Testimony of

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Before The

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Insurance, Housing & Community Opportunity

On the Topic Of

QRM & Implications for FHA Reform

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Chairman Biggert, Ranking Member Gutierrez, and Members of the Subcommittee, thank you for the kind invitation to return to the House where I was fortunate to serve alongside so many of you when I first came to Congress in January 1999. Before coming to Congress, I worked in the residential real estate industry for 33 years, and now as a policy maker, I welcome every opportunity to work on issues relating to housing finance and sustainable homeownership.

You have asked me to testify today on the implications of the proposed Qualified Residential Mortgage ("QRM") regulations implementing Section 941 of Dodd-Frank for the FHA's market share and our collective efforts to restore a healthy and vibrant private market as the primary source of home financing. Last summer, during the consideration of Dodd-Frank, I joined with Senators Mary Landrieu and Kay Hagan to sponsor the QRM language, and today I remain very confident that this provision will play a very key and integral role in attracting private capital back to United States housing finance and restoring FHA to its smaller, historical role in the market.

Before I begin, however, I want to pause and underscore the important the work of this Subcommittee, given the current condition of the United States housing economy. A couple of weeks ago, a CEO from a completely different business sector told me this economy will turn only when housing begins to turn, not before.

As we sit here today, there have been some 5 million foreclosures nationwide over the last 5 years. The volume of REO inventory continues to stack up at Fannie Mae (153,224), Freddie Mac (65,174) and the FHA (68,997), not to mention at volume in private label securities and on bank balance sheets. Another 4 million loans are in some state of delinquency – 3.2 million of the 4 million are beyond six months late on payments. These numbers ignore another pressing problem across our country – homes with negative equity that – in many cases -- will take a lifetime to recover.   A recent survey of CoreLogic data found that among U.S. homeowners with mortgages, 52 percent – 24.8 million homeowners – have less than 25 percent equity in their homes. Negative equity has a chilling impact on the ability of households to move for a new job, retirement or an expanding family, and makes it impossible for many others to refinance into today's lower interest rates.

While there is plenty of blame to go around on how we got to this point, I want to highlight two practices or problems that I believe are most to blame: poor underwriting and bad loan products.

Years ago when I sold real estate in Atlanta, Georgia, lenders could not take short cuts in underwriting. Loans were fully documented, income and debt obligations of the borrowers were fully verified, and properties were accurately appraised. We've learned powerful lessons through this cycle that we all pay for shortcuts in underwriting processes.

We have also learned that while there were some loan products that were appropriate for a very narrow set of sophisticated borrowers, these products were overwhelmingly inappropriate for most borrowers. Products like negative amortizing mortgages, interest-only mortgages, short term ARMs spelled disaster for first time buyers and those with modest incomes, weaker credit or limited cash reserves.   Poor underwriting and risky products had much to do with the corrosion of mortgage securitization through the cycle, and if regulators had controlled just these two factors through this last cycle, we would be a far different place today. That is where the Qualified Residential Mortgage comes in. Last year, when the concept of risk retention was first put on the table by then-Chairman Barney Frank and added to the House-version of Dodd-Frank, the intent was to strengthen asset securitization by forcing more underwriting scrutiny at the closing table between the lender and the borrower.

When the House-passed bill came over to the other side of the Capitol, Senators Landrieu, Hagan and I understood that applying risk retention to safe, stable products and well-underwritten loans could unnecessarily raise costs for responsible, creditworthy borrowers. That is why we sought to improve the risk retention provision by creating strong incentives for borrowers, lenders and investors to seek out well-underwritten, sustainable mortgages.

Our concept was to provide for an exception to the 5% risk retention for high quality residential mortgages with underwriting and with product features that historical data prove have a reduced risk of default. A standards-based approach would incent high quality lending and borrowing without the higher costs, while risk retention would be targeted to risky lending behavior.

Our QRM standard included full documentation, consideration of monthly debt to income ratios, protection from mortgage payment shock, restrictions on risky product types (no negative amortization mortgages, no interest-only mortgages, or other unstable features), and for loans with less than 20% down payments, mortgage insurance or other credit enhancements obtained at the time of origination to the extent they reduce the risk of default.

Unfortunately, the regulators, in their Notice of Proposed Rulemaking, have narrowly interpreted the QRM exception to the point where it will never attract sufficient mortgage origination to support a new asset classification for securitization.

I have very specific concerns with the regulators' narrow interpretation of the QRM provision in Section 941 in their March 31, 2011 Notice of Proposed Rulemaking:

- First, Congress never included a down payment component to the QRM elements. That is not to say that I do not think there should be some level of down payment. In fact, I think a 5% down payment is the right number for the QRM securitization standard. Regrettably, the NPR sharply narrows the QRM with a required 20% down payment and very restrictive payment-to-income restrictions.
- Second, I have heard from more than one of the Risk Retention regulators that the Congress intended for the QRM standard to be a very narrow exception to the risk retention rule. Nothing could be further from the truth. In fact, the only "sizing" or limitation on the scope of QRM was expressly added in conference, and that limitation specifically says that the QRM shall be defined as "no broader than the definition of 'qualified mortgage'" in Title 14 of Dodd-Frank. Instead, the regulators have turned the QRM on its head in order preserve a vibrant *non-QRM* market – which is, frankly,

backwards. For housing to be restored to solid ground, we want to see a large and vibrant *QRM* market, not the other way around. Regulators should write the standard as Congress intended, and let the market – not Congress or the regulators – determine the relative size of the market for a new, high quality QRM mortgage security.

- Third, and most importantly for our purposes of today's hearing, the narrowly proposed QRM rule will have serious and adverse consequences for the FHA program and for our collective efforts to restore fully private capital as the primary source of mortgage credit in the market. Today, virtually all high LTV lending is being done by the FHA. The loan level price adjustments charged by Fannie Mae and Freddie Mac for all high LTV lending discourages conforming origination in those categories. The average loan purchased by Fannie and Freddie today has a 69% LTV and a 760 FICO score – standards that exclude many responsible borrowers from the conventional market. Moreover, Dodd-Frank exempts the FHA from risk retention altogether. That means that if safe high LTV conventional lending is not also included in the QRM standard, FHA will be the only option available for consumers without a sizeable down payment. We want private capital to be able to compete in all the corners of the mortgage market with well-underwritten, safe and stable mortgages. To do that, the

QRM market needs to be able to serve the many creditworthy low down payment borrowers who have long been the cornerstone of a strong U.S. housing market.

With the current condition of our United States housing economy, we need to encourage prudent, safe lending – including responsible high LTV lending – which has been a significant part of the mortgage finance system for decades. An unnecessarily narrow QRM does far more harm than good in helping reset strong, transparent standards for conventional lending and private mortgage securitization. The thirty year, fixed rate mortgage is the safest mortgage product in the market. I leave you with this question, if we are stuck with the NPR as it is proposed today where few mortgages qualify for the exemption from risk retention, what will a commercial bank do with its mortgage lending business: (1) hold all 30 year mortgages on their balance sheet and incur significant interest rate risk; (2) sell the fixed rate mortgages into the secondary market and incur the cost of risk retention, which will be passed down to the borrower; (3) offer only shorter term adjustable rate mortgage products, or (4) scale back or leave the mortgage business altogether? None of these are palatable options, and none are good for consumers or for the recovery of the housing market.

The QRM as proposed on March 31st, should be re-aligned to the intent of Congress and re-proposed on an expedited basis. The standard has huge implications for the FHA program, and more importantly for the recovery of private capital in our nation's system of housing finance. The regulators need to get this one right.