Fed plans revamp of mortgage rules

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The Federal Reserve on Tuesday announced an extensive shake-up of US mortgage regulation that it hopes will reduce abuses and pave the way for a revival in the subprime lending industry.

The proposed new rules go beyond disclosure requirements and industry guidance to ban some controversial lending and advertising practices outright and restrict others.

Randall Kroszner, the Fed governor in charge of the overhaul, said abusive practices harmed both consumers and the "integrity of the mortgage market". He said the Fed hoped that the new rules would make it likely that "responsible capital will again flow to traditionally underserved borrowers and communities".

The mortgage industry gave a cautious response to the plan. Kieran Quinn, chairman of the Mortgage Bankers Association, applauded the Fed's efforts but said "some of the restrictions in the proposals may unnecessarily limit the credit options available to borrowers".

However, the Fed plan was attacked by a string of top Democrats for not going far enough to protect the public from malpractice.

Chris Dodd, chairman of the senate banking committee, said the proposal was "deeply disappointing", while Barney Frank, chairman of the house financial services committee, said it confirmed his belief that the Fed "is not a strong advocate for consumers".

Charles Schumer, chairman of the joint economic committee, said Congress would have to legislate to impose tougher regulation itself.

The Fed plan puts in place a special layer of safeguards for subprime loans – defined as first lien mortgages with an interest rate more than 3 percentage points higher than the prevailing rate on government securities.

The proposed subprime rules would prohibit lenders from systematically lending without regard to a borrower's ability to pay, ban so-called no-documentation or low-documentation loans and require mandatory escrow accounts for taxes and insurance.

In addition, new rules for all mortgages would force brokers to disclose their fees to customers in advance, ban creditors and brokers from pressuring appraisers to inflate the value of a home and outlaw some techniques used by mortgage servicers to generate fees.

The Fed also intends to ban what it views as deceptive advertising practices. The new rules would require advertisements promoting loans with low initial "teaser" rates to state the later higher rates with "equal prominence and in close proximity".

The US central bank also proposes requiring lenders to make early disclosures to borrowers for all mortgages.

Most of the rules create obligations for mortgage lenders rather than brokers, as these larger institutions have a greater incentive to play by the rules. They will apply to all lenders.

Top officials believe that investors are so distrustful of subprime mortgage securities they would welcome additional regulation that would reduce the risk on these loans.

Rather than reviewing particular practices, the Fed staff analysed default data to try to identify why so many subprime loans were defaulting. They found no one practice was responsible for a large proportion of subprime defaults. Instead, defaults were linked to the combination of many dubious practices.

Fed policymakers believe that additional regulation is justified because of what economists call "information problems" – particularly relating to complex loans – and "incentive problems" in the securitised lending industry.

Ben Bernanke, Fed chairman, said "as the mortgage market has become more segmented and as risk has become more dispersed...the incentives to follow prudent lending have at times eroded".

Fed officials hope the new regulations will encourage investors to put money into the mortgage industry and in particular resume financing new subprime loans, by providing reassurance on the quality for the loans inside mortgage securities.

The regulations now go to consultation. The mortgage industry will argue that the rules should be relaxed to make it easier for people with irregular incomes and the self-employed to obtain mortgages.

Democratic members of Congress meanwhile will probably demand tougher rules on assessing ability to repay and an outright ban on commission arrangements that reward brokers for steering customers into higher rate loans.