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Congress Launches Proposals In Wake of Subprime Mess

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From The Wall Street Journal Online

Congress returned from vacation with a series of proposals that could reconfigure the mortgage market, suggesting lawmakers are in a mood to make substantial changes in the wake of the summer's subprime mess.

Possible bills in both the House and the Senate would expand homeowner protections to cover more high-cost loans, crack down on prepayment penalties and prohibit brokers from steering borrowers toward more-costly loans. Critics blame such practices for encouraging mortgage brokers and lenders to push unsophisticated borrowers to accept loans with onerous terms.

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The House version, which has yet to be introduced, could include a more controversial provision that would make buyers of mortgage debt on the secondary market liable for abusive practices by lenders. That provision will face stiff opposition and could chill an already-faltering secondary market.

The common ground between House and Senate Democrats increases the likelihood that Congress will complete some kind of mortgage legislation. The precise details and timing remain hard to predict.

This summer, a growing number of foreclosures and delinquencies among borrowers with subprime and some other types of mortgages led to a freeze in certain sectors of the credit market. Officials have worked to calm jittery financial markets, with limited effect.

Underpinning much of the subprime boom was the rapid growth of a secondary market for mortgages, in which lenders packaged loans as securities and sold them to other investors. That spread the risk among many different players. Critics charged that because liabilities were thinly spread, neither lenders nor investors had enough incentive to make sure loans were sound.

Yesterday, Sen. Christopher Dodd of Connecticut, chairman of the Senate Banking Committee and a candidate for the Democratic presidential nomination, announced plans for an ambitious bill. One key part would ban payments to mortgage brokers known as yield-spread premiums, or YSPs, on subprime loans. Lenders pay YSPs to brokers when borrowers pay a higher interest rate than the best one they could qualify for. Critics say that gives brokers an incentive to push higher-cost loans. The mortgage industry says it can be a way for consumers to compensate brokers without paying upfront fees.

The Dodd plan also would prohibit lenders from giving subprime loans to borrowers who could qualify for prime loans.

This month, several Democrats on the House Financial Services Committee -- Chairman Barney Frank of Massachusetts and North Carolina Reps. Melvin Watt and Brad Miller -- hope to introduce a bill that is likely to mirror Mr. Dodd's approach in many respects. "It's a very hopeful sign," said Mr. Miller.

House Democrats want to address another, more problematic question: whether secondary buyers of mortgage debt should be legally liable for the underlying loans. Democrats acknowledge this is likely to be a sticking point.

Lawmakers say they want to encourage good underwriting practices while being sensitive to industry complaints. Anne Canfield, executive director of the Consumer Mortgage Coalition, which represents national lenders, said that additional liability would increase interest rates by an average of 1.5 to two percentage points.

"One of the arguments we've got against regulation in any way of the secondary market is you will impinge on the market and kill the market," said Mr. Frank. But "giving the investor some assurance of quality in what he or she is being asked to invest in is part of the role of regulation....It can help the market."

Mr. Miller said the legislation would allow secondary lenders to avoid being sued if loans meet criteria such as appearing to comply with the law and avoiding some subprime tactics, such as prepayment penalties.

Indicating the future contours of the debate on this issue, some Republican members said Congress shouldn't rush to judgment.

"The one thing we shouldn't do is rush out and change a market that is working and working well, and brought home ownership to historic highs," said Republican Rep. Spencer Bachus, the ranking member of the House Finance Committee, at a hearing. He said it was "characteristic of this Congress in the past [to] rush to regulation in a crisis, which has left us all with a hangover when it's over."

State legislatures have tried assigning secondary liability in the past,

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with limited success. Georgia passed a law in 2002 that extended liability to a loan's end buyer, essentially holding them responsible for the actions of underwriters. After mortgage underwriters threatened to leave the state and the major credit-rating concerns said they wouldn't rate pools of mortgages that included Georgia loans, the legislature voted to weaken the liability component in 2003.

A congressional push to add liability to the mortgage market will also likely face resistance from the Bush administration, which has been outspoken about the cost of lawsuits in driving overseas companies from doing business in the U.S.

"A lot of the key details [of the Senate plan] are missing," said Kurt Pfotenhauer, a senior vice president at the Mortgage Bankers Association, a trade group. He agreed that YSPs need to be addressed, because of the potential for abuse, but said it isn't clear that an outright ban is the best solution.

Mr. Pfotenhauer noted that Congress has struggled for years to achieve a consensus on how to combat predatory-lending practices. The issue is very hot now, he noted, because of a surge in defaults and foreclosures. But passing legislation still "isn't a slam dunk," he said.

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