Calendar No. 243

105TH CONGRESS
1st Session

SENATE

REPORT
105–129

HOMEOWNERS PROTECTION ACT

OCTOBER 31, 1997.—Ordered to be printed

Mr. D'AMATO, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

[To accompany S. 318]

The Committee on Banking, Housing, and Urban Affairs, to which was referred the bill (S. 318), having considered the same, reports favorably thereon with an amendment in the nature of a substitute and recommends that the bill (as amended) do pass.

INTRODUCTION

On Thursday, October 23, 1997, the Senate Committee on Banking, Housing, and Urban Affairs favorably reported S. 318, the "Homeowners Protection Act of 1997." This legislation will enable homeowners to cancel unneeded private mortgage insurance ("PMI") and requires that they receive informative disclosures of their rights. The Committee worked from base text, or "Committee Print," containing revisions to S. 318. The Committee adopted an amendment offered by the Chairman and the Ranking Member comprised of noncontroversial matters. In addition, two amendments were offered and adopted by voice vote.[1] The vote on final passage was 16 to 1 in favor of final passage.[2]

LEGISLATIVE HISTORY

Senator D'Amato introduced S. 318 on February 12, 1997 (Senators Bryan, Dodd, Domenici, Kempthorne, Bingaman, and Durbin are cosponsors of the legislation). On Tuesday, February 25, 1997,

[1] The two amendments pertained to the treatment of adjustable rate mortgages and the exemptions contained in Section 3 of the bill that allow PMI coverage to be maintained until the loan is half-way amortized.

[2] Senators D'Amato, Shelby, Mack, Faircloth, Bennett, Grams, Enzi, Hagel, Sarbanes, Dodd, Kerry, Bryan, Boxer, Moseley-Braun, Johnson, and Reed voted for final passage. Senator Allard voted against final passage and Senator Gramm abstained.

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the Committee held a hearing on the issue of PMI cancellation and S. 318. Witnesses included Representative James V. Hansen (R. Utah), who introduced PMI legislation in the House and has been a leader on this issue. Also testifying were: Michelle Meier, Counsel for Government Affairs, Consumers Union; R. Layne Morrill, President-elect, National Association of Realtors; Kenneth L. Nicholson, President, Nicholson & Co. and President, Appraisal Institute; Brian L. McDonnell, President/CEO, Navy Federal Credit Union, testifying on behalf of the National Association of Federal Credit Unions (NAFCU) and the Credit Union National Association (CUNA); Ron McCord, President, American Mortgage and Investment Co. and President, Mortgage Bankers Association (MBA); Frank Sutkowski, Senior Executive Vice President and Director of Lending Liberty Bank (Middletown, Ct.), testifying on behalf of America's Community Bankers (ACB); and William H. Lacy Chairman/CEO, Mortgage Guaranty Insurance Corp. (MGIC), testifying on behalf of the Mortgage Insurance Companies of America (MICA).

BACKGROUND/NEED FOR LEGISLATION

PMI: a helpful tool for expanding home ownership opportunity

PMI is a property insurance line that protects lenders from mortgage default risk. In the most general sense, PMI provides middle class home buyers the same type of protection that FHA insurance provides lower income homeowners.[3] PMI for residential real estate has been available for about 40 years, and today it is used extensively to facilitate "high-ratio" loans (loans in which the loan to value ratio ("LTV") is more than 80 percent, i.e., the borrower makes a down payment of less than 20 percent). Traditional underwriting principles for residential mortgage lending dictate that a lender receive 20 percent for a down payment.[4] Such a requirement creates a "stake in the venture" for a homeowner; a homeowner that has a 20 percent investment in a residence is unlikely to walk away from that investment. The requirement of an 80 percent LTV often prevents many cash-tight but credit-worthy homeowners from purchasing a home. PMI enables these would-be homeowners to purchase a home without the 20 percent down-payment required by the traditional underwriting standards of most mortgage lenders. PMI has also been a tool to enable cash-flush consumers with poor credit histories to obtain loans. In so doing, PMI has expanded the opportunity for home ownership, particularly for middle-class and first-time home purchasers.

PMI makes high-ratio lending possible by protecting lenders who make such loans from the risk of default and foreclosure. These policies can be written to cover as much of a loan as the lender

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[3] Report of the State Corporation Commission on Private Mortgage Insurance, Commonwealth of Virginia Senate Doc. No. 13, p. 6 (1955). PMI is mortgage guaranty insurance that private-sector insurers issue. It differs from FHA insurance and VA guarantees in a number of ways. First, FHA insurance and VA guarantees cover only non-conforming loans, while PIA covers conventional loans. FHA insurance is typically required on the entire mortgage rather than a certain percentage of that loan, and is frequently required to be carried over the entire life of the loan. *Id.* (summarizing information contained in the Mortgage Insurance Companies of America's 1993–1994 Fact book).

[4] "Private Mortgage Insurance," G. Canner, W. Passmore and M. Mittal, *Federal Reserve Bulletin,* vol. 80, no. 10, 1994.

may desire (and the insurer is willing to cover), but typically lenders seek PMI to insure the initial 20 percent of the loan value against loss.[5] PMI enables the lender to recover costs associated with the resale of foreclosed property as well as for accrued interest payments or fixed costs, such as taxes or insurance policies, paid prior to resale. A borrower in default receives no benefits and recovers no funds from the PMI policy.

PMI cancellation: a process immune from market discipline

Hearing witnesses from both consumer groups and the mortgage-related industries agreed on the premise that PMI is a beneficial financial product that has expanded home ownership opportunities.[6] While PMI protects lenders and thereby encourages high-ratio lending, there comes a time when the protection afforded to the lender (and paid for by the homeowner) becomes unnecessary—specifically, when the homeowner's equity investment in the residence gives the lender sufficient security. According to witnesses from the lending community, as a general rule this occurs when the homeowner has accumulated 20 percent equity.[7]

Nevertheless, many homeowners have experienced problems canceling unneeded PMI. Homeowners that do not refinance or buy another home could continue to pay for the PMI coverage for the entire life of the loan. In many instances, homeowners are never informed of their right to cancel PMI. In other instances, homeowners have faced unnecessary impediments when they attempt to cancel PMI. Because the protections that PMI offers flow to parties who are not paying for it, market discipline does not necessarily address this problem. At the same time, carrying costs for unnecessary PMI can be significant. Since PMI costs between $20 and $100 per month, the costs can reach into the hundreds, or even thousands of dollars per year—with the possibility that these costs could be incurred over the entire life of a 30 year loan.[8] In addition, excessive PMI coverage does not benefit the homeowner, and provides little extra protection to a lender. The Committee received testimony and evidence indicating that this problem is quite widespread; the mortgage insurance trade association acknowledge that it impacts at least 250,000 homeowners. Other evidence indicates that the problem is even greater—one analysis of a 20,000 loan portfolio indicated that 1 out of 5 homeowners were paying for PMI, despite the fact that they had accumulated equity in excess of 20 percent.[9]

Presently, homeowners have limited recourse when they cannot cancel their PMI. Like issuers of other lines of casualty/property insurance, PMI issuers are subject to state regulation, and typically file their policy forms, endorsements and rate schedules with the

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[5] PMI is available in the secondary mortgage market. Typically, PMI insurers underwrite 5% of the mortgage pool underlying a mortgage-backed security.

[6] *See, e.g.,* Testimony of M. Meier, testifying on behalf of Consumer's Union; Statement of B. McDonnell, testifying on behalf of the National Association of Federal Credit Unions and the Credit Union National Association.

[7] Testimony of F. Sutkowski, testifying on behalf of ACB; testimony of B. McConnell, testifying on behalf of NAFCU and CUNA.

[8] "Running its Course; Homeowners Finding it Easier to Dump Mortgage Insurance," by Andrea Gerlin, *Wall Street Journal,* reprinted in the *Chicago Tribune,* January 26, 1997.

[9] "Legislation Targets Overcharges on Private Mortgage Insurance," Kenneth R. Harney, *The Washington Post,* February 22, 1997, Sec. E, P. 1.

state prior to commencing sales within that state. A small number of states have laws pertaining to PMI. Nevertheless, even in these states homeowners have faced difficulties in obtaining a cancellation of their PMI policies.

SUMMARY OF THE LEGISLATION

The reported version of S. 318 contains revisions to the bill that was introduced earlier in the session. The PMI language is, in turn, based on proposed language that was developed shortly after the bill's introduction and reflects concerns with S. 318 that were raised at that time.

Two general concerns were voiced about the Homeowners Protection Act as originally introduced. These concerns related to: the creation of a new federal regulatory/enforcement regime, and the attendant compliance problems; and the inflexible 20 percent cancellation rule originally considered for this legislation. There was consensus among the witnesses that testified at the Committee hearing that mortgagees must have the flexibility to require PMI coverage in a slumping market, when depreciation may eliminate accumulated equity. Some witnesses expressed concern that an inflexible 20 percent cancellation rule would have a net effect of denying certain borrowers the opportunity for home ownership. Concern was voiced that an inflexible cancellation rule would stifle the development of new loan products that might require deeper PMI coverage, but that allow prospective buyers who cannot raise significant down payments to obtain mortgage financing at affordable rates.[10]

The reported bill addresses these concerns, but retains the essential consumer protections of S. 318. This legislation was introduced to address one recurring problem: homeowners have been unaware of their ability to get PMI coverage canceled and PMI was maintained long after there was any need for that coverage. The goal of this legislation has always been to avoid unneeded PMI coverage by giving homeowners an affirmative cancellation right. The reported language seeks to achieve this goal without any federal regulator and in a manner consistent with sound underwriting standards.

S. 318 retains one of the most important protections that the original bill provided—it prohibits life-of-the-loan insurance coverage for traditional borrower-paid PMI products. Mortgage industry participants testified that such policies are not necessary or appropriate.[11] The reported bill permits borrower-initiated cancellation when the homeowner has accumulated 20 percent equity in the home. The bill mandates that as a general rule, PMI must be terminated when a homeowner accumulates 22 percent equity. The reported bill would also prohibit borrower-paid PMI coverage for the life of the loan; even "high risk" loans that have traditionally required enhanced PMI protections could only be subject to PMI coverage until the loan was at the midpoint of the amortization period. These substantive protections apply prospectively—they do

[10] Prepared Statement of the American Bankers Association on S. 318, February 25, 1997; Prepared Statement of Freddie Mac on the Homeowners Protection Act, February 25, 1997.

[11] Testimony of R. McCord, testifying on behalf of the Mortgage Bankers Association; testimony of F. Sutkowski, testifying on behalf of ACB.

not apply to any mortgage entered into before the effective date of the Act. The Committee decided against retroactive application because of the disruptive effect this would have on the secondary market.[12]

Another change in the reported bill is that it is free-standing, rather than amendatory. (S. 318 as introduced amended the Truth-in-Lending Act). The reported bill also simplifies the disclosure requirements of the legislation. These changes reflect comments of hearing witnesses. For instance, the bill as introduced could be construed as requiring monthly disclosures to homeowners regarding PMI cancellation; this requirement would be costly and would make the disclosures so mundane that they would be rendered meaningless. As one witness stated, the "required frequency of notices under S. 318 may confuse rather than help customers." This same witness recommended periodic disclosures to supplement the disclosure given at closing, and recommended that servicers be allowed to coordinate these notices with annual tax forms or escrow statements.[13] The reported bill adopted these suggestions in the hopes of providing homeowners with disclosures that provide meaningful notice without imposing unnecessary compliance costs on servicers.

The bill as reported addresses lender paid mortgage insurance ("LPMI") differently than traditional mortgage insurance. LPMI is a mortgage insurance product that the consumer pays for through a higher interest rate on his or her loan. The Committee received evidence that LPMI can provide homeowners with income tax benefits, if they choose to itemize their tax returns, by building the PMI premium into the interest payments that the homeowner makes. Evidence was also presented that many homeowners prefer LPMI because it allows them to avoid up-front, lump-sum payments that must be made at closing for traditional PMI.

Payments for LPMI are built into the cost of the loan and capitalized over the life of the loan. As a result, the only way LPMI can be canceled by the borrower is if the borrower refinances the mortgage or pays off the mortgage. The Committee received evidence that the interest rate variation on LPMI-covered loans could reduce these loans' marketability because the income stream from interest payments is an essential pricing determinant in the secondary market. If the market had to incorporate the interest rate variation into its pricing decisions, LPMI may no longer be a cost-effective alternative, and consumers who might be able to benefit from LPMI would not be able to obtain it.[14] Based on the evidence that LPMI may provide benefits to certain home buyers, and because home buyers can choose between LPMI and borrower-paid mortgage insurance (BPMI), the Committee incorporated an amendment that exempts LPMI from borrower-initiated cancellation and automatic termination and provides more meaningful disclosures to allow consumers to make informed choices.

[12] Testimony of W. Lacy, testifying on behalf of the MICA.
[13] Statement of F. Sutkowski, testifying on behalf of ACB.
[14] Prepared Testimony of ACB, February 25, 1997.

SECTION-BY-SECTION ANALYSIS

Section 1. Short title

This section designates this Act as the "Homeowners Protection Act of 1997."

Section 2. Definitions

This section provides the definitions of a number of terms necessary to implement this free-standing legislation.

Section 3. Termination of PMI

Subsection 3(a) authorizes borrower-initiated cancellation once a consumer has accumulated 20 percent equity in his or her home (determined according to the amortization of the loan or any prepayments). This provision is substantially unchanged from the bill as introduced.

A homeowner must meet a number of conditions to initiate cancellation. These conditions were developed in response to testimony received during the hearing on S. 318.[15] First, the borrower must request cancellation in writing and have a "good payment history" (as defined in this bill). Second, if the holder of the mortgage requires it, the home owner must also provide evidence that the property value has not depreciated below the value of the property at closing. The mortgage holder has discretion to require the consumer to provide whatever evidence of current market value the holder deems appropriate. The Committee believes that mortgage holders should strive to set evidentiary requirements that, while consistent with and necessary for sound underwriting practices, will not impose undue costs on borrowers who must provide and pay for this evidence. Third, the holder of the mortgage may also require certification that the equity of the mortgagor in the residence securing the mortgage is unencumbered by a subordinate lien. In addition, the bill requires that the mortgage holder disclose its requirements to the borrower as soon as cancellation is requested. The Committee believes that this requirement will benefit consumers by establishing evidentiary requirements that will not vary during the cancellation process.

Subsection 3(b) mandates automatic termination of PMI at the 22 percent equity level. Again, the point at which the 22 percent equity level is reached is determined by payments made according to the initial amortization schedule. The only condition on this requirement is that the borrower must be current on all payments due on the loan at the time PMI is terminated; if not, the PMI must be terminated as soon as the borrower becomes current.

The Committee expects that the cancellation and termination provisions contained in Subsections 3(a) and (b) will be made available to the overwhelming majority of home buyers. Also, it is the hope of the Committee that those lenders/investors that have adopted cancellation guidelines that permit homeowners to terminate PMI prior to accumulating 20 percent equity will continue to permit them to do so. Lenders who permit cancellation of unneeded PMI coverage under terms more favorable to homeowners than

[15] *See, e.g.,* Prepared Statement submitted by ACB, February ?, 1997.

those provided in this bill should be encouraged to do so. The bill is not intended to create a 20 percent minimum equity requirement for PMI cancellation; rather it creates a floor—lenders and investors may not impose more restrictive requirements than the provisions in this Act.

Nevertheless, the Committee understands that there are types of loans with default risk factors or characteristics such that the loans could not be prudently made were PMI coverage not available. For these "high-risk" loans PMI may be required until the mid-point in the loan's amortization period.

Section 4. Disclosure requirements and Section 5. Notification upon cancellation or termination:

The substantive cancellation rights that S. 318 provides only extend to mortgages that are entered into after the effective date of the Act (i.e., one year after the date of enactment). The disclosures required under Sections 4 and 5 of this bill pertain to mortgages entered into both before and after the date of enactment of this Act.

Disclosures at closing

For new loans (those made on or after 1 year after the date of enactment), all mortgagors must receive, at closing, disclosures of their cancellation and termination rights. Borrowers must also be provided with an amortization schedule and be advised of when they can effect their cancellation or when termination will automatically occur. There are mortgages that are exempted from the general cancellation/termination rules of Subsections 3(a) and (b), and are subject to "half-life" termination. Mortgagors of those loans must be apprised at or prior to closing that their mortgage is an exempted transaction.

Annual notice

Both non-exempted and exempted mortgagors must receive annual disclosure of their rights and information (telephone number and mailing address) that will enable them to contact the servicer regarding their cancellation and termination rights under this Act. Mortgagors, whose mortgages are in effect prior to the effective date of this bill, must be apprised, on an annual basis, of existing cancellation rights (i.e., under state law or at the discretion of the mortgage holder), and must be provided with contact information for determining and effecting whatever cancellation rights or opportunities may be available. These disclosures need not be separate, but can be included as part of other annual disclosure requirements.

Notice of cancellation/termination

Thirty days after cancellation/termination, the servicer must notify the borrower whether PMI has been canceled/terminated. If PMI has not been canceled/terminated, the servicer must inform the borrower of the grounds relied upon in making this determination. Unearned premiums must be returned to the homeowner within 45 days of the date the servicer receives the borrower's cancellation request.

Section 6. Disclosure requirements for lender paid mortgage insurance

This section establishes the disclosures that must be provided to home buyers at commitment, describing, among other things, LPMI and the differences between the product and BPMI.

Another notice must be provided to homeowners 30 days after the date on which their PMI would have been cancelable under Section 3 had they not chosen LPMI, and informing the homeowner that they might want to consider refinancing options. These disclosures may be made on standardized forms.

Section 7. Fees for disclosure

Prohibits the imposition of fees on consumers for the disclosures required by this Act.

Section 8. Civil liability

One of the most controversial provisions in S. 318 as introduced would have given rulemaking authority to the Federal Reserve Board. Because of concerns about regulatory burden that this provision would engender, this provision was removed from the bill as reported. The enforcement mechanism for this bill is private litigation. The Committee adopted language based on other consumer credit laws, permitting actual and specified statutory damages, as well as costs and reasonable attorney fees.

Subsection 7(c) of the reported legislation provides that the failure of a servicer to comply with the requirements of this Act due to the failure of a holder of a mortgage or mortgage insurer to comply with the requirements of this Act, shall not be construed to be a violation of this Act by the servicer. This provision was included because of the unique role the servicer has in this bill's compliance scheme.[16] Servicers are responsible for conveying information and funds between homeowners and mortgage insurers or mortgage holders. Cancellation or termination of private mortgage insurance requires the participation of the servicer and, with respect to certain activities like the remittance of unearned premiums, the mortgage insurer. This provision was included solely to protect the servicer in those circumstances where the mortgagee or mortgage insurer or holder of the mortgage fails to carry-out its responsibilities to effect cancellation or termination. It is also not intended to impose any additional requirement or liability on a mortgagee or mortgage insurer or holder of the residential mortgage. The Committee's intention in this section is that each party should be held liable only for their respective responsibilities under this Act. However, this provision is not intended to exempt any party from liability for failure to undertake an action required of that party to effect a consumer's rights under this Act.

Section 9. Effect on other laws and agreements

The reported bill creates a 2-year Statute of Limitations for lawsuits under this Act. The two year period begins at the time the borrower discovers the alleged violation. The reported bill also contains a preemption provision, applicable only to mortgages entered

[16] See, Testimony of R. McCord, on Behalf of the MBA.

into on or after the effective date of this Act. Investors cannot require servicers to adhere to any other cancellation or termination guidelines than those outlined in this Act, nor can investors require servicers, who have canceled or terminated PMI according to this Act, to buy-back loans.

Section 10. Construction

This Act does not impose any requirement for private mortgage insurance in connection with a residential mortgage transaction.

Section 11. Effective date

This Act will become effective 1 year from the date of enactment.

Section 12. Abolishment of the thrift depositor protection oversight board

This Section would abolish the Thrift Depositor Protection Oversight Board ("Oversight Board"), consistent with H.R. 2343, passed by the House on September 23, 1997. When the Resolution Trust Corporation ("RTC") terminated on December 31, 1995, the Oversight Board's primary function—overseeing and monitoring the RTC's operations—ceased. The Oversight Board's two remaining responsibilities are oversight of the Resolution Funding Corporation ("REFCorp") and, through fiscal year 1998, non-voting membership on the Affordable Housing Advisory Board. The Affordable Housing Advisory Board, chaired by the designee of the Secretary of Housing and Urban Development, advises on policies and programs related to the provision of affordable housing property, and sunsets on September 30, 1998. In addition, as long as the Oversight Board remains in existence, it has continuing administrative and reporting functions that will continue until about 2030. Under this section, the Oversight Board's REFCorp oversight responsibilities are transferred to the Secretary of the Treasury, and the Affordable Housing Advisory Board is restructured to eliminate the non-voting seat held by the Oversight Board. Elimination of the Board could save over $250,000 a year in personnel and overhead costs for each of the remaining 33 years of the Board's life.

REGULATORY IMPACT STATEMENT

In compliance with paragraph 11(b) of rule XXVI of the Standing Rules of the Senate, the Committee has determined that this legislation will not result in a significant net increase in the regulatory burden that the Federal Government imposes. S. 318 provides homeowners with the right to cancel their PMI, but does not impose upon any regulatory authority the requirement of enforcing the law. This legislation establishes disclosure requirements that will impose certain costs on servicers, but the Committee has attempted to minimize the costs of these disclosures by permitting these disclosures to be coordinated and included with existing federal disclosure requirements. The bill also provides broad preemptive language that will minimize compliance costs with respect to state laws. In light of these variables and the limited resources of the Committee, it is impracticable to provide a more specific estimate of the regulatory impact of this legislation, and the costs associated with the regulatory burden created by this legislation.

COST OF LEGISLATION

Senate Rule XXVI, section 11(b) of the Standing Rules of the Senate, and section 408 of the Congressional Budget Impoundment and Control Act, require that each committee report on a bill contain a statement estimating the cost of the proposed legislation, which was prepared by the Congressional Budget Office. This statement has been requested from the Congressional Budget Office, but it was not available at the date of filing this report. When the information is made available to the committee, it will be placed in the Congressional Record.

CHANGES IN EXISTING LAW

In the opinion of the Committee, it is necessary to dispense with the requirements of paragraph 12 of rule XXVI of the Standing Rules of the Senate in order to expedite the business of the Senate.

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