TESTIMONY OF

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BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

HEARING ON

H.R. 1728, THE MORTGAGE REFORM AND ANTI-PREDATORY LENDING ACT OF 2009

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Chairman Frank, Ranking Member Bachus, thank you for permitting me to testify here today on behalf of the Securities Industry Financial Markets Association[1] and the American Securitization Forum[2] regarding mortgage finance reform and in particular certain mortgage origination practices that contributed to the housing crisis affecting the nation today. We are pleased to have worked on this issue constructively with the Committee as it moved toward passage of H.R. 3915, the "Mortgage Reform and Anti-Predatory Lending Act of 2007" last Congress. We appreciate the opportunity to highlight the key considerations that have guided our involvement and identify our concerns about the provisions contained in H.R. 1728, the "Mortgage Reform and Anti-Predatory Lending Act of 2009."

We believe the 2007 bill struck a reasonable balance and are encouraged that the Committee used that bill as a starting point for H.R. 1728. We also understand that the mortgage market is vastly different than it was in the fall of 2007. The housing GSEs have been placed into government conservatorship, a number of major mortgage market participants have gone out of business and the government has taken unprecedented steps to stabilize the financial system, minimize foreclosures and encourage mortgage lending. Given these developments, and the lack of an existing securitization and subprime mortgage market, we believe every effort should be made to take bold action now to facilitate a functioning and fair mortgage market for the future. We offer three key suggestions for improving H.R. 1728:

- Protect the Prime Market. We recommend that the Committee revise the current legislation to ensure the continued functioning of the prime mortgage market. As currently drafted, the bill could impose potential legal liability on secondary purchasers of all mortgage loans -- and provides only a rebuttable presumption against liability for "qualified mortgages" (a narrow subset of certain 30 year fixed rate loans). There are a host of other prime loans that provide meaningful benefits to qualified borrowers depending on their individual situation and the existing interest rate environment. We hope the Committee will expand and strengthen this safe harbor to help ensure the continued availability of a host of different prime loans. In particular:
    - ***Expand the definition of "qualified mortgage" to include other prime loans.*** (Although there will always be disagreements over where to best draw the line, at a minimum this should include loans where the federal government establishes underwriting criteria (e.g., FHA, VA and GSE), 7 and 15 year and longer fixed

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

[2] The American Securitization Forum ("ASF") is a broadly-based professional forum of participants in the U.S. securitization market. Among other roles, ASF members act as issuers, underwriters, dealers, investors, servicers and professional advisers working on securitization transactions. More information about ASF and its involvement in financial accounting matters may be found at www.americansecuritization.com. ASF is an adjunct forum of SIFMA.

rate loans and adjustable rate loans with APRs that fall within a narrow band of "prime");

- ***Provide a meaningful safe harbor for secondary purchasers of these prime loans*** (i.e., "qualified mortgages") by limiting the "rebuttable presumption" to *creditors* (those who actually made the loans). This language was included in the 2007 legislation so that secondary purchasers can continue to provide liquidity to the prime market and should be added back to H.R. 1728.

- <u>Better Align Incentives in the Subprime Mortgage Market</u>. Clearly there were problems in the subprime market that should be addressed legislatively to ensure that they do not happen again. Most bad actors are gone; regulations have been implemented to facilitate stronger underwriting standards; far fewer bad loans are still being made and fewer still securitized; but thoughtful legislation can help prevent backsliding when markets turn around. H.R. 1728 contains a number of important provisions for ensuring those protections: it offers a host of strong originator obligations; important ability to repay and net tangible benefit protections and liability up and down the mortgage chain including the securitizer. One addition included in this regard is a minimum five percent risk retention requirement for creditors of non-qualified mortgages. We agree that requiring creditors to have some "skin in the game" may help better facilitate the traditional lender-borrower relationship. In addition, we appreciate the Committee's willingness to facilitate an open regulatory process for putting such a requirement in place. Our members have expressed some concern that (1) an overly burdensome standard could substantially reduce the ability of non-bank mortgage lenders to provide liquidity for this market; and (2) creditors who do provide needed mortgage credit may find their inability to hedge or shed these risks limit their competitiveness and lending capacity. Balancing these conflicting interests is difficult. We hope Congress and the regulators will be careful to focus clearly on the ultimate goal of aligning borrower and creditor incentives and not unintentionally restrict credit or undermine safety and soundness, which is obviously not in anyone's interest. Accordingly we recommend:

    - ***Providing regulatory flexibility to consider (1) the duration of the risk retention; (2) the size and calculation of the retention; and (3) circumstances when hedging might be used in a way that protects safety and soundness and ongoing business flexibility without undermining the needed alignment of borrower-lender interests. We also recommend that federal regulators work with their foreign counterparts to facilitate a coordinated global approach.***

- <u>Clear Rules are Key</u>. Over the last year we have been reminded that consumer protection and safety and soundness are interrelated; and the same rules should apply to all entities engaged in the same activity. Otherwise some market participants will find ways to exploit differences to bypass standards. This is particularly true in large liquid markets like those that existed for mortgages and mortgage-backed securities. The 2007 bill recognized this by setting strong underwriting and secondary market standards and making clear that the remedy was the sole remedy available for claims against secondary purchasers. H.R. 1728, however, revises those provisions and creates uncertainty about when and whether states may impose other obligations on secondary market participants for ability to repay and net tangible benefit tests. The liquidity needed to fund a functioning U.S. mortgage market requires that these assets be sold to longer-term investors (freeing up capital for new loans). While creditors should be held to account for the loans they make, the sale and resale requires legal certainty and commoditization for subsequent buyers. We believe H.R. 3915 better achieved this balance. To help facilitate their continuing participation, the Committee should make clear that these investors will not need to monitor fifty plus different standards before providing liquidity by:

- ***Establishing a single clear standard for secondary market participants related to the ability to repay and net tangible benefit tests established by H.R. 1728.***

We believe these are modest changes that go directly to protecting the availability of good prime credit to current and future American homeowners, without undercutting this Committee's interest in regulating subprime and predatory mortgage lending practices.

Detailed Discussion

Because H.R. 1728 is so similar to last Congress' H.R. 3915, it may be helpful to provide some context by briefly discussing the 2007 bill before moving to the differences with H.R. 1728. We believe the House wisely sought to limit the majority of H.R. 3915's provisions to subprime loans by focusing on the core practices that it believed contributed to the credit crisis. The underlying premise was that every segment of the market – from borrower and broker through to the investor – bore some responsibility for the breakdown, but that loans to borrowers who may not meet traditional agency standards could be made in a responsible way, and that there was a desire to see industry continue to support this segment of the mortgage market. As such, the committee worked to make the new requirements relatively understandable and the penalties for violations maintained a sense of proportionality.

Since then the availability of subprime credit has evaporated. This market has not returned. The prime market is functioning but fragile, and the private mortgage securitization market remains dormant. Congress and the Administration have taken numerous initiatives to address the current foreclosure and housing crisis. The Federal Reserve Board has addressed a number of underwriting concerns when it enacted its final regulations to the Home Ownership Equity Protection Act in July 2008. As a result, it appears that any new legislative initiative will be prospective in nature in anticipation of the eventual return of a private lending and securitization market, and one of the key questions going forward is the extent to which policymakers wish to encourage the return of private investment in housing finance, particularly for borrowers who may not meet agency standards.

During its deliberations of last Congress' bill, the House sought to balance the legitimate interests of borrowers, lenders and assignees in addressing five basic issues: (i) who should be subject to the law's requirements, (ii) what types of residential mortgage loans should be subject to the law's requirements, (iii) what does the law require, (iv) what are the remedies for violations of the laws, and (v) what is the relationship of the new federal law with state laws addressing similar issues. We believed then, and we still believe today, that there are certain principles that guide the ability and willingness of the industry to participate in the primary and secondary mortgage markets. First, lenders, assignees and securitizers need legal certainty before being subjected to potential legal liability. Second, borrowers and market participants are looking primarily for a system that works: one that protects both the legitimate interests of innocent consumers from inappropriate lending products and practices and provides incentives for investors to invest the funds needed to help get that borrower a home. Although we had some concerns, we felt that many of the provisions of H.R. 3915 provided a fair balance and appreciate that most were included unchanged in H.R. 1728.

I. BACKGROUND ON H.R. 1728

A. Substantive Requirements

Substantially all of the provisions in H.R. 3915 are contained in the new H.R. 1728 or have been enacted in subsequent legislation such as the Housing and Economic Recovery Act. Like last Congress' bill, H.R. 1728 essentially imposes four substantive obligations, two on mortgage lenders (defined as "creditors") and two on mortgage originators (which would include both independent mortgage brokers and employee loan officers of mortgage lenders). First, it would prohibit a creditor from making a residential mortgage loan unless the creditor makes a reasonable and good faith determination, based on verified and documented information, that at the time the loan is consummated, the consumer has a reasonable ability to repay the loan according to its terms (or to make the combined payments on all loans on the same dwelling about which the creditor knows or has reason to know), and all applicable taxes, insurance, and assessments. Second, H.R. 1728 would provide that no creditor may extend credit in connection with any residential mortgage loan that involves a refinancing of a prior existing residential mortgage loan unless the creditor reasonably and in good faith determines, at the time the loan is consummated and on the basis of information known by or obtained in good faith by the creditor, that the refinanced loan will provide a net tangible benefit to the consumer.

While last Congress' ability to repay and net tangible benefits standards technically applied to all "residential mortgage loans," its presumptions protected large portions of the prime market and secondary purchasers. This permitted secondary purchasers to continue to provide liquidity to the prime market, while holding creditors responsible for the particular lending decisions (even for safe harbor loans). H.R. 1728 significantly reduces the size of the safe harbor and eliminates the protection for secondary purchasers (i.e. even safe harbor loans can be rebutted against secondary purchasers). These changes mean that secondary purchasers of loans could risk legal liability for prime loans made by others (even 30 year fixed rate loans) within the "qualified mortgage safe harbor." This risks a substantial reduction in investor participation in the mortgage markets.

Third, the 2007 bill required that mortgage originators "diligently work to present the consumer with a range of residential mortgage loan products for which the consumer likely qualifies and which are appropriate to the consumer's existing circumstances." Furthermore, the duty would mandate that originators make complete and timely disclosures to a borrower of the comparative costs and benefits of each product offered, the nature of the originator's relationship to the borrower, and any relevant conflicts of interest. This duty would apply to both prime and subprime, consumer purpose, residential mortgage loans. These provisions are largely unchanged. Fourth, H.R. 1728 clarifies and expands to all loans, last Congress' language prohibiting mortgage originators from receiving additional compensation based on the terms of a loan (other than principal amount).

B. Remedies for Violations

The remedies for violations of these provisions differ depending on the violations. The standard civil liability provisions of the Truth in Lending Act would apply to violations of the H.R. 1728's provisions. H.R. 1728 would increase the type and amount of monetary damages that would be available for violations.

TILA currently imposes liability primarily on lenders who fund loans in their name; it applies to "creditors," but not mortgage brokers. H.R. 1728 would extend TILA civil liability to include mortgage originators. A mortgage originator that violates the duty of care and anti-steering provisions would be liable for actual and statutory damages but not enhanced damages. However, those monetary damages would be capped at the greater of three times the total amount of direct and indirect compensation or gain accruing to the mortgage originator in connection with the mortgage loan, plus costs and attorney's fees, and actual damages; H.R. 3915 would have limited the damages to the multiple of compensation or gain.

H.R. 1728 also would materially expand rescission as an available remedy. Rescission, which extinguishes the loan and requires the creditor or assignee to return to the borrower all amounts he or she previously paid, is an extraordinary remedy under current law but limited in its application from a time standpoint. Under TILA currently, a borrower has a right to rescind a refinancing mortgage loan transaction for three days after closing or until the delivery of certain material disclosures, whichever is later. If the creditor fails to provide those disclosures altogether, or fails to provide accurate material disclosures, the right to rescind extends to three years. This three-year term is considered the "extended" right to rescind, compared to the "general" rescission right that is limited to three days following closing.

H.R.1728 would provide an extended right to rescind for certain of its new loan origination provisions. Rescission would be available to consumers as a remedy for violations by creditors of the proposed underwriting requirements. If the creditor could not provide, or a consumer could not obtain, rescission because the loan was held by somebody else, the liability would have to be satisfied by providing the financial equivalent of a rescission, plus costs and reasonable attorney's fees. Further, a creditor would not be liable for this new rescission remedy if the creditor cures the violation within 90 days after the consumer notifies the creditor of the violation. H.R. 1728 creates an exemption from liability and rescission in the context of borrower fraud or deception.

As with H.R. 3915, H.R. 1728 would impose limited assignee liability for violations by creditors of its underwriting requirements but not for violations by mortgage originators, although it does not define the term "assignee." Liability would extend to assignees and "securitizers." A "securitizer" is defined as any person that assigns residential mortgage loans, to any securitization vehicle. It also exempts "securitization vehicles" from assignee liability, which meant that trusts or other entities that issue securities backed by the loans and that also hold those loans, as well as the purchasers or repackagers of the securities, would not be liable for others' violations. This is a vital protection that helps facilitate investor participation in the mortgage markets.

An assignee or securitizer that acts in good faith would be liable in an individual action for rescission, costs and attorney's fees, but not for money damages. It could avoid rescission as a remedy in one circumstance. It could cure a violation within 90 days by modifying or refinancing the loan, at no cost, to provide terms that would comply with TILA (as amended) at time of origination, plus refund costs and pay reasonable attorney's fees.

H.R. 1728, however, deletes an important protection for secondary purchasers of loans contained in last Congress' bill. An assignee or securitizer would not have been subject to liability under the previous bill if the assignee or securitizer had followed rules promulgated by federal banking and securities regulators; established a policy to only buy "safe harbor" mortgages *and* required the seller to represent and warrant in the loan sale agreement that all of the loans met the safe harbor requirements.

H.R. 1728 expressly states that these are the exclusive liabilities that could be imposed on an assignee for violation of the proposed underwriting requirements. H.R. 1728 provides a limited preemption of state laws that would apply additional rules and penalties to secondary market participants with regard to the construct in H.R. 1728. Specifically, H.R. 1728's liability provision would expressly supersede any state law or application of state law that provides additional remedies against any assignee, securitizer, or securitization vehicle. The remedies described in the new liability provision would constitute the sole remedies against an assignee, securitizer, or securitization vehicle for a violation of the ability to repay or net tangible benefit standard or any other state law addressing that specific subject matter. However, H.R. 1728 expressly would *not* preempt the applicability of state laws against creditors, nor would it preempt the availability of state law remedies for fraud, misrepresentation, deceptive acts and practices, false advertising, or civil rights laws against an assignee, securitizer, or securitization vehicle for its own conduct in connection with the making of a loan, or the sale or purchase of residential mortgage loans or securities.

C. Revisions to the High Cost Loan Requirements of HOEPA

While the bulk of H.R. 1728 is the creation of a new regulatory regime for higher cost, subprime loans that did not rise to the level of high cost loans under HOEPA, it also would increase the universe of loans that would be subject to HOEPA and the substantive restrictions that would apply to such loans.

II. POSITIVE ELEMENTS OF H.R. 1728

H.R. 1728 contains a number of valuable provisions. It properly differentiates between the new legal responsibilities of mortgage brokers and mortgage lenders, recognizing the inherent differences in the roles of the two types of originators and the related expectations of consumers. It seeks to limit the applicability of its provisions to residential mortgage loans not meeting the criteria for the exception, recognizing that the lending abuses that afflicted the subprime market were generally absent in the prime market. It qualifies the responsibilities of creditors to lessen the likelihood of successful claims for errors in judgments made in good faith. While it increases the monetary damages that would be available for violations, it limits the availability of "enhanced" or penalty damages to ensure some level of proportionality between the violation and the remedy. While it increases the availability of the extraordinary remedy of rescission, it offers a creditor the ability to avoid rescission by curing the violation.

The bill also properly balances its treatment of assignees, although the term remains undefined. There are major limitations on assignee liability that are worth noting. First, no assignee would be responsible for violations by mortgage originators, recognizing that it would be virtually impossible for an assignee to diligence a mortgage broker's activities. Second, it excludes from any assignee liability the securitization trusts and their certificate holders, instead focusing on the assignees in the chain up until a securitization is issued. Third, it limits the types of remedies that could be asserted against assignees to individual claims for rescission, thereby eliminating claims asserted on a class basis or for money damages. Fourth, it permits assignees, like creditors, to cure the violation in lieu of providing the remedy of rescission. Unfortunately, H.R. 1728 deleted the provision contained in H.R. 3915 that protected secondary purchasers that took strong steps to completely avoid loans that were not in the safe harbors.

III. CONCERNS WITH H.R. 1728

Although we continue to have concerns about several issues from H.R. 1728, we appreciate the committee's balanced approach and beginning the discussion with the final version of H.R. 3915.

We would like to highlight a few concerns:

Scope of the "Qualified Mortgage" Safe Harbor. The definition of qualified mortgages is too narrow and creates the risk that legitimate forms of responsible lending will be impaired by their non-qualified status. The definition of qualified mortgages should be revised to include FHA-insured, VA guaranteed and, loans eligible for purchase by Fannie Mae or Freddie Mac (particularly because they are under government control). The federal government already is deeply involved on a real time basis in developing eligibility criteria and overseeing the performance of the loans originated under those criteria. It makes little sense to have the federal banking agencies developing the eligibility criteria for loans administered under the auspices of other federal agencies and opening the door to confusing inconsistencies between and among federal agencies.

We believe qualified mortgages should not be limited to fixed rate loans or loans with terms of only thirty years. Responsible adjustable rate mortgage loans have been originated for many years before the subprime crisis. The problem that emerged with hybrid ARMS pertained to the frequency and size of the adjustments and lack of underwriting to the likely increases on the loans. These features can be regulated without effectively banning adjustable rate mortgage loans. Similarly, it is ironic that a qualified mortgage would exclude 40 year mortgage loans at the very time that the Administration's loan modification programs emphasize such loan terms to promote long term affordability. Moreover, fifteen year loans rarely if ever have been associated with abusive lending and long have been a valuable tool for borrowers to accumulate equity in their homes.

"Strength" of Qualified Mortgage Safe Harbor. We believe creditors and assignees will need greater certainty whether or not the loans they are making and purchasing will be subject to legal liability. The new "rebuttable presumption" means that no one knows at the time a loan is made (or purchased) what standards apply, who is responsible for violations and what remedies apply. This uncertainty will impair the willingness of some to participate in the mortgage market. We recommend a stronger, more certain safe harbor. If the safe harbor may be "rebutted" it should be rebuttable only against the creditor (the entity that actually made the loan), not subsequent purchasers. This problem is exacerbated by the deletion of H.R. 3915's "policies and procedures" language (discussed above) and the elimination of language contained in H.R. 3915 stating that loans outside the safe harbor cannot be inferred to violate the law. Eliminating this last provision strongly implies that loans that are outside the safe harbor *do* violate the ability to repay/net tangible benefit test and will greatly reduce their availability. This is particularly troubling given the size of the safe harbor.

Conflicting Legal Standards. We are concerned that Congress may be inadvertently establishing a number of conflicting standards for unfair and deceptive acts or practices among other abusive lending topics. H.R. 1728 contains a new provision (Section 105(a)) that provides broad discretion for regulators to promulgate rules to address lending practices including "unfair and deceptive acts and practices." Section 208 (the preemption provision) attempts to provide a single secondary market standard for violations of ability to repay and net tangible benefit, but provides that nothing in this act "limits [state laws] regarding the availability of remedies based upon…deceptive acts or practices" and adds a new definition for when "acts or practices are deceptive" for purposes of this provision (and therefore, for purposes of 50 different state laws). Finally – and separately – there is (1) the delegation of authority in HOEPA on which the Federal Reserve Board relied in issuing its regulations last year and (2) new FTC authority granted in recent appropriations legislation which also seems to attempt to address this issue. There is a real risk that each of these similar standards will be interpreted differently creating a host of conflicting legal standards that will reduce the desire of investors to participate in the mortgage market. Although we understand that the Committee is not at this time reviewing all the conflicting definitions of unfair or deceptive nationwide, at a minimum we ask that the Committee reestablish a single standard for secondary market participants with respect to the specific obligations imposed under this act.

Possible Contraction in Mortgage Credit. The combination of new HOEPA triggers (contained in H.R. 3915), the new smaller and weaker safe harbor, and conflicting legal standards risks a contraction in mortgage credit, particularly for borrowers who do not meet agency criteria. This could erode further the availability of credit, particularly in higher interest-rate environments where adjustable rate mortgages may be more attractive to borrowers than long-term fixed rate mortgages.

Risk Retention Requirement. Finally, we support policy steps to achieve a more effective alignment of incentives between mortgage originators and investors, to ensure that mortgage originators have a direct economic interest in the underwriting quality and credit performance of loans that are funded via the secondary market. However, we have some concerns about whether the specific risk retention provisions of H.R. 1728 are the best way to achieve this objective and believe an open regulatory process for risk retention requirement may help facilitate a balanced approach that provides the right “skin in the game” while minimizing unintended consequences, such as:

- *A reduction in mortgage market liquidity.* The current language could adversely affect financial institutions--and on the capacity of the broader financial market to fund mortgage credit for new home purchase and refinancing transactions. Non-depository institutions could encounter severe constraints on their ability to raise and retain capital sufficient to satisfy these recourse obligations. These institutions provided important capital and competition to the mortgage markets. Depository institutions, which may already be capital constrained, would be required to hold capital on their books that could otherwise be deployed to support additional consumer and business lending.

- *An unintended increase in longer-term risk.* Requiring that creditor retain a minimum *five percent credit risk and not hedge that risk directly or indirectly* could pose problems if markets change and management, foreseeing a possible credit issue (or hoping to avoid one), is prohibited by law from taking steps to minimize that risk to the institution. This may also raise longer-term, safety and soundness concerns – particularly if this risk retention extends for a significant period.

  Similarly it could limit some of the flexibility needed to manage mortgage lending businesses and adapt to changing markets (for example, if an institution wants to sell-off its mortgage assets *in toto* and exit the mortgage business or whether the provision as drafted would apply a risk retention requirement to standard financing transactions, such as repurchase arrangements, which many mortgage originators use to finance their loan portfolios). Could a company just sell the all the mortgage assets *and the retained risk,* or must it retain the risk even after it has exited the business?

To facilitate a reasonable balance between the possible unintended consequences and the desire to better align incentives, the Committee may want to consider providing regulatory flexibility to consider (1) the duration of the risk retention; (2) the size and calculation of the retention; and (3) circumstances when hedging might be used in a way that protects safety and soundness and ongoing business flexibility without undermining the needed alignment of borrower-lender interests. We also recommend that federal regulators work with their foreign counterparts to facilitate a coordinated global approach.

European regulators are far along in the process of developing legislation that would also require originators to retain skin in the game. Their approach has been to include many specifics in a piece of pan-European legislation that will be relatively difficult to amend once passed into law. A more effective approach would be for Congress to lay out the broad principles of what retention should encompass, and to designate the relevant regulator to implement those principles and to monitor compliance.

A proposal that this committee should consider in order to achieve two of the important goals of this legislation is the construction of a statutory covered bond market. Covered bonds show the promise of improving liquidity to the mortgage markets by providing a complementary source of financing while financial institutions retain these loans on their portfolios. In the U.S. we have suffered from statutory uncertainty as to the treatment of covered bonds – while regulators have sought to provide some comfort in this area, without legislative clarity, investors will be reluctant enter this market. Once established however, a covered bond market would allow investors to invest with confidence in pools of mortgages. This will drive funds into this important sector, fostering solid underwriting and funding mortgages held on balance sheets.

Thank you very much for the opportunity to raise these issues. We look forward to working with the Committee to craft legislation that protects homeowners while ensuring a vigorous home finance market.