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Before the Board of Governors of the Federal Reserve System
Hearing On the Home Equity Lending Market

June 14, 2007

I would like to start by thanking Governor Kroszner and the Federal Reserve Board for holding this important hearing today and I appreciate the opportunity to participate. I am a Research Analyst at the Joint Center for Housing Studies of Harvard University, one of the Nation's leading sources of information and analysis on housing and market dynamics.

My testimony builds from two recently released reports that I co-authored with a Joint Center colleague, William Apgar. These studies explore mortgage market behavior and examine variation in the nature and extent of regulatory oversight of the various individuals and institutions that comprise the alternative mortgage delivery channels. These "Understanding Mortgage Markets" papers can be found on the Center's website.[1]

In my testimony, I will emphasize three principles for regulatory reform:

- Consumers have innate decision making weaknesses, and understanding these weaknesses may help us craft better regulatory strategies and market solutions.
- The current regulatory system is uneven, unfair and distorts the market. The Fed should use its existing authority or seek additional authority, where necessary, to apply reforms across all market players.
- The Fed should set minimum standards across mortgage channels and allow states to innovate. The Fed should be careful of delegating responsibility to the states, as they may not have the resources necessary for enforcement.

Foreclosures are on the Rise

The dramatic increase in mortgage lending- especially in nonprime lending – has brought with it a diverse array of new mortgage products. This growth has expanded access to credit to

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[1] Essene, Ren and William Apgar. 2007. *Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans*. Cambridge: Harvard University. Apgar, William, Amal Bendimerand and Ren Essene. 2007. *Mortgage Market Channels and Fair Lending: An Analysis of HMDA Data.* Cambridge: Harvard University. Available from: http://www.jchs.harvard.edu/understanding_mortgage_markets/index.html

consumers who have not traditionally been well served by the mortgage market. It has enabled millions of homeowners to tap accumulated equity to help meet their consumption and investment needs. Yet, as you have heard today, mortgage delinquencies continue to accelerate particularly in the subprime market, which makes up about seven percent of all homeowners. The share of subprime loans originated in 2000 and foreclosed as of May, 2005 was a distressing 12.9%- even though fewer were the riskier payment-option and interest-only product types and these loans benefited from falling interest rates from 2000 to 2003 and rising prices since 2000.[2] With the introduction of loans with riskier features, like deeply discounted 2/28 ARMs and interest-only payment schedules, the risks have multiplied for borrowers, lenders and investors alike.

Meanwhile, the American Housing Survey estimates that the number of homeowners with negative net equity is up to 13% among owners that had bought their home in the previous two years. With the real housing affordability crisis that exists across the U.S., some households are taking on debt that they have little or no capacity to repay, and increasing numbers of borrowers risk losing their homes to foreclosure. Although higher foreclosures within non-traditional products is not surprising, given that they are priced for greater risk and default rates, the level of these losses appears to be greater than expected by originators, investors and rating agencies alike. These higher than expected losses will therefore drive more mortgage companies into bankruptcy, and force others to increase their reserves against these losses.[3]

What We Know About Consumers

There is growing evidence that many families take out mortgages that (1) they do not understand or (2) are not suitable for their needs. Behavioral economics and market research suggest that consumers often make choices that may not be in their best interests and that they may later regret. Even the most sophisticated borrowers find it difficult to shop effectively in today's complex market. Therefore, the ability of many consumers to make informed choices is limited.

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[2] Joint Center for Housing Studies. 2007. *The State of the Nation's Housing: 2007*. Cambridge: Harvard University. 17-18. Available from: http://www.jchs.harvard.edu/publications/markets/son2007/index.htm
[3] Ibid. 3.

Consumer preferences are malleable, not fixed. Consumers often enter the market not knowing exactly what kind of mortgage they want or need, and therefore are vulnerable to outside influence. Their preferences depend on how choices are framed, and the context and order in which information is presented. Because of product complexity, consumers are often unsure of which product best meets their needs. Consumers tend to overweigh perceived short term savings and discount longer term expenses or risks, leading them to make choices based on their current circumstances instead of their long term best interest.

Consumers often lack awareness of mortgage prices. Given the complexity of loan pricing and the variation of loan features, many consumers have difficulty understanding alternative mortgage products. This mortgage pricing complexity makes it difficult for consumers to comparison shop. Consumer awareness is also limited by the lack of mortgage pricing transparency and the fact that obtaining a mortgage is an infrequent event. Furthermore, the pricing information consumers do receive often comes too late in the process to be helpful.

Consumers particularly struggle with choices that involve payments over time. Consumers have difficulty assessing future situations, including changes in house prices, interest rates and income. This multi-period decision making problem is particularly difficult to evaluate and "short cuts" methods often lead to costly mistakes. Consumers are often unable to determine what actual risks they face over time. When consumers make decisions they later regret, high transaction costs may make it difficult to correct this mistake.

Understanding the price of mortgage credit is clearly more difficult than it is for simple consumer goods. Unlike simple products that typically have a single price component, loan pricing is a combination of interest rates, points, fees, prepayment penalties, and other factors. Moreover, features such as interest rates and prepayment penalties vary constantly in response to changing economic conditions. This makes it difficult for consumers to track, no less learn how the various components of price relate to one another. High transaction costs limit the ability of consumers to make adjustments post purchase, even if they have learned that their original choice was flawed.

What We Know about the Market

Given these consumer decision making weaknesses, consumers are therefore strongly susceptible to outside influence.

Push marketing may exploit consumer weaknesses. Mortgage sales and marketing efforts may exploit various consumer decision making weaknesses. In particular, some mortgage market participants use their knowledge of consumer decision making tendencies to aggressively market specific mortgage products that may not be in the best interest of the borrower. While marketing communications often provide consumers with relevant information to make informed choices, some marketing and sales practices appear to cross the line. Instead of supporting informed choices, aggressive and misleading marketing can play on consumer fears and lack of knowledge.

The structure of the mortgage market creates additional challenges. The widespread use of mortgage broker and loan officer incentives that are linked to specific loan products and terms may result in consumers not obtaining the best mortgage for which they qualify. These incentives, designed to encourage mortgage brokers and loan officers to convince consumers to select specific and often higher-priced mortgage products, further stimulates aggressive "push marketing" efforts.

New "affordability" loan products pose significant risks. Many of today's nontraditional loan products seek to help prospective homebuyers overcome affordability barriers, or enable existing homeowners to utilize equity in their homes for a variety of purposes. Yet inappropriate marketing of these products can saddle low-income and low wealth individuals with mortgage debt that they are unable to pay, and in doing so simply worsen their economic circumstances.

The lack of uniform regulations distorts the market and is unfair to consumers. Historically, federal regulation has played a central role in efforts to promote fair and efficient market functioning by clearly and explicitly defining acceptable industry and consumer practices. For example, by imposing sanctions on those that fail to honor basic norms, well structured regulations have the capacity to protect the interests of not just consumers, but also lenders from the adverse effects of destructive business practices that some competitors may resort to in pursuit of market share. Therefore, creating uniformity aligns the industry with the goal of promoting access to good loans. Regulatory uniformity is critical to create a level playing field across the industry, and clear enforcement mechanisms are needed as well.

Unfortunately, existing federal mortgage market regulations have not fully adapted to the substantial changes in the mortgage industry that have occurred over the past quarter century. Changes include the rapid increase in non-bank lenders and mortgage brokers who largely operate outside of many key components of the federal regulatory structure. Indeed, since mortgage brokers and non-banks play a dominant role in the subprime market, the most vulnerable borrowers are less likely to benefit from federally mandated consumer protections that are generally present in the prime market. This lack of regulatory uniformity can distort market activity, as less regulated market segments exploit the advantage of reduced regulations over their more regulated competitors. Identifying new and innovative legislative and regulatory approaches to improving the efficiency and fairness of the nation's mortgage markets is critical.

POLICY IMPLICATIONS

The findings presented above suggest that industry leaders, advocates and government officials should work cooperatively to eliminate practices that take undue advantage of consumer's limitations in selecting the mortgage product that best suits their needs. The "Understanding Mortgage Markets" papers focus on a range of solutions such as helping the industry to strengthen its efforts to enhance their capacity to achieve best practices and eliminate the "bad actors," those industry participants who seek to gain competitive advantage by deploying illegal or unethical business practices.

The papers also suggest ways that consumer groups can assist consumers at the point of sale. These recommendations build from the proposition that consumer education alone is often not sufficient to counter aggressive marketing practices. This is especially the case in situations where incentives payments for loan officers and/or mortgage broker are linked to specific loan products and terms that result in consumers not obtaining the best mortgage for which they qualify. Instead, the recommendations may help guide consumers to "good loans", as defined below. For example, a third party advice system could provide a network of "trusted advisors" with interests aligned with the borrower's interest. A phone-based second opinion hotline could help consumers navigate through the complexity of both the mortgage process and products. The creation of an automated pricing guide would assist consumers working with a trusted advisor to understand the costs and benefits of specific mortgage options. Framing choices in terms consumers can best understand and enabling consumers to make choices that reflect their longer term interest would create an environment that guides consumers to "good loans."

While expanding the range of consumer assistance mechanisms can be helpful, the need undoubtedly remains to eliminate abusive and deceptive practices. The industry must have the will and the mechanisms in place to sanction or otherwise force out of the market those "low roader" participants unwilling to adhere to industry "best practices" and who engage in illegal or unethical business practices. In particular, push marketing practices that encourage borrowers to select mortgage products that they don't understand, have only limited ability to repay, and may come to regret later. Such practices not only take advantage of borrowers, they also threaten the safety and soundness of key elements of the national mortgage finance infrastructure. That has recently become only too evident in bankruptcies of major finance companies and the impact on investors.

Efforts must be expanded to guide consumers to "good loans." The idea of individual choice is a deeply held value in the U.S., yet "letting the consumer decide" has distinct limitations. Building on socially motivated CBOs and national scale organizations, it is important to affirmatively steer consumers to "good loan" choices that are transparent and fairly priced, that on net provide net benefit to the consumer and that do not expose a borrower to unexpected foreclosure and default risks. Essene and Apgar (2007) defined a "good loan" and specifically stated that "transparent" means consumers understand both the advantages and risks associated with a loan product, "fairly priced" means the loan is priced in a manner that is consistent with the underlying loan risks and costs of providing the loan, and "net benefit" means the loan is consistent with both the short and long-run interests of the consumer and that consumers have a reasonable prospect of being able to repay.

While much attention has focused on banning specific products and loan terms that may be inherently unfair, such as the past banning of credit life insurance, it is also important to focus attention on the process of mortgage lending itself. The industry will continue to innovate and create new products, and regulating specific terms may not keep pace with these innovations. Therefore, focusing on efforts to reform the mortgage process is an equally important strategy. For the purpose of my testimony today, I will focus primarily on the papers' recommendations that relate to regulatory changes.

Change disclosure regulations to <u>enhance consumer shopping</u>. Unfortunately, existing disclosure mechanisms all too often prove ineffective in preventing consumer abuse. In particular, the information that is needed to engage in informed shopping is often not provided in a timely manner, nor in a manner that consumers can incorporate readily into their shopping behavior. Expanded disclosures of prepayment penalties, lack of escrows, and stated income loans alone will not be sufficient, unless it is combined with efforts to allow the consumers to process this information by creating more time for the consumer to shop.

Lenders could be required to provide TILA disclosures, and these additional disclosure provisions, 3 to 7 days prior to closing and to extend the "right of rescission" period. By further modifying applicable TILA regulations, it would be possible to require "high risk" borrowers to seek a second opinion. Other useful changes include adding a requirement that the Good Faith Estimates (GFE) "go hard" earlier in the process and expanding efforts to monitor "bait and switch practices" that can render GSEs meaningless. Most importantly, matching these changes in disclosures with hands-on consumer assistance would provide the most relevant support to consumers.

Apply behavioral principles to <u>lead consumers to "good loans"</u>. Using the "opt-in/opt-out" principle and setting the default to the desired outcome can help consumer's obtain a "good loan" product. Today, subprime borrowers are typically offered mortgage products that make no provision for escrowing property taxes and insurance which is often not divulged to consumers. By starting with the default option of not including these items in the quoted "monthly payment," aggressive agents encourage consumers to focus on the lower initial payments. They often do not mention that this payment excludes property taxes and insurance. The result is that many borrowers end up in financial distress due to these large, one-time bills. Mandating the escrowing of taxes and insurance will help the consumer budget for these mortgage related expenses. Those borrowers who meet a certain set of criteria, e.g. lower income to housing expense ratio, could be allowed to "opt out" of this requirement, a feature that would still allow for mitigating circumstances of some borrowers.

Create a more <u>uniform regulatory environment</u>. Fundamental fairness suggests that the nature and extent of federal oversight and consumer protection should not depend on the details of which particular mortgage broker or loan officer takes the mortgage application, which particular retailer or wholesaler originates the mortgage, and which secondary market channel is tapped to secure the investment dollars that ultimately funds the loan. While distinct mortgage channels have a clear role to play in creating an efficient mortgage market, they should not influence access to consistent and fair regulations and oversight. Congress and the Federal Regulatory Agencies, in cooperation with consumer and industry representatives should take the following actions to establish minimum standards while allowing for states to innovate.

- **Recently released Interagency Guidance should be extended to cover non-banks**.

Since this Guidance generally only applies to federally-regulated deposit-taking institutions, the federal government should consider extending the guidance to all lenders, including non-bank independent mortgage companies.

- **The Federal Government should license brokers**.

Monitoring of the activities of mortgage brokers is largely a state function. Given that the nature and extent of state involvement in these matters varies widely, the Federal Government should assume responsibility for licensing and establishing minimum standards for acceptable mortgage broker behavior. The goal is to require that these standards apply evenly to all individuals (mortgage brokers and loan officers alike) and in so doing, reduce the state-by-state variation that now exists in access to basic consumer protections against broker abuse. Some states have passed licensing laws for mortgage bankers, mortgage brokers and mortgage loan officers. Any new regulation should be done in conjunction with these state efforts and not preempt good, existing state laws. Instead, it should allow for states to innovate. These state laws provide a framework for what an effective regulation system could become.

- **The Federal Government should support state mortgage market oversight activities.**

Absent expanded federal action, there is a clear role for individual states to insure that the new consumer protection measures embedded in the Guidance apply to all institutions and not just regulated financial institutions and their affiliates. To the extent that the Federal Government continues to delegate to the states the significant responsibility for regulating key elements of the mortgage market, it should provide targeted grants and other forms of assistance to support state enforcement and the monitoring efforts in these areas as well.

The problem of abusive mortgage lending cannot be ignored or dismissed as the misguided efforts of a few "bad apples." Rather these abuses are rooted in the structure of the mortgage industry itself, particularly the incentives offered to mortgage brokers and loan officers to market and sell loans. Identifying new and innovative legislative and regulatory approaches to improving the efficiency and fairness of the nation's mortgage markets is crucial. There can be no doubt that too many consumers are making ill-informed decisions by selecting mortgages products they will live to regret. The proposals presented here seek to combat the aggressive sales and marketing practices of some, while still recognizing the importance of involving consumers in important life choices.