Finishing What Dodd-Frank Started: Why Housing Finance Reform Still Matters

While the subprime mortgage rupture and the foreclosure crisis have been making headlines for several years now, steep and unequal barriers to sustainable lending have characterized the housing landscape for decades. Minority and low-income communities were targeted by predatory lenders against the backdrop of a dual credit market in which affordable, sustainable loans were out of reach for many qualified prospective homeowners. In the wake of the subprime collapse, the details of those predatory practices finally came into public view. With the support of civil rights advocates, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] in 2010, aiming in part to reform lending practices. Despite the important consumer protections advanced by Dodd-Frank, however, the movement towards fair and sustainable credit remains incomplete: the legislation created a framework for more robust, focused consumer protections and restraints on lenders, but did not address fundamental issues in the secondary market. Because loan securitization policies and practices shape the extent to which sustainable mortgages are reliably available, and are needed to incentivize the operation of inclusive, accurate lending, equitable reform of the secondary mortgage market is a crucial next step. The window of debate over a successor structure to the government-sponsored enterprises, Fannie Mae and Freddie Mac (known as the GSEs) provides an opportunity for policymakers to ensure that all Americans can participate in the market on fair terms. Secondary mortgage market reform is a crucial arena in protecting housing choice, addressing disparities in access to credit, and ensuring that the purchase and securitization of mortgages adheres to fair housing and other civil rights principles.

As has been extensively documented, the foreclosure crisis has resulted in a tremendous loss of wealth and residential stability, for minority communities in particular.[2] These impacts are magnified within communities, as foreclosures bring down property values, leading to blighted neighborhoods and decreased tax revenues. Renters suffer as well as homeowners, due to poor building maintenance and evictions.[3] The secondary market - influential in shaping which lending practices are profitable—contributed to these problems by trading in exploitative loans while failing to sufficiently support fair and accessible lending. Much of the damage of the crisis can be traced to targeting by predatory lenders and to the inaccessibility of affordable credit, even for qualified potential borrowers. Due to a history and continued practice of lending discrimination that can be traced back for many decades, communities of color lacked viable lending alternatives and familiarity with the mortgage market.[4] Many borrowers who could have qualified for more affordable and sustainable prime loans took out subprime loans (frequently due to a lack of other options),[5] and often, the fees and terms attached to subprime loans reflected a lack of oversight and healthy competition, rather than a disinterested calculation of risk.[6]

As described more fully below, the secondary market continues to present obstacles to fair and sustainable lending that will hamper our housing market and economy going forward and that disproportionately burden Americans of color and Americans of modest income. Specifically:

- Inadequate stability and liquidity for loans enabling multifamily homes, affecting millions of families who rent their homes.
- The need for securitization standards that incentivize fair lending and guard against discrimination.
- Flaws in credit scoring practices that inaccurately exclude borrowers.
- Disconnects between certain loan features such as downpayments and actual risk.
- Underwriting criteria that may incentivize unsustainable lending.
- A lack of basic civil rights regulations at the Treasury Department and uneven enforcement among other regulatory bodies.

Fortunately, research and experience highlight an innovative body of policy approaches that can address these problems in ways that strengthen and protect our financial sector, housing market, and economy as a whole. These include:

- Government engagement to support both stability (by ensuring constant and stable funding) and coverage (by ensuring the availability of financing for sustainable loans to all qualified home buyers and owners) in mortgage lending. For example, a successor entity to Fannie Mae and Freddie Mac could be designed to continue the GSEs' key contributions, while avoiding past errors. As well as providing guarantees, such an entity could support loans that are not cost-effectively securitizable but have significant social value, such as modified mortgages and small multi-family projects.
- Clear and effective incorporation of existing civil rights requirements, including those of Title VI of the Civil Rights Act of 1964 and Title VIII of the Civil Rights Act of 1968 (both prohibiting discrimination, and requiring steps to affirmatively further fair housing).[7] For example, federal support in the secondary mortgage market should promote underwriting standards that incentivize the location of affordable housing in "high opportunity" neighborhoods outside racially identified, high poverty areas.[8] Additionally, HUD should promptly implement a disparate impact regulation under the Fair Housing Act, and Treasury should address its lack of pertinent civil rights regulations, under Title VI and Title VIII.
- Stable financing for a range of housing choices, including government support for affordable (mixed-income) rental housing. This should focus on creating an adequate supply of rental housing, as well as directing the development of that housing to high-opportunity neighborhoods.
- Data collection and analysis of sufficient breadth and rigor to render secondary market transactions transparent and accountable to regulators and the public, including for purposes of assessing civil rights compliance.
- Accurate risk assessment practices, designed to effectively protect lenders, investors, and the system, without perpetuating unjustified disparities in credit availability and pricing. This includes improving the fairness of credit scoring practices; scrutinizing loan features (such as downpayments) to assess their true bearing on risk; and guiding underwriting practices to ensure that they are both disciplined and equitable.

These reforms should be a priority in crafting a new housing finance system that, far from replicating the mistakes of the past, would serve all Americans fairly and sustainably.

The Dodd-Frank Act and Primary Market Reform

The Dodd-Frank legislation contributed valuable reforms to the mortgage market, by barring many deceptive and predatory lending practices, reforming mortgage industry practices and products that encouraged abuses, and bolstering oversight. Fair lending advocates heralded the bill as promoting "innovative but responsible lending," by "correcting perverse incentives, installing important safeguards, and encouraging efforts to more accurately determine risk profiles."[9] The law's provisions include establishing new regulation of credit rating agencies; requiring loan securitizers and originators to retain an economic interest in assets (risk retention); establishing the Consumer Financial Protection Bureau, with the authority to issue rules to protect consumers, including by prohibiting mortgage terms and practices found unfair, deceptive, or predatory; allowing for more robust enforcement by states; establishing an Office of Housing Counseling within HUD; and establishing liability for mortgage originators in violation of its standards for fair treatment of borrowers.[10] In provisions amending the Truth in Lending Act, Dodd-Frank prohibited the steering of consumers into predatory or unwarrantedly disadvantageous loans,[11] and specified that "abusive or unfair lending practices that promote disparities among consumers of equal credit worthiness but of different race, ethnicity, gender, or age" were also prohibited.[12]

Despite these advances, Dodd-Frank left much work yet to be done, particularly in two areas: 1) developing affirmative practices to encourage an inclusive market that does not leave historically underserved communities out in the cold; and 2) addressing the ongoing need for affordable rental housing. These aspects of housing finance need to be addressed to provide borrowers and renters with stable, affordable housing options. This need is acute not only for individual borrowers, but for entire communities still reeling from the impacts of unfair lending practices, with declines in property values and tax revenue accompanying high foreclosure rates.[13]

The Secondary Market and Equitable Access to Sustainable Mortgages

The direction that housing finance reform takes will influence the availability of sustainable credit and home ownership for millions of Americans. Much of the growth in American home ownership throughout the past century can be traced to the influence of the secondary mortgage market, and in particular to the GSEs. In keeping with their government-created charters, the GSEs brought liquidity, stability, and affordability to the mortgage market, helping millions of Americans step into homeownership with the assistance of long-term, stable mortgages. These contributions benefited the country as a whole, promoting affordable housing choices, stability, and wealth-building opportunities for the workforce and all Americans. Yet despite their affordable housing goals, the GSEs – like the broader market – left many qualified borrowers underserved.[14]

Secondary market reform proposals such as the Administration's, which fails to offer affirmative support for an inclusive market, fall short of providing the stable, fair, and accessible mortgage market that America needs. Dodd Frank took aim at fraudulent, discriminatory lending practices, as well as the hazardous investment practices that fueled them. However, there is a remaining need to actively provide for equitable access to housing loans, and to ensure those loans are adequately financed through the secondary market. Without sufficient government support, the credit vacuum that left many communities vulnerable to predatory lending in the first place will go unaddressed, restricting housing choice and market participation for many qualified borrowers. This will impair the stability and wealth-building opportunities that homeownership endows, and that benefit individuals, neighborhoods, and the nation as a whole.

A significant question in restructuring the secondary mortgage market is how to ensure liquidity on a nationwide scale, to serve both single-family and multifamily borrowers, and with a framework that encompasses underserved markets.[15] The GSE successor structure will need to take those inherited responsibilities into account, but must also improve upon the prior system's record of performance in safe and sound lending to minorities. Government involvement (as through guarantees), as well as strong oversight and enforcement, will be critical to this endeavor's success.[16] It is important to ensure that already underserved communities, including those where credit risk may be poorly understood, are not cut off from the benefits conveyed by a government role. The system should also be able to sustain diverse financial institutions that can cater to the breadth of communities.

The Secondary Market and Rental Housing

Secondary mortgage market reform will impact people across the housing spectrum, including millions of renters across the country.[17] Market-rate rental housing is beyond the reach of many Americans,[18] an issue that may be exacerbated by future increases in demand,[19] and that indicates the need for policymakers to incentivize the development of affordable rental units. This is an issue of particular relevance to low-income and minority households, each of which are disproportionately renters.20 Under the current system, the GSEs have been a significant contributor to multifamily credit, providing liquidity by creating a demand for those securities.[21]

The GSEs' successor regime in housing finance will need to ensure liquidity and stability for multifamily, as well as single-family, loans. In addition to contemplating how the secondary market can best support multifamily development, policymakers should give targeted consideration to affordable housing in particular. Issues at stake include the availability of government guarantees to lower the cost of financing affordable rental housing;[22] support for Low Income Housing Tax Credit (LIHTC) investment;[23] and the financing of underserved sectors, such as small multifamily properties.[24] As discussed in our accompanying brief on "Affirmatively Furthering Fair Housing and Secondary Mortgage Market Reform," (PRRAC, June 2011)[25] the secondary market should guide the development of affordable housing to high-opportunity areas and should promote integration.

The Secondary Market and Fair Housing Compliance

While robust primary market enforcement is essential to ensure fair lending, it must be complemented by oversight of civil rights compliance in the secondary market. The secondary market can incentivize responsible lending, and should be structured to actively do so. While Dodd Frank attempts to govern which loans are permissible, it is the securitization standards that determine which loans are marketable, and therefore are likely to be generated. Additionally, individual mortgage originators may not consciously intend to discriminate or be aware of their role in contributing to a larger pattern, as they respond to underwriting criteria. It falls to secondary market regulation to incentivize fair lending and guard against discrimination through those criteria.

As a new system of housing finance unfolds, underwriting and risk assessment practices left unaddressed by Dodd Frank will need to be examined on a number of levels. This includes improving the fairness of credit scoring practices; scrutinizing loan features (such as downpayments) to assess their true bearing on risk; and guiding underwriting practices to ensure that they are both disciplined and equitable. Where higher costs are disproportionately imposed on minority borrowers, it is important to understand whether this pricing is due to a legitimate business justification — in other words, whether it truly reflects risk to the lender.

The GSEs historically brought a measure of consistency to the home mortgage market through standardized underwriting criteria, which are shaped by financial safety considerations and dictate the acceptable risk features of purchased loans.[26] However, underwriting criteria which do not accurately reflect risk can result in disproportionate loan denials to minorities;[27] conversely, they may incentivize unsustainable lending. Similarly, miscalculations about the level of risk incumbent in particular loan or borrower characteristics (such as loan to value ratios or credit scores) can yield discriminatory results. This can be damaging to individuals, communities, and the market, as it fails to allow fair participation by prospective borrowers.

The financial crisis has shown the importance of strong regulation and oversight, as well as the destructive results of unfair lending. While Dodd-Frank made important advances on this front, government agencies, including HUD, DOJ, Treasury, the SEC, and the CFPB, will need to coordinate their efforts to ensure effective enforcement of anti-discrimination laws in the secondary, as well as primary, mortgage market.[28] This entails focusing resources, and issuing strong regulations and guidance, to effectively implement Title VI of the Civil Rights Act of 1964, Title VIII of the Civil Rights Act of 1968 (the Fair Housing Act), and other laws specifically in application to the secondary market. Federal agencies are responsible both for ensuring nondiscrimination and for the duty to affirmatively further fair housing, and must attend to the impacts of mortgage securitization policies and practices on civil rights. For example, critical regulatory gaps – such as Treasury's lack of regulations implementing Title VI or the duty to affirmatively further fair housing,[29] as well as HUD's need to promptly implement a clear disparate impact regulation under the Fair Housing Act[30] – must be addressed, and regulations and guidance need to speak specifically to mortgage securitization.

Relatedly, improved data collection and analysis on a secondary market level is fundamental to ensuring fair lending. Meaningful reporting that renders secondary market transactions transparent and accountable to the public is a key component of effective oversight. Even conscientious regulators may find it hard to keep pace with highly incentivized, competitive private actors, and data analysis at the secondary market level provides a crucial enforcement tool. Additionally, as the new system of mortgage finance and its effects are still uncertain, there should be ongoing monitoring of the effect of new policies on segregation and homeownership rates.

Conclusion

The housing finance system of the future must be designed to promote stable, equitable credit for all American communities. Continued government involvement is needed to provide fair access to the market and to sustainable loan products, in order to ensure that housing choices are available for homeowners and renters. Additionally, there is a continuing need to redress the historical inequities that made so many borrowers vulnerable to predatory lending in the first place. These aspects of responsible and inclusive housing finance should be key considerations for legislators and other policymakers.

Prepared by the Opportunity Agenda for the *Civil Rights and Housing Finance Reform* series.

References

1 Dodd-Frank Wall Street Reform and Consumer Protection Act, 11 P.L. 203 (2010).

2 Even back in 2009, the wealth drain for African Americans was an estimated $164 billion. “Discrimination and Mortgage Lending in American: A Summary of the Disparate Impact of Subprime Mortgage Lending on African Americans,” Monique Morris, NAACP (March 2009), citing Center for Responsible Lending. See also “From Foreclosures to Re-Redlining,” California Reinvestment Coalition, at 18. A recent report from the Center for Responsible Lending found that nearly 8 percent of African American and Latino homeowners have faced foreclosure, compared to 4.5% of non-Hispanic white homeowners. Center for Responsible Lending, http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosures-by-race-and-ethnicity.pdf. As data gathered under the Home Mortgage Disclosure Act (HMDA) reveals, African Americans and Latinos have received disproportionate shares of unsustainable loans; suffered disproportionate foreclosures; have less access to credit; and witness shrinking homeownership rates. “A National Tragedy: HMDA Data Highlight Homeownership Setbacks for African Americans and Latinos,” Center for Responsible Lending Issue Brief (Sept. 2010).

3 See, e.g., “Upkeep neglect bedevils tenants: Renters suffer in foreclosures”(March 12, 2011), http://news.cincinnati.com/article/20110313/BIZ/103130333/; “Renters becoming latest victims as foreclosure crisis widens: Multifamily Defaults Rising: Some tenants left in dilapidated buildings,” *Washington Post* (Nov. 23, 2009), http://www.washingtonpost.com/wp-dyn/content/article/2009/11/22/AR2009112200927.html?hpid=topnews; “Housing Crisis Hits Renters Hard,” *ABC News* (April 24, 2008), http://abcnews.go.com/GMA/story?id=4715736.

4 Brescia, 2 Alb. Gov’t L. Rev. 164, 172-73. For one discussion of the history of lending discrimination, focusing in particular on the FHA, see also Gordon, Adam, “The Creation of Homeownership: How New Deal Changes in Banking Regulation Simultaneously Made Homeownership Accessible to Whites and Out of Reach for Blacks,” 115 Yale L. J. 186 (2005).

5 Id.

6 See Alan M. White, “SUBPRIME MORTGAGE AND DISCRIMINATORY LENDING: BORROWING WHILE BLACK: APPLYING FAIR LENDING LAWS TO RISK-BASED MORTGAGE PRICING,” 60 S.C.L. Rev. 677 (2009).

7 Title VI prohibits discrimination on the basis of race, color, or national origin in programs receiving federal financial assistance, 42 U.S.C. §2000d, et seq.; Title VIII, the Fair Housing Act, prohibits discrimination in the sale, rental and financing of dwellings based on race, color, religion, sex or national origin, 42 U.S.C. §3601, et seq. Section 3608(e)(5) of the Fair Housing Act requires HUD to “administer the programs and activities relating to housing and urban development in a manner affirmatively to further the policies of [the Fair Housing Act].” The FHA seeks “to provide, within constitutional limitations, for fair housing throughout the United States;” to “remove the walls of discrimination which enclose minority groups;” and to foster “truly integrated and balanced living patterns.” Additionally, Executive Order 12892, as amended (Leadership and Coordination of Fair Housing in Federal Programs: Affirmatively Furthering Fair Housing), provides that programs and activities relating to housing and urban development (including any Federal agency having regulatory or supervisory authority over financial institutions) shall be administered in a manner affirmatively to further the purposes of the Act. E.O. 12892, Equal Opportunity in Housing (Jan. 17, 1994), 59 F.R. 2939.

8 See “Affirmatively Furthering Fair Housing and Secondary Mortgage Market Reform: Making the Connection,” Philip Tegeler and Henry Korman, PRRAC (June 2011), available at http://www.prrac.org/pdf/AFFH_and_GSE_Reform.pdf.

9 Opportunity Funding Corporation, “The Way Forward: Proposals to Resolve the Crisis and Rebuild Wealth,” at 10, available at http://mba.yale.edu/news_events/pdf/economic_stabilization_whitepaper.pdf.

10 Dodd-Frank Wall Street Reform and Consumer Protection Act, 11 P.L. 203 (2010); see also “A Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act,” at http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf.

11 For example, Dodd-Frank includes language prohibiting:

(A) mortgage originators from steering any consumer to a residential mortgage loan that: (i) the consumer lacks a reasonable ability to repay …or (ii)

has predatory characteristics or effects (such as equity stripping, excessive fees, or abusive terms);

(B) mortgage originators from steering any consumer from a residential mortgage loan for which the consumer is qualified that is a qualified mortgage…to a residential mortgage loan that is not a qualified mortgage;

(C) abusive or unfair lending practices that promote disparities among consumers of equal credit worthiness but of different race, ethnicity, gender, or age; and

(D) mortgage originators from: (i) mischaracterizing the credit history of a consumer or the residential mortgage loans available to a consumer; (ii) mischaracterizing or suborning the mischaracterization of the appraised value of the property securing the extension of credit; or (iii) if unable to suggest, offer, or recommend to a consumer a loan that is not more expensive than a loan for which the consumer qualifies, discouraging a consumer from seeking a residential mortgage loan secured by a consumer's principal dwelling from another mortgage originator. Dodd-Frank Wall Street Reform and Consumer Protection Act, 11 P.L. 203, Sec. 1403 (2010).

12 Id., Dodd-Frank Wall Street Reform and Consumer Protection Act, 11 P.L. 203, Sec. 1403 (2010).

13 See, e.g., Raymond Brescia, "Worst Of Times: Perspectives On And Solutions For The Subprime Mortgage Crisis: Article: Subprime Communities: Reverse Redlining, The Fair Housing Act And Emerging Issues In Litigation Regarding The Subprime Mortgage Crisis," 2 Alb. Gov't L. Rev. 164, 169 (2009).

14 See "Furthering Fair Housing, the Housing Finance System, and the Government Sponsored Enterprises," Henry Korman for Kirwan, p. 9.

15 See "Improving U.S. Housing Finance through Reform of Fannie Mae and Freddie Mac: Assessing the Options," Furman Center (2010) at 11.

16 Id. at 12.

17 See "Furthering Fair Housing," Kirwan at 20.

18 "America's Rental Housing: Meeting Challenges, Building on Opportunities," at 24.

19 Id. at 3.

20 The minority share of renters is 45%, with significant growth within the past decade, and half of immigrants are renters; renters are also "heavily concentrated in the bottom half of income distribution." "America's Rental Housing: Meeting Challenges, Building on Opportunities," Joint Center for Housing Studies of Harvard University (2011), p. 3, available at http://www.jchs.harvard.edu/publications/rental/rh11_americas_rental_housing/AmericasRentalHousing-2011.pdf.

21 Id. at 11; "A Responsible Market for Housing Finance," Center for American Progress (2011) at 26.

22 "Responsible Market for Housing Finance," CAP (2011), at 44; "A Responsible Market for Rental Housing Finance," CAP (2010) at 29.

23 "A Responsible Market for Rental Housing Finance," CAP (2010) at 29.

24 "Meeting Multifamily Housing Finance Needs During And After The Credit Crisis: A Policy Brief," Joint Center for Housing Studies, Harvard University (2009) at 7, available at http://www.jchs.harvard.edu/publications/finance/multifamily_housing_finance_needs.pdf.

25 See "Affirmatively Furthering Fair Housing and Secondary Mortgage Market Reform: Making the Connection," Philip Tegeler and Henry Korman, PRRAC (June 2011), available at http://www.prrac.org/pdf/AFFH_and_GSE_Reform.pdf.

26 See "Furthering Fair Housing, the Housing Finance System, and the Government Sponsored Enterprises," Henry Korman for Kirwan, at 17, available at http://4909e99d35cada63e7f757471b7243be73e53e14.gripelements.com/FairHousing_FairCredit/korman_ffh_and_the_gses_revised_090410.pdf.

27 Id.

28 Id.

29 See PRRAC et al. Letter to Treasury, Oct. 2010, available at http://www.prrac.org/pdf/civil_rights_letter_to_Michael_Barr_10-26-10.pdf.

30 See Disparate Impact Under the Fair Housing Act: A Proposed Approach, Robert Schwemm and Sara Pratt, NFHA (2009), available at http://www.nationalfairhousing.org/Portals/33/DISPARATE%20IMPACT%20ANALYSIS%20FINAL.pdf