HOUSING POLICY COUNCIL
THE FINANCIAL SERVICES ROUNDTABLE

Statement of

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before the

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"H.R. 1728:

Mortgage Reform and Anti-Predatory Lending Act"

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Introduction

Chairman Frank, Ranking Member Bachus, and Members of the Committee, I am John Dalton, President of the Housing Policy Council ("HPC") of The Financial Services Roundtable.[1] Thank you for the opportunity to present the views of the Housing Policy Council on H.R. 1728, "The Mortgage Reform and Anti-Predatory Lending Act." My testimony today will focus on what has happened in the mortgage lending industry over the past few years, discuss the key elements of H.R. 1728 that we support, and identify areas of the bill we think need improvement.

Mistakes Made

Over the last few years, lenders and other participants in the mortgage industry made some serious misjudgments and mistakes. Heading that list was the assumption that housing prices would continue to rise and support increasing loan volumes. That mistaken assumption helped contribute to a relaxation in underwriting standards, including the use of "no document" loans, 100% financing, and the over-promotion of certain mortgage products, such as hybrid and option ARMs. The originate-to-distribute loan origination model was misused by some instead of being used wisely to generate appropriate funding for secure and reliable residential mortgage loans.

On behalf of the Housing Policy Council, I apologize for these mistakes and misjudgments.

[1] The Housing Policy Council, established in 2003, is part of The Financial Services Roundtable. The Housing Policy Council is devoted to mortgage finance issues of significance to consumers, the economy, and the members of the Roundtable. Today, the Housing Policy Council consists of twenty-six of the nation's leading mortgage lenders, representing 65% of mortgages originated, and 76% of mortgages serviced in the US.

In all candor, these actions were well intentioned and were taken as part of an effort to expand housing opportunities for Americans. Homeownership became a reality for many Americans and products were available for borrowers in a variety of positions. The majority of these borrowers were successful. Nevertheless, mistakes were made that contributed to the current crisis.

Like every member of this Committee, the members of the Housing Policy Council want to ensure that these mistakes are not repeated and that mortgage credit is available to American consumers in a responsible and well-regulated environment. We stand ready to work with this Committee to ensure that reforms take place. We are fortunate in that reforms have already been started by self-policing in the industry, regulations promulgated by federal regulators, and the rejection of some of the worst of the practices by the market itself. We are prepared to work with this Committee as it tries to ensure that mortgage lending reforms are thorough and cover the weaknesses revealed by the recent housing downturn.

We support legislation that will strengthen mortgage lending and securitization practices. H.R. 1728 contains provisions which would implement changes in the system and we support those which we believe strengthen the system and benefit consumers. The challenge the Committee faces is crafting a bill that creates protections against inappropriate practices, yet preserves a vibrant system of mortgage finance. Several of the provisions in H.R. 1728, such as the definition of "qualified" mortgage, the duty of care, and the 5% credit risk retention requirement can be crafted in a slightly different way and still address the intended goals of the legislation. As presently drafted, we believe these provisions would cause a significant contraction in mortgage lending. While the current crisis is the result of inadequate and uneven standards and safeguards in providing mortgage credit, we urge the Committee to seek a balance between new regulation and keeping mortgage credit available for Americans who need it and can qualify for it.

Changes in the Industry

Since 2007, the industry and its regulators have taken a number of actions to address the practices that contributed to the current financial crisis. Underwriting standards have been revised and strengthened, both voluntarily and through regulation. Low and no-document loans are no longer being made, and many of the alternative mortgage products offered in the last few years are no longer available. I would like to give a brief overview of some of the most significant changes that have taken place during the past couple of years.

Many Originators have been Eliminated

Many originators have gone out of business. The business model they used which became more aggressive with weaker underwriting led to their failures. They no longer are a part of the industry.

Distribution has Changed

Broker originations have dropped considerably as a percentage of all new loans. While this decline is largely due to a drop in loan applications, it also is due to greater oversight and regulation of brokers. The Office of the Comptroller of the Currency ("OCC") now requires national banks and their subsidiaries to have their brokers sign a broker fee agreement with each borrower. In addition, broker licensing will be required in every state this year as mandated under the SAFE Mortgage Licensing Act, an Act generated by this Committee. A loan originator registry which will track bad actors throughout the country is also in place. The SAFE Act will provide better licensing and oversight of brokers

Loan Products Have Changed

Loan products have been revised in response to a failure of the market to support them and to actions taken by the federal banking agencies. In 2006, the federal banking agencies issued the Joint Guidance on Nontraditional Mortgage Product Risks (“Guidance”). That Guidance was designed to set standards for interest-only and payment option ARMs. Under the terms of the Guidance, borrowers qualify for these loans only if it can be shown that they can pay the full debt at maturity under the fully indexed rate, and without excessive reliance on credit scores for qualification or dependency upon collateral for repayment. This Guidance applies only to federally regulated banks and their subsidiaries, but most states adopted comparable regulations for state chartered banks.

In June 2007, the federal banking agencies issued the Statement on Subprime Mortgage Lending, which focused on hybrid ARMs. The Statement required prudent qualifying standards for these loans to avoid unsupportable “payment shock.” In the Statement, the banking agencies also required documentation and verification of income for subprime borrowers. This Statement also applied only to federally regulated institutions, but most states adopted similar regulations for state chartered institutions.

In July 2008, the Federal Reserve issued amendments to its Home Ownership and Equity Protection Act (HOEPA) regulation which applied to all lenders whether state or federally regulated. Those amendments implement many of the underwriting reforms that were proposed in H.R. 3915, legislation which was generated by this Committee and passed by the House in 2007. Those amendments will take effect on October 1, 2009.

<u>The Secondary Market</u>

On Wall Street, the business of private-label securitization has essentially stopped. Over the long-term we should strive to bring private-label securitizations back to the market with proper safeguards. Securitization is a powerful tool that allows for the free flow of capital throughout the economy. We must build a regulatory model that properly addresses the risks inherent in a sophisticated system while keeping intact the benefits of a system that allocates capital quickly and efficiently from investor to borrower and back.

To this end, we have a great deal of work to do. Today, the Federal Reserve essentially finances the American housing market. The Federal Reserve's credit easing plan, which includes the purchase of up to $1.25 trillion in Agency mortgage-backed securities, is essentially the lone support of the US housing market right now. We greatly support the actions taken by the Federal Reserve in this regard. The actions of the central bank have helped push mortgage rates to historic lows and have created a refinancing market.

But we also worry that over the long-term a properly functioning housing finance system requires the return of private capital to the secondary trading market. It can not and should not be the role of the central bank to serve as the primary source for housing finance in our country. Private capital must return to the market.

According to data compiled by the Department of the Treasury, foreign investors have either reduced or held steady their monthly holdings of US Agency and mortgage bonds since this crisis peaked in late September 2008. Since that time, global institutions have sold a net

$125 billion of American mortgage bonds, initially driving up interest rates sharply and forcing the Federal Reserve to stand-in as buyer of last resort. Billions of dollars in capital are now idle, waiting for clarity on where the United States mortgage market goes from here. The decisions we make now will have long lasting effects on the American and global economy for years to come. The eyes of investors across the world are now focused squarely on Washington, as they watch to see what we do to help re-build a more sustainable secondary market system. We must get this right.

Administration's Making Home Affordable Program

The Housing Policy Council supports the Administration's efforts to help at-risk homeowners through the Making Home Affordable Program ("Program"). We support the Program and believe the Administration is on the right track by focusing on making loans affordable for at-risk homeowners. We are working with representatives from Treasury, the Department of Housing and Urban Development, Fannie Mae and Freddie Mac to understand and implement this important program and will do our best to make it a success. All servicers of Fannie and Freddie loans will participate in the Program for GSE-owned loans. Servicers for private label securities are examining their ability to apply the Program to loans in private mortgage-backed securities. On April 16, Treasury announced the participation in the loan modification Program by a number of major servicers who are Housing Policy Council members. We appreciate the Administration's willingness to work with servicers in the implementation of this Program.

HPC member companies continue to work to keep as many people in their homes as possible, and the vast majority of our members are also members of the HOPE NOW Alliance.

The HOPE NOW Alliance and the Homeowner's HOPE Hotline, 888-995-HOPE, are reaching and assisting homeowners struggling with their mortgage payments by providing opportunities for at-risk homeowners to contact and talk to their servicer or a trained non-profit counselor for free. HOPE NOW servicers are now modifying 100,000 or more loans a month, and reached a record high of 134,000 loan modifications in February 2009, the most recent month for which we have data. That number does not include the Administration's Program which is still in its beginning stages. In addition, HOPE NOW is educating borrowers on the Administration's Program through the HOPE Hotline and homeownership preservation events. In the past 12 months, HOPE NOW has held over thirty-five in-person events across the country where more than 25,000 homeowners met directly with their servicer or a non-profit counselor. Most recently, HOPE NOW assisted more than 3,300 homeowners in Atlanta on April 15 and 16. HOPE NOW incorporated the Administration's Program and some borrowers in attendance received this new modification solution. We plan a total of thirty outreach events for 2009. The Homeowner's HOPE Hotline is receiving thousands of calls per day from homeowners and the members of the Alliance have mailed over 4.1 million letters, averaging 200,000 per month, to at-risk homeowners offering assistance and urging them to call their servicer or the HOPE hotline.

Provisions in H.R. 1728 Supported by HPC

The Housing Policy Council believes there are many elements of H.R. 1728 that will lead to a better mortgage market and we support those provisions. For example, we believe that no originator should originate a mortgage if it does not believe that the borrower has a reasonable ability to repay the loan, including all applicable taxes and insurance payments, based upon information available at the time the loan is made. The lender should base its belief upon reasonable considerations, and those should include the borrower's income, ratio of debts to income, credit history, employment, and financial resources. Those elements are included in the bill and we believe they are appropriate.

If the loan is a variable rate loan, the lender should determine the ability to repay the loan based upon a fully indexed amortizing schedule of payments. Appropriate criteria should be verified and documented. We support those provisions. We also support full disclosure to borrowers in advance, and have in the past supported even broader changes that would permit borrowers to shop with better understanding of the products and prices.

We also believe that yield spread premiums should be prohibited. We oppose paying brokers compensation based on charging a borrower higher prices than that for which he or she qualifies. We oppose steering borrowers to higher priced loans, and we support escrow requirements for taxes and insurance payments.

In other words, there are many provisions in this bill that we have supported in the past and continue to support. We hope they become law and believe that their passage will lead to a sounder mortgage market in which those who can qualify for mortgage loans will receive them at a fair price that they can repay. That should not be interpreted to mean that we believe that the bill should be supported without change.

Provisions in H.R. 1728 that Need Modification

We believe there are some important provisions that have major flaws and would urge the Committee to either delete or modify those provisions before moving the bill. Absent those changes, we fear that the bill would create an environment that would lead to a drop in the percentage of homeowners in the country and an increase in costs for those who manage to get mortgage loans.

Here are those provisions which we believe compromise the effectiveness and desirability of H.R. 1728; listed in the order in which they appear in the bill.

Duty of Care

The Duty of Care provisions in sec. 102 of the bill create a duty which the creditors are simply not able to meet. Originators can make a judgment that borrowers do or do not have the financial ability to repay a loan. They have the expertise and the ability to do that, providing that borrowers do not deceive them.

Originators do not, however, have the ability to determine what loan is “appropriate” for a borrower, nor are they able to discern what is meant by predatory “effects” in sec. 103, a definition that will probably only be known after a number of lawsuits are decided. The terms “predatory characteristics or effects” are undefined, provide no guidance, and will put originators at risk of litigation. These terms are not necessary since the bill and present law prohibit abusive or unfair lending practices and require that the originators determine that the borrower has the ability to repay the loan. If “appropriate” is limited to “ability to repay the loan,” and predatory characteristics and effect are carefully spelled out so that originators have a clear direction to follow, we can support the provision.

We urge that Congress limit duties it plans to impose upon originators to those duties which they have the ability to meet, not ones that are vague and beyond their ability to meet.

Applicability of Steering Prohibition

While we fully support the concept that originators should not be compensated for charging a borrower prices higher than those for which the borrower qualifies, we are concerned that the provision as written in sec. 103 may have unintended negative consequences. We support the general concept that the compensation to a mortgage originator should not vary based on the terms of the loan, and that a borrower should always be offered a qualified loan if the borrower meets the requirements for that loan. Certain loan products, however, may take more of an employee's time and effort to process than other loans. For example, FHA, VA and CRA loans often take longer to process and many are for a smaller principal amount than a conventional 30-year fixed rate loan. As the bill is currently drafted, creditors could not give their employees sufficient incentive pay to process such loans as the incentive must be based on the same incentive plan for conventional 30-year fixed rate loans. Employees will not want to work on such products because their total compensation will be less than if they process easier loans with higher principal amounts. We believe this is not the intended purpose of this section and want to work with the Committee to try to correct it.

Definition of Qualified Loans

The definitions of qualified loans in sec. 203, and the effect of those definitions, also warrant change. We suggest that VA, FHA, and rural housing loans, as well as loans sold to Fannie Mae and Freddie Mac be added to the standards. VA, FHA, and rural housing loans that are made or guaranteed by the applicable governmental departments are governed by an extensive array of conditions that are at least equal to the standards established in this section and thus, should be included within the definition of qualified loans. Similarly, Congress and

FHFA have the authority to carefully regulate the quality of conforming loans that can be purchased by Fannie Mae and Freddie Mac, and the federal government fully guarantees the MBS issued by the enterprises. Loans meeting those standards should be included within the definitions of qualified loans.

We urge that more precise directions be given to the agencies to permit loans of durations other than 30 years and with adjustable rates to qualify. The present language of the bill requires that all loans within the definition of qualified loans must be of precisely 30 years duration, and while it is silent on rate, we understand the intention is that the rate be fixed, and not adjustable. Adjustable rate loans and loans with other durations than 30 years, provided that they meet all the other standards within the section and pass regulatory muster should be included as qualified loans. Many highly qualified borrowers would prefer to have rates that adjust or repay their loans more rapidly than 30 years. Those borrowers should not be penalized under an assumption that a 30-year fixed rate loan is the only appropriate loan; other fully underwritten fixed rate and adjustable rate loans are also safe. It also should be noted that modifications under the Administration's Making Home Affordable Program ("Program") may not meet the definition of a qualified loan. Under the Program's guidelines, the term of the new loan can be up to 40 years.

We also believe that the presumption should be irrebuttable. If the loans meet those standards, making the presumption irrebuttable will provide some certainty to lenders and avoid a string of lawsuits created by imaginative plaintiffs who want to avoid their own responsibilities. Creditors must have guidance that provides certainty that practices they are following will comply with statutory requirements. This can only be achieved if the standards are fully articulated, and compliance with the standards is deemed to satisfy the statutory tests.

Risk Retention

The risk retention provisions in H.R. 1728 are designed to assure that the original lender retains some risk in the performance of a mortgage loan. We support the general concept of originators retaining some credit risk. Too many originators failed to pay sufficient attention to risk during the past few years, and such a requirement would instill greater attention to underwriting standards. However, a requirement to retain 5% of the credit risk for every loan sold could reduce banks' incentives to make mortgage loans, or lead banks to increase the costs of mortgage borrowing, or both. Thus, unless carefully drafted, one unintended effect of the risk retention requirement will be to reduce levels of homeownership.

Even small changes in capital requirements can have a disproportionate impact on a lender's behavior. Mortgage originators operate with narrow spreads between expenses and profits. Therefore, any additional capital costs associated with making a mortgage loan will require a lender to evaluate whether the loan is yielding a sufficient return to justify the capital allocation required. If not, a lender will have to consider either increasing the return on the loan by raising interest rates and other charges, or if that is not practical, reducing the amount of capital allocated to the loan by limiting the production of new mortgage loans. The extent to which this will be felt by the public depends on the significance of the higher capital charge.

The impact of the risk retention provision in H.R. 1728 will vary based upon the manner in which it is implemented by federal banking regulators. If a lender's risk retention position is intended to absorb all of the losses on a loan until the amount of retention if exhausted (i.e., a first loss position), then a lender will be required to treat all of the loans in a securitization as if they were never sold. On a pool of $100 million in mortgage loans this would equate to a capital charge of $5 million.

We have a number of ideas for refining the risk retention requirement in the bill to promote greater attention to underwriting standards without creating such damage to the market.

First, we recommend the scope of loans subject to the requirement be more targeted. As drafted, the requirement applies only to loans that are not “qualified” loans. As noted above, we believe that the definition of “qualified loan” is too narrow; it fails include many loans that are safe and sound, including FHA, VA, rural housing, and loans sold to Fannie Mae and Freddie Mac. The risk retention requirement would be better focused if these loans were deemed to be qualified loans. This would focus the risk retention requirement on the type of loans that were the source of the problem, namely risk loans. It would achieve the goal of mandating more intense scrutiny for higher risk loans without curtailing the availability of mortgage credit for better borrowers.

Second, we recommend that the regulators be explicitly authorized to apply the 5% credit risk requirement on a pro-rata basis with the assignee. As noted above, the existing requirement could be read to require a lender to hold a 5% first loss position against a pool of mortgages, and this would impose a sizable cost that would substantially curtail mortgage lending activities. Under a pro-rata approach, however, the lender would have a 5% interest in the loan proceeds that is equal in priority to the assignee’s interest. In other words, both the lender and the assignee would share proportionally in any loss. For example, if the 5% risk retention requirement is applied on a pro rata basis and there is a $100 loss, the lender would incur a $5 loss, and the assignee would incur a $95 loss. This ensures that a lender will continue to have some “skin in the game”, without having the unintended consequence of significantly reducing mortgage availability. Furthermore, applying the risk retention requirement on a pro-rating basis is similar to the approach that the European Union (EU) is considering. The EU, however, would apply the risk retention to securitizers, not originators.

Third, we recommend that the risk retention requirement be time limited. As drafted, a lender must retain an ever increasing amount of capital against its mortgage loans. For example, if a lender makes $100 in mortgage loans in year 1, the lender would be required to have $5 risk retention position against those loans. In year 2, if the lender makes another $100 in mortgage loans, its risk retention positions would include not only the original $5, but another $5 for a total of $10. Under the bill, this process would go on indefinitely. To avoid this excessive build-up of capital depleting positions, we recommend that the retention requirement be subject to an 18 month time limit. Given the enhanced underwriting standards otherwise mandated by the bill, we would expect the time period in which a loan becomes a nonperforming, early default loan to be reduced to around 12 to 18 months. Therefore, it would seem reasonable to set the outer limit of the retention requirement at 18 months.

Finally, we recommend that the Committee authorize the banking regulators to permit lenders to implement alternatives to the 5% requirement that may achieve the same goal as the 5% requirement. For example, the regulators could permit a lender who sells a loan to receive from the buyer only 95% of the sales price when the sale is consummated, and receive the full sales price only after certain performance benchmarks are reached.

This is a complex issue. We would like to work with the Committee on this issue going forward.

Uniform National Standard

We believe that all of the matters covered in this bill should set the standard for loans nationwide. In other words, this federal law should be a national standard. The mortgage industry is a national industry. Mortgage rates are set by national markets, and many of the basic terms and conditions in loans are set by Fannie Mae and Freddie Mac. The protections afforded consumers should also be national in scope and application. Indeed, gaps in consumer protection regulation contributed to the recent crisis in our financial markets.

These national standards should not be a floor for additional regulation by individual States. Additional, and different, state regulations will add compliance costs for lenders and increase the cost of mortgages for consumers. Strong and uniform national standards are the best protection for consumers.

Conclusion

The Housing Policy Council supports reforming the mortgage industry to ensure that the mistakes made over the past several years do not happen again. We want to continue to work with this Committee to ensure that these reforms curtail bad practices while maintaining a strong system of mortgage finance.