

A Federal Suitability Requirement for Home Loans

A Northeast-Midwest Institute Issue Brief

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Summary

Consumer advocates and others contend the federal government could reduce predatory lending and thus prevent some home mortgage foreclosures through a suitability standard that would require lenders and mortgage brokers to provide home loans suitable to their borrowers. Supporters of a suitability rule for home lending favor federally mandated regulation similar to what takes place now for investment securities, such as stocks and bonds. Supporters argue that suitability requirements and enforcement would provide a now-missing deterrent against predatory lending practices and offer low-income persons the same type of protection for their investments in a home as wealthier investors enjoy for their investments in stocks and bonds. Supporters say a suitability rule is flexible, allowing innovation in the mortgage market while also ensuring that consumers are protected from new predatory practices. Proponents also favor suitability because it could apply to all types of mortgages and would move beyond the limited effectiveness of consumer education efforts and loan disclosure requirements by putting assessment of home loan suitability in the hands of the lending professionals with the knowledge and tools to judge it. Detractors argue that suitability would be harder to apply to the home loan market, where affordability and loan terms are key issues, than to the investment securities market, where the issue is the risk characteristics of different investment options. They also express concern that suitability might lead to frivolous lawsuits, as well as court decisions that would hinder emerging home lending practices and innovations. Opponents contend that suitability requirements would impose paternalistic restrictions on consumers and force lenders and brokers into an unnecessary financial planning role.

Interest in Suitability

At a September 2006 Capitol Hill roundtable session, congressional staff, local officials, consumer advocates, and representatives of mortgage lenders and brokers discussed approaches to federal home loan regulation with a focus on predatory lending practices. Predatory lending is one cause of home foreclosures, which lead to abandoned properties, deteriorating neighborhoods, declining municipal tax revenues, and increased costs to the cities and taxpayers who must address the fallout. A number of roundtable participants mentioned the concept of suitability for home loans, although not all participants favored the idea. Supporters cite existing federal law as inadequate and see suitability as a way to offer consumers additional protection both from potentially abusive new mortgage products and from the possibility that borrowers with adjustable rate mortgages (ARMs) might fall victim to predatory home lending practices as hundreds of billions of dollars in ARMs reset to higher interest rates in 2007 and raise for some the threat of foreclosure. The Northeast-Midwest Institute, with support from the Surdna Foundation, produced this issue brief to provide background about suitability requirements in the context of home mortgage lending, done as a follow-up to the roundtable session.

Suitability and Home Mortgage Lending

A suitability rule for home mortgage lending would require that lenders and mortgage brokers – or some subset of them – provide a loan suitable to the borrower based on relevant factors, including the borrower's financial circumstances, objectives for taking the loan, and ability to repay. The idea of a suitability rule for home lending is borrowed from the requirement that financial representatives and brokerage firms must have reasonable grounds to believe that investment securities, such as stocks and bonds, are suitable for their customers. As a complement to existing laws and regulations,

supporters of a suitability rule for home lending favor federally mandated regulation along the lines of what occurs for investment securities.

Suitability Regulation in the Investment Securities Market

Securities regulators have long relied on suitability rules and concepts when overseeing the conduct of broker-dealers under the provisions of the Securities Exchange Act of 1934. Multiple suitability rules and concepts have emerged because several agencies and organizations oversee the securities industry, including the federal Securities and Exchange Commission (SEC) and national self-regulatory organizations such as the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE). Over the years, the SEC has initiated administrative and judicial actions against broker-dealers to enforce suitability obligations through application of SEC Rule 10b-5 and other anti-fraud provisions of federal securities laws. The SEC is authorized to register national securities associations and exchanges with rules designed in part to "prevent fraudulent and manipulative practices, [and] to promote just and equitable principles of trade..." Under federal law, the SEC reviews and approves the disciplinary rules for members of the securities associations and exchanges.

NASD's Securities Suitability Rule

Federal law requires that securities dealers and brokers join federally registered national self-regulatory organizations, and those organizations in turn must adopt disciplinary rules for members. The most commonly cited suitability rule is NASD's Rule 2310, the first rule to impose an explicit suitability obligation. NASD has been enforcing Rule 2310 since at least 1938, when Congress passed amendments to the Securities Exchange Act authorizing the self-regulation of the securities industry. Under federal law, virtually every securities firm doing business with the U.S. public belongs to NASD.

In general, securities broker-dealers obtain the necessary information for Rule 2310 from customers when securities accounts are opened, and they then periodically update that information. Rule 2310 requires that a NASD member

- "Have reasonable grounds for believing that [a] recommendation is suitable" for a customer based upon available facts, including facts about the customer's other security holdings and his or her financial situation and needs
- Make reasonable efforts, before executing a recommended transaction, to obtain information about
 - “(1) the customer's financial status;
 - (2) the customer's tax status;
 - (3) the customer's investment objectives; and
 - (4) such other information used or considered to be reasonable... in making recommendations to the customer.”

NASD Rule 2310 has been interpreted to impose two main obligations. The first, called reasonable-basis suitability, focuses on the investment product rather than the customer, and it means that a broker-dealer must have a reasonable basis to conclude that a securities recommendation is suitable for at least some investors. NASD explains this reasonable-basis obligation as akin to a due diligence requirement because a broker must fully understand the product before evaluating its suitability for at least some investors. The second obligation, called customer-specific suitability, requires a broker-dealer to determine whether the recommended security is suitable for a particular customer. As part of this analysis, the broker-dealer must determine if the recommended security is a good match based on the customer's financial holdings, financial status, tax status, investment objectives, and financial situation and needs.

NASD Rule 2310 is triggered when a broker-dealer recommends a security transaction, not when the broker-dealer merely takes an order for a self-directed trade. Although application of Rule 2310 applies only to recommendations, the rule's reach is broad. For instance, a broker-dealer cannot make

unsuitable recommendations even if the customer has expressed an interest in engaging in inappropriate trades. Similarly, a broker-dealer can be held liable for unsuitable trades even if the customer understood a recommendation's pros and cons but decided to follow the broker's advice.

Enforcement of Suitability in the Securities Market

To enforce suitability rules in the securities industry, NASD and other self-regulatory organizations can take disciplinary action against members. For example, NASD can impose any fitting sanction on a broker-dealer who violates Rule 2310, including censure, a fine, suspension, expulsion, and a temporary or permanent cease-and-desist order. The SEC becomes involved when it reviews appeals of disciplinary actions by the self-regulatory organizations – including those involving claims of suitability – and through the commission's own administrative and judicial actions under the SEC's Rule 10b-5 and other anti-fraud provisions, although anti-fraud cases initiated by the SEC require a higher threshold of evidence than actions by the self-regulatory organizations.

In addition to these actions by securities regulators, securities customers may pursue claims and seek damages based on suitability, ordinarily through arbitration. A customer also may be able to maintain a private action in court against a broker-dealer based on the anti-fraud provisions of the federal securities laws, depending upon the facts and circumstances, including whether the terms of the customer agreement require arbitration.

Proposed Elements for Suitability in the Home Loan Market

Supporters of a federal suitability standard for the home lending market have suggested that loan originators be required to determine the suitability of a home loan for a borrower based on such factors as the following:

- The borrower's financial circumstances, including employment status, income level, the likelihood that income level might change, other available financial resources, level of other debt, number of dependents, and age
- The borrower's ability to repay the loan, based on such considerations as the monthly loan payment, including principal, interest, taxes, insurance, and other required charges; monthly household income; income available after reasonably anticipated expenses and after the dollars needed to service other household debt; and the maximum possible monthly payments for the loan in cases of variable interest rates or variable payments for interest and principal
- The borrower's objectives for the loan, potentially including reducing the interest rate or the loan payment amount, changing the terms of a home loan, and paying down other debt.

Other home loan suitability suggestions include:

- Requiring that the refinancing of a home loan provides a benefit to the borrower
- Excluding from consideration the borrower's equity in a home when determining the borrower's ability to repay a loan
- Holding the borrower's overall debt to a set percentage (such as 50 percent) of the borrower's documented monthly income, assuming that the benchmark leaves the borrower with enough monthly income to meet reasonably anticipated expenses
- Prohibiting lenders from steering borrowers to higher priced loans than those for which they would otherwise qualify – for example, prohibiting subprime loans for borrowers who qualify for loans in the prime lending market.

In general, advocates for a federal suitability requirement propose that Congress specify a limited number of critical elements for suitability in the home loan market. In addition, they call for Congress to establish a federal agency with authority to regulate suitability issues for home lending, oversee arbitration approaches and procedures, and address new abusive practices if they emerge. Many supporters also favor establishment of a private cause of action so that individual borrowers would be able to bring legal claims for suitability violations instead of having to depend upon the federal

government to take legal action that covers their specific predatory lending cases. As with suitability in the investment securities market, legal recourse for borrowers in the home mortgage market would provide another avenue for enforcement of suitability, proponents say.

Following the suitability model from the investment securities sector, some supporters of suitability in the home lending market have proposed that the federal government require mortgage lenders and brokers to join self-regulatory organizations in order to conduct business. The self-regulatory organizations, like those in the investment securities sector, would need to develop standards and rules – including a suitability rule – subject to review and approval by a federal agency, and they would need to establish procedures for disciplining members who violate the rules, with federal agency oversight. Others favor direct federal agency regulation instead of self-regulation for the home lending industry.

Arguments in Favor of a Suitability Rule for Home Mortgage Lending

Supporters cite several benefits to regulating home loans through a federal suitability rule for mortgage lenders and brokers. They argue that market incentives too often fail to deter abusive home loan practices because brokers, lenders, and others involved in loan originations receive their payments upfront – before mortgages are sold and resold in the secondary mortgage market – and therefore bear little in the way of costs for unsuitable loans and resulting foreclosures. Suitability requirements and enforcement would correct this by providing a needed deterrent against predatory lending, supporters say. Proponents also suggest that the suitability protections now offered to securities investors for their assets should be extended to home ownership, which constitutes the main asset for many of the lower-income persons most likely to fall victim to home lending abuses.

By requiring that a loan be suitable for a borrower, a federal suitability standard would avoid strict regulation that specifies a limited number of allowable mortgage arrangements or bans mortgage terms and practices that may be unreasonably burdensome or predatory for some borrowers but not for others. Mortgage lenders and brokers often oppose state laws and federal proposals aimed at predatory lending in part because they argue that such legislative action lacks flexibility and therefore cannot keep pace with emerging market developments and innovation. Supporters of a suitability rule note that lenders, brokers, and the industry as a whole would retain flexibility under the requirement that home loans be suitable to borrowers. Flexibility may be particularly important for the mortgage marketplace, which has changed considerably in the last 20 years and could continue to do so.

Another advantage to federal action, according to proponents, is that a suitability requirement could be applied universally to all types of mortgage loans, much as the suitability rules in the investment securities sector apply to the wide range of investment options, securities firms, and broker-dealers. The federal Home Ownership and Equity Protection Act (HOEPA), which takes aim at abusive home loans, currently covers very few mortgages because lenders have adjusted their terms and practices to avoid the HOEPA triggers and the risks associated with offering loans covered by the act. In addition, state measures aimed at restricting predatory lending practices do not apply to federally-chartered financial institutions. Even when state regulations do apply, lenders can use adjustable rate mortgages to offer temporary low rates that fall below the triggers of state anti-predatory lending measures, and they are thus able to extend loans that may eventually become high-cost and possibly abusive.

From the standpoint of its supporters, a federal suitability rule for home lending would move beyond the limitations of efforts designed to reduce predatory lending through loan disclosure requirements and financial literacy initiatives for consumers. In a 2004 report, the Government Accountability Office commented that consumer education efforts and loan disclosure rules, while useful, may be of limited effectiveness in reducing predatory lending because of “the complexity of mortgage transactions, the difficulties in reaching target audiences,” and the inability of financial counselors to review actual loan documents for the people they counsel. According to supporters, a suitability rule would put assessment of a loan’s potential pitfalls into the hands of those best qualified to determine the risks –

the lenders and brokers who understand complex loan terms and can draw upon underwriting guidelines and loan repayment histories to judge suitability.

Proponents say a suitability rule that requires loans based on borrowers' ability to repay would compel lenders to follow mortgage industry underwriting guidelines and avoid asset-based lending for owner-occupied properties. This relates to cases where now, for example, the equity value of the borrower's home, and not the borrower's income level, determines home loan refinancing options. Supporters also note that borrowers would gain protection from a requirement that their ability to repay be based on income available after reasonably anticipated expenses, including other debt payments. Some underwriting guidelines, including those of the U.S. Veterans Administration for insured home loans, already factor in residual income considerations for low-income borrowers.

Arguments against Suitability Rules for Home Loans

Although some argue that suitability rules would work well for the home lending market, others have doubts. Some lender and mortgage-broker associations have reserved comment, urged caution, or raised concerns about suitability rules for home lending.

Detractors suggest that suitability rules work better for the investment securities sector than they would for the home lending market because the suitability of investments is easier to gauge than the suitability of a home loan. For securities, suitability addresses the risk characteristics of an investment and generally does not concern questions about an investor's ability to pay for the investment, or questions about the terms of sale. With home lending, however, the borrower's ability to afford the mortgage might be central to the question of predatory lending. And the terms of the mortgage – in effect, the terms of sale – are often what distinguish an abusive home loan from a reasonable one. Questions of pricing and practice for home loans present a challenge beyond that of risk assessment for securities investments, opponents say.

Opponents worry, too, about frivolous lawsuits if federal suitability rules are adopted and matched with a private course of action, allowing borrowers to bring legal claims in home lending cases. In addition, court action might lead to decisions that hinder emerging practices and innovation in the home lending market, they say.

Detractors argue that suitability would impose rules that are overly paternalistic and restrict consumer choices. Under those circumstances, lenders and mortgage brokers would have less flexibility to meet the individual needs of borrowers, opponents say. They also object that suitability rules would force home mortgage lenders and brokers to engage in research that goes beyond what's needed for a home loan and veers instead into the realm of financial planning.

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