Written Testimony

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Introduction

Chairman Arrington, Ranking Member O'Rourke, and Members of the Subcommittee, thank you for inviting me to appear today to discuss the important issues regarding aggressive practices by some lenders in the VA market, and the impact this is having on veteran borrowers.

Role of Ginnie Mae in the Market

For background, the Government National Mortgage Association, or "Ginnie Mae," was established in 1968 with the mission of bringing global capital into the U.S. housing market while at the same time minimizing risk to the American taxpayer. Ginnie Mae does this by guaranteeing the timely payment of principal and interest to our bond holders on behalf of borrowers who qualify for our program. By allowing these investors the opportunity to lend capital into the U.S. housing finance system with the knowledge that the federal government stands behind the credit risk of our mortgage-backed securities ("MBS"), Ginnie Mae provides access to global capital for lenders of all sizes and supports the federal mortgage insurance programs at the Federal Housing Administration, the Department of Veterans Affairs, the Department of Agriculture, and HUD's Public and Indian Housing. Ultimately, more than 98 percent of the loans insured by the FHA, VA, and USDA are financed through Ginnie Mae MBS.

Ginnie Mae provides this government backstop on qualifying MBS to protect against losses in catastrophic situations, and our securities are the only MBS to carry the explicit full faith and credit guaranty of the U.S. government. We are also responsible for policing our program to protect against loss. Our statutory mission is to provide liquidity to the U.S. housing market and to protect taxpayers.

Since 1968, Ginnie Mae has performed these twin missions successfully, growing to almost $2 trillion in outstanding principal balance guaranteed today. This has helped millions of low-and-moderate income, veteran, and rural Americans obtain financing that otherwise would not be available to them. Just as important, Ginnie Mae has never needed an emergency infusion of funds to do its job, even during the 2008 financial crisis. The design features of the Ginnie Mae model significantly limit taxpayer exposure to risks typically associated with secondary market transactions while still providing liquidity for the overall housing finance system.

The easiest way to understand Ginnie Mae's mission is that we oversee a process for ensuring the success of the government's MBS guarantee. To accomplish this, Ginnie Mae manages technology and infrastructure designed to track the payment of principal and interest, made by borrowers to their lenders, making sure it ultimately gets into our common security and to investors on time and in full every single month. When a low-income borrower in an FHA loan, a rural borrower in a USDA loan, or a veteran borrower in a VA loan makes a mortgage payment, we make sure the servicer of the mortgage submits that payment to the investor who owns the MBS. If we do our job well, veterans gain access to more affordable home financing terms, and the capital necessary to make these loans remain reliably available through all economic cycles.

<u>VA Loan Churn Background</u>

The issue we are here to talk about today - the rapid refinance of VA loans held in Ginnie Mae securities - has had a significant impact on Ginnie Mae MBS market trading and pricing dynamics over the past few years. I thank you very much for bringing attention to this issue. Hopefully increased Congressional and federal agency oversight can help effectuate some needed changes in behavior.

At times what we are here to discuss may seem like a technical issue, but the consequences are anything but. Without proper policing by Ginnie Mae or the VA, every single veteran who relies on our program will pay a higher rate than they should. If we take for granted the capital that makes our program work, it may not continue to flow into our market. That is not a risk we should take.

It is difficult to describe what is transpiring without using jargon or technical terms like “prepayment speeds,” “loan seasoning,” and “premium MBS pricing.” But ultimately what we care about is the following: if our security is not functioning well, veterans will have difficulty getting a home loan, and if they do get a loan they will pay a higher rate. Since this “loan churn” problem began, Ginnie has recognized that failure to curtail these practices could ultimately harm borrowers in the form of higher interest rates. That is why we take this issue incredibly seriously, and why we pledge to you today that we are working hard to put an end to it once and for all.

In early 2016, Ginnie Mae and our investors first began to identify early loan repayments and serial refinancing as a problem with much greater incidence in the VA mortgages in our securities than loans insured by other agencies. Mortgage loans often prepay, especially when interest rates drop. But Ginnie Mae began to notice prepayments at speeds that could in no way be justified by economic factors.

Some strange pricing dynamics in our security – specifically a weakening of Ginnie MBS prices versus other MBS – further alerted us to the growth of anomalous refinancing behaviors. Clearly, Ginnie Mae investors had begun to take note as well. After some initial internal analysis, it became more obvious that some lenders had apparently found an opportunity to take advantage of service members and veterans to make a quick profit for themselves by aggressively pushing a series of loan refinance offers. These are done without any regard for the consequences for our security, other veterans, or other borrowers who rely on our program.

It seems that the core issue stems from two fundamental, underlying dynamics. First, we have an increasing number of veterans in the United States, and many of them fall prey to advertising schemes that give the appearance of coming from reputable sources. Second, the Ginnie Mae security trades at a premium price, and this incentivizes lenders to pull loans from pools at “par[1]” and deliver them into a security at a premium, booking a profit each time this occurs. We

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[1] Par simply means a bond that trades at 100 cents on the dollar, often denoted as “100-00.” Most Ginnie MBS trade above this price today. Specifically, prices closer to 105. This means every time a lender pulls a loan from a pool at par and redelivers it into a new security at 105, it books ~5 points (or 5% of the loan balance) as profit.

believe it may be the confluence of these factors that has enabled this new, unacceptable and dangerous market behavior.

Upon further investigation, we believe that some lenders have capitalized on these dynamics by employing two patterns of note. The first is the origination of a loan substantially above prevailing market interest rates, sometimes called a "premium loan." At times these loans may include debt consolidation, and at times they are provided to borrowers with very low credit scores, which explains some of the reasons that they carry high interest rates. But often our analysis has found that premium VA loans simply represent a business model of using aggressive marketing tactics to originate a loan at an interest rate higher than the veteran borrower should otherwise be paying, as proven by the rapid refinance that occurs almost immediately thereafter.

These loans are profitable for the company originating the loan and issuing the loan into a Ginnie Mae security because they can immediately sell the loan into a Ginnie Mae MBS pool at a high dollar price because of the high accompanying interest rate, and pocket the so-called "cash gain on sale." This essentially means those lenders who originate high interest rate loans charge veterans too much and book a large profit right up front, knowing that the veteran has a rate that is above market and knowing that the veteran will likely refinance in the future to obtain a true market rate. These loans not only give the borrower an interest rate half of one percentage point or more above what they could be paying, but they are ripe to be cherry-picked out of a Ginnie security by that same lender or another lender looking to profit on a quick refinance.

And this is when we see another tactic used by many lenders - a quick refinance, or sometimes multiple refinances, of a premium loan. Soon after a veteran's first loan closes, veterans begin to immediately receive a constant stream of solicitations for refinance offers from other companies using the data from the first loan closing. These offers promise anything from skipping a few monthly payments to taking cash out to lowering a rate by getting into an adjustable rate mortgage. Many of the solicitations appear misleading, but many also prove successful, as we see veteran borrowers being convinced to refinance their loans multiple times in a year without much tangible benefit.

This entire scheme relies on a steady stream of veterans who may not be exceptionally financially savvy, or may be having financial difficulties making them desperate for some cash, which these offers often promise to help fix.

In many cases, a single veteran is refinanced multiple times in less than a one-year period, sometimes, according to our data, with very limited benefit to the veteran. Sometimes, in fact, with each refinance the veteran is seeing his or her loan balance grow. According to many of the flyers and advertisements we've collected, quite often the fees to refinance are buried or hidden. The refinances, advertised with teaser rates and no money down, are in many cases leaving veteran borrowers further and further in debt, while providing minimal monthly cost savings.

In reviewing recent months' data on VA refinances, we have found the average cost of doing a fixed rate to fixed rate refinance is approximately $6,000 in fees, for an average payment savings of $90 per month. That means it will take the veteran five and a half years to break even on the fees incurred for the refinance.

Another alarming development that you need to be aware of is that, with interest rates having bottomed out and opportunities to refinance from a fixed rate loan into a new fixed rate loan having been exhausted, we are now seeing a trend of brokers and lenders marketing the refinancing from a fixed rate loan into an adjustable rate mortgage. When veterans do this, the new loan may result in a short-term teaser rate that lowers the borrowers' monthly payment, but could also result in higher monthly payments for the borrower in the future. For refinances from fixed rate to adjustable rate loans, the average is $12,000 in fees for a monthly payment savings of $140 and seven years to break even, assuming the mortgage rate doesn't adjust upward.

Additionally, as home prices have risen in recent years, some lenders have come to specialize in the "cash out refinance" business. There is nothing wrong with helping veterans take advantage of this benefit. But our data raises some pretty serious questions, for example we see loans where borrower credit characteristics appear to change inexplicably from one month to another. And, we are seeing the creation of a large group of veterans who once had equity in their home but no longer do after the cash out refinance. In these instances, if a veteran borrower someday chooses to move, he or she might need to bring a check to the closing to do so. In our view, this is an area of concern.

Finally, we now also see offers by refinance lenders to refund the tax and insurance escrows normally maintained by the servicer and accumulated as part of the monthly "PITI" (principal and interest, taxes and insurance) mortgage payment. In these cases, the veteran is lured in by a scheme to skip a mortgage payment while the new loan is initiated, get an escrow refund, and look at the monthly payment without an escrow charge, with the closing costs folded into the loan. This tactic can lead to larger mortgages, more debt and the veteran paying a lot of money in fees for a riskier mortgage without sufficient escrows.

The bottom line is that marketing and promotional materials being received by many veterans today often include misleading terms that are too good to be true. These mailers are also frequently disguised as checks or documents appearing to be official correspondence from the Department(s) of Defense or Veterans Affairs, or the IRS, instructing the veteran to call the number listed to discuss their VA benefits, or a similar ploy.

Investors and the MBS Market

Beyond the problems created for individual veteran borrowers targeted for high rates or rapid refinancing, loan churning has serious implications for the broader mortgage market as well. In recent years, investors have priced Ginnie Mae bonds at a premium to the conventional market due to the explicit government guaranty. This premium directly translates into lower interest rates enjoyed by veterans as well as borrowers from the other government loan programs. As the VA loan program has grown as a percentage of the Ginnie Mae portfolio, the increase in loan churning activity has also become more apparent and an increasing area of concern.

Loan churning is a problem for investors because, as loans are refinanced, they are removed from MBS pools and with them, the return expected from the monthly principal and interest payments. Because of this increased prepayment risk, investors are today less willing to price Ginnie Mae bonds at a premium (or, as noted above, a price above "par"). A reduction in investor demand puts downward pressure on the prices of Ginnie Mae securities, which ultimately harms veterans by increasing borrowing costs, since as bond prices fall, interest rates offered to borrowers increase. And, because loans from the other government loan programs are comingled in Ginnie Mae securities, borrowers in the other government loan programs are paying the increased costs as well. This represents a direct wealth transfer from VA, FHA, USDA, and PIH borrows to a relatively small number of VA lenders who abuse our program.[2]

These challenges are not theoretical. They very much exist today and impact the rates that all FHA, VA, and USDA borrowers pay every month. As recently as December of last year, Ginnie Mae leadership spoke directly with several large foreign institutional investors regarding their ongoing investment in Ginnie Mae MBS. A common theme in every conversation was concerns about the VA loan churn issue and its impact on their investment in Ginnie Mae MBS. The foreign investor market, particularly central banks and government pension funds, has been a major source of capital for the Ginnie Mae program, and we have no choice but to take these concerns very seriously. The inability to model and price Ginnie Mae MBS due to the unpredictable nature of the rapid prepayment speeds on Ginnie Mae bonds is a serious challenge for any securitization program and all who rely on it. If this dynamic continues and investors choose to flee the Ginnie Mae market, it could very well cause even higher borrowing cost for all veterans and others in the coming years.

To mitigate this problem in the short-term, we have been outlining for these investors the additional steps we are taking. We must take these risks seriously at all times, and we must deliver on tangible solutions this year.

<u>Ginnie Mae Changes, Task Force, and Upcoming Actions</u>

Broadly, we believe the long-term solution to this issue comes in three steps. The first is through Ginnie Mae tightening its requirements for access to our security when we see patterns of injurious behavior. We have taken some steps here and more will be forthcoming throughout 2018, including the elimination of premium loans from our securities. The second is by VA establishing a solid framework that would ensure veterans are protected from predatory lending practices, including excessive fees, thereby ensuring any refinance represents a tangible benefit to the veteran. The third is the continuous surveillance of data collection and analysis to enforce adherence to the first two steps.

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[2] Because the loan churning problem has been most pronounced in the VA loans in our pools, this testimony focuses on the veteran loan experience as we have observed it. However, Ginnie Mae single-family MBS pools comingle VA, FHA, RD and PIH loans in the pools. The consequence is that a detracting feature of one agency's program that results in a loss of value for that agency's mortgage loans, will have an effect on the price of the overall MBS and, therefore, all of the government loans will suffer a loss in value at the risk of entailing higher interest rates.

Looking at these steps in more detail, I will begin by outlining the actions that Ginnie took in 2016, but more importantly the actions we plan for 2018.

In late 2016, in order to attempt to combat these practices, Ginnie made an initial program change to the Ginnie Mae rules in an attempt to address the issue within Ginnie Mae's legal and regulatory authority. Specifically, we changed rules on how soon after one mortgage loan is originated, a streamline refinance transaction of that same loan could be pooled into a Ginnie Mae security.

Those initial measures were successful in stopping the rapid refinance practices with many lenders for a short period of time. However, after the first required six-month seasoning period lapsed following the effective date of the 2016 rule, in mid-2017 Ginnie Mae again saw an increase in loan repayments and securitization that strongly suggested further steps were needed. Notably, we also saw that some lenders had actively worked to evade the new rules Ginnie Mae implemented by changing their tactics. For example, some lenders starting using "cash-out" or other types of refinances, which were not addressed by the 2016 rule change.

As part of our ongoing effort to curtail these practices and to protect the health of our security, in December of 2017 Ginnie Mae announced a strengthened rule, saying that absolutely no refinances, including both streamline and cash-out refinance loans, will be permitted into Ginnie pools for six months after origination of the underlying loan, thus eliminating the loophole that some lenders used to evade our original 2016 rules. We also announced the outline of the additional steps we will be taking in the coming weeks to continue to put a stop to this behavior, which I will discuss in more detail below.

As it has been widely reported, in late 2017 Ginnie Mae and VA formed the Ginnie Mae – VA Refinance Loan Task Force to continue and to intensify our work on this issue. The task force meets regularly and is focused on closely examining the issue as a team, gathering market data, and reviewing lender behaviors related to refinancing loans to determine the program and policy changes needed to stop detrimental market behavior. At its core, the task force is in place to make changes that stop bad actors from posing an undue risk or burden to veterans or the American taxpayer.

The first action to come out of the task force is the change Ginnie Mae announced early last month - the expansion of the loan seasoning requirements for cash-out refinance loans securitized into Ginnie Mae securities. But we do not intend to stop there. To help identify market outliers, we have also greatly increased the tracking and analysis of the prepayment rates of issuer portfolios. An inexplicably fast prepayment rate is an indication that the lender is aggressively churning borrowers without regard to whether or not a refinance actually benefits a veteran. As such, in 2018, any issuer with pool performance that appears materially out of step with market peers will receive increased attention and engagement from Ginnie Mae, and we will be putting such lenders on notice in the coming weeks.

Furthermore, we recently announced that prepayment information will be included in Ginnie Mae's internal Issuer Operational Performance Profile ("IOPP") scorecard. This scorecard is used to evaluate issuers against their peers, and it is the first set of data we look to in evaluating an issuer on a regular basis. Appropriate action will be taken against issuers found to be consistent outliers, potentially including removing them from the Ginnie flagship ("Ginnie II") security.

An additional change we are actively working to address is the definition of a premium rate loan as it pertains to their permissibility in the Ginnie Mae standard MBS pools. These loans, which I discussed earlier in my testimony, are identified as having an interest rate spread of more than 150 basis points in rate (or 1.50%) above prevailing market interest rates for Ginnie securities. We will soon be announcing definition and operational processes that will clarify our definition of a premium loan and enable the enforcement of this rule. We believe this will help to curtail abusive origination practices and slow Ginnie Mae prepayment speeds, lessen investor concerns over the health of our security, while at the same time helping prevent veterans from paying more on a loan than they otherwise should.

Finally, it is worth noting that we have received whistleblower calls from employees who work in firms that they believe are engaging in unethical churning of veteran loans. Ginnie Mae does not today have sufficient legal authority to offer whistleblower protections to these individuals, but, because our securities are traded, the SEC does, and so we have connected these individuals with the SEC. At the same time, we have been receiving complaints from veteran borrowers about aggressive solicitation practices, and we have alerted the Consumer Financial Protection Bureau (CFPB).

Conclusion

In conclusion, I believe that 2018 will be an inflection point for this issue. Changes must be made to finally put a stop to bad actors abusing the VA home loan program and the Ginnie Mae security, delivering harmful loan products to veterans, and jeopardizing the efficient borrowing costs for all government borrowers.

I very much appreciate the opportunity to discuss this critical issue and to work with Congress to bring increased attention to lending practices that are negatively impacting many Americans. At Ginnie Mae we are determined to continue our efforts until concrete solutions have been implemented that protect veterans, the Ginnie Mae program, and ultimately the American taxpayer. Thank you again, for inviting me to testify today. I look forward to answering your questions.