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TESTIMONY OF

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SECU OF MARYLAND
ON BEHALF OF THE
CREDIT UNION NATIONAL ASSOCIATION

BEFORE THE
UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

HEARING ON
HOUSING FINANCE REFORM: ACCESS TO THE SECONDARY MARKET FOR SMALL FINANCIAL INSTITUTIONS

JUNE 28, 2011

Testimony of
Rod Staatz
President and Chief Executive Officer
SECU of Maryland
On behalf of the
Credit Union National Association
Before the
United States Senate
Committee on Banking, Housing and Urban Affairs
Hearing on
Housing Finance Reform: Access to the Secondary Market for
Small Financial Institutions
June 28, 2011

Mr. Chairman, Ranking Member Shelby, Members of the Committee, thank you very much for the opportunity to testify at today's hearing and to present the views of the Credit Union National Association regarding housing finance reform.[1] My name is Rod Staatz and I am president and chief executive officer of SECU of Maryland.[2] I am a member of both CUNA's Board of Directors as well as its GSE Reform Task Force.

A healthy, efficient and accessible secondary market is vital to credit unions and the millions of consumer they serve. In the wake of the financial crisis, we agree that the problems that led to the conservatorships of the Federal National Mortgage Association (FNMA or Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) need to be addressed in a comprehensive and meaningful manner. The institutional, regulatory and incentive structures that resulted in the taxpayer bailout of Fannie Mae and Freddie Mac must not be replicated. However, as Congress and the

[1] CUNA is the nation's largest credit union advocacy organization, representing approximately 90 percent of the 7,500 state and federal credit unions in the United States and their 93 million members.
[2] SECU of Maryland is a state chartered, federally insured credit union headquartered in Linthicum, MD. It serves 242,800 members and has $2.09 billion in total assets as of December 31, 2010.

Administration undertake this effort, it is critically important that the widespread availability of mortgage credit, housing affordability, consumer protection, financial stability within the system and strong regulation are maintained and enhanced.

My testimony will focus on the state of credit union mortgage lending, credit union principles for housing finance reform, our concerns with the federal regulators' proposed rule related to qualified residential mortgage and our concerns with new mortgage servicing standards.

Credit Union Mortgage Lending

Credit unions are increasingly important lenders in the residential mortgage market. After averaging just over 2% of all residential first mortgage originations in the decade and a half ending in 2007, the credit union share of originations more than doubled to 5% during the past three years, and more recently has risen to almost 6% (Chart 1). This increase was brought on by credit unions' resiliency during the recent financial crisis when other lenders, particularly those that relied most heavily on the secondary market, had to curtail lending. As the secondary markets collapsed in 2008, credit unions were able to continue lending, in part because they made loans for their own portfolios. Since 2007, credit unions have originated over a quarter of a trillion dollars in residential first mortgages ($266 billion). (Chart 2)

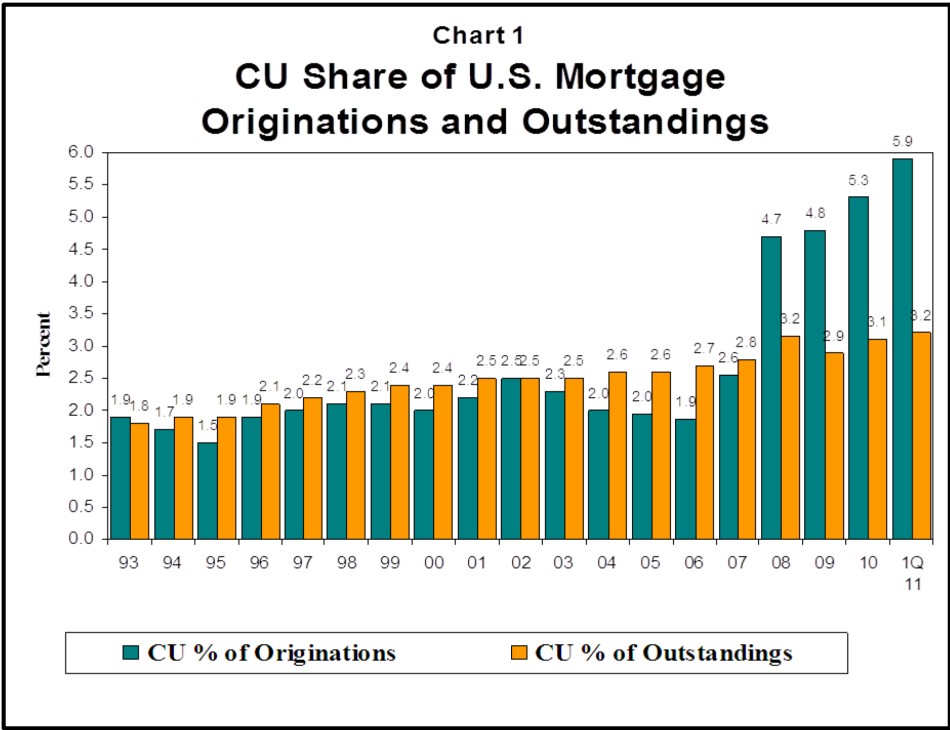


Chart 1
CU Share of U.S. Mortgage Originations and Outstandings
Percent
CU % of Originations
CU % of Outstandings

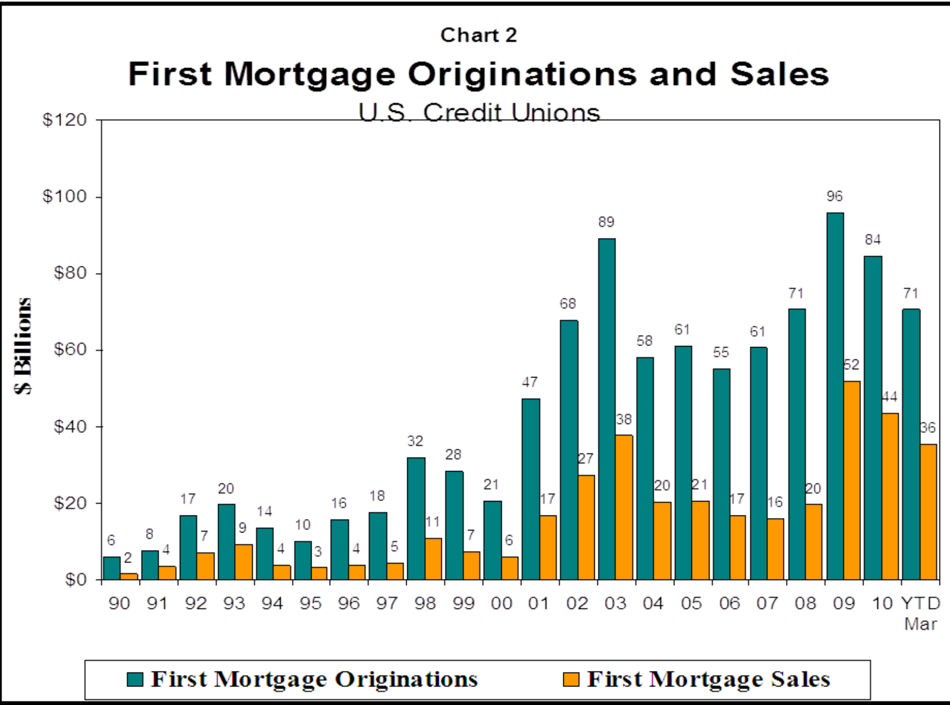
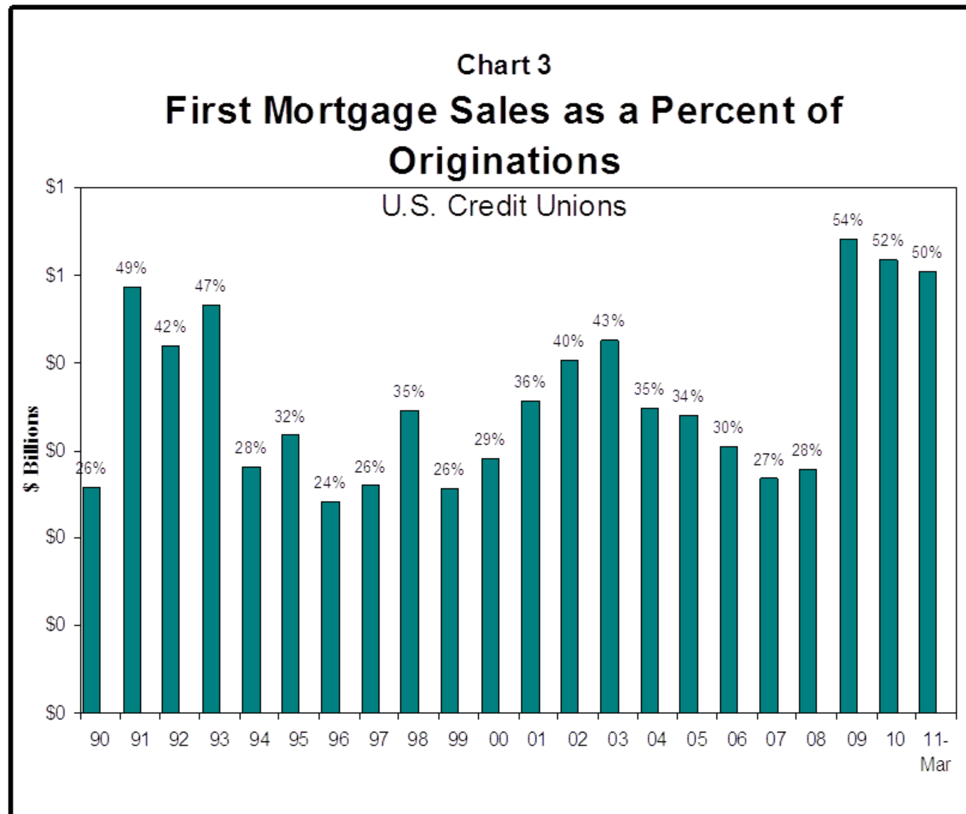


Chart 2
First Mortgage Originations and Sales
U.S. Credit Unions
$ Billions
First Mortgage Originations
First Mortgage Sales

Traditionally, credit unions have been primarily portfolio lenders, typically only selling between a quarter and a forty percent of their originations (Chart 3).



However, this does not mean that credit unions are not heavily reliant on a smoothly functioning and accessible secondary market. There have been times, such as during the past two years, when credit unions have sold over half their new loans. The decision by a credit union on whether to hold or sell a mortgage is primarily one of prudent asset/liability management (ALM). As evidenced by the S&L debacle in the 1980's, financial institutions funded by mostly short-term retail deposits must be very cautious about the interest-rate and liquidity risks of holding long-term, fixed rate mortgages on their balance sheets. Most credit union ALM policies, which are required and

substantially influenced by state and federal examiners, stipulate the amount of their assets that can be devoted to fixed-rate and adjustable-rate mortgages (ARMs), typically with much lower limits for fixed-rate loans. Depending on the stage of the interest rate cycle and member preferences, there are many times when a credit union's ability to hold fixed rate mortgages in portfolio is much less than the demand for such loans from members.

Whenever members take out ARMs, or when a credit union is below its policy limit on fixed rate loans, that credit union is likely to portfolio rather than sell new originations so long as interest rates are acceptable. On the other hand, when members are demanding primarily fixed-rate loans, credit unions may need to sell most of their new production. Under these circumstances, whether or not a credit union can hold or sell it new loans is largely out of its control. It depends instead on member behavior, interest rates, and regulator-influenced policy limits. Therefore, access to a smoothly functioning and accessible secondary market is vital to a credit union's ability to meet its members' mortgage borrowing needs.

These ALM issues are behind the recent swings in credit union loan sales to the secondary market. In 2007 and 2008, as the financial crisis deepened and other lenders had to curtail lending, credit unions increased their first mortgage lending, from $55 billion in 2006 to $61 billion in 2007 and $71 billion in 2008. At the beginning of 2007, credit unions' fixed-rate mortgages amounted to a fairly modest 14.5% of assets, and during 2007 and 2008, interest rates on 30-year, fixed- rate mortgages averaged about

6%. In that environment, credit unions could prudently hold the bulk of new loans in portfolio, and sold only 27% of originations in 2007 and 28% in 2008.

Circumstances had changed dramatically by the beginning of 2009. The proportion of credit union assets in fixed rate mortgages had risen by 2.6 points to 17.1%, member demand for mortgages was rising, and interest rates had fallen to around 4.5%. In this new environment, access to a secondary market was vital. Credit unions were able to originate a record $96 billion in new loans in 2009 and almost as much ($84 billion) in 2010 by doubling their secondary market sales to 54% of originations in 2009 and 52% in 2010. They were able to meet their members' needs without creating undue exposure to interest rate risk by accessing the secondary market. Indeed, despite the very high mortgage loan production during 2009 and 2010, the proportion of credit union assets in fixed-rate mortgages actually declined slightly during the period, from 17.1% to 16.8%. That was appropriate interest-rate risk management in a period when long term mortgage interest rates were near all-time lows.

In addition to ALM considerations, credit unions must also be mindful of potential liquidity issues, even when granting adjustable rate mortgages. Because most deposits in credit unions are much shorter term than a portfolio of thirty-year mortgages, it is imperative that if a credit union holds a substantial portfolio of AMRs, whose variable rate feature protects against the risk of rising funds costs in the future, that credit union must also be able to sell those loans in the future if liquidity needs arise. A liquidity need could result from future member behavior beyond the control of a credit union, such as a surge in loan demand or an outflow of deposits. Therefore, even those

loans that a credit union intends to hold in portfolio must be salable on the secondary market. Again, access to a smoothly functioning and accessible secondary market is vital for credit unions.

Credit Union Principles for Housing Finance Reform

The federal government has a very important role to ensure the secondary market operates efficiently, effectively and fairly for borrowers and lenders alike. As Congress and the administration consider comprehensive changes to the housing finance system, it is imperative that the entities that fill the market space currently occupied by Fannie Mae and Freddie Mac continue to facilitate credit union lending so that credit unions may continue to be a source of reliable mortgage credit for their members.

Quite frankly, many credit unions fear a world in which the secondary mortgage market is occupied by a handful of very large banks. Concerns about access to and pricing in such a market are frequently expressed. Will the large banks want to deal with small financial institutions such as credit unions? If so, will the pricing be competitive with larger financial institutions? Will large banks favor their own mortgage originating divisions or subsidiaries? While these are among the most significant concerns credit unions have with respect to a large-bank dominated market, they are not the only concerns.

Credit unions value the relationship they have with their members. The mortgage application – especially under the new underwriting guidelines – is rich with borrower information. If the only conduits to the secondary market were the largest banks in the

country, credit unions would be in the position of selling their mortgages – and their members' financial information – to complex financial institutions that compete with them in other markets. Credit unions are skeptical that regulatory firewalls sufficient to prevent the banks from mining credit union member data could be constructed and enforced. Furthermore, some credit unions may be reluctant to sell a loan to a large bank if that meant that they would also lose the opportunity to service the loan. Preservation of the member relationship is very significant to credit unions.

The lack of uniform standards and procedures in a market operated by the largest banks is also a concern for credit unions. Each bank is likely to have different underwriting standards, documentation requirements and procedures, in the absence of regulation requiring them to operate in a similar manner. This will severely limit the ability of small financial institutions to shop their loans to multiple secondary market participants. Therefore, credit unions would likely engage in a relationship with just one secondary market participant, which would have to make it very difficult for the credit union to move its business.

We believe that it is very important that there be a neutral third party in the secondary market: an entity which is independent of any firm that has any other role or business relationship in the mortgage origination or securitization process. Its sole role would be as a conduit to the secondary market.

Having noted our concern with any proposal that would result in a secondary market operated exclusively by the largest banks, we believe the following principles are important to consider as comprehensive housing finance reform proposals are developed.

- Equal Access: The secondary market must be open to lenders of all sizes on an equitable basis.
- Strong Oversight and Supervision: The entities providing secondary market services must be subject to appropriate regulatory and supervisory oversight to ensure safety and soundness; they should also be subjected to strong capital requirements.
- Durability: The new system must ensure mortgage loans will continue to be made to qualified borrowers even in troubled economic times.
- Financial Education: The new housing finance system should emphasize consumer education and counseling as a means to ensure that borrowers receive appropriate mortgage loans.
- Preservation of the 30-year fixed rate mortgage: This product is the centerpiece of the mortgage lending market and the new system should facilitate its availability to qualified borrowers.
- Affordable Housing: The important role of government support for affordable housing should be a function separate from the responsibilities of the secondary market entities.
- Reasonable and Orderly Transition: The transition from the current system to any new housing finance system must be reasonable and orderly.

Equal Access

The paramount concern for credit unions is equitable access to the secondary market in whatever form it may take.

Whether the functions of the GSEs are privatized or remain public to some degree, it is essential that the federal government's regulation of the secondary market ensure lenders of all types and sizes, including credit unions, have access to a secondary market that is equitable. This means that terms, rates, and conditions for selling loans in the secondary market must be affordable and fair to all lenders, regardless of their size or charter type.

Consistent with this objective, to the extent the participation of other institutions in the secondary mortgage market is enhanced by investments such as covered bonds, regulators should not encumber the ability of healthy credit unions to offer such investments. Further, credit unions should be able to have access to supplemental capital as other financial institutions are permitted to do, which will help provide additional resources to protect the National Credit Union Share Insurance Fund (NCUSIF) from any losses at credit unions, including those in connection with their mortgage lending or related activities.

A widely expected feature of any reformed system to replace the current GSEs is more explicit pricing of any government guarantee of mortgage-backed securities. CUNA believes that future guarantee fees should accurately account for risk and fully insulate the taxpayer from loss. We would hope that in any reform, the pricing of

guarantee fees will recognize in some way the historical performance or track record of different types of lenders. Perhaps once a loss absorbing pool has reached an adequate level, excess amounts could be refunded to issuers based on the performance of the loans they have sold. Credit union mortgages are demonstrably less risky than mortgages made by other lenders. Since the beginning of the financial crisis, the net charge-off rate on credit union mortgage loans has consistently been much lower than at banking institutions. From 2007 to 2010, the average net charge-off rate on mortgages held in credit union portfolios has been less than a third of the similar rate at banks: 0.4% compared to 1.3%.

Strong Supervision

One of the major weaknesses of the secondary market that contributed to the recession was the lack of appropriate supervision of the GSEs. Not only was the regulatory framework for the GSEs fragmented, the size and complexity and activities of these organizations and their activities made it extremely difficult for them to be properly supervised. Thus, when the GSEs increased their purchase of subprime mortgages prior to 2007, regulators did not step in to correct these practices, resulting in unbelievable losses and ultimately the conservatorship of FNMA and FHLMC.

Proper supervision of new secondary mortgage market entities would entail comprehensive regulations that address safety and soundness issues while allowing them to have flexibility to operate well and develop new programs in response to marketplace demands. Sufficient supervisory resources must also be provided to allow the regulator to recognize problems in a timely manner and work with the industry to develop feasible

solutions. Appropriate regulation should also help ensure that all mortgage lenders have equitable access to the secondary market and that all types of participating lenders are fairly represented on the boards of secondary mortgage market entities.

New regulations for the reformed housing finance system should also ensure that the process of mortgage asset securitization is transparent and subject to appropriate supervision, for federally guaranteed as well as for private label securities.

Durability

The new system must ensure mortgage loans will continue to be made to qualified borrowers even in troubled economic times. This will improve macroeconomic performance and prevent job loss by dampening the pro-cyclicality of the housing sector. Without the backstop of a federally insured or guaranteed component of the revised system (whether that is an entity or an explicit federal guarantee of securities), we are concerned that private capital would quickly dry up during difficult economic times, effectively halting mortgage lending altogether.

Financial Education

Legislation and regulations implementing the new housing finance system should emphasize consumer education and counseling as a means to ensure that borrowers receive appropriate mortgage loans, without being overly prescriptive.

Credit unions are leaders in providing quality, accessible financial education to their members, which may help account for credit unions' generally low loan

delinquency rates. If more lenders took steps to assure such information and training is provided to consumers, borrowers would have a much better understanding and awareness of how the mortgage loan process works, including their substantial risks and obligations as well as their rights. While such efforts will not eliminate problems relating to a borrower's lack of understanding, they would go a long way toward minimizing losses some lenders have experienced because the borrower did not understand his or her commitments. Borrowers would also benefit by avoiding the significant problems that arise from loans that they simply cannot afford. Efforts to emphasize consumer education in the mortgage loan process should be coordinated with the new Office of Financial Literacy.

Preservation of the 30-year Fixed Rate Mortgage

While unique to the United States, the 30-year fixed rate mortgage is the centerpiece of our housing market. The feedback we have received from credit unions throughout the country is that this is a product that credit union members favor. Without a federally supported secondary mortgage market, loan originators are unlikely to offer long term fixed rate mortgages because they do not want to bear the combined risk of fluctuating interest rates and long-term exposure to credit risk. We believe that any housing finance reform proposal should support the continued availability of this product. We understand that in the future, the costs of any federal support necessary to preserve the 30-year fixed rate mortgage should be borne by the mortgage finance system, i.e., lenders and borrowers, and not the taxpayer.

Affordable Housing

The reformed secondary mortgage market should distinguish between public policy goals with respect to affordable housing, and the broader issue of secondary market availability for mortgages. To be clear: we believe that the federal government has an important role to play in encouraging homeownership and access to mortgage credit for creditworthy lower income homebuyers. However, we feel that such help should be provided under the auspices of the federal government, such as the Federal Housing Administration, separately from the functioning of the conduit to the secondary market for standard mortgages. The requirements of a program to stimulate the supply of credit to lower income borrowers are not the same as those for the more general mortgage market. Combining both goals in a single vehicle can frustrate the achievement of both goals. In that regard, affordable housing mandates should be directed to and implemented by the federal or state governments, which will work with private lenders to achieve those objectives. That is not to say that the private secondary market should not be allowed to work with lenders such as credit unions to facilitate mortgage lending for lower income borrowers, but directives, goals, or quotas should not be applied by regulators to private secondary mortgage market entities.

Some have suggested a nexus exists between federal support for the general mortgage market and affordable housing goals in that the financial institutions that benefit from federal support for the general secondary should in return take on additional obligations to meet affordable housing goals. We believe this possible connection could best be addressed in two ways: first, by appropriately pricing guarantee fees to minimize

the chance of taxpayer expense, and second, perhaps by adding a small supplement to guarantee fees, the proceeds of which could be used by some other federal agency in a more targeted fashion in furtherance of affordable housing goals.

Transition

Any transition from the current system to a reformed housing finance approach must be carefully planned and well executed. Credit unions and other lenders will need sufficient time to prepare for the changes so that members are not negatively affected; they will need to change their computer systems, re-train staff, and change other operational processes, and this will result in significant expenses that must be recognized as part of this transition process.

Most important, Congress, the Administration and the regulators should avoid taking steps in the interim that may further disrupt a housing market in fragile recovery. We are particularly concerned with proposed definition of qualified residential mortgage (QRM), which we will discuss below.

CUNA Strongly Opposes the Proposed QRM Standard

An issue that could significantly impact the accessibility of credit unions to the secondary mortgage market is the proposed definition of a Qualified Residential Mortgage (QRM), which is included in the credit risk retention proposal issued for comments by the federal bank regulators and the Securities and Exchange Commission in March. CUNA is working with a coalition of lenders and other stakeholders to oppose the adoption of the QRM provisions. The proposed rule sets forth an extremely narrow

definition of QRM, beyond what was contemplated under the Dodd-Frank Act, which requires a credit risk retention rule.

Under the credit risk retention proposal, a lender would not have to meet the requirement to retain a 5 percent interest in home loans that are securitized if its loans meet the QRM criteria. These provisions include: maximum debt- to-income ratio of 28% for borrowers at the start of the loan; at least 20% down payment from the borrower for purchase loans, with no provisions for private mortgage insurance that could be used to offset lower down payments; and borrowers must not have any 60-day delinquencies in the last two years, or bankruptcy, foreclosure or short sale in the last 36 months.

The QRM proposal is not directed at credit unions and the National Credit Union Administration was not one of the agencies mandated by the Dodd-Frank Act to develop the credit risk retention rules. Also, many credit unions hold a significant portion of their loans in portfolio and any loans they do sell to Fannie Mae and Freddie Mac, while the GSEs are in conservatorship, would be exempt. Nonetheless, credit unions are seriously concerned about the QRM proposal. As addressed below our overarching concern is that the QRM will become a template that regulators will seek to impose on all home mortgage loans, whether they are securitized or not. Such a result would severely limit the ability of credit unions to tailor mortgage loans to meet their members' particular needs. Moreover, the stringent definition of a QRM could effectively shut an entire class of otherwise qualified borrowers out of the mortgage market for low-cost financing and could potentially dry of mortgage liquidity for small lenders.

In crafting the concept of the QRM exemption, Senators Landrieu, Hagan and Isakson considered and intentionally omitted a minimum down payment requirement.[3] This is because there is strong evidence that high minimum down payments are not a significant factor in reducing defaults compared to underwriting and other mortgage product features.[4] Many factors combine to create a low-risk mortgage loan: down payment, credit history, employment history, ratio of payment to income, etc. Many well-underwritten loans have down payments of less than 20 percent.[5] Thus, provided each mortgage is properly underwritten, credit unions can and do structure very low-risk loans to meet their members' needs – even where a member does not have a 20 percent down payment. This is particularly important for credit unions as member-owned financial institutions. Under the proposed QRM standard, borrowers who are otherwise qualified but who haven't been able to save enough for a 20 percent down payment would likely be automatically denied access to the lowest rate loans with the safest features.

Along these lines, although the proposed QRM is intended to be the exception rather than the rule in the private mortgage market, it runs a significant risk of turning into the standard for mortgages – especially for credit unions. This is because the National Credit Union Administration (NCUA), which supervises the safety and

[3] See February 16, 2011 letter from Senators Landrieu, Hagan and Isakson to the QRM regulators.
[4] See Qualified Residential Mortgage Coalition, "Proposed Qualified Residential Mortgage Definition Harms Creditworthy Borrowers While Frustrating Housing Recovery", May 2011 (note that CUNA is a signatory to this white paper).
[5] Indeed, as Senator Isakson reiterated in the June 22, 2011 press conference on this issue, "[w]e understood America didn't have a down payment crisis in housing we had an underwriting crisis in housing." Senate News Conference with Members of the Coalition for Sensible Housing Policy Transcript, June 22, 2011.

soundness of all federally insured credit unions, generally requires credit unions to adhere to Fannie Mae and Freddie Mac underwriting standards. As the status of GSE reform is unknown, in the absence of a replacement for the existing GSEs, a QRM standard could be viewed by NCUA as necessary to any potential safety and soundness concerns are met. Based on these serious concerns with the QRM standard, we believe it must be redesigned to incorporate the broadest criteria possible, consistent with the intent of Congress, to encourage responsible lending standards that will support a housing recovery while attracting private capital to the secondary market and reducing future defaults.

The QRM standard as currently proposed not only creates unnecessary barriers for qualified borrowers, but it also limits the flexibility credit unions have in tailoring loans to their members' needs, and could potentially make it difficult for small financial institutions like credit unions to make non-QRM loans. We urge Congress to insist that the regulators go back to the drawing board to redevelop the QRM and issue a new proposed QRM definition for public comments.

Mortgage Servicing Standards

Mortgage loan servicing is an important component of home mortgage loan process for lenders and borrowers. It is critical that servicing activities and those providing servicing be subject to necessary and effective supervision. We support the general principles contained in the Servicing Alignment Initiative (the "Initiative") announced by the Federal Housing Finance Agency earlier this Spring directing Fannie Mae and Freddie Mac to establish consistent mortgage loan servicing and delinquency

management requirements for loan servicers acting on behalf of Fannie Mae and Freddie Mac.[6] The Initiative directs Fannie Mae and Freddie Mac to align servicing requirements in four key areas: (1) borrower contact, (2) delinquency management practices, (3) loan modifications, and (4) foreclosure timelines. Additionally, the Initiative introduces incentives and compensatory fees for servicers to reinforce effective execution in these areas. The Initiative also required the issuance of Servicing Standards for Delinquent Mortgages (the "Standards"), which were recently issued by the GSEs.[7]

We are concerned, however, that the potential effect of the Initiative on small financial institutions, including credit unions, may have the unintended consequence of becoming overly burdensome. With the multitude of existing regulatory burdens already placed upon small financial institutions, the increasing regulatory requirements pursuant to the Dodd-Frank Act and other government initiatives relating to housing finance and mortgage loan origination and servicing in general, additional guidelines and requirements such as the Initiative and Standards will likely require small financial institutions to retain additional employees and volunteers to comply with such requirements, stretch small financial institutional monetary resources to untenable levels, or worse, force more of these institutions, including credit unions, to cease to exist altogether.

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[6] See April 28, 2011 News Release issued by Federal Housing Finance Agency at http://www.fhfa.gov/webfiles/21190/SAI42811Final.pdf.
[7] See June 6, 2011 News Release issued by Fannie Mae at http://www.fanniemae.com/newsreleases/2011/5408.jhtml?p=Media&s=News+Releases

As you know, credit unions are not-for profit financial cooperatives, and the only owners of a credit union are its members, who receive the benefit of ownership through reduced fees, lower interest rates on lending products, including mortgages, and higher dividends on savings products. Because of this structure, the cost of a credit union's compliance with overly burdensome regulations impacts its members directly. Every dollar that a credit union must spend on complying with overly burdensome regulations and requirements is a dollar that cannot be utilized to benefit the credit union's membership. And, because of this structure, credit unions have a strong incentive to act in the best interest of their members.

In contemplating the balance between providing accessibility to the secondary market for small financial institutions with the importance of effective supervision and regulation of any entity providing such secondary market services, we encourage the Committee to give strong consideration to the compliance burden that may be placed on the small financial institution servicers balanced against the very low incidence of abusive practices by credit unions. The end goal of serving consumers' needs in the housing finance market should continue to be met effectively and efficiently.

Conclusion

Reform of the housing finance system has already proven to be a very difficult challenge, but failing to make necessary changes to improve the system will result in even greater challenges for the economy, lenders, and borrowers. Mortgage lending is a significant activity for many credit unions and is a vital financial service for their

members and for the economy, and we urge Congress to consider the concerns and recommendations raised in this testimony.

Mr. Chairman, on behalf of America's credit unions and their 93 million members, thank you for the opportunity to testify at today's hearing. I would be happy to answer any questions.