



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410

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**Hearing before the House Financial Services Committee
Subcommittee on Capital Markets and Government Sponsored Entities
on**

Understanding the Implications and Consequences of the Proposed Rule on Risk Retention

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Chairman Garrett, Ranking Member Waters, and other distinguished Members of the Subcommittee, thank you for the opportunity to testify today on the implications and consequences of the proposed rule on risk retention. My name is Bob Ryan and I am the Acting Assistant Secretary for Housing and Acting Commissioner of the Federal Housing Administration (FHA) at the U.S. Department of Housing and Urban Development. In my former role as Deputy Assistant Secretary for Risk Management and Regulatory Affairs and FHA's Chief Risk Officer, I oversaw FHA's enterprise risk management functions in a division encompassing all of its business lines, including single family, multifamily and healthcare. Combined with nearly three decades within the private sector in all aspects of the mortgage market, my experience gives me a deep understanding of the mortgage origination and capital markets processes and the government's role within them.

I am here today to discuss the Qualified Residential Mortgage (QRM), as defined in the recently issued Notice of Proposed Rulemaking on risk retention, in the context of the FHA's current and on-going role in the housing market.

As this Committee is aware, HUD is one of six agencies participating in the risk retention rulemaking process. These agencies were specified by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which sets forth the parameters of that process.

The goal of the proposed risk retention rule is to provide clarity and offer "rules of the road" to the securitization markets. The proposed rule is one part of the Administration's goal of bringing private capital back into the housing finance system. Getting this right is critical. With the

financial crisis, we saw how bundling and packaging mortgages to sell on Wall Street with no accountability helped lead to the erosion of lending and underwriting standards that fed the housing boom and deepened the housing bust. Dodd-Frank specifically requires that securitizers or originators have ‘skin in the game’ by retaining at least 5 percent of the credit risk and the proposed rule sets out a variety of options to accomplish that mandate.

The proposed rule also seeks to define a QRM – a loan that would not be subject to the risk retention requirements as provided by Dodd-Frank. Let me be clear: we fully support requiring more “skin-in-the-game” requirements as well as underwriting standards, including full documentation, both of which the proposed QRM definition addresses. We believe in fostering loan products that allow borrowers to prudently manage risk, support their monthly payments and succeed in obtaining sustainable homeownership.

The crisis has highlighted the importance of strong underwriting standards and the need for heightened due diligence on the “3 C’s” of lending: credit, collateral and capacity. In other words, a lender needs to truly assess a borrower’s capacity to repay a loan, a buyer’s credit experience, the value of the property being financed, and the type of mortgage. More specifically, for credit, that means fully understanding the borrower’s credit history and scanning for foreclosures, bankruptcies, liens and/or judgments, mortgage delinquencies, credit delinquencies, repossessions, collections, or charge-offs. It means verifying credit accounts, their type, age, limits, usage and the status of revolving accounts. For collateral, it means an accurate and objective appraisal of the property and assessing the down payment structure. For capacity, it means verifying monthly housing expense-to-income ratio or monthly debt payment-to-income ratio, confirming employment and income, identifying cash reserves and weighing that against the characteristics and purpose of the loan type considered. In this manner, a lender can properly identify responsible borrowers that can achieve sustainable mortgages.

Strong underwriting has been at the core of FHA’s success. Because FHA insures lenders against losses that may result in the event of a borrower default, that commitment is made under the condition that lenders are required to abide by extensive documentation and underwriting guidelines to originate sustainable mortgages. Lenders are also required to provide loss mitigation opportunities to help borrowers avoid default or foreclosure. Steps taken to hone our underwriting standards in the past year have allowed FHA to materially strengthen its balance sheet and to further strengthen its capital reserves. I would also like to add that, pursuant to the specific provisions of Dodd-Frank, loans insured by FHA are exempt from the risk retention requirements.

Given the exigencies of strong underwriting for healthy, sustainable mortgages, we must be mindful of the trade-off presented by the current definition of QRM between improvement in loan quality and affordability and accessibility for prospective homebuyers. In other words, how much lift to performance do we get to the exclusion of creditworthy borrowers with a tighter band? While QRM is designed to create a class of loans that have a lower likelihood of default,

in its proposed definition it has the potential to exclude a number of buyers. Stated another way, this definition has the potential to create false positive situations that deny creditworthy borrowers affordable loans in this class. This potential situation then begs one of the questions for which we actively seek comment: what costs will borrowers allocated to the non-QRM bucket have to face? In turn, what impact will this bifurcated mortgage market have on liquidity? Again, we look forward to receiving feedback on this issue. By answering these challenging questions, we can better fashion a system that strikes the right balance between strong underwriting and ensuring all creditworthy borrowers have access to affordable products.

On a more granular level, QRM status is determined by a number of factors, including product type, Payment-to-Income (PTI)/Debt-to-Income (DTI) ratios, Loan-to-Value ratio (LTV) and delinquency history, as defined within the proposed rule. Not surprisingly, much of the debate has focused on the appropriate LTV ratio that should be required in the rule. While there is no question that larger down payments correlate with better loan performance, down payments only tell part of the story. That is why the proposed rule includes an alternative definition that considers a 10% higher LTV with the inclusion of credit enhancement that duly incorporates strong underwriting requirements and servicing standards.

In addition to LTV, we must also focus on the other QRM requirements. FHA uses both downpayment and FICO scores to allocate credit assistance, which, together, we have found to be a much better predictor of loan performance than just one of those components alone. For instance, FHA insured loans with LTV above 95% and a FICO score above 580 perform better than loans with LTV below 95% and a FICO score below 580, while loans with a LTV above 95% and a FICO score below 580 perform significantly worse than all other groups, as illustrated below.

**FHA Single Family Insured Loan Claim Rates
Relative Experience by Loan-to-Value and Credit Score Values¹**

**Ratios of Each Combination's Claim Rate
to that of the Lowest Risk Cell²**

¹ Based on experience of the FY 2005 – FY 2008 insurance cohorts, as of February 28, 2010. These ratios represent averages of the cell-level ratios in each cohort.

² Claim rates in the first row and last column are the low-risk cell and are represented by a ratio value of 1.00. Values in all other cells of this table are ratios of the cell-level claim rate to the claim rate of the low-risk group.

Loan-to-Value Ratio Ranges	Credit Score Ranges ³			
	500-579	580-619	620-679	680-850
Up to 90%	2.6	2.5	1.9	1.0
90.1 - 95%	5.9	4.7	3.8	1.7
Above 95%	8.2	5.6	3.5	1.5

Source: US Department of HUD/FHA; March 2010

Moreover, our two-step FICO floor scales the level of down payment required based on the borrower's score with 3.5% required for a score above 580 and 10% if between 500 and 579. The point here is that not only is it necessary to give FHA the flexibility necessary to respond to market conditions and manage risk, but also that a number of factors can predict or impact loan performance – as identified in the overall QRM proposal – and downpayment level alone cannot be seen as exclusively predictive of loan performance. To that end, we seek comment on the impacts of each of the QRM criteria. In addition to FHA, Fannie Mae and Freddie Mac have a long history of providing loans with 10% down payment with the use of mortgage insurance that have exhibited strong performance.

To quote my predecessor, David Stevens, “we have a responsibility to continue our work fixing the fundamental flaws in the mortgage market to help restore confidence among homeowners, lenders, and investors.” Defining QRM in this joint rule making effort is indeed a step forward in that reform process But we cannot rest. Now rule makers should strive to ensure that it supports a liquid and robust marketplace and the return of responsible private capital based on prudent risk retention that will make the market sturdier. To do so, we must flesh out all the issues QRM presents.

We have been pleased to participate in this inter-agency effort and have posed many questions in the proposed rule on which we are eager to receive feedback. I want to emphasize that no final decisions have been reached and we look forward to reviewing and considering all the comments that are received. We also remain committed to open dialogue with the Committee and look forward to engaging with a wide range of stakeholders to understand their concerns so that we strike the right balance between managing risk and maintaining access to safe, responsible homeownership.

³ Loan-level scores represent the decision FICO scores used for loan underwriting. This analysis includes all fully-underwritten loans, purchase and refinance, but excludes streamline refinance loans.