Testimony of

NATIONAL CONSUMER LAW CENTER

before the

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

regarding

H.R. 607

HOMEOWNERS INSURANCE PROTECTION ACT

March 18, 1997

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Mr. Chairman and Members of the Committee, the National Consumer Law Center thanks the committee for inviting us to testify today regarding the implications of passage of H.R. 607 for low-income consumers.

The National Consumer Law Center is a nonprofit organization specializing in consumer credit issues. We work with thousands of attorneys around the country, representing low-income and elderly homeowners, who request our assistance with the analysis of credit transactions to determine appropriate claims and defenses their clients might have.[1] As a result of our daily contact with these practicing attorneys we are very familiar with the consumer credit issues facing low-income borrowers in most states in the union. We have worked for years, in a variety of forums, to facilitate the ability of our low-income clients to obtain and maintain homeownership. For example, in addition to our work with legal services attorneys and private attorneys on cases and projects to reduce mortgage costs; we have a number of contracts with mortgage servicers to avoid foreclosures.[2] In a different arena, we have endeavored to explain the impact of various federal legislative proposals on our low-income clients to members of Congress for the past several years. We are interested in private mortgage insurance ("PMI") because it is generally an additional cost for our low-income clients when they purchase or refinance a house.

We commend Mr. Hansen and the other sponsors of H.R. 607 for taking the initiative on behalf of consumers to reduce the cost of private mortgage insurance. H.R. 607 is a very good start toward the effort of reducing homeownership costs.

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[1] The National Consumer Law Center, Inc. (NCLC) is a nonprofit Massachusetts corporation founded in 1969 at Boston College School of Law and dedicated to the interests of low-income consumers. NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government and private attorneys across the country. *The Cost of Credit* (NCLC 1995) (plus the 1996 Supplement), *Truth in Lending* (NCLC 3rd Ed. 1995) (plus the 1996 Supplement) , and *Unfair and Deceptive Acts and Practices* (NCLC 1991) (plus the 1996 Supplement) are several of our twelve practice treatises published by NCLC which, along with our newsletter, *NCLC Reports Consumer Credit & Usury Ed.*, describe the law and conditions currently applicable to home lending.

[2] We have contracts with Freddie Mac and the FDIC to work with financially distressed homeowners and their lenders to avoid foreclosures and keep the borrowers in their homes through work out agreements. We also have a grant from Fannie Mae for the same purpose.

This testimony has three parts:

- **Part One** has some general information in Private Mortgage Insurance, and the ways in which it impacts on consumers' mortgages, and on low-income borrowing in particular.
- **Part Two** provides an analysis of H.R. 607; what this bill does and does *not* do for consumers.
- **Part Three** sets out basic principles that we recommend be included in a bill designed to reduce unnecessary PMI costs for consumers.

Part One: General Information on Private Mortgage Insurance, and its Impacts on Low-income Homeowners.

Private Mortgage Insurance is an important tool which helps enable low-income and minority borrowers to obtain homeownership, *but it is not the primary tool in the marketplace.* Without a doubt, FHA is "the primary bearer of credit risk for home purchase loans to lower-income and black or Hispanic borrowers and in lower-income and minority neighborhoods."[3] As the Federal Reserve recently pointed out, conventional mortgage lenders only provided approximately one-fourth of loans to low-income and black or Hispanic borrowers. The message from this information is that PMI insurance is an important vehicle to enhancing homeownership, but it is not the dominant provider of low-income homeownership opportunities.[4] Therefore, the regulations considered for PMI insurance should be written with this consideration.[5]

There has been a lot of discussion about the propriety of establishing a federally proscribed 80 to 20% loan to value ratio ("LTV") for PMI. The mortgage industry has indicated that 80% LTV may be too high as a federal standard, and that it wants flexibility to require PMI on loans with a lower LTV ratio. However, according to the Federal Reserve Board, among Fannie Mae and Freddie Mac mortgages in 1995, there were ***zero*** *loans with PMI insurance which had an original loan to value ratio of 80 % or less.*

[3] "Distribution of Credit Risk Among Providers of Mortgages to Lower-Income and Minority Homebuyers," *Federal Reserve Bulletin,* vol. 82 (December 1996) at 1089.

[4] PMI insurance is generally used by borrowers who are a better credit risk, or who wish to obtain loans over the FHA limits.

[5] The use of PMI is a primary tool for lenders to reduce their risk of loss due to borrowers' failure to pay their mortgage loans as scheduled. When a borrower defaults on a home loan, the lender generally forecloses on the loan. Even if the property has not lost value, there are a number of costs associated with foreclosure, including unpaid interest, legal expenses, costs to maintain the property and costs from the sale of the property. PMI reduces the lender's credit risk by providing a portion of the lender's losses after a default. Different PMI policies and companies provide different coverage for loans. As a result, PMI providers basically perform their own underwriting review, evaluating both the creditworthiness of the prospective borrower and the adequacy of the collateral offered. Because many lenders sell their mortgages to Fannie Mae and Freddie Mac (Federal National Mortgage Association and Federal Home Loan Mortgage Corporation, respectively), the underwriting guidelines of these agencies are generally followed by the PMI provider. ("Private Mortgage Insurance," *Federal Reserve Bulletin*, vol. 80 (October 1994), pp. 883-99.)

Further, much of the analysis on the proper point for automatic termination of PMI insurance has been based on loans which have original ratios of 90% or 95%. The industry has provided amortization schedules to staff showing that loan to value ratios do not drop fall to 80% or below for some higher interest rate loans until after the mid-point on a 30-year loan.[6]

This argument is somewhat disingenuous, because the Federal Reserve Board has found that the privately insured mortgages—those held by Fannie Mae and Freddie Mac—are more concentrated in the 80% to 90% range.[7] ***Loan to value ratios of 80% or less are met much sooner for loans with original LTVs of less than 90%.*** For example, ***in a 30-year loan at an 8% interest rate, which has an original LTV ratio of 85%, the equity in the home equals 80% of the loan in the 5th year*** (using the original price of the home as the measure). Following is a table which illustrates this at various interest rates:

85% LTV at Origination
30 Year Loans

Interest Rate on Loan	**When Principal Equals 80%**	**LTV Ratio Halfway through Term**
8%	5th year, 4th month	65%
9%	6th year, 2nd month	67%
10%	7th year (0 months)	69%
11%	7th year, 11th month	71%
12%	8th year, 10th month	73%
13%	9th years, 9th month	74%
14%	10th year, 8th month	76%

As a significant number of PMI loans in the marketplace are originated with a LTV ratio of less than 90%, and the borrowers' equity meets or exceeds the 80% LTV point in first *third* of the loan term, or less, automatic termination clauses should be required based on these realities. Requiring automatic termination only halfway through the loan term is a rather extravagant degree of extra premiums allowed to servicers.

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[6] Industry schedules show, for example, that on a loan with an original 95% LTV, the 80% ratio is not reached until the 11th year for a 30 year loan with an 8% interest rate; the 13th year for a loan with a 10% interest rate; the 15th year for a loan with a 12% rate; and the 17th year for a 14% interest loan.

[7] "Distribution of Credit Risk Among Providers of Mortgages to Lower-Income and Minority Homebuyers," *Federal Reserve Bulletin,* vol. 82 (December 1996) at 1099-1100.

Part Two: Analysis of H.R. 607—What this Bill Does and Does *Not* Do for Consumers.

The intent of this bill is good: to reduce the amount of unnecessary PMI premiums paid by borrowers. However, as the bill was originally drafted, only a few borrowers would be able to actually benefit from its provisions. (We are aware that new drafts of language on H.R. 607 have been continually proposed during the last few days, many provisions of which differ significantly from those in H.R. 607. As it hard to discuss a constantly moving target, we thought it best to address our remarks to the original version of H.R. 607. In **Part Three** of this testimony, we provide reactions to other suggestions which have been made.)

The original version of H.R. 607 does not create any new rights to cancel PMI insurance. Instead, the bill requires a lot of new disclosures about the borrower's *possible* right to cancel. The effect of requiring disclosures of a right which may not exist would be only to tantalize and frustrate those borrowers who choose to act on the disclosures—only to find that they have no right to cancel their PMI insurance. Such a consequence cannot be what was intended by the sponsors.

Further, the conditions for cancellation are not limited in any way, other than the fact that they must be disclosed. A lender—or servicer—could disclose, for example, that one of the conditions for cancellation be something like: "The lender must be satisfied that its general underwriting requirements will not be compromised by allowing the private mortgage insurance to be canceled on your home." In such a case the disclosure, and any rights which might flow from it, becomes meaningless; the lender would have retained the right to refuse cancellation based upon a subjective reason, unknown and unchallengeable by the borrower.

Part Three: Basic Principles for a Bill Designed to Reduce Unnecessary PMI Costs for Consumers.

1. Disclosure is fine, but the benefit to the consumer is really embodied in the *right* to cancel the PMI. Disclosures do not create rights--except to obtain the disclosures. Information about actual rights that exist is important. But if H.R. 607 is meant to be a bill which actually provides benefits to consumers, it should actually create rights for consumers. Indeed, the mortgage industry benefits from clarity of obligations as well.

2. Automatic termination of PMI is the key to protecting consumers from unnecessary PMI premiums. More consumers will benefit--and the mortgage industry will avoid unnecessary costs and litigation--from a crystal clear requirement of termination of PMI at a certain point in the loan term. Obviously, the earlier this point, the more consumers benefit. However, legislators should bear in mind that whatever disclosures, and early rights to terminate PMI, are otherwise created, *the majority of PMI borrowers will continue to pay PMI premiums until the automatic termination provision requires cancellation.*

Most borrowers will not take advantage of a possible right to cancel PMI premiums, if they first must bear the cost of an appraisal. The costs of an appraisal can vary widely even within a single community. And many borrowers may be wary of incurring the costs of an appraisal when they are not certain that it will have the desired result of causing the PMI premium to be canceled.

Having to come up with the money to fund the appraisal to prove the value of the house poses a significant hurdle--and unfair impacts--on low-income households. Studies have shown that many households do not have access to "investment capital," and cannot afford to make expense saving improvements, even if they know that these expenditures will result in immediate savings. Studies and cases from the efforts in the energy area to curtail costs by reducing energy needs provide examples of this problem. Even though with an energy conservation program a household can save $500 in electricity bills over the next two years, if the household does not have the initial $400 to invest in an energy efficient refrigerator, no refrigerator will be purchased, and no savings will be realized.[8]

3. Cancellation of PMI insurance should occur automatically at or very near 80% LTV. One must look at the actual purpose of PMI: to provide some insurance to lenders from (a) credit risky borrowers, and (b) inadequacy of collateral on the loan.[9] Once the borrower has been paying on a loan for enough years to reduce the LTV ratio to less than 80%, the lender *is in the same position with this borrower as it would have been at the inception of the loan had the borrower put 20% down.* Additionally, the lender has *this borrower's payment record* to ensure that there is no unreasonable credit risk.

Therefore, it is rational to require automatic cancellation of PMI premiums at the point during the loan term when the borrower reaches a LTV ratio at which this lender would have been willing to make the loan *without* PMI coverage in the first place.

As the industry standard for requiring PMI coverage is 80%, that seems to be a reasonable trigger to require its cancellation as well. The industry has spent a lot of energy discussing the need for flexibility, and how it will hurt low-income borrowers in particular if PMI must be canceled at the arbitrary point of 80% LTV in every loan. Yet there are no loans (or so few that they have not been documented by the Federal Reserve Board) that are currently being made in which PMI insurance is required for a loan with an LTV ratio of less than 80%. However, if the industry is insistent on its need for flexibility in the future (which could only mean that in the future PMI insurance might be required for loans where 25% or more would have to be paid on the home by the borrower), logic dictates a trigger equivalent to the lender's own: that LTV ratio at which this lender would have been willing to make this loan to this borrower with no PMI required.

4. Automatic cancellation at a later time would be better than discretion and confusion. As lenders will understandably want some cushion against the 80% LTV ratio when there has been an uneven payment history indicating a risk of default, some additional premiums on all loans would not be inappropriate as a trade-off for the automatic cancellation on all loans. In other words, it would be better to require the cancellation of all PMI premiums—so long as payments on the loan are current—

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[8] For example, this issue of "hurdle rates" was significantly explored, and found to be unfair, in this review of an electric company's conservation program. Re: Western Massachusetts Electric Company, 87 PUR 4th 306 (Mass. DPU 1987).

[9] "Private Mortgage Insurance," *Federal Reserve Bulletin*, vol. 80 (October 1994) at 887.

when the LTV ratio has gone 2 or 3% beyond the 80% LTV initially required, rather than create a right which can be rebutted by the lender under a variety of circumstances. Thus, if the original loan documents indicate that the lender has required PMI because of an 80% LTV, than the PMI should have to be automatically canceled when the borrower's LTV reached 78%. This automatic right would be subject only to the requirement that the payments on the loan are current.

Again, clarity of obligation and certainty of when the premiums have to be canceled are of considerable benefit to borrowers and the industry alike. Confusion of when the right kicks in, disputes over the validity of one appraisal versus another, and concerns about payment history are all avoided with this proposal.

5. Automatic cancellation at halfway through the loan term provides an absurd amount of extra and unnecessary premiums for PMI to be paid. If H.R. 607 is intended to be a consumer protection bill, it should not read as a major gift to loan servicers and PMI providers. As most borrowers will rely on the automatic cancellation provisions to see actual savings from canceled PMI premiums, the automatic cancellation provision will become the industry standard. If the automatic cancellation occurs halfway through the loan term, as has been proposed by some, borrowers in *most PMI* loans will end up paying unnecessary PMI premiums for 9 years or more. (See chart on page 3). If Congress is unwilling to require automatic cancellation at 80%, or some point reasonably close, at the least, automatic cancellation should occur one third of the way through the loan term.

6. With a strong automatic cancellation provision which relates to the original value, an additional right to cancel when the borrower's equity meets the trigger based on current value should also be included. As many homes do increase substantially in value, and the lender's risk is therefore significantly reduced, borrowers should also have the right to prove that their loan to value ratio has been met by showing the current value of the home.

7. Any requirement for an appraisal to be provided by the borrower should be met with a recent tax appraisal. Often property tax appraisals undervalue the home. Rarely do they overvalue homes. Clearly tax appraisers have an interest in fairly evaluating the real worth of the home (too low will reduce the property tax revenue to the local government; too high will ignite the wrath of taxpayers.) Therefore, if a recent tax appraisal indicates that the value of the home meets the required LTV ratio, that should be sufficient to meet the appraisal requirements for early cancellation.

8. Lenders should be allowed to reject early cancellation of PMI coverage only for a *recent* payment history which indicates a real risk of default. A number of proposals for H.R. 607 have been considered which would allow early cancellation subject to the lender's refusal because of the borrower's payment history. Borrowers' payment histories should only be relevant in this regard (a) during a reasonably recent period of time, and (b) to the extent that they actually show risk of default.

9. All rights created, whether to automatic cancellation or to early termination, should be required to be set out in the contract between the lender and the borrower. Some recent proposals have also been considered which would provide that the borrower's right to cancel PMI insurance would be set out in the annual statement of such rights provided to the borrower by the servicer. This effectively provides no rights to the borrower, and as the original version of H.R. 607, it will only serve to tantalize and frustrate borrowers. The rights must be specified in the contract to be understandable and enforceable.

10. The Act establishing the rights of borrowers to cancellation of PMI premiums should be enforced by the Federal Reserve Board, not by the Department of Housing and Urban Development. HUD is a department with a myriad of diverse responsibilities, and a less even record of meeting those responsibilities. The Federal Reserve Board has demonstrated that it can implement the complex web of financial credit laws including the Truth in Lending Act, the Fair Credit Reporting Act, the Equal Credit Opportunity Act, among others, in a way which is understandable and meaningful to the credit industry and consumers.[10]

11. The PMI Cancellation Law should be self-enforcing with adequate damages for failure to comply, statutory damages and attorneys fees. As unpopular as lawyers are these days, they still serve a valuable purpose: they enforce the laws. Violation of any requirement of the PMI cancellation law should lead to liability, including actual damages, a reasonable statutory penalty in the discretion of the court, and attorneys fees. Allowing attorneys fees for individual actions will provide a method of redress for individual consumers, without which they will have no effective way of obtaining relief for violations of the new law.

In sum, we propose the following principles:

- Automatic cancellation of PMI insurance at the point during the loan term when the borrower reaches a LTV ratio at which the lender would have been willing to make the loan *without* PMI coverage.
- Borrowers should be allowed to cancel PMI insurance earlier when the borrower's equity meets the trigger based on the home's current value.
- Requirements for an appraisal of the current value of the home should be satisfied by a recent tax appraisal.
- Lenders should be allowed to reject early cancellation of PMI coverage only for a *recent* payment history which indicates a real risk of default.
- All rights created, whether to automatic cancellation or to early termination, should be required to be set out in the contract between the lender and the borrower.
- The Act establishing the rights of borrowers to cancellation of PMI premiums should be enforced by the Federal Reserve Board.
- The PMI Cancellation Law should be self-enforcing with adequate damages for failure to comply, statutory damages and attorneys fees.

Thank you for requesting our input on behalf of our low-income clients on this important piece of legislation.

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[10] NCLC's endorsement of the Federal Reserve Board for implementation of a PMI cancellation law does not mean that we agree with everything that the Board has done. But we generally approve of their method of regulation.