin. 289, 338 (2007).

[5] See Center for Responsible Lending and National Consumer Law Center Amicus Curiae brief citing e.g. Susan E. Woodward, U.S. Dep't of Housing and Urban Dev., Office of Pol'y Dev. And Research, *A Study of Closing Costs on FHA Mortgages*, (2008).

[6] Center for Responsible Lending and National Consumer Law Center Amicus Curiae brief citing Jackson & Burlingame, Kickbacks of Compensation, 12 Stan. J. L. Bus & Fin. at 323.

mortgage broker actual lives up too their off-stated (but never written) commitment to serve in the best interest of their consumer client, their incentive – a bigger paycheck - to produce a loan with a YSP is clear. Same with the mortgage lender and investment bank, who now have a loan with a bigger interest rate to sell.

To make matters worse, almost any loan with a YSP is sure to have a prepayment penalty. In plain English, a prepayment penalty is a charge to a borrower who repays their loan "too soon," typically during the first few years of the loan's existence. What makes this product so cynical, and so closely intertwined with a YSP, is that the very existence of the YSP means that the consumer has an interest rate that is higher than they actually qualify for. Therefore, if the consumer acts rationally and shops for a lower interest and enters into a new mortgage, they will be punished with a steep prepayment penalty.

In all my years talking, interviewing, and representing consumers, I never met one consumer who actually understood that they were charged a YSP or that the YSP led to a higher interest rate than they were otherwise qualified for. I simply can't imagine how this practice was not deceptive or just plain unfair. Abuse of this practice increased the likelihood that loan originators will improperly steer consumers into risky and expensive loans. It was harmful not only to prospective homeowners but also to the soundness of the housing market.

D. The Disappearance of Escrow Accounts

Because the borrower has become the product to be created and sold, mortgage originators became experts at getting borrowers to take out loans that make little or no economic sense. A classic and pervasive practice in the all too recent mortgage market was the "promise" that a new loan would allow the borrower to pay a lower monthly mortgage payment. What the borrower was not told was that their new payment did not include their taxes and insurance (for escrow), so that their lower payment really was just a mathematical fiction (otherwise known as a lie).

E. Reckless Underwriting and the Rise of Community Endangering Loan Products

In place of an efficient market that provides real consumer choice and rewards consumers for smart credit decisions and rational aspirations, what we saw was a mortgage market that has recklessly created and sold risky mortgage products that excessively benefited all of the market players at the expense of the American consumer and our nation's communities. In a rational marketplace these loans made no sense. Looking at them however through the lens of a fundamentally flawed and previously unregulated mortgage marketplace, they unfortunately made perfect sense (at least at the time they were made).

Simply put, in order to meet the demand of voracious Wall Street investors, originators ignored basic, common-sense underwriting principles to boost their loan volume with new "exotic" mortgage products. Instead of the traditional 30-year fixed rate mortgage, no-doc or "stated-income" loans were created so loan originators could make more money (it was less work and they could charge borrowers a higher interest rate) and they fed the beast that wanted high-risk products that would produce a higher return for investors. Underwriting adjustable rate mortgages only at the initial interest rate, without considering how homeowners would be able to pay their loans once the payment adjusted upward, was also quite profitable for mortgage originators and the investment banks that were fed by them. These fundamentally unsustainable loan products, in all their derivations (including 2-28s and option ARMs) were destined for failure and failed they have and we still are living with the consequences.

In response to this crisis, Congress finally and belatedly took action, by passing the historic "Dodd–Frank Wall Street Reform and Consumer Protection Act" (Dodd-Frank). While I'm happy to and will address some of the important mortgage origination reforms created by this necessary and important law, the question before our panel today seems extremely premature as to the impact of both Dodd-Frank and reforms made or being contemplated by bank regulators. Simply, we really won't know how successful the law will be in creating a fair and honest mortgage marketplace until we have a fully functioning housing market. And unfortunately that won't happen until we effectively resolve the foreclosure crisis that continues to serve as an anchor on our housing market and on our overall economy.

The passage of Dodd-Frank

Beyond the creation of the Consumer Financial Protection Bureau (CFPB), I believe that the greatest impact Dodd-Frank will ultimately have is in its reform of the mortgage origination marketplace (once it's really functioning again). Of the problems I laid out earlier in my testimony, Dodd-Frank attempted to effectively address the key problems faced by consumers attempting to receive a fair and honest mortgage deal. Among the highlights:

1. Yield Spread Premiums Banned

The banning of yield spread premiums (YSPs) and other broker compensation based on the terms of a consumer's loan (except for the amount borrowed) may be the most important change to the mortgage origination landscape. No longer will mortgage brokers be allowed to benefit from steering consumers into loans with high rates or other terms lucrative for mortgage companies but harmful to consumers.

2. Forced Arbitration Clauses and Single-Premium Credit Insurance Banned;

While these anti-consumer provisions had been eliminated in much of the mortgage market, they still occasionally reared their ugly head in private label sponsored mortgages. Restoring a consumers right to hold mortgage banks accountable in court and finally putting an end to the abusive and costly practice of packing credit insurance on to a mortgage loan provide important protections for consumers.

3. *Limitation on Prepayment Penalties*

Another of one of the more abusive practices witnessed in the very recent mortgage market past, prohibiting prepayment penalties for subprime loans (as determined by a rate spread), adjustable-rate loans, and all loans that do not fit into "safe harbor" mortgages" should eliminate the problem of homeowners being trapped in expensive mortgage loans.

4. *The Ability-to-Repay Requirement*

Consumers were typically amazed (and appalled) when I explained that there was no federal law that prohibit mortgage originators from making loans that borrowers could not afford. Now that this has been remedied, I would hope that the mortgage industry would once again engage in fair and responsible underwriting of loans.

5. The expansion of HOEPA

Congress' original (and later the Federal Reserve Bureau's) definition of a high cost loan was simply too broad and allowed originators to make abusive loans that just skirted underneath the HOEPA defined limits. Through expanding the range of loans subject to HOEPA by lowering its triggers, by expanding the definition of points and fees and by creating a new trigger based solely on the timing or amount of prepayment penalties, and by adding important protections for consumers being sold a high-cost loan, the law provides consumers with much more robust protection from high cost loans.

6. Appraisal Reform

Phony appraisals were a source of great abuse and one of the reasons why so many homeowners today live with mortgages that exceed the value of their home. By imposing new restrictions on appraisals, including standards for appraisal independence and a prohibition on creditors extending mortgages if the creditor knows of a violation of these standards, the law took an important first step in protecting consumers from appraisal fraud.

7. The creation of "Safe Harbor" Mortgages

While the law, leaves the ultimate definition of "safe harbor" mortgages to the bank regulators it does lay out some extremely important guideposts. Among the standards that must be met for a mortgage to be "Qualified," the mortgage originator must document income and conduct an ability-to-pay analysis that considers taxes, insurance, and—for adjustable rate mortgages—the highest possible mortgage payment that could be required during the first five years of the loan. Additionally, to qualify for safe harbor status, loans generally cannot exceed thirty years and may not include negative amortization, a balloon payment, or points and fees exceeding 3%.

In an effort to hold investment banks accountable for the loans they help produce, the law also built in a 5% retention provision for these "securitizers" which can only be waived for loans that meet a substantive safe harbor at least as restrictive as the one described above (this is the Qualified Residential Mortgage standard that regulators are currently working on). Both the creation of an identifiably safe mortgage and a system where securitizers retain an interest in the mortgages they help create are extremely helpful to consumers looking to be treated fairly in the mortgage origination marketplace.

8. A Single, Integrated Disclosure

Dodd Frank requires the CFPB to create "a single, integrated disclosure" for mortgage transactions that combines the RESPA settlement statement and the mandatory TILA disclosures for mortgages. For more than a decade, federal regulators have struggled to createda fair and simple disclosure that gives consumers the essential information they need to both shop for a mortgage and then ultimately choose wisely for themselves. Each time HUD or the Federal Reserve attempted to develop a form that offered some promise for consumers, objections arose from various single-interest entities who feared that real, honest and consumer-friendly disclosures might hurt their bottom lines (i.e consumers would not choose their products or pay their inflated costs, if they actually understood what they were getting), and the effort failed.

This time, with a singularity of purpose, the CFPB has begun a fair and extremely open process to create a disclosure that actually meets the stated goals of RESPA and TILA, to help build a competitive mortgage market that allows informed consumers to actually shop for the best mortgage product. While the process has not yet been completed, we have been extremely impressed by both the empirical research conducted by the CFPB and the clarity and appropriateness of their initial disclosure prototypes. Of course, there is a long way to go in creating a final product, but it appears that the CFPB is well on its way to creating a binding TILA/RESPA integrated disclosure that will promote a fair, competitive and robust mortgage market.

Conclusion

Today, almost one year since the passage of the groundbreaking Dodd-Frank, our nation and hundreds of thousands of former and current homeowners, continue to struggle to right themselves. NACA strongly supports the mandates of Dodd-Frank whose greatest impact will be to reform the abuses in the mortgage origination marketplace. Homeownership remains a viable path to families building a positive economic future; many of the law's provisions, will safeguard minority, low and moderate income communities with the new consumer protection rules. NACA looks forward to the continued building of a strong watchdog agency in the Consumer Finance Protection Bureau.

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	**2. Organization or organizations you are representing:**
Ira Rheingold	National Association of Consumer Advocate

3. Business Address and telephone number:

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4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**
☐ Yes ☑ No	☐ Yes ☑ No

6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

7. Signature:

Ira Rheingold

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