Testimony of

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On Behalf Of the
National Association of Home Builders

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Mortgage Lending Reform: A Comprehensive Review of the American Mortgage System

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On behalf of the more than 200,000 members of the National Association of Home Builders (NAHB), I thank you for the opportunity to submit this statement on the issue of mortgage lending reform. My name is Joe Robson, and I am a builder and developer from Tulsa, Oklahoma, and the 2009 NAHB Chairman of the Board.

Overview

The housing market, the financial system and the economy's performance continue to reel from the impacts of the mortgage market excesses of earlier this decade. Soaring mortgage foreclosures and declining home prices are interacting in an adverse feedback cycle that shows no signs of diminishing. While the nation will continue to suffer these consequences in the months ahead, the mortgage system itself has already undergone radical reform and change.

The mortgage products and lending practices most responsible the current troubles are no longer in use. Federal and state banking regulators have taken significant steps to curb risky mortgage lending activities, establish sounder underwriting and loan management policies, and improve consumer information and safeguards. Congress has taken action to improve standards for and oversight of mortgage lending. In addition, the private-label securities market, which was the primary vehicle for exotic mortgages, has shut down as investors fled to safer havens, while the mainstream lenders have shifted to an extremely cautious posture. The pendulum, in fact, has swung back well past center so that mortgage credit is currently available only to those with unblemished credit histories who have resources to make a heavy downpayment on their home.

NAHB's members have supported steps to ensure that mortgage lending occurs in a safe and sound manner, with sound underwriting, prudent risk management and appropriate consumer safeguards and disclosure. Home builders and their customers, however, have been significantly impacted by the upheaval in the financial marketplace and, therefore, are highly focused on what might lay ahead. There is a great deal of uncertainty with regard to how the mortgage lending system will function when the housing and financial markets finally stabilize and return to more normal operation, and there is a deep concern that additional market dislocations will increase the depth and length of the current downturn. As Congress considers additional actions to avoid future mortgage lending problems, NAHB urges careful evaluation of steps already taken, ongoing market impairments and structural shifts in the housing finance system, and the immediate and longer-term impacts on the cost and availability of mortgage credit for qualified borrowers.

Changes in Mortgage Regulation

A host of anti-predatory legislative and regulatory proposals have been introduced, in addition to regulatory guidance, to reform and tighten mortgage lending requirements over the last several years.

Nontraditional Mortgage Guidance

On December 21, 2005, the federal banking agencies jointly issued proposed guidance expressing their supervisory concerns regarding nontraditional mortgages, especially those instruments with negative amortization such as interest-only and payment option mortgages. These mortgages typically provide borrowers low monthly payments during the first five years of the loan, but a higher loan balance and payments over the remaining 25 years of the loan. Regulators were correctly concerned that home buyers took out such loans, especially in high price appreciation markets, to purchase homes they could not otherwise afford and that they would be unable to meet the higher payments as interest rates rise and home values decline. On September 29, 2006, the agencies issued the *Final Interagency Guidance on Nontraditional Mortgage Products,* which was aimed at ensuring that these products are offered in a safe and sound manner and in a way that clearly discloses their risks and benefits to consumers.

Subprime Mortgage Lending Statement

On March 2, 2007, the federal banking agencies issued a proposed *Statement on Subprime Mortgage Lending* (Statement) to complement the *2006 Final Interagency Guidance on Nontraditional Mortgage Products*. The final Statement, which was issued on June 29, 2007, requires that lenders use the fully indexed, fully amortizing rate when underwriting a subprime mortgage loan. The Statement cautions against risk-layering features, including an expectation that stated income and low documentation loans should be accepted only if there are documented mitigation factors that minimize the need for repayment capability verification. In addition, borrowers should be allowed to refinance a loan within a minimum of sixty days of its reset period without incurring a prepayment penalty.

Prior to finalizing the Statement, financial institution regulators convened a summit on subprime lending on April 16, 2007. Participants included senior executives of regulatory agencies, lenders and secondary market firms. The federal banking regulators issued a *Statement on Working with Mortgage Borrowers* at a hearing before the House Financial Services Committee on the following day. That statement encouraged financial institutions to work constructively with residential borrowers who are financially unable to make their contractual payment obligations on their home loans. In the press release accompanying the final Subprime Statement on June 29, the regulators stressed that the final guidance reinforced their April statement, noting that workout arrangements are in the best interest of both financial institutions and mortgage borrowers.

The Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) endorsed both the guidance on nontraditional mortgages and the Statement on Subprime Mortgage Lending and developed their own model statements that state regulatory bodies could adopt at their discretion.

Mortgage Reform and Anti-Predatory Lending Act of 2007

Responding to the turmoil in the nation's subprime markets, the House on November 15, 2007, passed the *Mortgage Reform and Anti-Predatory Lending Act of 2007* (H.R. 3915) by a vote of 291-127. The bill, which seeks to curb abusive mortgage lending practices, would require lenders to make sure borrowers have a reasonable ability to pay back a loan; bring loan originators and mortgage brokers under a nationwide licensing registry; expand some limits on high-cost mortgages; and establish some legal liability standards for mortgage securitizers. Lawmakers also adopted provisions from separate legislation (H.R. 3837) sponsored by Rep. Paul Kanjorski (D-Pa.) that would establish federal standards for appraisers and would require lenders to establish escrow accounts for certain loans to protect borrowers against unexpected tax bills and insurance premiums. Finally, the bill would expand the definition and consumer protections for high-cost loans, prohibit prepayment penalties, provide protections for renters affected by single-family foreclosures, and establish new disclosure requirements for all loans.

Homeownership Preservation and Protection Act of 2007

In the Senate, *The Homeownership Preservation and Protection Act of 2007* (S. 2452), sponsored by Banking Committee Chairman Christopher Dodd (D-CT), was introduced on December 12, 2007. In general, S. 2452 established new protections for borrowers of subprime and “non-traditional” loans. It prohibits mortgage brokers from steering prime borrowers to more expensive subprime loans; creates a fiduciary duty between mortgage brokers and borrower; prohibits prepayment penalties and yield spread premiums for nontraditional loans; requires analysis by lender of the borrower’s ability to repay and determination that a subprime loan will provide a net tangible benefit a borrower.

Home Ownership and Equity Protection Act and Truth in Lending Act Regulations

On December 18, 2007, the Federal Reserve Board released proposed changes to regulations issued under the *Home Ownership and Equity Protection Act* (HOEPA) and the *Truth in Lending Act* (TILA) to better protect consumers and facilitate responsible lending. A final rule was approved on July 14, 2008. The rule prohibits unfair, abusive or deceptive home mortgage lending practices and contains borrower protections that are similar to those outlined in H.R. 3915 and S. 2452. The proposal would expand the range of loans covered by establishing a threshold for “higher-priced mortgage loans” (HPML). The rule's definition of HPMLs was intended to capture virtually all loans in the subprime market, but generally exclude loans in the prime market. To provide an index, the Federal Reserve Board will publish the "average prime offer rate," based on a survey currently published by Freddie Mac. A loan is an HPML if it is a first-lien mortgage and has an annual percentage rate that is 1.5 percentage points or more above this index, or 3.5 percentage points if it is a subordinate-lien mortgage. This definition overcomes certain technical problems with the original proposal that was based on a spread between mortgage and Treasury yields.

The Board established four consumer protections for HPMLs, including: (1) lenders would be prohibited from engaging in a pattern or practice of extending credit without considering borrowers’ ability to repay; (2) lenders would be required to verify borrower income and assets; (3) the use of prepayment penalties would be restricted (no penalty could apply for at least 60 days before any possible payment increase); and (4) lenders would have to establish escrow accounts for property taxes and insurance. For all mortgages, lenders would be required to increase mortgage loan disclosures. In addition, lenders would be prohibited from compensating brokers through yield-spread premiums unless there is a written agreement with the borrower that discloses such an arrangement, and lenders and brokers would be prohibited from pressuring appraisers for higher valuations.

S.A.F.E. Mortgage Licensing Act

Through the S.A.F.E. Mortgage Licensing Act (Division A, Title V of the *Housing and Economic Recovery Act of 2008*), states are encouraged through the Conference of State Bank Supervisors and American Association of Residential Mortgage Regulators to establish a Nationwide Mortgage Licensing System and Registry for residential loan originators. S.A.F.E. will cover all persons who take residential mortgage loan applications and offer or negotiate mortgage terms. The Act establishes minimum standards for licensing and registration. Licensees must demonstrate financial responsibility, character, and general fitness; complete pre-licensing educational requirements; pass a written test; and meet either net worth or a surety bond requirement. HUD is required to establish a backup licensing and registry system for the licensing and registration of loan originators for any state that fails to establish a state system within one year from enactment. The Act also requires Federal banking regulators to jointly establish a registry of loan originators for federally regulated bank and thrift institutions and their subsidiaries.

Forty-two state regulatory agencies have indicated their intent to transition into the CSBS/AARMR system and have committed to participating in the Nationwide Mortgage Licensing System (NMLS) which was launched on January 2, 2008 (all 50 states are expected to join the system). The NMLS is just one aspect of a multi-faceted plan being implemented by CSBS and AARMR to improve regulation and bring about greater uniformity across state lines in mortgage supervision.

Changes in Mortgage Market Conditions Since 2007

In the fall of 2007, when the House Financial Services Committee deliberated on H.R. 3915, mortgage markets were in disarray because of the turmoil in the subprime mortgage market that was beginning to spill over into the conforming and jumbo markets. As documented in the previous section, many steps have been taken by regulators since that time to rein in the mortgage origination practices that have ultimately resulted in record loan delinquencies and foreclosures.

In late 2007 and 2008, as private label investors realized that they had miscalculated the risks of the mortgage securities they were holding, valuation of these securities became difficult or impossible to determine. The investor backlash affected all mortgage products not backed by the federal government (FHA or VA loans) or the government-sponsored enterprises (Fannie Mae and Freddie Mac). First, the subprime market seized up, which then spread to Alt-A ARMs and the jumbo market – loans to credit-worthy borrowers with loan amounts greater than the conforming loan limit.

Higher Loan Limits Provide Limited Relief

In efforts aimed at adding liquidity to mortgage markets, actions by Congress[1] in 2008 increased the size of loans that could be held or securitized by Fannie Mae and Freddie Mac, insured by the Federal Housing Administration (FHA), and guaranteed by the Department of Veterans Affairs (VA). These changes have resulted in record volumes and increased market share for FHA and VA, however, overall purchase money mortgage market activity has continued to decline steadily. In addition, the jumbo mortgage market, which is funded by privately held securities, has failed to reappear for all but the most creditworthy borrowers – and then only at interest rates far above those for conforming loans.

Tighter Credit Underwriting Standards

Fannie Mae, Freddie Mac, and the private mortgage insurers have eliminated their lower-downpayment programs while tightening underwriting standards in the face of increasing loan delinquencies and defaults as well as corporate financial problems. Unlike Fannie Mae and Freddie Mac, which were placed into Conservatorship by the federal government in 2008, the private mortgage insurers are endeavoring to preserve their capital by withdrawing from all but their mainstream business lines and by tightening their standards in the segments of the mortgage markets they continue to serve. Mortgage credit standards are even tighter for prospective home buyers in areas such as Florida, where housing markets continue to be severely impacted by foreclosures and new homes that remain unsold two or three years following construction.

Foreclosure Moratoriums

As the end of 2008 approached and loan delinquencies continued to increase, Fannie Mae, Freddie Mac, and numerous loan servicers agreed to cease their pursuit of foreclosures in favor of placing greater emphasis on loan modifications and workouts. These efforts have continued into the first quarter of 2009. It is generally believed that the costs of foreclosure and its impact on families and neighborhoods are greater than the costs that are associated with efforts to modify or restructure loans in ways that allow homeowners to remain in place. Questions have been raised recently regarding the effectiveness of loan modifications, with some sources stating that up to half of the borrowers whose loans are modified will fail to meet the restructured obligations.

Administration Refinance and Modification Program

On February 18, President Obama outlined the multifaceted Homeowner Affordability and Stability Plan (the Plan) that is aimed at preventing millions of foreclosures. The Plan has three main elements: refinance program for borrowers with diminished equity, but current payments; a $75 billion loan modification program for struggling homeowners; and, steps to bolster Fannie Mae and Freddie Mac's support to the mortgage market. Details of the mortgage

[1] The Economic Stimulus Act of 2008 (Pub.L. 110-185), the Housing and Economic Recovery Act of 2008 (Pub. L 110-289), the Recovery and Reinvestment Act of 2009 (ARRA) (Pub. L. 111-5), and the Veterans' Benefits Improvement Act of 2008, (Pub. L.110-389).

refinance and modification initiatives were released on March 4 as the "Making Home Affordable" (MHA) program.

The Home Affordable Refinance program applies to conforming loans owned or guaranteed by Fannie Mae and Freddie Mac where the loan-to-value ratio has risen above 80 percent because of a decline in house value. Such borrowers have until June 10, 2010, to refinance to a lower interest rate mortgage if they are an owner occupant, current on their loan, and have a loan-to-value ratio no greater than 105 percent.

The Home Affordable Modification program builds on the loan modification protocol developed by the FDIC, where a loan is modified by reducing the interest rate, increasing the term and/or deferring/reducing principal payments, if such adjustments result in a better net present value for the mortgage investor than disposition through foreclosure. The goal of this program is to reduce homeowners' monthly mortgage payments to sustainable levels.

Of course, the effectiveness of these programs to stem the tide of defaults remains to be seen, as does their long-term effect on investors' willingness to return to the mortgage markets.

<u>Impact of Mortgage Lending Conditions on Home Builders</u>

Tighter Mortgage Lending Standards

NAHB's members and their customers have been significantly impacted by the mortgage market upheavals since 2007 and there is deep concern that the dislocations in the financing markets will increase the depth and length of the housing downturn.

In a recent NAHB survey, 68 percent of the home builders responding said that home buyers think it is hard to get financing to purchase new homes. Mortgage financing is also a significant barrier to greater sales of existing homes, which keeps current homeowners from being able to sell their homes in order to purchase a new home.

Single Family Appraisal Problems

NAHB is concerned that many appraisers have adopted an overly cautionary approach to valuation because of widespread criticism of overly optimistic appraisals as one cause of the current housing and credit crisis. NAHB's members have reported numerous instances of homes that failed to be appraised at the agreed-upon sales price or even the cost of construction. Depending on the degree of the appraisal shortfall, the home builder faces the decision of reducing the sale price or canceling the sale.

NAHB's members have in recent months frequently expressed concern that appraisers have often used sales of homes in foreclosure or other distressed circumstances as comparables for appraisals of new homes without having made the appropriate value adjustments. Properties that are used as comparables are not subject to the same degree of scrutiny as the subject property. In the case of new home appraisals, comparable properties are often older and, if involved in a foreclosure or distressed asset sale, may suffer from neglect and damage that would not be known unless the appraiser conducted thorough inspections. Unfortunately, most agencies require only cursory reviews of the condition of comparables, which means that appraisers may overlook damage and neglect and, as a result, insufficiently adjust the values of properties that are used as comparables. NAHB has asked Fannie Mae and Freddie Mac to review and reiterate their guidance to seller-servicers in this regard.

The concern about inappropriate choices of comparables or insufficient adjustments is frequently voiced by NAHB members in conjunction with observations that the appraisers in question are from outside of the area of the subject property and are working under contact with an Appraisal Management Company (AMC) at a level of compensation that is less than the prevailing rate in the area. Below-market appraiser compensation, when combined with short turnaround times, may mean that appraisers who perform appraisals for AMCs are the least experienced and therefore less competent to perform appraisals during these times of turbulent market conditions.

Appraisers bear the responsibility to "disclose the lack of knowledge or experience to the client before accepting the assignment" under the standards as promulgated in the Uniform Standards of Professional Appraisal Practice (USPAP).[2] While the foregoing requirement is very clear, it is not clear that the AMC has an obligation to inform the client that the appraiser lacks the appropriate level of knowledge regarding a market with which he or she may not be familiar.

Appraiser competence is also a concern. Most lenders require appraisers only to be licensed, which is minimum standard for appraisal practice. While many licensed appraisers produce quality work, those who are certified have met higher standards for education and experience. Section 1404 of the *Housing and Economic Act of 2008* (Pub.L. 110-289) no longer allows licensed appraisers to perform appraisals in conjunction with FHA-insured single family loans. After June 1, appraisers who choose to perform FHA appraisals will have to be certified.

Positions and Recommendations

NAHB supports and encourages continued mortgage market innovation to improve housing affordability and expand homeownership opportunities as long as such loans are prudently underwritten to ensure that the form of financing is appropriate for the borrower and market and consumers are fully aware of the features and risks of the loan. NAHB opposes predatory lending practices. NAHB has supported efforts of the federal and state banking regulators to issue guidance on nontraditional and subprime mortgage lending, although NAHB's support is conditioned on the regulators exercising care in the banking supervision/examination process to avoid unnecessarily reducing the flow of mortgage credit, limiting consumer mortgage options, or raising housing credit costs for qualified home buyers.

[2] Uniform Standards of Professional Practice 2008-2009 edition, Appraisal Standards Board, p.U-11

At its most recent board of directors meeting, NAHB adopted policy expressing the following principles for mortgage lending:

- Underwriting standards and decisions should be based on documented borrower credit and repayment capacity rather than expectations of rising collateral value.
- There should not be overly rigid adherence to loan-to-value limits that results in inappropriate rejections of creditworthy borrowers.
- Underwriting decisions should be based on mortgage quality and not driven by fee income.
- Mortgage brokers and lenders should be subject to adequate oversight.
- Mortgage originators, lenders and investors should have appropriate accountability and liability for the instruments in which they are involved.
- The process for mortgage securitization must be more transparent, providing adequate collateral and risk information for investors and regulators.
- Credit rating organizations must have adequate oversight and restrictions to ensure objective evaluations and avoid conflicts of interest.
- Appraisals should be undertaken by fully qualified individuals and should accurately reflect values under orderly market conditions.
- The appraisal system should not exacerbate price volatility.
- Distressed sales should not be used to determine value.

NAHB has also supported efforts to improve consumer education on financing and owning a home. NAHB provided financial support for and served on the board of the American Homeowner Education and Counseling Institute, which established and promulgated standards for home buyer education and counseling. NAHB has worked with the NAACP to improve the quality and flow of information for minority home buyers and with a unit of the Department of the Treasury on similar efforts.

NAHB believes it is important that efforts to ensure prudent mortgage lending and risk management practices as well as adequate consumer disclosures are comprehensive and uniform for all institutions and organizations that are involved in providing mortgage credit. NAHB also believes institutions' control systems should encompass both institution personnel and applicable third parties, such as mortgage brokers and correspondents. Further, institution compensation programs should avoid providing incentives that are inconsistent with prudent underwriting or that steer consumers to subprime loans to the exclusion of other products for which the borrower may qualify.

NAHB also believes that continued coordinated regulatory efforts among federal and state agencies is necessary to ensure prudent lending practices and effective consumer protections while facilitating efficient operation of the residential mortgage markets. Most importantly, any steps to reform mortgage lending practices should not include provisions that would inadvertently or unnecessarily disrupt the mortgage lending process, limit consumer financing options, or increase the costs or reduce the availability of mortgage credit.

NAHB offers two specific policy recommendations:

Federal Pre-emption – NAHB urges Congress to implement a clear national framework for mortgage origination standards to replace the current patchwork of state and local laws, which often lead unnecessary restrictions on mortgage credit. Specifically, Congress should establish a federal pre-emption statute creating essential uniformity in the mortgage market.

Arbitration – NAHB strongly supports the use of alternative dispute resolution techniques, including binding arbitration, as the most rapid, fair and cost effective means to resolving disputes. Invalidating binding arbitration provisions in contracts would undermine decades of jurisprudence strongly favoring arbitration of disputes where the parties have agreed to use the arbitration process. NAHB opposes any attempt to prohibit the use of pre-dispute arbitration in contracts.

Conclusion

Thank you once again for this opportunity to provide the home builder perspective on the issue of mortgage lending reform. The home building industry has been significantly impacted by the recent upheaval in the financial marketplace and, therefore, is highly focused on what may lay ahead. There is a great deal of uncertainly with regard to how the mortgage lending system will function when the housing and financial markets finally stabilize and return to more normal operation, and there is a deep concern that additional market dislocations will increase the depth and length of the current downturn. NAHB has supported efforts to ensure that mortgage lending occurs in a safe and sound manner and that abuses in lending practices be properly addressed. We look forward to working with this Subcommittee, and the full House Financial Services Committee, to ensure that any steps taken in this effort do not unnecessarily reduce the flow of mortgage credit during this time of extreme market turmoil. I welcome any questions you may have for me.