

THE GREAT RECESSION'S MOST UNFORTUNATE VICTIM: HOMEOWNERSHIP

Robert M. Couch

Counsel

Bradley Arant Boult Cummings LLP

© 2013 Robert M. Couch. Rob Couch is a member of the Banking and Financial Services practice group at Bradley Arant Boult Cummings LLP. He serves as a Commissioner on the Housing Commission of the Bipartisan Policy Center, Washington, DC. Rob served as General Counsel of the U.S. Department of Housing and Urban Development (HUD) and as President of the Government National Mortgage Association (Ginnie Mae). His first tour of duty in government was as a law clerk to Hon. Lewis F. Powell, Jr., associate justice of the U.S Supreme Court. Rob is a former Chairman of the Mortgage Bankers Association of America. The author would like to recognize the invaluable contributions of Jennifer Gisi, and the assistance of Emily Ruzic and Nino Yu Tiamco to this article.

The Great Recession's Most Unfortunate Victim: Homeownership

CONTENTS

| | |
|---|----|
| Executive Summary | 1 |
| Introduction..... | 2 |
| Why Homeownership?..... | 7 |
| How Homeownership?..... | 10 |
| The Underwriting Process..... | 14 |
| Servicing of Mortgages..... | 22 |
| Trouble in Paradise | 24 |
| Government to the Rescue | 26 |
| Loan Servicing Out of the Shadows. | 39 |
| “So, we are out of the woods now, right?” | 48 |
| The New Normal for Losses | 55 |
| Time for a Change?..... | 70 |
| Conclusion | 78 |

TABLES

| | |
|---|----|
| Table 1 – Credit Scores by Percent of Population | 18 |
| Table 2 – Default Rate by FICO Score..... | 19 |
| Table 3 – Credit Score and LTV Characteristics of Fannie Mae Loans..... | 33 |

CHARTS

| | |
|--|----|
| Chart 1 – National Homeownership Rate: 1900 to 2013-Q2..... | 4 |
| Chart 2 – Cumulative Default Rates on Freddie Mac Loans | 56 |
| Chart 3 – Spread Between the FNMA 30-Year MBS Rate & the Actual 30-Year Rate | 68 |

EXECUTIVE SUMMARY

Taken as a whole, a disturbing picture emerges from recent reports on the state of the residential housing markets in the United States. That picture can be summarized as follows:

- Homeownership rates continue to plummet throughout the country.
- The deterioration in homeownership has been disproportionately severe on African-Americans, Hispanics, and younger people, leading to a widening of the gap in minority/white homeownership rates.
- Recent data have ratified the importance of credit scores and down payments in predicting loan performance.
- The trend towards tighter loan underwriting has been the major contributor in declining homeownership rates.
- Policymakers have taken a host of steps to protect homeowners from foreclosure, prevent future lending problems, and punish perceived bad actors.
- The combination of the evolving loan performance track record and the policy steps that have been imposed on the lending industry make it exceedingly hard for borrowers to get new loans.
- Efforts to protect borrowers who fail to pay their loans have the effect of compounding the losses from bad loans, thereby encouraging even more conservative lending, thereby hurting a much larger group of potential borrowers by depriving them of the opportunity to achieve homeownership.
- Policies need to change if we wish to continue making homeownership for the broadest group of worthy borrowers a reality in the United States.

INTRODUCTION

Anyone who has been lately to a church potluck dinner, or a child's basketball game, or a Rotary Club meeting has heard some version of these stories. The storyteller wants to refinance his mortgage to take advantage of the low interest rates he sees on the news, but his bank won't approve his loan only because he was laid off for three months a couple of years ago and missed a couple of payments. Or, a grown child, living in the storyteller's basement having graduated from college three years ago, finds the "perfect" starter home, but is unable to buy it due to a lack of credit history. Or, the storyteller has a neighbor down the block who has been living in his house for the past 2 ½ years without making any payments on his mortgage and the condition of the house has gone to the dogs.

While the economy officially moved out of recession back in 2009, and there are signs that the value of homes has begun to climb again, there is a widespread belief that changes in the marketplace have not worked to the benefit of average Americans who want to own the home in which they live. The belief is warranted. A spate of recent reports leads to the troubling conclusion that recent government efforts to cut struggling homeowners some slack may be hurting many more who would like to attain (or retain) the Dream of Homeownership.

Since the early twentieth century, the goal of homeownership has been almost synonymous with the American Dream. After all, any marketing pitch involving this subject is accompanied by an image, either real or imaginary, of a happy nuclear family sitting on the front steps of a modest, but neatly kept, home with a yard and a dog — in

short, model and content citizens, and not without some reason. Various studies have shown that homeownership comes with a multitude of benefits — homeowners have better health and increased educational attainment, and homeownership has been shown to correlate with more taxes paid, a higher voting rate, and increased family net worth.

Because of the real and perceived benefits of owning the place where your family lives, there has been a steady progression of governmental efforts to make this status achievable. Despite this longstanding national policy to encourage homeownership, however, a recent string of reports has presented some troubling news. These reports provide a disturbing picture of homeownership trends over the past several years and some clues about what is causing these trends. Taking a comprehensive look at the housing finance landscape leads one to the conclusion that many of the policies we are pursuing as a nation are having the unintended consequence of reducing the ranks of homeowners in the United States.

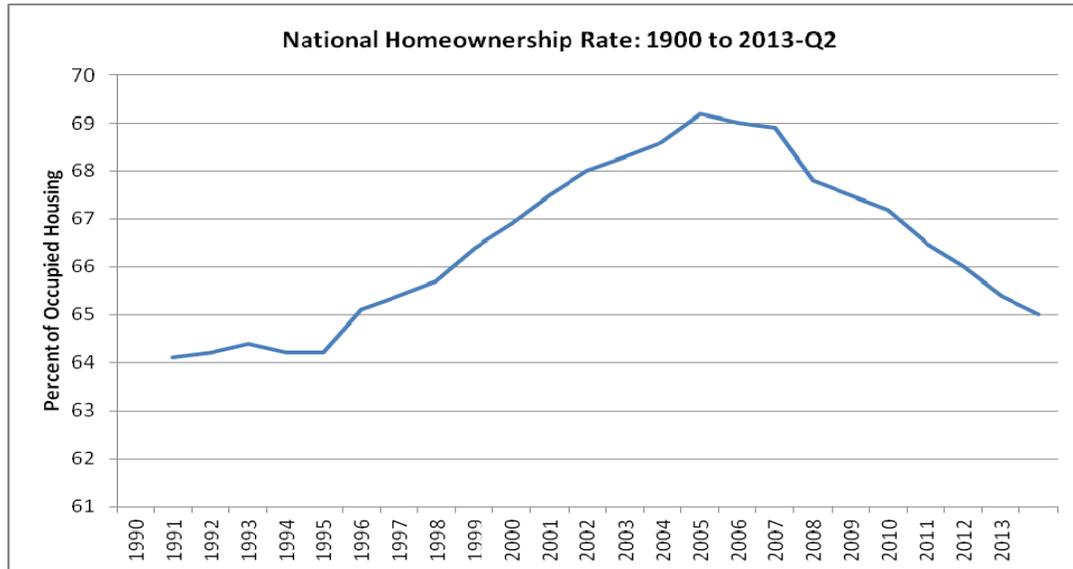
The primary disturbing report is from the Harvard Joint Center for Housing Studies.¹ In its annual report on the state of housing issued in June, the Joint Center describes a continuing, steady, and precipitous decline in the nation's homeownership rates. As shown in Chart 1, this trend began in 2006 and has continued, unabated, through the second quarter of 2013.² More troubling is that the trend is most pronounced within those demographic groups with the most ground to make up: African-Americans, Hispanics, young people, and first-time home buyers. The report goes further to attribute

¹ JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *THE STATE OF THE NATION'S HOUSING* (2013).

² Recent reports from the Census Bureau conclude that the trend continued in the second quarter of 2013. *Residential Vacancies & Homeownership in the Second Quarter 2013*, U.S. CENSUS BUREAU NEWS (July 30, 2013), <http://www.census.gov/housing/hvs/files/currenthvspress.pdf>.

much of the cause of the decline to increasingly stringent lending standards on the part of mortgage lenders nationwide.

Chart 1³



A second body of data came out in March and April of this year, when both Freddie Mac and Fannie Mae released loan level data on large pools of mortgages originated in 1999 through 2012.⁴ This release marks the first time data in this much detail has been made public by these Government Sponsored Enterprises (“GSEs”). It reveals details on a loan-by-loan basis of loan performance, as well as borrower credit information, at the time of origination. The data show a strong correlation among loan characteristics, such as credit scores, loan purpose, the appraised value of the collateral, and the track record of the borrower in paying the loan. The data also reveal that the

³ U.S. CENSUS BUREAU, Current Population Survey/Housing Vacancy Survey, Historical Tables, Tbl.14 (2d Quarter 2013).

⁴ *Single Family Loan-Level Dataset*, http://www.freddie.mac.com/news/finance/sf_loanlevel_dataset.html (last visited Sept. 6, 2013); Fannie Mae Single-Family Loan Performance Data (June 20, 2013), <http://www.fanniemae.com/portal/funding-the-market/data/loan-performance-data.html>.

correlation between marginal credit and/or excessive leverage at origination and poor loan performance grows stronger as property values decline in an economic downturn.

The third major releases occurred with the fourth and fifth progress reports of the Monitor of the \$25 billion settlement fund that resulted from the litigation brought by the federal government and forty-nine state attorneys general against five of the largest mortgage loan servicers.⁵ When examined in the aggregate, the performance of the five settling servicers as described in those reports shows overall compliance with a major restructuring of mortgage loan servicing systems throughout the country, as well as payments of billions of dollars to hundreds of thousands of borrowers who may or may not have suffered injury as a result of servicing practices.

The Monitor's reports immediately drew mixed reactions from policy makers. Many suggested that the few areas of non-compliance indicated a laissez-faire attitude on the part of servicers. Others focused on the dramatic progress made by the servicing industry in adopting practices that benefit defaulting borrowers. There is near universal agreement, however, on one point: the cost of administering a mortgage loan that has gone into default will increase dramatically in the years ahead. As a result, there are increasing incentives embedded in the servicing rules to make only loans that have the very highest probability of performing throughout their lives.

When all of these reports are viewed in the totality, a picture emerges. For the foreseeable future, it will be increasingly difficult for borrowers with less-than-stellar

⁵ *Final Progress Report*, OFFICE OF MORTG. SETTLEMENT OVERSIGHT (Aug. 22, 2013), <https://www.mortgageoversight.com/reports/final-progress-report/>.

credit or little money to invest in a down payment to qualify for a mortgage. In times past, the housing finance system might take a chance on a borrower who has average credit, or lacks an extensive credit history. That “benefit of the doubt” will no longer accrue, and it will be increasingly important for would-be borrowers to maintain good credit or repent from past payment sins and rehabilitate their credit scores. These consequences are accruing with very little consideration being given to what should be the appropriate level of delinquencies. As a nation, we are not grappling with the most fundamental issue: at what point does the desire to avoid foreclosures give way to the societal benefits that accompany homeownership?

The implication of all of this is far-reaching and troubling. African-Americans, Hispanics and low-to-moderate income families tend to have lower credit scores and less cash to inject into a home purchase. Accordingly, the new and stricter lending paradigm will be felt more by the borrower groups that historically have tended to have lower homeownership rates, thus widening a gap that has existed for years. Stated in other terms, well meaning promise keepers who are fully prepared to fulfill their mortgage obligations will pay the price for policies designed to ease the burden on those who have failed to comply with the terms of their home loans.

WHY HOMEOWNERSHIP?

Over the years, study after study has concluded that homeownership comes with a multitude of benefits well beyond the intangible pride and satisfaction that comes from being in control of an important circumstance of daily life. Although homeownership has associated costs and risks, homeowners generally enjoy substantial financial advantages. As a homeowner makes payments against his mortgage, and as the value of the property appreciates, the borrower's equity in the home increases. If necessary, this equity can be accessed through the sale of the home or through a "cash out" refinance or a revolving line of credit. Homeowners also enjoy tax benefits, as, in most cases, the annual interest paid on a mortgage and property taxes are fully deductible. Because of the development of the fixed-rate mortgage and the cap placed on adjustable-rate mortgages, homeowners are insulated from some of the inflationary pressures on the cost of housing faced by renters.

The importance of the possible wealth effect of owning your own shelter cannot be overstated. For the past thirty years, the wealth gap between the wealthiest citizens and moderate wealth families in the United States has grown steadily wider.⁶ Recent studies have reported that this widening has continued even as the country has begun to recover from the Great Recession.⁷ Households that are able to convert their greatest monthly living expense – rent—into a tax protected asset through amortizing long-term debt have

⁶ Arloc Sherman & Chad Stone, CTR. ON BUDGET & POLICY PRIORITIES, INCOME GAPS BETWEEN VERY RICH & EVERYONE ELSE MORE THAN TRIPLED IN LAST THREE DECADES, NEW DATA SHOW 2 (2010); *see also* Eric S. Belsky, JOINT CTR. FOR HOUS. STUDIES, HARVARD UNIV., THE DREAM LIVES ON: THE FUTURE OF HOMEOWNERSHIP IN AMERICA 3 (2013).

⁷ *Homeowners Benefits*, HABITAT FOR HUMANITY OF SAN ANTONIO, <http://www.habitatsa.org/about/benefits.aspx> (last visited Sept. 6, 2013).

a powerful tool for accumulating wealth. The family that owned its own home in 2010 had a median net worth of \$174,500, as compared to families who rented at \$5,100.⁸ Homeownership alone cannot solve all economic disparities, but it is an effective means of working toward that goal.

The benefits of homeownership extend beyond the financial ones. For instance, it has positive effects on the children of homeowners. Children who grow up in owned homes have higher academic achievement scores in both reading and math and have a 25% higher high school graduation rate than children whose parents rent.⁹ Children of homeowners are twice as likely to acquire some post-secondary education, and they are 116% more likely to graduate college.¹⁰ As adults, they earn more and are 59% more likely to own their own home, extending the benefits of homeownership on to the next generation.¹¹

Society as a whole also benefits from homeownership. Research has shown that homeowners are more likely to be satisfied with their neighborhoods, and thus are more likely to give back to their communities.¹² People who own their homes more often participate in civic activities and work to improve the local community, and they are 15%

⁸ Jesse Bricker, Arthur B. Kennickell, ET AL., BD. OF GOVERNORS OF THE FED. RESERVE SYS., 98 FED. RES. BULL. No. 2 at 18 (2012).

⁹ Homeowners Benefits, *supra* note 7.

¹⁰ *Id.*; Joseph M. Harkness & Sandra J. Newman, *Effects of Homeownership on Children*, Jun. 2003 FED. RES. BD. N.Y. ECON. POL. REV. 87, 92.

¹¹ Homeowners Benefits, *supra* note 7.

¹² *Id.*

more likely to vote.¹³ Lastly, they tend to have greater longevity in a residence, leading to a more stable neighborhood.¹⁴

The principal downside of homeownership is the lack of mobility that accompanies it. If the economy in the vicinity of the home undergoes stress and high unemployment, the owner is less able to pick up and move to a new area with more job opportunities. The stability that the home affords in good times can become an albatross in bad. Despite this glaring drawback, policy makers have long considered the benefits of homeownership to greatly outweigh the disadvantages.

¹³ *Id.*

¹⁴ *Id.*

HOW HOMEOWNERSHIP?

The most basic hurdle on the path toward buying a home is having enough cash to pay the agreed upon price of the home. An obvious solution to this problem is to borrow enough to cover the purchase price. Outside of the closest of friends and family, a potential lender is not likely to make such a loan unless it is reasonably certain that the borrower will pay it back. As a result, the borrower makes a solemn promise to pay back the loan, along with an additional amount to compensate the lender for the use of the money in the meantime, a.k.a. interest. The terms of this agreement are memorialized in a formal document called a promissory note.

But the purchase of a home requires a sizable sum of money, and, as a result, the loan to make the purchase may need to be commensurately sizable. A lender likely will not be inclined just to rely on the borrower's promise to repay such a large sum. It will require additional security to make the loan, and the most obvious form of security is the asset that is the subject of the transaction: the home.

The ability to pledge one's home as security for a loan goes back to the common law of England prior to colonization of North America. At their core, these laws provide that as long as a borrower pays his mortgage, he can stay in the home and enjoy the benefits of homeownership. If he stops paying his debt, the lender has the right to take the home, sell it, and apply the proceeds against the debt, returning any excess to the borrower. Because of the seriousness of this result, all of the states have laws that spell out the legal formalities that must precede foreclosure.

Up until the mid-1930s, homeownership in the United States was reserved for those with sizeable down payments or those who farmed their land.¹⁵ The low homeownership rate was perpetuated by residential mortgages that had short terms, variable interest rates, and required “balloon”, or lump sum, payments at the end of their terms. Large down payments and low loan-to-value (“LTV”) ratios were also common requirements for loans. As housing values fell after 1927 and deposits dried up during the Great Depression, banks that held mortgages refused to, or were unable to, refinance loans, causing thousands of borrowers to default. The period between 1931 and 1935 saw as many as 1,000 foreclosures per day nationwide.¹⁶

In response, the federal government created the Federal Home Loan Bank system in 1932. This new government-sponsored network served as a credit backstop and increased the amount of mortgage funds available to local financial institutions. In 1934, the government created the Federal Housing Administration (“FHA”), which helped standardize single-family mortgages by insuring only mortgages that met certain limits on principal obligation, interest rate, LTV ratio, and loan duration. In 1944, the Veterans’ Administration established a home loan guarantee program which helped military veterans and their families secure homeownership. These developments helped homeownership rates rise from 43.6% in 1940 to 55% by 1950.¹⁷

¹⁵ Kenneth A. Snowden, RESEARCH INST. FOR HOUS. IN AM., *MORTGAGE BANKING IN THE UNITED STATES, 1870-1940* at 59 (2013).

¹⁶ David C. Wheelock, *The Federal Response to Home Mortgage Distress: Lessons from the Great Depression*, FED. RES. BANK OF ST. LOUIS REV. May/June 2008 (Part I) 133, 138 (2008).

¹⁷ *Historical Census of Housing Tables*, U.S. CENSUS BUREAU (Oct. 31, 2011), <http://www.census.gov/hhes/www/housing/census/historic/owner.html>.

In 1937, Congress created the National Mortgage Association (“Fannie Mae”) to provide a secondary market for mortgage lenders to gain access to capital for FHA-insured loans. Fannie Mae became two separate entities in 1968. The new Government National Mortgage Association (“Ginnie Mae”) remained part of the government, and Fannie Mae became owned by private investors, although it continued to enjoy certain unique benefits provided by statute. In 1970, the secondary market grew with the creation of the Federal Home Loan Mortgage Corporation (“Freddie Mac”).

The 1970s saw the creation of the first mortgage backed securities (“MBS”) by Ginnie Mae. Soon Fannie Mae, Freddie Mac, private Wall Street firms, and large commercial banks began engaging in securitization, which took off in the 1980s. MBS allowed companies that originated mortgages an efficient method of pooling and selling groups of mortgages. The proceeds from the sale of the MBS could then be recycled into new mortgage loans. The expansion of MBS issuances catalyzed the integration of the mortgage market into the capital markets, thereby broadening the institutional base for mortgage funding. Also, by setting clear benchmarks for loans eligible for securitization, Ginnie Mae, Fannie Mae, and Freddie Mac helped improve the overall credit quality of the system.

The backing of the U.S. Government, whether real or implied, as well as the standardization of the securities, made MBS a popular investment for foreign investors, including sovereigns. Investment in U.S. MBS by China alone grew from \$100 million in

2002 to over \$100 billion by 2006.¹⁸ The growth and globalization of capital markets for mortgage-backed securities increased liquidity for these instruments and reduced interest rates, thereby making mortgages more affordable for millions of American families. These various developments led to a wide range of mortgage financing options not found in most other countries. For example, the most common mortgage product in the U.S. is the long-term, fixed-rate mortgage. This product provides cost certainty and protection from the risks associated with fluctuating interest rates; it is also relatively rare in other countries where shorter-term and variable-rate mortgages are the norm.

¹⁸ Alphonso Jackson, U.S. DEP'T OF HOUS. & URBAN DEV., THE GROWING IMPORTANCE OF FOREIGN INVESTMENT IN U.S. HOUSING MARKET: FOREIGN HOLDINGS OF AGENCY MORTGAGE-BACKED SECURITIES (2007), available at <http://www.hud.gov/content/releases/07-072table.pdf>.

THE UNDERWRITING PROCESS

Over the years, lenders have developed increasingly sophisticated criteria that have to be met before approval of a home loan. The process of determining the anticipated performance of a loan is referred to as “underwriting” the loan. Because every lender wants the amount lent to be repaid, with interest, the underwriting process is designed to predict, as of the date that the loan is made, the chances that the borrower will fulfill his promise to repay as memorialized in the note. Each lender determines how high the probability of repayment needs to be in order to make the loan. Because no one has a crystal ball and can foresee the borrower’s circumstances over the following thirty-year time span, no system is perfect.

When a lender considers making a loan, it does so only if it can earn a reasonable return on the money lent in light of the risk being undertaken that the money will not be paid back. This decision is a function not only of the stated return on the loan but also the degree of certainty that the loan will be repaid. No loan carries a 100% certainty of repayment. Unexpected events can occur. Historically, the top three reasons given for borrower non-performance are job loss, divorce, and health issues. No underwriting system can foresee such issues. However, different borrowers take their responsibilities to repay more seriously than others under all circumstances, and the likelihood of repayment increases. The lender’s objective is to gather enough facts to determine those borrowers who are most likely to repay the loan at the stated interest rate. Over the years, this decision making process has become more and more refined.

While not able to predict the future with certainty, lenders have attempted to develop systems to gauge the borrower's ability and willingness to repay their loans. For many years, lenders would rely on an evaluation of the four C's of lending: Credit, Collateral, Capacity and Character. Credit refers to the borrower's history of repaying his debts. The responsibility he has shown repaying prior debts, particularly other mortgage debt, is seen as an accurate indicator of how seriously he would undertake to repay a new loan.

Most of the large creditors in the United States, such as banks, mortgage servicers, credit card companies, and automobile financial companies regularly submit reports to credit reporting companies showing payment histories of borrowers who have accounts with these creditors. Credit reporting systems in the United States have become more and more sophisticated over the years. According to the Federal Reserve, the three major credit reporting agencies in this country gather information on credit transactions undertaken by over 225 million individuals.¹⁹ These agencies generate more than 1 billion credit reports on these borrowers each year.²⁰

The second underwriting criterion is Collateral. Since the debt is to be a secured loan, a determination has to be made as to whether the value of the collateral is sufficient to cover all, or a significant portion, of the debt in the event of a default. There are some relatively easy indicators of value, such as the price paid for the home and its assessed value on the tax collector's books, but most lenders require an arms-length appraisal of

¹⁹ BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT TO CONGRESS ON CREDIT SCORING & ITS EFFECTS ON THE AVAILABILITY & AFFORDABILITY OF CREDIT 14 (2007).

²⁰ *Id.*

the property to confirm the value. The lender then sets a maximum LTV percentage that determines the highest percentage of the value that will be lent against that property. The difference between the loan and the value of the home is the borrower's "equity" in the home. The higher the amount of equity, the lower the risk of loss to the lender in the event of a foreclosure. Also, the greater the amount of borrower equity, the more the borrower perceives he has "skin in the game" and, thus, the harder he will work to perform on his promise to repay.

A borrower may have the desire to repay a loan, and the loan may be adequately secured, but the debt may be so large in comparison to the borrower's income that the monthly payments are too overwhelming. Thus, the lender's underwriting criteria will take into account another factor: Capacity. There are two shorthand measurements of the borrower's capacity: the ratio of the new monthly mortgage payments to the borrower's monthly income, and the ratio of all of the borrower's monthly debt service, including the new mortgage, to his monthly income. The investor in the mortgage will set maximum levels for both ratios, and, absent other compensating factors (e.g. regular periodic bonuses), if the borrower exceeds one of the levels, he will not qualify for the loan.

Character is the most difficult criteria to define and measure, and it potentially may be misleading. The concept is used to determine whether the borrower is "good to his word." The concept harkens back to the days when most mortgage loans were made by small, community based savings institutions in which someone in the bank knew the customer personally and could make a judgment about the borrower's general propensity to live up to his obligations. Reliance on this criterion has steadily lessened over the years as lenders have grown in size and the underwriting of loans has been separated –

physically and figuratively – from the point where the loan is originated. Some allege that character lending, because it depends on non-quantifiable characteristics, may result in impermissible discrimination against some groups of potential borrowers. For these reasons, subjective decisions about character have been replaced by much more objective criteria measuring willingness and ability to repay.

One of the most important developments in loan underwriting has been the establishment, refinement and acceptance of numerical credit scores. The use of a numerical index as a shorthand indicator of creditworthiness has been around for decades, but credit scores gained widespread acceptance with the development of FICO scores by the Fair, Isaac and Company in the late 1950s. The use of credit scores in the mortgage underwriting process became standard practice in the 1990s. Today, all of the nationwide credit-reporting agencies make available to their subscribers a single number for virtually every borrower. This number attempts to gauge the likelihood that the borrower will repay his debt. In its report to Congress on credit scoring in 2007, the Federal Reserve concluded, “The available evidence indicates that the introduction of credit-scoring systems has increased the share of applications that are approved for credit, reduced the costs of underwriting and soliciting new credit, and increased the speed of decision making.”²¹

The exact formulas used and the weights assigned to individual factors vary by company, but generally include the borrower’s history of payment on mortgage, credit card, utilities and other consumer debts. The score also takes into account the maximum

²¹ BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 19 at O-4.

amount of credit available under approved revolving credit facilities, such as home equity lines of credit and credit cards, and the current outstanding balances on those lines. The credit score attempts to determine whether the borrower's needs for credit are accelerating by measuring whether there have been other recent inquiries into the borrower's credit history by other lenders.²²

The refinement of credit scores allows the industry to look at the overall general population along a continuum. Based on raw credit scores, individuals in the United State who have such scores break down roughly into the percentages shown in Table 1.

Table 1 – Credit Scores by Percent of Population²³

| FICO Score | Percent of Population | Cumulative Percent of Population |
|-------------------|------------------------------|---|
| 800 or More | 13% | 13% |
| 750-799 | 27% | 40% |
| 700-749 | 18% | 58% |
| 650-699 | 15% | 73% |
| 600-649 | 12% | 85% |
| 550-599 | 8% | 93% |
| 500-549 | 5% | 98% |
| Less than 499 | 2% | 100% |

Stated another way roughly 40% of the population has credit scores greater than 750, and the median credit score for an individual in this country is 720.²⁴ But the

²² The use of credit scores has been criticized by some as failing to take into consideration other non-traditional indicators of creditworthiness. For instance, recent immigrants may have paid monthly rents steadfastly to landlords who were not required to report these payments to the credit reporting agencies. In such instances, the borrower may not have a credit score, or the credit score may not reflect this important set of data bearing on the borrower's propensity to pay regularly for shelter. In recent years, many lenders have established separate programs to serve such borrowers, but such programs entail more manual and costly underwriting, and data to support non-traditional underwriting criteria is relatively sparse.

²³ BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 19 at 133 t.1.

²⁴ *Id.* at 27.

likelihood of default does not match the dispersion of credit scores. According to data from a 2007 Federal Reserve report, based on loans originated in 2000 and 2001, defaults on new loans two years after their origination increase exponentially as the credit score of the borrower at the time of origination falls, as the data in Table 2 illustrates:

Table 2 – Default Rate by FICO Score²⁵

| FICO Score | Default Rate |
|-------------------|---------------------|
| 720 or more | 1.0% |
| 680-719 | 4.4% |
| 640-679 | 8.9% |
| 600-639 | 15.8% |
| 560-599 | 22.5% |
| 520-559 | 28.4% |
| Less than 520 | 41.0% |

The Federal Reserve study cited above was conducted during a relatively robust time in the nation’s real estate markets. Thus, during periods of rising home value, borrowers who are firmly in the middle of the credit spectrum are four times as likely to default on their mortgage loan as the third of the population with the best credit scores. Borrowers with the lowest scores make up 25% of the population, but are twenty to forty times more likely to default than those in the top 25%. The conclusion from this data is that, during “normal times”, relatively small decreases in credit scores of potential borrowers dramatically increase the likelihood that such borrowers will default on their mortgage obligations. Viewed from a different perspective, however, while borrowers

²⁵ *Id.* at 133 t.2.

with scores between 640 and 720 are riskier than those above 720, more than 90% of that group of higher risk borrowers will perform as agreed.²⁶

The recent release of loan level data by Fannie Mae and Freddie Mac reconfirm the conclusions in the 2007 Federal Reserve study. That data includes loss experience after the collapse of the real estate industry in 2007. According to an analysis of the Freddie Mac data by Amherst Securities, the data show that the correlation between the rapid rise in defaults as credit scores decline gets more pronounced during periods of house price deflation.²⁷ One contributor to this rise is the tendency of borrowers to walk away from their collateral when the value of the property falls below the outstanding balance of the mortgage. Such borrowers are referred to as being “under water,” and the further under water a loan is, the more likely the borrower is to give up the struggle to make his payments if funds become tight. Some borrowers who can afford to pay in such circumstances choose not to—a practice known as a “strategic default.” Increases in defaults frequently are exacerbated by the fact that loss severity grows during such

²⁶ The traditional underwriting methods as enhanced with credit scores were further modernized in the 1990s with the introduction of automated underwriting systems by Fannie Mae and Freddie Mac. These systems attempted to combine objective data regarding a borrower’s ability, willingness, and capacity to pay into an automated system that would produce underwriting decisions quickly and remove as much subjectivity as possible from the process. Soon after introduction, most of the large nationwide lenders had taken the basic Fannie and Freddie models and customized them for their own proprietary loan products, as well as FHA and VA loans. Eventually, the FHA came up with its own automated underwriting system as well. While no system is perfect, the hope was to develop a system that could most accurately measure the quality of the loan application. Lenders began to increasingly rely on these automated systems to process their loans. These automated decisioning engines also allow for more sophisticated pricing of loans requiring riskier loans to bear higher interest rates or greater fees.

²⁷ Laurie Goodman ET. AL., *A First Look at Freddie’s New Loan Level Credit Performance Data*, AMHERST MORTG. INSIGHT, Mar. 25, 2013 at 4. The correlation described above would be even more pronounced if all loans were included. However, both the Fannie Mae and Freddie Mac data only include thirty-year fixed-rate mortgages with full documentation and expressly exclude non-traditional loans with more risky characteristics. FANNIE MAE, FANNIE MAE SINGLE-FAMILY LOAN PERFORMANCE DATA GLOSSARY 1 (2013); FREDDIE MAC, SINGLE FAMILY LOAN-LEVEL DATASET: GENERAL USER GUIDE 4 (2013).

periods simply because the foreclosure sale brings in lower proceeds when house values decline.

SERVICING OF MORTGAGES

Servicers are another key player in the borrowing process, although they generally have maintained a low profile. Historically, the servicing of a mortgage loan has taken place behind the scenes with little or no attention from the press, policy makers, or regulators. As long as delinquencies and foreclosures stayed low, they were able to avoid the limelight. This behind-the-scenes status changed dramatically during the recent financial crisis.

A mortgage loan servicer performs several basic functions. After a loan is closed, the servicer takes control of the file containing the basic loan documents, including the note memorializing the borrower's promise to repay the loan, and the mortgage document that specifies under what circumstances the servicer can seize and sell the borrower's home to satisfy the borrower's obligations. The servicer gives notice to the borrower as to how and where to make his monthly mortgage payments. As the payments are made over the years, the servicer keeps records of the loan and the amount still owed. If the borrower misses a payment, the servicer sends a reminder. In the event that the reminders go unheeded, the servicer has the responsibility of providing notice of impending foreclosure and then following through with public notice, seizure, and sale of the home where necessary.

Typically, the servicer will perform a few other functions to insure that the value of the collateral for the loan—the home—is maintained. The most common example is the collection of monthly escrow payments used to pay the property taxes and casualty

insurance premiums on the property.²⁸ In the event that the originating lender did not require that escrows be collected, the servicer monitors the status of taxes and insurance on the property. If those expenses have not been paid, the servicer has the obligation to pay the taxes or place insurance coverage on the property. In such cases, the amounts the servicer advances on behalf of the borrower are typically added onto the balance of the loan.

²⁸ If the loan originator required the borrower to purchase mortgage insurance, the servicer may also pay those premiums out of the monthly payments as well.

TROUBLE IN PARADISE

In the early 2000s, conditions seemed ideal for Americans to realize the dream of homeownership. Mortgage interest rates were relatively low, investors seemed to have an unquenchable appetite for loans, and originators were highly motivated to produce the loans. Banks and other lenders made it easy to qualify by loosening credit standards and creating new loan types that had fewer requirements to verify borrower information. Home values increased steadily and, in some parts of the country, rapidly. While the homeownership rate hovered steadily around 64% from the late 1960s through 1994, it rose steadily for the next decade and reached an all-time high in the United States of 69.2% in 2004.²⁹ Minority homeownership also reached new highs during this same period.

The rise in ownership levels was accompanied by increased access for the owner to his equity in the home. In addition to monthly incremental increases in equity caused by the normal amortization of the outstanding principal balance of the loan (for loans requiring monthly principal payments), the rapid increase in property values in many locales caused a rapid increase in the value of the ownership stake in the home. The mortgage industry developed or refined many products that provided fairly quick and easy ways to extract the borrowers' equity in the home ranging from streamlined, cash-out refinances to home equity lines of credit. The combination of easy access and borrower perception that rising values would quickly replenish "used" equity led to

²⁹ U.S. CENSUS BUREAU, *supra* note 3.

persistently low equity cushions in homes despite fairly dramatic increases in home values.

Beginning in 2006, home price appreciation in many areas slowed and then peaked. As prices began to level out, speculators in single-family homes began to exit the market putting downward pressure on prices. Borrowers who had attempted to extract the maximum amount of equity from their homes began to find that their loan balances exceeded the value of the home they had purchased. Without rapidly increasing values, other borrowers who may have relied on increasing home prices to allow them to sell homes or refinance them to relieve pressure could no longer take advantage of this option. As a result, mortgage delinquencies began to increase in 2006. As those delinquencies became more and more acute, foreclosure inventories, or the number of homes in the foreclosure process, throughout the country began to increase as well.

By early 2007, the foreclosure inventory had increased by almost 50% over historic levels.³⁰ By the end of that year, foreclosure inventories had more than doubled over their year-end 2006 levels.³¹ By that point the mortgage contagion had spilled over into the broader economy. By March 2009, the Dow Jones Industrial Average had fallen steadily by 54% from its highs in the fall of 2007.³² The economic slump caused decreases in the home price index to accelerate. Falling home prices led to more delinquencies and more foreclosures. By December 2009, loans in foreclosure, which

³⁰ Polly D'Avignon ET. AL., *We Didn't Listen: A Timeline of Facts, Projections & Voices From the Past Few Years As the Worst Was Going Down*, HOUSINGWIRE, Apr. 2010, 56-59.

³¹ *Id.*

³² Christina Rexrode, *The DJIA, Oct. 7, 2007: Then vs. Now*, CHI. SUN TIMES, Mar. 5, 2013, <http://www.suntimes.com/business/18655355-420/the-djia-oct-7-2007-then-vs-now.html>.

stood at about 110,000 units in December 2006, were up to 350,000 units, an increase of almost 220%.³³

³³ Daren Blomquist, *A Record 2.8 Million Properties Receive Foreclosure Notices in 2009*, REALTYTRAC, <http://www.realtytrac.com/landing/2009-year-end-foreclosure-report.html> (last visited Sept. 10, 2013); *U.S. Foreclosures Decrease 9 Percent in December*, REALTYTRAC, Feb. 9, 2007, <http://www.realtytrac.com/content/press-releases/us-foreclosures-decrease-9-percent-in-december-2006-2151>.

GOVERNMENT TO THE RESCUE

The Melt-Down in the real estate industry quickly resulted in remedial action at all levels of government: federal, state and local. Poor timing amplified the repercussions of the unraveling of the residential real estate market as it dragged the broader market into the most serious recession since the Great Depression. The succession of widely publicized failures on Wall Street and the emergency entrance of Fannie Mae and Freddie Mac into conservatorship occurred as a presidential election year kicked into high gear. Both political parties at every level saw a need to propose, and, if possible, enact solutions to address real and perceived problems. The various efforts on the legislative and regulatory front can be broken into three broad groups: steps to protect and promote struggling homeowners, steps to “fix” the system to prevent future recurrences, and steps to punish those deemed to be at fault for causing the problems in the first place.

Congress acted with uncharacteristic speed to help those who already had homes and mortgages. In July of 2008, Congress passed the Housing and Economic Act of 2008. That legislation was followed in October of the same year by the Emergency Economic Stabilization Act (“EESA”). Soon after the passage of EESA, and using funds authorized by it, the Treasury Department began injecting massive amounts of capital into the economy through the Troubled Asset Relief Program (“TARP”). The most visible use of funds authorized by TARP were injections of capital into financial institutions to provide sufficient capital to prevent a collapse of the banking system, but TARP also authorized use of sizable amounts of money to help those homeowners who were deemed to be overburdened by debt.

Empowered by the new legislation and existing powers, housing agencies created or adapted a string of programs to provide relief. The first such effort was the “Hope for Homeowners” (“H4H”) program created in the waning days of the Bush Administration. It provided the opportunity for borrowers to refinance into FHA loans at reduced payments provided they would share with the government future appreciation in the value of their home. After many tweaks in the program and millions of dollars of development fees, by the time it was suspended in 2011, the H4H program had resulted in less than 600 loans nationwide.³⁴ Despite these lackluster results, the basic concepts behind H4H were applied to “new and improved” programs.

Soon after his election, President Obama shepherded through the Homeowner Affordability and Stability Plan (“HAMP”) using more funds approved in the TARP. To date, more than 1.25 million loans have been modified under HAMP.³⁵ An outgrowth of HAMP was the Home Affordable Refinance Program (“HARP”). The combination of these plans allowed borrowers to refinance their Fannie Mae or Freddie Mac owned or guaranteed loans into GSE loans with more affordable payments. The conceptual appeal of these programs increased substantially in November 2008, when the Federal Reserve

³⁴ Brian Collins, *FHA’s H4H Program Ending Soon with Disappointing Results*, NAT’L MORTGAGE NEWS, June 30, 2011, http://www.nationalmortgagenews.com/dailybriefing/2010_379/h4h-program-ending-soon-1025487-1.html?site=default_on.

³⁵ In contrast, servicers have delivered more than 5.4 million proprietary loan modifications to U.S. borrowers during the same time period. According to the Obama administration, government modifications exhibit lower delinquency and re-default rates than industry modifications. However, this can be attributed to the fact that government modifications focus on principal reduction, while proprietary modifications focus on offering fixed rates and reduced principal and interest monthly payments. Writing down a large amount of the principal on a loan may be the simplest way to make it more affordable for homeowners, but having the government re-write mortgage contracts causes increased uncertainties and losses to the industry, which will be passed down to consumers through the form of more expensive mortgages and tightened credit. HOPE NOW, *Industry Extrapolations & Metrics 5* (Aug. 2013); Christina Mlynski, *Foreclosure Programs Aid 1.6 Million Homeowners: Obama Scorecard*, HOUSINGWIRE, June 7, 2013, <http://www.housingwire.com/articles/foreclosure-programs-aid-16-million-homeowners-obama-scorecard>.

announced its Quantitative Easing Program to lower long-term rates by purchases of assets, principally mortgage-backed securities, in the open market.

Despite the appealing characteristics of a HARP refinance, few borrowers took advantage of the program. Conversations with mortgage originators revealed that the lenders were slow to offer the program as an alternative to borrowers for fear that, if the borrower defaulted on the new loan, the GSEs would require the lender to repurchase the loan. In September of 2012, FHFA announced changes to the HARP program that, in effect, gave assurances to the lending community that loans that met the HARP guidelines would be insulated from repurchase requests. After that announcement, the volume of loans running through the program increased dramatically, and through August of 2013, almost 2.9 million loans have been refinanced under it.³⁶

Congress also attempted to use the Internal Revenue Code to help the housing market and attempt to reverse falling home values. In July of 2008, Congress enacted the First Time Homebuyer Tax Credit that provided up to \$7,500 of federal income tax relief to those who purchased their first homes. The credit was later increased to \$8,000, and it was extended past its original expiration date of April 2009 multiple times. The numbers indicate that the tax credit did generate some activity in the housing markets, but that activity subsided quickly after the credit expired.³⁷ In fact, some studies have concluded that the credit mostly accelerated purchases that would have taken place anyway and, as a

³⁶ FED. HOUS. FIN. AGENCY, REFINANCE REPORT 3 (Aug. 2013).

³⁷ Karen Dynan, Ted Gayer, & Natasha Plotkin, AN EVALUATION OF FEDERAL & STATE HOMEBUYER TAX INCENTIVES 13-14 (2013).

result, home sales in the months following the expiration date of the credit were depressed due to the artificially high level of closings in the second quarter of 2010.³⁸

During the months and years following the enactment of HERA and EESA, a series of programs were enacted and funds set aside for a variety of relief efforts. They included the Neighborhood Stabilization Program (\$6.92 billion), HFA Hardest Hit Fund (\$7.6 billion), the Emergency Homeowners Loan Program (\$1 billion), and the FHA Short Refinance Option. These efforts were augmented by a variety of administrative changes in federal loan programs, including loss mitigation rules at FHA, and foreclosure procedures mandated by Fannie Mae and Freddie Mac. State and local authorities got into the act with a host of efforts intended to provide relief for homeowners ranging from foreclosure moratoria to property tax abatements.³⁹

While policymakers at every level have been active in their attempts to help those struggling to keep their homes during hard times, they have also been intent upon making sure that the mistakes of the past do not recur. On the “fix the system” front, the most far-reaching piece of legislation has been the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted in 2010. As it applies to the mortgage industry, the Act generally

³⁸ *Id.* at 9-10.

³⁹ Several state and local authorities have considered applying the law of eminent domain to underwater mortgages. This has been a hotly debated issue. Recently, the City of North Las Vegas, Nevada rejected the use of eminent domain while the City of Richmond, California has announced it will move forward with the policy and split the profits from the refinancing with a private contractor. REUTERS, *Richmond, California Banks Plan To Use Eminent Domain To Help Underwater Borrowers*, HUFFINGTON POST BUS., Sept. 11, 2013, http://www.huffingtonpost.com/2013/09/11/richmond-california-eminent-domain_n_3905885.html. Federal authorities have acted to discourage the use of eminent domain. HUD has expressed its position that any new mortgage created through eminent domain efforts may not qualify for FHA insurance while the FHFA has released a statement providing it may direct the entities it regulates to cease business activities altogether within jurisdictions that use eminent domain to restructure loans. U.S. DEP'T OF HOUS. & URBAN DEV., Letter to Representatives Royce, Miller & Campbell (Aug. 12, 2013); FED. HOUS. FIN. AGENCY, FHFA STATEMENT ON EMINENT DOMAIN (Aug. 8, 2013).

attempted to rein in non-traditional mortgage lending. The act created two new concepts: the Qualified Mortgage (“QM”) and the Qualified Residential Mortgage (“QRM”). In creating the QM, Congress hoped to legislate that any mortgage loans outside the traditionally underwritten and verified loan characteristics would be subject to strict ability to repay rules. In January of 2013, final regulations to interpret the “Qualified Mortgage” provisions of the Dodd Frank Act were adopted. Those regulations become effective in January 2014 and will provide a limited “safe harbor” from some challenges to foreclosure for loans that meet certain criteria that are designed to assure that the borrower has the ability to repay the loan.⁴⁰ There are differences in opinion as to whether or not the effect of that QM definition will be to further restrict lending outside the safe harbor provided by those rules.⁴¹ In creating the QRM, Congress intended to require that lenders keep some capital at risk for credit losses for the life of the loans. In August of 2013, the six federal agencies charged with defining a QRM under Dodd-Frank

⁴⁰ Under the CFPB’s new rules, in order to “qualify” for the safe harbor as meeting the “ability to repay” requirements, a mortgage cannot: i) have a debt-to-income ratio greater than 43%; ii) have negative amortization; iii) be interest only; iv) have balloon payments; v) extend beyond thirty years; or vi) have limited or no documentation. Ability-to-Repay & Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6408, 6506-07 (Jan. 30, 2013) (to be codified at 12 C.F.R. § 1026.43(e) (1-2)). The safe harbor becomes only a rebuttable presumption, offering less legal protection for lenders, at greater than 1.5% over the Average Prime Offer Rate (APOR). *Id.* at 6506, 6510.

⁴¹ As evidence that lending will be restricted, the Mortgage Bankers Association recently reported that the Mortgage Credit Availability Index decreased 0.7% in August and another 0.7% in September, an indication that lending standards are tightening. The report attributes the decrease to the beginning of QM implementation, noting that it was driven by a decrease in loans with features that fall outside the QM definition, such as loans with terms exceeding thirty years and interest-only loans. *Mortgage Credit Availability Declined in September*, MORTG. BANKERS ASS’N (Oct. 8, 2013), <http://www.mortgagebankers.org/NewsandMedia/PressCenter/85911.htm>. The federal banking agencies have released a statement acknowledging that some lenders may choose to originate all or predominately QMs when the rule takes effect and confirming that doing so would not violate fair lending standards. CONSUMER FIN. PROT. BUREAU ET. AL., INTERAGENCY STATEMENT ON FAIR LENDING COMPLIANCE & THE ABILITY-TO-REPAY & QUALIFIED MORTGAGE STANDARDS RULE 3 (2013).

proposed regulations that, in essence, would have the definition of QM and QRM mirror each other.

Dodd-Frank also created a new independent federal regulator, the Consumer Financial Protection Bureau (“CFPB”), and vested that agency with enforcement of virtually all of the then-existing federal consumer protection laws. Dodd-Frank also empowered the CFPB to create a plethora of new protections. The Act further gave the CFPB enforcement authority over a broad range of financial services providers, whether or not those providers were already regulated by existing banking agencies. Thus, many mortgage originators that are not affiliated with banks are receiving compliance examinations, or audits, by federal regulators for the first time ever — a level of scrutiny to which they may not be accustomed. The CFPB also adopted in January 2013 a new set of consumer oriented servicing standards that would apply to large and medium-sized servicers nationwide.⁴² The new rules are scheduled to become effective in January 2014.

Fixing the system has also involved adjustments to loan approval systems. In recognition of the higher level of losses, the loan guarantors, Fannie Mae and Freddie Mac and FHA began to raise the fees they charged to issue their guaranties. At the same time that guaranty fees were being raised, the same entities were tightening the criteria with which a loan had to comply to receive federal credit coverage. In addition, FHA, which had seen its market share grow from 4.5% in 2006 to roughly 30% in 2012,⁴³ raised its premiums for mortgage insurance and adopted strict enforcement guidelines for

⁴² Ability-to-Repay & Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. at 6506-07 § 1026.43(e) (1-2).

⁴³ U.S. DEP’T OF HOUS. & URBAN DEV., FHA-INSURED SINGLE FAMILY MORTGAGE ORIGINATIONS & MARKET SHARE REPORT 2012-Q2 (2012).

its Neighborhood Watch program. In effect, these guidelines suggested that lenders who made riskier loans relative to their peers would be subject to penalties, including loss of their ability to make FHA loans.

All of these changes resulted in stricter underwriting by lenders. The effect was to cause the average credit score of loans produced after 2007 to increase steadily and average loan-to-value ratios to fall. The following table shows the credit score and loan-to-value characteristics of the Fannie Mae loans produced from 2005 to 2012.

Table 3 – Credit Score and LTV Characteristics of Fannie Mae Loans⁴⁴

| Year | Average Credit Score | LTV Ratio |
|-------------|---------------------------------|------------------|
| 2005 | 719 | 72.0 |
| 2006 | 716 | 73.4 |
| 2007 | 716 | 75.5 |
| 2008 | 738 | 72.0 |
| 2009 | 761 | 65.8 |
| 2010 | 762 | 65.8 |
| 2011 | 762 | 66.6 |
| 2012 | 761 | 67.8 |

Despite the increased costs to the users of government sponsored mortgage programs, one of the immediate results of the rapid declines in home values and increased delinquencies was a flight of private capital from the market. Private-label securities, which had achieved a market share of more than 20% in 2006, had virtually

⁴⁴ FANNIE MAE, Fannie Mae 2012 CREDIT SUPPLEMENT 5 (2013). LTV Ratio is the weighted average origination loan-to-value ratio and excludes HARP loans. Freddie Mac data, taken from its recent loan-level data release, shows the same trend, with average credit scores rising from 724 in 2005 to 767 in 2012. FREDDIE MAC, SINGLE-FAMILY LOAN LEVEL DATASET: SUMMARY STATISTICS 3 (2013).

disappeared from the market by 2008.⁴⁵ In their place, government guaranteed securities stepped up. By 2012, 99.2% of all mortgage-backed securities, which comprised more than 90% of all single-family mortgage loans, were guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae.⁴⁶

Another theme that has permeated the efforts of government regulators and enforcers since the housing finance system imploded has been that someone should be punished for what happened. Efforts to sanction those responsible for the mortgage crisis have proven difficult. From the start, the blame for the problems in the industry was widespread and not limited to one clearly defined culprit or set of culprits. To the extent that the sub-prime lenders were to blame, they were almost entirely out of existence by 2008. Fannie Mae and Freddie Mac went into conservatorship midway through 2008, and new management soon took over at both companies. Those managers who were around and who have been the subject of enforcement actions have largely been exonerated.⁴⁷

⁴⁵ William R. Emmons, FED. RESERVE BANK OF ST. LOUIS, *THE PAST, PRESENT & FUTURE OF THE U.S. MORTGAGE MARKET* (2008); Nick Timiraos, *Rethinking Fannie, Freddie—and the 30-Year Mortgage*, WALL ST. J., Sept. 22, 2013, <http://online.wsj.com/article/SB10001424127887324807704579087072063293460.html>.

⁴⁶ BIPARTISAN POLICY CTR., *Analysis of Data from INSIDE MORTG. FIN. PUB'NS, MORTGAGE & ASSET SECURITIES ISSUANCE* (2013).

⁴⁷ Alan Zibel, *Franklin Raines: Case Dismissed*, WALL ST. J., Sept. 20, 2012, <http://blogs.wsj.com/developments/2012/09/20/franklin-raines-case-dismissed/>; see also Kerri Panchuk, *OFHEO Settles with Former Fannie Mae CEO & Executives*, DSNEWS.COM, Apr. 20, 2008, <http://www.dsnews.com/articles/ofheo-settles-with-former-fannie-mae-ceo-executives-2008-04-21>; Tom Schoenberg, *Ex-Fannie Mae Executive Howard Dismissed from Suit*, BLOOMBERG, Oct. 16, 2012, <http://www.bloomberg.com/news/2012-10-16/ex-fannie-mae-executive-howard-dismissed-from-fraud-suit.html>; Alan Zibel, *Freddie Mac's Former CEO Settles Charges for \$16.4M*, USA TODAY, Nov. 6, 2007, http://usatoday30.usatoday.com/money/companies/management/2007-11-06-freddie-settlement_N.htm. However, an SEC enforcement action is still pending against former Fannie Mae CEO Daniel Mudd. Max Abelson, *Daniel Mudd, Fannie Mae's Former CEO, Is Doing Awesome*, BUS. WK., May 30, 2013, <http://www.businessweek.com/articles/2013-05-30/daniel-mudd-fannie-maes-former-ceo-is-doing-awesome>.

Wall Street firms that were active in the packaging and selling of mortgages have recently been the subject of actions by the SEC, but purchasers of the MBS have had difficulty showing that they were misled.⁴⁸ By and large, it appears that the biggest culprit was a runaway residential real estate market that came crashing back to earth, coupled with new loan products that permitted overly expansive underwriting criteria.

One of the biggest obstacles to laying blame lies in the fact that the borrowers received the benefit of their bargains.⁴⁹ While there have been a few reported cases of out and out fraud perpetrated against borrowers, in the vast majority of cases, the borrowers received the proceeds of the loan, either in cash or through the satisfaction of pre-existing debt. Moreover, the borrower signed documents stating that he knew the terms of the loan and promising to repay the principal amount, plus interest. In many non-performing loans, once the borrower stopped making the agreed upon payments, he stayed in the house for an extended period of time without paying anything. Nevertheless, borrowers have, by and large, been viewed by policymakers as victims and not culprits.

Efforts to punish wrongdoers instead have focused on the originators, sellers, and packagers of the mortgages. Purchasers and guarantors of loans, starting with Fannie Mae and Freddie Mac, began to scrutinize the files of the loans that had gone bad. Where they could find evidence of misrepresentations or misstatements, they issued requests to the entities that had sold them the loans to repurchase them. In many cases, this created a

⁴⁸ However, some have been successful in obtaining large settlements. *Investors & Countrywide Agree to Landmark \$500 Million Settlement*, COHENMILSTEIN.COM (Apr. 17, 2013), <http://www.cohenmilstein.com/news.php?NewsID=561>.

⁴⁹ *Schaefer v. Indymac Mortg. Serv.*, No. 12-2388, 2013 U.S. App. Lexis 20143, at *20, *23 (1st Cir. Oct. 2, 2013); *Parkway Bank & Trust Co. v. Korzen*, 2013 Ill. App. (1st) 130380, at 46 ¶79 (2013).

chain reaction with the loans being pushed back through the pipeline to the mortgage originators, mostly mortgage brokers at the time. Because most of these brokers had scant amounts of capital in their companies, many were quickly forced out of business by having to repurchase the non-performing loans. As a result, the better-capitalized middlemen in the chain, in many cases regulated depositories such as banks, have been left “holding the bag.”

Federal regulators also became much more creative in their approach to punishing wrongdoers. In 2011, the Justice Department announced that it had filed a complaint against Deutsche Bank under the federal False Claims Act (“FCA”).⁵⁰ The FCA is a statute enacted in 1863 to enable the federal government to exact heavy penalties from contractors that submitted fraudulent invoices to the government. The Justice Department applied the plain language of the statute to the FHA mortgage origination process and claimed that Deutsche Bank had violated the FCA because a company that the bank had bought had filed mortgage insurance claims with FHA on loans that it knew, or should have known, would go bad. The FCA had never before been applied in this context. Under the statute, such charges, if successful, would have entitled the government to treble damages. Deutsche Bank quickly settled the case for \$202 million,⁵¹ but the ramifications for the industry were enormous.

⁵⁰ Press Release, U.S. ATTORNEY S. DIST. OF N.Y., *Manhattan U.S. Attorney Sues Deutsche Bank & Subsidiary MortgageIT for Years of Reckless Lending Practices* (May 3, 2011).

⁵¹ *HUD Inspector General & U.S. Attorney Announce \$202 Million Settlement with Deutsche Bank & Mortgage IT* (May 10, 2012), http://portal.hud.gov/hudportal/HUD?src=/press/press_releases_media_advisories/2012/HUDNo.12-082.

The Department of Justice had hit a proverbial gold mine. The combination of the perfect vision of hindsight, the application of subjective underwriting concepts viewed through the lens of a “should have known” standard, and treble damages, has led to substantial claims by the federal government against many mortgage lenders with enough capital to remain in the business through the Melt-Down. Only one of these cases has made it to trial as of yet, but the size of the potential liability has led to a series of expensive settlements with the government.⁵² Bank of America, after declining to settle with the government for claims under the FCA and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”), was recently found liable for having fraudulently made and sold defective mortgages.⁵³

Enforcement actions by the federal government have not been limited to the FCA. In 2011, the Federal Housing Finance Authority (“FHFA”) sued 17 banks and financial institutions for allegedly selling MBS to Fannie Mae and Freddie Mac that “had different and more risky characteristics than the descriptions contained in the marketing and sales materials.”⁵⁴ Recently, in what may be related actions, JPMorgan Chase has tentatively agreed to pay \$13 billion to settle claims from the FHFA that JPMorgan failed to disclose material information with respect to \$33 billion of loans that had been securitized through

⁵² More recently, the Justice Department has invoked the civil money penalty provisions of the Financial Institutions Reform, Recovery, and Enforcement Act to force settlements with companies involved in the mortgage securitization process, such as the large credit ratings agency, Standard & Poors.

⁵³ In addition, the jury in that case found a former manager of Countrywide Financial Corporation, which Bank of America purchased in 2008, personally liable for the fraud. Landon Thomas, Jr., *Jury Finds Bank of America Liable in Mortgage Case*, N.Y. TIMES DEALBOOK, Oct. 23, 2013, http://dealbook.nytimes.com/2013/10/23/jury-finds-bank-of-america-liable-in-mortgage-case-nicknamed-the-hustle/?_r=1.

⁵⁴ FED. HOUS. FIN. AGENCY, *News Release: FHFA Sues 17 Firms to Recover Losses to Fannie Mae & Freddie Mac* (Sept. 2, 2011).

Fannie Mae and Freddie Mac.⁵⁵ Bank of America has been sued by both the Department of Justice and the Securities and Exchange Commission with respect to mortgage-backed securities that it sold to the public in 2008.⁵⁶ There are a plethora of other reports of ongoing investigations and settlement discussions by the federal government with mortgage lenders.

The thread that seems to run through all of these efforts is that lenders should have been able to anticipate the poor performance of the residential mortgages they originated and sold. This presumption is a fundamental change in the long standing expectation that an originator is responsible only for gauging the likelihood of payment at the time of origination and not expected to possess the skill sets of a soothsayer regarding future calamities that may befall the borrower.⁵⁷

⁵⁵ Ben Protess & Jessica Silver-Greenberg, *Tentative Deal Hands JPMorgan Chase a Record Penalty*, N.Y. TIMES DEALBOOK, Oct. 19, 2013, http://dealbook.nytimes.com/2013/10/19/jpmorgan-said-to-be-discussing-13-billion-settlement-over-mortgage-loans/?_r=0.

⁵⁶ *Bank of America Sold \$850 in “Toxic Waste” Mortgage Securities: DOJ*, FORBES, Aug. 6, 2013, <http://www.forbes.com/sites/halahtouryalai/2013/08/06/bank-of-america-hit-with-fraud-suits-over-855m-in-mortgage-securities/>.

⁵⁷ In July 2013, the Justice Department issued a subpoena to Clayton Holdings LLC, one of the firms that was most active in performing the diligence on residential MBS deals for Wall Street firms in the years leading up to the mortgage crisis. The Justice Department said the subpoena was issued as part of a “broad and ongoing nationwide investigation into the assembly, underwriting and issuance of residential mortgage backed securities during the time period between 2005 and 2007.” Phil Mattingly, *U.S. Subpoena of Wall Street Due Diligence Firm Targets Banks*, BLOOMBERG, Aug. 29, 2013, <http://www.bloomberg.com/news/2013-08-29/u-s-subpoena-of-wall-street-due-diligence-firm-targets-banks.html>. Such discovery efforts, if successful, would be another example of turning a process designed to improve the quality of loans in MBS into a means of punishing the purveyors of the MBS that contain those loans.

LOAN SERVICING OUT OF THE SHADOWS

Turmoil in the economy that was widely attributed to the mortgage industry caused scrutiny of all aspects of the lending process. While companies were fairly quick to begin making changes to their loan underwriting methods, servicers of mortgage loans were slower to react to the tsunami of problem loans. Because the loan servicing industry is historically driven by low levels of delinquencies and foreclosures, the industry was totally unprepared for the rapid loan performance deterioration that began in 2007.

The level of attention and expense required to service a loan increases dramatically when a borrower, for whatever reason, begins to miss payments. At that point, the servicer must undertake an increasingly involved series of labor intensive steps to attempt to collect the loan and ensure that the home is occupied (or secured) and maintained. Historically, the exact progression of steps has been governed by a combination of the requirements of state law, the rules specified by the owners of the loans and, if applicable, the requirements of any guarantors or credit enhancers of the underlying debt, such as the GSEs and mortgage insurers. As a rule of thumb, until recently, in the mortgage loan servicing industry, the cost to service a performing loan was approximately \$6 per month. Loans that are thirty days past due cost approximately \$20 per month to service. By the time a loan is over sixty days past due that figure skyrockets to \$60 per month, a multiple of twelve times the cost of servicing a performing loan.⁵⁸ A recent study by the credit rating firm Fitch Ratings estimates that

⁵⁸ Recent proprietary studies of servicing costs set these figures at much higher levels, with performing loans costing between \$7 and \$10 per loan per month, and servicing costs of delinquent loans at approximately \$100 per loan per month.

recent changes in the rules governing the servicing of non-performing loans will cause these costs to double.⁵⁹

As delinquencies began to surge in 2007, mortgage servicers allegedly cut corners at all stages of the foreclosure process. The first way they did this, according to their detractors, is called “dual tracking” – where the foreclosure process continues while the borrower attempts to renegotiate his loan. In the past, servicers routinely continued running notices and preparing for sale of the home while having “loss mitigation” discussions with the borrower. The lender proceeds on both “tracks” because of the difficulty, expense, and time lost when a foreclosure process is placed on hold pending the outcome of a loan modification process only to have to be restarted if discussions with the borrower are unsuccessful.

There were also widespread charges that “foreclosure factories” were not working with borrowers in good faith. Borrowers expressed frustration with the difficulty of making contact with servicers and being bounced around within the servicer’s organization once contact had been made. Borrowers complained that they should be provided with a “single point of contact” at the servicer with whom they could discuss resolution of their defaults. In short, what may have seemed to be an efficient operation to the servicer’s management was a customer service nightmare to the borrower.

Another way in which servicers were cutting corners has been termed “robo-signing.” In December 2009, in a routine deposition, a middle-level employee in the

⁵⁹ *Sharp Rise Expected in Cost to Service Mortgage Loans*, FITCH RATINGS (Feb. 2, 2012), http://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/Sharp-Rise-Expected?pr_id=741511.

servicing department at mortgage lender, GMAC Mortgage, LLC, testified that he signed off on approximately 10,000 summary judgment affidavits per month.⁶⁰ Those affidavits were necessary to start the foreclosure process on homeowners. Under state laws, the signer of those documents is supposed to have “personal knowledge” of the facts, such as non-payment of the debt, justifying foreclosure. In the deposition, this team leader for the document execution team testified that he signed off without verifying the information set forth in the affidavits. He also admitted to regularly disregarding notary requirements for the affidavits.

It quickly became apparent that the lack of attention to detail was not unique to GMAC. Pretty soon, all of the big servicers confessed that they routinely took shortcuts to handle the mountains of paperwork that had been generated by the mortgage Melt-Down. To one degree or another they had all failed to take seriously their obligations under state laws to confirm the balances and payment histories of borrowers before initiating foreclosures. There were also widespread violations of the rules requiring signatories to sign in the presence of the notary public. These “failure to witness” breaches constitute technical violations of the notary requirements, irrespective of the notary’s familiarity with the signer and his signature. Compounding these improprieties were reports that employees of foreclosure law firms were rewarding employees with lavish gifts for expediting paperwork.⁶¹

⁶⁰ Debra Cassens Weiss, *How 2 Pro Bono Lawyers Uncovered “Robo-Signer,” Halting Foreclosures in 23 States*, ABA J., Sept. 23, 2010, http://www.abajournal.com/news/article/how_2_pro_bono_lawyers_uncovered_robo-signer_halting_foreclosures_in_23_sta/.

⁶¹ Dugald McConnell, *Foreclosure Mess: Fake Signatures & Lavish Gifts*, CNN MONEY, Oct. 20, 2010, http://money.cnn.com/2010/10/20/real_estate/gifts_for_robosigners/index.htm.

Because of the increase in foreclosure activity and the perceived hardship it was causing borrowers, pressure was exerted on public officials to take punitive actions against servicers. In the fall of 2010, there was an unprecedented effort by the attorneys general of all fifty states and over a dozen regulators and agencies within the federal government to coordinate efforts to address concerns that servicers were routinely disregarding the protections laid out in federal and state laws for consumers at risk of foreclosure. These efforts ultimately led to a settlement with the five largest servicers announced in February 2012.⁶²

That settlement provided, among other things, for the servicers to extend \$17 billion in relief to borrowers nationwide in principal reductions and other forms of loan modifications. The settlement also required servicers to provide up to \$3 billion in refinancing relief nationwide and \$1.5 billion in payments to borrowers who had lost their homes to foreclosure. The payments required to be paid to foreclosed-upon borrowers were to be made without regard to financial harm, if any, incurred by the borrowers. The forty-nine states represented in the settlement⁶³ were also to receive immediate payments to help fund consumer protection and foreclosure protection efforts. With some pride, the settlement announcement further stated that it included “first ever nationwide reforms to servicing standards ... requir[ing] single point of contact, adequate staffing levels and training, better communications with borrowers, and appropriate

⁶² *State Attorneys General, Feds Reach \$25 Billion Settlement with Five Largest Mortgage Servicers on Foreclosure Wrongs* (Feb. 9, 2012), <http://naag.org/state-attorneys-general-feds-reach-25-billion-settlement-with-five-largest-mortgage-servicers-on-foreclosure-wrongs.php>; Consent Judgment, *United States v. Bank of Am. Corp.*, No. 12-00361 (D.D.C. Apr. 4, 2012).

⁶³ Oklahoma did not join the settlement.

standards for executing documents in foreclosure cases, ending improper fees, and ending dual track foreclosures for many loans.”⁶⁴

To ensure compliance with the settlement agreement, servicers were required to regularly report compliance to an independent, outside Monitor who reports to the attorneys general, with heavy penalties for non-compliance with the terms of the settlement, including missed deadlines. In August of 2013, the Monitor submitted his fifth and final progress report regarding the status of the settlement. In that report, the Monitor stated that as of the date of the report, “643,726 borrowers benefited from some type of Consumer Relief totaling \$51.332 billion, which, on average, represents about \$79,742 per borrower.”⁶⁵ Included in that relief, were almost 96,000 borrowers who successfully completed a first lien modification and received \$10.399 billion dollars in principal forgiveness averaging approximately \$109,000 per borrower. In October of 2013, the Monitor released a report showing that, as of December 31, 2012, the banks’ progress in satisfying their obligations to provide both consumer and refinancing relief ranged from nearly halfway to more than complete.⁶⁶

The settlement has not been without its detractors. At the outset, some commentators expressed concern that cash payments were being made to borrowers without any showing of actual damages suffered by the recipients. Such payments smack of unjust enrichment where borrowers received the proceeds of loans, and then reneged on their promises to repay them. Others felt that servicers were getting off the hook for

⁶⁴ NAAG, *supra* note 62.

⁶⁵ OFFICE OF MORTG. SETTLEMENT OVERSIGHT, FACT SHEET: FINAL PROGRESS REPORT (2013).

⁶⁶ OFFICE OF MORTG. SETTLEMENT OVERSIGHT, FACT SHEET: INTERIM CREDIT (2013).

relatively paltry settlement terms. In addition, the settlement has been criticized because the large servicers receive credit towards their obligations under the settlement by reducing principal balances on loans that they do not own. Others have criticized the settlement because many of the states that received money to help homeowners and prevent foreclosures have diverted their share of the proceeds to plug holes in their general operating budgets.⁶⁷

At the same time the settlement discussions were taking place in the “robo-signing” case, the Office of the Comptroller of the Currency and the Federal Reserve were negotiating with the same five servicers and nine others over general servicing practices. Those negotiations led to enforcement actions against all fourteen in April of 2011. Under these enforcement actions, companies voluntarily entered into consent orders relating to their servicing operations. Under the terms of the consent orders, each servicer had to adopt a comprehensive action plan (“CAP”). The CAPs were required to address a broad range of perceived short-comings in servicing operations and compliance, including provision of sufficient financial resources for loss mitigation and regulatory compliance, complete with organizational structuring and staffing for these activities. Each servicer also had to adopt metrics to measure its success in meeting the terms of the consent order and establishing controls over the compliance functions. The consent orders also required the creation of programs to manage third-party service providers and the creation of plans for dealing with the Mortgage Electronic Registration System (“MERS”).

⁶⁷ Pamela M. Prah, *States Used Mortgage Settlement Money To Balance Budgets*, USA TODAY, Oct. 8, 2013, <http://www.usatoday.com/story/news/nation/2013/10/08/states-used-mortgage-settlement-money-to-balance-budgets/2942193/>.

The most important and far reaching feature of the consent orders was the establishment of an independent third-party foreclosure review for all loans that had gone through the foreclosure process during the height of the Melt-Down. Pursuant to the requirements of the independent foreclosure review, more than four million letters were mailed to borrowers who had been foreclosed upon in 2009 and 2010.⁶⁸ Those letters offered a free review of their loan files if the borrower believed mistakes had been made. The independent foreclosure reviews were also publicized through public service announcements that reached over 160 million people and paid advertisements that generated more than 341 million impressions.⁶⁹ The original deadline for filing requests for free reviews was April 30, 2012. That deadline was later extended three separate times until December 31, 2012. A second mailing went out to borrowers in June of 2012. In addition, the firms that were hired to conduct the independent review took random samples of over 150,000 files to review for improper conduct. After all of the efforts to generate responses from disgruntled mortgagors, a total of less than 494,000 requests for reviews resulted from the outreach to 4.4 million recipients of foreclosure notices.⁷⁰ To date, the OCC and the Federal Reserve have not publicly released any analysis regarding the substance or legitimacy of any requests for review.

On January 7, 2013, the OCC and Fed announced that they had settled with most of the firms subject to the consent orders rather than complete the independent

⁶⁸ OFFICE OF THE COMPTROLLER OF THE CURRENCY, INTERIM STATUS REPORT 8 (2012).

⁶⁹ *Id.* at 8-9.

⁷⁰ *Independent Foreclosure Review: Borrower Outreach Mailing & Response Data*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., <http://www.federalreserve.gov/consumerinfo/borrower-outreach-mailings-and-response.htm> (last updated Aug. 2, 2013).

foreclosure review.⁷¹ The terms of the settlement provided for cash payments to eligible borrowers in amounts ranging from hundreds of dollars up to \$125,000, depending on the type of possible servicer error. The announcement of the settlement stated that the OCC and the Federal Reserve accepted this agreement because the settlement “provides the greatest benefit to consumers subject to unsafe and unsound mortgage servicing and foreclosure practices during the relevant period in a timelier manner than what had occurred under the review process.” The announcement further stated that: “Eligible borrowers will receive compensation whether or not they filed a request or review form and borrowers do not need to take further action to be eligible for compensation.” About 90% of all borrowers whose mortgages were serviced by the settling banks would receive payments under the terms of the settlement.

By July of 2013, all fourteen of the entities that were subject to the 2011 consent orders had entered into the independent review settlement. Once again, some observers criticized the settlement as providing payments to borrowers who had not suffered any demonstrable damages. On the other hand, some “consumer advocates” criticized the deal saying that regulators had settled for a relatively small amount given the nature of the alleged improprieties.⁷² Some reports have indicated that out of the 4.4 million

⁷¹ OFFICE OF THE COMPTROLLER OF THE CURRENCY, NR 2013-3: Independent Foreclosure Review to Provide \$3.3 Billion in Payments, \$5.2 Billion in Mortgage Assistance (Jan. 7, 2013).

⁷² In related cases, Lender Processing Services, Inc., whose DocX subsidiary handled more than half of the nation’s foreclosures prior to its closing in 2010, entered into separate settlements with the Justice Department for \$35 million and forty-six attorneys general in the District of Columbia for \$120.6 million. Roy Oppenheim, *Latest Robo-Signing Settlement Bittersweet for Consumers*, U.S. NEWS & WORLD REP., Feb. 25, 2013, <http://www.usnews.com/news/blogs/home-front/2013/02/25/latest-robo-signing-settlement-bittersweet-for-consumers>; REUTERS, *Robo-Signing Fraud Case Is Settled*, N.Y. TIMES, Feb. 15, 2013, http://www.nytimes.com/2013/02/16/business/robo-signing-fraud-case-is-settled.html?_r=0. Those settlements resolved allegations over the company’s involvement in “robo-signing” of documents from 2003 to 2009. In connection with those charges, one former officer of LPS plead guilty to criminal charges

borrowers who were subjects of foreclosure, a staggeringly small number – just fifty-three – were not in default on their mortgages and still received foreclosure notices.⁷³ Those borrowers were scheduled to receive the largest checks under the terms of the settlement.

The 2011 consent orders also required a complete review and revamping of mortgage servicing procedures at the fourteen selling banks. In many cases, these new procedures mirrored the procedures required in the robo-signing settlement. In addition, the OCC took action in April 2013 to extend those procedures to all large and mid-sized national banks.⁷⁴ The CFPB also announced in January 2013 new servicing rules with similar provisions that would apply to all mortgage servicers servicing over 5,000 loans.⁷⁵ For all intents and purposes, the provisions of the settlement, the consent orders and the CFPB's rules, when they become final in January 2014, will create a new customer-friendly, but very expensive, set of procedures to be followed by servicers when dealing with delinquent borrowers.

and received a sentence of five years in prison. The settlement with the company has been criticized as being a slap on the wrist.

⁷³ Daniel Fisher, *I Stand Corrected: OCC Review Found 53 Foreclosures on Current Borrowers*, FORBES, Apr. 10, 2013, <http://www.forbes.com/sites/danielfisher/2013/04/10/i-stand-corrected-occ-review-found-53-foreclosures-on-current-borrowers/>.

⁷⁴ OFFICE OF THE COMPTROLLER OF THE CURRENCY, MINIMUM STANDARDS FOR PRIORITIZATION & HANDLING BORROWER FILES SUBJECT TO IMMINENT FORECLOSURE SALE (2013), *available at* http://www.occ.gov/topics/consumer-protection/foreclosure-prevention/foreclosure_standards_42013.pdf.

⁷⁵ *CFPB Rules Establish Strong Protections for Homeowners Facing Foreclosure*, CONSUMER FIN. PROT. BUREAU (Jan. 17, 2013), <http://www.consumerfinance.gov/newsroom/consumer-financial-protection-bureau-rules-establish-strong-protections-for-homeowners-facing-foreclosure/>; Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X), 78 Fed. Reg. 10,696, 10,697-99 (Feb. 14, 2013).

“SO, WE ARE OUT OF THE WOODS NOW, RIGHT?”

The Great Recession officially ended with the second consecutive quarter of GDP growth in 2009. The real estate markets seemed to stabilize in 2012, and there is evidence that a modest recovery has taken hold in 2013. The level of seriously delinquent loans and properties and foreclosures has steadily declined since 2008. Policy makers have enacted a series of changes to lending rules and servicing rules with the intent of protecting borrowers going forward. It stands to reason that all of the improvements and changes would have begun to cause homeownership rates in the United States to reverse their downward trend and start showing improvement.

It comes as no surprise that homeownership would decline during periods of economic stress. When unemployment rates rise and property values fall, one would expect delinquencies and foreclosures to rise as well. Further, by definition, a borrower who has to turn his home over to a lender through voluntary or involuntary measures is no longer an owner of that home. At the same time, logic would seem to dictate, that a reversal of these negative trends would bolster homeownership. As economic conditions improve, household formation increases and, thus, a greater pool of possible new homeowners forms. It follows that the combination of these factors should reverse the trend of declining homeownership. As the report of the Harvard Joint Center on Housing Studies shows, however, this has not been the case. Homeownership has continued to flag throughout the country.⁷⁶

⁷⁶ JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *supra* note 1 at 19; U.S. CENSUS BUREAU, *supra* note 2.

The Joint Center Report goes a step further and identifies the most likely culprit in the continuing shrinkage in the ranks of homeowners – the mortgage industry. The report concludes that “continuing credit constraints” have shut out large numbers of would-be homeowners.⁷⁷ This conclusion seems counter-intuitive for a number of reasons.

First and foremost, as the Joint Center points out, homeownership is more affordable today than it has been in decades. The Housing Affordability Index, which combines home prices, mortgage rates, and household incomes, is near its most favorable level since the National Association of Realtors began tracking it in 1970.⁷⁸ While this favorable level has given up some ground recently due to slightly higher mortgage rates and increases in property values, by historical levels, now is still a great time to buy a home. In fact, a recent report from Trulia concludes that owning a home is less expensive than renting in each of the 100 largest metro markets in the United States.⁷⁹

Compounding these favorable conditions for potential homeowners, conditions for mortgage lenders would appear to be ripe for a surge in lending. Current pricing for home loans for lenders would appear to provide unusual incentives to generate more volume. The interest rates charged to consumers on mortgages as compared to the yield required on those loans in the secondary market, also known as the “spread”, is

⁷⁷ JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *supra* note 1 at 19-20.

⁷⁸ *Housing Affordability Index to Set Annual Record for 2012*, NAT’L ASS’N OF REALTORS (Jan. 9, 2013), <http://www.realtor.org/news-releases/2013/01/housing-affordability-index-to-set-annual-record-for-2012>; *see also* BEACON ECON., CALIFORNIA’S HOUSING MARKET RECOVERY & HOME FORECLOSURE TRENDS 5 (2013).

⁷⁹ Jed Kolko, *Until Mortgage Rates Hit 10.5%, Buying a Home Will Still be Cheaper than Renting*, FORBES, June 14, 2013, <http://www.forbes.com/sites/trulia/2013/06/14/buying-cheaper-than-renting-til-mortgage-rates-hit-10-5/>.

consistently wider today than at any time in recent memory. Given this wide margin on loans, one would assume that lenders would be anxious to originate more loans, thereby generating greater profits. In addition, low lending activity for the past several years has created a great deal of capacity within the system, presumably further encouraging lenders to lend. Unfortunately, the real dynamics within the industry are much more complicated.

In order to fully understand the forces at work, it is necessary to understand the structure of the industry and the changes that have come to pass in the last few years. An old timer in the industry once gave the following definition of a mortgage banker: “A mortgage banker makes every loan he can sell, and sells every one he can make.” While fairly simplistic, this quote sums up much of what is right and what is wrong with the mortgage industry.

The beauty (and inherent risk) of the industry is that it has developed over the years so that a relatively small amount of capital can be recycled over and over to generate a fairly substantial volume of mortgage loans. Prior to the Melt-Down, the food chain in the industry, by and large, consisted of a mortgage broker at the retail level originating a loan. Prior to 2006, more than 65% of mortgage loans started with a mortgage broker. That loan was then sold to a mortgage banker who had the capital to hold it on his books through some temporary financing structure while the paper work was accumulated and the loan was put in process for servicing. At some point, the loan would be sold upstream to an aggregator, who would accumulate a pool of loans for sale to either Fannie Mae or Freddie Mac or to Wall Street in the form of a MBS. While there were a number of variations on this theme, it describes generally how the system worked.

This general structure has changed dramatically over the last few years. Now the food chain consists of loans originated by mortgage bankers or commercial banks with mortgage operations. The loan is then sold to an upstream correspondent who has a relationship with Fannie Mae, Freddie Mac and/or Ginnie Mae, or, if the originator has sufficient capital to deal directly with the agency, there may be no need for an upstream aggregation. Small banks, in particular, have become increasingly active in selling individual loans to the “cash windows” at Fannie Mae and Freddie Mac. Some stronger mortgage brokers still exist, but the overall market share of loans originated by brokers has fallen to between five and ten percent. There is also a small flow, less than 10%, of residential mortgages that are kept on the books of the originator if it is a bank, credit union, or other highly capitalized entity.

This changing structure of the industry has been accompanied by a fairly significant consolidation within the industry. Consolidation trends began several decades ago but accelerated during the recession as troubled institutions got gobbled up by their stronger counterparts. Consolidation has slowed somewhat recently, but, today, the top five mortgage companies in the United States originate or buy more than 50% of the mortgages created nationwide.⁸⁰ As has been the case for many years, the ultimate buyer of the mortgage may not be the entity that has the contact with the borrower, but increasingly the top aggregators are also those with a retail origination structure in place.

⁸⁰ Rob Chrisman, *U.S. Mortgage Market Share Changing. There's Room for Smaller Lenders*, BASIS POINT, Mar. 23, 2013, <http://thebasispoint.com/2013/03/23/u-s-mortgage-market-share-changing-theres-room-for-smaller-lenders/>.

To understand why underwriting standards throughout the industry have become so much more stringent in recent years, I spoke with the individuals responsible for setting underwriting standards in small, medium and large mortgage companies across the country. The smaller lenders acknowledged that they are merely playing by the rules set by the larger upstream lenders to whom they sell loans. Lenders large enough to package loans on their own accord and sell them to the GSEs consistently reported the same reasons for the tightening of underwriting standards: the risk of put-backs, changes in loss assumptions, and increased costs.⁸¹

At first blush, it would seem that lenders would not have any motivation to apply underwriting criteria more stringent than those required by the entities assuming the credit risk on the loan. Today, those entities are government agencies: Fannie Mae, Freddie Mac, FHA, VA, and the U.S. Department of Agriculture through its rural housing programs. Those agencies ostensibly assume the credit risk on more than 90% of all mortgages originated.⁸² While those government programs are designed to absorb the risk of nonpayment, each of these agencies has become much more proactive in avoiding responsibility for bad loans. To that end, they have become much more aggressive in recent years in scouring the loans that do not perform according to their terms to determine if there were any mistakes made in the origination of the loans. If a mistake can be found, no matter how immaterial (according to lenders), the agency will require the mortgage banker that applied for the federal guaranty or insurance to re-purchase the

⁸¹ See Jim Parrott & Mark Zandi, MOODY'S ANALYTICS & URBAN INST., OPENING THE CREDIT BOX 3-4 (2013).

⁸² See Bipartisan Policy Ctr., *supra* note 46.

loan. That entity will attempt to put the loan back down the food chain to the originator of the mortgage. In addition, some agencies, such as FHA, have become much more active in monitoring the performance of loan originators and disqualifying them from federal programs if they deem the performance of their book of business to be too poor relative to other lenders in the market.

To compensate for these efforts many lenders have put in place “credit overlays” on their programs to require higher quality loans to avoid any risk of put-back and re-purchase. These overlays are enhanced underwriting criteria that go beyond the minimums set by the agencies. Virtually all of the large aggregators at the top of the mortgage food chain have such criteria, so their effect is felt throughout the mortgage distribution system. The intent of applying more stringent rules is, in essence, to buy insurance against problems down the road.

The ramifications of increased put-backs by the agencies cause tightened credit standards in other, more indirect, ways. Lenders are more conscious of the risk that they may wind up with a loan if it becomes non-performing because, at that point, it is not just a “cost of servicing” issue for them. It is an issue of the costs associated with being forced by Fannie Mae, Freddie Mac, or FHA to buy back that loan, and assumption of the credit risk of a loan that is demonstrably bad. As a result, lenders are more focused than ever that they comply with the letter of GSE rules more than the spirit. Through stringent underwriting and processing, they hope to dramatically reduce the odds a loan will become non-performing. While lenders have for the past twenty years based their decisions to lend, or not, on sophisticated systems that have attempted to assess the likelihood of a loan default, they fear even a single non-performing loan now because

there is a much heightened risk that it will instantly trigger a search for even a non-material flaw as a reason to put the loan back through them. Privately, virtually all lenders complain that many of the put-backs they are receiving relate to minor mistakes or appraisal errors in the loan file that took place many years before the borrower began to miss payments.⁸³ Whether such examples are truly widespread or not, they contribute to more conservative underwriting of new loans.⁸⁴ This post-facto review also reflects a fundamental shift away from the traditional principle that the originator should not be responsible for changes in circumstances long after the loan is closed.

⁸³ See e.g., Amilda Dymi, *Lenders Watch Out for GSE Buyback Demands*, NAT'L MORTGAGE NEWS, Sept. 5, 2013, http://www.nationalmortgagenews.com/dailybriefing/Lenders-Watch-Out-for-GSE-Buyback-Demands-1038631-1.html?ET=nationalmortgage:e4584:448841a:&st=email&utm_source=editorial&utm_medium=email&utm_campaign=MSN_Bulletin_090513&site=default_msn; Brian S. Levy, *Buybacks—They're Not Going Away*, MORTGAGE BANKING, Sept. 2013, at 42.

⁸⁴ For example, in the second quarter of 2013, the average FICO credit score of a conventional mortgage acceptance was 761, while the average score of rejections was 726. Christina Mlynski, *Tighter Underwriting Standards Squeeze Mortgage Credit*, HOUSINGWIRE, Oct. 8, 2013, <http://www.housingwire.com/articles/27301-tighter-underwriting-standards-squeeze-mortgage-credit>.

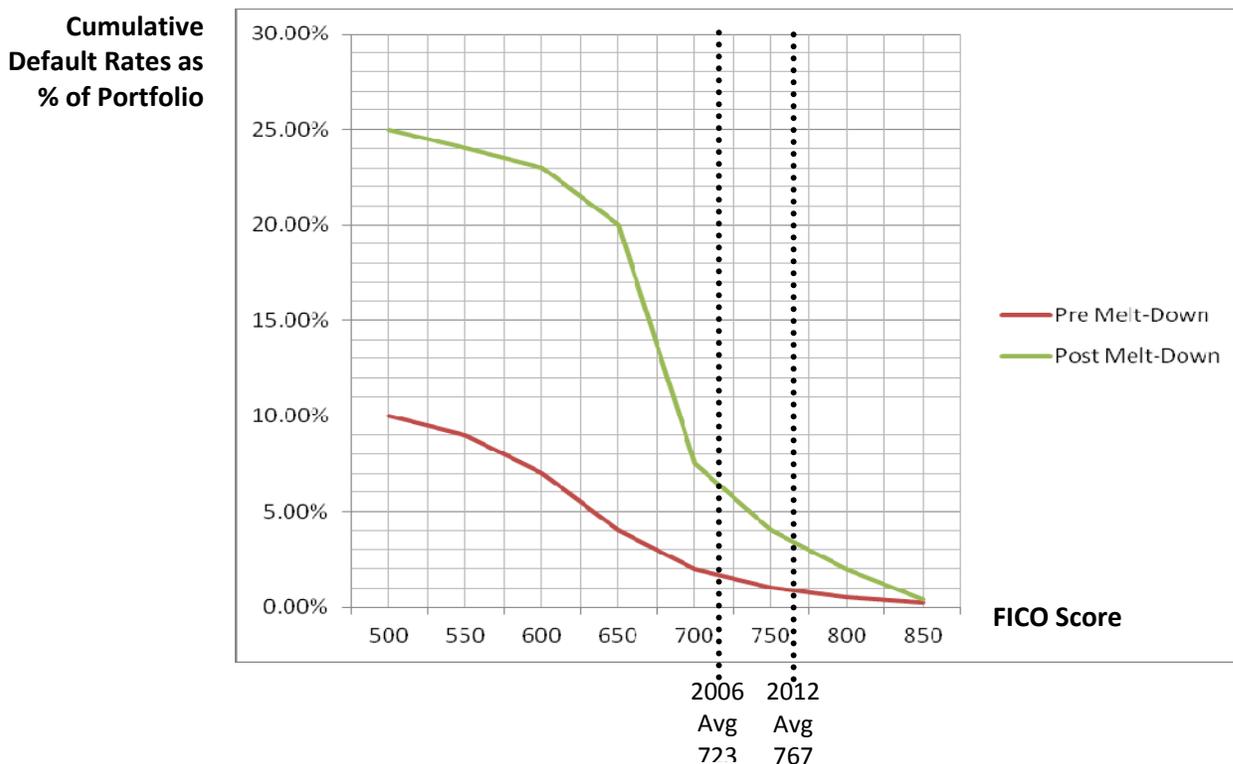
THE NEW NORMAL FOR LOSSES

Underwriting models are dynamic and change constantly as new data become available or economic conditions change. All of the underwriting models that lenders use to gauge potential credit losses are predicated on assumptions regarding loss expectations on pools of loans with similar characteristics. Many of those assumptions have been based on historical loss experience. Pools of loans with quantitative credit profiles are expected to perform roughly like previous pools of loans with similar profiles. One result of the real estate crisis, however, is that prior loss tables have undergone significant revision.

Over the six decades preceding the real estate crash in 2007-2008, there were no periods in which nationwide real estate values underwent sustained house price depreciation. By and large, with the exception of a handful of local market dislocations and quarterly decreases, home prices rose steadily over the preceding fifty-plus years. Thus, while the actuaries could make assumptions about how borrowers would react in times of significant, long-lasting decreases, the true test came during the Melt-Down. As the loan level data from Fannie Mae and Freddie Mac show, the frequency of non-payment by mortgage borrowers accelerated during the period of the recession. Logically, delinquencies should rise during periods of economic stress, as unemployment rates rise, but the increases in delinquencies were greater than anyone expected.

A graphic depiction of this phenomenon can be created by using FICO scores as a proxy for credit quality and over-laying expected loan loss curves designed to convey the cumulative changes in the assumptions underlying underwriting decisions.

Chart 2 – Cumulative Default Rates on Freddie Mac Loans⁸⁵



The prevailing school of thought in the popular press is that the dramatic increase in delinquencies after 2005 was tied to the expansion of lending to “sub-prime” borrowers during the period from 2000 to 2007. Proponents of this line of reasoning tend to divide all loans into two categories. One subset of loans is the traditional, plain vanilla, strictly underwritten loans that adhere to high credit scores, low loan to value ratios, and verified information. All other loans, from this perspective, fall into the sub-prime category.

⁸⁵ Post Melt-Down data are from loans produced in calendar years 2006 through 2008. Cumulative data after 2008 do not provide sufficient history to be meaningful. Data from Goodman ET. AL., *supra* note 27. Because of the qualifications in the Freddie Mac dataset, discussed above in note 27, it is safe to assume that had the riskier loans been included, the Post Melt-Down loss charts would have been even steeper. Presumably, inclusion of all loan types would adversely affect the Pre Melt-Down loss figures as well, but to a much lesser extent.

Such thinking belies the true continuum of loan products that were available in the first half of the last decade. Many lenders marketed products they called “Alt-A” or “Non-prime”, products that had slightly worse credit characteristics than the “prime” product. In fact, throughout the crisis, Fannie Mae and Freddie Mac were considered to offer only “conforming” product. Yet, Fannie and Freddie both created new products that were intended to compete in the non-prime space, and their overall loss experience on their loan portfolios originated after 2003 was dramatically worse than their pre-2003 experience.⁸⁶ Much of the blame for this poor performance lies in the overall decline in home values after 2006, but the composition of the portfolios was a contributing factor.⁸⁷

Many critics have suggested that the poor performance of the Fannie Mae and Freddie Mac loan books from 2004 through 2008, and the ultimate bail-out of those entities, resulted from steps they took to comply with the affordable housing goals imposed on them by policy makers. There can be no debate that both government sponsored enterprises struggled to comply with those goals and expanded their loan offerings during the fifteen years following the enactment of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.⁸⁸ This explanation, however, is incomplete.⁸⁹

⁸⁶ FANNIE MAE, *supra* note 44 at 10; FREDDIE MAC, SECOND QUARTER 2013 FINANCIAL RESULTS SUPPLEMENT 31 (2013)

⁸⁷ For example, while subprime loans made up only 0.7% of Fannie Mae’s portfolio for years 2006 and 2007, Alt-A loans made up 21.8% of its portfolio in 2006 and 16.6% in 2007. FANNIE MAE, *supra* note 44 at 5.

⁸⁸ The Affordable Lending Goals were established by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 to help more low-income and minority borrowers access affordable mortgages. In 2000, HUD significantly increased the GSEs’ goals to require that 50% of their loan purchases should be to borrowers with incomes less than or equal to the area median income, up from the 42% requirement in

Recent studies have attributed much of the poor performance of loans leading up to the Melt-Down to a recent tendency of borrowers to extract as much equity from their homes as possible.⁹⁰ Under this theory, the thin layers of equity in refinanced homes led to a greater percentage of borrowers walking away from their loans when property values turned. Some commentators have gone further and suggest that the Federal Reserve encouraged, through low-rate policies, the extraction of equity as a means of stimulating the overall economy.

Some of the increases in delinquencies were caused by programs instituted by policy makers and intended to lessen the detrimental effects of the crisis. For instance, early on in the crisis, Fannie Mae and Freddie Mac had a loan modification program – the Hope for Home Owners Refinance Program - that prohibited borrowers from participating until the loan had achieved a status of being past due more than ninety days. Borrowers who were, and wanted to stay, current, but lower their payments to affordable levels, were dumbfounded to learn that in order to qualify for help they had to quit paying their loans. In fact, in May of 2009 the Helping Families Save Their Homes Act required borrowers to certify a real need for participation in the Hope for Home Owners Refinance Program and prohibited borrowers from intentionally defaulting simply to qualify.

1997. This goal was increased to as high as 56% in 2008. DEP'T OF HOUS. & URBAN DEV., ISSUE BRIEF: HUD'S AFFORDABLE LENDING GOALS FOR FANNIE MAE & FREDDIE MAC (2001); DEP'T OF HOUS. & URBAN DEV., OVERVIEW OF THE GSEs' HOUSING PERFORMANCE, 2000-2007 at 6, t.3 (2008), *available at* <http://www.huduser.org/datasets/GSE/gse2007.pdf>.

⁸⁹ Nick Timiraos, *Mortgages Reach 5-Year High*, WALL ST. J., Sept. 19, 2013 at A2.

⁹⁰ This argument is supported by data showing a dramatic increase in the number of cash-out refinances and sub-ordinate lien products. Steven Laufer, FED. RESERVE BD., EQUITY EXTRACTION & MORTGAGE DEFAULT (2013); Michael LaCour-Little, A CLOSE LOOK AT RECENT SOUTHERN CALIFORNIA FORECLOSURES (2009).

Whether one attributes the increased delinquencies to the rise of sub-prime lending, exotic loan products, the imposition of affordable housing goals, the extraction of equity, or the rapid drop in home prices, the indisputable fact that emerges from the GSEs' loan-level data is that defaults on loans produced after 2003 were significantly greater than those preceding the Melt-Down.

Changes in the loss models extend beyond the assumptions regarding the likelihood of losses. Lenders have also had to revise their assumptions regarding the severity of losses. As one would expect, the possibility that collateral values could decline—perhaps significantly—leads to the inexorable conclusion that, in the event that the collateral has to be seized and sold during such periods of real estate value deflation, the proceeds from the sale will be less and the losses will be greater. But there are other factors that have changed expectations of loss severity.

Historically, the foreclosure process has been governed by state law. The speed and efficiency of this process through the Melt-Down varied widely from state to state. Evidence shows that states with judicial foreclosure processes, which require the borrower and lender to go to court to finalize a foreclosure, have longer foreclosure timelines and higher foreclosure inventories, resulting in a slower recovery in housing prices than states with nonjudicial foreclosure processes.⁹¹ Additional state and local

⁹¹ Diana Aqra, *Distressed Housing High in Slow Foreclosure States*, MORTG. PROF'L AM., May 30, 2013, <http://www.mpamag.com/real-estate/distressed-housing-high-in-slow-foreclosure-states-15279.aspx>; Diana Olick, *Housing Recovery Leaves Some Behind*, CNBC, Mar. 7, 2013, <http://www.cnbc.com/id/100533234>; Julie Schmit, *States' Foreclosure Pace Affects Home Prices*, USA TODAY, Feb. 16, 2013, <http://www.usatoday.com/story/money/business/2013/02/15/home-prices-up-more-in-fast-foreclosure-states/1899845/>. While some have argued that nonjudicial foreclosure processes perpetuate fraud, such as robo-signing, it is clear that the judicial foreclosure process has severely hindered recovery in states that require it. Abigail Field, *The Foreclosure Mess: It's Even Worse in "Nonjudicial" States*, DAILY FIN., Oct.

attempts to safeguard borrowers have delayed the foreclosure process even more, causing an even slower recovery in home prices and increased costs for lenders and investors.⁹²

Many of the new federal rules regarding servicing of delinquent loans have also increased the cost of resolving those loans. As pointed out above, the procedures that were enacted as a result of the robo-signing scandal have now become widely applied throughout the servicing industry. Those rules require a number of additional steps in the process of resolving severely delinquent loans. These steps not only delay the resolution, but also increase dramatically the cost of achieving that resolution.

In addition, servicers have increased risk of penalties for making mistakes in conducting the process. These penalties are significant under the CFPB rules and may be even greater in those states that have adopted a “Homeowners’ Bill of Rights.”⁹³ Adding to these risks, in those loans that have some form of federal guaranty or mortgage insurance, there is a risk that the Department of Justice will attempt to recoup losses and assess treble damages under the False Claims Act.⁹⁴ The SEC and the Department of

30, 2010, <http://www.dailyfinance.com/2010/10/30/the-foreclosure-mess-its-even-worse-in-nonjudicial-states/>.

⁹² Olick, *supra* note 91. In addition, while new mortgage delinquencies are falling in states with nonjudicial foreclosure processes, states with judicial foreclosure processes are seeing an increase in new delinquent mortgages, likely driven by the slow recovery in home prices. *Id.*

⁹³ For example, both California’s and Nevada’s Homeowners’ Bill of Rights statutes provide for the award of treble damages, or \$50,000, whichever is greater, for intentional or reckless material violations of the requirements for dealing with delinquent loans. A.B. 278, 2011-2012 Sess., at 19 (Cal. 2012); SB 321, 77th Sess., at 15 (Nev. 2013). Earlier this year, Minnesota passed a Homeowners’ Bill of Rights that awards attorney fees to a prevailing homeowner in an action to set aside a sale or who successfully defends a foreclosure by action. 2013 MINN. LAWS Ch. 115 at 4.

⁹⁴ The string of settlements with the federal government is ongoing, with Sun Trust recently striking a \$628 million deal with the Department of Justice, HUD, and the Federal Reserve, followed by JPMorgan’s tentative \$13 billion settlement with the Department of Justice, both reached in hopes of reducing each banks’ uncertainty surrounding the mortgage crisis. Laura Mercinek, *SunTrust Mortgage Settlements To*

Justice have gotten more active recently in pursuing mortgage securitizers under federal securities laws.⁹⁵

All of these new rules have the effect of increasing the severity of the loss when a loan goes bad. When these factors are considered in light of the data showing that the likelihood of loss grows significantly greater as credit quality becomes marginally worse, and that declining property values can magnify this loss severity, the net effect is for lenders to become increasingly conservative in their underwriting. And, as a result, overall average credit scores go up and loan-to-value ratios go down in the overall pool of mortgage loans closed.⁹⁶ The Fannie Mae data set forth in Table 3 above show precisely that sort of trend in the years that have followed the real estate crisis.⁹⁷ In effect, the cost of foreclosure prevention and loss mitigation programs enacted in response to past increases in problem loans has been converted into more conservative lending standards for all borrowers.

Cut Profit by \$179 Million, BLOOMBERG, Oct. 10, 2013, <http://www.bloomberg.com/news/2013-10-10/suntrust-mortgage-settlements-to-cut-profit-by-179-million-1-.html>; Protesse & Silver-Greenberg, *supra* note 55. Since 2010, U.S. banks have paid more than \$66 billion in settlements arising out of the mortgage crisis, and SNL Financial estimates that number to rise to \$107 billion. Saabira Chaudhuri, *Crisis-Era Legal Tab for U.S. Banks Is Poised to Climb*, WALL ST. J., Oct. 29, 2013, at C2.

⁹⁵ See discussion in “*Government to the Rescue*” above.

⁹⁶ For example, in the second quarter of 2013, the average FICO credit score of conventional mortgage rejections was 726, which is higher than the 2006 average of Freddie Mac loans shown in Chart 2 above. Mlynski, *supra* note 84.

⁹⁷ In addition, recent analysis of HMDA data and credit report data concludes that the credit scores of borrowers obtaining a mortgage in 2012 were much higher than in 2006. Correspondingly, delinquency rates on 2010 loans were much lower than on 2006 loans. Neil Bhutta & Glenn B. Canner, BD. OF GOVERNORS OF THE FED. RESERVE SYS., MORTGAGE MARKET CONDITIONS & BORROWER OUTCOMES: EVIDENCE FROM THE 2012 HMDA DATA & MATCHED HMDA-CREDIT RECORD DATA 5 (2013).

Many of these changed circumstances and their effect on loan losses are quantifiable. Other, more subtle, changes are not. In conversations with loan servicers, one detects a level of frustration trying to determine what the rules are when it comes to handling a severely delinquent loan.⁹⁸ Every attempt must be made to allow the delinquent borrower to cure his breach. All actions by the servicer are subject to second guessing and hindsight review. For many lenders, the best way to avoid this difficult situation, and its concomitant losses and reputational risks, is to be even more conservative in the loan underwriting process. In terms of the graphic depiction in Chart 2 above, this skittishness pushes the bar further to the right.

Of course, moving the bar to the right has an effect on many potential borrowers. An increase in average FICO scores from 723 to 767 has the effect of excluding roughly an additional 20% of potential borrowers. Stated another way, the new average FICO score of 767 is higher than that of more than 60% of the American population. Most of the excluded folks are credit-worthy and will pay their mortgages as promised, but the cost of dealing with the few who will not pay on time has caused “the benefit of the doubt” to shift. And the effect of this shifting will be felt disproportionately by certain minorities and first time homebuyers.

⁹⁸ For example, the procedures implemented by Fannie Mae as part of the Servicing Alignment Initiative contained provisions to slow down the foreclosure process by requiring servicers to contact delinquent borrowers and explore all available workout options. However, the same policy provided a consistent timeline to implemented, covering the time from the date missed payments were due to foreclosure referral. While servicers were to be paid incentives for modifications, the policy also implemented compensatory fees for servicers who delayed foreclosure sales beyond the timeline. It is easy to understand why servicers may feel conflicted. FANNIE MAE, *SERVICING ALIGNMENT INITIATIVE—OVERVIEW FOR FANNIE MAE SERVICERS* (2011).

To the extent that this string of dominos going from recent losses and policy changes to stricter underwriting criteria to lower home ownership rates applies in the general population, the effect is magnified on certain subsets of the population. In its 2010 report entitled “Does Credit Scoring Produce a Disparate Impact?,” the Federal Reserve Board discussed the breakdown of credit scores by demographic groups.⁹⁹ On a scale of zero to 100 where 50 is the average credit score of the general population, the credit metric for African-Americans as a group is 25.6. On the same scale, the average credit metric for Hispanics 37.9. For all people in the thirty to thirty-nine year-old age group, the average is 40.3.¹⁰⁰ While there is no direct correlation between this scale and the numerical index used in FICO scores, there is a relative correlation.¹⁰¹ Moving the average credit scores in the chart above to the right has the effect of cutting off larger portions of demographic groups with lower average credit scores. In other words, stricter underwriting guidelines lead to fewer minority homeowners and first time homebuyers.¹⁰² That is precisely the conclusion reached by the Joint Center’s Report:

[H]omeownership rates for households in the 25-54 year-old age group were at their lowest point since record keeping began in 1976. The drop in homeownership rates

⁹⁹ Robert B. Avery, Kenneth P. Brevoort, & Glenn B. Canner, BD. OF GOVERNORS OF THE FED. RESERVE SYS., DOES CREDIT SCORING PRODUCE A DISPARATE IMPACT? (2010).

¹⁰⁰ In contrast, the average is 54.2 for whites and 54.5 for Asian-Americans. People over age sixty-two have an average score of 67.7. *Id.*

¹⁰¹ A recent analysis by the Federal Reserve of both the 2012 HMDA data and matched credit report data confirms that credit scores of black and Hispanic borrowers tend to be lower at the time of loan origination than those of Asian and white borrowers. Correspondingly, delinquency rates for black and Hispanic borrowers tend to be higher. Bhutta & Canner, *supra* note 97 at 5.

¹⁰² This is especially troubling in light of a new report that found the African-American community lost more than half its net worth as a result of the housing crisis, due to the fact that “black wealth is more concentrated in homeownership than any other asset.” Lew Sichelman, *Housing Downturn Hurting African-Americans Severely*, NAT’L MORTG. NEWS, Oct. 7, 2013, at 1.

has also been particularly severe among minorities. At 43.9 percent, the homeownership rate for African-American households is at its lowest level since 1995. Both the Hispanic homeownership rate (46.0 percent) and the white homeownership rate (73.5 percent) are at their lowest values in a decade. Since their peaks, homeownership rates have fallen just 2.7 percentage points among whites, but 5.8 percentage points among blacks and 3.3 percentage points among Hispanics. As a result, the Hispanic-white gap has widened and the black-white gap has reached historic proportions.¹⁰³

There is a temptation to attribute the disproportionately severe decrease in homeownership for minorities to racial discrimination. Clearly, the data that drives credit scores is on its face color blind. Some have argued, though, that the disproportionate effect that its application has on certain protected classes means that it has an impermissible disparate impact on those borrowers. The 2007 report by the Federal Reserve Board to Congress concluded that this was not the case.¹⁰⁴

The conservative underwriting standards and overlays applied by lenders have been compounded by conservatism in the appraisal industry.¹⁰⁵ Virtually all lending criteria used by lenders and the agencies contain a maximum loan to value, or LTV, ratio. The “value” in this computation almost always depends on a market value as determined by an appraisal performed by a qualified appraiser of the property that will serve as the collateral of the loan. At the same time that lenders have been lowering the maximum

¹⁰³ JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *supra* note 1 at 17.

¹⁰⁴ BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 19.

¹⁰⁵ For simplicity sake, Chart 2 above uses only one underwriting criteria, FICO score of the borrower. As discussed above, another critical criterion in the underwriting of mortgage loans is the ratio of the amount of the loan request to the appraised value of the home. The Freddie Mae loan data reveals that from 2006 to 2012, the average LTV of closed loans fell from 75.7 to 72.5%. By requiring more cash up front as a down payment, lower LTVs have the effect of compounding the shrinking of the pool of eligible borrows caused by rising FICOs.

LTV for home loans, appraisers have made achievement of those levels more difficult through restrained assessments of value.

The reaction of the appraisal industry is understandable. In the wake of the Melt-Down, the industry was criticized for having been too liberal in the values it ascribed to homes. Appraisers were accused of having been overly influenced in their valuations by the lenders and realtors who were anxious to make sure that contracts for sale and refinancing transactions closed. To remedy this perception of undue influence, Fannie Mae and Freddie Mac adopted new rules in 2010 that require new levels of independence between appraisers and those that have an economic interest in seeing the home appraise at higher levels.¹⁰⁶ These rule changes have been coupled with a natural tendency for appraisers to react to charges of excess by being slow in assigning values to acknowledge that property values had bottomed out and begun to rise.

Communities that saw the highest levels of foreclosures have been the ones most affected by conservative appraisals. One widely-applied method of determining value is to look for comparable sales in a neighborhood. If a community has had a number of forced sales, whether through foreclosure auctions or otherwise, those sales will depress the appraised values of others in the community, despite the fact that the property being appraised is not being put through an expedited sale. The GSEs have tried to address this quirk in the valuation process through rule changes, and its influence has diminished as foreclosure starts have fallen, but its depressing effect on property values lingers.

¹⁰⁶ FANNIE MAE, ANNOUNCEMENT SEL-2010-14: APPRAISER INDEPENDENCE REQUIREMENTS (2010), FREDDIE MAC, Bulletin No. 2010-23 (2010).

The issue of the wide primary/secondary spread in mortgage rates also speaks to the seismic changes in the structure of the lending process over the past few years. When asked why the spread has widened so dramatically since 2007, lenders point to two factors: increased guaranty fees and increased costs to do business. With respect to the former, each of the agencies, with the exception of VA and USDA, has raised the cost for a lender to purchase credit risk protection. Depending on the lender, Fannie Mae and Freddie Mac have raised their guaranty fees by twenty-five to forty basis points during this period.¹⁰⁷ FHA's up front mortgage insurance premium has increased from 125 to 175 basis points, and its ongoing annual premium has risen from fifty to 135 basis points.¹⁰⁸

In addition to increases in the cost of credit insurance, the cost to underwrite a loan and comply with the myriad of regulations that govern the application, closing, and funding process have skyrocketed. All of the forces that have caused underwriting standards to tighten have also caused a heightened emphasis on careful application of those standards by underwriters and review of the quality of their work and compliance with the layers of applicable regulations. Those regulations, most of which are embodied in the regulations promulgated under the Real Estate Settlement Procedures Act and the Federal Truth in Lending Act, have reduced or eliminated tolerances for errors in the paperwork. The Mortgage Bankers Association estimates that the average large-lender mortgage underwriter went from being able to underwrite 188 loans per month in 2002 to

¹⁰⁷ See FREDDIE MAC, *supra* note 86 at 8.

¹⁰⁸ Compare DEP'T OF HOUS. & URBAN DEV., Mortgagee Letter 2008-16 (Jun. 11, 2008) with DEP'T OF HOUS. & URBAN DEV., Mortgagee Letter 2013-04 (Jan. 31, 2013) and DEP'T OF HOUS. & URBAN DEV., Mortgagee Letter 12-4 (Mar. 6, 2012).

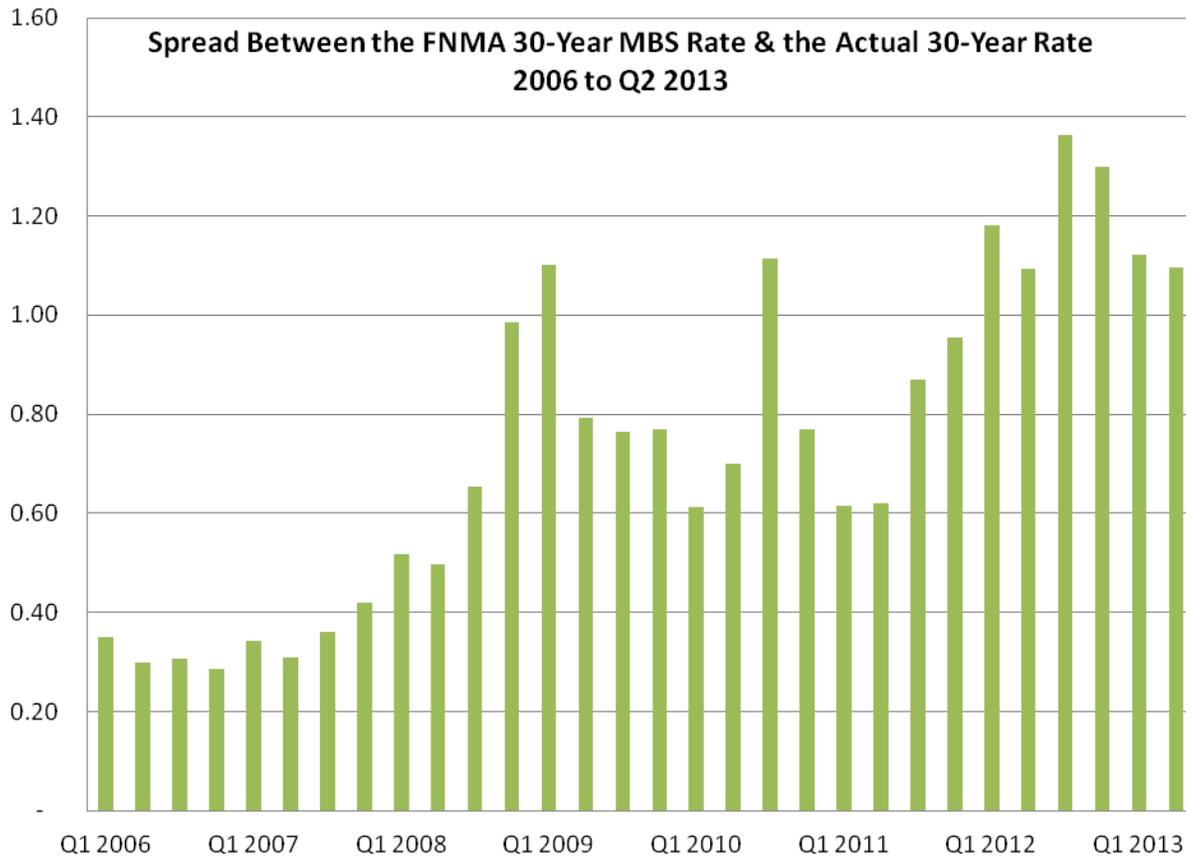
only being able to underwrite only forty-nine loans per month in 2012.¹⁰⁹ Overall, the cost for both large and mid-size lenders to put the average mortgage loan on the books rose from about \$2,350 in 2002 to about \$4,800 in 2012.¹¹⁰

These costs are being built into the interest rate on the mortgage through the spread between the interest rate the borrower pays and the interest rate that the ultimate investor in the loan receives. The chart below shows how that spread has widened since 2007.

¹⁰⁹ Marina Walsh, MORTG. BANKERS ASS'N, HUMAN RESOURCES COMPENSATION ROUNDTABLE 2013: MORTGAGE COMPANY PERFORMANCE TRENDS: FINANCIAL & OPERATIONAL METRICS 27 (2013).

¹¹⁰ *Id.* at 26.

Chart 3¹¹¹



The implication of these widened spreads is that the increases in loss severity and the cost of rule changes after the Melt-Down are being translated directly into higher interest rates being paid by new borrowers today. This increase, in turn, means relatively higher monthly payments on the new loans. In addition, because all lenders and agencies, as well as the new “Qualified Mortgage” and “Qualified Residential Mortgage” definitions, have maximum debt-to-income (“DTI”) rules, the increased spread means that projected monthly payments to satisfy the new mortgage go up and fewer

¹¹¹ Data from BLOOMBERG LP as of September 19, 2013.

prospective borrowers can qualify.¹¹² Once again, the unintended consequence of these market changes is fewer loans and fewer homeowners.

¹¹² The proposed rules defining both a “qualified residential mortgage” and a “qualified mortgage” use a 43% total debt to income ratio as the primary qualifier even though, in the first case, the context is whether the loan is sufficiently safe as not to require “skin in the game” and, in the latter case, the context is the borrower’s ability to repay the loan. As explained above, the lender’s underwriting decision almost always involves other factors including the borrower’s credit score and the amount of the loan relative to the property’s value. On a \$250,000, fixed rate thirty-year loan, an increase of .75% in the interest rate of the loan, which is roughly the amount by which the spread has increased since 2006, results in an increase in the monthly payment of approximately \$109.00.

TIME FOR A CHANGE?

Some have suggested that it is time for the United States to reassess its commitment to homeownership; that the security of tenure provided by ownership is outweighed by the mobility and flexibility of renting and that housing is too volatile an investment to be viewed as a vehicle for wealth formation. In those quarters, the emphasis on converting renters to owners during the Clinton and George W. Bush administrations went too far and became over-emphasis. In effect, people were “duped” into striving for a status that they were unprepared to assume. This push led to excessive leverage, home price hyper-inflation, a home price bubble, the bubble bursting, and, ultimately, the worst recession in decades. In this view, homeownership is the cause, not the victim, of the recent crisis.

Whether or not you agree with the conclusion that many borrowers were hapless participants in the housing market, such a viewpoint overlooks the undisputed advantages that accrue to owning the home in which you raise your family. Individual families, and society as a whole, benefit dramatically from policies that encourage ownership. Moreover, an array of recent surveys indicates that most American families that rent continue to harbor the dream of owning a home one day.¹¹³ The Dream of Ownership appears to be alive and well.

Assuming that the decades-old goal of increasing homeownership is sound, and there is a desire to narrow the gap between majority and minority homeownership, and

¹¹³ Belsky, *supra* note 6 at 5.

further assuming that the nation wants to encourage first-time home buyers to take the plunge, what lessons should be gleaned from the last six years? Are there recent policy changes that need reexamination, or are there more changes that are warranted by what we have been through as a country? My hope is that a discussion will take place that unbundles all the changes that have been layered on the process over the past few years to determine whether the benefits gained by a few consumers outweigh the limitations placed on the access to credit that apply to a substantially greater number of consumers. We need to rebuild a system that encourages lenders and investors to take a chance on borrowers with less than pristine credit.

First and foremost, policy makers need to recognize the merits of the system that functioned so well for many decades. Under that system, mortgage originators were encouraged to lend to a wider group of borrowers, even though a small slice of that group would wind up losing their homes through foreclosure. It was widely understood that the benefits of moving millions of families into homeownership far outweighed the costs incurred by using foreclosure to enforce the repayment obligations of the small slice of borrowers who became delinquent on their loans. This principle does not suggest that every family should be, or desires to be, homeowners; only that the pendulum has swung too far in the other direction. Policy makers should be debating what level of delinquencies we should be shooting for, rather than crafting “no foreclosure” policies.

To that end, regulators need to recommit to the principle of personal responsibility as the bedrock of the mortgage system. The borrower needs to recognize that he is the party in the transaction that is charged with the primary responsibility for determining whether a particular loan product and loan amount is suitable given his

circumstances, and whether he can reasonably expect to be able to repay the loan. While the lender needs to make an independent determination whether he will be able to recoup his investment, the borrower is in the best position to know whether the loan is right for him and his family.

The borrower also needs to recognize that a mortgage note reflects his unqualified commitment to repay the loan. This promise, as memorialized in the note, is unconditional. It does not state that the obligation expires if the value of the property falls below the outstanding amount of the loan. Thus, the borrower must recognize and accept that a transaction involving leverage entails both obligations and risks. The risk of devaluation of the collateral doesn't shift to the lender when prices fall. If the lender chooses to modify this obligation due to changed circumstances, it can do so, but forcing a lender to accept modifications makes all lenders less likely to extend credit in the future.

While the borrower is in the best position to ensure that the loan is suitable and in his best interests, lenders have responsibilities, too. The originator of the mortgage owes the borrower a duty of good faith and fair dealing, with full and timely disclosure of all relevant characteristics of the loan. At the other end of the transaction chain, the lender has an obligation to the investor and/or the assumptor of the credit risk to produce a loan that has the specified loan characteristics at the time the loan is made.

The duties owed by the lender to the borrower are spelled out in a host of regulations, both federal and state, that govern the lending transaction, the most important of these being the federal Truth-In-Lending regulations and the Real Estate Settlement

Procedures Act. Of more recent vintage are procedures that have been enacted to ensure compliance with these rules. The most important of these are the SAFE Mortgage Licensing Act of 2008, which requires mortgage loan originators nationwide to be trained and licensed, and the new rules requiring the Consumer Financial Protection Bureau to conduct compliance examinations on lenders whether or not they are regulated as banks.

The parties that assume the credit risk in the transaction have also taken steps to enforce their contractual position vis-a-vis the originator. As discussed above, underwriting criteria have tightened, required documentation and verifications have increased, and borrowers have been restricted in how much equity they can extract from their homes and how they can use the proceeds. More disturbingly, many investors appear to have chosen to sit on the sidelines unless they can pass the credit risk of the transaction on to a governmental entity.¹¹⁴ Anecdotally, investors say they are willing to analyze price, and assume the risk of non-payment, but cannot do so as long as the “rules of the road” are in flux. Investors appear to be willing to assume credit risk in the mortgage market, but they seem to be unwilling to assume the regulatory risk of the uncertain and uneven application of new regulations and policies.

This reluctance is why the regulatory and legislative policies governing the mortgage market are so critical. In order to encourage more risk-bearing private capital back into the market and ease today’s rigid underwriting criteria, certainty must return to

¹¹⁴ The unwillingness of private capital to reenter the market will become more acute if proposed legislation passes that scales back the role of the federal government in the market. Legislation currently being considered in both the U.S. House of Representatives and the U.S. Senate would, to varying degrees, scale back the amount of credit risk assumed by the federal government in most mortgage transaction. The expectation is that private capital will step into the breach.

the rules applied to the process.¹¹⁵ Policy makers should refrain from attempting to change the rules after the fact through well-intended efforts to protect defaulting borrowers. While principal write-downs, for instance, may appear to be the best economic alternative for all parties once a loan has gone into default, the message it sends to future lenders is that the system will not enforce the borrower's promise to repay. In a similar vein, efforts to apply the laws of eminent domain to underwater mortgages have the effect of injecting a new element of uncertainty into the lending process. In the short run, the borrower benefits; in the longer run marginal borrowers are excluded from the opportunity to become home owners.

Loan put-back policies at Fannie Mae and Freddie Mac and indemnification requests at FHA are other manifestations of the unsettled market. When asked the reason behind onerous underwriting criteria, lenders uniformly cite the uncertainty of the loan repurchase requests by these government entities as the reason. Despite efforts by the Federal Housing Finance Agency and the Federal Housing Administration to define the circumstances that will warrant a loan put-back and the time horizon for eligibility, the perception of open-ended liability for the lender persists.¹¹⁶ To reduce underwriting overlays, regulators need to reduce the uncertainty.

¹¹⁵ On August 28, 2013, the six federal agencies charged with defining a “qualified residential mortgage” (“QRM”) under Dodd-Frank for purposes of credit risk retention proposed regulations that, in essence, would have the definitions of QM and QRM mirror each other. Linking up these concepts is an example of the type of regulatory coordination that is good for the industry and good for consumers. These definitions are highly technical, but important, and bring much needed certainty to the process.

¹¹⁶ Kate Berry, *Fannie & Freddie Aim for Mortgages with “Zero Defects”*, AM. BANKER, Sept. 17, 2013, http://www.americanbanker.com/issues/178_180/fannie-and-freddie-aim-for-mortgages-with-zero-defects-1062150-1.html.

The rules governing the servicing of delinquent loans provide another opportunity to return certainty to the process. Historically, an essential feature of the mortgage transaction has been the right and ability of the owner of the loan to seize and liquidate the collateral in an orderly fashion if the borrower fails to live up to his end of the bargain. Regulatory and legislative efforts to “soften” this process in times of economic stress have caused long-term damage to the system. It is important for policy makers to realize that the cost of efforts to ease the burden on those who default on their loans is being converted into underwriting criteria that affect a much larger group.

Foreclosure is a servicer’s path of last resort when a loan goes bad. Only in the rarest of circumstances do the proceeds of a sale exceed the outstanding debt and the costs of the foreclosure. Lenders have no incentive to foreclose if a more viable and economical alternative can be devised. However, once the decision to foreclose has been made, the system benefits from clear and certain “rules of the road” to encourage efficient processing of the transactions. With this clarity, the negative consequences of foreclosure proceedings are less likely to spill over to innocent bystanders and weigh down market values in the community. Fewer homes fall into disrepair causing blights on neighborhoods. On the other hand, the transaction costs of lengthy foreclosure processes flow through to others as lenders increase interest rates and tighten underwriting standards to offset these costs.¹¹⁷

¹¹⁷ Jeff Brown, *Overhang Hangover: The Housing Market’s Future*, BANKING MY WAY, <http://www.bankingmyway.com/real-estate/foreclosures/overhang-hangover-housing-markets-future> (last visited Sept. 19, 2013); Olick, *supra* note 91; *Long Judicial Foreclosure Timelines Challenge Investors*, HOUSINGWIRE, Aug. 6, 2013, <http://www.housingwire.com/articles/25987-long-judicial-foreclosure-timelines-challenge-investors>.

The need for certainty in the process extends to the efforts of regulators to find ways to punish those responsible for the mortgage crisis and enforce the rule going forward. The use of creative theories of liability is to be applauded in instances of fraud and recklessness. However, widespread application of such theories to ordinary business dealings causes general skittishness and an unwillingness of lenders to be innovative and take chances.

Policy makers need to recognize the goal should not be “no bad loans”. Some level of loan defaults is inevitable.¹¹⁸ The emphasis should be on determining what the proper level of non-performers is, and to place that credit risk on the parties that have made an economic assessment of that risk. Failure to employ enforcement mechanisms with clearly delineated “rules of the road” causes a restriction in the pool of borrowers who will get the chance to become homeowners. Likewise, enforcement actions that require payments to borrowers without evidence that damages have been suffered bring uncertainty to the process, engender moral hazard, and undermine the rule of law.

The overarching principle in all of these recommendations is that care should be given to ensure that policies intended to protect those who, for whatever reason, cannot live up to their obligation to repay their loan, will not be applied in ways that penalize those who are not parties to the transaction. If private investors are willing to assume the

¹¹⁸ Mark Fleming, *Making Mortgage Lemons*, HOUSINGWIRE, Oct. 7, 2013, <http://www.housingwire.com/blogs/1-rewired/post/27287-making-mortgage-lemons> (“[D]ocumentation being incorrect or DTI being calculated incorrectly . . . are the reasons that loans are ultimately repurchased—a failure to manufacture the loan properly. Requiring very high credit scores may reduce the risk of default but it doesn’t prevent us from making a mortgage lemon and only serves to dramatically reduce the pool of eligible borrowers.”)

credit risk of more borrowers on the credit margins, those potential borrowers should be given the opportunity to succeed, even though a fraction will fail.

CONCLUSION

In conclusion, despite the results of the servicing settlements and other government policies intended to help struggling borrowers and to protect hard hit communities, they have instead resulted in payments to those who broke their promises to stay current on loans and misguided policy changes that come at the expense of credit-worthy borrowers who are now subjected to tighter credit standards. The combination of these unintended consequences has resulted in fewer homeowners, particularly first time purchasers, and the widening of the homeownership gap between minorities and white Americans. The overarching policy goal should be to facilitate homeownership, not to shift the burden of non-performance from defaulters to aspiring borrowers. Policies need to change if we wish to continue making homeownership a reality for the broadest group of eligible borrowers in the United States.