NFHA
National Fair Housing Alliance

Testimony of Deborah Goldberg, National Fair Housing Alliance
On Private Mortgage Insurance
Before the House Financial Services Committee Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
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Good afternoon. On behalf of the National Fair Housing Alliance (NFHA), I want to thank you for the opportunity to testify today about private mortgage insurance. Founded in 1988, the National Fair Housing Alliance is a consortium of more than 220 private, non-profit fair housing organizations, state and local civil rights agencies, and individuals from throughout the United States. NFHA uses comprehensive education, advocacy and enforcement programs to provide equal access to apartments, houses, mortgage loans and insurance policies for all residents of the nation. My name is Deborah Goldberg, and I am the director of NFHA's Hurricane Relief Project. I am also involved in NFHA's public policy work on a range of financial services issues, including lending, insurance and foreclosures.

Introduction

NFHA commends the Financial Services Committee for holding this series of hearings on the future of the nation's housing finance system, and the Subcommittee for holding this hearing on the role of private mortgage insurance in the housing market. We believe that homeownership is an important path to building wealth, and done correctly, can be a mechanism for eliminating much of the considerable racial and ethnic gap in wealth that divides our country.[1]

In the face of the foreclosure crisis we are currently facing, some may conclude that our housing policies have gone too far in promoting homeownership, and that we should pull back from that goal. Having watched this crisis unfold in communities of color all across the country, we come to a different conclusion. We believe that it is critical to understand the extent to which the crisis has been fueled by a misalignment of interests

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[1] See Edward N. Wolff, "Recent Trends in Household Wealth in the United States: Rising Debt and the Middle-Class Squeeze—An Update to 2007," Levy Economics Institute of Bard College Working Paper No. 589, March 2010, which compares income, net worth, non-home wealth and homeownership rates for Non-Hispanic Whites, Non-Hispanic African-Americans and Hispanics from 1983 to 2007. Using data from the Federal Reserve Board's Survey of Consumer Finances, Wolff found that the mean non-home wealth for Non-Hispanic whites in 2007 was $495,300. For Non-Hispanic African-Americans, the mean non-home wealth was $70,700, and the mean for Hispanics was $96,300. Homeownership rates for these groups were 74.8%, 48.6% and 49.2%, respectively.

between borrowers and lenders, brokers, investors and servicers, which created financial incentives to put borrowers in unsustainable loans. It is also critical to understand the types of loan products which are – and are not – sustainable, the protections needed to prevent unsustainable products from flooding the market, and the mechanisms like private mortgage insurance that can be used to mitigate against mortgage risk.

My testimony today will address the questions raised by the Subcommittee, including:

- The role and importance of private mortgage insurance to consumers;
- The impact of private mortgage insurance on loan modifications;
- Whether private mortgage insurance benefits borrowers and alternatives that may be available;
- The need for additional consumer protections related to private mortgage insurance; and
- How private mortgage insurance should be paid for.

The Role and Importance of Private MI Companies

The primary beneficiaries of private mortgage insurance are the originating lender and the investor in the loan. The former gains the ability to sell the loan, freeing capital to make more loans. The latter gets protection against the risk of default, without having to pay for the insurance policy. The mortgage insurance premium is paid by the borrower, who gets no benefit in the event of a default.

That is not to say that private mortgage insurance has no benefits for borrowers. To the contrary, private mortgage insurance makes it possible for people to buy a home with a down payment of less than 20%. In that sense, mortgage insurance is a win-win proposition. It protects the lender and investor, is profitable for the insurer, and puts homeownership within reach for the borrower. Without private mortgage insurance, the requirement for a large down payment would be an impossible barrier to homeownership for many people of color and low- and moderate-income people, who have less accumulated wealth than white households or higher income households. When combined with solid underwriting and sustainable loan terms, loans with low down payments carrying private mortgage insurance have shown stable performance.

The federal government's mortgage insurance programs, particularly the Federal Housing Administration (FHA), have also made homeownership possible for many families of color and many with modest incomes. FHA, developed in 1934 to jump start the housing market during the Great Depression, provided the model upon which today's private mortgage insurance industry is based, and demonstrated that it was possible to make homeownership work for families with modest income. The MI industry has provided an important private sector alternative to that mortgage insurance program, creating competition for FHA and other government programs, and providing choice for borrowers. This competition has been critical to the health of many communities.

Private Mortgage Insurance and Loan Modifications

The presence of private mortgage insurance on a loan, and the opportunity for a servicer to file a claim for the covered portion of the loan balance, could tip the scales in favor of moving forward to foreclosure. In this situation however, the interests of the borrower and the private mortgage insurer are aligned. They both benefit if foreclosure can be avoided. The borrower gets to keep his or her home and the insurer gets to avoid paying a claim. Neighboring homeowners also benefit when foreclosure is avoided, as does the community as a whole.

Efforts by private mortgage insurance companies to help prevent foreclosure are not merely charitable; they also serve the companies' bottom lines. Nonetheless, we commend the industry for stepping forward early on to raise concerns about the potential for this "thumb on the scale" effect, and for working with the Treasury Department, servicers and borrowers to try to prevent foreclosures.

One option the industry has put forward is the pre-claim advance, through which the private mortgage insurer makes a partial payment to the servicer before the loan goes to foreclosure in order to make a loan modification viable. Where this can be used, it has the potential to keep the borrower in the home, save money for the mortgage insurer, and provide a favorable economic return to the investor.

Unfortunately, the impact of these and other private mortgage insurance industry loss mitigation efforts is unclear. Borrowers may not be aware that their loan carries mortgage insurance, and are even less likely to know whether or not their servicer has filed a claim or how that claim was resolved. As a result, borrower advocates have little evidence about how private mortgage insurance is affecting foreclosure prevention efforts.

We are not aware of any comprehensive data tracking the number of mortgage insurance claims paid as the result of foreclosures, the number of loan modifications made where pre-claim advances were involved, and the number of modifications that were able to be accomplished without intervention from the MI company. In order to fully understand the role that private mortgage insurance plays in loan modifications, it would be very helpful to have data on these issues. Such data should also include information about any patterns that are developing based on borrower characteristics, loan characteristics, geographic location, investor requirements or other factors affecting the outcome. We encourage the Subcommittee to explore these questions in more depth.

Alternatives to Private Mortgage Insurance

There are a number of alternatives to private mortgage insurance, some of which are more beneficial to borrowers than others. In the subprime market, for example, it was not uncommon to see so-called "piggy-back loans," where the first mortgage was limited to 80% of the purchase price, but the borrower took out a second loan for 10% to 20% of the remaining amount. This kept the first mortgage down to 80%, but left the borrower with a combined loan-to-value ratio of 90-100%. Such a high level of housing debt proved unsustainable for many borrowers.

On the other hand, the community development world has crafted a number of alternative credit enhancements that have benefited borrowers, lenders and investors. For example, some non-profit organizations have developed extensive homeowner and credit counseling programs, sometimes with substantial requirements for one-on-one counseling sessions, that can serve as an alternative form of credit enhancement. This homebuyer education process gives borrowers the information necessary to manage the costs and responsibilities of homeownership, and connects them to resources that can help them through any unexpected difficulties. Because it can, in some cases, eliminate the need for private mortgage insurance, it is less costly for the borrower. At the same time, it gives lenders and investors confidence that the borrower will make payments in a timely manner.[2]

A variation on this approach is the sweat equity model used by Habitat for Humanity, which requires potential homeowners to spend a specific number of hours working on the construction of their homes. The investment of time and labor by the homeowner minimizes the likelihood that he or she will default. In some places, local Habitat programs have been able to partner with lenders to provide homebuyers with mortgages that rely on this sweat equity as a credit enhancement, rather than requiring private mortgage insurance.

"Earned equity" is another form of credit enhancement that has been used in the community development world. This is a type of rent-to-own arrangement, where a portion of the tenant's monthly rent payment is set aside in an escrow account controlled by a non-profit organization. If the tenant makes rent payments on a timely basis for a specified period of time, he or she obtains a loan to purchase the property, and when the tenant assumes ownership, the funds in the escrow account are converted into a down payment-like equity investment on his or her behalf.

Another approach is for a third party, generally a community development corporation or other non-profit organization, to set up a reserve account that is held against specific loans. If any of the borrowers whose loans are backed by the reserve account should default, the reserve funds are used to make the lender whole.

Often, these credit enhancements are layered, so that sweat equity, earned equity or a third party reserve account would be combined with extensive borrower education. A drawback to these approaches, as compared to private mortgage insurance, is that they lack standardization. As a result, their use is relatively limited. And to the extent that they are used in conjunction with loans that are held in portfolio by the originating lender, their volume is necessarily constrained.

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[2] One example of a program using this model is the Anti-Predatory Lending Remediation Program developed by the Toledo Fair Housing Center in partnership with Fannie Mae. Other organizations have used a similar model.

We commend the Subcommittee for considering alternative forms of credit enhancement as part of its deliberations about the future of the housing finance system, and encourage you to look for ways to expand the use of credit enhancements that lower costs to the borrower while providing protection for the lender and investor.

Protections for Consumers: Fair Housing Concerns

a. The Federal Government Has an Interest and Obligation to Ensure the Private Mortgage Insurance Industry Operates Fairly

The PMI companies have benefited tremendously from federal requirements imposed on the Government Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac. According to the terms of their charters, the GSEs cannot purchase loans with down payments smaller than 20% unless they have some form of credit enhancement. Private mortgage insurance has been the primary mechanism through which the GSEs have met this requirement. Without this requirement, there is little question that the private mortgage insurance industry would be much smaller.

In addition, the risk retention provisions of the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act also create a carve-out for private mortgage insurance.[3] Thus, regardless of what the future may hold for the GSEs, the private MI industry will continue to benefit from federal regulatory requirements. Together, these federal regulatory requirements have played an essential role in creating a market for the industry. As a result, the federal government has both a special interest and a special obligation to ensure that the industry is operating in a manner that is fair and non-discriminatory, as well as safe and sound.

b. MI Companies Are Subject to the Fair Housing Act

The federal Fair Housing Act[4] makes it illegal to discriminate on the basis of race, color, religion, national origin, sex, familial status or disability in all real-estate related transactions. Among other provisions, Sec. 804. [42 U.S.C. 3604] of the Act makes it unlawful:

> (a) To refuse to sell or rent after the making of a bona fide offer, or to refuse to negotiate for the sale or rental of, *or otherwise make unavailable or deny*, a dwelling to any person because of race, color, religion, sex, familial status, or national origin. (emphasis added)

Sec. 805. goes on to say:

[3] The Dodd-Frank Wall Street Reform and Consumer Protection Act addresses risk retention requirements in Sec. 941. The law directs federal regulators to define a "qualified residential mortgage," and set risk retention requirements taking into consideration, among other things, ‘‘ mortgage guarantee insurance or other types of insurance or credit enhancement obtained at the time of origination, to the extent such insurance or credit enhancement reduces the risk of default."

[4] 42 U.S.C. 3601 et seq.

(a) In General.--It shall be unlawful for any person or other entity whose business includes engaging in residential real estate-related transactions to discriminate against any person in making available such a transaction, or in the terms or conditions of such a transaction, because of race, color, religion, sex, handicap, familial status, or national origin.

(b) Definition.--As used in this section, the term "residential real estate-related transaction" means any of the following:

(1) The making or purchasing of loans or providing other financial assistance--

(A) for purchasing, constructing, improving, repairing, or maintaining a dwelling; or

(B) secured by residential real estate.

The Act covers mortgage insurance transactions, just as it does mortgage lending and homeowners insurance. This means that private mortgage insurance companies may not deny coverage or offer coverage on different terms and conditions to borrowers based on their membership in any of the classes protected under the Act. They may not treat borrowers differently, nor may they institute policies that have a disparate impact on members of protected classes.

c. The Industry's Lack of Transparency Creates Fair Housing Concerns

Relatively little detailed information is available to the public about many of the operations of the private mortgage insurance industry, including its underwriting standards, the characteristics of the borrowers to whom it provides insurance and the geographic location of the properties securing the loans insured. Eight companies voluntarily submit aggregate information to the federal banking regulators in conjunction with the Home Mortgage Disclosure Act. These data provide a high level overview of activity by these particular companies, but not the level of granularity needed to determine fair lending compliance. They do not include data at the loan or census tract level, for example, which would be necessary for fair housing compliance purposes. This lack of transparency raises concerns about potential fair housing and other consumer protection problems in the industry.

d. The Problem of Adverse Competition

This concern is compounded by the fact that borrowers do not obtain private mortgage insurance directly. Rather, when it is required, it is arranged by the lender. This means that mortgage insurers compete for the lender's business, not the borrower's business, creating the conditions in which adverse competition can take place. Private MI companies have an incentive to make their product as attractive, and as profitable, to lenders as possible. They have very little incentive to attract borrowers through lower prices or more competitive terms and conditions. This may or may not result in terms, conditions or prices that disadvantage members of protected classes, but more transparency in this area would enable the agencies responsible for ensuring Fair Housing

Act compliance and members of the public to determine whether or not problems do exist.

Because borrowers do not shop for private mortgage insurance directly, they have no basis for comparing their private MI coverage with that of others who are similarly situated. This makes it nearly impossible for them to determine whether they have been treated fairly, and underscores the importance of oversight by the government. Unfortunately, in our experience, fair housing compliance is not an area in which most state insurance regulators have significant expertise, nor do they make it a focus of their market conduct examinations. The federal government could play a very useful role to protect consumers if it stepped in to ensure fair housing compliance by mortgage insurance companies.

Our concern about these fair housing issues is also based on the history of racial redlining and other forms of discrimination in the real estate industry overall, many of which were institutionalized by the federal government in the early days of the Federal Housing Administration.[5] While the discriminatory policies of the FHA have long since been

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[5] At the time FHA was established, real estate, lending and appraisal manuals embraced the idea that racial homogeneity was key to sustaining home value and that the racial characteristics of the neighborhood affected real estate value and, therefore, loan risk. In one appraisal treatise, the author indicated the significance race played in property valuation. Frederick Babcock wrote in chapter 7, “Influence of Social and Racial Factors on Value” of his appraisal manual, *The Valuation of Real Estate* (New York: McGraw, 1932)

> "Among the traits and characteristics of people which influence land values, racial heritage and tendencies seem to be of paramount importance. The aspirations, energies, and abilities of various groups in the composition of the population will determine the extent to which they develop the potential value of the land." (pg. 86)

> "Most of the variations and differences between people are slight and value declines are, as a result, gradual. But there is one difference in people, namely race, which can result in a very rapid decline. Usually such declines can be partially avoided by segregation and this device has always been in common usage in the South where white and Negro[sic] populations have been separated." (pg. 91)

Indeed appraisal manuals created by the American Institute of Real Estate Appraisers listed a ranking of races and nationalities to indicate their impact on real estate value. The most favorable groups were listed at the top. The least favorable groups were listed at the bottom. One of the rankings appeared as follows:

1. *English, Germans, Scotch, Irish, Scandinavians*
2. *North Italians*
3. *Bohemians or Czechs*
4. *Poles*
5. *Lithuanians*
6. *Greeks*
7. *Russians, Jews (lower class)*
8. *South Italians*
9. *Negroes*
10. *Mexicans*

eliminated, their impact lingers in the market place, and we are still struggling to overcome them. In the absence of a rigorous system of fair housing oversight and enforcement for the private mortgage insurance industry, it is difficult to have confidence that its policies and procedures have been subjected to the necessary fair housing compliance evaluation.

e. Reliance on Credit Scores May Disadvantage Protected Classes

Another area of concern from a fair housing perspective is the industry's use of credit scores for determining whether to offer mortgage insurance to a particular borrower, and what price to charge. This concern is based on two primary factors. First, the use of credit scores tends to disadvantage people of color, women, and others whose scores are often lower than those of white borrowers. This may be due to their lack of access to mainstream sources of credit and their resulting reliance on sources of credit that affect credit scores negatively, like finance companies and payday lenders.

Second, there is growing concern about how useful credit scores are for predicting loan performance and whether the financial sector is placing too much reliance on credit scores rather than other risk factors such as loan terms. Recently, many consumers with perfect payment records have found that lenders have lowered their credit limits in order to reduce the lenders' own exposure. The resulting increase in credit utilization has led to plummeting credit scores, even while the consumers continue to make timely payments. Such changes raise the question of whether the consumer's previous (higher) credit score was accurate, whether the current (lower) score is accurate, or whether neither is an accurate measure of the credit risk he or she poses.

f. The Need to Distinguish Between Risky Loans and Risky Borrowers

In the mortgage arena, research conducted by the Center for Community Capital at the University of North Carolina indicates that loan characteristics, including prepayment penalties, adjustable interest rates and origination channel (i.e., broker originated loans

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This concept was not only embraced and perpetuated by the private sector but, was fully adopted by the government as the Home Owners Loan Corporation, the Federal Housing Administration, and the Veterans Administration all based their underwriting guidelines on these biased viewpoints.

The Home Owners Loan Corporation, founded in 1932, created a series of color-coded maps indicating the level of risk presented by each neighborhood. Race was a key factor in determining the risk level of neighborhoods evaluated by the HOLC. (See Hillier, Amy, *Residential Security Maps and Neighborhood Appraisals: The Home Owner's Loan Corporation and the Case of Philadelphia*, Duke University Press, 2005) The HOLC institutionalized the practice of lending redlining within the federal government. This served to sanction discriminatory policies and practices that were already being perpetuated by the private sector. Because racially mixed neighborhoods and predominately African-American communities were graded as the areas with the highest degree of risk, very few loans were approved in these areas.

By the time the FHA and VA programs were established, lending redlining was a systemic function of the federal government. The FHA and VA utilized the same restrictive and discriminatory policies that had been adopted by the HOLC. The FHA referenced minorities as adverse influences upon a neighborhood.

vs. retail loans) are better indicators of loan performance than borrower characteristics.[6] Unfortunately, credit scoring systems do not make this distinction, a problem with profound implications. Nearly 3 million households have gone through foreclosure since 2007, and millions more face foreclosure in the next few years. Many of these families were sold inappropriate and unsustainable loans, whose risky features doomed them from the outset. Had they been placed in loans without the same risk characteristics, they might well still be in their homes and making timely mortgage payments.

Communities of color, which were targeted for abusive loan products, have been particularly hard hit by the foreclosure crisis. In particular, African-American and Latino borrowers received a disproportionate share of sub-prime, higher cost and unsustainable loans.

- African-Americans and Latinos are more likely to receive payment-option and/or interest-only mortgages than their White counterparts. [7]
- African-Americans and Latinos are much more likely to receive a subprime loan than their White counterparts according to HMDA data. Roughly 54% of African-Americans and 47% of Latinos received subprime loans compared to approximately 17% of Whites.
- Even higher income African-Americans and Latinos receive a disproportionate share of subprime loans. According to one study that analyzed more than 177,000 subprime loans, borrowers of color are more than 30 percent more likely to receive a higher-rate loan than white borrowers, even after accounting for differences in creditworthiness.[8]
- An analysis by the Center for Responsible Lending shows that borrowers residing in zip codes whose population is at least 50 percent minority are 35 percent more likely to receive loans with prepayment penalties than financially similar borrowers in zip codes where minorities make up less than 10 percent of the population.[9]

Moreover, a recent study by the Center for Responsible Lending demonstrates that African-Americans, Latinos and Native-Americans are more likely to experience foreclosure than their White counterparts. The study reveals that African-Americans are 76% more likely, Latinos are 71% more likely and Native Americans are 31% more likely than their White counterparts to experience foreclosure[10].

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[6] Lei Ding, Roberto G. Quercia, Wei Li, and Janneke Ratcliffe **, "**Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models**,**" May 17, 2010, Forthcoming in *Journal of Real Estate Research,* available at *http://www.ccc.unc.edu/abstracts/091308_Risky.php.*

[7] *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders*. Consumer Federation of America, May, 2006.

[8] See Bocian, D. G., K. S. Ernst, and W. Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending, May 2006, p. 3.

[9]Bocian, D.G. and R. Zhai, *Borrowers In Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans*, Center for Responsible Lending, January 2005.

[10] Bocian, et. al., "Foreclosures by Race and Ethnicity: The Demographics of a Crisis", July, 2010. http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosures-by-race-and-ethnicity.pdf

To the extent that risky loan features were responsible for these foreclosures, failure to distinguish between risk associated with the loan product and risk associated with the borrower may unfairly increase disparities in credit scores between people of color and others. Continued use of credit scores under these circumstances, by private mortgage insurers and others, raises significant fair housing concerns. We urge the Subcommittee to explore this issue in greater detail, and to take any steps necessary to ensure that the use of credit scores for mortgage insurance underwriting and/or pricing does not disadvantage people of color and others protected under the Fair Housing Act.

Paying for Private Mortgage Insurance

The cost of private mortgage insurance is commonly built into the borrower's monthly mortgage payment. Other arrangements do exist, but they are used much less extensively. Under federal statute, when a borrower can demonstrate that the loan-to-value ratio has dropped below 80%, he or she can request the servicer to cancel the private mortgage insurance coverage, and the monthly premium is no longer collected by the servicer. Further, when the outstanding loan balance drops below 78% of the original loan balance, the servicer is required to cancel the mortgage insurance policy. Because the payments are made monthly, rather than rolled into the principal balance, cancellation under either of these circumstances is relatively easy.

It is critical that any alternative payment arrangement the Subcommittee might consider be structured so that it can be cancelled when coverage is no longer required. Any arrangement that rolls the premiums into the loan balance works to the disadvantage of the borrower, who will be forced to pay interest on that coverage for the life of the loan, even if the coverage is no longer in force.

Conclusion

Once again, I thank the Subcommittee for holding this hearing and for inviting me to testify. As you consider the future of the housing finance system, it is important to think about the need for credit enhancements to expand homeownership options and to consider whether alternatives to private mortgage insurance can and should be explored. It is also important to ensure that the industry operates in a manner that is fair and non-discriminatory. If the Subcommittee can obtain some of the data discussed here, it will help to ensure that the debate about these very complex questions is better informed. NFHA will be happy to assist you in your investigation of these questions in any way that we can, and I look forward to your questions.