Want a Robust Housing Market? Then Adjust the Regulatory Mindset*

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Three important papers have been published in the past few months that question the assumptions underlying the basis for passage of certain housing related provisions in the Dodd-Frank Act, and the implementation of those provisions. In some respects they simply articulate what many have been thinking, but in other ways they raise entirely new views of the housing crisis. Taken in total, they suggest that there should be an adjustment of the mindset among regulators if the goal is to encourage the creation of a robust housing market.

The papers are: Reclaiming the Rules: Solutions for Mortgage Servicing by Katherine Porter[1]; Servicing is an Underappreciated Constraint on Credit Access by Laurie Goodman[2]; and Changes in Buyer Composition and the Expansion of Credit During the Boom by Manuel Adelino, Antoinette Schoar, and Felipe Severino.[3]

Starting with the last mentioned paper first, the authors have uncovered facts that raise questions about accepted assumptions on the impact of the aggressive lending on poor populations. Instead of using zip code data, they based their analysis on actual loans. They determined which individual borrowers actually received loans in various zip codes, and discovered that (1) the relationship between income and DTI was generally consistent across all borrowers in all income ranges; (2) most debt, both that which remained current and that which ended in default, was concentrated in middle and upper income borrowers; and (3) the relationship between mortgage size and income growth was generally consistent with that of previous periods.

Using just zip codes masked the real results of the lending that was occurring in the period of the run up to the crisis point, 2002–2007. Unsustainable credit was not flowing disproportionally to poor people. The possible exaggeration of income in those loans (through no doc or low doc) was considered and found not material. For example, the authors compared agency and non-agency loans and found a strong correlation

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1] ***Reclaiming the Rules; Solutions for Mortgage Servicing, A Report of the California Monitor***, Porter, September 30, 2014.

[2] ***Servicing is an Underappreciated Constraint on Credit Access, Housing Policy Center Brief***, Goodman, Urban Institute, December 2014.

[3] Changes in Buyer Composition and the Expansion of Credit During the Boom, Adelino, Schoar and Severino, Working Paper 20848, National Bureau of Economic Research, January 2015.

of buyer income and mortgage growth. They also found that IRS income for the various zip codes equated to the increase in income they had found in their loan document analysis. Finally, they found that even if you accepted the assumption that such loans exaggerated income, the most aggressive conclusions about the amount of overstatement of no or low doc loans income was only around 20 to 25 percent, those loans only at most accounted for 30 percent of all loans, and the new buyer income increases in their analysis is 75 percent and greater. Even using the assumptions "no doc" advocates could use, therefore, using income data in the loans themselves produced accurate results.

The authors attribute the crisis more to exaggerated expectations. They conclude that all zip codes became more leveraged because the number of new buyers increased across all zip codes, new mortgages were more highly leveraged because old mortgages would have had equity built up, and with the housing sector as leveraged as it was throughout most of the country (probably based on the expectation of ever increasing prices of houses), any significant pause in increase in home prices would result in a major downturn.

Had this study been in existence at the time Congress was considering the Dodd-Frank Act's housing provisions, it would have provided the Members of Congress with a different view of the crisis. Whether they would have chosen to act upon this view of the facts rather than another view is difficult to say, but it may be that the lenders would not have been seen to be acting against the interests of poor people, and may not have had the bulk of the blame (and stifling regulations) placed on them.

The other two papers both focus on mortgage servicing. The Porter report was the final report of the California Monitor for the National Mortgage Settlement. While difficult to summarize, it repeatedly makes the point that there were basic mistakes made in implementing the Dodd-Frank Act by regulators. One basic mistake made was to enshrine the National Mortgage Settlement as the inviolable guide to how the rules should be written. She points out that the agreement was written hastily in the midst of the crisis and without an understanding of how its provisions would endure in the real world.

> Regulators, attorneys general, and legislators should have identified the National Mortgage Settlement as a stepping-stone to more successful regulations and remedies.....Some settlement provisions failed to provide homeowners with adequate protections or transparency into the servicing process, and placed unnecessary operational burdens on servicers that did not lead to better outcomes....Still attorneys general and regulators have copied [these rules] verbatim into recent [laws and rules]....Learning is a key task of effective lawmaking. This report identifies the failure to improve on, or even assess, laws.[4]

She recommends more cooperative efforts by CFPB with the industry:

> Reusing ineffective rules will never lead to better outcomes. Regulators, particularly the CFPB, must have a deeper understanding of how mortgage servicers operate and which current rules are weak or failing. The best approaches are data-driven and cooperative with industry....We have reached the limits of where even well-intentioned lawyers — lobbyists for industry and rule makers for government — can take mortgage servicing.[5]

The report takes particular issue with the Bureau's use of language in its rules (called "government speak" in the report).

[4] p. 5.
[5] p. 6.

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> "[T]he use of language is often unclear, excessively wordy, and far too complex for even a sophisticated homeowner to understand. [Regulators] perpetuate, and even sanction, poor communication through their own poorly written sample language...[S]ervicers actually take on compliance risk when they draft better language...."[6]

The report also believes the Bureau mandates excessive and irrelevant language, citing its rule on denial letters, saying that in one case a servicer is following that rule and sending 20 page denial letters to homeowners. Because the letters still contain the poorly worded denial reasons discussed in some detail in the report, "homeowners now have five explanations that they do not understand instead of one."[7]

Mandated time lines are often unreasonable creating unreasonable expectations, and important terms have vague definitions that make them difficult to comply with or enforce.

The report recommends that the GSEs be leveraged to make the changes necessary, that rules should encourage the use of technology, and that the Bureau engage in better consumer testing of real world provisions.

That discouraging assessment of the state of the mortgage servicing rules is somewhat reflected in the Goodman paper. This paper concludes that servicing delinquent loans contributes to credit overlays. She says that while nonperforming loans amount to about 6.7% of a typical servicer's total loans, they absorb 50% of the servicing resources. That cost must be priced into the servicer's products and services.

The risk of put backs and litigation, combined with the high cost and other uncertainties about servicing rules leads to not a tightening of the credit box, but a tightening within the credit box. For example, the lengthy and extending foreclosure timelines in judicial foreclosure states, combined with the pressure to resolve FHA and GSE loans, leads to "tension, if not outright conflict."[8] That this is not a small problem nor one that is solving itself is shown by the fact that the average length of time a loan was delinquent in 2008 was 18 months, but now is 36 months. The pipeline is clogged in judicial states and has been cleared in non-judicial states.

Goodman praises the GSEs for the efforts they have made to make reasonable changes in their servicing demands, but believes that the FHA is far behind. As she puts it, there is "a higher hill to climb at FHA." The FHA has conflicting timelines and onerous penalties. The result is that most loans violate at least one of the present timeframes and incur penalties and fees. A situation in which "a process that assess fees on the overwhelming majority of loans that default simply makes lenders less willing to underwrite loans that have any chance of defaulting."[9]

Public policy implications

Reports such as these that highlight problems associated with servicing help clarify why the credit box remains tight. While there are many other reasons, the uncertainties and risks around delinquent mortgage servicing alone are so great that lenders must take care not to make loans that appear to be possible candidates for default, and the problems around non-default servicing create similar problems.

One answer that could be attempted, of course, is that additional information provided by these kinds of reports could be used by legislators, regulators and enforcement officials in reviewing whether present

[6] p. 6.
[7] p. 10.
[8] p. 4.
[9] p. 8.

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rules are in accord with the real causes of the crisis, and whether in creating the rules, the best choices have been made among many that could have been chosen.

Another point clearly made is that drafters of laws and regulations should not assume too much. Zip codes, for example, are useful for many purposes, but as this research shows, are not definitive on what individual borrowers received loans, what their incomes were, what their DTI ratios were, etc. Assumptions based on faulty data (i.e., using entire zip code demographics) create an impression of lenders, for example, that is not supported by the facts. It is not far-fetched to conclude that this kind of analysis, coupled with headline grabbing anecdotes, led to a punitive mindset against lenders among the public, legislators and regulators that, in turn, led to more and more onerous regulations, hampering the return of a robust housing market.

Finally, the clear implication of these papers is that everyone involved should spend some quiet time reading writers like Kindleberger,[10] and absorb the lesson of history that there will always be movements in housing prices. They go up and they go down. Sometimes they will result in manias (think tulip bulbs) that create bubbles, and at that point there is a temptation to believe that they will always go up, that this time we have figured out how to stop the cycle.

Well, we haven't.

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[10]Manias, Panics and Crashes: A History of Financial Crises, Charles Kindleberger.

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