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The house price bubble and the financial crisis exposed significant weaknesses in mortgage underwriting, the packaging of mortgage-backed securities (MBS), and the mortgage servicing industry. Over the course of the Great Recession and slow financial recovery, numerous corrective measures ensued, including relief for homeowners underwater on their mortgages and at risk of foreclosure, the voluminous 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act, and subsequent rulemaking on new standards for mortgage underwriting and servicing. As the so-called government-sponsored enterprises (GSEs)—Fannie Mae and Freddie Mac—return to profitability and make significant repayments and dividend payments to the federal government, there is still significant controversy over the housing finance structure that will eventually replace them, as well as uncertainty over the market share private-label MBS will regain.

The fall of the GSEs, leading to their rescue by the federal government in 2008, was blamed not only on excessive risk taking that benefited a few individuals at the top at the expense of the government but also on what some considered to be excessive commitment to the goal of raising the level of homeownership in the United States. At this juncture, five years after the financial crisis and during a still-slow recovery from the Great Recession, significant changes have occurred to the mortgage underwriting, securitization, and servicing processes to reduce credit risks and increase fairness to consumers. At the same time, an unintended consequence has been a reduction in homeownership, particularly among certain minority and low-income groups, and there is confusion, disagreement, and misunderstanding over whether and why the federal government should be pursuing the goal of increased homeownership. This article sheds light on changes that have taken place in the mortgage industry, how homeownership has suffered, and why homeownership is a goal worth pursuing.

Among the developments in mortgage underwriting, securitization, and servicing reviewed in the following pages are the following:

- The origins of the Federal Home Loan Bank (FHLB) system, Federal Housing Administration (FHA), GSEs, other housing-related government agencies, and MBS.
- How lenders over the years have developed underwriting systems to gauge borrowers' ability and willingness to repay their loans, and the criteria that have to be met before approval of home loans.
- How credit scores were developed as a shorthand numerical index of creditworthiness.

- The home price appreciation and subsequent deflation phenomena.
- The role and function of servicers, how they emerged from behind the scenes during the financial crisis as mortgage delinquencies and foreclosures escalated in ways never seen before, how the servicers cut corners at all stages of the foreclosure process, and how public officials took punitive actions against the servicers.
- Government relief programs, including efforts on the legislative and regulatory front to protect struggling homeowners.
- Parts of the Dodd–Frank Act relevant to MBS, including efforts to rein in nontraditional mortgage lending and the creation of the Consumer Financial Protection Bureau (CFPB), which in turn adopted a new set of consumer-oriented servicing standards.
- Efforts to punish wrongdoers, including enforcement actions by the Department of Justice and the Federal Housing Finance Agency (FHFA) originators, sellers, and packagers of mortgages.

RECENT TRENDS IN HOMEOWNERSHIP

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 young 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 toward 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 and 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.

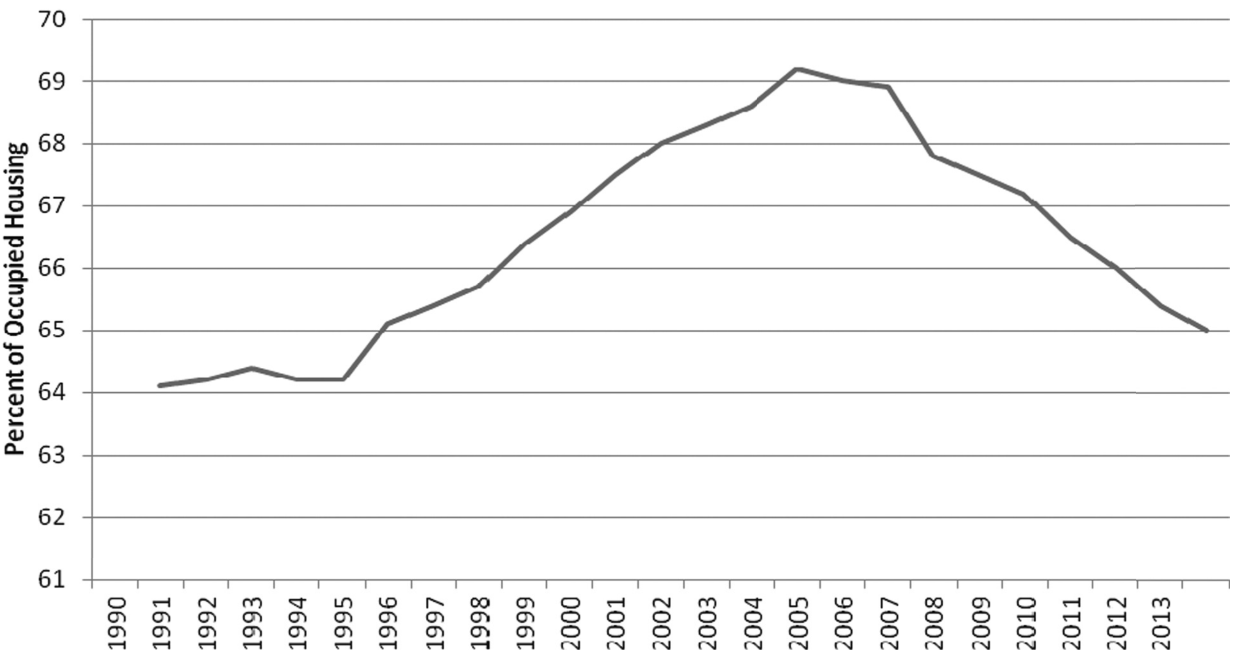
In its annual report on the state of housing issued in June, the Joint Center for Housing Studies of Harvard University [2013] describes a continuing, steady, and precipitous decline in the nation's homeownership rates. As shown in Exhibit 1, this trend began in 2006 and has continued, unabated, through the second quarter of 2013 (U.S. Census Bureau [2013c]). 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 homebuyers. The report goes further to attribute much of the cause of the decline to increasingly stringent lending standards on the part of mortgage lenders nationwide.

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 (Freddie Mac [2013a], Fannie Mae [2013a]). This release marks the first time data in this much detail have been made public by these 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 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 Office of Mortgage Settlement Oversight [2013a], the monitor of the $25 billion settlement fund that resulted from the litigation brought by the federal government and 49 state attor-

Exhibit 1

National Homeownership Rate: 1990 to 2013-Q2



Source: U.S. Census Bureau [2013a,b].

neys general against five of the largest mortgage loan servicers. 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 policymakers. Many suggested that the few areas of noncompliance 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 totality, a picture emerges. For the foreseeable future, it will be increasingly difficult for borrowers with less-than-stellar 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 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 the issue 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 her mortgage and as the value of the property appreciates, the borrower's equity in the home increases. If necessary, this equity can be accessed though the sale of the home or through a "cash out" refinance or revolving line of credit. Homeowners also enjoy tax benefits; 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 30 years, the wealth gap between the wealthiest citizens and moderate wealth families in the United States has grown steadily wider (Sherman and Stone [2010], Belsky [2013]). Recent studies have reported that this widening has continued even as the country has begun to recover from the Great Recession (Chokshi [2013]). Households that are able to convert their greatest monthly living expense—rent—into a tax-protected asset through amortizing long-term debt have a powerful tool for accumulating wealth. The family that owned its own home in 2010 had a median net worth of $174,500, whereas families who rented had one of $5,100 (Bricker et al. [2012]). 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 a 25% higher high school graduation rate than children whose parents rent (Habitat for Humanity of San Antonio [2013]). Children of homeowners are twice as likely to acquire some post-secondary education, and they are 116% more likely to graduate from college (Harkness and Newman [2003]; Habitat for Humanity of San Antonio [2013]). As adults, they earn more and are 59% more likely to own their own home, thus extending the benefits of homeownership on to the next generation.

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. People who own their homes more often participate in civic activities and work to improve the local community, and they are 15% more likely to vote. Lastly, they tend to have greater longevity in a residence, leading to a more stable neighborhood (Habitat for Humanity of San Antonio [2013]).

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, policymakers have long considered the benefits of homeownership to greatly outweigh the disadvantages.

How Homeownership?

The most basic hurdle on the path toward buying a home is having enough cash to pay the agreed-on price of the home. An obvious solution to this problem is to borrow enough to cover the purchase price. But 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.

However, 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 laws of England, prior to colonization of North America. At their core, these laws provide that as long as a borrower pays her mortgage, she can stay in the home and enjoy the benefits of homeownership. If she stops paying her 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 (Snowden [2013]). The low homeownership rate was perpetuated by residential mortgages that had short terms and 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 (Wheelock [2008]).

In response, the federal government created the FHLB 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 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 that helped military veterans and their families secure homeownership. These developments helped homeownership rates rise from 43.6% in 1940 to 55% by 1950 (U.S. Census Bureau [2011]).

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 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 to have 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 more than $100 billion by 2006 (Jackson [2007]). The growth and globalization of capital markets for MBS 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 United States 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.

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 her 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 30-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 nonperformance 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 borrowers' ability and willingness to repay their loans. For many years, lenders would rely on an evaluation of the four Cs of lending: credit, collateral, capacity, and character. Credit refers to the borrower's history of repaying her debts. The responsibility she has shown repaying prior debts, particularly other mortgage debt, is seen as an accurate indicator of how seriously she 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 more than 225 million individuals. These agencies generate more than 1 billion credit reports on these borrowers each year (Board of Governors of the Federal Reserve System [2007]).

The second underwriting criterion is collateral. Because 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 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 she has "skin in the game," and thus, the harder she will work to perform on her 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. The two shorthand measurements of the borrower's capacity are 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 her 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, she 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 her word." The concept hearkens 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 her 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 nonquantifiable 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 Financing Corporation (FICO) scores by 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 her 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." (Board of Governors of the Federal Reserve System [2007]).

The exact formulas used and the weights assigned to individual factors vary by company, but generally they include the borrower's history of payment on mortgage, credit card, utilities and other consumer debts. The score also takes into account the maximum 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 need for credit is accelerating by measuring whether there have been other recent inquiries into the borrower's credit history by other lenders.[1]

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 States who have such scores break down roughly into the percentages shown in Exhibit 2.

Stated another way, roughly 40% of the population has a credit score of greater than 750, and the median credit score for an individual in this country is 720 (Board of Governors of the Federal Reserve System [2007]). But the 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 Exhibit 3 illustrates.

Exhibit 2
Credit Scores by Percentage of Population

FICO Score	Percentage of Population	Cumulative Percentage 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%

Source: Board of Governors of the Federal Reserve System [2007].

The Federal Reserve study 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 20 to 40 times more likely to default than those in the top 25%. The conclusion from these 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 with scores of between 640 and 720 are riskier than those who have scores of above 720, more than 90% of that group of higher-risk borrowers will perform as agreed.[2]

Exhibit 3
Default Rate by FICO Score

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%

Source: Board of Governors of the Federal Reserve System [2007].

The recent release of loan-level data by Fannie Mae and Freddie Mac reconfirms the conclusions in the 2007 Federal Reserve study. The data include 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 (Goodman et al. [2014]). 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 "underwater," and the further underwater a loan is, the more likely the borrower is to give up the struggle to make her 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 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, policymakers, 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 her 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 when necessary.

Typically, the servicer will perform a few other functions to ensure 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.[3] In the event that the originating lender does 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.

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 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 (U.S. Census Bureau [2013a,b]). Minority homeownership also reached new highs during this same period.

The rise in ownership levels was accompanied by increased access for the owner to her 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 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 historical levels. By the end of that year, foreclosure inventories had more than doubled over their year-end 2006 levels (D'Avignon et al. [2010]). 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 (Rexrode [2013]). 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 stood at about 110,000 units in December 2006, were up to 350,000 units, an increase of almost 220% (Blomquist [2010]; RealtyTrac [2007]).

Government to the Rescue

The meltdown 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 2008, Congress passed the Housing and Economic Recovery Act of 2008 (HERA), which 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 fewer than 600 loans nationwide (Collins [2011]). 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) by using more funds approved in TARP. To date, more than 1.26 million loans have been modified under HAMP.[4] 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 announced its Quantitative Easing Program to lower long-term rates by purchases of assets, principally MBS, 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 had been refinanced under it (Federal Housing Finance Agency [2013]).

Congress also attempted to use the Internal Revenue Code to help the housing market and attempt to reverse falling home values. In July 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. In fact, some studies have concluded that the credit mostly accelerated purchases that would have taken place anyway, and as a 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 (Dynan et al. [2013]).

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), FHFA 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 the 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.[5]

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 on 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 Act enacted in 2010. As it applies to the mortgage industry, the Act generally attempted to rein in nontraditional mortgage lending. The act created two new concepts: the qualified mortgage (QM) and 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 2013, final regulations to interpret the QM provisions of Dodd–Frank 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.[6] 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.[7] 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 2013, the six federal agencies charged with defining a QRM under Dodd–Frank 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, 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 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.[8] 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, Freddie Mac, and the FHA—began to raise the fees they charge 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, the FHA, which had seen its market share grow from 4.5% in 2006 to roughly 30% in 2012 (U.S. Department of Housing and Urban Development [2012a]), raised its premiums for mortgage insurance and adopted strict enforcement guidelines for 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 LTV ratios to fall. Exhibit 4 shows the credit score and LTV characteristics of the Fannie Mae loans produced from 2005 to 2012.

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 disappeared from the market by 2008 (Emmons [2008]; Timiraos [2013a]). In their place, government-guaranteed securities stepped up. By 2012, 99.2% of all MBS, which composed more than 90% of all single-family mortgage loans, were guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae (Bipartisan Policy Center [2013]).

EXHIBIT 4

Credit Score and LTV Characteristics of Fannie Mae Loans[9]

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

Source: Fannie Mae [2013b].

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 subprime 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 (Zibel [2007, 2012]; Panchuk [2008]; Schoenberg [2012]; Abelson [2013]). Wall Street firms that were active in the packaging and selling of mortgages have recently been subject to actions by the U.S. Securities and Exchange Commission (SEC), but purchasers of MBS have had difficulty showing that they were misled (Cohen Milstein Sellers & Toll PLLC [2013]). 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.[10] Although a few cases of out-and-out fraud perpetrated against borrowers have been reported, in the vast majority of cases, the borrowers received the proceeds of the loan, either in cash or through the satisfaction of preexisting debt. Moreover, the borrower signed documents stating that she knew the terms of the loan and promising to repay the principal amount, plus interest. In many nonperforming loans, once the borrower stopped making the agreed-upon payments, she stayed in the house for an extended period of time without paying anything. Nevertheless, policymakers have viewed borrowers, by and large, as victims, 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 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 nonperforming 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) (U.S. Attorney Southern District of New York [2011]). 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, but the ramifications for the industry were enormous (U.S. Dept of Housing and Urban Development [2012c]).

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 meltdown. 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.[11] 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.[12]

Enforcement actions by the federal government have not been limited to the FCA. In 2011, the 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." (Federal Housing Finance Agency [2011]). Recently, in what may be related actions, JPMorgan Chase has 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 Fannie Mae and Freddie Mac. Bank of America has been sued by both the Department of Justice and the SEC with respect to MBS that it sold to the public in 2008 (Touryalal [2013]).

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 longstanding expectation that an originator is responsible only for gauging the likelihood of payment at the time of origination and is not expected to possess the skillset of a soothsayer regarding future calamities that may befall the borrower.[13]

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 low levels of delinquencies and foreclosures have historically driven the loan-servicing industry, 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 30 days past due cost approximately $20 per month to service. By the time a loan is more than 60 days past due, that figure skyrockets to $60 per month, a multiple of 12 times the cost of servicing a performing loan.[14] A recent study by the credit rating firm Fitch Ratings estimates that recent changes in the rules governing the servicing of nonperforming loans will cause these costs to double (Fitch Ratings [2012]).

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," whereby the foreclosure process continues while the borrower attempts to renegotiate her 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 with 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 servicing department at mortgage lender, GMAC Mortgage, LLC, testified that he signed off on approximately 10,000 summary judgment affidavits per month (Weiss [2010]). 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 nonpayment 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 meltdown. 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 (McConnell [2010]).

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 50 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, announced in February 2012, with the five largest servicers (National Association of Attorneys General [2012]).[15]

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 borrowers were to be made without regard to financial harm, if any, incurred by the borrowers. The 49 states represented in the settlement[16] 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 standards for executing documents in foreclosure cases, ending improper fees, and ending dual track foreclosures for many loans" (National Association of Attorneys General [2012]).

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 noncompliance with the terms of the settlement, including missed deadlines. In August 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" (Office of Mortgage Settlement Oversight [2013a]). 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 (Office of Mortgage Settlement Oversight [2013b]).

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, whereby 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 relatively paltry settlement terms. In addition, the settlement has been criticized because the large servicers receive credit toward 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 (Prah [2013]). At the same time the settlement discussions were taking place in the "robo-signing" case, the Office of the Comptroller of the Currency and Federal Reserve were negotiating with the same five servicers and nine others over general servicing practices. Those negotiations led to enforcement actions against all 14 in April 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 shortcomings 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).

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 meltdown. Pursuant to the requirements of the independent foreclosure review, more than four million letters were mailed to borrowers who had been foreclosed in 2009 and 2010. 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 more than 160 million people and paid advertisements that generated more than 341 million impressions (Office of the Comptroller of the Currency [2012]). 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 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 (Board of Governors of the Federal Reserve System [2013]). To date, the Office of the Comptroller of the Currency (OCC) and 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 Federal Reserve announced that they had settled with most of the firms subject to the consent orders rather than complete the independent foreclosure review (Office of the Comptroller of the Currency [2013a]). 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 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 2013, all 14 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.[17] Some reports have indicated that out of the 4.4 million borrowers who were subjects of foreclosure, a staggeringly small number—just 53—were not in default on their mortgages and still received foreclosure notices (Fisher [2013]). 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 14 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 midsize national banks (Office of the Comptroller of the Currency [2013b]). The CFPB also announced in January 2013 new servicing rules with similar provisions that would apply to all mortgage servicers servicing more than 5,000 loans (Consumer Financial Protection Bureau [2013b]).[18] 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.

"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. Policymakers 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 her 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 University Joint Center for Housing Studies shows, however, this has not been the case. Homeownership has continued to flag throughout the country (Joint Center for Housing Studies of Harvard University [2013]; U.S. Census Bureau [2013c]).

The Joint Center for Housing Studies 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 (Joint Center for Housing Studies of Harvard University [2013]). This conclusion seems counterintuitive for a number of reasons. First and foremost, as the report 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 (National Association of Realtors [2013]; Beacon Economics [2013]). Although 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 (Kolko [2013]).

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 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 past 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 meltdown, 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 paperwork 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 an 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 past 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 5% and 10%. A small flow, less than 10%, of residential mortgages are also kept on the books of the originators if they are banks, credit unions, or other highly capitalized entities.

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 were acquired 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 (Chrisman [2013]). 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.

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 which 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 (Parrott and Zandi [2013]).

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, the 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 (Bipartisan Policy Center [2013]). Although 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 repurchase the 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 the 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 repurchase. 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 the FHA to buy back that loan, and assumption of the credit risk of a loan that is demonstratably bad. As a result, lenders are more focused than ever on complying 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 nonperforming.

Although for the past 20 years lenders have 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 nonperforming loan now; there is a much heightened risk that it will instantly trigger a search for even a nonmaterial 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 (Dymi [2013]; Levy [2013]). Whether such examples are truly widespread or not, they contribute to more conservative underwriting of new loans.[19] 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.

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.

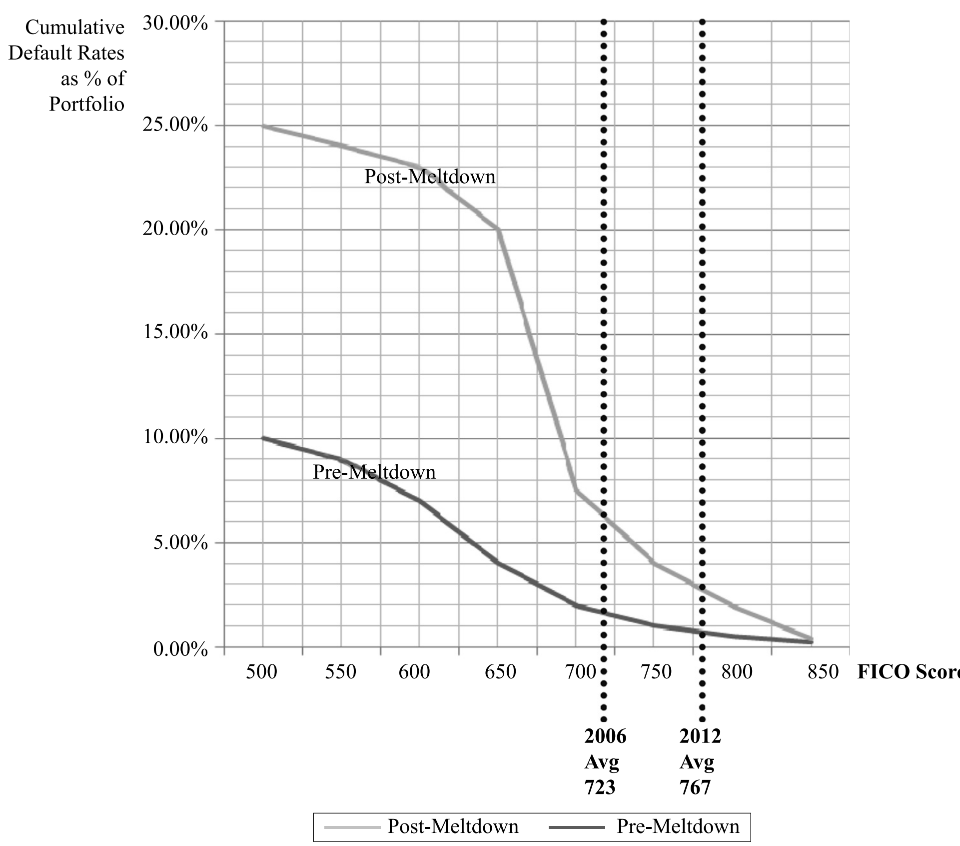
Over the six decades preceding the real estate crash in 2007–2008, there were no periods in which nationwide real estate values underwent sustained house price depreciation. By and large, with the exception of a handful of local market dislocations and quarterly decreases, home prices rose steadily over the preceding 50-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 meltdown. As the loan-level data from Fannie Mae and Freddie Mac show, the frequency of nonpayment 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.

Exhibit 5 displays a graphic depiction of this phenomenon by using FICO scores as a proxy for credit quality and overlaying expected loan-loss curves designed to convey the cumulative changes in the assumptions underlying underwriting decisions.

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 "subprime" 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 LTV ratios, and verified information. All other loans, from this perspective, fall into the subprime category.

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" products. Yet, Fannie and Freddie both created new products that were intended to compete in the nonprime space, and their overall loss experience on their loan portfolios originated after 2003 was dramatically worse than their pre-2003 experience. Much of the blame for this poor

EXHIBIT 5
Cumulative Default Rates on Freddie Mac Loans[20]



performance lies in the overall decline in home values after 2006, but the composition of the portfolios was a contributing factor (Fannie Mae [2013b]; Freddie Mac [2013b]).

Many critics have suggested that the poor performance of the Fannie Mae and Freddie Mac loan books from 2004 through 2008, and the ultimate bailout of those entities, resulted from steps they took to comply with the affordable housing goals imposed on them by policymakers. There can be no debate that both GSEs struggled to comply with those goals and expanded their loan offerings during the 15 years following the enactment of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.[21] This explanation, however, is incomplete (Timiraos [2013b]).

Recent studies have attributed much of the poor performance of loans leading up to the meltdown to a recent tendency of borrowers to extract as much equity from their homes as possible.[22] 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 policymakers 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 H4H refinance program—that prohibited borrowers from participating until the loan had achieved a status of being past due more than 90 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 2009 the Helping Families Save Their Homes Act required borrowers to certify a real need for participation in the H4H refinance program and prohibited borrowers from intentionally defaulting simply to qualify.

Whether one attributes the increased delinquencies to the rise of subprime 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 meltdown.

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, state law has governed the foreclosure process. The speed and efficiency of this process through the meltdown 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 non-judicial foreclosure processes (Agra [2013]; Olick [2013]; Schmit [2013]; and Field [2010]).[23] Additional state and local 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 (Olick [2013]).

Many of the new federal rules regarding servicing of delinquent loans have also increased the cost of resolving those loans. As previously pointed out, 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."[24] 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.[25] The SEC and Department of Justice have become more active recently in pursuing mortgage securitizers under federal securities laws.[26]

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. As a result, overall average credit scores go up and LTV ratios go down in the overall pool of mortgage loans closed.[27] The Fannie Mae data in Exhibit 4 show precisely that sort of trend in the years that have followed the real estate crisis.[28] 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.

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.[29] Every attempt must be made to allow the delinquent borrower to cure her 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 Exhibit 5, 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 creditworthy 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. Certain minorities and first-time homebuyers will feel the effect of this shifting disproportionately.

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 to 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 (Avery et al. [2010]). On a scale of 0 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 30–39-year-old age group, the average is 40.3.[30]

Although no direct correlation exists between this scale and the numerical index used in FICO scores, there is a relative correlation.[31] Moving the average credit scores in the chart 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.[32] 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 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 (Joint Center for Housing Studies of Harvard University [2013]).

There is a temptation to attribute the disproportionately severe decrease in homeownership for minorities to racial discrimination. Clearly, the data that drive credit scores are 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 (Board of Governors of the Federal Reserve System [2007]).

The conservative underwriting standards and overlays applied by lenders have been compounded by conservatism in the appraisal industry.[33] Virtually all lending criteria used by lenders and the agencies contain a maximum 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 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 meltdown, 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 (Fannie Mae [2010]; Freddie Mac [2010]). 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 had 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.

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 the VA and U.S. Department of Agriculture (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 25 bps to 40 bps during this period (Freddie Mac [2013b]). FHA's upfront mortgage insurance premium has increased from 125 bps to 175 basis points, and its ongoing annual premium has risen from 50 bps to 135 bps.[34]

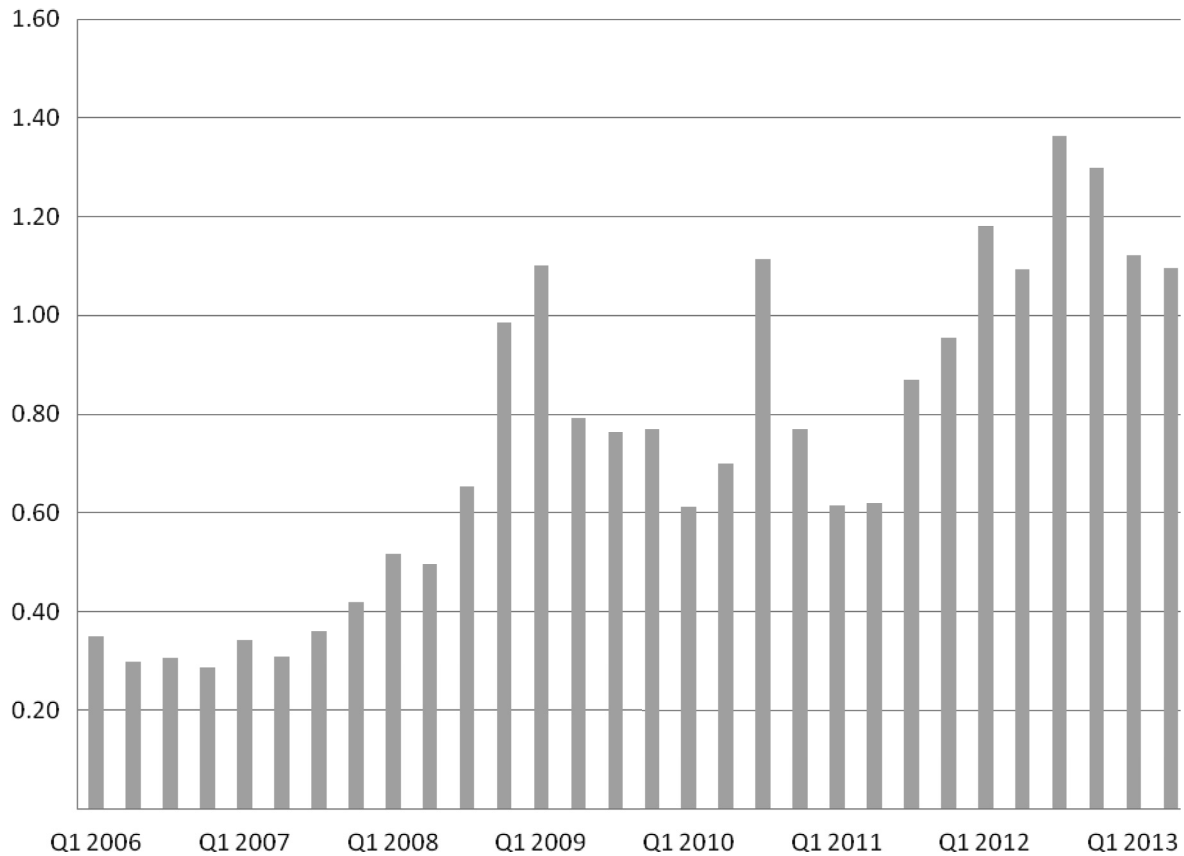
In addition to increases in the cost of credit insurance, the costs to underwrite a loan and comply with the myriad regulations that govern the application, closing, and funding process have skyrocketed. All of the forces that have caused underwriting standards to tighten have also caused a heightened 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 being able to underwrite only 49 loans per month in 2012. Overall, the cost for both large and midsize lenders to put the average mortgage loan on the books rose from about $2,350 in 2002 to about $4,800 in 2012 (Walsh [2013]).

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. Exhibit 6 shows how that spread has widened since 2007.

The implication of these widened spreads is that the increases in loss severity and the cost of rule changes after the meltdown 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 QM and QRM 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 prospective borrowers can qualify.[35] Once again, the unintended consequence of these market changes is fewer loans and fewer homeowners.

E X H I B I T 6

Spread Between the FNMA 30-Year MBS Rate and the Actual 30-Year Rate, 2006 to Q2 2013



Note: Data from Bloomberg LP as of September 19, 2013.

Time for a Change?

Some have suggested that it is time for the United States to reassess its commitment to homeownership—the security of tenure provided by ownership is outweighed by the mobility and flexibility of renting, and 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. In effect, people were "duped" into striving for a status that they were unprepared to assume. This push led to excessive leverage, home price hyperinflation, 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 individual families, and society as a whole, 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 (Belsky [2013]). 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 further assuming that the nation wants to encourage first-time homebuyers to take the plunge, what lessons should be gleaned from the past six years? 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 applies 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, policymakers 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. Policymakers 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 she 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 her circumstances, and whether she can reasonably expect to be able to repay the loan. Although the lender needs to make an independent determination whether she will be able to recoup her investment, the borrower is in the best position to know whether the loan is right for her and her family.

The borrower also needs to recognize that a mortgage note reflects her 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 her 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 is 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-à-vis the originator. As discussed previously, 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.[36] Anecdotally, investors say they are willing to analyze price and assume the risk of nonpayment, but they 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 the rules applied to the process.[37] Policymakers 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 long run, marginal borrowers are excluded from the opportunity to become homeowners.

Loan put-back policies at Fannie Mae and Freddie Mac and indemnification requests at the 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. Despite efforts by the FHFA and FHA 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 (Berry [2013]). To reduce underwriting overlays, regulators need to reduce the uncertainty.

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 her 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 policymakers 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 (Brown [2013]; Olick [2013]; and HousingWire [2013]).

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.

Policymakers need to recognize the goal should not be "no bad loans." Some level of loan defaults is inevitable (Fleming [2013]).[38] The emphasis should be on determining what the proper level of nonperformers 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 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 creditworthy borrowers who are now subject 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 nonperformance 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.

ENDNOTES

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.

[1]The use of credit scores has been criticized by some as failing to take into consideration other nontraditional 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 nontraditional underwriting criteria are relatively sparse.

[2]In the 1990s, the introduction of automated underwriting systems by Fannie Mae and Freddie Mac further modernized traditional underwriting methods as enhanced with credit scores. 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 Veterans Affairs (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 engines also allow for more-sophisticated pricing of loans, requiring riskier loans to bear higher interest rates or greater fees.

[3]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.

[4]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 rewrite 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 [2013]; Mlynski [2013a]).

[5]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 [2013b]). Federal authorities have acted to discourage the use of eminent domain. The U.S. Department of Housing and Urban Development (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. Dept. of Housing and Urban Development [2013a]; Federal Housing Finance Agency [2013a,b]).

[6]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 of greater than 43%; ii) have negative amortization; iii) be interest only; iv) have balloon payments; v) extend beyond 30 years; or vi) have limited or no documentation. See 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.

[7]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 30 years and interest-only loans (Mortgage Bankers Association [2013]). 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 Financial Protection Bureau [2013a,c]).

[8]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).

[9]The LTV ratio is the weighted average origination LTV ratio and excludes HARP loans (Fannie Mae [2013b]). 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 [2013a]).

[10]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 p. 79 (2013).

[11]More recently, the Justice Department has invoked the civil money penalty provisions of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 to force settlements with companies involved in the mortgage securitization process, such as the large credit ratings agency Standard & Poor's.

[12]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 (Thomas [2013]).

[13]In July 2013, the Justice Department issued a subpoena to Clayton Holdings LLC, one of the firms 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." (Mattingly [2013]) 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.

[14]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.

[15]Consent Judgment, United States v. Bank of Am. Corp., No. 12-00361 (D.D.C. Apr. 4, 2012).

[16]Oklahoma did not join the settlement.

[17]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 46 attorneys general in the District of Columbia for $120.6 million. (Oppenheim [2013]; Reuters [2013a]) 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 pleaded guilty to criminal charges and received a sentence of five years in prison. The settlement with the company has been criticized as being a slap on the wrist.

[18]Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X), 78 Fed. Reg. 10,696, 10,697-99 (Feb. 14, 2013).

[19]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 (Mlynski [2013b]).

[20]Post-meltdown data are from loans produced in from 2006 through 2008. Cumulative data after 2008 do not provide sufficient history to be meaningful; data are from Goodman et al. [2014]. Because of the qualifications in the Freddie Mac dataset, discussed in Note 27, it is safe to assume that had the riskier loans been included, the post-meltdown loss charts would have been even steeper. Presumably, inclusion of all loan types would adversely affect the pre-meltdown loss figures as well, but to a much lesser extent.

[21]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 of less than or equal to the area median income, up from the 42% requirement in 1997. This goal was increased to as high as 56% in 2008. (U.S. Dept. of Housing and Urban Development [2001, 2008a]).

[22]This argument is supported by data showing a dramatic increase in the number of cash-out refinances and subordinate lien products (Laufer, [2013]; LaCour-Little et al. [2009]).

[23]Although 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.

[24]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.

[25]The string of settlements with the federal government is ongoing, with SunTrust recently striking a $628 million deal with the Department of Justice, HUD, and Federal Reserve, followed by JPMorgan's $13 billion settlement with the Department of Justice, both reached in hopes of

reducing each banks' uncertainty surrounding the mortgage crisis (Mercinek [2013]; Barrett and Fitzpatrick [2013]). 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. (Chaudhuri [2013]).

[26]See the discussion in the Government to the Rescue section.

[27]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 Exhibit 5 (Mlynski [2013b]).

[28]In addition, recent analysis of the Home Mortgage Disclosure Act (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 (Bhutta and Canner [2013]).

[29]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 be 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 [2011]).

[30]In contrast, the average is 54.2 for whites and 54.5 for Asian Americans. People over age 62 have an average score of 67.7 (Avery et al. [2010]).

[31]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 and Canner [2013]).

[32]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" (Sichelman [2013]).

[33]For simplicity's sake, Exhibit 5 uses only one underwriting criterion—the FICO score of the borrower. As discussed previously, 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 Mac loan data reveal that from 2006 to 2012, the average LTV of closed loans fell from 75.7% to 72.5%. By requiring more cash upfront as a down payment, lower LTVs have the effect of compounding the shrinking of the pool of eligible borrowers caused by rising FICOs.

[34]Compare U.S. Dept. of Housing and Urban Development [2008b] with U.S. Dept. of Housing and Urban Development [2013b] and [2012b].

[35]The proposed rules defining both a QRM and QM use a 43% total DTI 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 earlier, 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, 30-year loan, an increase of 0.75% 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.

[36]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.

[37]On August 28, 2013, the six federal agencies charged with defining a 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 they bring much needed certainty to the process.

[38]"[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 (Fleming [2013])."

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