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PUBLIC PROPOSALS FOR THE FUTURE OF THE HOUSING FINANCE SYSTEM

HEARING

BEFORE THE

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

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

EXAMINING PUBLIC PROPOSALS FOR THE FUTURE OF AMERICA'S HOUSING FINANCE SYSTEM

MARCH 29 AND MAY 26, 2011

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C O N T E N T S

TUESDAY, MARCH 29, 2011

WITNESSES

Additional Material Supplied for the Record

THURSDAY, MAY 26, 2011

WITNESSES

PUBLIC PROPOSALS FOR THE FUTURE OF THE HOUSING FINANCE SYSTEM—PART I

TUESDAY, MARCH 29, 2011

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:03 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I call this hearing to order.

As we begin this hearing, I am reminded of the former Chairman's farewell speech on the Senate floor. He challenged Senators to rise to the expectations of the American people and work toward consensus to address the difficult times facing families across the Nation.

While mortgage credit continues to be available, it is almost exclusively through Fannie Mae, Freddie Mac, and the FHA. Maintaining the housing finance system in this way is not sustainable for the long term. Reforming our housing finance system will require the kind of hard work and consensus building that the Senate is known for. This endeavor can only be accomplished through passionate but civil debate.

To help us frame the debate, we have four witnesses before us today with proposals for the future structure of the housing finance system. I would like to thank each of you for being here today and for taking the time to try and find a path forward for the Nation's housing market. I was pleased to see that all your plans considered how changes would affect the cost and availability of mortgage credit to qualified families.

These are complex issues with real consequences, and it is understandable that reasonable people will disagree about the path forward. While disagreement can help further our understanding of the potential impact of changes, we are not here to simply attack each other's ideas. I hope that in the great tradition of this body we can disagree without being disagreeable.

The Committee's first hearing on this topic was a constructive discussion about the options for the future, and I hope we can continue that discussion today. At that time in the Committee agenda that I released in February, I raised several points for consideration. These included preserving the 30-year fixed-rate mortgage, ensuring that community banks continued to have equal access to the secondary market, protecting the availability of affordable housing, and safeguarding taxpayer dollars. I look forward to hearing from our witnesses about how each of their plans address these points.

Before I conclude my statement, I would like to note that the FDIC is considering the proposed QRM definition, as required by the Dodd-Frank Act. Like other rulemakings, there will be a comment period before the definition is finalized. I would encourage extensive and thoughtful public comments about the proposed rule to ensure that all sides are heard.

Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman. Thank you for putting this hearing together today.

Today the Committee will again take up the issue of housing finance system. At the Committee's last hearing, we heard from Treasury Secretary Geithner about the need for reform. Secretary Geithner noted that our housing market is now entirely dependent on Government support. He warned that private capital will not return until we fix the problems in our private mortgage market. He also told the Commission that Congress should, therefore, pass housing finance reform during this Congress.

I agree with Secretary Geithner that housing finance reform is overdue and should be promptly addressed. Chairman Johnson has also stated that this is one of his highest priorities. However, I also believe that before Congress can consider legislation, this Committee needs to do its homework.

The Committee needs, I believe, to thoroughly examine Federal housing policy and identify the problems with our current system. Accordingly, I believe this hearing is premature at the moment. Before we discuss solutions, I think on this Committee we should first clearly identify the problems we are trying to solve. Without that examination, a thorough examination, I fear that the Committee will again yield to the temptation of picking a solution before it has accurately described the problem. I think legislation should be driven by facts, not by predetermined outcomes.

I would propose that the Committee establish a formal process for considering housing finance reform. This process, I believe, should include a series of hearings that are proceeded by comprehensive staff work.

First, the Committee should hold a series of investigative hearings to examine Federal housing policy and our housing finance system. These hearings would seek to determine what aspects of our system have worked well and should be retained, as well as which aspects should be reformed or discarded. As part of these hearings, I believe that the Banking Committee would also examine what caused the failures of Fannie Mae and Freddie Mac. We have not done that thoroughly yet.

The Committee would next gather the proposals for reforming our housing finance system from a wide variety of interested parties across industry, academia, and the public. I also believe the Banking Committee should then commence a second series of hearings examining the costs and the benefits of these proposals, directly applying the lessons learned from our first round of hearings. And once the Banking Committee has identified the problems and researched the potential solutions, we will then be ready for the final phase, which would be legislating.

I understand that this process would be time-consuming and require a great deal of effort, but that is what this Committee should be about. I do not believe that the Committee has much choice. It is the only way to produce legislation on a subject as complex and important as housing finance. This process would help educate us on the issues so that we can make informed decisions here in the Committee and in Congress.

It would also ensure that any legislation passed is effective and has the fewest unintended consequences. In addition, this process would offer the best chance of forging a bipartisan consensus on how we should proceed. Unfortunately, the Committee failed to follow this course with the Dodd-Frank legislation, and the result was partisan legislation that is full of technical problems that has had serious adverse unintended consequences. I hope we do not here repeat this mistake with housing finance reform.

Thank you, Mr. Chairman.

Chairman JOHNSON. Before I introduce our witnesses, would other Members like to make brief opening statements? I will also keep the record open for 7 days for statements and questions. Senator Reed.

[No response.]

Chairman JOHNSON. Senator Moran.

Senator MORAN. No, Mr. Chairman.

Chairman JOHNSON. Senator Merkley.

[No response.]

Chairman JOHNSON. I would like to introduce our first witness, Mr. Michael Berman. Mr. Berman is chairman of the Mortgage Bankers Association and a founder of CW Financial Services. In addition to his capacity as chairman, Mr. Berman also leads the MBA Task Force entitled "The Council on Ensuring Mortgage Liquidity: The Future of Fannie Mae and Freddie Mac."

Our next witness is Dr. Arnold Kling. Dr. Kling is a member of the Mercatus Center's Financial Markets Working Group. Prior to Mercatus, Dr. Kling had extensive experience at Freddie Mac and the Federal Reserve and has authored numerous books relating to the mortgage financial crisis.

Next is Dr. Mark Zandi. Dr. Zandi is chief economist for Moody's Analytics, where he directs research and consulting. Moody's Analytics is a provider of economic research data and analytical tools. Dr. Zandi has frequently testified before Congress on various economic topics, including before this very Committee, and we welcome you back.

Our last witness is Janneke Ratcliffe. Ms. Ratcliffe is a senior fellow at the Center for American Progress. Her work focuses on research and policy within the area of housing finance. In addition to her work at CAP, Ms. Ratcliffe is associated director at the Center for Community Capital at the University of North Carolina.

We thank all of you for testifying before us today. Mr. Berman, proceed.

STATEMENT OF MICHAEL D. BERMAN, CHAIRMAN, MORTGAGE BANKERS ASSOCIATION

Mr. BERMAN. Thank you, Chairman Johnson and Senator Shelby, for the opportunity to testify today. I have been in the real estate finance industry for over 25 years, and my company has been active in the commercial mortgage-backed securities arena as an investor, lender, issuer of securities, servicer, and special servicer. We have also been an active Fannie Mae, Freddie Mac, and FHA multifamily lender and servicer.

The current housing crisis has prompted a fundamental rethinking of the part played by the Government in the housing finance system. Certainty of the Federal role in the housing market is necessary to encourage private capital to return.

Several factors contribute to the current uncertainty and the lack of private capital in the housing market. Ongoing uncertainty on risk retention rules, GSE reform, and the future of the conforming loan limits raise questions about the consistency of national housing policy. While the Administration's recently released white paper on reforming the housing finance system was an important first step, much work lies ahead, and we must act in a deliberate, coordinated, and comprehensive fashion.

MBA firmly believes that a carefully crafted Government role can serve to maintain the nascent housing market recovery and preserve the availability of the affordable 30-year fixed-rate mortgage. To this end, in 2008 MBA convened the Council on Ensuring Mortgage Liquidity, which I chair. This 23-member council was made up of industry practitioners from the single-family, multifamily, and commercial sectors of the real estate finance industry. Its mission was to look beyond current market conditions to what a properly functioning secondary mortgage market would look like.

In September of 2009, MBA first articulated a plan outlined in my written testimony. It is based on three key principles:

First, secondary mortgage market transactions should be funded with private capital. Private capital should take two forms: capital that takes on credit risk on the mortgages, and capital from bond investors that takes on interest rate risk.

Second, to promote uninterrupted market liquidity for the core mortgage market, the Government should provide an explicit but limited credit guarantee on a class of mortgage-backed securities backed by core, well-underwritten single-family and multifamily mortgage products. This guarantee should not be free, but should be financed with risk-based fees to be deposited into an FDIC-type insurance fund.

Third, taxpayers and the system should be protected through limits on the mortgage products covered, permissible activities, portfolio size and purpose, coupled with strong risk-based capital requirements and risk-based payments into a Federal insurance fund. This plan has largely been mirrored in Option 3 of the Administration's White Paper as well as plans proposed by other industry practitioners and trade groups.

Let me be clear. MBA's plan is not an extension of the current *status quo.* It focuses on core products and enacts five significant lines of defense to protect taxpayers. We believe that once the transition is complete, the Government footprint in the real estate market would be much smaller than today.

The framework we have proposed is not intended to be the entire market. It is meant to focus on a narrowly defined set of core mortgage products that are essential to have available through all market conditions. Our proposal recognizes the need for a wide array of products through a reemergence of the private market, including private label securities and covered bonds.

We must also ensure that the transition from the current system to a new model is as seamless as possible. As taxpayers, we have a $150 billion investment that we need to protect. Measures such as focusing the GSEs on a narrow range of mortgages and winding down their portfolios can be undertaken now. While we continue to rely on the GSEs as we identify a clear path forward, we must work to remove uncertainty and ensure that the GSEs' resources are of service now and throughout the transition.

The challenge of retaining and recruiting talented professional cannot be understated. Without their talent, our housing finance system would be further at risk.

Mr. Chairman, MBA's recommendations combine an acknowledgment that only a Government guarantee can attract the depth and breadth of capital necessary to support the market during times of economic stress, with a reliance on private capital, insistence on multiple layers of protections for taxpayers, and a focus on ensuring a competitive and efficient secondary mortgage market. These proposals were developed by industry practitioners and represent a practical approach to ensuring liquidity in the mortgage market.

As you and other policy makers are aware, 16 diverse organizations coalesced this week around a similar set of principles, calling for a continued, predictable Government role in the housing finance system to promote investor confidence and to ensure liquidity and stability. We welcome your thoughts and comments on our idea.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Mr. Berman.

Dr. Kling.

STATEMENT OF ARNOLD KLING, PH.D. MEMBER, MERCATUS CENTER FINANCIAL MARKETS WORKING GROUP, GEORGE MASON UNIVERSITY

Mr. KLING. Thank you, Chairman Johnson and Ranking Member Shelby. I would like my written testimony to appear in the record.

Chairman JOHNSON. It will be.

Mr. KLING. Thank you.

I will have to apologize in advance. I am going to overlook the many minor areas of agreement I have with other people at the table and focus on fundamental disagreements. And my remarks may be rather harsh because this country is suffering badly from the consequences of God-awful housing policy, and I cannot help but feel exasperated by it.

What my message boils down to is that when it comes to coming up with another institution that supplies a Government guarantee in the mortgage market, we should just say no.

Our friends at American Progress have some critical things to say about the private sector, and a lot of them are justified. It would be naive to think that the private sector always gets everything right. But it would be really naive to think that the Government gets things right. Government has committed large blunders, and Government has been captured by special interests. Right here at this table, we have two special interests represented. We have mortgage bankers who want a guarantee in the secondary mortgage market in order to make sure that we preserve the originate-to-distribute model. We have Moody's that wants to have a guarantee in the secondary mortgage market in order to ensure that securities are out there and they can earn fees from rating those securities. The only reason to have special interests here at the table is if you could look them in the eye and just say no.

Our country's economy is in a shambles because of a Government-sponsored credit binge in mortgage lending. If a household has $5,000 and walks into Las Vegas and says, "We would like $200,000 of poker chips," what would you say? If they walked into their stockbroker and said, "We would like $200,000 worth of stock," what would you say? And if they want a $200,000 house, what should you say? You should say no. Buying a $200,000 house with $5,000 down is gambling. Even if it is done under the auspices of a Government program designed by a well-intentioned organization, it is gambling and it is wrong.

Only in Washington, after this shambles caused by a credit binge, would we be worried about making sure that there is more credit available in the secondary mortgage market. That is like if a town had been devastated by a bunch of drunken hooligans, I think most people would be saying let us worry about not having binge drinking. Instead, if that happened in Washington, we would be worrying about how can we keep the bars stocked? How can we make sure that everyone has access to alcohol? We would not want anyone to miss out. Only in this upside down world of Washington.

I wish that our friends at American Progress and other well-intentioned people would focus on projects that would help American households become better at saving, not bigger borrowers.

If we do without a Government guarantee, will the secondary mortgage market survive? Not necessarily. We might go back to lending like when I was growing up where, if you got a mortgage loan, the same bank that lent you the money held onto the mortgage until you finished making the payments. That would not be a disaster for the American people.

If we do not have a guarantee, will as much foreign capital come into the American mortgage market? I sure hope not.

Will the 30-year fixed rate still be the standard mortgage? It will if consumers choose it when it is appropriately priced.

Again, the markets will not do everything right, but without a guarantee, things will not go as badly wrong as they did with the Government-sponsored enterprises. Any scheme to bring Government back in as a player providing a guarantee is the financial equivalent of building a new nuclear power plant right on top of a fault line. Based on our experience, we should just say no.

Chairman JOHNSON. Dr. Kling, I would remind you that we are here to have a productive discussion about the future of our housing finance system, not to quote your blog to attack other witnesses' proposals and just hope my temper stays in check. I ask that the full blog post be entered into the record. Please be considerate of the Senate rules of civility in the remainder of your testimony.

Mr. Zandi.

STATEMENT OF MARK ZANDI, PH.D., CHIEF ECONOMIST, MOODY'S ANALYTICS

Mr. ZANDI. Thank you, Mr. Chairman, Senator Shelby, and the rest of the Committee, for the opportunity to speak today. You should know I am chief economist of Moody's Analytics, which is an independent subsidiary of Moody's Corporation, and I am also a director of the MGIC Corporation, which is the Nation's largest mortgage lender. My views I am expressing today are mine, not Moody's or MGIC's. I am going to make three points in my remarks.

First, the Federal Government should significantly scale back its current role in the housing and mortgage markets. As has been pointed out, nearly all of the mortgage loans originated in the past couple of years have been FHA, Fannie, or Freddie loans, Government loans. While changing this quickly would be disruptive to the housing market and economy, it is not sustainable in the long run.

This untenable situation is the result of the collapse of the private mortgage market during the financial panic. Just to give you a number, at the peak of the housing bubble in 2005, the private market accounted for roughly two-thirds of all originations, and powering the private market was the securitization process, which at its core was fundamentally flawed. No one in the process was responsible for making sure that it was working properly. Mortgage banks and brokers, investment banks, credit rating agencies, and Government regulators themselves all made mistakes. And right now the private market is comatose.

To allow the private market to revive, the Government should phaseout Fannie and Freddie and significantly scale back the role of the FHA—again, not quickly but over time in a clearly defined way—and there are a number of policy tools to do that that I think the Administration has laid out that are useful: reducing conforming loan limits, which will begin later this year; raising insurance premiums at the FHA, Fannie, and Freddie; and requiring Fannie and Freddie to reduce the size of their loan portfolios. So point number one, I think it is very important for the Government to phaseout its role in the mortgage market.

Point number two, as the Government steps away from its current role, I think a so-called hybrid system should replace it. You know, there are many different forms of hybrid systems that have been proposed. The MBA and other think tanks, we have made our own proposal. And in these systems, private capital is key. It provides the underpinning for the system. Private investors own the loans and insure the loans.

But there is an important role for Government, and there are four key roles:

One, providing catastrophic insurance, so if things go very badly wrong, as they have—in this recent period and also in the Great Depression—the Government would provide support.

Second, standardization. The securitization process can be much more efficient if it is standardized, and I think Government plays a key role in providing that standardization.

Third, regulating the system, and that is key to any proposal. We need to have very strong, sound regulation to make sure that good mortgage loans are being made.

And if there are subsidies provided to disadvantaged households, they must be explicit and on-balance-sheet. I think that is very important. But that is a role for Government.

Just one quick point about catastrophic insurance. You know, to me I think it can be done reasonably well. The FDIC and FHA are good examples of where Government can get it roughly right. I mean, even the FHA, although it has come under significant criticism, has weathered the storm pretty well, and I think it will come out of this in reasonably good shape.

My third point—the second point being that I think a hybrid system would be the best system. My third point is that the hybrid system has a number of advantages over other proposals, most notably a fully privatized system. Let me just go through three of them.

First is I think mortgage rates would be measurably lower. I think for the typical borrower sort of in the middle of the distribution, under a fully privatized system in which investors truly believe that Government will not step in to save the system, which I think will be difficult to accomplish under any circumstance, interest rates will be nearly 100 basis points higher, about a percentage point higher.

Second, I think it will be very difficult to preserve a 30-year fixed-rate mortgage in a fully privatized system. You can do that in a hybrid system. In a fully privatized system, I think our system will evolve to be similar to the European system in which very few 30-year fixed-rate mortgages are offered.

And, finally, I do think under a hybrid system taxpayers will be compensated. The catastrophic insurance would be explicitly priced and charged for, unlike in a fully privatized system where it would be implicit. And at the end of the day, if things go badly wrong, I do think the Government would step in and it would cost taxpayers.

So, in conclusion, I think it is fair to say that mortgage rates are going to be higher after all of this, the availability of credit lower. But I think we need to be very careful how we design the system going forward. A hybrid system I think offers the best solution for our mortgage finance system.

Thank you.

Chairman JOHNSON. Thank you, Dr. Zandi.

Ms. Ratcliffe.

STATEMENT OF JANNEKE RATCLIFFE, SENIOR FELLOW, CENTER FOR AMERICAN PROGRESS ACTION FUND

Ms. RATCLIFFE. Thank you, Mr. Chairman, Ranking Member Shelby, and Members of the Committee. I am Janneke Ratcliffe, a senior research fellow at the Center for American Progress Action Fund and the executive director for the Center for Community Capital, and today I am especially honored to be asked to speak to you as a member of the Mortgage Finance Working Group. We began gathering in 2008 to chart a path forward for the mortgage market. Our "Plan for a Responsible Market for Housing Finance" is the result. It is included in full in my written testimony. I am going to summarize it, though I speak only for myself in the views expressed today.

Our collective experience in the 3 years we have spent hashing out these issues has made us well aware of the difficult challenge you now face. The immediate task is to restore confidence in the housing market. We are also convinced that, long term, housing can continue to be core to Americans' prosperity and economic security and the foundation of middle-class opportunity. To meet this mission, housing finance reform must meet three key goals:

First, provide broad access to reasonably priced financing for both home ownership and rental housing so that more families, including the historically underserved, can have safe and sustainable housing options.

Second, preserve the 30-year fixed-rate mortgage, which allows families to fix their housing costs, build assets, and plan for their future in an ever more volatile economy.

And, third, ensure that lenders, large and small, in communities large and small, can competitively offer the affordable, transparent, safe mortgage loans that the borrowers need.

History has shown us that a housing finance system left to private markets will be subject to a level of volatility that is just not systemically tolerable, given the importance of housing to the American economy and the American family.

Therefore, our proposal structures an appropriate Government role, which is essential for stability and consistent with the goals just listed. Our proposal keeps beneficial aspects of our current system, including broad and constant liquidity and good, safe mortgage products, but assigned certain functions performed by Fannie and Freddie to the private sector. The Government's role would be limited to a catastrophic backstop, one that is explicitly and actuarially priced, backed by an FDIC-like reinsurance fund and financed by levies on mortgage-backed securities. The backstop work be available only on loans meeting safe mortgage parameters, subject to stringent operational and securitization standards. Further, it would be available only through highly regulated single-purpose companies, chartered mortgage institutions, or CMIs, who put sufficient capital of their own in the first loss position. These capital levels would be higher than those previously required of Fannie and Freddie; thus, there would be several layers of protection standing ahead of taxpayer exposure: borrower equity, CMI capital, in some cases private mortgage insurance, and the catastrophic risk insurance fund.

Our proposal preserves the traditional role of originators with measures to ensure that lenders of all sizes in all communities can offer the same beneficial mortgage products, counteracting the current trend toward extreme market concentration, and includes a prohibition against CMIs being controlled by originators. This system would serve the vast majority of households, those seeking consistent, affordable credit and predictable housing costs.

We also include mechanisms to see that the benefits of this system are available in a more fair and equitable way than before, and that prevent the dual market where certain classes of borrowers and communities are relegated to separate, unequal markets. These mechanisms prevent the CMIs from "creaming the market" and require them to extend the benefits of the system to all qualified borrowers. For those families whose housing finance needs require more support, we call for the establishment of a market access fund to promote products that close market gaps, which would complement the Affordable Housing Trust Fund and the Capital Magnet Fund; and we also outline steps to revitalize the FHA.

In closing, I would say a note of caution about proposals that recommend complete privatization of the housing finance system, or privatization with occasional Government intervention. Such radical proposals would not achieve stability and, in fact, would expose taxpayers to more risk and would expose our economy to boom-bust cycles. They would also result in some stark consequences for American households. Mortgage finance would predominantly be in the form of loans with shorter duration and higher costs, and the 30-year fixed-rate mortgage would not be available under affordable terms for most families.

Rental housing would be less available and would cost more, even as there would be greater demand for it, and fewer working families would have access to asset-building potential of home ownership, and this pillar of the economic mobility that has characterized the American economy would be lost.

Thank you for inviting me to talk about the work my colleagues and I have done. I will be happy to answer your questions.

Chairman JOHNSON. Thank you, Ms. Ratcliffe.

Dr. Zandi, Ms. Ratcliffe, and Mr. Berman, the insurance system you proposed differs from the FDIC Deposit Insurance. If losses from banks' insolvencies exhaust the Deposit Insurance Fund, the FDIC raises insurance rates on the surviving banks and the Government takes no loss. Should the mortgage market have a similar clawback mechanism, perhaps including clawbacks from banks and other firms that sold mortgages to the securitizers in the new system? Dr. Zandi.

Mr. ZANDI. Yes, I think it should have a clawback mechanism so that if the reserve fund is depleted, that it can be replenished through these types of levies. So I think that would be entirely appropriate in the context of a hybrid system that I proposed, yes.

Chairman JOHNSON. Ms. Ratcliffe.

Ms. RATCLIFFE. I would agree.

Chairman JOHNSON. And Mr. Berman.

Mr. BERMAN. The system that we have proposed is slightly different, Mr. Chairman, in that in our system, the FDIC-type insurance fund would only come into play if these mortgage credit guarantor entities, or CMIs, actually had gone under and all of their assets were depleted. So in that case, there would be nothing—there would be nobody to claw back from. We think that that alignment is critically important. Again, if private capital is going to be in the risk position for the credit on these mortgages, we believe that stockholders and bondholders who have invested in those entities would be most vigilant if their capital was totally at stake first before any FDIC-type insurance fund were available.

Chairman JOHNSON. Dr. Kling, in your paper, you state that the Government should ensure that any housing subsidies should be on budget, and you mentioned more robust rental vouchers and grants for homebuyers. How would you structure grants to homebuyers?

Mr. KLING. I think that grants to homebuyers might take the form—might take a number of forms. You could have some kind of matching program for down payments. But I think you have—we have an Earned Income Tax Credit. If we could have some kind of savings tax credit that would encourage savings, a Saved Income Tax Credit, that would be a better way to help low-income households get into the housing market so that they would come in with equity in the home. The best guarantee in a mortgage is a 20 percent down payment, and if we could get households to save up to that 20 percent down payment, we will have a stable mortgage finance system. And if we do not do that, even with a Government guarantee, it will just come to grief.

Chairman JOHNSON. Dr. Kling, the vast majority of subprime and Alt-A loans were issued securitized and included unstructured securities such as CDOs by sophisticated financial market participants other than GSEs. These private market solutions failed with terrible results outside the private mortgage market and Wall Street. Why should we expect that the combination of private market mortgage securitization and private insurance will produce a different result next time?

Mr. KLING. I hope that the private securitization market does not come back unless it gets—unless it comes back in a reformed way. I think it is pretty dead now. I think it deserves to be dead. I think that the only thing that caused it to arise was a phenomenon called regulatory arbitrage, where the Basel Capital Accords gave rewards to banks for holding lousy mortgages, packages of securities, and punished banks for holding good mortgages as whole loans. If we change the capital requirements, we will have more sensible policies.

And when we talk about pricing this Government guarantee, we are going to run into exactly the same issues that the Basel Capital Accords ran into. That is, if you have crude risk buckets, people are going to arbitrage against that and you are going to have the exact same problem, that the private markets are going to figure out how to dump all the risk on the Government and keep all the profits for themselves, and that is the danger of bringing the Government in as a guarantor.

Chairman JOHNSON. Ms. Ratcliffe, quickly, with QRM being considered today, there is a good deal of focus on the down payment that a borrower brings to the table as a way to reduce the likelihood of default. In your experience are there other factors that can help assess this risk?

Ms. RATCLIFFE. Low down payment loans can be made safely, and there are many ways to do this and we have lots of evidence, and I would just like to cite some research that we have been doing at the Center for Community Capital. We have been tracking a portfolio of 50,000 mortgages that were made in the decade leading up to the crisis. These loans were made by banks around the country. The median income of a borrower in this program was $34,000. Fifty-four percent of the borrowers had credit scores of 680 and below. And 69 percent, almost 70 percent of the participants in this program, put down less than 5 percent on their mortgage. These loans were originated under lenders' CRA and Affordable Housing programs.

To date, fewer than 5 percent of these mortgages have entered into foreclosure and the households have managed to accumulate a level of equity in their home, at the median, $25,000, that they could not have achieved with any other mechanism out there.

What led to this success? It is pretty clear that it is well-underwritten access to 30-year prime priced fixed-rate mortgages. We have taken borrowers in this portfolio and compared them to their counterparts in the subprime market and found that the same borrowers given a different set of products were three to five times as likely to be in default.

So, as I said, it is good product, fairly priced, with solid underwriting. Reserves are also helpful and probably more valuable to a modest income household than having all their money invested in their down payment. Escrows—and there are other things that have been proven to help, as well, prepurchase counseling, down payment assistance. And so we believe that there are many ways to assure safe high LTV lending, and without that, you shut a lot of people out of home ownership.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Recently, Secretary Geithner before this Committee warned us of the difficulty in appropriately pricing a guarantee for mortgage-backed securities, and he cautioned, and I am quoting, "Guarantees are perilous. Governments are not very good at doing them, not very good at designing them, not very good at pricing them, not very good at limiting the moral hazard risk that comes with them." Those were the words of our Secretary of Treasury. Mr. Berman, Dr. Zandi, Ms. Ratcliffe, do you agree with Secretary Geithner?

Mr. BERMAN. If I may, Senator, in the first instance, there is no question that there is risk in any pricing mechanism.

Senator SHELBY. Sure.

Mr. BERMAN. But having said that, I think we have two new circumstances that should help us dramatically. The first is that we have just come through the greatest crisis since the Great Depression, so the data that we have in terms of a stressed economy and what the effect of that economy would be on various mortgage products gives us a much greater amount of information to make better decisions on.

Second, in what we have described in our mortgage credit guarantor entity guarantee, we would have what we have called core mortgage products that would, in some respects, attract, for instance, the QRM, the Qualified Residential Mortgage, kinds of products. And again, we have a substantial amount of data and those are more conservative loans than the kinds of pricing that have oftentimes failed.

So for those two reasons, we think we could do a lot better this time around.

Senator SHELBY. Dr. Kling, do you agree with Secretary Geithner?

Mr. KLING. I would probably agree even more strongly, because I have a background in the analytics of pricing mortgage default rates——

Senator SHELBY. Absolutely.

Mr. KLING. ——and they—first of all, it is a difficult problem. Second, it differs greatly by mortgage product. You cannot just have a one-price-fits-all guarantee. And finally, when you are at the high LTV level, it is just a pure bet on house prices. You are just guessing which way house prices will go. Any loan you make, no matter how bad, no matter how low a down payment, has at least a 50 percent chance of paying off because the house price might go up. But that does not mean it is not gambling. It is still gambling and the pricing of it is extremely difficult.

Senator SHELBY. Dr. Kling, you have cited some of the potential risk that you would see to the taxpayer in having the Government price the guarantee. That is what you are talking about, the risk there, is it not?

Mr. KLING. It is a catastrophic risk. You will probably make money most of the time, like picking up nickels in front of a steamroller, and then at some point, that steamroller is going to get you.

Senator SHELBY. Dr. Zandi, do you agree with Secretary Geithner's comment?

Mr. ZANDI. I do. I think it would be very difficult to price risk. It is, for the private sector as well as the Government sector. I would say just a few things, three quick things.

Senator SHELBY. OK.

Mr. ZANDI. First of all, that in the hybrid system we are discussing, it is catastrophic insurance, so most of the risk would be—well, all but the very catastrophic events would be covered by the capital provided by the private sector.

Second, it can be done. I think the FDIC and the FHA are good examples of that and they are relevant to this discussion.

And three, the third thing I would say is that in a fully privatized system, you are not getting rid of the risk. You still have the catastrophic risk, and at the end of the day, the Government will step in. I just believe that if we come push to shove, that it is going to be very difficult for the Government not to step in and save the system, and therefore it is better to explicitly price for that service that you are providing to give taxpayers some compensation for it.

Senator SHELBY. Ms. Ratcliffe, do you have any comments there? Do you agree with Secretary Geithner or disagree?

Ms. RATCLIFFE. I think I would agree with Dr. Zandi, and I want to just——

Senator SHELBY. But not with Secretary Geithner?

Ms. RATCLIFFE. No, I think that the Government is going to have to set the price on the risk one way or another, whether it is through capital reserving requirements—and I wanted to add a little bit about the capacity of the system that we proposed, the hybrid system, which would put private capital in the first loss position and responsible for pricing the risk, but also recognize the efficiencies that brings to the system by having special purpose entities whose job it is to pool risks and manage risks across institutions, across geographies, across vintages. That makes for a much more efficient risk management system.

Senator SHELBY. Ms. Ratcliffe, in your proposal, you call for a guarantee of mortgage-backed securities. That is what you are basically saying here, right?

Ms. RATCLIFFE. Similar to what Dr. Zandi talked about, we would have the privately capitalized chartered mortgage institutions taking the first loss and guaranteeing the mortgage-backed securities. Then the next level of defense would be an FDIC-like insurance fund that is paid into by the private market and the Government backstop would be catastrophic only.

Senator SHELBY. But Secretary Geithner basically says that any Federal guarantee should be priced according to the risk, without any political considerations. Do you disagree with that?

Ms. RATCLIFFE. No, I do not disagree with that.

Senator SHELBY. OK. Mr. Berman, the plan put forth by the Mortgage Bankers Association argues that social policy goals, such as affordable housing initiatives, should be pursued through explicit Government programs rather than entities in the secondary market. What is the advantage, Mr. Berman, of housing policy goals pursued through Government programs instead of through private entities, and what types of distortions could indirect public or social housing policy goals have on the economy?

Mr. BERMAN. In the first instance, we would like to separate out the possible distortions of subsidies that would indirectly or could indirectly affect, for instance, what we just talked about, the pricing of risk.

Senator SHELBY. Explain what you mean.

Mr. BERMAN. So housing goals, we believe, should be separated from the hybrid Government system that we have described. We believe that FHA, USDA, Rural Housing, are appropriate places where the Government can very specifically have programs. We would also suggest that there could be a tax or a levy, if you will, on these new mortgage credit guarantor entities that could be put into a pool that could be used. But again, it would be a very explicit source of payment for subsidies and would not cloud the pricing of the risk or distort the pricing of the risk.

Senator SHELBY. Dr. Zandi, in your testimony, you stated that the mortgage finance system should be, quote, “capitalized sufficiently to withstand losses on defaulting mortgages that would result if house prices declined by, say, 25 percent.” Under this standard, how high would down payment requirements need to be for potential borrowers? Ten percent? Twenty percent? And if this standard had been in place prior to the crisis, how much more capital would Fannie and Freddie have been required to hold?

Mr. ZANDI. Well, if Fannie and Freddie were capitalized to a 10-percent house price decline scenario— 10 percent—and——

Senator SHELBY. And that was not good enough.

Mr. ZANDI. It was obviously not good enough, and so I think 25 percent—just as a starting point for discussion, because that is the price declines that we are going to experience in the current housing crash.

Senator SHELBY. Mr. Chairman, if I could, Dr. Kling, could you take a moment to describe to the Committee how the policies—you recently wrote a paper dealing with the financial crisis of 2008. In it, you discussed the connection between what you described as, quote, "bad bets by our Nation's financial system and a U.S. housing policy such as affordable housing goals, the CRA, and the Federal guarantees." Could you describe how these policies and insufficient capital standards have caused the financial crisis?

Mr. KLING. Well, that is a—I will try to keep my answer brief, but that is a——

Senator SHELBY. No, that is very important.

Mr. KLING. OK. The—first of all, encouraging low down payment lending is a mistake. It just creates gambling. It does not help neighborhoods. It destabilizes them, because people can only buy houses when prices are rising, and then when prices stop rising, they default and then the whole neighborhood collapses. So we destabilized housing markets by encouraging low down payment lending.

The capital requirements, as I mentioned earlier, encourage securitization of really bad mortgages and allowed regulatory capital to arbitrage. You talked about Freddie and Fannie supposedly having 10 percent capital. A lot of that was not real capital. It was tax loss carry-forwards and other soft forms of capital. And I am not convinced that the regulator really was on top of the caliber of mortgages that were in Freddie's and Fannie's portfolios, and I do not think they really understood how much capital they really needed. So that is, very briefly, some of the things that contributed.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Reed.

Senator REED. Mr. Chairman, let me, if I may, I will pass to Senator Merkley, if he is ready.

Chairman JOHNSON. Senator Merkley.

Senator REED. I have just arrived from Armed Services.

Senator MERKLEY. Thank you very much, Mr. Chair and Senator Reed.

I wanted to start, Ms. Ratcliffe, with your commentary on your study in which you looked at low down payment lending to determine whether or not low down payments drove foreclosures. And if I understood your testimony correctly, you found that it was not low down payments that drove lending, but it was more predatory mortgages, I assume, teaser rate mortgages, triple-option loans, and so forth.

Ms. RATCLIFFE. Yes, sir. In our particular study where we compared the folks who had borrowed with low down payment loans with sustainable prime priced 30-year fixed-rate mortgages to purchase homes *versus* those in the subprime sector, the primary drivers of the difference in default was adjustable rate features and broker channel and prepayment penalties. So these are some of the features that we identified.

Meanwhile, I mean, I think we have gotten to the point where, somehow, low down payment lending has become conflated with the term subprime, and I am not sure that is justified. Twenty-seven million Americans between 1990 and 2009 have purchased a home with less than 20 percent down. It roughly represents a third of the market in normal times, and in the most recent year, I understand from some data from the National Association of REALTORS® that some 57 percent of homes purchased in 2010 put down 10 percent or less on their mortgage. So it is an important part of the segment and it does not equate with subprime lending.

Just as an example, if you look at what has caused a disproportionate share of losses at the GSEs, it is the Alt-A portfolio, which had higher loan balance loans and average down payment of closer to, I believe, 27 percent and higher credit scores. These were not low down payment borrowers that caused this crisis.

Senator MERKLEY. So, Mr. Kling, you have noted the risks that were created by various mortgages, but you really emphasized the size of the down payment. Given the type of study that Ms. Ratcliffe is noting, why do you not emphasize getting rid of the predatory practices, the teaser rates, the steering payments, the liar loans, and so forth rather than the low down payment?

Mr. KLING. I think we should get rid of all—Senator, I think we should get rid of all the bad practices in mortgage lending that grew up over the last two decades. But there is simply no way to make low down payment lending safe in an environment—any environment other than a rising house price environment. Her study covered the last decade. If you made a low down payment loan in 2001, there was enough of a price increase after that that you are probably fine, but it only works in that environment and it creates this cycle of a boom as house prices are rising, and then once they stop rising, everybody crashes. You get this epidemic of foreclosures. It destabilizes the entire market.

Senator MERKLEY. One thing I was struck by is when you were talking about mortgages, you kept referring to the notion of gambling, and certainly it seems like there is an element of risk in every investment, but the term—if you take the framework that any investment that has risk is gambling, then all investing is gambling. Is that not really just a—why are you bringing this to bear and why not say nobody should buy stock, because stock can go up and down.

Mr. KLING. I am not—Senator, I am not saying that nobody should buy a house. I am not saying that nobody should buy stock. I am saying that we should reduce the degree of gambling. So in the stock market, I believe the margin requirement is something like 50 percent. We do not require a 50 percent down payment for buying a home, but I think a 20 percent down payment is reasonable.

Senator MERKLEY. I will just share that in my working class neighborhood of three-bedroom ranches, the average price of a house is around $200,000, and at 20 percent down, that is $40,000. There are very few working families in America that would become homeowners at a $40,000-plus closing cost. And yet if we look across our economy at the major instruments that have brought people into the middle class, one is education. One is starting businesses. But the broadest is home ownership, and I am just concerned that given the light of the type of studies that have seen vast transfers of wealth to working Americans through home ownership, I mean, Mr. Kling, you may be throwing the baby out with the bathwater here.

Mr. Zandi, did you want to comment?

Mr. ZANDI. Senator, I just want to make a couple of points. One is I think it is important first to recognize that after you control for all the things that affect default, down payment matters, but it does not matter as much as you might think. So if you control for a credit score, if you control for debt-to-income ratio, if you control for product type, if you control for investor-owned *versus* owner-occupied, all of these things, then you will see that default rates do rise. They do rise as the down payment becomes smaller, but the increases are quite modest, up almost to a 95 percent LTV.

The second point I would make is that because of the decline in housing values that has occurred over the last several years, if you limit lending to 20 percent down, you are going to be locking out the vast majority of American middle-income households because there is no equity left. It has been wiped out in this period. So there is a big chunk of the American population that will have a very difficult time participating in home ownership.

And the third thing I would say is that you can price for risk, so if, in fact, you start—if you provide loans with lower down payments, then I think it is reasonable to charge a higher interest rate for that because it is riskier.

Senator MERKLEY. Thank you. My time has expired, so I will apologize because I see more comments desired, but in respect to my colleagues, I will defer.

Chairman JOHNSON. Senator Reed.

Senator REED. Thank you very much, Mr. Chairman.

Mr. Berman, the 30-year fixed mortgage has been sort of the North Star of American housing for a long time. How do you think it will be maintained? Should it be maintained? What is your view in terms of that product as a centerpoint of the mortgage market?

Mr. BERMAN. Senator, the most recent study we have has it over 80 percent of mortgage loan applications in February for home purchases were for 30-year fixed-rate mortgages. So it has clearly become a staple for the American consumer. Importantly, we have made a value decision in making that available and having the Government role make it affordable, that where homes are oftentimes the most significant asset that one would own throughout their lifetime, that taking the credit risk on that home is one thing, but taking an interest rate risk is quite another. And so having the 30-year fixed-rate mortgage as an affordable product allows homeowners to virtually eliminate that risk in that they can have a fully amortizing mortgage product, and then, of course, given the prepayment flexibilities that we have, it allows for when rates go down that they can again get another 30-year fixed-rate mortgage, again reducing their interest rate risk.

As you know, it is a very unusual instrument in terms of what is happening in other countries, and I think that the uniqueness in the United States is that we have made that decision that we want to protect homeowners from the interest rate volatility that would otherwise impact them.

Senator REED. Some of the proposals would perhaps make that a less available product, is that your analysis of the competing proposals?

Mr. BERMAN. Yes. In fact, the TBA market, the "to be announced" market that has really been created by Fannie Mae and Freddie Mac has become a vitally important way for 30-year fixed-rate mortgages to be priced and then securitized. There would be very few participants in the 30-year fixed-rate mortgage market if there was no securitization allowed, given that it would make it very difficult for any small banks or independent mortgage bankers to participate whatsoever.

And furthermore, the ability of providing the affordability in terms of rates for those 30-year mortgages would be severely negatively impacted, anywhere from 50 to 150 basis points, if people were securitizing 30-year fixed-rate mortgages and did not have the TBA market to utilize as a hedging instrument.

Senator REED. Dr. Kling, your comments on the 30-year mortgage, the proposals?

Mr. KLING. I believe that American consumers prefer the 30-year fixed-rate mortgage and I believe the market will provide what the consumers want. The——

Senator REED. At a price they can pay?

Mr. KLING. The President's report on housing finance said that any rational housing reform is going to lead to a higher cost of mortgage credit. You cannot continue to subsidize mortgage credit and mortgage credit risk without running into trouble. It is not a rational policy.

You know, 20 years ago, the difference between the interest rate in the jumbo loan market, that is the markets that Freddie and Fannie were not eligible to guarantee, and the Freddie and Fannie market was only 25 basis points, one-quarter of 1 percent. So I do not think that is a very frightening number.

A more frightening number would be, you know, Ms. Ratcliffe said that of these wonderful well-underwritten low down payment loans, 5 percent of them defaulted. Well, we used to assume that you would lose 50 percent on each defaulted loan. So a 5-percent default and you have a 50 percent loss rate, that is a two-and-a-half percentage point difference in price. You would have to charge 250 basis points more on that loan compared to a loan that has much lower default risks.

So the key is to have loans that have lower default risk. That is the key to having low interest rates. The interest rate risk is not so much of an issue and the—certainly, the Canadian homebuyers have never suffered from having interest rate shocks, even though they have a 5-year rollover, and if the American people choose to something like a 5-year rollover, I do not think it would be a disaster. I do not think that is what they choose. I think they will choose a 30-year. I think it will be——

Senator REED. Well, let me have Ms. Ratcliffe respond, because her analysis was questioned.

Ms. RATCLIFFE. Thank you. I had a couple points to make. First of all, the additional charge for the higher risk would not necessarily fall on the loan every year. It would be spread over the life of the loan to begin with.

I also wanted to make a point about the math that says that borrowers in the jumbo markets pay only, you know, 30 to 50 basis points more for a mortgage than in the Fannie and Freddie sector.

Our proposal sees that there are certain segments of the market which will probably always be able to, at a reasonable price, access a fixed-rate mortgage. Even through the jumbo market is still much more—tends much more toward adjustable-rate mortgages, there are fixed-rate mortgages there. And for high-income borrowers, that will probably remain an option. It is the rest of the market that we are worried about having access to the 30-year fixed-rate market.

The volatility that has been talked about that we are living through right now was not caused by the 30-year fixed-rate mortgage but more it was a boom-bust cycle driven by private capital, which tends to behave very procyclically. So in good times, they undercapitalize risk. They rush in. They exacerbate bubbles. And then in bad times, they overprice risk and they basically freeze up.

The Government recognized this in 1934 when it decided to opt for stability in the mortgage system by introducing the FHA and the 30-year fixed-rate mortgage and a number of standards to go with it, and it has become a key element in the strengthening of the middle class. And what works so well about this product is that, of course, the payments stay fixed, so over time, as income rises, the family has more disposable income for spending or for investing, and with amortization and just modest amounts of appreciation over the long run, this becomes a great asset-building tool for future financial needs.

So that product in and of itself inherently reduces risk, because over time, debt-to-income improves, and in normal environments, LTV should improve. So using that product allows us to put more people into homes more sustainably and more safely than if we just went to ARMs. They are just simply a riskier product. Even if you just look at the——

Senator REED. I——

Ms. RATCLIFFE. I am sorry.

Senator REED. My time—the Chairman has been very gracious, but thank you very much.

Mr. BERMAN. Senator, may I just make one clarification?

Senator REED. Yes.

Mr. BERMAN. I appreciate that. Oftentimes, the jumbo mortgage market, 30-year fixed as compared to the conforming market, and one of the underlying assumptions that I think we have to be very careful about is that in order to price and hedge those jumbo loans, even though they are outside of the Fannie and Freddie arena, they are utilizing the Fannie and Freddie TBA market to hedge those instruments. If that market had disappeared, the hedging costs would, in fact, rise and that 30 to 50 basis points would be much more dramatic.

Chairman JOHNSON. Senator Hagan.

Senator REED. Thank you.

Senator HAGAN. Thank you, Mr. Chairman, and thank you for your testimony here today, all of you.

Ms. Ratcliffe, in your testimony you talk about the need for standardization of underwriting and documentation rules. Why is the standardization so important in the mortgage market? Can you go over that, please?

Ms. RATCLIFFE. Well, certainly. One of the things we saw with the private label securitization boom was a real complexity of products. They became so opaque that it was difficult for investors to understand what they were investing in. It became really impossible for borrowers to understand what they were borrowing. It became difficult to comparison shop.

You know, I have never actually read every document in my 30-year fixed-rate mortgage because I know what I am getting when I sign up for it, and I can look in the Sunday paper or go online and make comparisons. But when you have proliferation of complex products that no one can understand, it introduces new risks into the system. So we think standardization is an important aspect of a stable mortgage system.

Senator HAGAN. And would you agree that the qualified residential mortgage helps drive the standardization that you have spoken about?

Ms. RATCLIFFE. So I think since we are sort of looking at new definitions coming out for the qualified residential mortgage, it is hard for me—I have not studied them closely, and there is a whole lot in flux with the secondary market still in flux. So I would sound a note of caution that QRM standards that are too restrictive will actually increase taxpayer risk and not address the access, make access harder. So it could potentially drive, for example, high LTV lending all into the FHA sector unnecessarily, which would put them all under 100 percent Government guarantee, which I do not think you need. And then it would leave sort of the large banks with excess capital to be free to serve the rest of the market. Again, you might find a lot of adjustable rate mortgages combined with higher LTV products there, which would introduce additional systemic risk, and then the FHA sector might suffer collateral damage from that as well.

So I just think it is important—I think it is preliminary, so I do not know, but I think it is important to think hard about the unintended consequences of the QRM.

Senator HAGAN. Thank you.

Dr. Zandi, on March the 8th, you wrote a special report for Moody's Analytics that focused on the risk retention requirements in Dodd-Frank and made some recommendation for what the qualified residential mortgage should look like. And as you know, that is a rule that I coauthored with Senator Landrieu and Senator Isakson to ensure that we did not inadvertently restrict the availability of capital for well-underwritten loans.

In your report you discuss the importance of the rule-writing process on the qualified residential mortgage. Can you tell the Committee why you think it is important—and I know we have been discussing this—that regulators get this rule right and some of the features that you believe it should include?

Mr. ZANDI. Yes. I think QRM is important because it will determine, at least in the immediate future, before we nail down the rest of the mortgage finance system, pricing for loans. So loans that are QRM, that qualify, will have a lower price—a lower interest rate, a higher price, than those that are not. And it is not quite—I state that with conviction and certainty, but it is not quite clear exactly the numbers involved, how big a difference is this going to make, and I do not think anyone really knows.

So, given that, the inability to really even come up with a good estimate of what the impact will be, I think it is important to keep the QRM box wide, at least initially. And I do not know the rules—I have not looked at them carefully yet, but what I saw seemed reasonable to me. Keeping Fannie and Freddie loans QRM now in this environment I think makes a lot of sense. It keeps the box relatively wide.

I think the one thing that I would encourage is that right now, as I understand it, QRM is 20 percent down on non-Fannie/Freddie/FHA. I think that makes sense if it is not credit enhanced. So if you have private mortgage insurance, then I think it is reasonable to define a QRM loan with a higher loan-to-value ratio, a 90-percent LTV. So I think that would be a reasonable thing to consider carefully in this rulemaking period, and my inclination would be to include that.

The other aspects of it look quite reasonable to me, very consistent with sort of the proposals I made in that paper that you referred to.

Senator HAGAN. Well, I definitely think that the 20 percent is too high for so many of the people in our Nation to actually go out there and buy that home. I think what Ms. Ratcliffe was saying, too, earlier in that the numbers— could you repeat those numbers again that you listed?

Ms. RATCLIFFE. Well, I have listed many numbers.

Senator HAGAN. I am sorry. The numbers of people who have actually purchased a home.

Ms. RATCLIFFE. Right. Over the last couple of decades, it is 27 million homeowners. We would never want to say that those were all subprime homeowners. I may have been one of those along the way. And as I said, in normal times it is roughly about 30 percent of the market. In the last year, it looks like it has been almost double that share putting down 10 percent of less on their mortgage, on their home purchases.

Senator HAGAN. And also, Dr. Zandi, currently small lenders are able to participate in the mortgage market, obviously, by selling their loans to Fannie Mae and Freddie Mac without having to go through one of the big banks to accumulate enough loans to create the securitization pool. What would the Administration's proposals do to the ability of small lenders, such as community banks, to compete in the mortgage market? And what would this do to the concentration of the market?

Mr. ZANDI. Well, this is a very good point, that in any mortgage finance reform that you decide to do, you have to be cognizant of the impact on the industrial structure of the mortgage origination, mortgage market. Already the market has gotten much more concentrated as a result of the financial collapse and crisis. If you look at the share of origination volume and the share of servicing done by the top five, it is measurably higher than at any time in history, and you can see it in the interest rates that they charge. They do have market power. And we are going to see—it is going to be a really good test this fall when conforming loan limits come down, and they are going to be asked to kind of fill the void. We will see what the pricing looks like and how much pricing power they actually do have.

So one of the beauties of our system is that we have a lot of small banks, a lot of community banks, and we need to preserve that. I think that is a strength of our economy and our financial system, and any financial—QRM, risk retention rules, anything you do I think needs to be looked at through that prism, what impact it will have, because we need to preserve that competition to keep those interest rates lower. And, frankly, I do think this is a problem. I think interest rates—people are paying higher interest rates now and will pay higher interest rates going forward because of the concentration that has already occurred in the system.

Senator HAGAN. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you all for your testimony.

I just want to establish one or two things because I keep hearing this debate that the facts—or assertions that are claimed as facts, and I want to make sure that we all talk about the same thing. So either to Ms. Ratcliffe or Dr. Zandi, I constantly hear that the GSEs led the charge into subprime lending, when I look at the FCIC report and other crisis books and pretty much see that the private sector rushed madly into the subprime lending, and, unfortunately, the GSEs lost their way and followed that. Is that a fact?

Mr. ZANDI. My view of this is that the private subprime Alt-A market ballooned out in the mid part of the decade, and that squeezed Fannie Mae and Freddie Mac out of the market up until the very end of the boom. To me, the best statistic, the most telling statistic from the Federal Reserve's flow of funds is the share of the mortgage market accounted for by Fannie Mae and Freddie Mac. If you go back to 2003—I do not have the numbers exactly right, but orders of magnitude, it was about 52, 53 percent of the market, 52 to 53 percent of all outstanding mortgage debt was either insured or owned by Fannie Mae and Freddie Mac. By 2006, say 3, 3½ years later, their share had fallen to 40 percent. That is a 10-percentage-point drop. That is just an incredible shift. And that is not because they did not want the business. It is because they got driven out of the business.

Now, unfortunately, by the end of the bubble, late 2006 into 2007, they wanted back in, and that is when they made their very serious errors and started to get into Alt-A lending.

Senator MENENDEZ. And that is what we have to ensure in my mind and reform——

Mr. ZANDI. And that is what we are paying for right now.

Senator MENENDEZ. Absolutely. But it did not lead the way here.

Mr. ZANDI. It did not.

Senator MENENDEZ. Second, I always hear that the Community Reinvestment Act is to blame for the crisis because it supposedly forced banks to lend to minorities whose loans were bad, when, in fact, isn't it true that only 6 percent of the subprime loans were made by entities that were even subject to the Community Reinvestment Act and 94 percent of the loans were made by lenders not subject to the Community Reinvestment Act?

Ms. RATCLIFFE. That is true, and I would add that only 1.3 percent of mortgages made over the period in question were CRA-covered loans that were also high-cost loans. So it is hard to imagine that 1.3 percent of the loans made could have led us to this point.

Senator MENENDEZ. So I guess this is one of those things that if you say a lie enough it ultimately somebody will believe it, because the facts clearly do not substantiate that.

Let me ask you two questions. You know, I listen to a lot of the community banks and others, and they say to me they are able to participate in the mortgage market by selling loans to Fannie and Freddie without having to go through one of the big banks to accumulate enough loans to create a securitized pool. What would the various reform proposals do to the ability of small lenders, such as community banks or mortgage brokers, to compete in the mortgage market? What would this do to the concentration of the market in the hands of a few players?

Ms. RATCLIFFE. So our proposal lays out as one of our primary goals that lenders of all sizes in all communities can offer access to the same kinds of products, and that will be—in order to have that, you need a robust and independent secondary market. Our proposal has specific criteria in it for ensuring that the entities providing that access to the market, the CMIs in the case of our proposal, cannot be controlled by lenders and cannot have overconcentration of business going to individual lenders. So it has deliberate elements in it to ensure that lenders of all sizes—community banks, credit unions, nonprofit financial institutions, and the like—can still access the system.

Senator MENENDEZ. Well, a corollary of that—and I would invite either one of your or anyone's answer. We continue to hear that private capital is on the sidelines awaiting for the Government to get out of the way before it enters the secondary mortgage market. Can any of you provide us with data indicating the amount of capital awaiting to return to the secondary mortgage market and indicate a timeline for its reemergence? You know, the reason I ask is because there is opportunity for that capital in both the commercial real estate and the jumbo market space, but it has not entered those markets, and there is no Government participation in those fields. So I would like to know where all this capital is sitting on the sidelines waiting to come in. It seems to be waiting for some, you know, heralded moment.

Mr. ZANDI. Well, I think there is no answer to that question. We do not know for sure. And that argues for going slowly, making one step change at a time. And I think actually the policy path that has been laid out is a good one and an appropriate one.

So on October 1st, the conforming loan limits revert back to their precrisis levels. This will be a very good test to see will the private market step in. Will the big banks with balance sheets that have capacity to lend step up and lend and at what interest rate?

Allowing and asking the FHA to raise its insurance premium slowly but surely I think makes perfect sense. It helps to shore up the FHA system. It also makes it more viable for private capital to come in. A good step to take.

QRM, implementing that over the course of—and other risk retention rules over the course of the next year, year and a half, makes perfect sense. Let everyone get used to it and get the rules defined. So the things that you have done, at least the path that seems to be in force, I should say, requiring Fannie Mae and Freddie Mac to reduce the size of their loan portfolios over time, in an orderly, clearly defined way makes perfect sense. Doing all these things is a good test. Each step of the way we will just see how much private capital is going to come in and at what cost. And I think that is exactly what you should do, and, fortunately, it seems like we are going down that path.

Mr. BERMAN. Senator, I think I would like to underscore the caution that we would need to proceed with. While I think we all agree that the path forward is to reduce the size of the Government footprint and reduce the market share of Fannie and Freddie and FHA, each of these levers, whether it is the conforming loan limit or G-fees or the QRM standards, will have an independent but related impact, and the key is the private markets have spoken that they do not have confidence. We will not see private markets come back in and make loans and buy bonds until there is confidence reestablished. We have seen over the last couple of years only two RMBS, mortgage-backed securities issuances, and they are at 55 to 65 percent loan-to-value. There is clearly a lack of confidence.

I think if we were to move forward, even if the path is the right one, but if we move forward at the wrong pace, before there is enough investor confidence to come back into the market, the swings and the volatility at a time when the markets are so fragile and housing markets are so fragile could, in fact, endanger the nascent recovery that we have begun to see.

Senator MENENDEZ. Mr. Chairman, I know my time has expired. I want to thank you for this hearing. I think our challenge here, my personal view, is that our goal is to protect the taxpayers but still have the opportunity for a middle-class family to get a 30-year mortgage and be able to do so in a marketplace that allows them as a responsible borrower to be able to achieve that. And I am really concerned about the calls by some to just yank out the GSEs totally and what that means to this market.

So thank you very much. Thank you for your answers.

Chairman JOHNSON. I understand that Senator Shelby has a couple more questions.

Senator SHELBY. Thank you. Thank you, Mr. Chairman.

Dr. Kling, thank you for your testimony and your candor. In order for this Committee, I believe, to reform Fannie Mae and Freddie Mac, it must first understand why those institutions failed.

I will say it again. My microphone was not on. In order for this Committee to reform Fannie and Freddie, I believe that we must understand here why those institutions failed so that we do not repeat our past mistakes here in the Banking Committee. Dr. Kling, could you describe some of the factors that you believe led to the collapse of Fannie Mae and Freddie Mac?

Mr. KLING. Well, Senator, I can try. Fundamentally, when you create a guaranteed enterprise like that, when the Government creates a guarantee, the private sector ultimately is going to find a way to load the risk onto the Government, onto the taxpayers, while it is making profits. So in some sense that kind of failure is inevitable.

Senator SHELBY. Explain what you meant there. I agree with you, but explain to the public what you meant, to load the taxpayer——

Mr. KLING. Well, if you have a guarantee against catastrophic loss, then you earn your highest return by taking the most catastrophic loss, and then most of the time you take a return, because by definition a catastrophic loss is something that happens very rarely, is very unexpected. You know, we do not have 25-percent house price declines every year. So it is a very rare event, and you load up on the risk for the rare event because you earn a return for taking that risk, but that risk is borne by the taxpayer. So that is, you know, fundamentally what is going on.

You also have the phenomenon of procyclical regulation. We heard talk about the markets being cyclical, but the regulators and Congress are very cyclical. Five years ago, if you had had mortgage lenders in this room, you would have been berating them for turning down good loans. Now you are coming up with rules to try to keep them from making bad loans, so the regulations are actually going with the cycle. And this kind of—so procyclical regulation was certainly a factor with Freddie Mac and Fannie Mae because just as the housing bubble was heating up, they were ratcheting up their housing goals that they felt required that they go after low-quality mortgages. So that was a factor. I think there were also idiosyncratic factors.

In 2007, I wrote something for a book that I was drafting saying that Freddie Mac and Fannie Mae are not part of the subprime crisis; they are going to survive. So I was shocked. There must have been some changes in the philosophy and the corporate culture there that—you know, because in the 1990s no-doc loans, we put a stop to that. Freddie and Fannie got together and said, "We are not going to do that."

You know, you are always under pressure——

Senator SHELBY. And what happened? Tell us what happened. In the 1990s they were not doing this. Tell us what happened.

Mr. KLING. They stopped doing the low-doc loans until in the late 1990s they came back again. And that is the pressure you are going to face with this QRM or whatever, that the lenders are always coming back to you and saying, well, what if we did this credit enhancement, what if we gave you excess collateral, you know, what if we showed you that these loans that we have been doing actually have not been defaulting so much. They are always pushing the envelope, and the regulators are going to feel that, too, and I think they are going to be procyclical; that is, over time, as the housing market gets better, the regulators will sort of loosen up the definition of what is a qualified residential mortgage or whatever, and they will just be back in the same boat.

Mr. BERMAN. Senator, if I may?

Senator SHELBY. Sure.

Mr. BERMAN. One of the areas that we have not really focused on this morning is the multifamily sector, and as you are, I am sure, well aware, Fannie Mae and Freddie Mac last year had—the last 2 years have had between 60 and 80 percent of the multifamily market. That is an area where, in fact, they were successful and they were disciplined——

Senator SHELBY. What is the default rate on the multifamily? Low?

Mr. BERMAN. It is under 1 percent. I think Freddie Mac is about 25 basis points and Fannie Mae is about six——

Senator SHELBY. That is unusual. That is good.

Mr. BERMAN. And they also faced some of the same pressures that the single-family brethren faced with pressure from——

Senator SHELBY. What did they do right there as opposed to the other? Did they not succumb to pressure, the multifamily, and succumb to political pressure in the other? What happened?

Mr. BERMAN. In fact, in the multifamily sector, they stayed disciplined. The products that they brought out to the public, the way those products were underwritten, the loan-to-values, the cash-flows, stayed conservative, and so their default rates tell a very different story and, in fact, have provided a important service when the private sector has vanished from that market.

Senator SHELBY. Dr. Kling.

Mr. KLING. Well, I actually had a different experience in multifamily. It was very traumatic. In the late 1980s, Freddie Mac did not have a disciplined approach to lending in multifamily and had a horrible default experience. They lent cash-out refinances to landlords, to slumlords, who would then take the cash and then not put anything into the building in terms of maintenance. And so the properties went down, and people——

Senator SHELBY. Went down.

Mr. BERMAN. In 1990, Freddie Mac actually shut down for 3 years their multifamily program.

Senator SHELBY. So they learned something, didn't they?

Mr. BERMAN. Exactly. They learned the lesson and then did it right——

Senator SHELBY. Multifamily.

Mr. BERMAN. Yes.

Senator SHELBY. Dr. Kling, quickly, would you sum up the bad choice, I would call it, or the devil we know *versus* the devil we do not know as we talk about reforming Fannie Mae and Freddie Mac? We know a lot about Fannie and Freddie. We know they do have some good things. But we know they have made some big mistakes, too, as opposed to re-creating a new structure. Sum it up for us quickly.

Mr. KLING. I am terrified of creating a new structure because you are going to have inexperienced institutions and above all inexperienced regulators. I think we know how to make the Freddie and Fannie model work better than it did by having the regulators require real capital and by restricting Freddie and Fannie to high-quality mortgages. So that would be better than coming up with something new. That would be less frightening. But I still think——

Senator SHELBY. It would be a lot less risk to the taxpayer, too, wouldn't it?

Mr. KLING. Certainly. Certainly less risk to the taxpayer. Just to keep them as they are would be less risky. Still, my preferred approach would be to phase them out and let the private market develop, and it might not necessarily be a secondary mortgage market, a TBA market. It might be banks lending the way they used to lend, and, you know, although that would be a problem for some of the people in this room, I do not think it would be a problem for the American taxpayer or the American homeowner.

Senator SHELBY. Thank you.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thanks again to our witnesses for being here today. It is essential that we create a stable, sustainable housing market for American families. There are several additional proposals and certainly many opinions regarding the changes that need to be made. I look forward to discussing those further as the Committee continues to consider the future of the housing finance system.

This hearing is adjourned.

[Whereupon, at 11:30 a.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF MICHAEL D. BERMAN

CHAIRMAN, MORTGAGE BANKERS ASSOCIATION

MARCH 29, 2011

Introduction

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify on behalf of the Mortgage Bankers Association (MBA).[1] My name is Michael D. Berman, CMB, and I am the current Chairman of MBA. I have been in the real estate finance industry for over 25 years and am a founder and member of the Board of Managers of CW Financial Services. I also serve as President and Chief Executive Officer of CW Capital. Headquartered in Needham, Massachusetts, CW Capital is one of the top 10 lenders to the multifamily real estate industry, with $3 billion in annual production and over 150 employees in 12 offices throughout the country. My responsibilities include overseeing the strategic planning and operations for all of the company's loan programs, including multifamily programs with Fannie Mae, Freddie Mac, and the Federal Housing Administration (FHA). CW Capital has been active in the commercial mortgage-backed securities (CMBS) arena as an investor, lender, primary servicer and issuer of securities. Additionally, CW Capital is a special servicer of approximately 20 percent of the CMBS market.

Today's hearing is on the very important issue of housing finance reform. Exactly 1 year and 6 days ago I testified on this very topic before your colleagues on the House Financial Services Committee. Much has changed during those past 12 months.

On the legislative front, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). While it is too early to assess the full impact of this legislation, the financial services industry already has been directing considerable resources toward preparing for the avalanche of new implementing regulations on the horizon. Congress and the Administration have voiced a desire for private capital to return to the mortgage market. However, we must be clear that several pending regulatory actions have the potential to increase the cost and decrease the availability of credit to many potential borrowers, as these regulatory actions may drive private capital away from the market, directly contrary to the stated intent.

On the economic front, data in recent months have been stronger than anticipated, with personal consumption expenditures and business spending propelling the current pace of economic recovery. The job market continues to improve, at a disappointing pace, and housing markets remain weak, but we are beginning to turn the corner with respect to mortgage performance.

We also note that the Obama administration recently issued a report to Congress on reforming America's housing finance market. The report, issued by the Departments of Treasury (Treasury) and Housing and Urban Development (HUD), renewed its commitment to affordable rental housing and laid out three potential ways to structure Government support in a housing finance market. There are positive aspects of each of the Administration's three options, and, in fact, we believe that our proposal is aligned in part with the Administration's thinking. I will briefly touch on other key points about the report later in my testimony.

While much has changed in the past year, much remains the same. For example private capital still has not sufficiently returned to the mortgage market, leaving the Federal Government to backstop some 90 percent of all home mortgage loans. Nearly half of the new home loans for home purchase are guaranteed by the FHA, the Department of Veterans Affairs (VA), or the Department of Agriculture's Rural Housing Services (USDA) programs. Almost all other home mortgage loans and most mortgage refinancings are financed through Fannie Mae and Freddie Mac, both of which are in Government conservatorship. Fannie Mae and Freddie Mac also now purchase more than half of all multifamily mortgages, loans to owners, and

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, DC, the association works to ensure the continued strength of the Nation's residential and commercial real estate markets; to expand home ownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: *www.mortgagebankers.org.*

developers of rental residential properties. Because of the current difficulty of attracting investors, only a handful of boutique private label securitization transactions have taken place during the past 3 years, with ultra-low risk loan characteristics such as very low loan-to-value ratios. The investment community anticipates only three or four more transactions in the year ahead. This situation is as undesirable as it is unsustainable.

MBA continues to identify the key components and optimal structure of a safe, stable and liquid housing finance system for the long-term. I have the privilege of chairing the "Council on Ensuring Mortgage Liquidity" that has been charged by MBA to undertake this initiative. The council's approach has been to examine the issues so that stakeholders can assess options in a measured, thoughtful manner. My fellow council members also are industry practitioners who understand the capital markets and have perspective on what will and will not work. Therefore, the council's recommendations are grounded in pragmatism.

We knew in setting up the council that the policy winds would shift with economic circumstances. Therefore, we continue to refine our recommendations in the context of current events.

Before I go into the specifics of MBA's recommendations, I would like to explain the basic tenets of housing policy that guided the council's work. We believe that housing policy begins with the premise that shelter, like food, is a basic human need. As such, a good and just society ensures that all of its citizens are able to attain at least a minimum standard in terms of their housing, and many families are able to do much more, achieving the American Dream of owning a home. U.S. housing policy, developed over decades, has consistently highlighted these objectives. These include:

- Bringing stability and affordability to the single- and multifamily mortgage finance markets (through Fannie Mae, Freddie Mac, Ginnie Mae, and the Federal Home Loan Bank System);
- Promoting home ownership (through FHA, VA, USDA, the mortgage interest deduction and down payment assistance programs);
- Providing consumer protections to homebuyers and renters (through fair housing, truth in lending and other regulatory efforts);
- Providing subsidies to fill gaps between low-income households' incomes and market rents (through project- and tenant-based Section 8 and other programs); and
- Supporting and promoting the development and preservation of affordable single- and multifamily housing (through HUD and other subsidy and grant programs).

All of these efforts are vitally important, and all are necessary to maintain a housing market that provides safe, decent and affordable housing to the American public. In the wake of the recent crisis, policy makers may choose to re-order or change the emphasis of these priorities to some extent. However everyone would agree they are all important. MBA's recommendations are designed to further this policy in a safe, sound, and efficient manner.

The MBA Proposal

MBA's recommendations were first issued in September 2009, in a document titled "Recommendations for the Future Government Role in the Core Secondary Mortgage Market." (*See, www.mortgagebankers.org/advocacy/issuepapers/ceml.htm.*) These recommendations established a foundation for the current debate and have been integrated in many of the proposals that have since come forward, including the Administration's.

Key Principles and Components

Three principles lie at the heart of MBA's recommendations. First, secondary mortgage market transactions should be funded with private capital. Second, the importance of housing, whether owner-occupied or rental, in the U.S. economic and social fabric warrants a Federal Government role in promoting liquidity and stability in the mortgage market. This role should be in the form of an explicit credit guarantee on a class of MBS, and the guarantee should be paid for through risk-based fees. Third, taxpayers and the system itself should be protected through limits on the mortgage products covered, limitations on the types of activities undertaken, strong risk-based capital requirements, and actuarially fair payments into a Federal insurance fund.

The financial crisis proved that some form of Government support is required to keep the mortgage market open during times of distress. The current dearth of activity outside of the existing Government-supported liquidity channels exemplifies the risk averse nature of private capital. More importantly, even in good times, investors will remember the experiences of the recent crisis. If they doubt their ability to sell mortgages during a crisis, they will be less apt to buy them outside of a crisis.

However, the size and scope of the U.S. housing market mean that, except in times of extreme duress, the Federal Government's secondary market role should be to promote liquidity for investor purchases of MBS, not to attempt to provide the capital for or absorb the risks itself.

A guarantee that aims to protect the entire market will be both less effective and less efficient than targeted support for the core of the market, those products that regulators determine should be available to borrowers at all times.

The centerpiece of MBA's recommendation for Federal support for the secondary mortgage market is a new line of MBS. Each security will have two components: (a) private, loan-level guarantees from privately owned, Government-chartered and regulated mortgage credit-guarantor entities (MCGEs) which will in turn be backed by (b) a security-level, Federal Government-guarantee (GG) "wrap." The Government guarantee will be conceptually similar to that provided by Ginnie Mae by guaranteeing timely interest and principal payments to bondholders and explicitly carrying the full faith and credit of the U.S. Government.

Investors in the guaranteed MBS would face no credit risk, but would take on the interest-rate risk from the underlying mortgages. In supporting their loan-level guarantees, the MCGEs would rely on their own capital base as well as risk-retention from originators, issuers and other secondary market entities such as mortgage insurers. Only in the event of a failure of a MCGE would the Government guarantee come into play. Before taxpayers were called upon to support the guarantee, a Federal insurance fund, capitalized by risk-based fees charged on the supported securities would be next in line. Only in the event that the insurance fund ran dry would there be a call on taxpayer resources. The fund would be capitalized so that this would be an extremely unlikely event, and could likely include provisions to have future MCGEs repay the taxpayers over time as well.

Mortgage Credit Guarantor Entities (MCGEs)

The MCGEs will be privately owned, mono-line institutions focused solely on the mortgage credit guarantee and securitization business. This business encompasses both single-family and multifamily residential mortgages. The loan-level MCGE guarantee would be backed by private capital held by the MCGEs which would be overseen by a strong regulator.

The MCGEs will be required to manage their credit risk by using risk-based pricing, originator retention of risk (such as reps and warrants backed by sufficient capital to support them), private mortgage insurance (PMI) and risk transfer mechanisms including other risk-sharing arrangements, to ensure that there is a strong capital buffer before the GG and insurance fund would come into play. Loans would not be included in a GG security unless they were guaranteed by a MCGE.

In most cases the MCGEs will own the loans underlying the GG securities they issue, and in the event of foreclosure could own the real estate collateral. The MCGEs will have standard corporate powers to raise debt and equity. Other than access to the related GG security they could issue, none of the corporate debt or equity the MCGEs issue would be guaranteed, either explicitly or implicitly, by the Federal Government. The MCGEs must be sufficiently capitalized to weather all but the most extreme credit events, and should report regularly to the satisfaction of the GG, Treasury, and the MCGEs' regulator.

Because the key mission of the MCGEs will be to guarantee and securitize mortgages through the program described, their portfolio holdings of mortgage assets would be limited to *de minimis* levels. Their portfolios would only be used to (a) aggregate allowable mortgages for securitization, (b) hold REO properties prior to disposition, and manage loss mitigation through foreclosure, modifications and other activities, (c) incubate mortgages that may need seasoning prior to securitization, (d) develop new mortgage products through a strictly limited level of research and development prior to the development of a full-fledged securitization market, and (e) fund highly structured multifamily mortgages that are not conducive to securitization.

The number of MCGEs should be based on the goals of (a) competition, (b) strong and effective regulatory oversight, (c) efficiency and scale, (d) standardization, (e) security volume and liquidity, (f) ensuring no one MCGE becomes "too big to fail," and (g) the transition from the current Government sponsored entity (GSE) framework. Initially, we would expect the number of MCGEs to be two or three. The regulator would have the ability to increase that number, through the granting of charters, as the market develops. Intense competition along a number of dimensions would benefit borrowers and the market as a whole. The market would also benefit from standardization of the mortgage-backed security (MBS) structure so that investors can easily compare security offerings across MCGEs.

The existing system extended an implied Federal backing to all the activities of Fannie Mae and Freddie Mac, including not only their mortgage guarantees, but also their portfolio investments, derivative counterparties and corporate bondholders. Some of those activities were clearly allocated insufficient capital, underpriced and under-supervised. In our proposal, the extent of Federal backing would be greatly constrained, making explicit what is guaranteed and what is not, and establishing mechanisms to properly capitalize, price and supervise those activities.

It is important to reiterate that while the MBS in this model would be guaranteed by the Government, the MCGEs as institutions would not be. The corporate debt and equity issued by the MCGEs would be purely private. As with other firms, investors in MCGE equity and debt would accept the potential risk of failure and loss. For this reason, the MBA proposal recommends regulators charter enough MCGEs to establish a truly competitive secondary market, and to overcome issues associated with "too big to fail."

Government Guaranteed "Wrap"

The Government guaranteed MBS issued by the MCGEs would carry a guarantee of timely interest and principal payments, would explicitly carry the full faith and credit of the U.S. Government and would be supported by a Federal insurance fund, funded by risk-based fees charged for the securities at issuance and on an ongoing basis. Due to similarities in responsibilities and likely structure, Ginnie Mae could potentially take on the responsibilities of the GG.

The GG would be responsible for standardization of mortgage products, indentures and mortgage documentation for the core mortgage market. Minimum regulated fees would be established for ongoing servicing, surveillance and reporting. This would ensure standardization and liquidity throughout the core market. Each MCGE would individually issue GG securities under this standardized regime. These securities would carry the GG security-level guarantee backed by the MCGE loan-level guarantee; accordingly, the MCGEs will have approved and insured the underlying collateral.

The mission of any federally related mortgage securitization and guarantee program should be explicitly limited to ensuring liquidity in the core mortgage market through the issuance and guarantee of MBS. This important mission should not be distorted by additional public or social housing policy goals. To the degree additional objectives and housing policies are desired, they should be pursued through FHA, VA, USDA, Ginnie Mae and direct Federal tax and spending programs, which should be adequately funded and supported to meet these important objectives. Potentially, a surcharge could be placed on the insurance premiums to accumulate an affordable housing fund. This surcharge should be tracked separately to ensure that the insurance fund is actuarially sound.

While the full faith and credit of the U.S. Government should mean there will not be a need for a liquidity backstop, in times of extreme market distress liquidity could be provided to the GG securities market through Treasury and/or Federal Reserve purchases of GG mortgage securities. As a result, there would be no need for the MCGEs' portfolios to take on the role of "liquidity providers of last resort."

Reform Recommendations of the Administration

As was mentioned above, the housing finance reforms issued by Treasury and HUD included three possible restructuring options. The Administration's first option would limit the Government's role almost exclusively to the existing targeted assistance initiatives of FHA, VA, and USDA. The overwhelming majority of mortgages would be financed by lenders and investors and would not benefit from a Government guarantee.

In the second option, targeted assistance through FHA and other initiatives would be complemented by a Government backstop designed only to promote stability and access to mortgage credit in times of market stress. The Government backstop would have a minimal presence in the market under normal economic conditions, but would scale up to help fund mortgages if private capital became unavailable in times of crisis.

Compared to the first and second options, the third option creates a broader role for the Government in ensuring stability in times of market stress. Alongside the FHA and targeted assistance initiatives, the Government would provide reinsurance for certain securities that would be backed by high-quality mortgages. These securities would be guaranteed by closely regulated private companies under stringent capital standards and strict oversight, and reinsured by the Government. The Government would charge the MCGEs a premium to cover future claims and would not pay claims until private guarantors are wiped out.

MBA believes there are positive aspects of each of the Administration's options. For example, as in option one we place a high value on having private capital bear most of the risk. As in option two we think the MCGE channel will naturally decline during good times, and expand during crises. In terms of form and function, option three closely resembles MBA's recommendations.

Other Liquidity Channels

No formula for restructuring the housing finance system is complete unless other private and public liquidity channels are factored into the equation. In MBA's recommendation, there would continue to be key roles for the fully private market, as well as for FHA, VA, USDA, and Ginnie Mae and the Federal Home Loan Banks, particularly as such roles evolve in support of public or social housing policy goals and objectives. MBA's MCGE framework is not intended to be the entire market. It is meant to focus on a narrowly defined set of core mortgage products that should be available in all market conditions.

We also believe it is appropriate to consider additional means of funding for mortgage credit as a part of the broader reform process, including potentially developing a legislative framework for a covered bond market. We will work with Congress to explore opportunities in this area.

Loan Characteristics

One issue that arises frequently during the housing finance reform debate is the question of the availability and pricing of long-term, fixed-rate financing. For decades, the 30-year, fixed-rate mortgage has allowed families to budget their finances and safely build wealth. In evaluating the options for a future housing finance system, we should consider carefully the implications of such options on the availability and pricing of those mortgages.

Homeowners in the U.S. have come to view the 30-year, fixed-rate, self-amortizing, prepayable mortgage as the product standard. Payments are predictable and borrowers are protected from fluctuations in interest rates. From the borrower's perspective, it is the simplest mortgage product available. If rates rise, payments are unchanged. If rates decline, borrowers typically have the option to refinance at no explicit cost.

Although thought of as consumer friendly, from the standpoint of an investor, the 30-year, fixed-rate, self-amortizing, prepayable mortgage is actually a very complex product. Borrowers refinance when rates drop, transforming a loan with a nominal 30-year maturity to a short-term instrument. When rates increase, refinances disappear, extending the expected life of the loan. Banks and thrifts that fund themselves with deposits are not natural holders of 30-year, fixed-rate, prepayable loans, because they would inevitably be borrowing short and lending long. With the beginning of the U.S. MBS market in the early 1970s, it was discovered that investors were willing to bear the prepayment risk associated with these loans, so long as they were protected from the credit risk. From that point to today, with a few exceptions, most investors either did not have the capacity or the willingness to take on the credit risk, particularly given the uncertainty involved with systemic credit events such as the one we just lived through.

The appeal of the 30-year fixed-rate mortgage in the U.S. is also a result of the role the GSEs play in the "To-Be-Announced" (TBA) market. As the name suggests, the defining feature of a TBA trade is that the underlying mortgage loans have not been identified and may not even have been originated on the trade date. Instead, participants agree only on a defined set of parameters of the securities to be delivered. This contrasts sharply with private-label MBS, whose loans must be originated before trading. The TBA market also significantly lowers the transaction costs associated with originating, servicing, and refinancing a mortgage. In addition, the TBA market provides an efficient way for lenders to hedge the interest rate risk involved in offering borrowers the ability to lock-in a rate for 30 days while closing on a mortgage. TBA prices, which are publicly observable, also serve as the basis for pricing and hedging a variety of mortgages that are not TBA-eligible, such as high-balance (*i.e.,* "jumbo") loans not eligible to be purchased by the GSEs. TBA trading is thus a key link between the primary and secondary mortgage market and constitutes a major difference from nonagency or private-label MBS.

It is also notable that long-term fixed-rate mortgages are unusual elsewhere in the world. A key reason for the distinctions in products between countries is differences in funding. Deposit funding dominates in most countries, while the U.S. is unique in terms of the importance of securitization. Over 60 percent of U.S. residential mortgages have been securitized. The next closest countries are Canada, Spain, and the United Kingdom with 24 to 28 percent securitized. Therefore, in order to maintain the availability and affordability of the 30-year, fixed-rate mortgage, the U.S. needs a vibrant secondary market where investors can focus on and manage interest rate and prepayment risks, while being shielded from the uncertainties surrounding mortgage credit risk.

MBA's recommendations take care to ensure that capital is available to creditworthy borrowers in all communities. We believe formal establishment of the core residential mortgage market will set a benchmark for consumers, underwriters, investors, and others. For consumers, the presence of well-defined core mortgage products will provide a standard against which other products can be assessed. The core market will also provide considerable stability, ensuring that mortgage products of a known type will be available in all market conditions. For underwriters, the characteristics of the "well-documented, well-understood" mortgages of the core market will provide a known base for modeling and pricing risk. Variations would be considered a part of the non- core market and would operate outside of any taxpayer backstop. For investors, the core market will establish performance and pricing standards for use in GG MBS investing, and against which other investment options can be judged.

It also must be remembered that the mortgage market and the GSEs support the financing of both single-family and multifamily properties, and that both serve important roles in housing our Nation. MBA's recommendations are geared to both parts of the market. The same structure, rationales, and tenets apply to the Federal role in the core single-family and multifamily secondary mortgage markets. Even though the multifamily market had much lower default rates and stronger performance than the single-family ownership market during the recent downturn, it is also subject to liquidity crises.

Transition

Both MBA and the Administration's recommendations recognize the importance of careful execution during the transition from the current to the future state of the housing finance system. The Administration's report included actions that can be taken now to reduce the Government's role and taxpayer exposure in the market. For example, they advocate for gradually increasing guarantee pricing at Fannie Mae and Freddie Mac, reducing conforming loan limits, and increasing down payment requirements. The Administration also plans to continue winding down Fannie Mae and Freddie Mac's investment portfolios.

While these actions may prove to be effective levers for adjusting the mixture of private capital and Government support, it is very important that any action take place in a careful and deliberate manner. Ignoring the consequences of interim actions and the pace of economic recovery could shock a still-fragile housing market, severely constrain mortgage credit for American families, and expose taxpayers to unnecessary losses on loans the institutions already guarantee. During the transition, it is also important that the operations of Fannie Mae and Freddie Mac continue to serve the market and the American people, including retaining the human capital necessary to effectively run both institutions.

While a gradual transition to the new housing finance may be desirable, there are strong reasons to lay out a clearly defined future for mortgage finance as soon as possible. The uncertainty over the future policy environment is likely deterring the recovery by inhibiting the ability of businesses and investors to plan and move forward.

The longer the uncertainty persists, the more difficult it becomes to retain and/or recruit personnel with the necessary skill sets to execute financing. Both the multifamily and single-family markets are vulnerable in this regard.

Regulators also should proceed with caution as they continue to implement the Dodd-Frank Act. One of our concerns is that the magnitude and scope of reforms poses challenges from a coordination standpoint. The scope of the Dodd-Frank Act's new consumer protections, underwriting provisions, risk retention requirements, disclosure, liability and operational requirements is profound. Adding secondary mortgage market reforms to this equation will require the highest degree of care and coordination.

One aspect of Dodd-Frank in particular that merits attention is the risk retention provision, including its exemption for qualified residential mortgages (QRM) and framework for commercial real estate MBS. The QRM is likely to shape housing finance for the foreseeable future and may even serve as a precursor for what the future GSE is likely to be eligible to securitize. An overly restrictive QRM definition that does not heed the Congressional intent will displace a large portion of potential homebuyers, which in turn will slow economic growth and hamper job creation.

MBA believes Congress can play a role in the transition by encouraging regulators to formulate a strategic theme to guide their actions going forward. For example, before attempting to attract private capital back to the housing finance market by increasing Fannie Mae and Freddie Mac's guarantee fee, regulators should consider the extent to which risk retention rules may drive private capital away from the market.

A narrowly defined Government role of guaranteeing credit risk at an actuarially fair price promotes liquidity and limits volatility in the secondary mortgage market, which makes it easier for homebuyers to obtain mortgages during normal economic times and mitigates the risk and consequences of volatility in the housing market and financial markets. This assumes that the Government can accurately assess what is an actuarially fair price. Mispricing the wrap premium by either over- or under-charging for the wrap has costs.

Pricing risk is difficult for both the private sector and the Government. However, it is less difficult now than it was 5 years ago. At that time rating agencies and investors looked to "stress events" for which there were incomplete data and different market practices. Having just experienced the worst real estate downturn since the Depression, we now have vast amounts of data that can provide the basis for more robust and accurate risk pricing models.

Experience has also shown that Governments intervene to protect depositors and prevent housing market collapses. Knowing this, MBA believes taxpayers are better served by clearly defining the boundaries of such intervention and collecting revenues up front rather than paying a lump sum *ex post facto.*

Conclusion

It is time to commit to a future housing finance system for the United States. The Administration, Congress, and the private sector share a responsibility to work together to build a stronger and more balanced system of housing finance. MBA looks forward to working closely with the Committee on this issue in the weeks and months ahead. Thank you again for the opportunity to appear before the Committee today. As MBA's deliberations on these topics continue, we would welcome the opportunity to come back and update you on our work.

PREPARED STATEMENT OF ARNOLD KLING

PH.D. MEMBER, MERCATUS CENTER FINANCIAL MARKETS WORKING GROUP, GEORGE MASON UNIVERSITY

MARCH 29, 2011

Thank you, Chairman Johnson and Ranking Member Shelby, for inviting me to testify at the hearing today on the future of the housing finance system.

My testimony can be summed up in three words: Just Say No.

The time has come to say no to the mortgage lobby. Send them home empty-handed. Let ordinary Americans win one for a change.

A coalition of real estate agents, Wall Street investment firms, mortgage bankers, community activist groups, and others spent the last 40 years lobbying to protect and expand subsidies for mortgage credit. They usually got what they wanted. And what did the American public get? We got a housing bubble, a financial crisis, a bailout, a recession, and millions of homeowners drowning in debt.

That shameless coalition is back again, insisting that Government must provide a guarantee in the mortgage market. Just say no.

This country is in a mess today because mortgage borrowing and mortgage lending were carried to excess. Given what we have just experienced, one would think that proposing a new Government guarantee to prop up the mortgage industry would be considered totally inappropriate. If a mob of people had gone through the town on a drunken rampage, committing reckless acts of vandalism, would the city officials be focused on trying to restock the bars?

There is a way to guarantee reliability of mortgages that does not require a Government agency. The solution is for most borrowers to make down payments of 20 percent, which was typical before the madness of the last two decades. Stop making so many loans where the down payment is just 2 percent (or less). At the risk of oversimplifying slightly, I would say that a loan with a 20 percent down payment is a good loan, and a loan with a 2 percent down payment is a bad loan. With good loans, the mortgage market does not need a Government guarantee. With bad loans, a guarantee can only come to grief.

What should we say to someone who wants to buy a $200,000 house but has only $5,000 saved up? In most cases, we should say the same thing we would say if they wanted $200,000 in poker chips in Las Vegas or $200,000 worth of stock. We should just say no.

If it is in the public interest for more people to own their homes, then I would suggest coming up with policies that expand home ownership, rather than mortgage indebtedness. We should try to come up with programs that encourage people to save for down payments, rather than encouraging them to take on too much debt. Instead of trying to ensure that everyone has access to the mortgage equivalent of cheap alcohol, we should be helping people to drink less.

Does the Government need to support the rental market? Then provide more generous housing vouchers to renters, rather than handing out subsidies that encourage indebtedness among landlords. Landlords, too, should have significant equity in their properties. Otherwise, at the first sign of trouble they will stop maintaining their buildings, allowing them to fall into disrepair and adversely impacting their tenants.

These days, it seems as if everyone in Washington has a blueprint for restructuring the mortgage industry around some newly created institution or Government guarantee program. Just say no.

This is the time of year when college basketball is on everyone's mind. Imagine what would happen if during a game, a team were to go through a streak of terrible shot selection, falling way behind and leading the coach to call time out. A normal coach would say, "Settle down. Take the shots you know how to make, and stay away from low-percentage shots." If instead he were a Washington policy wonk, he would say, "We need to restructure the whole team. No more two guards, two forwards, and a center. From now on we are going to use a bishop, three pawns, and a rook. Refer to the diagrams in this memo."

The mortgage industry equivalent of bad shot selection is bad loans. If the mortgage industry stops making bad loans, then Washington does not need to come in with a new playbook and a new set of roles that people have to learn to play. With good loans, the mortgage finance business will take care of itself.

The most urgent need for housing finance policy today is to ration the use of Government-subsidized mortgage credit, which right now is excessive and out of control. I hope that as soon as tomorrow, Congress will enact legislation that narrows Government support to the single purpose of helping people purchase homes for their own use. Such legislation would prohibit Freddie Mac, Fannie Mae, and FHA from offering any support for loans to non- owner-occupied home borrowers, for cash-out refinances, for nonamortizing loan products, and for any other mortgage that fails to fulfill the purpose of helping households build up equity in their places of residence.

These immediate steps should be followed by legislation that reduces the maximum loan amount eligible for purchase by, say, 25 percent each year. Loan limits for the agencies will permit private lenders to reenter the market. Once we create a playing field in which private lenders have a chance to compete, we can reassess the need for further Government intervention. My prediction is that we will find that the private sector is fully capable of taking care of the mortgage needs of real homebuyers. But in any event, we do not have to make that determination until we give the market a chance.

As we reduce the role of Government agencies, we can monitor the behavior of the private sector and adapt our policies accordingly. If the private sector goes back to making bad loans, which I doubt will happen, we can regulate to stop that. If the private sector leaves gaps in accessibility to good housing, we can enact programs to address that. Those programs might consist of assistance targeted at specific needs, rather than generic subsidies to the mortgage industry.

I understand why various interest groups want to have a Government guarantee for mortgages. Without a guarantee, it is possible that the secondary mortgage market will decline in importance or perhaps even disappear altogether. We might see the market revert to old-fashioned mortgage lending, where the bank keeps your loan until you finish paying it off.[1] I think that homeowners could live with that. I understand that it would be hard on the mortgage bankers, the Wall Street firms, the rating agencies, and the other special interests that count on the Government to prop up the secondary market.

Just say no.

[1] Arnold Kling, "Two Approaches to GSE Reform" (working paper no. 11-07, Mercatus Center at George Mason University, March 2011), *http://mercatus.org/sites/default/files/publication/wp1107-two-approaches-to-gse-reform__0.pdf.*

APPENDIX: CHARGING FOR RISK

Some proposals for a Government guarantee envision charging a fee to private institutions that take advantage of the guarantee. This is much easier to do than it sounds.

If the same fee were charged, regardless of mortgage characteristics, it would make the institutions that use the guarantee relatively less competitive in the market for low-risk loans and relatively more competitive in the market for high-risk loans. Thus, charging for the guarantee could very well have the perverse effect of encouraging institutions to take more risk.

In theory, the solution is for the Government to charge a variable guarantee fee, one which is higher for loans with riskier characteristics. The agency administering the fee would develop "risk buckets" and charge different fees for loans in different buckets.

However, even risk buckets can be manipulated in what is known as "regulatory arbitrage." Many of the fancy new financial vehicles created in the decade leading up to the financial crisis were introduced in order to get high-risk assets reclassified into low-risk buckets. See my paper, *Not What They Had in Mind: A History of Policies That Produced the Financial Crisis.* [2]

[2] Arnold Kling, "Not What They Had in Mind: A History of Policies That Produced the Financial Crisis of 2008" (Arlington, VA: Mercatus Center at George Mason University, 2009), *http://mercatus.org/sites/default/files/publication/NotWhatTheyHadInMind%281%29.pdf.*

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WORKING PAPER

TWO APPROACHES TO GSE REFORM

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TWO APPROACHES TO GSE REFORM

Arnold Kling

INTRODUCTION AND SUMMARY

In this paper, I offer two alternatives to reforming Freddie Mac and Fannie Mae, the government-sponsored enterprises (GSEs). One approach is to restore the *status quo ante*, meaning that Freddie Mac and Fannie Mae would be returned to the investing public as private corporations with government backing, able to purchase loans for securities and able to hold securities in portfolio, subject to limits on loan amounts and subject to safety-and-soundness regulation. I call this the "devil you know" strategy, because I believe it would be safer than trying to create a new form of government-guaranteed mortgage system. The other approach would be for the government to get out of the mortgage-guarantee business, and to let the mortgage market evolve in a decentralized way, I call this the "Jimmy Stewart banker" strategy, because my expectation is that it would return mortgage lending to local banks, which would retain the loans that they originate.

The "devil you know" approach of reviving the GSE model has a number of advantages. It would ensure the survival of the 30-year fixed-rate mortgage. It would take advantage of the substantial organizational capital that the GSEs have accumulated with respect to standardizing mortgage lending, managing credit and interest-rate risk, and using computer technology to handle complexity and achieve reliability. In addition, there is a regulatory model for the GSEs, based on stress testing, that is very robust: it only failed because political leaders imposed other priorities on the GSEs that were in conflict with safety and soundness. With the lessons learned so painfully in the recent crisis, this regulatory model can be solidified.

Any attempt to reengineer a housing-finance system with a new set of government-guaranteed entities would entail all of the risks of restoring the existing GSEs, plus more. The taxpayers would be exposed to similar potential hazards, but with new and inexperienced organizations engaged at the level of enterprise management and regulatory oversight.

The "Jimmy Stewart banker" approach has the advantage of reducing the involvement of the federal government in the mortgage market. It likely would lead to a more decentralized mortgage-finance system, with a much smaller role for Wall Street, thus reviving an American tradition of smaller, independent financial institutions. It would create a playing field that is not dominated by gigantic, government-advantaged firms. It would offer politicians less opportunity to impose priorities on the mortgage-lending process that produce instability and hazard. It would not set up a game in which GSE shareholders have an interest in seeking out high-risk, high-return strategies that conflict with the public interest.

In the next section of this paper, I discuss public policy objectives that pertain to housing and the GSEs. Then, I describe the "devil you know" approach of restoring the GSEs with an improved regulatory structure. After that, I describe the "Jimmy Stewart banker" approach, in which mortgage lending might revert to an originate-and-hold model, rather than rely on securitization. In the conclusion, I explain why this latter approach may be preferable.

PUBLIC POLICY OBJECTIVES

In my opinion, the key to successful reform in housing finance is clarifying the public policy objectives. Vague and contradictory objectives played a large role in the catastrophe that befell Freddie Mac and Fannie Mae. In particular, the phrase "affordable housing" is gauzy and imprecise, and this creates a dysfunctional tension between public and private objectives.

Former Treasury Secretary Lawrence Summers expressed the frustration of dealing with this lack of clarity:

> What went wrong? The illusion that the companies were doing virtuous work made it impossible to build a political case for serious regulation. When there were social failures the companies always blamed their need to perform for the shareholders. When there were business failures it was always the result of their social obligations. Government budget discipline was not appropriate because it was always emphasized that they were

> "private companies." But market discipline was nearly nonexistent given the general perception—now validated—that their debt was government backed. Little wonder with gains privatized and losses socialized that the enterprises have gambled their way into financial catastrophe.[1]

The lack of clear public policy objectives created an opening for the executives of Fannie Mae and Freddie Mac were able to steamroller those from the private sector or in Washington who might attempt to get in the way.[2]

Rather than employing the vague term "affordable housing," policy makers should articulate clear objectives with respect to the mortgage market. The issues include the extent to which government should subsidize mortgage credit, goals for the distribution of mortgage credit, and goals for shaping the types of loans available in the market.

Policy makers have wanted to encourage home ownership. There is a belief that owners create stable communities where properties are well maintained. There is a concern that renting is associated with transience and property depreciation. In addition, home ownership can promote thrift. As mortgage loans amortize and as house prices increase, home owners accumulate an asset in the form of home equity. (Note that with a fixed-rate, level-payment mortgage, equity accumulates as long as house prices rise, even if they rise more slowly than the overall rate of inflation.)

In practice, pursuit of these goals through mortgage policy has been inefficient and even counterproductive. Subsidized mortgage credit helps to drive up home prices, so that the effect on the home ownership is attenuated, as higher prices put homes out of reach for the marginal household. In recent years , the frenzy of mortgage lending fueled speculative purchases, with 15 percent of mortgage loans going for owners who were not occupants of the houses that they were financing.[3] Moreover, the goal of encouraging thrift and the accumulation of assets was undermined by the proliferation of lending with loan down payments, exotic mortgage instruments in which principal is not reduced over time, cash-out refinancing, and second mortgages.

The issue of the distribution of mortgage credit caused much confusion. The GSEs were given quotas with respect to the income of borrowers, and those quotas were used in part to justify a foray into risky lending activities. As the housing bubble inflated, the quotas were raised, forcing the GSEs to acquire more mortgages from low-income borrowers even as the ratio of median house price to median income was rising.

Another reason that the GSEs undertook risky activities is that they were "following the market." If they are going to serve a public policy purpose of shaping the types of mortgage loans, then they should be holding fast to principles of responsible lending, rather than following fashions.

Overall, the involvement of the GSEs in mortgage finance was totally out of proportion relative to the limited public policy objectives that are reasonable. They were financial behemoths and political giants, but the social goals for housing

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1 Lawrence Summers, "You Want Creative Capitalism? Try This," in Michael Kinsley, ed., *Creative Capitalism: A Conversation with Bill Gates, Warren Buffett, and Other Economic Leaders* . N.Y., NY: Simon and Schuster, 2008. p. 196.

2 See the anecdotes in Bethany McLean and Joe Nocera, *All The Devils are Here*. N.Y., NY: Portfolio/Penguiin, 2010. For example, on p. 17,

> How did Fannie Mae persuade Pierce to rule in its favor? Not be sweet-talking, that's for sure; Maxwell had an iron fist inside that velvet glove of his. "We essentially gutted some of HUD's control over us in a bill that passed the House housing subcommittee," Maloni says today. In that bill, HUD's ability to approve new programs was revoked. HUD went to Fannie, and essentially pleaded for mercy. "In return for asking the Congress to drop the provision, HUD approved Fannie as issuers," says Maloni.

> Maloni also called Lou Nevins and told him that if Salomon didn't back off, Fannie wouldn't do business with the bank anymore... This was a major threat. "It's like the post office saying we won't deliver your mail!" Nevins says. He remembers thinking to himself, "If they get away with this, there won't be a private company in the world that will stand up to them."

3 See Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, "The 2006 HMDA Data," *Federal Reserve Bulletin*, December 2007, pp. A73-A109.

policy were poorly addressed and the ultimate risks borne by taxpayers cannot be justified.

Going forward, I would recommend clarifying objectives in the following ways:

Public policy should not seek to encourage mortgage borrowing as a means for promoting home ownership. Instead, home ownership should be presumed to embody a significant down payment (10 percent or more) and the gradual accumulation of equity. We should not encourage the dissipation of home equity through non-amortizing mortgage loans, cash-out refinancing, or second mortgages.

Public policy should not encourage lenient mortgage credit as a means for engaging in redistribution. Assistance for low-income households should consist of grants that are explicitly accounted for in the government budget.

To the extent that the government intervenes in the mortgage market, it should be selective in the products it supports, rather than subsidizing any and all forms of mortgage lending. In particular, we should consider limiting the subsidy to first mortgage loans for purchase of an owner-occupied home, with amortization that accumulates equity and a rate of interest that is fixed for five years or longer. The market may offer loans for refinancing, second mortgages, loans for non-owner-occupied homes, non-amortizing loans, and short-term adjustable-rate loans, but there is no reason for government-backed agencies to become involved in those activities.

If policy makers agree that government involvement in the mortgage market should be limited to the purpose of supporting the mortgage products that encourage the prudent accumulation of equity in homes, then it should be feasible to develop a mortgage finance strategy that is sound. On the other hand, if the government's objectives for the mortgage market remain broad and poorly specified, then any approach to reforming housing finance is likely to fail.

THE DEVIL YOU KNOW

Before we bury Freddie Mac and Fannie Mae, we should praise them. As tools for making capital available for mortgage lending, the GSEs are efficient. Mortgage rates in the market for loans eligible for sale to the GSEs were typically 0.25 to 0.50 percentage points below those on comparable loans in the "jumbo" market (for mortgage above the limit set for the GSEs by Congress). Although some of this difference may have been due to the perception of a government guarantee, it should be noted that banks and thrifts that can serve the "jumbo" market also have access to a government guarantee in the form of deposit insurance.

The GSEs' risk-management strategies and systems are very sophisticated, well-developed, and sound. These systems failed largely due to the pressure applied by political leaders to provide lenient, subsidized mortgage credit to fuel an unsustainable expansion of speculative home buying.

In order to be able to channel capital from around the world into loans to individual American households to buy homes, the GSEs had to create standards for mortgage underwriting and processing. This standardization is a success story.

Mortgage underwriting is subject to the classic statistical problem of type I and type II error. Type I error is the approval of a mortgage for a borrower who subsequently defaults. This error imposes a large cost on the borrower and the lender. Type II error is the failure to approve a mortgage for a borrower who would have repaid the loan as scheduled. Committing this error causes both the lender and the borrower to miss out on the opportunity for a mutually beneficial transaction.

Political leaders often seem unable to grasp these elementary concepts. Before the financial crisis, politicians complained about mortgage borrowers who were being turned down for loans. Implicitly, the politicians were unwilling to forgive type II errors. On the other hand, after the crisis, legislative language was proposed to forbid mortgage lenders from making loans to borrowers who could not repay, in effect trying to outlaw type I errors.

This political criticism is unwarranted and only served to exacerbate the housing cycle. During a boom, type I errors are forgiven by rising house prices that insulate lenders from risk, so that it is easy for politicians to complain that too many mortgage applicants are being turned down. On the other hand, in the wake of a crash, threatening to criminalize type I errors will take away lenders' willingness to absorb risk at the time when the market needs it most.

In fact, it is unrealistic to expect to eliminate either type of error completely. The practice of underwriting is an effort to try to cut down on both types of errors as much as possible.

Over the last several decades, the GSEs have continually improved the accuracy of underwriting decision-making, making it possible to commit fewer type II errors without adding to the risk of type I error. In addition, their promulgation of standards and automation technology has lowered the administrative costs involved in mortgage underwriting.

In addition to underwriting standards, GSEs have developed a number of risk management tools for addressing the moral hazard that is associated with the process of originating mortgage loans for sale to third parties. They implement quality-control audits of lenders who sell loans, and they require lenders to buy back loans that do not fall within underwriting perimeters or lack proper documentation. They set minimum capital standards for sellers in order to ensure that originators can in fact stand behind the loans that they sell. They issue guidelines and training manuals to foster compliance with standards.

The GSEs use risk-based pricing, loss reserving, and capital policies. This means that for loans with lower down payments or other characteristics that add to risk, higher interest rates are charged, more reserves are set aside to cover potential losses, and a larger capital base is maintained.

The capital base is calibrated to withstand a severe stress test. At one time, the stress test was patterned after the experience of collapsing home values during the Great Depression. Subsequently, the stress test was moderated to be patterned after large regional downturns in the post-war period.

Over the past decade, many critics of the GSEs warned that their large size and high leverage posed a risk to taxpayers. However, these critics tended to see interest-rate risk as the primary threat. Rather than sell mortgage securities to other institutions, the GSEs increasingly held securities in their own portfolios, financed by debt. This creates a risk of maturity mismatch. If the average duration of mortgage security assets in your portfolio is 20 years, and the average duration of your debt is 5 years, then rising interest rates can cause a significant loss in market value. Given the high ratio of assets to capital at these enterprises, the result could be catastrophic losses. This sort of loss plagued the savings-and-loan industry in the 1970s and early 1980s, and in fact Fannie Mae in that period suffered losses and may even have been technically bankrupt. (Freddie Mac in that period held a negligible portfolio.)

As it turns out, interest-rate risk was not a factor in the collapse of the GSEs. (They had to be bailed out because of credit losses.) In fact, they have developed effective mechanisms for adjusting their portfolios to remain hedged with respect to the level and volatility of interest rates. Their interest-rate positions also are subjected to severe stress tests (variation up or down in interest rates) in order to determine capital standards. This approach to managing interest-rate risk is as sound as one could hope for.

With all of these mechanisms in place, why did the GSEs absorb large losses, so that they had to be taken into conservatorship in 2008? Narrowly speaking, there appear to be two reasons. One reason is that their capital was overstated, because they counted as capital items, such as tax-loss carry-forwards, which did not constitute part of an asset base that could be absorb losses, which is the purpose of capital. Another reason is that as the GSEs strayed far from the investment-quality lending (meaning mortgages with significant down payments and other risk-reducing characteristics) that was their original charter, they failed to assess the impact of these higher-risk loans on capital needs under a stress scenario.

The agency that regulated the GSEs, known at the time as the Office of Federal Housing Enterprise Oversight (OFHEO), was derelict in executing its authority. Critics have correctly pointed out that OFHEO was structured as an arm of the Department of Housing and Urban Development (HUD), rather than the Department of the Treasury. HUD's primary mission is to promote better housing and expanded home ownership, and it was pressing the GSEs to meet affordable housing goals, which conflicted with the objective of maintaining safety and soundness.

In view of this past experience, the "devil you know" approach should consist of the following elements.

The plan should be to return the GSEs to shareholder-owned status. This probably requires wiping out existing shareholders, creating a "bad bank" to hold the securities backed by low-quality mortgages, and capitalizing the two enterprises with new initial public offerings.

Responsibility for regulatory oversight of the GSEs should be placed under the Department of the Treasury, with a mandate to focus solely on safety and soundness. The stress-test approach should be constantly improved. Above all, capital standards should be enforced, and only capital that can absorb losses should be counted.

The practice of assigning affordable housing goals to the GSEs should be abandoned. Instead of creating incentives for the GSEs to undertake risky lending, the mandate to purchase only investment-quality loans should be reiterated and strengthened.

The core mission of the GSEs should be to provide long-term, fixed-rate mortgage loans to clearly qualified borrowers, who make sizable down payments. A down payment of 20 percent (or 10 percent if supplemented with private mortgage insurance) was once standard, and ought to become standard again. More exotic mortgage instruments might be provided by fully private lenders, but the GSEs do not need to support that market. Public policy goals to expand home ownership should be pursued using explicit, on-budget subsidies, not through cross-subsidization mandated by quotas imposed on the GSEs.

The GSEs should continue to be able to hold portfolios and to manage interest-rate risk, subject to capital and regulatory requirements. However, Treasury should prevent and penalize any attempts by the GSEs to exploit their low borrowing costs by engaging in hedge-fund-like activities or other financial strategies that are not essential to the mortgage securities business.

To avoid a repeat of the current foreclosure mess and to ensure clear property records moving forward, an agency should be created to replace local property recording offices with a definitive, standardized national database. This is probably a good idea regardless of how the future of the GSEs is addressed, but it is particularly important if securitization is supposed to continue to play an important role in mortgage finance.

The main social benefit of this "devil you know" strategy is that it would help maintain a stable mortgage market, dominated by the 30-year, fixed-rate mortgage with a reasonable down payment. (I would argue that, prior to their foray into nontraditional mortgages, the GSEs *were* a stabilizing force in the mortgage market. That is why I believe that, if properly regulated, they could once again be a stabilizing force.) Given the adverse experience that the United States has had with other mortgage instruments, both in the Great Depression and in the recent period, this would provide comfort and reassurance. Note, however, that many other countries, including Canada, have achieved high rates of home ownership with shorter-term mortgage products.

Offsetting this benefit, there would be the risk that the GSEs would once again fail, imposing costs on taxpayers. However, such a risk is likely to exist under any arrangement in which the government tries to channel funds into mortgage lending to support the 30-year fixed-rate loan.

There are not many institutions or individuals willing to tie up funds for an uncertain period of up to 30 years. True, there are pension funds and insurance companies with a need for long-term assets. However, their appetite for 30-year mortgages is not likely to be sufficient to sustain a volume comparable to what was purchased by the GSEs. To be issued in large volume, 30-year mortgages must have a funding source that offers greater liquidity, meaning that the investor can get out of his or her position well before the 30-year final maturity date. That in turn requires funding instruments that are tradable. If the value of the underlying collateral and/or the viability of the institution must be assessed each time the instrument is traded, the resulting transaction costs will be prohibitively high. Thus, to make mortgage securities liquid, it is almost certain that a government guarantee will have to be inserted somewhere into the process.

If there is bound to be a government guarantee in any event, then the challenge of protecting taxpayers from risks is going to require a regulatory mechanism. Other mechanisms, such as the Basel international bank capital standards, or the systems used to safeguard the Federal Deposit Insurance Corporation or the Pension Benefit Guaranty Corporation, have not performed so well that they offer an attractive alternative. Other regulatory mechanisms are unproven.

In that regard, the GSE approach has a reasonable combination of theoretical justification and promising past performance. While it is true that the system cracked under extreme stresses and with the weakness of having regulatory oversight attenuated by its placement under HUD, if the lessons of this history are learned, then the taxpayer protections can be fairly robust. The shareholder-owned structure gives the GSEs an incentive to adopt internal controls in order to maintain franchise value. Having a focused regulator using capital requirements based on stress tests forces the shareholders to have sufficient "skin in the game" that management will pay close attention to risk.

It is worth pointing out that the taxpayers have not suffered from any failure of interest-rate risk management by the GSEs. Given that history, any call to restrict their operations to credit guarantees would seem perverse. It would get them out of the business that has caused no trouble, while keeping them in the business that blew up in the crisis.

Taking away the GSEs' power to hold mortgages in portfolio might be proposed with the intent of insulating taxpayers from a blow-up should Freddie or Fannie fail to manage interest-rate risk carefully. However, bear in mind that whatever interest-rate risk the GSEs are not taking will be borne elsewhere. Having the interest-rate risk management visible within the GSEs may be preferable to not knowing where or how interest-rate risk is being managed. With much of the nation's assets currently concentrated in the largest institutions, there is a good chance that if interest-rate risk causes problems, then one or more "too big to fail" banks will be affected. Ultimately, the exposure of taxpayers could be just as great or greater than if the GSEs' portfolio business had been left alone.

Attempting to channel funds to 30-year fixed-rate mortgages through a new entity or set of entities presumably would require the insertion of a government guarantee at some point. This would be trading the devil we know for the devil we don't know. We do not know what new regulatory difficulties would be posed by a different institutional structure with an embedded guarantee. However, there is little reason to expect that a new and untried regulatory mechanism will be impregnable in theory, and even less reason to be confident that it will work as intended in practice.

One of the most important bulwarks that the GSEs provide against catastrophic failure is their stock of organizational capital. Their staff and their computer systems contain a lot of embedded knowledge relevant to solving the many problems associated with linking the capital markets to the mortgage market. Creating a new institutional structure would require at least some of this knowledge to be reinvented, imposing considerable costs—and risks—on the system.

The "devil you know" strategy, as envisioned here, would limit the GSEs to supporting long-term fixed-rate mortgages for well-qualified borrowers. It would not involve them in goals to expand home ownership to borrowers with inadequate income, assets, or credit scores.

There may be a valid social goal of providing assistance to some under-qualified borrowers to purchase homes. However, the position I would take is that programs to achieve this goal ought not to operate through indirect mortgage subsidies. Instead, they should be designed as on-budget subsidies. For example, the government could give under-qualified borrowers grants that could be used to help make payments for the first three years of a mortgage. However, the interest rate on the mortgage should reflect its risk (as reduced by the existence of the grant) when priced in the market, rather than carrying an artificially subsidized rate.

Regardless of social goals, it is my view that the government should never encourage expansion of mortgage lending with low down payments. Lowering the down payment tends to amplify the housing cycle. When prices are rising, people are more apt to buy with little money down, hoping to capitalize on continued appreciation. This feeds the boom. Then, when prices stabilize, many of these speculative borrowers are unable to sustain their debt load, which causes distress sales. This worsens the downturn. If the value of home ownership is that it fosters prudence, then speculative purchasing of homes with little or no money down has to be considered antithetical to that objective.

One flaw in the "devil you know" approach will be shared by any approach that relies on a government guarantee to help channel funds into long-term, fixed-rate mortgages. That flaw is the tendency for regulatory controls on risk-taking to degrade over time. There are two sources of weakness, one financial and one political. The financial threat comes from innovation. The financial system naturally evolves mechanisms that increase the profits to be gained by exploiting a guarantee. Risk naturally flows in the direction of guarantee-backed firms.

The political weakness is that regulated firms have an incentive to lobby to create opportunities to exploit guarantees. Freddie Mac and Fannie Mae were notoriously powerful in the political realm. When Treasury Secretary Paulson put the GSEs under conservatorship, ending their lobbying was a high priority. There is a legitimate fear that if we return to the status quo ante, then the GSEs will gradually regain their formidable political prowess. This could be used to press for expanded opportunities for risk-taking and increase the perils faced by the taxpayers.

Overall, the "devil you know" strategy strikes me as the least problematic way to maintain the channels of funding between the capital markets and long-term, fixed-rate mortgages for well-qualified home buyers. This may not be a large benefit, when compared with the costs and trauma of the recent crisis and bailouts.

THE JIMMY STEWART BANKER APPROACH

Mortgage loans used to be made by local deposit-taking institutions. The loans were held by the bank. When a borrower was late with payments, the bank had local knowledge that could be used to decide the appropriate course of action. If that course of action was foreclosure, the information in the county recording office would show that the bank was the legal holder of the mortgage note and could move forward toward taking possession of the property.

What I call the Jimmy Stewart banker approach would be for the government to exit the mortgage guarantee business. The GSEs would be gradually phased out, by reducing each year for period of three to five years the upper limits on the loan amounts they can purchase. At the end of this phase-out period, their purchases would cease altogether. In addition, I would favor replacing FHA and VA mortgage loans with grants to the eligible recipients, as mentioned in the previous section. These grants would be used to make mortgage payments in the first years of the mortgage. However, this change to FHA and VA can be addressed separately from the phase-out of the GSEs.

As the GSEs are phased out, they would be replaced by whatever emerges in the market. One cannot predict with certainty what will evolve, but my expectations would be as follows.

Local banks would revert to the practice of originating and holding mortgages. That is my reason for referring to this as the Jimmy Stewart approach. Of course, if some other practice were to emerge, then it might not resemble the sort of mortgage lending that I envision here. (One other possible outcome is that the private securitization market could revive. In my judgment, this is unlikely, because the agency ratings that were the key to the private mortgage securities market have lost credibility. Another possible outcome would be the emergence of a small number of dominant national mortgage lenders, able to raise capital both domestically and internationally. These would be private analogues to the GSEs. Again, I think this is unlikely to occur, because memories of the financial crisis will make money managers reluctant to offer low-cost financing to such enterprises.)

Jimmy Stewart banks probably would offer mortgages for shorter terms than the 30-year fixed-rate mortgage that has been the standard in the United States for many years, but which is less common in most other countries. For example, the standard in Canada is a five-year rollover mortgage, in which amortization takes place on a 30-year schedule but the interest rate adjusts every five years.[4]

Again, there are other possible outcomes. Banks might find that the interest-rate swap market or the market for covered bonds (bonds issued with mortgages as collateral) is deep enough to allow them to issue 30-year fixed-rate mortgages while laying off the interest-rate risk.

The reason that I suspect that something like the five-year rollover mortgage would dominate in the absence of government intervention is that the regulatory environment in the United States no longer encourages depository institutions to have large maturity mismatches.

Until 1980, interest rates on deposits were regulated, and neither capital requirements nor deposit insurance premiums

4 See Donald J. Lessard, "Roll-over Mortgages in Canada," in *New Mortgage Designs for Stable Housing in an Inflationary Environment*, Federal Reserve Bank of Boston Conference Volume 14, January 1975, pp. 131-141. http://www.bos.frb.org/economic/conf/conf14/conf14g.pdf

were calibrated to risk. In this environment, depository institutions had stable funding costs and they could engage in maturity mismatching without any checks. Depositors had no reason to be concerned with the institution's asset-liability strategies because the depositors were protected by insurance. The absence of risk-based capital or deposit insurance premiums left banks and thrift institutions free to try to earn the spread between regulated deposit interest rates and long-term mortgage rates.

The increase in inflation in the 1970s left many thrift institutions bankrupt. Their insolvent state was disguised by historical accounting that did not recognize the losses embedded in their holdings of long-term mortgage assets. However, as the decade of the 1980s wore on, the weaknesses in their balance sheets were exposed, and many thrifts had to be closed and their depositors bailed out at taxpayers' expense, in what became known as the S&L crisis.

The S&L crisis yielded a number of important lessons. One lesson is that it is important for regulators to be able to assess the true financial condition of depository institutions, rather than allow insolvency to be disguised by historical-cost accounting. Another lesson is that deposit insurance premiums and capital requirements have to be adjusted for risk, including the interest-rate risk that depository institutions take when they fund long-term assets with deposits. Requiring higher deposit insurance premiums and imposing higher capital requirements for greater risk would make it more expensive for depository institutions to offer long-term, fixed-rate mortgages.

By 1990, the savings-and-loan industry had shrunk drastically. Over the next 20 years, the main funding instrument for long-term, fixed-rate mortgages came to be callable debt issued by the GSEs. The call provisions enabled the GSEs to hedge much of the risk embedded in prepayment options. That is, suppose that a mortgage borrower obtains an 8 percent, 30-year loan and the GSE finances this by issuing 20-year bonds at an interest rate of 6.5 percent. Two years later, it might be the case that rates have fallen, with mortgage rates at 5.5 percent and bonds at 4.0 percent. In that case, borrowers will refinance at the lower rate, and if the GSE has failed to hedge against this risk, it will retain the 6.5 percent bond as a liability, while having only the 5.5 percent mortgage as an asset. If the 20-year bond is callable in 5 years, the GSEs exposure to prepayment risk is greatly reduced.

For the 30-year, fixed-rate mortgage to remain attractively priced in the Jimmy Stewart banker scenario, mortgage lenders would have to be able to issue callable debt without paying a large premium over Treasury interest rates. This is unlikely. Small depository institutions lack the name recognition and market credibility to tap into important sources of funds, particularly from foreign investors. In addition, their long-term-debt lacks explicit government backing (unlike their deposits, which are insured) and presumably would not carry any implicit guarantee, either. Thus, their debt would be unlikely to enjoy the AAA ratings that accrued to the GSEs.

In short, depository institutions would appear to lack access to low-cost, long-term funding. Relying on deposits to fund long-term, fixed-rate mortgages would, under prudent regulation, impose on these institutions substantial costs in the form of deposit insurance premiums and capital requirements. On the other hand, attempting to match funding by tapping the long-term debt market would be more expensive than it is for the GSEs, with their worldwide recognition and government backing.

Thus, what I expect to emerge as the GSEs are phased out is a mortgage finance system in which mortgage loans are bought and held by depository institutions. These loans will have a 30-year amortization schedule, but the interest rate will adjust about every five years. Thirty-year fixed rate loans will continue to be available, but at an interest-rate premium that is high enough that their share of the market will be much less than is the case today.

Assuming that it transpires as I would expect, this modest restructuring of mortgage credit, with more 5-year adjustable-rate mortgages and fewer 30-year, fixed-rate mortgages is likely to prove benign. As noted, many other countries have done well with mortgages with rates that stay fixed for shorter periods than 30 years.

With lending decisions made by local depository institutions, mortgage finance can arrive at a better mix of rules and judgment. We are much less likely to see an outbreak of the sort of collective insanity that infected the housing finance system from 2003 through 2007. Under that system, there emerged a demand for mortgage-backed securities that was so perversely high that mortgage originators lost any incentive to adhere to sensible underwriting standards.

One adverse consequence of a mortgage finance system that relies on securitization carried out by entities backed by the government is that it fosters extreme concentration in finance. The percentage of assets controlled by the nation's largest financial institutions was much greater during the era of securitization than was the case when savings and loans were a major factor in mortgage lending.

A high degree of financial concentration is typical in Europe and in Asia, but the United States has a longstanding tradition of preferring a more decentralized financial system. Our fear has been that large banks form a symbiotic relationship with political forces, which makes for corporatism or "crony capitalism." When finance is concentrated, government tends to become heavily involved in the allocation of capital, to the detriment of smaller entrepreneurs who lack political connections.

The problems of crony capitalism were evident with the GSEs, which were notorious for heavy-handed lobbying efforts and for hiring executives with strong political connections. By the same token, the market allocation of capital was heavily compromised, as politicians conferred advantages on the GSEs that gave them market dominance, while putting pressure on the GSEs to make financial decisions based on political considerations, most notably the affordable housing goals.

Securitization also greatly increased the role in mortgage finance of a few Wall Street firms. These firms developed a number of financial strategies which, while profitable in the short run, exposed their companies to catastrophic risks. The Dodd-Frank financial reform bill embodies a number of regulatory mechanisms intended to prevent a recurrence of this, but many economists familiar with financial regulatory history are skeptical that these mechanisms will work for very long. Instead, we believe that there is more safety in reverting to a simpler financial process that is less dependent on a few large firms.

For implementing the Jimmy Stewart banker approach, the following considerations should be kept in mind:

Regulators should monitor the distribution of interest-rate risk. They should not allow it to become concentrated in ways that put the Federal Deposit Insurance Corporation at risk. This means that banks should not be permitted to fund long-term, fixed-rate mortgages with short-term deposits without paying a stiff premium. Also, to the extent that they engage in hedging strategies that involve counterparties, regulators will need to verify the soundness of the strategies and of the counterparties. Regulators should conduct regular stress test simulations of alternative interest-rate scenarios with respect to individual insured institutions as well as with respect to the entire system, including counterparties.

As in the "devil you know" approach, Congress should back away from attempts to expand home ownership through lenient mortgage credit with low down payments. As discussed earlier, any housing subsidies should be on budget, such as in the form of grants to assist households in making mortgage payments early in the life of the loan.

With less government effort to steer funding toward mortgage finance, we should be prepared to see mortgage borrowing scaled back, as borrowers and lenders undertake transactions that reflect the true price of credit risk. Down payments should tend to be larger than they have been in recent years, and house price increases should be more restrained.

This shift away from high-leverage housing finance should be considered a benefit of the Jimmy Stewart banker approach, rather than a cost. With less of the world's capital siphoned into driving up house prices and leverage in the United States, more funds will be available for other productive investment projects. This also should help facilitate what many experts at the International Monetary Fund and elsewhere see as a long-needed adjustment in international capital flows, with the United States moderating its absorption of foreign capital and reducing its trade deficit.

CONCLUSION

I believe that the best approach to GSE reform would be to phase out the GSEs over a period of three to five years, and to allow alternative channels of mortgage finance to evolve. Regulators should pay attention to this evolution, in order to ensure that interest-rate risk does not become inappropriately concentrated, with particular concern for protecting the FDIC.

The basic approach to phasing out the GSEs would be to gradually reduce the ceilings on the loan amounts that they can securitize. For example, if these limits were lowered by 20 percent per year, then after five years they could not longer securitize loans.

However, I would advocate eliminating some GSE activities much sooner. For example, within six months, they should stop purchasing loans for non-owner-occupied homes (including multi-family), cash-out refinances, and adjustable-rate mortgages. Their purchases of loans with down payments of less than 20 percent should be capped, either in dollar terms or as a percent of loans purchased, and these caps should fall to zero within three years.

As the market evolves, it is possible, if not likely, that the interest rate on 30-year fixed-rate mortgages will rise in relation to other interest rates. This is likely to reduce household leverage in the housing market, and it is likely to induce many home purchasers to shift toward variable-rate instruments, such as a five-year adjustable-rate mortgage.

This GSE phase-out would help to avoid a resurgence of a financial system that became both overly concentrated and overly enmeshed in political cronyism. It would make it easier for the United States to return to its traditions of decentralized, varied financial institutions.

One concern with phasing out the GSEs is that this would put upward pressure on mortgage interest rates and consequently put downward pressure on house prices. If this is an issue, then I think it would better for the government to offer a direct subsidy to for home purchases than keeping the GSEs in place indefinitely. I certainly do not believe that such a subsidy is warranted. However, the indirect subsidy implied by keeping the GSEs at their current level of involvement in the mortgage market is even less warranted.

If the possibilities of a reduced supply of mortgage funds and a rise in the relative cost of the 30-year fixed-rate mortgage are too unpalatable to contemplate, then it would be better to restore the GSEs to their previous status, rather than to create a new and different structure with government backing. The GSE model can be fixed by giving their regulator an unambiguous focus on safety and soundness, by insulating the GSEs from pressures to subsidize risky lending, and by reinstating and tightening their charter restrictions against purchasing loans with low down payments.

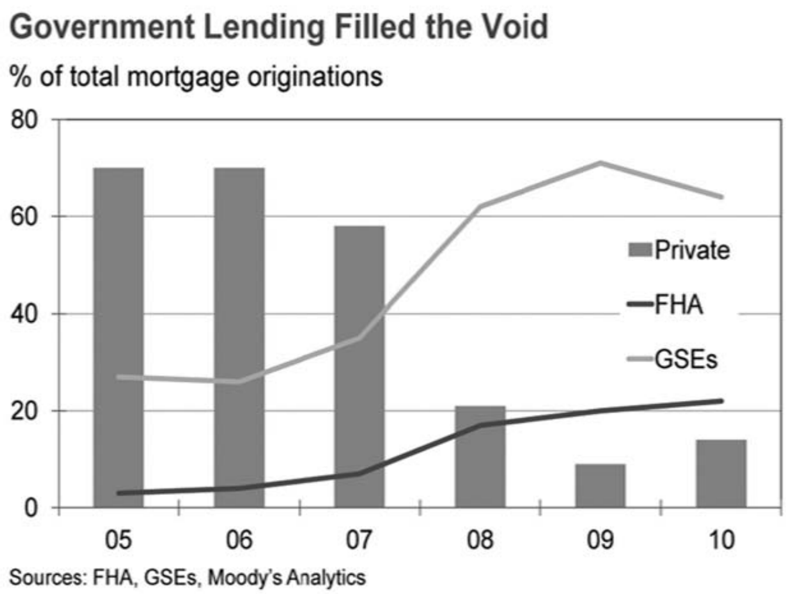
The worst option, in my opinion, would be to create a new government-backed system to channel funds into mortgages. Such an approach would necessarily involve the worst features of the GSE model, namely the close relationship between politics and mortgage finance, the unnatural concentration of the mortgage industry, and the inevitable deterioration of the ability of policy makers to contain or correctly price risk. At the same time, a new approach would impose a steep learning curve on both the new entities and their regulators, saddling taxpayers with unnecessarily high and uncertain costs.

PREPARED STATEMENT OF MARK ZANDI

CHIEF ECONOMIST, MOODY'S ANALYTICS

MARCH 29, 2011

No one is comfortable with the Federal Government's current outsize role in the housing and mortgage markets. Nearly all of the first mortgage loans originated in 2010 were made by the Federal Government through the Federal Housing Authority, Fannie Mae, and Freddie Mac (*see,* Chart). Acting on behalf of taxpayers, the FHA is taking on much more credit risk than was ever envisaged for this institution, and Fannie and Freddie are operating in conservatorship, a kind of regulatory purgatory. While changing any of this quickly would disrupt the still-fragile housing market and economy, none of it is sustainable in the long run.



This untenable situation is the result of the collapse of the private mortgage market during the financial panic. At its peak in 2005 in the midst of the housing bubble, the private market accounted for more than two-thirds of all originations. Powering private mortgage lending was securitization—the process of packaging mortgage loans into securities sold to global investors. Securitization was not new: The FHA, Fannie Mae, and Freddie Mac had been securitizing mortgages for more than 25 years. But during the housing bubble, securitization surged in both size and scope, incorporating a wider range of mortgages, including subprime, Alt-A, and option-ARM loans. Securitization also grew more complex and opaque, so that even the most sophisticated investors had trouble evaluating the risks.

Critically, moreover, no participant in private mortgage securitizations had the responsibility for ensuring that the process worked. Mortgage banks and brokers originated loans but quickly sold them to investment banks, which packaged the loans into securities. Credit rating agencies assessed them, and in doing so may have unknowingly used faulty information provided by the investment banks. Investors who purchased the securities took the ratings largely on faith. And Government regulators provided little oversight, feeling the private market could regulate itself. Yet as the events of the past 3 years show, it clearly could not. Today, the private mortgage market is comatose.

Administration's Proposal

The Obama administration in its recently released white paper appropriately argues that the Government should phase out Fannie Mae and Freddie Mac and significantly scale back its role in the mortgage market—not quickly, but over time in a clearly defined way to allow the private market to revive.[1] A number of policy tools can help achieve this, including reducing conforming loan limits; raising insurance premiums and down payments on loans insured by the FHA, Fannie Mae, and Freddie Mac; and requiring Fannie and Freddie to shrink their loan portfolios.

The Administration proposes three potential options for the mortgage finance system as the Government steps away:

- Option 1 would limit the FHA to a small part of the mortgage market, fully privatizing the rest of the market with neither explicit nor implicit Government support.
- Option 2 would limit the FHA to a small part of the mortgage market in normal times, leaving the rest to private lenders, but would provide a mechanism, which the Administration did not define, for the Government to significantly expand its role if the private market falters.
- Option 3 would limit the FHA to a small part of the mortgage market in normal times, with private lenders making up the rest of the market, but the private market would be backstopped by explicitly priced catastrophic Government insurance. The Government would step in only after private investors were wiped out.

Hybrid System

Option 3 is similar to the hybrid private–public mortgage finance system Moody's Analytics has proposed, as have others, including the Housing Policy Council, the Mortgage Bankers Association, and the Center for American Progress.[2] A hybrid system could take many forms, but the most attractive would retain several roles for the Federal Government—insuring the system against catastrophe, standardizing the securitization process, regulating the system, and providing whatever subsidies are deemed appropriate to disadvantaged households. Private markets would provide the bulk of the capital underpinning the system and originate and own the underlying mortgages and securities.

The Government would provide catastrophic insurance on mortgage securities only after major losses, much as the FDIC insures bank deposits. The FDIC ended runs by scared depositors on U.S. banks during the Great Depression. Catastrophic mortgage securities insurance would eliminate runs by scared investors on the global financial system such as those in 2008, precipitating the Great Recession.

Catastrophic insurance would ensure that mortgage credit remains ample in the bad times, and—assuming it is properly priced—at no cost to taxpayers. It would also reduce the odds of bad lending in good times, since the insurance would be offered only to qualifying mortgages or to others only at a high price. Since private financial institutions would put up the system's capital, there would be significant incentive to lend prudently and, given the competition in a mostly private system, to innovate as well.

A hybrid system is superior to the other options for the future mortgage finance system, resulting in measurably lower mortgage rates, greater credit availability for more homeowners, and preservation of the popular 30-year fixed-rate mortgage. It also will compensate taxpayers for the risk of backstopping the mortgage finance system—a risk that will continue to exist no matter what choices lawmakers make for reform.

In a hybrid system, mortgage rates would be higher than they were before the housing crisis, but only because the previous system was undercapitalized. If the future system is capitalized sufficiently to withstand losses on defaulting mortgages that would result if house prices declined by say 25 percent—consistent with the price declines experienced in the current housing crash—mortgage rates would be approximately 30 basis points higher. Before the financial crisis, the mortgage finance system was capitalized to losses associated with a 10 percent decline in house prices.

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[1] The Treasury white paper can be found at *http://www.treasury.gov/initiatives/Documents/Reforming%20America%27s%20Housing%20Finance%20Market.pdf.*

[2] A detailed description and analysis of the Moody's Analytics proposal for a hybrid system is available at *http://www.economy.com/mark-zandi/documents/Mortgage-Finance-Reform-020711.pdf.*

The Moody's proposal is similar to a number of other proposals; the most notable include a proposal by the Housing Policy Council of the Financial Services Roundtable (a group of 32 leading national mortgage finance companies) *http://www.fsround.org/housing/gse.htm,* the Mortgage Bankers Association *http://www.mbaa.org/Advocacy/IssuePapers/CEML.htm,* and the Center for American Progress *http://www.americanprogress.org/issues/2011/01/pdf/responsiblemarketforhousingfinance.pdf.*

Lower Mortgage Rates

But mortgage rates in the proposed hybrid system would be almost 90 basis points lower than under a fully privatized system. This is a significant difference. The monthly principal and interest paid by a typical borrower who has taken out a $200,000 loan for 30 years at a 6 percent interest rate is $1,199 under the hybrid system. With a 90-basis point premium in the privatized system, the monthly payment increases to $1,317, a difference of $118, or nearly 10 percent. The difference in payments under the two systems would likely be even greater for borrowers with less than stellar credit or who are seeking loans with higher loan-to-value ratios. The greater the risk, the greater the rate premium under the privatized system.

There are three fundamental reasons why mortgage rates will be lower in a hybrid system than they would be with full privatization:

Explicit pricing: Advocates of a privatized market presume that the Government could credibly pledge never to intervene during a crisis. If private investors actually believed this, they would require larger returns on mortgage investments to protect against a catastrophic outcome. The cost of private mortgage insurance would therefore be higher.

On the other hand, if investors believe the Government would bail out the market in a crisis, they will necessarily underprice the risk, leaving taxpayers exposed. History strongly suggests Government would not allow the housing market to fail; no matter what lawmakers pledge today, investors know political winds change in times of economic stress. Taxpayers will be better off if the Government explicitly acknowledges this likelihood and collects an insurance premium in exchange for its guarantees.

Standardization: Under the current mortgage system, Fannie Mae and Freddie Mac mortgage securities are highly liquid instruments, largely because they conform to strict guidelines. Investors in these securities pay for this standardization, which helps ensure a robust secondary market. Private-label mortgage securities are not standardized—a Wells Fargo security trades differently than one from Citibank or another issuer. Markets in these individual securities are thus much thinner, with wider bid-ask spreads.

Scale: Mortgage securitization has large fixed costs. Under a privatized system, each securitizer would bear the cost of operations, Administration, reporting, auditing, *etc.* A single Government-run securitization agency (a feature of most hybrid systems) would achieve economies of scale. The provision of insurance, including catastrophic risk insurance, also benefits from scale.

Standardization and scale are more likely with Government coordination. Could industry participants come together to set tight standards on securities and achieve some economies of scale through clearinghouses? Possibly, but that hasn't happened so far. The American Securitization Forum, which issues guidelines, has little authority to audit or enforce them.

Preserving the Fixed-Rate Mortgage

Homeowners would also benefit from the preservation of the popular 30-year fixed-rate mortgage, a type of loan that would quickly fade in a fully privatized system. The FHA introduced this type of mortgage after the Great Depression to forestall the mass foreclosures that occurred during that period. The current foreclosure crisis is a stark reminder of this benefit, as the bulk of recent foreclosures are on homeowners who had adjustable-rate mortgages.

Financial institutions have historically found it very difficult to manage the interest rate risk in such mortgages: As the cost of funds changes, the rate received from homeowners remains fixed. The savings and loan industry collapsed largely because of the mismanagement of this interest rate risk during the 1980s, and even Fannie and Freddie got into trouble using inappropriate interest-rate hedging techniques to manage their earnings in the early 2000s. It thus is not surprising that 30-year fixed-rate mortgages are very uncommon overseas, where the interest rate risk resides with lenders with no support from the Government. Indeed, it is likely that a privatized U.S. market would come to resemble overseas markets, primarily offering adjustable-rate mortgages.

Other Considerations

Taxpayer bailouts would also be unlikely in a hybrid system, as homeowners and private financial institutions would be required to put substantial capital in front of the Government's guarantee, and there would be a mechanism to recover costs if necessary.

Given the fragile states of the U.S. housing market and economy, a transition from the current nationalized mortgage system to a hybrid system would take years and raise many issues, but these would be manageable. Given the expertise they have acquired over the past several decades, the downsized Fannie and Freddie could become Federal catastrophic insurers. The transition would also involve establishing institutions and an infrastructure necessary to attract private capital.

One potential weakness of a hybrid system involves moral hazard: If private investors believe the Government will bail them out if things go badly, they will take inappropriate risks. Moral hazard cannot be eliminated in a hybrid model, but it can be significantly mitigated. The system we support would require enough private capital to withstand massive losses—those associated with a 25 percent decline in house prices. The Government's catastrophic insurance would kick in only if the losses were even greater, providing significant financial incentive for private investors to make sound lending decisions.

It is also important to recognize that moral hazard exists even in a fully privatized system. Investors in such a system are likely to assume that in extreme circumstances the Government would still step in, congressional pledges to the contrary notwithstanding. Recent experience has only reinforced this belief, as the Government stepped in during the financial crisis to bail out the system. In the hybrid system plan, the Government's backstop is explicit and paid for by private investors.

Assertions that Wall Street banks and their associated financial institutions would fare better in a hybrid system than they would with full privatization are misplaced. In fact, Wall Street's profits would likely be greater in a privatized system, which would be more fractured and less liquid, resulting in wider bid-ask spreads and thus bigger opportunities to profit from arbitrage. The need for ratings or other forms of credit analysis will also be much greater in a privatized system that is less standardized and not ultimately backed by the Government.

Mortgage rates will be higher in the future than they were in the past and borrowers will face larger hurdles to obtain mortgage loans. Given the Nation's fiscal challenges, the Federal Government cannot afford to continue large subsidies for home ownership. It is unclear that these subsidies were effective in any event, given the current foreclosure crisis. Nonetheless, it is critical that the mortgage finance system be better designed, or the costs for future prospective homeowners will be prohibitive, and the costs to taxpayers in the next financial crisis will be overwhelming. And if mortgage finance reform is done right, the American dream of home ownership will remain in reach for most.

PREPARED STATEMENT OF JANNEKE RATCLIFFE

SENIOR FELLOW, CENTER FOR AMERICAN PROGRESS ACTION FUND

MARCH 29, 2011

Good morning Chairman Johnson, Ranking Member Shelby, and Members of the Committee. I am Janneke Ratcliffe, a Senior Research Fellow at the Center for American Progress Action Fund and the executive director for the Center for Community Capital at the University of North Carolina at Chapel Hill.

Today I am especially honored to be asked to speak to you as a member of the Mortgage Finance Working Group. The members of this working group began gathering in 2008 to chart a path forward for the mortgage market. Our "Plan for a Responsible Market for Housing Finance" is the result. I will summarize our proposal, which is included in full in my written statement, but I speak only for myself in any views expressed here today.

Our collective experience and the 3 years we spent hashing out these issues has made us well aware of the difficult challenge you now face. The immediate task is to restore confidence in the housing market but we are also convinced that, long term, housing can continue to be core to Americans' prosperity and economic security, and the foundation of middle-class opportunity. To meet this mission, housing finance reform must meet three key goals:

- First, provide broad access to reasonably priced financing for both home ownership and rental housing so that more families, including the historically underserved, can have safe and sustainable housing options to meet their needs.
- Second, preserve the 30-year fixed-rate mortgage, which allows families to fix their housing costs, build assets, and plan for their future in an ever more volatile economy.
- And third, ensure that lenders, large and small, in communities large and small, can competitively offer the affordable, transparent, safe mortgage loans that borrowers need.

Our proposal achieves these goals by building on lessons from the past, both what went wrong and what was done right.

Principles of a New System Based on Lessons Learned From the Past

History has shown us that a housing finance system left to private markets will be subject to a level of volatility that is not systemically tolerable, given the importance of housing to the economy and to the American family.

The past decade exposed flaws in our housing finance architecture.[1] The availability of mortgages was wildly cyclical, resulting in excessive mortgage credit during the housing boom, followed by a nearly complete withdrawal of credit when the bubble burst. The risk of many of the mortgages originated during the housing bubble was underpriced. At the same time, these mortgages were not sustainable for consumers, as low teaser rates and opaque terms masked their high overall cost over time.

The housing bubble was driven by the development of a "shadow banking system" in which mortgage lending and securitization was largely unregulated and certainly undisciplined. In time, this system drew in the quasi-governmental entities Fannie Mae and Freddie Mac who increased their own overall risk during the "race to the bottom" that implicated almost all mortgage lenders during the 2000s. In particular, as Fannie Mae and Freddie Mac lost market share to private mortgage-backed securities issuers who were underpricing risk, the two mortgage finance giants lowered their own underwriting standards and increased their leverage in an attempt to compete. The result: Taxpayers were left exposed to major losses.

The new system must be designed to avoid the same pitfalls in the future. Keeping this in mind, we built our proposal on five key principles: liquidity, stability, transparency, affordability, and consumer protection.

First, There Must Be Broad and Constant Liquidity

The new system needs to provide investors the confidence to deliver a reliable supply of capital to ensure access to mortgage credit for both rental and home ownership options, every day and in every community, during all kinds of different economic conditions, through large and small lenders alike.

Broad and constant liquidity also requires effective intermediation between borrower demands for long-term, inherently illiquid mortgages and investor demands for short-term, liquid investments. The capital markets have therefore come to play an essential role in mortgage finance. But as the past decade so stunningly demonstrated, left to their own devices, capital markets provide highly inconsistent mortgage liquidity, offering too much credit sometimes and no credit at other times with devastating effects on the entire economy.

To communities, liquidity means that lenders of all sizes can offer their customers in all communities beneficial mortgage products. Currently, an estimated 70 percent of all mortgage originations flow through four lenders—JPMorgan Chase Co., Bank of America Corp., Citigroup Inc., and Wells Fargo & Co.—all of which benefit from Federal deposit insurance and an perceived and unpaid too-big-to-fail guaranty. Without consistent and equitable access to a fairly priced secondary market, the country will be in danger of losing the services of community banks, credit unions, and other lenders that can meet the needs of their communities on a more tailored and targeted basis than these larger institutions. These many small but important financial institutions need a well-functioning secondary market so they can access the capital they need to originate more mortgages.

To American families, consistent liquidity also means that developers will find capital to finance new and rehabilitated apartments and other homes so inadequate supply does not put decent rental options out of reach. It means that regardless of what community they live in, lenders will offer credit at a fair price. It means that families will be able to afford a long-term mortgage they can budget for without fear that interest rates will drive up their costs. It means they can put their hard-earned savings into a home with confidence that, whether the economy is up or down, when they need to sell, potential buyers will have access to credit from an array of competing lenders and the family will be able to sell their home at a fair market price.

Second, Any New System Must Foster Financial Stability

Stability is achieved by reining in excessive risk taking and promoting reasonable products and sufficient capital to protect our macro economy and household economies from destructive boom-bust cycles. A totally private mortgage market is inherently inclined toward extreme bubble-bust cycles, which cause significant wealth destruction that brings with it devastating repercussions not only for homeowners and lenders but also for neighborhood stability, the larger financial system, and the broader economy.

[1] Markus K. Brunnermeier, "Deciphering the Liquidity and Credit Crunch 2007–08", *Journal of Economic Perspectives* 23(1) (2009):77–100.

Private mortgage lending is inherently procyclical. Mitigating that tendency requires strong, consistently enforced underwriting standards and capital requirements that are applied equally across all mortgage financing channels for the long cycle of mortgage risk. As we saw in the previous decade, capital arbitrage can quickly turn small gaps in regulatory coverage into major chasms, causing a "race to the bottom" that threatens the entire economy.

Stability for the market requires sources of countercyclical liquidity even during economic downturns. For families, stability means that they will not experience wild fluctuations in home values, allowing them to plan financially for their families, education, businesses, or retirement.

Third, Transparency and Standardization Will Support These Other Principles

Underwriting and documentation standards must be clear and consistent across the board so consumers, investors, and regulators can accurately assess and price risk and regulators can hold institutions accountable for maintaining an appropriate level of capital.

During the housing bubble, the housing finance system experienced a seismic shift toward complex and heterogeneous products that could not be understood by consumers at one end of the chain to securities that could not be understood by investors at the other. The lack of transparency and standardization set the stage for adverse selection because the issuers knew more than the investors.

Because the state of the whole secondary market affects the pricing of each packaged pool of mortgages in it, a safe and liquid securitization market can only exist if investors have access to information about all mortgage-backed securities in the market place. A private mortgage-backed securities market will not reemerge unless investors are convinced these issues have been resolved. Secondary market transparency and standardization lower costs and increase availability.

For borrowers, standardization and transparency means that they can make good choices from among well-understood and standard mortgage products. The mortgage products they can choose from are not so complex that their consequences are hidden.

Fourth, The System Must Ensure Access to Reasonably Priced Financing for Both Home Ownership and Rental Housing

Liquidity and stability are essential to affordability and, for most families, the lower housing costs produced by the modern mortgage finance system over the past half century (before the recent crises) facilitated wealth building, enabling them to build equity, save, and invest. This contributed to the building of a strong middle class and has been an important guiding concept in modern U.S. housing finance policy—and a key component of the American socioeconomic mobility of the 20th century.

A pillar of this housing system is affordably priced long-term, fixed-rate, fully self-amortizing, prepayable mortgages, such as the 30-year mortgage. The long term of this loan provides borrowers with an affordable payment while the fixed-rate, the option to prepay, and self-amortization features provide the financial stability and forced savings that are critically important to most families, while retaining the opportunity for mobility.

Multifamily rental housing also gains stability from long-term, fixed-rate financing. Banks and other lenders, however, are reluctant to offer long-term, fixed-rate mortgages to homebuyers or multifamily mortgage borrowers unless the lenders have a consistently available secondary market outlet. In the absence of Government policies designed to explicitly support long-term, fixed-rate mortgages, it is likely that this type of mortgage would largely disappear from the U.S. housing landscape or become unaffordable to the Nation's middle class, which has been so effectively served by 30-year residential mortgages, and to the Nation's many renters who rely on multifamily property owners' ability to finance and refinance their apartment buildings.

One of the most important accomplishments of the modern U.S. housing finance system is the broad availability of mortgage credit, but the benefits of this system have not been equally shared by all qualified households. Who is qualified for home ownership? We have ample evidence that many households who may not fit the "20 percent down, established credit, 30 percent debt-to-income" model can become successful long-term homeowners, when given access to well-underwritten, affordable, fixed-rate financing.[2] For example, at UNC, we follow a portfolio of nearly 50,000 mortgages made by banks across the country over the decade preceding the crisis; loans made under affordable housing and CRA programs. The median borrower earned $30,792 a year, more than half of them had credit scores of 680 or below, and 69 percent put down less than 5 percent on their home purchase. Some of the conversations going on now suggest they were not qualified. But as of today, less than 5 percent of these loans have experienced foreclosure. Their delinquency rate is a fraction of that of subprime mortgages. In fact, the households have on the median, and over the period, managed to build more assets than through any other available mechanisms. They were able to do so because they had access to prime, fixed-rate, long-term amortizing mortgages that they could afford to repay.[3]

Liquid, stable, and affordable financing must also be more available for multifamily and rental housing because it results in more affordable and stable rents. The housing opportunity ladder begins with access to stable rental housing in reach of good jobs, where households can pay their rent and still have money left over to begin saving. It is projected that the shortage in affordable rental housing is only going to be exacerbated in the wake of the foreclosure crisis. Over the next 30 years, we may need to add more than 40 million new housing units of all types to meet the demand. We cannot get on track without a strong rental housing finance system.

Access to affordable credit does not mean that people should stretch to purchase more house than they can afford. It does mean that home ownership's benefits of forced savings and wealth appreciation are available to those with sustainable incomes and strong credit history without regard to race or geography. It also means that there is enough supply of quality rental housing appropriate for individuals and families so that rents charged are affordable—meaning housing costs are no more than 30 percent of incomes.

Finally, The System Must Support the Long-Term Best Interest of All Borrowers and Consumers and Protect Against Predatory Practices

The purchase of a home is a far more complicated, highly technical transaction than any other consumer purchase and occurs only a few times in a consumer's life. Mortgage consumers are at a severe information disadvantage compared to lenders. In addition, a mortgage typically represents a household's largest liability. A mortgage foreclosure therefore has outsized consequences for the borrower. As the current crisis so sadly demonstrates, mortgage foreclosures also deliver devastating consequences to communities, the financial markets, and the broader economy.

During the housing boom, unregulated and often predatory subprime lending not only failed to maintain or promote sustainable home ownership opportunities but also established a dual credit market where factors other than a borrower's creditworthiness—such as race or neighborhood location—determined the type and terms of the mortgages available. All too often, families were denied the best credit for which they qualified because their communities were flooded with unsustainable mortgage credit—in part because secondary market pressures created incentives to make and sell these loans instead of the safer, lower-cost products.

How the Goals of Our Proposal Support These Principles

In order to support these fundamental policy principles, our proposal for a new housing finance system sets out to achieve four key goals:

- Preserve the availability of 30-year fixed-rate mortgages, which allows families to fix their housing costs and better plan for their future in an ever more volatile economy.
- Provide access to reasonably priced financing for both home ownership and rental housing so families can have appropriate housing options to meet their circumstances and needs.
- Ensure that a broad array of large and small lenders (such as community banks, credit unions, and community development financial institutions) have access to secondary market finance so they can continue to provide single and multifamily mortgage loans in every community around the country.

[2] David Abromowitz and Janneke Ratcliffe, "Homeownership Done Right: What Experience and Research Teaches Us", (Washington: Center for American Progress, 2010), available at *http://www.americanprogress.org/issues/2010/04/pdf/homeownership_done_right.pdf.*

[3] Lei Ding and others, "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models", Working Paper (UNC Center for Community Capital, 2010), available at *http://www.ccc.unc.edu/abstracts/091308_Risky.php.*

- Address the continuing concerns of underserved borrowers or tenants whose housing needs may require some direct Government support.

The Importance of the 30-Year Fixed-Rate Mortgage

One important reason why the 30-year fixed-rate mortgage is superior to other mortgages is that it provides cost certainty. A U.S. household with a 30-year fixed-rate mortgage always knows what its mortgage payments will be. Because shorter-duration products are basically designed to be refinanced every 2 to 7 years, homeowners with these types of loans face significant risks that interest rates may rise, making their home payments unaffordable after that initial 2 to 7 year period expires.

This is true even when interest rates are stable or declining. Adjustable-rate and short-term mortgages expose borrowers not only to ordinary interest-rate risk but also to the risks that they may not be able to refinance when they need to, due to adverse changes in market conditions.

The 30-year fixed-rate mortgage insulates borrowers against these risks since their payment streams are fixed. If we transitioned to an economy where the 30-year fixed-rate mortgage was no longer the dominant mortgage product, Americans would face the risk of losing their home every time they refinanced, due to rising interest rates or an unavailability of refinancing options, even if they otherwise could have been able to make their payments.

The "Plan for a Responsible Market" ensures that the 30-year fixed-rate mortgage remains a widely available, efficiently priced choice for all qualified homeowners.

An Appropriate Government Role

History and experience shows that a Government role is necessary for a smoothly functioning mortgage market.

Prior to the introduction of the major housing and finance reforms of the 1930s (which established the Federal Housing Administration, the Federal Home Loan Bank System, the Federal Deposit Insurance Corporation, and Fannie Mae, among others), the United States had a mortgage system that closely resembled the purely private system conservatives are arguing for today. From our contemporary perspective, this system was a total failure, demonstrating the perils of calls to "reform" the mortgage system back into a purely private endeavor.

Residential mortgages prior to the 1930s had many of the same features as the unregulated mortgage loans of the 2000s, with products similar to the subprime mortgages and so-called Alt-A mortgages—then as in the 2000s they were short term (typically 5–10 years), they were interest only, they carried a variable rate of interest, and they featured "bullet" payments of principal at term (unless borrowers could refinance these loans when they came due, they would have to pay off the outstanding loan balance).

Moreover, mortgages in this earlier era had high down-payment requirements, typically more than 50 percent, and were offered at rates much higher than the ones we take for granted today. They were effectively confined to a very narrow band of Americans, with a much higher percentage of home purchases being cash only. As a result, home ownership was far less attainable than it is today, with a home ownership rate of 43.6 percent in 1940.

Some have asserted that the significant development of the financial sector since the 1930s means that a purely private mortgage system could effectively serve the mortgage needs of Americans today. They point to the nascent recovery in the so-called jumbo mortgage markets, an area that lacks any Government support because these mortgages are for the high end of the housing market, as evidence supporting the idea that the purely private markets can capably serve the mortgage markets.

This argument is fundamentally flawed for a number of reasons. First, it ignores the enormous size of the U.S. mortgage market, which currently has some $11 trillion in residential mortgage debt outstanding. The fact that the purely private markets may be able to meet the mortgage needs of a narrow, wealthy slice of homebuyers does not mean that they will be able to meet the mortgage needs of all Americans.

Second, and relatedly, this argument ignores the limited investor appetite for long-term debt investments—the type of investments that fund home mortgages—in the absence of a Government backstop. While investor demand for long-term sovereign debt is enormous, totaling many trillions of dollars for U.S. Treasuries alone, the demand for privately issued long-term mortgage obligations that don't carry a Government backstop is small in comparison.[4]

Without a Government backing, there is unlikely to be sufficient investment capital to fund the $11 trillion in U.S. residential debt outstanding, let alone to fund longer-term mortgages, such as the 15-year to 30-year fixed-rate mortgages that dominate the U.S. mortgage market. Almost certainly, the removal of the Government's role in the mortgage markets would result in sharp reductions in the availability of mortgage credit and an immediate transition to short-duration mortgages, such as the 2-year and 3-year adjustable-rate mortgages that dominated the purely private subprime and Alt-A markets during the 2000s.

Finally, this position ignores the highly cyclical nature of private mortgage lending. One of the major weaknesses of exclusively private mortgage lending is the unavailability of mortgage credit during housing market or economic downturns as lenders become highly risk averse. This in turn can quickly lead to a "vicious circle" where a lack of available mortgage credit exacerbates the housing downturn, accelerating price declines and causing more mortgage defaults, which then leads to an even greater risk aversion on the part of lenders to provide credit.[5]

The inability of a purely private mortgage finance system to meet the housing needs of a modern economy is also evident from the experience of developed economies around the world. While the exact particulars vary from country to country, every advanced economy in the world relies on significant levels of Government support, either explicit or implicit, in their mortgage markets.

Proposals that recommend complete privatization of the housing finance system (or privatization with occasional Government intervention) would not achieve stability and they, in fact, would expose families and taxpayers to even more risk. These radical privatization proposals would present as extreme a change in the housing finance system as we have witnessed since the 1930s and would leave the U.S. economy vulnerable to the kind of boom-bust cycle that unfettered private market forces caused then and again in the last decade. They also would result in some stark consequences for American families.

The predominant form of finance would be in the form of loans with shorter durations and higher costs, putting more households at greater financial risk. The 30-year fixed-rate mortgage would not be available under terms affordable to most families. Rental housing would be less available and more costly, even as there would be greater demand for it. Finally, fewer working families would have access to the asset-building potential of home ownership, and this pillar of the economic mobility that has characterized the American economy until recently would be lost—and with it part of the American Dream.

History has shown us that a purely private market will not work. Similarly, we know that the current overreliance on Federal Government intervention is unsustainable. Private capital must be encouraged to bear as much of the load as possible in our housing finance system going forward, but that is different from saying the market must be "privatized."

The proposal does induce private capital back into the system and structures an appropriate Government role to ensure that the broader housing policy goals are satisfied.

Features of the "Plan for a Responsible Market for Housing Finance"

Let me now describe the key features of the "Plan for a Responsible Market." The reforms and enhanced consumer protections enacted in the Dodd-Frank Act were an essential first step as is proper implementation of that law. The proposal of the Mortgage Finance Working Group creates a system that preserves the traditional roles of originators and private mortgage insurers, but assigning functions previously provided by the Government-sponsored enterprises, or GSEs, Fannie Mae and Freddie Mac, to three different actors—issuers; chartered mortgage institutions, or CMIs; and a catastrophic risk insurance fund, or CRIF.

Issuers will originate or purchase and pool loans; issue mortgage-backed securities, or MBSs; and may purchase credit insurance on MBSs that meets certain standards from CMIs.

CMIs also will be fully private institutions not owned or controlled by originators. They will be chartered and regulated by a Federal agency and their function would

[4] Bryan J. Noeth and Rajdeep Sengupta, "Flight to Safety and U.S. Treasury Securities", *The Regional Economist* 18(3) (2010):18–19, available at *http://www.stlouisfed.org/publications/re/articles/?id=1984.*

[5] Joint Economic Committee Majority Staff, "From Wall Street to Main Street: Understanding How the Credit Crisis Affects You" (2008).

be to assure investors of timely payment of principal and interest only on MBSs that are eligible for the Government guarantee.

The CRIF would be an on-budget fund (similar to the FDIC's Deposit Insurance Fund) that is run by the Government, and funded by premiums on CMI-guaranteed MBSs. In the event of the CMI's financial failure, the explicit guarantee provided by the CRIF would protect only the interests of holders of only qualified CMI securities.

The Government would price and issue the catastrophic guarantee, collect the premium, and administer the fund. The fund would establish the product structure and underwriting standards for mortgages that can be put into guaranteed securities and the securitization standards for MBSs guaranteed by the CMIs. The Government would also establish reserving and capital requirements for CMIs, and these would be at higher levels than those held by Fannie and Freddie.

It is important to note that under our plan, there would be several layers of protection standing ahead of any taxpayer exposure. Borrower equity, the CMI's capital, and in some cases private mortgage insurance all would stand ahead of the CRIF. All of these private sources of funds would need to be exhausted before the CRIF would have any exposure to loss.

We believe this system will serve the needs of the vast majority of households that are looking for the consistent availability of affordable credit and predictable housing costs that can be achieved through a limited Government market backstop.

This system will serve the vast majority of households seeking consistent, affordable credit and predictable housing costs that can be achieved through a limited Government backstop. We also include new mechanisms to see that the benefits of this system are made available in a fairer and more equitable way than ever before and to prevent the problem of a dual market where certain classes of borrowers and communities are relegated to separate, unequal markets. These mechanisms prohibit the CMIs from "creaming the market" and require them to extend the benefits of the system to all qualified borrowers, including those historically underserved. Further, to effectively serve those underserved borrowers or tenants whose housing needs require greater Government support, our plan proposes two parallel strategies: (1) establishing a new "market access fund" to provide responsible credit support and research and development funds to promising new products that close market gaps, and which would complement the Affordable Housing Trust Fund and Capital Magnet Fund established by the Housing and Economic Recovery Act of 2008; and (2) revitalizing the Federal Housing Administration, or FHA.

Ensure Nondiscriminatory Access to Credit

CMIs in the new housing finance system would be responsible for providing an equitable outlet for all primary market loans meeting the standards for the guarantee, rather than serving only a limited segment of the business, such as higher-income portions of that market.

This obligation would have four parts:

- CMIs would be expected to roughly mirror the primary market in terms of the amount and the geography of single-family low- and moderate-income loans (other than those with direct Government insurance) that are securitized and are eligible for the CMI guarantee. They would not be allowed to "cream" the market by securitizing limited classes of loans. This assumes that the primary market will be appropriately incentivized through the Community Reinvestment Act, which requires banks and thrifts to serve all communities in which they are chartered, including low- and moderate-income communities, consistent with safe and sound operations.
- CMIs that guarantee multifamily loans would be expected to demonstrate that at least 50 percent of the units supported by securitized multifamily loans during the preceding year were offered at rents affordable to families at 80 percent of the relevant area median income, measured at the time of the securitization.
- CMIs would be required to provide loan-level data on securitizations to the Government (which will be required to make these data public) that are no less robust than those of the Public Use Database currently produced by the Federal Housing Finance Administration.
- All CMIs would participate in a yearly planning, reporting, and evaluation process covering their plans for and performance against both the single-family and multifamily performance standards and Government-identified areas of special concern, such as rural housing, small rental properties, and shortages created by special market conditions such as natural disasters.

Like all other secondary market participants, CMIs would be required to abide by nondiscrimination and consumer protection laws. Substantial underperformance by a CMI could lead to fines and possible loss of its CMI license.

Market Access Fund

Some groups of borrowers and certain types of housing have not been well served by the system of the past. Rules against discriminatory lending and anticreaming provisions, such as those we have proposed for CMIs, will help, but are likely to be insufficient to fill all the gaps.

These gaps are especially important to fill in the aftermath of the housing crisis, where many communities saw equity stripped by subprime lending. Moreover, the larger economic downturn has hit underserved communities most heavily. These places most in need of capital to rebuild will be the last to get it from a private market left to its own devices.

Certainly, direct subsidies are critical where deep Government support is needed, such as for low-income rental housing. In addition to existing programs like Section 8, the low-income housing tax credit, and HOME, a fully funded National Housing Trust Fund will help meet these needs. But beyond cash grants to support affordable housing, we need the entire housing finance system to provide access to credit for affordable rental housing and home ownership. Mortgage insurance provided by FHA and other similar programs brings private capital into underserved communities, but under these programs, a taxpayer insurance fund takes on almost all of the credit risk. Lenders who make FHA loans get fee and servicing income but they have very little capital at risk. Thus, FHA insurance ensures loans are available to markets and borrowers that private capital will not serve.[6]

CMIs are unlikely to make loans that they perceive as too risky or that might provide below-market rates of return. But this sector cannot be allowed to see itself as having no responsibility to serve low- and moderate-income communities, communities of color, and communities hard hit by the foreclosure crisis and other adverse conditions, claiming that the risks are inconsistent with their fiduciary duty to shareholders. The result could be a two-tiered system of housing finance, with FHA as the primary vehicle serving low- and moderate-income communities and communities of color and taxpayers absorbing all the risk, and private capital serving only the middle and upper parts of the market.

The market access fund offers a way to help CMIs and other private actors meet their obligations to serve the entire market.

Loan products that can successfully and sustainably meet underserved housing needs can eventually access the capital markets—if they can first gain a record of loan performance and market experience. Past examples include home improvement loans and guaranteed rural housing loans, as well as loans made less risky by quality housing counseling.

A market access fund would provide a full-faith-and-credit Government credit subsidy to cover part of these risks to enable entities including CMIs and nonprofit and Government (such as State housing finance agency) market participants to develop and establish a market for these innovative products. Examples of new products might include lease purchase loans, energy-efficient or location-efficient loans, shared equity loans, and loans on small multifamily properties.[7] The fund could also make available research and development funds (grants and loans) to encourage initial development of such products.

The market access fund would provide “wholesale” Government product support on a risk-sharing basis, in contrast to the retail, 100 percent insurance offered by the Federal Housing Administration. The fund would be required to meet specific performance goals relating, for example, to financing for housing in rural areas or places with high foreclosure rates, unsubsidized affordable rental housing, and man-

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[6] FHA’s history of service to low-income and minority communities has not, however, been without controversy, as in some communities and in some time periods, racial covenants, block busting, fraud, and other abuses by realtors, lenders, and other program participants that FHA failed to prevent have led to neighborhood deterioration. *See,* Sean Zielenbach, “The Art of Revitalization: Improving Conditions in Distressed Inner-City Neighborhoods” (New York: Garland Publishing, 2000).

[7] For example, one idea that has been proposed for the market access fund has been to capitalize an equity pool that would purchase participations in local and State “shared equity” home ownership funds, providing scale to this affordability product that has been greatly successful in smaller settings but which lacks access to the secondary capital markets and is thus otherwise limited in the funds it has access to. The two major barriers to scale for this product have been a large degree of heterogeneity in local products and a lack of standard performance data. The leveraging of market access fund capital would clearly address these hurdles and allow shared equity to achieve a larger scale, potentially accessing the secondary markets in time.

ufactured housing. And the fund's credit subsidy would only be available for products on a shared-risk basis, meaning that other capital would need to be at risk as well, providing both market discipline and an opportunity for these actors to learn how to serve underserved markets well. This in turn would pave the way for private capital to "mainstream" the products, increasing sustainable home ownership and affordable rental housing, and eventually reducing or eliminating the need for public support.

The market access fund would be funded by an assessment on all MBS issues. A portion of the assessment would go to the National Housing Trust Fund (for direct subsidy) and to the Capital Magnet Fund (for credit programs by Community Development Finance Institutions), as established under the terms of the Housing and Economic Recovery Act of 2008. It is important that the assessment be levied on both those issues guaranteed by CMIs and those without CMI guarantees to ensure that the responsibility to support better service to underserved markets primarily through private finance is supported by the jumbo market as well as the middle market.

By sharing the risk of loss, the market access fund makes it easier for private capital to serve underserved communities. Without this mechanism, there is a significant risk that the taxpayer will continue to stand behind too large a segment of the housing market through FHA/VA and a two-tier housing finance system will develop.

The market access fund will help CMIs and other private actors meet their obligations to serve the entire market while simultaneously providing the market discipline of private risk capital for new products that serve underserved communities. And it will do so while limiting the Government's role and exposure to risk.

Revitalized and Improved FHA

The role of the Federal Housing Administration as an essential countercyclical backstop has been demonstrated by its performance during the recent housing and financial crises. While it insured only 3.3 percent of single-family mortgages originated in 2006, by 2009, after private capital fled the housing market, its market share increased to 21.1 percent. Over the past year, FHA provided access to credit for about 40 percent of purchase mortgages.[8] In 2009, FHA insured 60 percent of all mortgages to African-American and Hispanic homebuyers, and mortgages for more than 882,000 first-time homebuyers.[9] Earlier in the economic and financial crises, these percentages were even higher.

FHA reported in November 2010 in its annual report to Congress that, under conservative assumptions of future growth of home prices, and without any new policy actions, FHA's capital ratio is expected to approach the congressionally mandated threshold of 2 percent of all insurance-in-force in 2014 and exceed the statutory requirement in 2015. In other words, if correct, FHA will have weathered the worst housing crisis since its creation in the aftermath of the Great Depression and will have done so without costing taxpayers a dime. FHA's market share was small during the worst of the crisis and, while it is sustaining significant losses from loans insured prior to 2009, better-performing loans are now helping to stabilize its financial position.

FHA, however, lacks the systems, market expertise, and nimbleness one would hope to see in an institution with more than $1 trillion of insurance-in-force.[10] Its product terms and many practices are prescribed by statute with such specificity that it makes prudent management of an insurance fund extremely difficult.

In 1994, the Joint Center for Housing Studies at Harvard teamed up with FHA Commissioner Nic Retsinas to conduct a series of public hearings and study the future of FHA. Their report and recommendations concluded that Congress should reinvent FHA as a Government corporation, under the direction of the secretary of the department of housing and urban development, with strict and independent oversight of its performance in serving underserved markets and maintaining financial soundness, but greater flexibility in product design to meet those ends.[11]

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[8] Office of Policy Development and Research, U.S. Housing Market Conditions (Department of Housing and Urban Development, 2010), available at *http://www.huduser.org/portal/periodicals/ushmc/fall10/hist_data.pdf.*

[9] Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2010 (Department of Housing and Urban Development, 2010), available at *http://www.hud.gov/offices/hsg/rmra/oe/rpts/actr/2010actr_subltr.pdf.*

[10] *Ibid.*

[11] Department of Housing and Urban Development and Harvard University's Joint Center for Housing Studies, "Creating a New Federal Housing Corporation", (1995), available at *http://babel.hathitrust.org/cgi/pt?view=image;size=100;id=mdp.39015034895089;page=root;seq=3.*

The Harvard proposal would have created a new Federal Housing Corporation with far greater flexibility in procurement and personnel policies in order to jumpstart the transformation to a more business-like agency with a public purpose. The proposal was adopted by President Clinton in a HUD Reinvention Blueprint released in March 1995.[12] Similar recommendations were endorsed by the Millennial Housing Commission in their report submitted to Congress in May 2002.[13] Each time, market, political, and inertial forces resulted in no action.

The thrust of these recommendations is on the mark. Most significantly, under these proposals, FHA could design loan products to help meet the needs of underserved markets. The FHA would need to charge premiums designed so the insurance funds would be actuarially sound. These products would be subject to independent credit subsidy estimates approved by the Office of Management and Budget and additional private market-like measures of risk. And the overall portfolio of insurance would be required to maintain adequate capital reserves to continue to protect taxpayers from insurance losses, as FHA has done since the Great Depression.

Other reforms would let FHA pay salaries at levels paid by the banking regulatory agencies, as comparable financial market expertise must be attracted to better protect taxpayers from the risks inherent in insurance. And procurement and budget flexibility would make it easier for FHA to use insurance fund resources to develop new systems and procure them more easily to better assess and manage risk in the insurance fund.

It is time to revisit these ideas. It is now evident that FHA is indispensable for economic stability and housing market equity. In light of its continued importance, we should ensure that FHA has the tools it needs to best meet underserved housing needs and provide countercyclical liquidity while doing what works to protect taxpayers optimally from any risk.

Conclusion

From the 1930s to the 2000s, the United States enjoyed a vibrant, stable, housing market that evolved to provide mortgage money at all times, in all parts of the country, for sustainable home ownership and rental housing. The system was not perfect but it contains valuable lessons for us as we look to rebuild. By applying those lessons to meet the goals outlined in this testimony, you have the opportunity to build a system that rebalances housing choices and works better for more households and more communities than the system that has been in place for the last 70 years.

Thank you for inviting me to talk about the work my colleagues and I have done and I would be happy to answer any questions.

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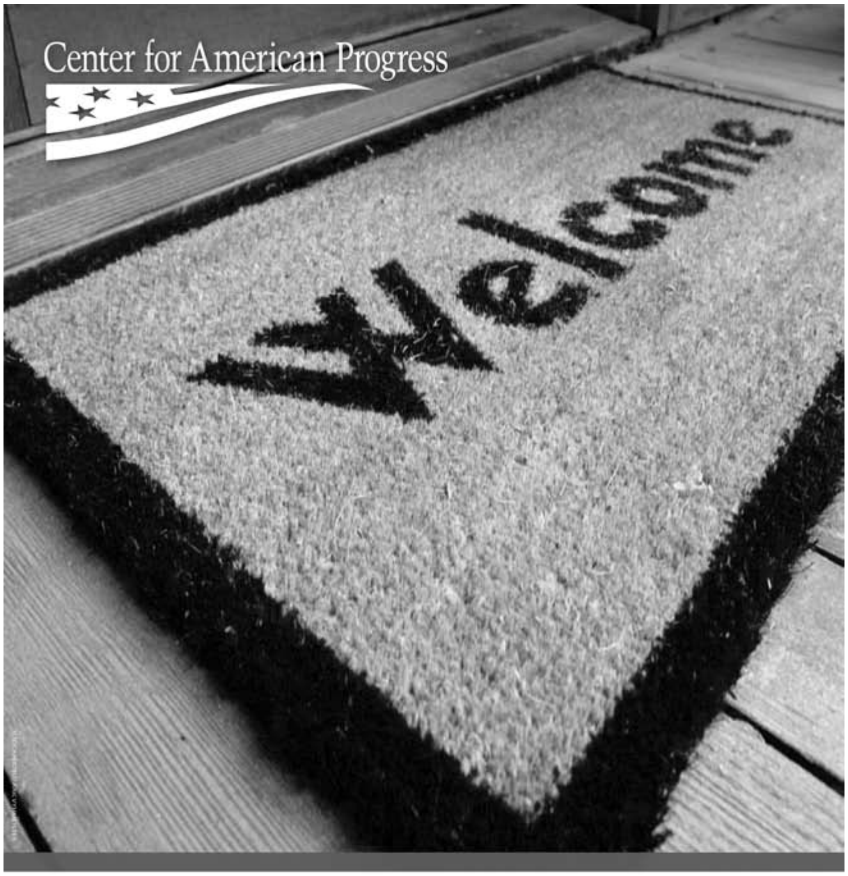
[12] HUD Reinvention: From Blueprint to Action (Department of Housing and Urban Development, 1995).

[13] The Millennial Housing Commission, "Meeting Our Nation's Housing Challenges: Report of the Bipartisan Millennial Housing Commission Appointed by the Congress of the United States" (2002), available at *http://govinfo.library.unt.edu/mhc/MHCReport.pdf.*



A Responsible Market for Housing Finance

A Progressive Plan to Reform the U.S. Secondary Market for Residential Mortgages

Prepared by the Mortgage Finance Working Group January 2011
Sponsored by the Center for American Progress

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About the Mortgage Finance Working Group and this report

This proposal is a product of the Mortgage Finance Working Group sponsored by the Center for American Progress, with the generous support of the Ford Foundation, and the Open Society Institute. The members of this working group began gathering in 2008 in response to the U.S. housing crisis in an effort to collectively strengthen their understanding of the causes of the crisis and to discuss possible options for public policy to shape the future of the U.S. mortgage markets. Unless otherwise noted, this proposal represents the views of the members whose names are below, in their individual capacities. Affiliations are provided for identification purposes only.

Membership in the Mortgage Finance Working Group

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Barry Zigas, Director of Housing Policy, Consumer Federation of America

Relationship to earlier work by the Mortgage Finance Working Group

In December 2009, our group released a draft of this report. This version supersedes that draft.

In July of 2010, we submitted a Response to the Departments of Housing and Urban Development and Treasury's notice and request for information (eDocket Number HUD-2010-0029) that included a slide deck describing our proposal in response to Question 4. This report supersedes that slide deck.

In October 2010, the multifamily subcommittee of the Mortgage Finance Working Group released a paper entitled "A Responsible Market for Rental Housing Finance." This report incorporates that paper by reference and does *not* supersede it, except to the extent it refers to terminology from earlier versions of the MFWG proposal that are not in this White Paper.

Contents

Introduction and summary

In the years prior to the Great Depression, American housing finance was characterized by wild boom-and-bust cycles, regionally disparate prices, and short-term balloon mortgages that severely restricted opportunities for average Americans to own a home. For close to 70 years following the reforms of the 1930s, that all changed. Well into the late 1990s, mortgage finance was continuously available, under terms and at prices that made sustainable homeownership available. A critically important element of this system was the development, starting in about 1970, of an effective secondary market for home mortgages—a marketplace where individual home mortgages are sold by lenders and packaged into mortgage-backed securities that can be sold to investors in the United States and around the world. This pool of capital provided widening opportunities for wealth accumulation for many American families, and supported significant, although not necessarily sufficient, quantities of affordable rental housing.

For some communities in our country, however, credit was constrained, leaving credit worthy borrowers behind. During the 1980s and 1990s, Community Development Financial Institutions, Community Development Corporations, and nonprofit organizations of all types, in partnership with local governments, mortgage lenders, and secondary market institutions demonstrated successful ways to discern the credit-worthy borrowers in underserved communities and to extend them safe, affordable mortgages. Unfortunately, just as these good innovations were picking up speed, so too were predatory mortgage finance products such as adjustable-rate mortgages with pricing gimmicks designed to encourage potential homeowners to borrow far more than they could manage.

These disastrous products exploded in volume, stole market share from the mainstream housing finance system, launched a precarious race to the bottom, and drove out sustainable affordable lending. Most of the predatory products were packaged into so-called private label mortgage-backed securities—securities backed by home mortgages that were not eligible to be guaranteed by the U.S. government-sponsored entities Fannie Mae and Freddie Mac, the two mortgage finance giants. In 2008, the system collapsed in a hail of badly designed loans, mispriced risk, excessive leverage, and lack of supervision, greatly exacerbating the Great Recession.

Today, the federal government backstops some 90 percent of all home mortgage loans. Nearly half of the new home loans are guaranteed by the Federal Housing Administration, the Department of Veterans Affairs, or the Department of Agriculture's Rural Housing Services programs. Almost all other home mortgage loans and most mortgage refinancings are financed through Fannie Mae and Freddie Mac, both of which are now in government conservatorship. The private secondary market in home mortgages disappeared in 2008 and remains moribund. Fannie Mae and Freddie Mac also now purchase more than 80 percent of all multifamily mortgages, loans to owners, and developers of rental residential properties. This new status quo is unsustainable.

We have the knowledge and the tools to create an American housing finance system that will be stable over the ups and downs of the economy—a system that relies upon private capital to equitably serve homeowners, renters and landlords, lenders, investors, and the larger American economy while promoting residential integration, the elimination of housing discrimination, and the provision of safe, decent, and affordable housing in all urban, suburban, and rural communities. The first step taken was Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, named after its two main sponsors, Sen. Christopher Dodd (D-CT) and Rep. Barney Frank (D-MA), which provides for creditable supervision of our nation's banking and securities system, including greater standardization and transparency of mortgage-backed securities, and enhanced consumer protection for home mortgages.[1]

The next step is to move away from our current nationalized mortgage finance system toward a system that once again relies on private-sector capital, through both depository institutions and the secondary mortgage market, to provide the bulk of mortgage finance for American homeowners and owners of rental property. This new mortgage finance system should be guided by five overarching principles:

- Liquidity: Provide participants in the capital markets with the confidence to deliver a reliable supply of capital to ensure access to mortgage credit, every day and in every community, through large and small lenders alike

- Stability: Rein in excessive risk taking and promote reasonable products backed by sufficient capital to protect our economy from destructive boom-bust cycles such as the one we are now struggling to overcome, and the ones that used to plague our economy before the reforms of the 1930s

- Transparency and standardization: Require underwriting, documentation, and analytical standards that are clear and consistent across the board so consumers, investors, and regulators can accurately assess and price risk, and regulators can hold institutions accountable for maintaining an appropriate level of capital

- Affordability: Ensure access to reasonably priced financing for both homeownership and rental housing

- Consumer protection: Ensure that the system supports the long-term best interest of all borrowers and consumers and protects against predatory practices

These principles form the framework for this proposal. We also focus on three specific goals:

- Preserving the availability of 30-year fixed-rate mortgages, which allow families to fix their housing costs and thus better plan for their futures in an ever more volatile economy

- Rebalancing U.S. housing policy so that private markets are the primary source of decent affordable rental housing, with public support where deep subsidy is needed

- Ensuring that a broad array of large and small mortgage lenders (such as community banks, credit unions, and Community Development Financial Institutions) have access to secondary market finance so that they can continue to provide single- and multifamily mortgage loans in every community across our country

To develop a new mortgage finance system based on these principles and with these goals in mind, we approached the problem by dividing both the homeownership and rental housing markets into three parts:

- Underserved borrowers or tenants, whose housing needs (whether as homeowners or renters) may require some direct government support

- Middle-market borrowers or tenants whose housing needs require secondary market liquidity and long-term finance, both of which can be achieved through a limited government backstop of the mortgage finance marketplace

- Higher income and wealthy borrowers and tenants, whose housing needs require government financial intervention only when mortgage markets freeze

Purchasing a home is one of the most important financial decisions most Americans will ever make. But the transactions between borrower and lender that happen in this primary market represent only a part of the housing finance system. To fund mortgage loans for homeowners and support rental housing, lenders need access to a pool of capital that in turn depends on a transparent, effectively regulated secondary market. This paper is concerned primarily with the secondary market, and in particular, the mortgage-backed securities market, which currently has about $9 trillion in securities outstanding.

Today (as before the crisis), the largest participants in this housing finance market are Fannie Mae and Freddie Mac. These two mortgage finance giants are currently in conservatorship and essentially owned by the federal government.[2] They perform an array of secondary market functions that together provide financing for a significant portion of our nation's rental housing and enable Americans to access long-term, fixed-rate mortgage finance. Access to stable, long-term mortages is a key to household stability and a means to accumulate assets that support retirement, education, and other family responsibilities.

Specifically, Fannie and Freddie buy loans from lenders. They hold some of these loans, particularly multifamily loans, on their balance sheet. But for the most part, the companies issue securities backed by those loans—mortgage-backed securities, or MBS. They also guarantee investors the timely payment of interest and principal on those securities, relieving investors of concerns about credit risk.

Fannie and Freddie provide investors with a basis for confidence that the securities will perform, as their own credit guarantee is backed by an implied—and since conservatorship, effectively explicit—guarantee by the U.S. government against the corporation's failure. With that backstop, investors believe there will be a market for any MBS they may wish to sell later, regardless of economic conditions. The result is a deep and liquid market for mortgage-backed securities that was able to continue to operate in 2008 even when other capital markets were frozen. Fannie and Freddie, with their government backing, were able to provide the countercyclical liquidity that kept mortgage money available when private firms without government backing could not do so.

We need a new system that is capitalized with as much private capital as possible while still serving the nation's housing needs.

The mortgage crisis occurred because we got away from the fundamental principles that guided the system for more than 70 years, and ignored the irresponsible actions of financial institutions and the dangers of unregulated, opaque markets. We know that when U.S. mortgage finance was essentially a purely private endeavor prior to the reforms of the 1930s, it failed. But we also know that the dominant role now played by the government through the conservatorship of Fannie and Freddie, and through federal agencies such as the Federal Housing Administration, which provides direct government guarantees, needs to be significantly reduced.

In short, we need a new system that is capitalized with as much private capital as possible while still serving the nation's housing needs. Any government guarantee must be explicit and paid for; we must avoid a repetition of the uncompensated implicit government guarantee that backed Fannie and Freddie before they collapsed into government conservatorship.

The challenge for policymakers is to reform the American housing finance system and create a new system that supports the American dream of homeownership, provides a sufficient stock of affordable rental housing, and restores integrity and accountability to the system. This new system must protect consumers and the broader economy from the predatory loans, excessive leverage, and lack of regulatory supervision that caused the recent financial crisis and led to an unsustainable reliance on federal government intervention in the mortgage market.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, with its reforms of the banking and securities systems, and enhanced consumer protections for mortgages and investor safeguards for mortgage-backed securities, was the first step. We build on these reforms and propose a system that preserves the traditional roles of mortgage originators but separates some of the functions previously provided by Fannie and Freddie, into the hands of three different actors: issuers, Chartered Mortgage Institutions, and a Catastrophic Risk Insurance Fund. These three actors would interact in this new system in the following way:

- Issuers are fully private entities that originate or purchase and pool loans, and issue mortgage-backed securities. Where the MBS themselves and the loans backing them meet certain standards, issuers may purchase credit insurance on the MBS from the new Chartered Mortgage Institutions for the benefit of their investors.

- Chartered Mortgage Institutions are fully private institutions, not owned or controlled by originators (other than potentially through a broad-based cooperative structure), chartered and regulated by a federal agency. These CMIs would provide investors in mortgage-backed securities a guarantee of timely payment of principal and interest on the securities, typically issued by others, backed by loans eligible for government support through the Catastrophic Risk Insurance Fund.

- The Catastrophic Risk Insurance Fund would be a government-run fund fully accounted for in the federal budget and funded by premiums on CMI-guaranteed mortgage-backed securities.The new fund would provide in exchange for these premiums an explicit guarantee of the Chartered Mortgage Institutions' obligations in the event of their financial failure. The government would price and issue the catastrophic guarantee, collect the premium for the guarantee, and administer the Catastrophic Risk Insurance Fund, much like the Federal Deposit Insurance Corporation's Deposit Insurance Fund. The new Catastrophic Risk Insurance Fund would set the product structure and underwriting standards for mortgages that can be put into securities guaranteed by the CMIs and securitization standards for MBS guaranteed by the CMIs.

To protect taxpayers and ensure that all requirements for the guarantee are met, the federal government also would regulate the Chartered Mortgage Institutions for both capital adequacy and compliance with consumer protection and other responsibilities. Finally, the government would serve as conservator or receiver for CMIs that fail, with responsibilities that include ensuring that the servicing of the remaining guaranteed securities is carried out by a qualified entity.

The primary function of CMIs would be to provide investors with assurance of timely payment of principal and interest on mortgage-backed securities that are eligible for the government guarantee. The CMIs would be allowed to hold some loans in their own portfolios, such as troubled loans removed from mortgage-backed securities as well as some multifamily mortgages, which are not easily securitized, but such on-balance-sheet activities would be limited.

The government would guarantee that in the event of the failure of the CMI investors would continue to receive timely payment of principal and interest on CMI-guaranteed mortgage-backed securities that meet product structure, underwriting, and securities structure standards. The government guarantee would be explicit and appropriately priced, and the proceeds would be held in a Catastrophic Risk Insurance Fund. The CMI's equity, which would be set by the government at significantly higher than levels required of Fannie Mae and Freddie Mac, as well as borrower equity and, in some cases, private mortgage insurance, would stand ahead of the Catastrophic Risk Insurance Fund in the event of a CMI failure. The Catastrophic Risk Insurance Fund would only be exposed to losses if a CMI collapsed, wiping out its shareholders and most of its creditors. Neither the equity nor the corporate debt of the CMIs would have any government backing.

Under this proposal, we estimate the cost of a 30-year fixed rate mortgage would probably increase about one-half of 1 percent, or only 50 basis points. Based on today's market that would bring prices back to the level of July 2009—a small price to pay for a robust mortgage market supported largely by private capital.

Our reforms will create a system that will serve the needs of the vast majority of those households that are looking for the consistent availability of affordable credit and predictable housing costs, which can be achieved through a limited government market backstop. There will continue, however, to be underserved borrowers, tenants, and communities, whose housing needs (whether as homeowners or renters) may require some direct government support. To ensure a housing market that effectively combines private capital and public support in a continuum that effectively serves all, we propose three parallel strategies.

First, the Federal Housing Administration would be preserved and granted additional authorities to ensure that they have the talent, systems, and flexibility to meet their public purposes and protect taxpayers from risk. Housing programs run by these agencies provide a level of support, primarily through credit enhancement, to support homeownership opportunities for families with lower incomes and limited resources, as well as to enable landlords to provide affordable rental housing to low- and moderate-income households.

Second, each Chartered Mortgage Institution would have an obligation to provide an equitable outlet for all primary market mortgages (other than those with direct government insurance) meeting the standards for the guarantee of well-designed, sustainable loans, rather than serving only a limited segment of the business such as higher-income portions of that market. With respect to multifamily lending, CMIs that securitize multifamily loans would be required to demonstrate that they are providing housing for working households. In addition, CMIs would be required to provide service to areas of specific concern identified annually, such as shortages created by natural disasters, rural housing, and small multifamily housing.

Third, we propose the creation of a Market Access Fund, financed by a small fee on all mortgage-backed securities. The Market Access Fund would, on a competitive and shared-risk basis, provide credit enhancement and research and development funds to promising but untested mortgage finance products that could better serve underserved markets. Market Access Fund credit enhancements, unlike Federal Housing Administration guarantees would back only a portion of the risk of a loss and would be available only for a limited period of time. The fee on all mortgage-backed securities would also fund the National Housing Trust Fund and the Capital Magnet Fund, two funds that provide finance to states and Community Development Financial Institutions primarily to support affordable rental housing, and which were to have been funded by Fannie Mae and Freddie Mac before they fell into conservatorship.[3]

The new mortgage finance structure we propose will provide stable, broad-based, privately capitalized housing finance so long as the entire mortgage market is subject to strong and consistent regulation. The reforms to the broader mortgage market enacted in the Dodd-Frank Act must be implemented to adequately protect against another race to the bottom. Our paper recommends careful attention to the implementation of the new rules.

We believe our proposal will restore the opportunity of homeownership as one of the fundamental tenets of the American Dream, and to ensure that abundant rental properties are available so that all Americans have access to decent shelter at a reasonable price. From the 1930s to the late 1990s the United States enjoyed a vibrant, stable, housing market that evolved to provide mortgage money at all times, in all parts of the country, for sustainable homeownership and rental housing. The system was not perfect, but as we rebuild we have much to learn from what worked in the period before negligent oversight allowed market distortions to implode our economy.

Our proposal builds on those lessons to construct a housing finance system characterized by liquidity, financial stability, transparency, standardization, affordability, and consumer protection. In the pages that follow, we will examine why the current housing finance system is unsustainable, and offer a detailed proposal for reform that simultaneously can achieve these goals and put private risk capital back at the center of mortgage finance.

As policymakers in the Obama administration and Congress begin to debate the future of the housing finance system, we have the opportunity to transform the system so it serves this nation even better and longer than did the system established in the 1930s. The job is substantively complex and politically challenging but essential. Our proposal recognizes these challenges and offers a comprehensive approach to create an American housing finance system that will be stable over the ups and downs of the economy and will equitably serve homeowners, renters, landlords, lenders, investors, and the larger American economy.

Time for reform

Shortly, housing and finance policymakers in the Obama administration and on Capitol Hill will be deep in debate about how to reform the nation's housing finance system, which imploded by the fall of 2008 and is now functional only because the government effectively guarantees about 90 percent of all new mortgages. Major reforms are necessary, both to rein in the systemic risks to our housing and financial markets that became apparent over the past decade, and to recalibrate the balance between homeownership and rental housing. These reforms will have enormous impacts on U.S. households.

In the wake of the mortgage crisis, a consensus emerged that the new post-crisis housing finance system will require large changes to Fannie Mae and Freddie Mac and might even require their elimination. But for decades, Fannie and Freddie were critical to the efficient functioning of the nation's housing finance system, serving as the engine of mortgage finance for middle-class Americans. Policymakers must carefully consider how to ensure that the public purposes served by these entities continue to be achieved.

Lessons learned

The past decade exposed some major flaws in our housing finance architecture.[4] The availability of mortgages was wildly cyclical, resulting in excessive mortgage credit during the housing boom, followed by a nearly complete withdrawal of credit when the bubble burst. The risk of many of the mortgages originated during the housing bubble was underpriced. At the same time, these mortgages were not sustainable for consumers, as low teaser rates and opaque terms masked their high overall cost over time.

The housing bubble was driven by the development of a "shadow banking system" in which mortgage lending and securitization was largely unregulated and certainly undisciplined, in time drawing quasi-governmental entities Fannie Mae and

Freddie Mac to increase their own overall risk during the "race to the bottom" that implicated almost all mortgage lenders during the 2000s. In particular, as Fannie Mae and Freddie Mac lost market share to private mortgage-backed securities issuers who were underpricing risk, the two mortgage finance giants lowered their own underwriting standards and increased their leverage in an attempt to compete. The result: Taxpayers were left exposed to major losses.

Among the lessons we should take away from this recent experience:

- Private mortgage markets are inherently procyclical, meaning they tend to provide too much credit during housing booms and too little credit during downturns, inflating bubbles and deepening downturns.

- In the absence of government strictures or incentives, private lending practices tend to customize products with shorter durations, adjustable rates, and other features that transfer risk to borrowers who are often unable to understand or manage the risk.

- The proliferation of nonstandard mortgage products such as those that flourished for a time amid the most recent housing bubble creates opacity and reduces market discipline, both for consumers and investors.

- Risk oversight must be imposed over the entire mortgage finance system because private capital will naturally go to those products, entities, or structures where capital requirements and regulatory oversight are lower or nonexistent, creating the kind of race to the bottom that we just experienced.

- Borrowers and lenders each have limitations in their ability to manage risk, but lenders are better equipped to deal with it as they have diversified portfolios, more resources to evaluate risk, and access to complex financial instruments for hedging against risk. Moreover, they are subject to supervision that should help to identify risk.

- Government support, where it exists, should be explicit, priced, and tailored to the purposes being served so that taxpayers are not unduly at risk.

- Gaps exist in the mortgage market—gaps that typically fail to direct sufficient affordable capital in a sustainable manner to underserved sectors, including low- and moderate-income borrowers, economically distressed regions and communities, and affordable multifamily rental housing.

- Affordability should be considered on a holistic basis, rather than in terms of short-term metrics (such as increases in the homeownership rate). The most problematic loans of the recent housing bubble were those that provided the illusion of affordability, such as through low "teaser rates" and negative amortization, but which were unsustainable over the long run.

Learning these lessons, the mortgage finance system of the future must be characterized by ample liquidity, financial stability, transparency, standardization, affordability, and consumer protection. Before detailing how these principles should be enshrined in a new housing finance system, let's first step back to examine the reason why a government role in our mortgage markets, particularly secondary mortgage markets, is so critical to our national economic well being, our shared prosperity, and for the common good of everyone seeking affordable shelter.

A government role is necessary for smoothly functioning mortgage markets

Our proposal starts with the fact (drawn from experience) that a government role is necessary for a smoothly functioning mortgage market. Prior to the introduction of the modern housing finance system in the 1930s, U.S. mortgage finance was essentially a purely private endeavor—and it failed.

Mortgage products required extremely high down payments (often over 50 percent), and carried high rates of interest, with large regional disparities in pricing—as much as four percentage points between different parts of the country.[5] Mortgages were short term (typically 5-to-10 years), interest-only, with a variable rate of interest, and "bullet" payments of principal at term. Unless borrowers could refinance these loans when they came due, they would have to pay off the outstanding loan balance.

Mortgage finance was effectively available only to a very narrow band of Americans. All others paid cash. The middle class was mostly shut out of homeownership.[6] Even then, the strong procyclical tendencies of mortgage lending were unmitigated, either by regulatory restraints on risk-taking during housing booms or with sources of countercyclical liquidity during housing downturns. As a result, the purely private mortgage system was highly unstable, suffering wealth-destructive bubble-bust cycles every 5-to-10 years.[7] As Federal Reserve economists Diana Hancock and Wayne Passmore observe, mortgage securitization also experienced these cycles in "what is now a familiar recurring history."[8]

The inability of a purely private mortgage finance system to meet the housing needs of a modern economy is also evident from the experience of developed economies around the world. While the exact particulars vary from country to country, every advanced economy in the world relies on significant levels of government support, either explicit or implicit, in their mortgage markets.[9]

Strong oversight of mortgage lenders and countercyclical mortgage credit generated many decades of unprecedented stability for investors and borrowers alike.

Modern U.S. housing finance policy was successful for nearly 70 years in promoting stability and prosperity

Despite its recently exposed flaws, the modern U.S. housing finance system, developed in the aftermath of the Great Depression, was largely successful in promoting stability and prosperity in the housing markets for nearly 70 years. This system relied on a mix of government support and regulation to encourage private capital to flow to sustainable mortgage products that were broadly available to all Americans. Regulatory oversight prevented the severe procyclicality that had manifested itself repeatedly before 1934, enabling a growing number of Americans to access reasonably priced, low-risk mortgages despite the inevitable ups and downs of local housing markets.

The establishment of new government (or government-sponsored) institutions such as the Federal Housing Administration, the Federal Home Loan Bank System, the Federal Deposit Insurance Corporation, and Fannie Mae led to the broad availability of affordable and well-designed mortgage financing options, opening up the possibility of sustainable homeownership or affordably priced rental housing to generations of lower- and middle-income Americans. By enabling working households to save and invest the bulk of their incomes, U.S. housing finance policy was a key part of the social mobility that characterized the second half of the 20th century.

As important, strong oversight of mortgage lenders and countercyclical mortgage credit generated many decades of unprecedented stability for investors and borrowers alike—until the ascendance of laissez-faire economic ideology led to a steep decline in prudent supervision over the housing and finance markets, resulting in the 2000s housing bubble and subsequent bust.

We note that the system in these decades was not as effective at ensuring that credit was available on equitable terms in all communities, although notable progress, consistent with safe and sound banking, was being made by the late

1990s. But the introduction of predatory products and their rampant and unabated spread in the 2000s made a mockery of the values that drove earlier efforts at expanding access to homeownership. Indiscriminate credit on irrational terms—credit that was doomed to fail—instead resulted in high concentrations of foreclosures and destruction of equity in underserved communities that had taken generations to create.

These are the lessons we take away from the history of our mortgage markets since the progressive reforms in the wake of the Great Depression. They are central to the principles that underlie our current reform proposal, to which we now turn.

Goals of a modern privately capitalized housing finance system

A reformed privately-capitalized housing finance system for the United States must be based upon five key public policy principles:[10]

- Liquidity: Broad and consistent access to mortgage credit across all communities in our county and during all kinds of different economic conditions
- Stability: Financial stability in mortgage finance to minimize bubble-and-bust cycles such as the one we are now struggling to overcome and the ones that used to plague our economy before the reforms of the 1930s.
- Transparency and standardization: Transparency and standardization of mortgage products and mortgage-backed securities that can be understood and accurately priced
- Affordability: Affordability so that access to reasonably priced sustainable mortgage finance is available for both homeownership and rental housing
- Consumer protection: Consumer protection so that mortgage products and practices are fair and equitable and in the long-term best interests of borrowers

Public policy based on these principles served our country well over many generations. It was departure from these principles that led to the unsustainable mortgage bubble and ensuing crisis. A return to these principles must form the basis of comprehensive mortgage finance reform. Let's examine each of them briefly in turn.

Broad and constant liquidity

Mortgage credit should be broadly available, serving a wide range of communities and housing types, including those that have traditionally been underserved. This will enhance economic stability while promoting safe, decent, and affordable housing for all, as well as residential integration and the elimination of housing discrimination. To achieve broad and constant liquidity:

- Quality housing finance should be available on a fair and equal basis to all suitable homebuyers, regardless of race, and should also be available to create and maintain sufficient stocks of rental housing.
- Mortgage credit should be available on a consistent basis to avoid exacerbating housing booms and busts, and to lessen the prospect of economic downturns.
- Both large and small lenders, including community banks, credit unions, and Community Development Financial Institutions should have consistent, equitably priced access to the secondary mortgage market.

Broad and constant liquidity requires effective intermediation between borrower demands for long-term, inherently illiquid mortgages and investor demands for short-term, liquid investments. Because long-term fixed-rate loans impose both interest rate and liquidity risk on lenders, they have become increasingly unwilling to hold these loans on their balance sheets. The capital markets therefore have become increasingly important to the intermediation necessary for mortgage finance. But as the past decade has stunningly demonstrated, left to their own devices, capital markets provide highly inconsistent mortgage liquidity, offering too much credit sometimes and no credit at others.

Standardized products help foster liquidity. The fungibility of standardized residential mortgages as well as of mortgage-backed securities based on these mortgages allows for the development of deep, liquid markets, increasing efficiency and improving prices.

It is also important to consider the distribution of mortgage originations. Currently, an estimated 70 percent of all mortgage originations flow through four lenders—JP Morgan Chase Co., Bank of America Corp, Citigroup Inc., and Wells Fargo & Co.—all of which benefit from federal deposit insurance and the perception that they are too big to fail. Without consistent and equitable access to a fairly priced secondary market, the country will be in danger of losing the services of community banks, credit unions, and other lenders that can meet the needs of their communities on a more tailored and targeted basis than can larger institutions, but need a well-functioning secondary market so they can access the capital they need to originate more mortgages.

Financial stability

A totally private mortgage market is inherently inclined toward extreme bubble-bust cycles, which cause the misallocation of capital and result in significant wealth destruction, with devastating repercussions not only for homeowners and lenders but also for neighborhood stability, the larger financial system, and the macroeconomy.[11] Mitigating the inherent procyclicality of mortgage lending requires reining in excessive risk-taking through strong, consistently enforced underwriting standards and capital requirements applied equally across all mortgage financing channels for the long cycle of mortgage risk. As we saw in the past decade, capital arbitrage can quickly turn small gaps in regulatory coverage into major chasms, causing a "race to the bottom" that threatens the entire economy.

Financial stability also requires that sources of mortgage liquidity be available during housing and economic downturns. Lenders are naturally inclined to minimize risk-taking during uncertain economic times, but the resulting absence of credit can severely exacerbate economic distress in a "vicious circle" of falling asset prices, increasing credit defaults, and reduced availability of loans. This problem is especially acute in economically distressed regions and communities. To stabilize the mortgage markets and the economy, sources of countercyclical liquidity are required.

Financial stability requires that sources of mortgage liquidity be available during housing and economic downturns.

Transparency and standardization

Transparency and standardization are essential to financial stability. Underwriting and documentation standards that are clear and consistent across the board enable consumers, investors and regulators to accurately assess and price risk and demand that institutions in the system hold an appropriate amount of capital. Similarly, when standardized securities trade in transparent markets, investors and regulators can understand the actual risk of both instruments and institutions and markets can price securities accurately.

During the housing bubble, the housing finance system experienced a seismic shift toward complex and heterogeneous products, from nonstandard mortgages that could not be understood by consumers at the bottom of the chain, to securities that could not be traded due to their complexity at the top. This lack of transparency and standardization resulted in opacity and adverse selection because the issuers knew more than the investors. The yields investors demanded to take on risk decreased while the risk of the underlying assets increased.

It is unlikely that a private mortgage-backed securities market will reemerge unless investors are convinced these problems have been resolved. Moreover, because the state of the whole secondary market affects the pricing of each packaged pool of mortgages in it, a safe and liquid securitization market can only exist if investors have access to information about all MBS in the market place. Mortgage-backed securities pooled together by our proposed Chartered Mortgage Institutions will not be priced properly if alternative investments that are in fact more risky are priced as if they had the same risk characteristics as the CMI pool. Standardized data fields with verification of data are necessary for all MBS, not just for CMI securities. Finally, no securitizer should be allowed to issue products that cannot be analyzed using standard financial models.

The Dodd-Frank Act establishes a framework for industry-wide regulation, transparency, and securitization. Effective implementation of the new law is a critical element in reestablishing a robust, privately-capitalized mortgage market.

Affordability

One of the most important accomplishments of the modern U.S. housing finance system is the broad availability of mortgage credit. Liquidity and stability are essential to affordability, but they will not do the job without specific attention to whether private mortgage credit is affordable to support sustainable homeownership and quality rental options for the vast majority of Americans.

For most Americans, the lower housing costs produced by the modem mortgage finance system facilitated wealth building, enabling them to build equity, save, and invest. This has contributed to the building of a strong middle class. That housing costs should ideally comprise no more than 30 percent of income is an important guiding concept in modern U.S. housing finance policy, and a key component of the American socioeconomic mobility of the 20th century. It should remain so in the 21st century.

A pillar of this housing system is affordably priced long-term, fixed-rate, fully self-amortizing, prepayable mortgages, such as the 30-year mortgage.[12] The long term of this loan provides borrowers with an affordable payment, while the fixed-rate, the option to prepay, and self-amortization features provide the financial stability and forced savings that are critically important to most families, while retaining the opportunity for mobility. Multifamily rental housing also gains stability from long-term, fixed-rate financing.

Banks and other lenders, however, are reluctant to offer long-term, fixed-rate mortgages to homebuyers or multifamily mortgage borrowers unless the lenders have a consistently available secondary market outlet.[13] In the absence of government policies designed to explicitly support long-term, fixed-rate mortgages, it is likely that this type of mortgage would largely disappear from the U.S. housing landscape or become unaffordable to our nation's middle class, which has been so effectively served by them.[14]

Affordable housing finance must also be available for areas that are not well served by mainstream financial channels, including multifamily rental housing and nontraditional credit risks such as prospective first-time homebuyers with incomes sufficient to support a mortgage but who are unable to raise a large down payment. We have ample evidence that many households who may not fit the "20 percent down, established credit, 30 percent debt-to-income" model can become successful long-term homeowners, when given access to well underwritten, affordable, fixed-rate financing.[15]

Consumer protection

The purchase of a home is a far more complicated, highly technical transaction than any other consumer purchase and occurs only a few times in a consumer's life. Mortgage consumers are at a severe information disadvantage compared to lenders. In addition, a mortgage typically represents a household's largest liability. A mortgage foreclosure therefore has outsized consequences for the borrower. As the current crisis so sadly demonstrates, mortgage foreclosures also have devastating consequences on communities, the financial markets and the broader economy.

During the housing boom, unregulated and often predatory subprime lending not only failed to maintain or promote sustainable homeownership opportunities but also established a dual credit market where factors other than a borrower's creditworthiness—such as race or neighborhood location—determined the type and terms of the mortgages available. All too often, families were denied the best credit for which they qualified because their communities were flooded with unsustainable mortgage credit—in part because secondary market pressures created incentives to make and sell these loans.[16]

To address the persistent problem of information asymmetries that tilt the mortgage finance system to disadvantage consumers, the system should have a built-in bias towards the long-term best interests of borrowers. Origination and secondary market protections, such as those created in the Dodd-Frank Act, respond to this concern. We look forward to their effective implementation. [17]

Putting our principles to work

All five of these principles must be part and parcel of any new housing finance system for the 21st century. As we will demonstrate in the next section of our paper, these five principles are key to all segments of the mortgage finance market, including all parts of the single-family home market and the multifamily mortgage market. To this we now turn.

Defining the mortgage market

Within the U.S. mortgage system, there are two distinct mortgage markets that are served by (and rely upon) a vibrant secondary mortgage market. The larger of these, and the one with which Americans are more familiar, is the market for single-family loans. There is also a significant market for multifamily housing loans, such as those used to finance apartments. (See box)

Mortgage Market Segmentation

Under the housing finance system that existed prior to the implosion of the housing market, there were three secondary market mortgage financing channels that operated through securitization for both the single family and multifamily markets[1]:

1. Loans originated with insurance from Federal Housing Administration, Department of Veterans Affairs, or other federal programs, and financed by the sale of mortgage-backed securities guaranteed by the government-owned Ginnie Mae

2. Loans originated to conform with guidelines set by Fannie Mae or Freddie Mac, and within mortgage limits established by government regulation, financed by the proceeds from sale of mortgage-backed securities issued and guaranteed by Fannie or Freddie (Fannie and Freddie also purchased loans, which they held on their balance sheets.)

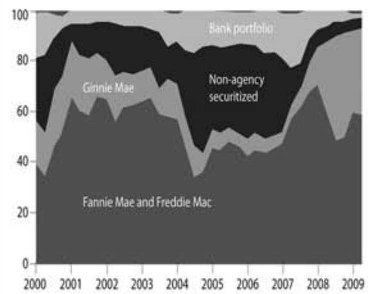
3. Loans originated to standards set by private financial institutions, including loans with balances above the limits set for Fannie and Freddie, and financed by the sale of mortgage-backed securities issued by MBS conduits created by these financial firms

In addition to these secondary market channels, there are of course lenders who hold the loans on their own balance sheets. These lenders are primarily funded through government-insured deposits. The share of depository-backed lending has steadily declined since the interest rate volatility of the 1970s, as mortgage financing has increasingly sought to transfer interest rate risk to investors, according to the Financial Crisis Inquiry Commission.

Private mortgage securitization grew from a small niche channel with about a 10 percent market share in 2002 to capturing nearly 40 percent of all mortgage originations—and accounting for over half of all mortgage-backed securities—in 2006. Just as dramatically, following the collapse of the housing bubble in 2007, private securitization essentially disappeared. Ginnie Mae, the government entity

Mortgage market share by channel

Market share percentage



Source: John Krainer, Federal Reserve Board of San Francisco (2009), available at http://www.frbsf.org/publications/economics/letter/2009/el2009-33.html.

that guarantees the timely payment of interest and principal on loans guaranteed or insured by federal agencies, Fannie Mae, and Freddie Mac now finance some 90 percent of all U.S. mortgage originations, with the rest being retained on the lender's balance sheet.[18] The chart to the left shows the dramatic swing in the share of private (non-agency) securitization. (See chart)

The three-tiered system that existed prior to 2008 roughly corresponds to the natural segmentation of the housing market, and a similar three-tier system should be expected to emerge as the housing market is reestablished. Yet government support within a private mortgage finance system—essential to liquidity, stability, and affordability—should be limited, explicit, and transparently priced.

So with these facts in mind, let's first look at the single-family mortgage marketplace and its secondary market and then the multifamily mortgage marketplaces.

Single family market segmentation

The single-family residential mortgage market can be broadly divided into three types of borrowers: underserved borrowers, middle-market borrowers, and higher-income/higher-wealth borrowers. (See table on page 23) We'll examine each of them in turn.

Underserved borrowers

There is a broad segment of society, including but not limited to low- and moderate-income households and communities of color, which has historically been poorly served by the purely private mortgage markets, in that credit worthy borrowers were denied equal access to the government supported mortgage system. These markets were especially badly served in the past decade, as lenders

Single family housing finance market segments

Underserved	Middle market	Higher wealth/higher income
Who are they?		
• Low and moderate income (LMI) and minority borrowers • Residents of LMI communities, communities of color, and communities hard-hit by foreclosure crisis • Young adults, seniors, others with limited access to credit • Rural communities	• Primarily middle-income households with some savings • Communities of color and communities hard-hit by foreclosure crisis • Middle-income households in high cost areas	• Higher-income households with lots of savings
Types of housing		
• Lower-priced owner-occupied (often first-time home buyer)	• Moderately priced owner-occupied (first-time and subsequent)	• Higher-cost owner-occupied • Second/vacation homes • Investment properties
Challenges		
• Limited wealth often a bar to down payments • Limited access to credit • Limited consumer information	• Predictable housing costs via long-term fixed rate finance • Consistent availability of credit allowing mobility	• Limiting systemic risks posed by speculation

Source: Mortgage Finance Working Group

and brokers with an originate-to-sell business model steered borrowers towards unsustainable products that initially appeared attractive but were in fact high-cost, high-risk products that led to high foreclosure rates and devastated communities.

All of us inevitably pay the price when some segments are underserved. New homeowners successfully entering the housing market and then climbing the housing ladder are essential to robust housing supply and demand. Decades of exclusion, followed by the abuses of the subprime boom, knocked out some of the rungs of that ladder. These must be restored to stabilize the rest of the housing system.

Many families in this category of borrower remain candidates for homeownership using traditional underwriting and long-term, fixed-rate mortgage products.[19] The government must ensure that these products remain available at reasonable prices in all markets, not allowing the development of dual markets as occurred during the boom. In addition, this group of borrowers is particularly dependent on strong regulatory oversight to prevent predatory lending practices, and to ensure that credit is being provided on nondiscriminatory terms.

While few of these borrowers will have sufficient wealth and savings to make large down payments (particularly in high-cost markets), some avail themselves of down payment assistance from local governments or other independent parties, and others utilize Federal Housing Administration mortgage insurance to access sustainable and affordably priced credit. Fannie and Freddie, too, have provided low down-payment mortgages, mitigating their risk through the borrower's purchase of private mortgage insurance.

High mandatory down payments, as some advocate in the post-crisis debate, could have a pernicious and potentially discriminatory effect on these borrowers and the communities in which they live. "Skin in the game" does reduce risk, but there are other proven ways to mitigate the risk of lower down payment lending. To serve these borrowers well, the system of the future must be flexible enough to ensure that the borrower's ability to sustain home ownership guides mortgage underwriting, rather than relying on crude proxies for risk mitigation.

Middle market

The second group of borrowers constitutes the so-called middle market, which historically had access to affordably priced long-term mortgages (such as the 30-year fixed-rate loan) with credit support from Fannie and Freddie. Given the inherent stability provided by long-term fixed-rate mortgage finance, and the large premiums required by purely private lenders to offer such products, particularly when the yield curve is steep, the government should continue its role of ensuring the broad and constant availability of affordably priced long-term fixed-rate products for owner-occupied housing.[20]

These borrowers may also access affordably priced, shorter duration mortgage credit (such as an amortizing mortgage with a fixed rate for five years, with later rate increases capped) from other lending channels, such as lenders who hold loans in their own mortgage portfolio or mortgage bankers who access the private securitization market. As demonstrated in the recent mortgage crisis, a critical role for the government will be to ensure that access to such products is coupled with strong protection from misleading mortgage products.

Higher income/ higher wealth

The third group includes higher-income and higher net-worth borrowers who have sufficient capital and collateral to access credit without any support from the federal government. Many also have the financial sophistication to accept the risks associated with adjustable rate mortgages or nontraditional loans. Borrowers in this category have typically received private mortgages that are retained by the originating lender or resold into private securitizations, although some higher-income and higher net-worth borrowers do use government-supported channels for loans of limited size.

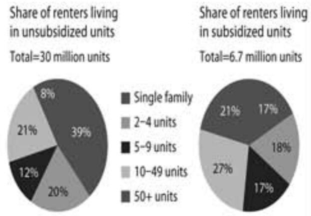
There is less public interest in or need to ensure constant availability of very large loans except under severe general mortgage market liquidity constraints, like those that occurred in 2008. Government credit support to this group of borrowers should be minimal, but government regulation should be robust. Several studies show that during the recent crisis, both serious delinquencies and foreclosures were positively correlated with loan size.

As of January 2010, for example, the serious delinquency rate on loans to owner-occupants that had balances over $1 million was more than 5 percentage points higher than on owner-occupant loans with lower balances. This represented a dramatic shift from the period before August 2008, when the delinquency rate for loans over $1 million was lower than for smaller loans.[21] And with subprime loans, as loan size increases, so does the probability that the loan will default.[22] High delinquency and default rates, no matter who the borrower, contribute to systemic risk. Appropriate regulatory oversight of both the primary and secondary markets for so-called "jumbo" loans is necessary.

Multifamily rental market segmentation[23]

Rental housing comes in the form of both single-family (traditionally 1-to-4 unit) and multifamily properties. Single-family rental financing has in the past largely been served by the same infrastructure that serves the single-family owner-occupied market, but multifamily rental is a notably distinct market, with distinct needs. Roughly 20 million Americans households live in rented units in 1-to-4 unit buildings, while 16.7 million American households live in apartments in multifamily buildings containing five or more units. The multifamily mortgage

Rental market segmentation by building type and subsidy



Source: Joint Center for Housing Studies of Harvard University, "America's Rental Housing: The Key to a Balanced National Policy" (2008).

market is best defined by who is served by the rental housing (those who live there) and by the types of buildings financed (building size, age, and type of owners). (See chart)

A combination of federal and state direct subsidies (such as housing created by the low income housing tax credit, public housing, or subsidized by Section 8 rental assistance) allows many households earning less than 60 percent of area median income to access affordable rental housing. But because the current system is targeted at promoting affordable rental housing for households with less than 60 percent of area median income, many households find themselves shut out of the market for affordable workforce housing.

As a result, many of these households pay more than 30 percent of their income for housing, a commonly used threshold for affordability, and millions of these households spend more than 50 percent of their income on housing. This is a very large segment of the population, for whom an improved multifamily finance system could provide real benefit without necessarily requiring more direct subsidy.

There is also an important difference between smaller multifamily properties (5-to-50 units), which currently house one-third of all renters, and larger apartment buildings that house about 10 percent of all renters. Smaller buildings tend to have a higher proportion of lower income occupants, for whom rent stability is especially important. Yet owners of smaller properties have far greater difficulty accessing stable mortgage finance. In 2001, 86 percent of larger (over 50 units) properties had a mortgage, and of these mortgages, 65 percent were longer-term and fixed-rate. In contrast, only 58 percent of buildings with 5-to-9 units had a mortgage, and just one-third of these had level-payment, fixed-rate loans.[24]

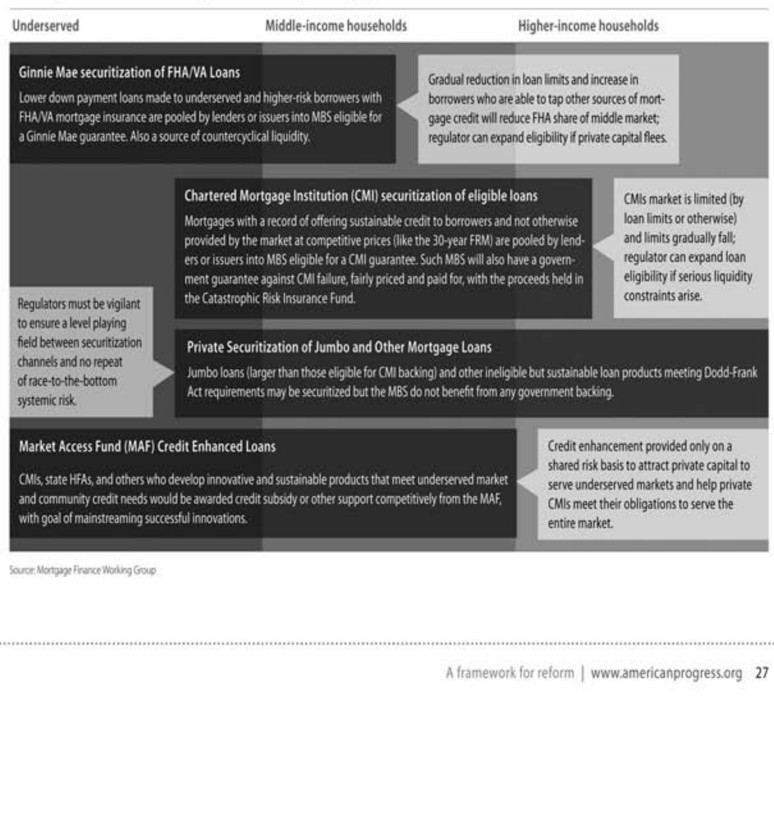
Fannie Mae and Freddie Mac currently play a large role in ensuring that housing finance is available to all multifamily rental properties (through both securitization and direct investment), as do the Federal Housing Administration, state housing finance agencies, and private financial institutions such as banks and insurance companies. Since the housing bubble began to deflate, Fannie's and Freddie's role has been absolutely essential; in 2009 they purchased or securitized over 84 percent of all multifamily mortgages.

A framework for reform

Our new framework for mortgage finance in the United States is guided by the principles of liquidity, stability, transparency, standardization, affordability, and consumer protection. We also draw upon lessons of the recent past. Our framework has four primary sources of secondary market mortgage liquidity. (See chart)

Under our proposed framework, the existing system of loans insured by the federal government through the Federal Housing Administration, the Department of Veterans Affairs, and the Rural Housing Services programs of the Department of Agriculture, which are bundled into securities enjoying a federal Ginnie Mae

Lending channels in a reimagined secondary mortgage market



Source: Mortgage Finance Working Group

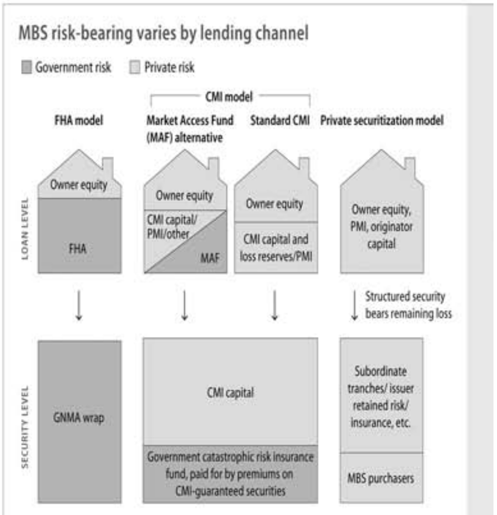
guarantee, would remain largely the same. We contemplate important reforms to FHA to revitalize that agency and improve its operations. We also expect that the market share of this government-backed financing channel will decline significantly from its current level, which has been elevated due to the lack of private lending sources following the bursting of the housing bubble.[25]

A wholly private secondary market without any government support would also exist. It is essential that this market—unlike the past—operate according to rules of consumer protection, capital backing, limited leverage, transparency, and realistic pricing, to prevent the "race to the bottom" that characterized the first decade of this century. Full disclosure of the characteristics of mortgage loans backing securities is essential. Our assumption is that the strong statutory and regulatory requirements established under the Dodd-Frank Act will fill this function. This market would primarily be for "jumbo" loans and certain adjustable rate mortgages.

The portion of the market between that in which individual loans carry a government guarantee and the market with no government backing whatsoever is the area that requires the most new thinking. Implementing the principles of liquidity, stability, transparency, standardization, affordability, and consumer protection requires some degree of government intervention. How can this be done in an efficient manner that also harnesses private capital, business, and operational skill and dexterity while significantly reducing the scope of government involvement and limiting the government's exposure?

We propose that the government's primary involvement in the private mortgage market be to provide a properly priced, explicit guarantee against catastrophic risk to mortgage securities backed by specific types and sizes of loans that the private market would not otherwise consistently and affordably provide. Over time, as the economy improves and a private secondary mortgage market begins to reemerge, we envision the percentage of the market backed by the government being gradually reduced. To some extent this will result from the reemergence of safe and sustainable adjustable rate products. But even in the fixed-rate market, the current share that is government-backed is excessive.

The reduction in government backing could be accomplished by limiting the maximum size of a loan eligible to be in a guaranteed security to, for example, a lower multiple of the median home sale price in more tightly delimited markets than is currently the case for the so-called conforming loan limit set by the Federal Housing Finance Administration that limits the size of loans Fannie and Freddie may purchase, securitize, and guarantee. Another alternative would be to start with a series of decreases in the limit to reflect declines in home prices since 2006.[26] With respect to multifamily loans, we propose that at least 50 percent of the units financed by the loans securitized by a Chartered Mortgage Institution in a given year be available at rents no greater than 30 percent of 80 percent of area median income at the time of securitization. (See chart)



Source: Mortgage Finance Working Group

The proposed Market Access Fund[27] would be a secondary market complement to the Affordable Housing Trust Fund and Capital Magnet Fund, two funds that provide funds to states and Community Development Financial Institutions primarily to support rental housing. The goal of the Market Access Fund would be to "mainstream" products that provide access to sustainable mortgage finance to borrowers and communities that have historically been underserved. By providing research and development funds, credit enhancement, and an opportunity for a product to test the market, the Market Access Fund would enable niche products to gain access to the capital provided by the secondary markets.

A Market Access Fund credit subsidy would be awarded competitively to partners, including Chartered Mortgage Institutions, state and local housing finance agencies, and large nonprofits that can bear a significant share of the risk of loss on the loans and deliver products to the market at scale. Loans with some risk sharing with the Market Access Fund could be eligible for either CMI or Ginnie Mae securitization.

The Market Access Fund would provide access to the secondary market for loans that need a level of government support between the Ginnie Mae securitization channel and the CMI securitization channel. For FHA-insured loans eligible for Ginnie Mae securitization, lenders are protected by a government-backed insurance fund against almost all of the risk of loss from default on loans originated to

FHA standards. For CMI securitization, the CMI and other private entities such as private mortgage insurers bear 100 percent of the risk of loss and the government-backed insurance fund is called upon to make investors whole only upon the failure of the CMI. The Market Access Fund would share the risk of loss on a loan or pool level for products that meet underserved needs, but only where private capital is also at significant risk.

By sharing the risk of loss, the Market Access Fund will make it easier for private capital to serve otherwise underserved communities. Without this mechanism, there is a significant risk that the taxpayer will continue to stand behind too large a share of the housing market through the direct guarantees of the FHA, VA, and USDA's rural housing programs, exposing taxpayers to risk that could, through the MAF, be shared with the private sector.

The Market Access Fund also counters the potential private-sector argument that serving moderate-income communities, communities of color, and communities hard-hit by the foreclosure crisis and other adverse conditions holds risks that are inconsistent with their fiduciary duty to shareholders. The Market Access Fund will help CMIs and other private actors meet their obligations to serve the entire market while simultaneously providing the market discipline of private-risk capital for new products that serve underserved communities. And it will do so while limiting the government's role and exposure to risk.

Our proposed structure preserves a mortgage system that is both local and national, and includes the features that have enabled our mortgage market to attract capital from around the world. Our proposal builds on recent statutory and regulatory accomplishments, including the Dodd-Frank Act. And it ensures that American homeowners, renters, and lenders of all sizes and types, in all parts of the country, at all times, will have access to appropriately- riced, low-risk mortgage finance.

Our new market structure

Originators, issuers, Chartered Mortgage Institutions, and government catastrophic risk insurance

The portion of the U.S. mortgage market backed by Fannie Mae and Freddie Mac has operated efficiently because the two institutions provide an array of essential functions. First, Fannie and Freddie buy loans from lenders, including long-term fixed rate loans that lenders would not make absent a reliable way to off-load the risk posed by such long-term obligations. Loans that they purchase with lower down payments must have private mortgage insurance (paid by the borrower) that gives Fannie and Freddie protection against loss, up to a set amount.

Second, Fannie and Freddie issue mortgage-backed securities backed by many of these loans—the process of "securitization." Third, they also hold some of these loans on their balance sheet. This practice is necessary to aggregate loans for securitization, to hold and test new products before they can gain secondary market acceptance, to provide liquidity for loans that are difficult to securitize (as is the case with some multifamily loans), and to provide lenders with liquidity so that they can continue to make loans when capital markets are constrained.

Fourth, for a fee, Fannie and Freddie guarantee investors against credit risk, providing their MBS investors with assurance of the timely payment of interest and principal on those securities, relieving investors of concerns about borrower default. Fifth, they deliver to investors a further guarantee—a basis for confidence that the mortgage-backed securities they offer for sale will perform as promised—as their own credit guarantee is backed by an implied (and since conservatorship, effectively explicit) guarantee by the U.S. government against their failure. Neither the investors nor Fannie and Freddie currently pay the government for providing this guarantee.

Sixth, these functions also enabled the development of deep liquidity in the so-called "To be Announced," or TBA, market, a type of futures market for mortgage-backed securities that allows lenders to provide consumers with interest rate forward commitments or "locks" on their mortgage interest rates before the final mortgage is signed and sealed. Finally, Fannie and Freddie delivered countercyclical liquidity so that mortgages were available for consumers no matter current housing market conditions of the direction of the broader economy.

Through much of the past 70 years, including the period since the capital markets froze in 2008, this system has resulted in mortgage money being consistently available, contributing substantially to broader economic stability. It has done so by connecting the local demand for mortgages with the international capital markets by creating a fully liquid investment attractive to a wide range of risk adverse investors. With the government standing behind mortgage-backed securities issued by Fannie and Freddie (whether implicitly before 2008 or effectively explicitly since conservatorship), investors believe there will always be a market for any MBS they buy now and may wish to sell later, regardless of economic conditions.

Through much of the past 70 years this system has resulted in mortgage money being consistently available, contributing substantially to broader economic stability.

The result is a deep and liquid market for mortgage securities that has been able to continue to operate since 2008, a period when other capital markets froze. In the future, all these functions need not be provided by the same entity. Indeed, separating them could reduce the risks of overconcentration in the market, enhance competition, and ensure access to all sizes of mortgage originators, including community banks and credit unions, while preserving the transparency, standardization, and scale that make for a broadly efficient and liquid market. Most importantly, the catastrophic risk guarantee must be separated from the other functions.

Thus, we envision a system with the following actors performing the key functions:

- **Originators**—lenders of all types would originate loans, as in the current system.

- **Issuers**—originators of individual mortgages as well as aggregators of those mortgages who would issue securities backed by mortgages originated by themselves or others.

- **Chartered Mortgage Institutions**—institutions not owned or controlled by originators (other than potentially through a broad-based cooperative structure), chartered and regulated by a federal agency, would guarantee timely payment of principal and interest on securities, typically issued by others, backed by loans eligible for a government guarantee against catastrophic risk.

- **Government catastrophic risk insurance**—an on-budget Catastrophic Risk Insurance Fund, funded by premiums on CMI-issued MBS, would be managed by the government to protect investors in the event of the failure of a Chartered Mortgage Institution; the government would price and issue the catastrophic guarantee, collect the guarantee premium, and administer the Catastrophic Risk Insurance Fund.

The government would set the product structure and underwriting standards for eligible mortgages and securitization standards for MBS guaranteed by Chartered Mortgage Institutions.[28] To protect taxpayers and ensure that all requirements for the guarantee are met, the government would regulate the CMIs for both capital adequacy—at levels significantly higher than required of Fannie and Freddie—and compliance with consumer protection and other responsibilities.

The government would serve as conservator or receiver for CMIs that fail, with responsibilities that include ensuring that the servicing of the remaining guaranteed securities is carried out by a qualified entity. Finally, the government would manage the Market Access Fund, which would use credit enhancement and other tools to help CMIs and others test and bring to market sustainable mortgage finance products for borrowers and communities that have historically been underserved.

The different functions of aggregation, insurance, and delivery of government guarantee currently performed by both Fannie Mae and Freddie Mac thus would be separated. Private capital would bear the major responsibility for underwriting, aggregating, securitizing, and guaranteeing mortgage credit for both affordable homeownership and rental housing. The CMI guarantee would be supported by borrower equity, often private mortgage insurance and other forms of credit enhancement, and the CMI's own capital. The government backstop against CMI failure would be explicit, limited, and priced. Neither the debt nor equity of the CMIs would be government backed, unlike the current system. (See chart)

Comparison of primary functional responsibilities in government-backed securitization (non-Ginnie Mae)

PROPOSED SYSTEM	CURRENT SYSTEM
LENDING	
Originators	Originators
INDIVIDUAL MORTGAGE INSURANCE FOR BENEFIT OF LOAN OWNER	
Private mortgage insurers	Private mortgage insurers
BUYING LOANS FOR SECURITIZATION	
Issuers	Fannie Mae and Freddie Mac
ISSUING MORTGAGE BACKED SECURITIES	
Issuers and CMIs (to limited extent)*	Fannie Mae and Freddie Mac
HOLDING WHOLE LOANS ON BALANCE SHEET	
Originators and issuers and CMIs (to limited extent)*	Fannie Mae and Freddie Mac
CREDIT GUARANTEE FOR BENEFIT OF MBS INVESTORS	
Chartered mortgage institutions (CMIs)	Fannie Mae and Freddie Mac
GUARANTEE OF GSE OBLIGATIONS	
Government catastrophic risk insurance fund, funded by premiums on CMI-guaranteed securities (explicit)	Government (implicit and not paid for)

* Not a primary CMI responsibility, but they would need authority to do for certain purposes.

Source: Mortgage Finance Working Group

The proposed Chartered Mortgage Institutions are likely to be significantly smaller than Fannie and Freddie are today, thus enhancing competition, reducing taxpayer risk, and improving access by smaller lenders to the secondary market. To further these ends, and to counterbalance the extreme concentration of the mortgage origination and servicing industries in entities that themselves have both an explicit government guarantee (on deposits) and implicit "too big to fail" backing, the only circumstance under which originating lenders would be allowed to have an ownership interest in a CMI would be as part of a broad-based mutually owned entity designed to ensure access, at equitable prices, to smaller lenders such as community banks, credit unions, and community Development Finance Institutions. In that context, and to assist in the achievement of public policy outcomes that may not coincide with the interests of private owners of CMIs, consideration might also be given to permitting CMIs established by government entities, such as housing finance agencies, individually or collectively.

Chartered Mortgage Institutions can have a variety of ownership structures

The failures of Fannie Mae and Freddie Mac raise the question whether public purposes and private ownership can be successfully mixed. Some advocate that the government have no role in housing policy, other than through agencies such as the FHA. For the many reasons discussed, we believe this is the wrong answer.

Conversely, excluding the benefits of private capital and entrepreneurship from implementation of federal housing policy is both unwise and unnecessary. We believe a variety of ownership structures can be successful. What is essential is that CMIs hold sufficient capital and be subject to robust regulation to limit losses and taxpayer exposure. Potential ownership structures include:

- Mutual associations, which are managed as corporations but where profits flow to customers, rather than outside shareholders
- State and local government ownership, such as through state housing finance agencies
- Cooperatives owned by lenders

Cooperative advocates suggest that such a structure can ensure broader lender access and by sharing risk among many parties, create an incentive to limit and better manage risk. It is important to recognize, however, that a cooperative is no more inherently inclined to serve interests beyond those of its members than is any other private ownership structure.

In particular, a CMI cooperative owned by mortgage lenders would be no more able or willing to provide countercyclical liquidity without government support than would any other financial market participant.[29] And a cooperative owned by very large originators could potentially become so dominant as to crowd out other CMIs.

Single mortgage-backed security product for a robust "To Be Announced" market

A critically important element of the current mortgage market is the "To Be Announced," or TBA market. This is actually two separate but similarly huge markets, in which approximately $3 trillion of Fannie Mae MBS and $2 trillion of Freddie Mac MBS trade.[30] In recent years, approximately 90 percent of all MBS issued by the two companies have been TBA-eligible. These markets take their name because investors can trade securities that are announced for issuance at a future date without settling the trades until the issuance occurs.

In the TBA market, two contracting parties agree on making or taking delivery, at a future date, of a certain number of Fannie Mae or Freddie Mac securities that meet certain limited parameters (such as the interest rate and the term of the mortgage). As a result, this market allows lenders to offer borrowers a rate lock—a firm commitment to close on a loan in the future at a certain rate—already knowing that secondary market capital will finance the loans. The TBA market also allows investors a unique product through which they can plan or hedge investments, because the bonds' yields are known well in advance of settlement.

The securities in this market are highly fungible, creating exceptionally deep liquidity, which in turn lowers prices to consumers. As discussed in a recent paper by staff economists at the Federal Reserve Bank of New York, the securities can trade this way because of their high degree of homogeneity (due to the standardized underwriting and securitization practices required by Fannie and Freddie), the two mortgage finance giants' credit guarantees (eliminating credit risk), and the exemption of MBS from the registration requirements of the Securities Act of 1933.[31]

Maintaining a TBA market is extremely important to market stability, efficiency, and liquidity. It keeps mortgages constantly available and prices low, and enables consumers to "lock in" mortgage rates so they can be certain of a mortgage's cost even if market interest rates increase after they have qualified. The structure we have proposed, with a unified government guarantee, a single set of government-defined underwriting and securities structure standards, and CMIs with substantial government oversight, should result in the development of a single, new TBA market, in which all MBS guaranteed by CMIs, with the additional catastrophic government guarantee, no matter who issues the security, could trade.[32]

The effect of this system on the price of a mortgage

How much will this proposed system raise the price of single-family mortgages that receive the benefit of the government guarantee against catastrophic risk? Even with significantly higher capital standards for CMIs than Fannie and Freddie were subject to, the answer is "not very much." The limitation of default risk through quality standards on the mortgages and securities; the explicit government guarantee that will reduce securities' investor return requirements; and returns on CMI capital that, while reasonable, are below the outsize returns received by holders of all financial institution equity in the years prior to 2008, should together result in an increase in mortgage interest rates of about one-half of one percent (50 basis points). To put that in perspective, interest rates on 30-year fixed rate mortgages were one-half percent higher than their December 2010 level in July 2009.[33] Each mortgage supported by the government guarantee will be required to bear the cost of:

- The capitalization of the CMIs
- The operation and credit risk to the CMIs
- The premiums paid to the Catastrophic Risk Insurance Fund
- The funding of the National Housing Fund, the Capital Magnet Fund and the Market Access Fund

While opinions differ on what the levels of these elements should be—the most important of which is the level of capital the CMIs would be required to hold—we can work off certain benchmarks.

One benchmark could be the FHA Mutual Mortgage Insurance Fund, which is required to hold capital (in addition to loan loss reserves) at 2 percent against higher loan-to-value mortgages. Private mortgage insurers, similarly exposed to high loan-to-value mortgage risk, must maintain 4 percent of capital for each dollar of risk insured, which works out to about 0.8 percent of the mortgage balance, and they must also hold loss reserves and set aside half the premiums received for 10 years.

The actual credit losses at Fannie and Freddie stemming from the crisis are very roughly projected at around 4 percent to 5 percent of loan balances, nearly half of which is attributable to so-called Alt-A and other subprime-type loans that would not be eligible to be insured by the CMIs. And banks are, in general, required to hold 4 percent capital against mortgages on their balance sheets. This implies that a capital requirement of between 2 percent and 4 percent of the balance of guaranteed loans for the CMIs, with an additional 1 percent to 2 percent ultimately being built up in the government's Catastrophic Risk Insurance Fund against the risk of CMI failure, should be sufficient.[34] Even a 2 percent capitalization requirement for the CMIs is many times higher than the capital requirement of just 0.45 percent required of Fannie and Freddie against securitized loans.

Assuming a reasonable rate of return to investors in these new Chartered Mortgage Institutions on an increased capital base as well as operating costs and credit losses comparable to Fannie and Freddie on prime loans; a 10-basis-point fee for the

National Housing Trust Fund, the Capital Magnet Fund, and the Market Access Fund; and a government guarantee premium of 10 basis points; the total ongoing annual guarantee fee would be approximately 70 basis points.[35] This compares to the pre-2008 benchmark guarantee fee for Fannie and Freddie of approximately 20 basis points,[36] a difference of 50 basis points. The actual likely difference, however, would be reduced (in the neighborhood of 10 basis points) by the improved price the CMI-guaranteed securities should command because of their now-explicit government guarantee. The result is a safer system, backed by far more private capital, at a small increase in the price of mortgage credit to consumers.

Chartered Mortgage Institutions in our new housing finance system will be responsible for equitably serving the primary mortgage market.

Ensuring fair and nondiscriminatory access to credit

Chartered Mortgage Institutions in our new housing finance system will be responsible for equitably serving the primary mortgage market as well as responding to areas of special concern where housing finance needs are not being effectively met, with potential assistance from the Market Access Fund.[37] CMIs primary obligation would be to provide an equitable outlet for all primary market loans meeting the standards for the guarantee, rather than serving only a limited segment of the business, such as higher income portions of that market.

In other words, Chartered Mortgage Institutions will not be able to "cream" the primary market. With respect to multifamily lending, CMIs that securitize multifamily loans will be required to demonstrate that they are providing housing for working households. In addition, CMIs would be required to provide service to areas of specific concern identified annually, such as shortages created by natural disasters, rural housing, and small multifamily housing. The Market Access Fund would be available to help them meet these responsibilities.

This obligation would have four parts:

- CMIs would be expected to roughly mirror the primary market in terms of the amount and the geography of single-family low- and moderate-income loans (other than those with direct goernment insurance) that are securitized and are eligible for the CMI guarantee. They would not be allowed to "cream" the market by securitizing limited classes of loans. This assumes that the primary market will be appropriately incentivized through the Community Reinvestment Act, which requires banks and thrifts to serve all communities in which they are chartered, including low- and moderate-income communities, consistent with safe and sound operations.[38]

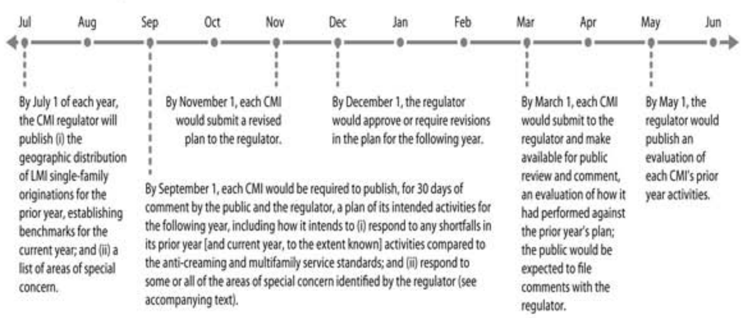
- CMIs that guarantee multifamily loans would be expected to demonstrate that at least 50 percent of the units supported by securitized multifamily loans during the preceding year were offered at rents affordable to families at 80 percent of the relevant area median income, measured at the time of the securitization.

- CMIs would be required to provide loan-level data on securitizations to the government (which will be required to make these data public) that is no less robust than that of the Public Use Database currently produced by the Federal Housing Finance Administration.

- All CMIs would participate in a yearly planning, reporting, and evaluation process covering their plans for and performance against both the single- and multifamily performance standards and government-identified areas of special concern, such as rural housing, small rental properties, and shortages created by special market conditions such as natural disasters. (See chart below for a hypothetical schedule)

Like all other secondary market participants, CMIs would be required to abide by nondiscrimination and consumer protection laws. Substantial underperformance by a CMI could lead to fines and possible loss of its CMI license.

Hypothetical annual planning, reporting, and evaluation schedule for CMIs' obligation to ensure fair and nondiscriminatory access to credit



Source: Mortgage Finance Working Group

How is this structure similar to Federal Deposit Insurance?

The proposed structure for government support of a limited portion of the mortgage securities market is similar to the deposit insurance system overseen by the Federal Deposit Insurance Corporation. Investors in mortgage-backed securities guaranteed by an eligible Chartered Mortgage Institution and receiving the government catastrophic risk guarantee will have the comfort of knowing their investment is ultimately backed by the full faith and credit of the U.S. government, preventing shadow banking runs and ensuring liquidity for this financing channel. Taxpayers are protected by CMI capital and loss reserves, and then by an on-budget Catastrophic Risk Insurance Fund, similar to the FDIC's Deposit Insurance Fund. (See chart on page 40)

This guarantee will be paid for by premiums set at rates designed to cover losses should a CMI fail. As with FDIC insurance of a limited level of deposits, the proposed government guarantee of MBS would be specific and limited, in this case to investment in specific mortgage-backed securities. As with FDIC insurance of bank deposits, the catastrophic risk insurance would not cover general creditors or shareholders of the CMI. Unlike the current system, in which the government ended up rescuing Fannie and Freddie, including in effect their creditors, without having received any insurance premiums to cover the risk, the government's risk in our system would be limited and paid for in advance. (See box)

How does the government's guarantee of CMI securities differ from the government's support of Fannie Mae and Freddie Mac?

The CMIs' primary function would be to provide the first-level pool guarantee function that Fannie and Freddie have performed since the 1980s. Until 2008, Fannie and Freddie' guarantee also included an implicit government guarantee against catastrophic risk for which the government was uncompensated. Since 2008, that guarantee has in effect been explicit, but the government is still not being compensated for it. In contrast, the CMI guarantee would serve as the condition precedent to the explicit, and fully-paid for government catastrophic risk guarantee and would only be available to securities that also had the CMI guarantee.

CMIs would be expected to set and enforce standards for the financial and operational strength of issuers, as Fannie and Freddie have always done for seller/servicers. The capital standards for CMIs would take external supports such as private mortgage insurance into account, providing an incentive for the CMIs to share risk with others interested in the performance of the mortgages. And the government catastrophic risk guarantee should enable continuation of a deep and liquid market for privately-issued securities backed by mortgages deserving of public support.

Our proposal adopts elements of the FDIC model to address the flaws in the current system of mortgage securitization

Federal deposit insurance for deposit-backed lending	Proposed system for mortgage securitization	Current system for mortgage securitization
Government guarantee is paid for and protected by sufficient capital, transparency, standardization, and a self-funded insurance fund.	Government guarantee is paid for and protected by sufficient capital, transparency, standardization, and a self-funded insurance fund	Government guarantee is not paid for, opaque, and not protected by sufficient capital or an insurance fund
REGULATION		
Banks are closely regulated as to capital, earnings, asset quality, liquidity, and management, in addition to compliance with consumer protection and other regulations. They are also obligated to serve all communities in which they are chartered, including low- and moderate-income communities, consistent with safe and sound operations.	CMIs and issuers are closely regulated as to capital, earnings, asset quality, liquidity, and management, in addition to compliance with consumer protection and other regulations. They are also obligated to provide fair and non-discriminatory access to the secondary market.	For the government-backed portion of the market, regulators allowed excessively high leverage, and as a result, the GSEs held insufficient capital against their risks, exposing taxpayers to major losses. For the private portion of the market, a lack of regulatory oversight allowed risk-taking to reach astronomical levels, creating a high probability of a "run on the bank" situation and thus exposing taxpayers to major losses.
TRANSPARENCY AND STANDARDIZATION		
Regulators have complete access to all bank books and records at all times, and banks are subject to periodic (and sometimes continuous) on-site examinations. Much financial information about individual banks (including privately-held institutions) is made available quarterly by bank regulators. Products are not standardized.	Regulators have complete access to the books and records of all CMIs and issuers at all times.	A lack of transparency and standardization in the private-label portion of the market decreased efficiency, made monitoring more difficult, and greatly increased the level of systemic risk posed.
INSURANCE		
Depositors are insured up to $250,000 per depositor, per insured bank. Banks pay risk-based premiums (assessments) to the FDIC, which holds them in the off-budget Deposit Insurance Fund. Neither bank equity nor other liabilities of banks (uninsured deposits, secured and unsecured debt) are insured by the FDIC.	Investors in CMI-guaranteed MBS are insured against CMI failure by the on-budget Catastrophic Risk Insurance Fund. CMIs pay assessments for each new issuance of MBS to a Catastrophic Risk Insurance Fund, administered by the CMIs' primary regulator. Neither CMI equity nor other liabilities of CMIs (uninsured deposits, secured and unsecured debt) are insured under this scheme.	No insurance fund to protect taxpayers against GSE losses, or the costs of bailouts provided to prevent a "run on the bank" situation from occurring among private investment banks. Thus, if the amount of capital held is insufficient, the taxpayer is exposed to losses. Moreover, it is unclear which liabilities of the GSEs or large investment banks (such as equity, uninsured deposits, secured and unsecured debt) are insured, or to what extent.
GOVERNMENT GUARANTEE		
FDIC deposit insurance is backed by the full faith and credit of the US Government. However, banks are required to make up any shortfall in the Deposit Insurance Fund through increased assessments.	The explicit full faith and credit of the U.S. Treasury stands behind the Catastrophic Risk Insurance Fund. However, any shortfall in the Catastrophic Risk Insurance Fund may also be made up through increased assessments on existing CMIs.	Government backing is implicit and unpaid for.

Source: Mortgage Finance Working Group

Countercyclicality

Left to its own devices, the mortgage market is inherently highly procyclical. As history, including the current crisis, repeatedly demonstrates, private capital experiences a "flight to safety" during market downturns, flowing towards safe sovereign-backed instruments such as U.S. Treasury bonds and away from mortgages and other private investments. Without a government guarantee, there is no reason to think that countercyclical liquidity will be available when needed.

In the recent past, countercyclical mortgage liquidity was largely provided by Fannie Mae and Freddie Mac through their portfolio purchases of mortgage loans and mortgage-backed securities. The two mortgage finance giants performed this function following the 1998 Asian and Russian debt crises and in the aftermath of the collapse of the hedge fund Long-Term Capital Management around the same time. And as discussed below, a potential source of countercyclicality in a reformed mortgage finance system could be the direct investments of the CMIs.

In the recent crisis, Fannie and Freddie were unable to fully meet the countercyclical needs of the market because of the size of the problem and constraints on their portfolios as part of their conservatorship. The Federal Reserve stepped in, committing to purchase up to $1.25 trillion in Fannie- and Freddie-backed MBS, thus providing continued liquidity to the market. Relying solely on the Federal Reserve, however, may not be wise.

Why? Because the Fed's existing mandates of maintaining price stability and maximizing employment already generate a good deal of conflict, with critics arguing that the Fed overly emphasizes one of the dual mandates over the other. A new third mission of providing countercyclical liquidity to the mortgage market would likely take a back seat to the Fed's existing goals. Countercyclical capability, however, is critical for the smooth functioning of the mortgage market. The form it takes is less important than ensuring that it is provided for in an intentional and effective way.

The portfolio capacity of Chartered Mortgage Institutions

Critics of Fannie and Freddie have been concerned for many years about the size of the companies' portfolios—the whole loans and securities on their balance sheets, in contrast to those they guarantee. The portfolios, which carry both interest rate and credit risk (the guarantee covers only credit risk) were the source of outsized profits, largely because the implicit government guarantee on the companies' debt meant they could fund their balance sheets more flexibly and less expensively than corporations without this backing. Our proposal, separating the government guarantee of securities from the implicit backing of the CMIs themselves would eliminate that benefit.

What's more, the CMIs would no longer be the principal purchasers and aggregators of loans. Instead, they would provide insurance to investors on securities issued by others. A regulatory limitation on the size of the portfolio that CMIs can maintain is appropriate to keep the CMIs focused on the guarantee business. But it is neither possible nor prudent to eliminate CMI portfolios altogether.[39] And for one purpose—countercyclical liquidity in a crisis—a backup government guarantee of a class of senior debt issued explicitly for this purpose should be available.

There are three key functions that a portfolio serves toward a stable and durable housing finance system: countercyclical liquidity, facilitating the credit guarantee, and financing loans that have features that make them difficult to securitize. While the first of these functions requires some government support, which can be effectively limited as described below, the second and third do not. Let's look at these functions in more detail.

Countercyclical liquidity

As discussed above, when capital markets freeze, mortgages become unavailable or excessively expensive, with adverse consequences not only for the housing market, but also generating and amplifying broader economic distress. But no entity without government direction and support has any incentive or capacity to provide liquidity when capital is fleeing the market.

While it might be possible for the Fed to serve this function, an additional and potentially potent source of countercyclical liquidity is the portfolio investment capacity of Chartered Mortgage Institutions. CMIs are close to the mortgage markets, and could easily step in by purchasing whole loans, mortgage securities, and other instruments to provide mortgage liquidity during housing downturns. But such capacity cannot be created overnight; a preexisting infrastructure in the form of an ongoing mortgage portfolio is required.

When countercyclical intervention is required, a CMI will be able to provide it only if it can finance the purchases on favorable terms. A government guarantee of a specific class of senior debt (similar to the limited FDIC bank debt guarantee program of 2009, which following a finding of systemic risk in the economy enabled banks to access the otherwise-frozen market for senior unsecured debt) could accomplish this without reinstating the implied U.S. government guarantee of all CMI debt. The terms and conditions of such senior debt would have to be carefully constructed to meet the potentially contradictory goals of quick intervention in the market and strictly limiting the guaranteed debt to only to those circumstances in which market conditions warrant it.

Effective mortgage securitization requires relatively fungible and homogenous assets underwritten to consistent standards.

Management of guaranteed assets

Companies insuring mortgage-backed securities must deal with nonperforming loans. The most efficient strategy is to buy the loans out of the guaranteed pool, substituting a new loan where that is permitted. Portfolio capacity enables a CMI to acquire a nonperforming loan, fulfill its obligation to investors, and hold the loan while it is evaluated and cured or disposed of.

This strategy increases the ability of the guarantor to modify loans to bring them back to performing status and keep homeowners in their homes or multifamily properties from deteriorating to the detriment of entire neighborhoods. This function is a natural outgrowth of the guarantee, and the cost would be covered by the CMI's guarantee fee; no government backing of debt would be required.

Financing loans that cannot be securitized

Effective mortgage securitization requires relatively fungible and homogenous assets underwritten to consistent standards. It is therefore difficult to securitize certain kinds of loans that have substantial public policy benefits, such as loans with tailored terms (as is the case with some multifamily loans), loans that are designed to test new parameters or extend access, or those that are simply not susceptible to securitization (as is the case with reverse mortgages). Allowing CMIs to hold a portfolio will enable them to finance these loans, at a price that covers the CMI's cost of capital, without any government guarantee of the CMI's debt.

Support for multifamily housing finance

The fallout from the current mortgage crisis, coupled with strong demographic trends, necessitates renewed attention to the financing needs of multifamily rental housing. More than one-third of American households live in rental housing, and in general they have lower incomes than those who own. While at the very lowest income levels, there is some direct government support, neither the government programs nor the private market effectively serve working-class households whose incomes are just above the eligibility thresholds for many subsidy programs. These families need affordably priced rental housing near their workplaces but it is in very short supply.

The combination of CMIs and a government catastrophic guarantee of the securities backed by multifamily mortgages that meet minimum underwriting standards or have special credit enhancements should increase the availability of longer-term mortgages for multifamily housing. This in turn should help lower the cost of financing affordable rental housing and ensure a more stable supply of financing throughout business and credit cycles. This framework should also make it possible to work with state and local housing finance agencies or other sources of local credit enhancement to adjust underwriting to meet local needs.

Moreover, any CMI that engages in multifamily securitization (whether focused solely on multifamily or as part of a business that also includes single-family activities) would be required to demonstrate annually that, at the time of origination, at least 50 percent of the units financed by securities it guarantees are affordable to a family making 80 percent of area median income. Based on the history of multifamily financing by Fannie Mae and Freddie Mac, we believe this affordability measure is easily achievable without posing an undue burden on the CMI, and it provides an important social benefit in meeting the need for affordable rental housing units.

For more information about the MFWG's analysis of the needs of the rental housing market and how CMIs and the Market Access Fund might help serve those needs, see "A Responsible Market for Rental Housing Finance."[40]

Reform of the Federal Housing Administration

The role of the Federal Housing Administration as an essential countercyclical backstop has been more than adequately demonstrated by its performance during the recent housing and financial crises. While it insured only 3.3 percent of single-family mortgages originated in 2006, by 2009, after private capital fled the housing market, its market share increased to 21.1 percent. Over the past year, FHA provided access to credit for about 40 percent of purchase mortgages.[41] In 2009, FHA insured 60 percent of all mortgages to African-American and Hispanic homebuyers, and mortgages for over 882,000 first-time homebuyers.[42] Earlier in the economic and financial crises, these percentages were even higher.

FHA reported in November in its annual report to Congress that, under conservative assumptions of future growth of home prices, and without any new policy actions, FHA's capital ratio is expected to approach the congressionally mandated threshold of two percent of all insurance-in-force in 2014 and exceed the statutory requirement in 2015. In other words, if correct, FHA will have weathered the worst housing crisis since its creation in the aftermath of the Great Depression and have done so without costing taxpayers a dime. FHA's market share was small during the worst of the crisis and, while it is sustaining significant losses from loans insured prior to 2009, better performing loans are now helping to stabilize its financial position.

FHA, however, lacks the systems, market expertise, and nimbleness one would hope to see in an institution with over $1 trillion of insurance-in-force.[43] Its product terms and many practices are prescribed by statute with such specificity that it makes prudent management of an insurance fund extremely difficult.

In 1994, the Joint Center for Housing Studies at Harvard teamed up with FHA Commissioner Nic Retsinas to conduct a series of public hearings and study the future of FHA. Their report and recommendations[44] concluded that Congress should reinvent FHA as a government corporation, under the direction of the Secretary of the Department of Housing and Urban Development, with strict and independent oversight of its performance in serving underserved markets and maintaining financial soundness, but greater flexibility in product design to meet those ends.

The Harvard proposal would have created a new Federal Housing Corporation with far greater flexibility in procurement and personnel policies in order to jumpstart the transformation to a more business-like agency with a public purpose. The proposal was adopted by President Clinton in a HUD Reinvention Blueprint released in March 1995.[45] Similar recommendations were endorsed by the Millennial Housing Commission in their report submitted to Congress in May 2002.[46] Each time, market, political, and inertial forces resulted in no action.

The thrust of these recommendations is on the mark. Most significantly, under these proposals, FHA could design loan products to help meet the needs of underserved markets. The FHA would need to charge premiums designed so that the insurance funds would be actuarially sound. These products would be subject to independent credit subsidy estimates approved by the Office of Management and Budget and additional private market-like measures of risk. And the overall portfolio of insurance would be required to maintain adequate capital reserves to continue to protect taxpayers from insurance losses, as FHA has since done the Great Depression.

Other reforms would let FHA pay salaries at levels paid by the banking regulatory agencies, as comparable financial market expertise must be attracted to better protect taxpayers from the risks inherent in insurance. And procurement and budget flexibility would make it easier for FHA to use insurance fund resources to develop new systems and procure them more easily to better assess and manage risk in the insurance fund.

It is time to revisit these ideas. It is now evident that FHA is indispensable for economic stability and housing market equity. In light of its continued importance, we should ensure that FHA has the tools it needs to best meet underserved housing needs and provide countercyclical liquidity while doing what works to protect taxpayers optimally from any risk.

Market Access Fund

Mortgage finance should ensure broad and sufficient mortgage availability on reasonable and sustainable terms. Yet some groups of borrowers and certain types of housing have not been well served by the system of the past. This can occur for a number of reasons, including perceptions of risk, smaller deal size, or higher origination costs. Rules against discriminatory lending and anticreaming provisions, such as those we have proposed for CMIs, will help, but are likely to be insufficient to fill all the gaps.

These gaps are especially important to fill in the aftermath of the housing crisis, where many communities saw equity stripped by subprime lending. Moreover, the larger economic downturn has hit underserved communities most heavily. These places most in need of capital to rebuild will be the last to get it from a private market left to its own devices.

Direct subsidies are critical where deep government support is needed, such as for low-income rental housing. In addition to existing programs like Section 8, the low income housing tax credit, and HOME, a fully-funded National Housing Trust Fund will help to meet these needs. But beyond cash grants to support affordable housing, we need the housing finance system to provide access to credit for affordable rental housing and homeownership. A relatively thin credit enhancement subsidy can help bring private capital to bear in meeting the affordable housing needs of many communities.

The whole loan mortgage insurance provided by FHA and other similar programs brings private capital into underserved communities. Under these programs, a taxpayer insurance fund takes on almost all of the credit risk. Lenders who make FHA loans get fee and servicing income, but they have very little capital at risk. Thus, FHA insurance ensures loans are available to markets and borrowers private capital will not serve.[47]

Under our proposed system, with CMIs putting private capital at risk ahead of any taxpayer exposure, the CMIs are unlikely to make loans that they perceive too risky or that might provide below market rates of return. The danger would be that the private sector could see itself as having no responsibility to serve low- and moderate-income communities, communities of color, and communities hard-hit by the foreclosure crisis and other adverse conditions, claiming that the risks are inconsistent with their fiduciary duty to shareholders. The result could be a two-tiered system of housing finance, with FHA as the primary vehicle serving low- and moderate-income communities and communities of color and taxpayers absorbing all the risk, and private capital serving only the middle and upper parts of the market.

A large number of civil rights organizations recently wrote of their concern about overreliance on FHA without other competitive sources of mortgage capital to meet the needs of underserved markets. The Market Access Fund offers a way to help CMIs and other private actors meet their obligations to serve the entire market.

With some ingenuity, it is possible to build a system that maximizes the use of private capital and market solutions for all markets where high quality sustainable loans can be found. Some loan products that can successfully and sustainably meet underserved housing needs can eventually access the capital markets—if they can first gain a record of loan performance and market experience. Past examples include home improvement loans and guaranteed rural housing loans, as well as loans made less risky by quality housing counseling.

With some ingenuity, it is possible to build a system that maximizes the use of private capital and market solutions for all markets where high quality sustainable loans can be found.

A Market Access Fund would provide research and development funds (grants and loans) and/or a full-faith-and-credit government credit subsidy to enable entities including CMIs and nonprofit and government (such as state housing finance agency) market participants, to develop and establish a market for these innovative products. Examples of new products might include lease purchase loans, energy efficient or location efficient loans, shared equity loans, and loans on small multi-family properties.[48]

The Market Access Fund would provide "wholesale" government product support, in contrast to the retail insurance offered by the Federal Housing Administration at origination. The fund would be required to meet specific performance goals relating, for example, to financing for housing in rural areas or places with high foreclosure rates, unsubsidized affordable rental housing, and manufactured housing. And the fund's credit subsidy would only be available for products on a shared-risk basis, meaning that other capital would need to be at risk as well, providing both market discipline and an opportunity for these actors to learn how to serve underserved markets well. This in turn would pave the way for private capital to "mainstream" the products, increasing sustainable homeownership and affordable rental housing, and eventually reducing or eliminating the need for public support.

Those who want to access the Market Access Fund would apply for allocation of the fund's credit subsidy. Premiums could be charged and the subsidy costs could well be recovered from many if not most successful products. The fund would have broad latitude to design effective partnerships, including the setting of credit enhancement premiums, use of subsidy, how the risk was layered, and other components, within the limits of funding available. Credit subsidies granted by the fund would be managed under the Federal Credit Reform Act, which would establish and ensure budget discipline and transparency, and each program awarded Market Access Fund dollars would be assigned a credit subsidy rate based on projected revenue and cost estimates as with other federal credit programs.

The Market Access Fund would be funded by an assessment on all MBS issues. A portion of the assessment would go to the National Housing Trust Fund (for direct subsidy) and to the Capital Magnet Fund (for credit programs by Community Development Finance Institutions), as established under the terms of the Housing and Economic Recovery Act of 2008. It is important that the assessment be levied on both those issues guaranteed by CMIs and those without CMI guarantees to ensure that the responsibility to support better service to underserved markets primarily through private finance is supported by the jumbo market as well as the middle market. At 10 basis points, and assuming a

4-year average life of MBS, the annual incremental accrual to these funds from this fee should reach $4 billion for every $1 trillion of securities issued by year five of the program, and maintain that level in every subsequent year. The funds could thus achieve scale and effectively meet the HERA requirements and replace the public purpose activities of Fannie and Freddie.

By sharing the risk of loss, the Market Access Fund makes it easier for private capital to serve underserved communities. Without this mechanism, there is a significant risk that the taxpayer will continue to stand behind too large a segment of the housing market through FHA/VA and a two-tier housing finance system will develop. The Market Access Fund will help CMIs and other private actors meet their obligations to serve the entire market while simultaneously providing the market discipline of private risk capital for new products that serve underserved communities. And it will do so while limiting the government's role and exposure to risk. (See box)

How the Market Access Fund is distinct from other funds

The Housing and Economic Recovery Act of 2008 created the National Housing Trust Fund and the Capital Magnet Fund. The National Housing Trust Fund allows the states to expand the supply of rental housing for those with the greatest housing needs. The Capital Magnet Fund enables Community Development Financial Institutions (CDFIs) and nonprofit housing developers to attract private capital and take affordable housing and community development activities to greater scale and impact. As mission driven organizations, CDFIs and nonprofit developers are proven agents of public policy, forging partnerships with the private sector and government at all levels.

As originally envisioned, the National Housing Trust Fund and the Capital Magnet Fund would have received funding through assessments on the GSEs. Each entity was to contribute 4.2 basis points of total new business purchases annually for two affordable housing funds: 65 percent to the National Housing Trust Fund and 35 percent to the Capital Magnet Fund. When the GSEs were put into conservatorship, their obligation to contribute to the National Housing Trust Fund and Capital Magnet Fund was suspended.

Unlike the National Housing Trust Fund or the Capital Magnet Fund, the Market Access Fund is not meant to provide project subsidy. Rather, this fund is meant primarily to share risk with private capital in a way that "mainstreams" responsible loan products that help meet the needs of underserved borrowers and housing types, thus paving the way for the private market to serve these markets more effectively.

Level regulatory playing field

In addition to regulation of mortgage products to protect consumers, consistent and comprehensive oversight of all mortgage market participants is essential to rein in the inherent procyclicality of mortgage lending and to prevent regulatory arbitrage. Unless the entire market is subject to substantially similar rules in areas such as disclosure and transparency, CMIs will be at a disadvantage and subject to being driven into a race to the bottom.

In our December 2009 draft white paper, we proposed a regulatory system for private issuers of mortgage-backed securities that would include capital standards alongside a requirement that only mortgages that had been demonstrated to be safe and sustainable would have access to the secondary markets. Since then, the Dodd-Frank Act became law in July 2010, which creates a regulatory capital requirement for securitization. Financial institutions that sponsor asset-backed securitization (including for mortgage-backed securities) are subject to a 5 percent risk retention requirement against which they must hold capital.[49]

Dodd-Frank also creates strong incentives to limit securitization to mortgages with safe and sustainable characteristics, through its exemption from the 5 percent risk retention requirement of "qualified residential mortgages." The specific criteria for "qualified residential mortgages" will be defined jointly by the banking regulators, the Securities and Exchange Commission, the Department of Housing and Urban Development, and the Federal Housing Finance Agency according to statutory guidelines meant to create incentives to originate safe and sustainable mortgage loans. The guidelines include documented underwriting, ability to repay the loan, product features that reduce payment shocks on adjustable-rate mortgages, and the presence of mortgage insurance or credit enhancement that reduces default risk. Dodd-Frank also explicitly prohibits loans that have balloon payments, negative amortization, prepayment penalties, interest-only payments, and "other features that have been demonstrated to exhibit a higher risk of borrower default" from qualifying as "qualified residential mortgages."[50]

Finally, Section 942 of Dodd-Frank requires the SEC to adopt regulations to enhance disclosure requirements for asset-backed securities. The regulations may require loan-level data "if such data are necessary for investors to independently perform due diligence." Given the impact of the lack of transparency that private mortgage-backed securities had on mispricing of risk during the housing bubble, such data would be extremely valuable.

Dodd-Frank creates a framework consistent with our December 2009 recommendations. We look forward to its effective implementation.

Conclusion

Planning for the transition to a new housing finance system

The transition from the pre-2008 housing finance system to the one we have today, in which 90 percent of newly originated mortgages have some sort of government backing, was done in crisis. We are fortunate to have the opportunity to plan for the next transition—a transition to a far greater share of the market being supported by private capital, with government backing limited, explicit, and fully priced. It is essential to do this in a thoughtful manner that will minimize market disruption and encourage maximum participation by private capital.

We do not have the blueprint for the transition, but there are three considerations that are essential to take into account. Specifically, policymakers must:

- Ensure the continued functioning of the single-and multifamily origination and TBA markets without interruption as the path to a new system becomes clear, as housing markets stabilize, and as personal balance sheets are repaired

- Maintain the liquidity of outstanding mortgage-backed securities and protect their value during the transition

- Preserve the human and technological capital that enables the mortgage securities market to work without failures in execution, delivery, or payment

With these considerations in mind, we can turn with confidence to reforming the current housing finance system, which is unsustainable. We have the knowledge and the tools to create an American housing finance system that will be stable over the economic cycle; rely upon private capital; and equitably serve homeowners, renters, landlords, lenders, investors, and the larger American economy, while promoting residential integration, the elimination of housing discrimination, and the provision of safe, decent, and affordable housing in all urban, suburban, and rural communities.

In this paper we have suggested a potential structure for a housing finance system that simultaneously can achieve these goals and while putting private risk capital back at the center of mortgage finance. We have both the time and the opportunity to transform the system so it serves this nation even better and longer than did the system established in the 1930s. The job is substantively complex and politically challenging. But we have the knowledge to accomplish the feat, if only we can come together to do so.

Endnotes

1 *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, Public Law 111-203, 111th Cong., 2d sess. (July 21, 2010), hereinafter "Dodd-Frank Act."

2 While there are other government sponsored enterprises, most notably the Federal Home Loan Banks, in this paper the term "GSEs" refers solely to Fannie Mae and Freddie Mac.

3 The Affordable Housing Trust Fund and Capital Magnet Fund are two separate but complementary funds created by the Housing and Economic Recovery Act of 2008 and intended to be financed by a small levy on Fannie Mae and Freddie Mac, with the goal of expanding the stock of affordably priced housing. The Trust Fund distributes funds to the states, who oversee the actual allocation of those funds, primarily for the production, preservation, and rehabilitation of rental housing. The Capital Magnet Fund is a competitive grant program for Community Development Financial Institutions (often referred to as CDFIs) and not-for-profit-housing developers, administered by the Treasury Department with the goal of attracting private capital for low-income housing and community development activities. Buzz Roberts, "Housing Bill Taps Fannie, Freddie for Housing Trust Fund, Capital Magnet Fund," *Journal of Tax Credit Housing* 1 (IX) (2008), available at http://www.lisc.org/files/7476_file_sep_thebuzz_jtch.pdf.

4 See Markus K. Brunnermeier, "Deciphering the Liquidity and Credit Crunch 2007-08," *Journal of Economic Perspectives*, 23 (1) (2009): 77-100.

5 See Ben S. Bernanke, "Housing, Housing Finance, and Monetary Policy," (Jackson Hole: Speech at the Federal Reserve Bank of Kansas City's Economic Symposium, 2007), available at http://www.federalreserve.gov/newsevents/speech/bernanke20070831a.htm.

6 See Richard K. Green and Susan M. Wachter, "The American Mortgage in Historical and International Context." Research Paper No. 06-12 (Institute for Law and Economics 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=908976.

7 See, for example, Gary Gorton, "Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007." Working Paper (Yale School of Management, National Bureau of Economic Research, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1401882; David C. Wheelock, "The Federal Response to Home Mortgage Distress: Lessons from the Great Depression," *Federal Reserve Bank of St. Louis Review*, May/June 2008, p. 134-39, available at http://research.stlouisfed.org/publications/review/08/05/Wheelock.pdf.

8 Diana Hancock and Wayne Passmore, "An Analysis of Government Guarantees and the Functioning of the Asset-Backed Securities Market" (Washington: Federal Reserve Board, Finance and Economics Discussion Series, 2010), p. 3.

9 Some observers have claimed that Denmark and Germany, which rely upon covered bonds issued by private issuers, do not provide government support for their mortgage markets. See, for example, Michael Lea, "Alternative Forms of Mortgage Finance: What Can We Learn from Other Countries?" (Cambridge: Harvard University Joint Center for Housing Studies, 2010), p. 23, *available at* http://www.jchs.harvard.edu/publications/MF10-5.pdf. While it is true that Denmark and Germany do not have explicit government support for their mortgage markets, there is a consensus belief, particularly among investors, that these countries implicitly back their mortgage finance institutions, in much the same way that the United States provided implicit support for the government-sponsored entities Fannie Mae and Freddie Mac prior to their conservatorship in 2008. For example, the Danish government's implied support for its mortgage lending institutions has been consistently described by research firms and rating agencies. See, for example, Christian Meldinger and Ivanka Stefanova, "Danish Covered Bonds—A Primer," (UniCredit Global Credit Research, 2008), available at http://www.nykredit.com/investorcom/ressourcer/dokumenter/pdf/SR080608_DanishCoveredBonds.pdf. (Note that Denmark's 2008 bailouts "affirmed the systemic support within the Danish banking system."); "Moody's downgrades Danske Bank to Aa3/C and Sampo Bank to A1/C" (London: Moody's Investor Service Global Credit Research Rating Action,2009), available at http://www.danskebank.com/da-dk/ir/Documents/Ratings/20090213_Moodys_Danske%20Bank.pdf. (Ratings action factored in Moody's "view on the very high probability of systemic support" from the Danish government.) Indeed, both countries recently provided strong affirmation of this implied guarantee when they provided major bailouts to troubled mortgage finance institutions during the credit crisis of 2008. In October 2008, Germany set up the "Special Fund Financial Market Stabilization" or SoFFin, a roughly 150 billion Euro fund meant to explicitly support the liabilities of 10 troubled German financial institutions, including one issuer of covered bonds and three Landesbanks (another type of German mortgage lender). See Bundesanstalt fur Finanzdienstleistunsaufsicht (BaFin), "Annual Report of the Federal Financial Supervisory Authority" (2008), p. 13, pp. 117-18, p. 123, available at http://www.bafin.de/cln_152/nn_720486/SharedDocs/Downloads/EN/Service/Jahresberichte/2008/annualreport__08__complete,templateId=raw,property=publicationFile.pdf/annualreport_08_complete.pdf. Also in October 2008, Denmark announced a sweeping guarantee of all deposits and senior debt issued by its banks. See Neelie Kroes, "Guarantee scheme for banks in Denmark" (Brussels: European Commission, 2008), available at http://ec.europa.eu/community_law/state_aids/comp-2008/nn051-08.pdf. This blanket guarantee followed two major bailouts for individual Danish financial institutions. See Meldinger and Stefanova, "Danish Covered Bonds"; see also Kroes, "Guarantee scheme for banks in Denmark."

10 For a more detailed discussion of the principles of the housing finance system, see Center for American Progress, "Principles to Guide Redevelopment and Regulation of a Renewed Mortgage Finance System" (2009), available at http://www.americanprogress.org/issues/2009/03/pdf/mortgage_finance_principles.pdf.

11 While there has been considerable debate about the exact causes of the most recent mortgage crisis, it is undisputed that private mortgage securitization, unregulated for risk capital or product or underwriting standards, grew to capture nearly 40 percent of the mortgage market during the height of the housing bubble. See Financial Crisis Inquiry Commission, "Securitization and the Mortgage Crisis" (2010), pp. 10-11, available at http://www.fcic.gov/reports/pdfs/2010-0407-Preliminary_Staff_Report_-_Securitization_and_the_Mortgage_Crisis.pdf. Loans originated for this "shadow banking system," as it became known, have subsequently suffered defaults at rates exponentially higher than for other types of mortgages. See Andrew Jakabovics, Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, "The Future of the Mortgage Market and the Housing Enterprises," Oct. 9, 2009, available at http://www.americanprogressaction.org/issues/2009/10/pdf/jakabovics_mortgage_testimony.pdf. As a result, many leading scholars believe that private mortgage securitization was a primary cause of the mortgage crisis.

12 See David Min, "Future of Housing Finance Reform: Why the 30-Year Fixed Rate Mortgage is an Essential Part of our Housing Finance System" (Washington: Center for American Progress, 2010), available at http://www.americanprogress.org/issues/2010/11/housing_reform.html.

13 For example, during the past decade, "non-agency" lenders (lenders originating loans not meant to be securitized by Fannie Mae, Freddie Mac, or Ginnie Mae) originated a markedly lower percentage of fixed-rate mortgages than agency lenders. See Andrew Davidson and Anthony B. Sanders, "Securitization after the fall" (2009), p. 10, available at http://merage.uci.edu/ResearchAndCenters/CRE/Resources/Documents/Davidson-Sanders.pdf.

14 Mark Perry, an AEI Visiting Scholar, is among the near consensus of experts who believe that long-term fixed-rate prepayable mortgages would not exist in the absence of government support, stating that "The 30-year fixed-rate mortgage has to be a creation of government intervention, and not the market, [because] it is a one-sided loan arrangement that bestows huge benefits on the borrower, but with almost no compensation benefits for the lender/bank/thrift…" Mark. J. Perry, "Should We End the 30-Year Fixed-Rate Mortgage?" Carpe Diem Blog, comment posted May 30, 2010, available at http://mjperry.blogspot.com/2010/05/should-we-end-30-year-fixed-rate.html. Arnold Kling, an adjunct scholar at the Cato Institute, has stated that the interest rate risk on a 30-year fixed-rate mortgage is essentially unhedgeable and therefore is not a market-based product. Arnold Kling, "More on the 30 Year Fixed Rate Mortgage," EconLog Blog, comment posted May 31, 2010, available at http://econlog.econlib.org/archives/2010/05/more_on_the_30-.html.

15 See Lei Ding and others, "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Scores," Working Paper (Center for Community Capital and Center for Responsible Lending, May 17, 2010), available at http://www.ccc.unc.edu/documents/Risky.Disaggreg.5.17.10.pdf.

16 See Eric S. Belsky and Nela Richardson, "Understanding the Boom and Bust in NonPrime Mortgage Lending," (Cambridge: Joint Center for Housing Studies, 2010), available at http://www.jchs.harvard.edu/publications/finance/UBB10-1.pdf.

17 See in particular, Title IX, Subtitle D; Title X; and Title XIV of the Dodd-Frank Act.

18 There has been one small private residential mortgage-backed securities deal in the last two years, totaling $238 million. See Jeff Hiltbrand and Mark Hughes, "Private market for mortgages shows signs of life," *Currency* (2010), available at http://www.gt.com/staticfiles/GTCom/Financial%20services/Currency/2010/Currency%20June%2010%20_securitizations_FINAL.pdf. That compares to $789 billion in RMBS issuances in 2006 alone. See Charles Wallace, "Unlocking the Asset-Backed Securities Market," *Institutional Investor*, Nov. 16, 2010, available at http://www.institutionalinvestor.com/Popups/PrintArticle.aspx?ArticleID=2716788.

19 See Ding, "Risky Borrowers or Risky Mortgages."

20 See Min, "Future of Housing Finance Reform."

21 See graphic in David Streitfeld, "Biggest Defaulters on Mortgages are the Rich," *The New York Times*, July 8, 2010, available at http://www.nytimes.com/2010/07/09/business/economy/09rich.html?_r=2&ref=business.

22 See Shane M. Sherlund, "The Past, Present, and future of Subprime Mortgages" (Washington: Federal Reserve Board, 2008), Table 5, available at http://www.federalreserve.gov/pubs/FEDS/2008/200863/200863pap.pdf.

The current conforming loan limit is significantly higher than would be justified under the traditional formula, and has been the same (with additional increases in high cost areas under the Economic Stimulus Act of 2008) since 2006, notwithstanding the Federal Housing Finance Administration's finding that house prices have been declining. See Federal Housing Finance Administration, "Maximum Loan Limits for Fannie Mae and Freddie Mac to Remain Unchanged for 2010," (2009), available at http://www.fhfa.gov/webfiles/15180/CLL_November_Release_11_12_09.pdf. These limits will remain applicable for loans originated prior to October 1, 2011. See Federal Housing Finance Administration, "Conforming Loan Limit," available at http://www.fhfa.gov/Default.aspx?Page=185. Under the Housing and Economic Recovery Act of 2008, the conforming limit cannot decline even if house prices decline. The special limits for high cost areas established under the Economic Stimulus Act and subsequently renewed are scheduled to expire in September 2011. Ibid.

23 See also Center for American Progress, "A Responsible Market for Rental Housing Finance" (2010), available at http://www.americanprogress.org/issues/2010/multifamily_rental_housing.html

24 See Joint Center for Housing Studies of Harvard University, "America's Rental Housing: The Key to a Balanced National Policy" (2008) p. 14.

25 In 2009, nearly half of all the purchase money mortgages originated were backed by the full-faith-and-credit of the federal government through the Federal Housing Administration, the Veterans Administration, the Farm Services Administration or the Rural Housing Service. See Federal Financial Institutions Examination Council, "Home Mortgage Disclosure Act Aggregate Report" (2009). National Summary Table A1, available at http://www.ffiec.gov/hmdaadwebreport/NatAggWelcome.aspx.

26 The current conforming loan limit is significantly higher than would be justified under the traditional formula, and has been the same (with additional increases in high cost areas under the Economic Stimulus Act of 2008) since 2006, notwithstanding the Federal Housing Finance Administration's finding that house prices have been declining. See Federal Housing Finance Administration, "Maximum Loan Limits for Fannie Mae and Freddie Mac to Remain Unchanged for 2010," (2009), available at http://www.fhfa.gov/webfiles/15180/CLL_November_Release_11_12_09.pdf. These limits will remain applicable for loans originated prior to October 1, 2011. See Federal Housing Finance Administration, "Conforming Loan Limit," available at http://www.fhfa.gov/Default.aspx?Page=185. Under the Housing and Economic Recovery Act of 2008, the conforming limit cannot decline even if house prices decline. The special limits for high cost areas established under the Economic Stimulus Act and subsequently renewed are scheduled to expire in September 2011. Ibid.

27 In previous iterations of our proposal, we referred to this institution as a "Housing Finance Innovation Fund."

28 It is possible that these standards will become de facto standards for the non-CMI market as well, which should increase the liquidity of those securities.

29 As discussed in an upcoming paper by Guy Stuart, a lecturer in public policy at Harvard University's Kennedy School of Government, the Federal Home Loans Banks are a notable example of a cooperative structure in housing finance, and one that enjoys an implied government guarantee as well. While many advocates of the cooperative structure have noted the relatively small loss levels for the FHLB system, they have generally ignored the FHLBs' significant protections against losses in their core activity of advance lending. FHLBs enjoy a first line on all collateral they claim against their advances, with the right to swap out defective collateral and to require overcollateralization at any time. As such, the FHLBs have never lost money on advances, but this does not speak to the cooperative structure. However, the FHLBs have suffered large losses on their direct investment activities which are not protected by the special collateral rights the FHLBs enjoy on their advances. These losses suggest that the cooperative structure may not be as risk-curtailing as some of its advocates suggest. Stuart also discusses the system's relative lack of affordable lending or countercyclical lending compared to Fannie Mae and Freddie Mac.

30 A TBA market for Ginnie Mae securities also exists, and operates similarly.

31 James Vickery and Joshua Wright, "TBA Trading and Liquidity in the Agency MBS Market," Staff Report No. 468, (Federal Reserve Bank of New York, 2010), available at http://www.ny.frb.org/research/staff_reports/sr468.pdf.

32 As with Ginnie Mae securities, individual mortgage originators could issue securities (analogous to Ginnie 1 securities) or pool them into multi-issuer securities (analogous to Ginnie 2 securities).

33 "30-Year Fixed-Rate Mortgages since 1971," available at http://www.freddiemac.com/pmms/pmms30.htm (last accessed January 2011).

34 Loans held on balance sheet, and thus subject to interest rate, as well as credit risk, would be required to be capitalized at a higher level than loans guaranteed. All these entities are also required to hold loan loss reserves, as would the CMIs. Loss reserves, under GAAP accounting, are procyclical, a particular problem in a bubble-and-bust cycle. Private mortgage insurers must also hold 50 percent of all premiums received for 10 years (which constitutes a counter-cyclical cushion), and must also hold loss reserves. See Mortgage Insurance Companies of America, "2008-2009 Fact Book and Directory" (2009), p. 24, available at http://www.privatemi.com/news/factsheets/2008-2009.pdf. Consideration should be given to other reserve structures, such as this premium reserve requirement.

35 The CMIs may act as fiscal agents to collect the guarantee premium for the Catastrophic Risk Insurance Fund, but the premium would be immediately paid over to the government. The goal is to bring the Catastrophic Risk Insurance Fund—over a reasonable period of time—1 to 2 percent of the principal value of all securities outstanding that are subject to the guarantee. Given that the fund will only be tapped in the event of a CMI failure, it is backstopped by CMI equity (which the government will regulate), PMI (in many cases), borrower equity, and collateral. Moreover, the mortgages guaranteed will be lower risk than those guaranteed by FHA. Therefore, a fund level of half the required FHA level should be adequate.

36 This is also consistent with the current guarantee fee level. See Freddie Mac, "Third Quarter 2010 Financial Results" (2010), Table 7A, available at http://www.freddiemac.com/investors/er/pdf/2010fin-tbls_3q10.pdf.

37 There have long been in place measures to create this outcome among federally regulated depository institutions, such as through the Community Reinvestment Act and other measures meant to ensure nondiscriminatory lending practices. But as mortgage financing has increasingly shifted away from depository institutions and towards the secondary markets, these laws have become increasingly less effective. For example, the share of outstanding mortgage originations attributable to CRA was only 5 percent between 1994 and 2002 in large metropolitan areas. See Neil Bhutta, "Giving Credit Where Credit is Due? The Community Reinvestment Act and Mortgage Lending in Lower-Income Neighborhoods," (Washington: Federal Reserve Board, Finance and Economics Discussion Series 2008-61, 2008), available at http://www.federalreserve.gov/pubs/feds/2008/200861/200861pap.pdf.

38 12 U.S.C. 2901 et seq.

39 These could be built on the foundations of the current GSE portfolios, scaled down through a gradual sell off of the current assets and maintained at a minimal level.

40 For more details on our proposal for multifamily rental securitization reform, see Center for American Progress, "A Responsible Market for Rental Housing Finance" (2010), available at http://www.american-progress.org/issues/2010/10/multifamily_rental_housing.html.

41 See Department of Housing and Urban Development, "US Housing Market Conditions" (2010), available at http://www.huduser.org/portal/periodicals/ushmc/fall10/hist_data.pdf.

42 See Department of Housing and Urban Development, "Financial Status of the FHA Mutual Mortgage Insurance Fund FY 2010" (2010), pp. 5-6, available at http://www.hud.gov/offices/hsg/rmra/oe/rpts/actr/2010actr_subltr.pdf.

43 Ibid, p.1.

44 See Department of Housing and Urban Development & Harvard University's Joint Center for Housing Studies, "Creating a New Federal Housing Corporation" (1995), available at http://babel.hathitrust.org/cgi/pt?view=image;size=100;id=mdp.39015034895089;page=root;seq=3.

45 See Department of Housing and Urban Development, "HUD Reinvention: From Blueprint to Action" (1995).

46 See The Millenial Housing Commission, "Meeting Our Nation's Housing Challenges: Report of the Bipartisan Millennial Housing Commission Appointed by the Congress of the United States" (2002), available at http://govinfo.library.unt.edu/mhc/MHCReport.pdf.

47 FHA's history of service to low income and minority communities has not, however, been without controversy, as in some communities and in some time periods, racial covenants, block-busting, fraud, and other abuses by realtors, lenders, and other program participants that FHA failed to prevent have led to neighborhood deterioration. See Sean Zielenbach, *The Art of Revitalization: Improving Conditions in Distressed Inner-City Neighborhoods*, (New York: Garland Publishing, 2000), p. 57, pp. 136-38.

48 For example, one idea that has been proposed for the Market Access Fund has been to capitalize an equity pool that would purchase participations in local and state "shared equity" homeownership funds, providing scale to this affordability product that has been greatly successful in smaller settings, but which lacks access to the secondary capital markets and is thus otherwise limited in the funds it has access to. The two major barriers to scale for this product have been a large degree of heterogeneity in local products, and a lack of standard performance data. The leveraging of Market Access Fund capital would clearly address these hurdles and allow shared equity to achieve a larger scale, potentially accessing the secondary markets in time.

49 *Dodd-Frank Act*, Section 941.

50 *Dodd-Frank Act*, Section 1412.

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I have to put together two presentations in a hurry. One is for **this Senate Banking Committee hearing** on proposals for housing finance. Actually, I probably will just speak extemporaneously to attack the other witnesses' proposals, and just hope that my temper stays in check.

Then, next Friday, I will be at the Kauffman Foundation bloggers' conference in Kansas City. I am going to cobble together a presentation there, also. If someone wants to get together in KC, let me know. My schedule is limited. Leave a comment if interested.

Also next weekend, I will be in St. Louis. Just getting together with folks I know there. But there might be spaces in my schedule. Again, leave a comment if you want me to try to fit you in.

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COMMENTS (7 to date) Latest Comment

Alex J. writes:

I'm in Kansas City and wouldn't mind getting together. I don't have a "Top 10 List of Things I Would Do With Arnold Kling in Kansas City", but lunch sounds fun. :)

Posted March 25, 2011 5:20 PM

David R. Henderson writes:

Dear Arnold,

Congrats. Make sure that when you testify that you "request that your written testimony be placed in the record as if read." The Chairman will always say yes and that you get both your written comments and your extemporaneous comments in.

Posted March 25, 2011 5:41 PM

ThomasL writes:

Dr. Kling,

Do you happen to know if the Mar. 29 hearing will be on any of the CSPANs?

Posted March 25, 2011 11:53 PM

Adam B. writes:

What part of St. Louis? I'm a young armchair economist considering my next steps, one of which could be a foray into grad school.

If you have a few minutes for me to pick your brain, I would really appreciate it.

Posted March 26, 2011 12:34 AM

David writes:

Does it cost anything to attend the presentations, or can one just show up? I don't see anything about prices at the Kauffman Foundation's website.

Posted March 26, 2011 10:21 AM

Seth writes:

I'm interested in a get together in KC if time permits.

Posted March 26, 2011 11:08 AM

Arnold Kling writes:

I expect some C-span coverage. Follow the link to the committee web site to see if they offer any clarification.

Posted March 26, 2011 3:27 PM

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STATEMENT SUBMITTED BY THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

On behalf of its nearly 5,000 member banks, ICBA is pleased to submit this statement for the record for this hearing on "Public Proposals for the Future of the Housing Finance System."

Community bank mortgage lenders have a great deal at stake in the future of housing finance in this country. Community banks serve the mortgage credit needs of rural areas, small towns, and suburbs across the Nation, and the secondary markets are a significant source of capital in support of this lending. Our members need a financially strong, impartial secondary market that provides equitable access and pricing to all lenders regardless of size or volume. We're grateful to Chairman Johnson for convening this hearing.

With regard to the Administration's recent report to Congress, "Reforming America's Housing Finance Market," we were encouraged to see the Administration recognize that smaller lenders and community banks serve their communities more effectively than larger lenders. Access to credit for these communities, along with the related imperatives of preserving a competitive market for credit and minimizing consolidation, are all criteria the Administration uses in evaluating proposals for remaking the Government's role in the secondary mortgage market. In this respect, we support the analysis provided by the Administration.

The Administration's report considers three broad approaches to secondary market reform:

- Nearly complete privatization of the housing finance system, with Government assistance for targeted groups of borrowers;
- A privatized system with a Government guarantee that becomes effective only during times of crisis, supplemented by Government assistance for targeted groups of borrowers; and
- A privatized system with catastrophic Government reinsurance buffered by private capital, in addition to Government assistance for targeted groups of borrowers.

Even the third catastrophic reinsurance option would entail a more circumscribed role for the Government in the housing market, emphasizing private capital as the primary source of mortgage credit and the first to bear losses. The Administration report has effectively shifted the debate; the spectrum of viable options ranges from narrow Government involvement to virtually full privatization. Government's historical role in housing is off the table. The Administration's report also indicated that it will reduce the conforming loan limits, raise guarantee fees to allow private-sector securitizers to be more competitive and raise down payment requirements, among other steps to shrink the Government's role in housing that don't require congressional approval. Wherever we end up, it will look significantly different than the precrisis Fannie and Freddie. ICBA welcomes this new reality as an appropriate response to the moral hazard and taxpayer liability of the old system. Our members are prepared to adapt and thrive in an environment of limited Government involvement.

A housing finance system with a smaller Government footprint, properly designed, can preserve the vital role of community banks. The worst outcome, for community banks and consumers, would be a system dominated by a few large, too-big-to-fail banks (TBTF), with community banks forced to the sidelines.

Such an outcome would simply replicate the moral hazard that prevailed under Fannie Mae and Freddie Mac. To allow a small number of large banks to dominate the secondary mortgage market would create a new variety of moral hazard, just as pernicious as the old variety. These dominant lenders, driven by quarterly earnings and dividends to unacceptable risk taking, would become too-big-to-fail because the market would know full well that the Government would bail them out (as it did in 2008) rather than let the housing market collapse. These lenders would in effect become privatized "Fannies" and "Freddies," with all the benefits and the risks that come with TBTF status. Privatization is not enough to cancel out moral hazard, which lies in the concentration of risk, and especially risk in the housing market because it occupies such a central place in our economy. These same TBTF banks are also the largest mortgage servicers and are responsible for much of the foreclosure mess, including the mishandling of America's military families. Any solution that fuels this consolidation is only setting up the financial system for an even bigger collapse than the one we've just been through.

To address these concerns, ICBA has set forth its own proposal for reform that would replace Fannie Mae and Freddie Mac with lender-owned cooperatives. We believe that this proposal would protect taxpayers from another bailout, ensure equal access and pricing for lenders of all sizes, deter further consolidation, ensure liquidity during periods of market stress, preserve the significant benefits of the "to-be-announced" (TBA) market, and minimize disruption in the market by providing for the direct transfer of Fannie Mae's and Freddie Mac's infrastructure to the new co-ops.

ICBA Proposal for Secondary Mortgage Market Reform[1]

Cooperative governance would ensure broad access and deter excessive risk taking

Fannie and Freddie would be restructured as cooperative entities owned by mortgage originators who purchase stock commensurate with their loan sales to the co-ops. This is similar to the capitalization of the Federal Home Loan Banks (FHLBs) and provides a capitalization source that can be adjusted based on market conditions and risk profile and performance of the co-ops' book of business. Members would have an incentive to transfer only soundly underwritten loans to the co-ops because any losses would adversely affect their capital investment.

The co-ops would be governed on a one-company-one-vote basis. Big banks would not be allowed to dominate the new co-ops. Further, directors would be appointed to represent various sizes and classes of members, while a minority number of seats would be reserved for outside independent directors with financial expertise.

The advantage of this form of governance is that all co-op members would enjoy open and equal access and benefits in terms pricing, regardless of their origination volume. This would prevent industry consolidation and preserve access to credit for the millions of small town and rural borrowers served by community banks. The housing market is best served by a large and geographically dispersed number of lenders. The co-ops would be required to provide liquidity to all home mortgage markets on a continuing and equitable basis. Guarantee fees and reinsurance fees would be set by the co-op boards and would be the same for all members. However, mortgage originators with substandard loan performance would be subject to additional surcharges and restricted access until their loan performance improved.

A limited scope of conservatively underwritten products would be eligible for sale to the co-ops

The co-ops would guarantee a limited range of conservatively underwritten products: 15- and 30-year fully amortizing mortgage loans that meet the definition of "qualified residential mortgage" (QRM) and adjustable rate mortgage loans that meet the QRM definition, would be exempt from risk retention requirements. Loans that fall outside of the QRM definition would require risk retention by the originator and additional risk to the co-ops would be priced accordingly. These provisions would shield the co-ops from excessive risk.

The co-ops would only be engaged in the secondary market and would be barred from operating in the primary market. They would not unfairly compete with mortgage originators.

A privately capitalized guarantee fund would insulate taxpayers

Mortgage-backed securities issued by the co-ops would be guaranteed by a fund capitalized by co-op members as well as 3rd party guarantors. Resources would be set aside in good times to prepare for challenging times. The Government would provide catastrophic loss protection, for which the co-ops would pay a premium. This guarantee, fully and explicitly priced into the guarantee fee and loan level price, would not only provide credit assurances to investors, sustaining robust liquidity even during periods of market stress, but—a point less often noted—it would enable the co-op securities to be exempt from SEC registration and trade in the "to-be-announced" (TBA) forward market.[2] Without the TBA market, which allows lenders to sell loans forward before they are even originated and to hedge their interest rate risk during the rate "lock" period, the 30-year fixed rate loan as we know it and on which our housing market is based will become a rarity. Though the co-ops would be ultimately backstopped by the Government, private capital from members and

[1] ICBA's cooperative model is similar to a proposal favorably analyzed by the New York Federal Reserve and the Government Accountability Office. It is also similar to a proposal put forth by the National Association of REALTORS®.

[2] In a TBA trade, participants agree to exchange a given volume of mortgage backed securities at a specified date and at an agreed-upon price. This allows lenders to sell mortgages forward before they are even originated. Because it facilitates hedging of interest rate risk, the TBA market also allows lenders to offer borrowers an interest rate "lock" for as long as 90 days. TBA trades are based on an assumption of homogeneity among the securities that will actually be included in the MBS. This assumption is facilitated by standardization in the underwriting of mortgages and by a Government guarantee, implied or explicit.

private reinsurers would absorb all but catastrophic losses; Government reinsurance funds and ultimately the taxpayer would be well insulated.

Easy Transition From Fannie Mae and Freddie Mac

The infrastructure of Fannie and Freddie—including their personnel, systems, automated underwriting engines—would transfer to the new co-ops. This is an essential feature of the proposal as it would minimize disruption in the market and reduce the cost of the transition to the new system.

The outstanding debt and securitizations of Fannie and Freddie would maintain the current guarantee.

Strong Supervision

The Federal Housing Finance Agency (FHFA) would regulate and supervise the co-ops. FHFA would be responsible for setting and monitoring capital levels based on market conditions, portfolio performance and overall safety and soundness. FHFA would approve all new mortgage products purchased by the co-ops.

Closing

Private entities will succeed Fannie Mae and Freddie Mac; that much is all but settled. Still to be determined is what form those entities will take—instruments of Wall Street or those in which community banks and large banks are equally represented and communities and customers of all varieties are served.

ICBA looks forward to working with this Committee, the Administration, and our industry partners to enact our proposal or another proposal that meets our criteria and is in the best interest of the communities we serve.

Thank you.

PUBLIC PROPOSALS FOR THE FUTURE OF THE HOUSING FINANCE SYSTEM—PART II

THURSDAY, MAY 26, 2011

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:26 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. Good morning. I call this hearing to order. We will excuse ourselves for an executive session when we get a quorum.

In the meantime, I would like to thank our witnesses for coming before the Committee to discuss their ideas for the future of America's housing finance system. As promised in the Committee agenda I released earlier this year, housing finance reform is one of my top priorities. The Committee has held three housing hearings in addition to the Subcommittee hearings held by Senator Reed and Senator Menendez. I anticipate at least one hearing on housing finance reform each work period for the rest of the year.

Our housing market continues its fragile recovery. In our efforts to reform the housing finance system we must take care not to disrupt that recovery. Witnesses testified in a previous hearing that without Fannie Mae, Freddie Mac and FHA providing liquidity, many families that could afford a home would not be able to get a mortgage in the current economic environment.

However, the Government's current dominant role in the market is unsustainable long term. This Committee must explore ways to bring private capital back to the market while also ensuring that credit remains available. As I have said before, there are other questions we must answer when considering the future of the housing finance system:

How will we preserve the availability of affordable, 30-year, fixed-rate, prepayable mortgages?

Should all lenders have equal access to the secondary market?

Will a new structure provide equal access for all qualified borrowers and market segments—including rural areas—to the mainstream housing finance system?

Will a new system maintain stable, liquid, and efficient mortgage markets for single-family and multifamily housing?

How will a new structure protect taxpayer dollars?

We must find workable solutions that preserve the option of responsible home ownership for future buyers and provide adequate financing for multifamily construction for those who prefer to rent rather than to own a home. I look forward to hearing the suggestions of our witnesses.

With that, I will turn to Ranking Member Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman. Thank you for calling this hearing. I think it is very important.

Today, as the Chairman has said, the Committee will continue its examination of proposals for reforming our Nation's housing finance system. I do not believe there is any dispute that our housing finance system is broken. Since 2006, housing starts have fallen by 67 percent, while existing home sales have fallen by nearly 13 percent in just the last year alone.

Likewise, home prices continue to decline in most markets. The latest median price of an existing home is more than 17 percent lower than just 2008. Our once dynamic and innovative housing market is now stagnant and damaged, crippled by regulatory uncertainty. Unfortunately, when market participants should be focusing on reviving our housing markets, Washington has forced them to vote countless hours and millions of dollars to navigating the scores of new regulations imposed by the Dodd-Frank legislation.

Accordingly, it should be no surprise to anyone that our housing market has not rebounded since the passage of the Dodd-Frank Act. By some measures, it is even worse because our private markets have been almost completely replaced by Government programs.

Last year, the Federal Government accounted for 96 percent of all mortgage-backed securities issued. Yes, 96 percent. In effect, Fannie and Freddie and FHA now occupy what used to be the private secondary mortgage market. And as a result, nearly all of the risk in our housing market is being transferred from private capital to the American taxpayer. I believe this is a wholly unacceptable situation.

Today we will hear from two very different points of view, I believe, on how to address this situation. One side will argue that our mortgage market needs the Federal Government to continue guaranteeing mortgages in one form or another. This means that the American taxpayer will continue to guarantee mortgage-backed securities while collecting a guarantee fee. It is not surprising that certain segments of the housing market advocate such a model.

Most businesses, not just housing, like Government subsidies if they can get them, and the housing market and the housing industry is no different. However, the Federal Government does not have a good track record on pricing risk and, thus, subsidies are not without cost. Indeed, Secretary of the Treasury Geithner warned this Committee in March, when he stated, and I quote, "Guarantees are perilous. Governments are not very good at doing them, not very good at designing them, not very good at pricing them, and not very good at limiting the moral hazard risk that comes with them." These are the words of our Secretary of the Treasury.

Given the combination of these difficulties, I believe we cannot assume a Government guarantee of mortgages can be achieved without risk to the taxpayer. And while a Government guarantee may be a good deal for the housing industry, it could be a very bad deal for the taxpayer.

The other side of the argument raises concerns with the Federal Government's domination of the mortgage finance market. We have heard from many witnesses over the years that the Government must remain engaged in the market because of concerns with private sector capacity. We must ask, however, whether the reduced role of the private sector is a result of market conditions or conditions created by Government policies.

Surely we should answer this critical question before we draw any conclusions about the wisdom of continued Government involvement in the mortgage market.

Mr. Chairman, I agree that many factors must be considered as we proceed with reform. I maintain, however, that protecting the American taxpayer must continue to be our number one priority.

Thank you.

Chairman JOHNSON. Before I introduce our witnesses, would other Members like to make very brief opening statements? Senator Reed.

[No response.]

Chairman JOHNSON. Senator Vitter.

STATEMENT OF SENATOR DAVID VITTER

Senator VITTER. Thank you, Mr. Chairman. I just want to echo many of Senator Shelby's comments. As many folks, including me, said many times last year, Dodd-Frank did not address one of the largest root causes of our recent crisis, and that is, Government housing policy, certainly including major problems at Fannie Mae and Freddie Mac.

This has come to light more and more with each passing week. Several months ago, JPMorgan issued a report that reexamined, based on new statistics and new information, the significance of this cause, and they basically said in very clear terms, we want to update our opinion and say that Government housing policy was a primary cause of the policy in light of reclassification of loans and new information that is now available.

Research from Ed Pinto at the American Enterprise Institute, a former chief credit officer at Fannie Mae, showed that there were 27 million subprime and other risky mortgages in the system when the housing bubble began to deflate in 2007. That was an aggregate value of over $4.5 trillion, 50 percent of all the mortgages in the United States.

Peter Wallison I think had it correct when he said that, "Although there were many contributing factors, the housing bubble of 1997–2007 would not have reached its dizzying heights or lasted as long, nor would the financial crisis of 2008 have ensued, but for the role played by the housing policies of the U.S. Government over the course of two Administrations."

So I am glad that this Committee is finally focusing on what was the largest—not the single but the largest—cause of the size and length of the bubble and the resulting crisis. And I encourage us to listen to this testimony, take in more information, and most importantly, act so that this Government policy does not continue and does not cause these enormous problems again in the future.

Thank you, Mr. Chairman.

Senator WICKER. Mr. Chairman?

Chairman JOHNSON. Yes.

Senator WICKER. I have a prepared an opening statement. Because of the hour I ask that it be included in the record at this time.

Chairman JOHNSON. It will be received.

I will remind my colleagues that we will keep the record open for 7 days for additional statements and questions.

I would like to welcome and introduce the witnesses that will testify here today.

Our first witness is Ms. Terri Ludwig, who is president and CEO of Enterprise Community Partners, Incorporated. Enterprise is a national nonprofit provider of capital that specializes in the creation of affordable homes and rebuilding communities. Ms. Ludwig has been with Enterprise since 2009 and began her tenure as CEO in January of this year.

Our second witness is Mr. Ron Phipps, president of the National Association of REALTORS®. The NAR is America's largest trade association, representing 1.1 million members involved in all aspects of the residential and commercial real estate industries. Mr. Phipps appeared before this Committee earlier this year, and we welcome him back.

Senator Reed, do you have any comments?

STATEMENT OF SENATOR JACK REED

Senator REED. Thank you very much, Mr. Chairman. I want to welcome Ron personally. Ron has been a great business and community leader in Rhode Island for 31 years. We were delighted when he was elected president of the National Association of REALTORS®. He has great insights. He has testified before the Committee previously, and I look forward to his testimony this afternoon, so thank you, Ron, for joining us.

Thank you, Mr. Chairman, for allowing me to speak. Thank you.

Chairman JOHNSON. Our next witness, Mr. Mark Parrell, is executive vice president and CFO of Equity Residential. Equity Residential focuses on the acquisition, development, and management of high-quality apartment properties within the U.S. Before serving as the company's executive vice president, Mr. Parrell served as senior vice president and treasurer, a role which put him in charge of capital markets, mortgage servicing, and tax and treasury functions for the company.

We welcome Mr. Greg Heerde to the Committee, who served as the managing director of Aon Benfield, a company that is the industry leader in placing treaty and facultative reinsurance. In his role at Aon Benfield, Mr. Heerde is responsible for assisting in the development of global strategy and advising the company in new insurance company formations, capital raising, and M&A transactions.

Next we have Mr. Martin Hughes, who is the president and CEO of Redwood Trust. Redwood Trust is a real estate investment trust which manages finances and invests in real estate assets. Mr. Hughes has served in his current role at the company since 2009, before which he served as co- chief operating officer and CFO.

Our final witness on the panel is Mr. Barry Rutenberg. Mr. Rutenberg is the first vice chairman of the board for the National Association of Home Builders. The NAHB has more than 160,000 members assisting their association to provide and expand safe, decent, and affordable housing opportunities for all consumers. Mr. Rutenberg has been active in the NAHB leadership structure at the local, State, and national levels throughout his career, serving on the board of directors since 1980.

Ms. Ludwig, please proceed.

STATEMENT OF TERRI LUDWIG, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ENTERPRISE COMMUNITY PARTNERS

Ms. LUDWIG. Chairman Johnson, Ranking Member Shelby, and distinguished Members of the Committee, thank you for inviting me to testify today, and thank you for holding these hearings on the challenging yet critical issue of how to reform our housing finance system.

My name is Terri Ludwig, and I serve as the president and CEO of Enterprise Community Partners. Enterprise is a national nonprofit organization that works across the country to provide affordable housing and strengthen communities.

Prior to joining Enterprise, I worked in the private sector for 20 years in investment banking. I partnered with groups like Enterprise, using capital markets to efficiently invest in affordable housing and community development. This experience has taught me that public–private partnerships are critical to bringing capital to working families and vulnerable populations.

I came to work for Enterprise because it is an organization that believes having a safe and affordable place to call home is an essential platform to help people achieve stability and a better life.

Enterprise works in places ranging from small rural towns to large urban centers and from Native American tribes to suburban job centers. During the past 30 years, Enterprise has invested more than $11 billion in communities. With our partners we have built and preserved nearly 300,000 homes, catalyzed economic development, and strengthened entire neighborhoods.

Enterprise has provided financing and development expertise to create affordable home ownership opportunities, but our primary focus is on providing quality, affordable rental housing.

I want to talk briefly why affordable rental housing is so important. The number one thing to take away from my testimony today is that any new housing finance system must focus on stability, liquidity, and affordability for this housing stock.

As the financial crisis has shown, America needs a full range of housing options. Multifamily rental housing is increasingly important for people at all income levels. But for low- and moderate-income families, the need for affordable rental housing is acute.

Housing costs consume two-thirds of the lowest-income families' household budgets, leaving only about $500 a month to cover basic needs, like food, health care, transportation, and clothing. And there is not a single county in the United States where a minimum wage worker can afford a one-bedroom apartment at local fair market rent. We believe that the public and private sectors play important roles in meeting these needs.

To be clear, we do not support the *status quo,* but any new system should consider the 11 million apartments that Fannie Mae and Freddie Mac have helped to finance and their historic role as a major investor in the low-income housing tax credit program, which has financed 90 percent of all affordable rental housing. Each year, this generates 140,000 jobs and $1.5 billion in State and local taxes.

Since the financial crisis, the GSEs have been one of the only sources of financing for affordable housing, purchasing 84 percent of all multifamily loans in 2009. Let me emphasize that this portfolio has performed extremely well, with less than a 1-percent foreclosure rate between 2005 and 2009. Compared to the single-family portfolio, the performance is quite dramatic.

You will hear a lot about numbers and percentages today, but what really matters is helping real families with real needs.

Jordan's Gate is a development in rural Opelika, Alabama. It is home to 48 working families earning up to 60 percent of the area median income, which is only about $13,200 a year. There is a child care center on-site providing a safe place for children while their parents are at work. Fannie Mae and Freddie Mac have invested in low-income housing tax credits and provided debt financing to make Jordan's Gate possible. Without support from the Government-supported secondary market, Jordan's Gate and much of the other housing that we have helped to create would likely not exist.

We ask that six principles should guide your deliberations as you consider changes to the housing finance system.

Number one, the Government must continue to play a role in providing liquidity and stability for affordable housing in all communities, including hard-to-serve markets, such as rural, and economically distressed areas.

Number two, the Government's role should be focused and targeted at affordable and workforce housing, including both rental and home ownership. We must also maintain the flow of capital to upgrade and finance an aging multifamily rental housing stock.

Three, mortgage financing should remain available for creditworthy borrowers in all communities.

Four, secondary markets that enjoy Government support and guarantees should have an affirmative obligation to finance affordable housing, including in rural and underserved areas. Assessments on mortgage-backed securities may be needed to fund affordable housing and community development activities.

Five, the low-income housing tax credit is an important source of equity investment in affordable multifamily housing. No changes to the housing finance system should negatively impact important improvement programs like this credit.

Six, credit channels for multifamily housing must remain open while we transition to a new system.

In closing, I would like to thank you for the opportunity to testify today. Enterprise very much looks forward to working with you as you consider housing finance reform, and I welcome any questions.

Chairman JOHNSON. Thank you, Ms. Ludwig.
Mr. Phipps, please proceed.

STATEMENT OF RON PHIPPS, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS®

Mr. PHIPPS. Good morning, Chairman Johnson, Ranking Member Shelby, and Members of the Committee. Thank you for inviting me to testify this morning.

My name is Ron Phipps. I am the 2011 president of the National Association of REALTORS®. I am proud to be an active part of a four-generation, family owned residential real estate business in Rhode Island. I am testifying today on behalf of the 1 million REALTORS®, the 75 million Americans who own homes, and the 310 million Americans who require shelter.

REALTORS® agree that the existing system failed and reforms are needed. We appreciate that the Committee is heeding Treasury Secretary Timothy Geithner's and the Ranking Member Shelby's warnings and cautions that a Federal housing policies must adequately be assessed and proper homework must be done before action is taken.

As you consider the future of the Federal housing policies, we ask you to keep in mind the immense value that sustainable home ownership provides to this country and to American citizens.

Right now, the mortgage markets are not working as they should and change is required. However, REALTORS® believe that the GSEs' housing mission, and the benefits that are derived from it, played a vital role in the success of this Nation's housing system and continue to play that role today.

Had there been no secondary market when market entities, like Fannie Mae and Freddie Mac, when the private market capitals reached their financial crisis, the American housing market would have come to a complete halt, throwing our Nation into an even deeper recession than we did see. We need only look at the current state of affairs in the commercial and jumbo market to see how bad it would be.

For this reason alone, REALTORS® believe that pure privatization of the secondary mortgage market is unacceptable; rather, NAR supports the creation of secondary mortgage market entities that include some level of explicit Government participation but protect the taxpayer and ensure that all creditworthy consumers have reasonable access to affordable mortgage capital. Moreover, these entities should provide a wide range of safe, reliable mortgage products such as 30-year or 15-year fixed-rate loans, traditional ARMs, and other products that have stood the test of time.

Let me be clear. REALTORS® agree that the reforms of our housing system, including GSEs, are required to prevent a recurrence of the housing market meltdown. However, we caution that significantly limiting the Government's role in housing finance will foster mortgage products that are more in line with business goals than in the best interests of the Nation's housing policy or the consumer. This action coupled with other unnecessary implementing rules that further curtail access to mortgage credit—for example, raising down payments have stark ramifications for the overall economy.

This leads me to the second significant concern that realtors have today, and that is, the definition of a qualified residential mortgage. QRMs, or risk retention requirements of the Dodd-Frank requirement, are expected to have basically lower rates and fees than other non-QRM products. REALTORS® believe that Federal regulators should honor the intentions of Senators Isakson, Hagan, and Landrieu by crafting a qualified residential mortgage exemption that includes a wide variety of traditionally safe, well-underwritten products such as 30-, 15-, and 10-year fixed-rate loans as well as 7–1 and 5–1 ARMs, and also loans with variable down payments or flexible down payments that require mortgage insurance. A very narrow QRM policy that does not heed their intention will displace a large number of potential homeowners.

As noted in a recent American Banker article, 69.5 percent of all loans originated in 2009 would not qualify under the new proposed QRM standards.

Moreover, an analysis of QRM by CoreLogic indicates that boosting down payments in 5-percent increments has only a negligible impact on the default rates, but significantly reduces the potential pool of borrowers. Further, a narrowly drawn QRM ignores the compelling data that demonstrates that sound underwriting, such as documentation of income, and use of traditional mortgages have a larger impact on reducing default rates and higher down payments. Saving for a down payment has always been a major obstacle. The Center for Responsible Lending indicates it will take 8 years for the average family earning $50,000 to come up with a 10-percent for a $150,000 mortgage. It will take them 13 years to come up with 20 percent.

Every decision that we make today regarding the housing finance system will have a significant impact on the ability of future generations to purchase homes. Moreover, these decisions will have a profound impact on our Nation's economy.

I thank you for the opportunity to present our thoughts. As always, the National Association of REALTORS® stands ready, willing, and able to work with you and our partners to make a future brighter for Americans. REALTORS® believe that housing is not a partisan issue, nor is it simply in the common interest. We really believe that it is in our national interest.

Thank you.

Chairman JOHNSON. Thank you, Mr. Phipps.

Mr. Parrell, please proceed.

STATEMENT OF MARK J. PARRELL, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, EQUITY RESIDENTIAL, ON BEHALF OF THE NATIONAL MULTI HOUSING COUNCIL AND NATIONAL APARTMENT ASSOCIATION

Mr. PARRELL. Thank you. Chairman Johnson, Ranking Member Shelby, and distinguished Members of the Committee, my name is Mark Parrell. I am the Executive Vice President and Chief Financial Officer of Equity Residential. My company is the largest publicly traded owner of apartments in the United States and we are also a large borrower from the GSEs, Fannie Mae and Freddie Mac. I am testifying today on behalf of the National Multi Housing

Council, NMHC, and its joint legislative partner, the National Apartment Association, NAA.

I appreciate the opportunity to present the industry's perspective on the role of Fannie Mae and Freddie Mac in the multifamily market and the benefits they produce from that presence. I will also explain why the private market alone cannot meet the industry's current and future capital needs.

First, a little background on our industry. Rental demand is surging because of changing demographics and new economic realities. More than four million members of the echo boom generation will turn 18 each year for the next decade, creating tremendous demand for housing. While there may be an oversupply of single-family housing, the Nation could actually see a shortage of multifamily housing as early as 2012.

Apartments are more than shelter. I would point out they are also a big economic powerhouse. We produce about $120 billion as an industry in rental revenues annually and we employ about 550,000 in managing apartments. Apartments also produce important societal benefits. They are environmentally sustainable, resource and energy efficient, and help create a mobile workforce that can relocate for job opportunities, and that is something I think is especially important in this recovery.

I highlight these things to help you understand why it is so important that Congress consider the unique needs of the apartment industry as you pursue reform options. Solutions that work for single family will not necessarily work for multifamily. Our sector warrants its own specialized analysis. To that end, let me share with you what works and what does not work in the current GSE system.

While the problems in the single-family sector are widely acknowledged, when it comes to the GSE's multifamily programs, much works. Let me be clear. I am not here to defend the GSEs or to suggest that they continue in their current form. I simply want to highlight the multifamily elements that are working and working at no taxpayer expense. In fact, many of the single-family housing reform proposals look a lot like the existing multifamily system, private capital taking a significant first loss position and the Government's involvement ebbing and flowing with changes in the availability of private capital.

The existing GSE multifamily housing finance system has attracted enormous amounts of private capital, helped finance millions of units of market-rate workforce housing, and all of this without direct Federal appropriations. It has filled a critical gap when private capital disappeared and ensured liquidity was available to refinance maturing mortgages.

In stark contract to the GSE single-family business, the multifamily programs were not part of the meltdown and are not broken. Overall loan performance remains strong, with delinquency and default rates at less than 1 percent. They have outperformed CMBS, commercial banks, and even FHA. In addition, since entering conservatorship, the multifamily portfolio has produced approximately $2 billion in profit for the Federal Government.

The most recent crisis underscores the need for a capital source that will be available in all markets at all times, not just in New

York City, but also in Sioux Falls, South Dakota, and Birmingham, Alabama. The GSE's share of the multifamily market has varied considerably over time, increasing at times of market dislocation and scaling back during healthier economic times.

A federally backed secondary market is also critical to refinancing the estimated $300 to $400 billion of multifamily mortgages that will mature by 2015. Unlike residential mortgages, which are typically for 30-year terms, most multifamily mortgages are for periods of seven to 10 years and do not fully amortize.

Without the GSEs' multifamily programs in the latest crisis, there would have been widespread foreclosures of otherwise performing apartment properties because owners would not have been able to refinance maturing mortgages. Property upkeep would have suffered and fewer units would have been built.

Finally, I would like to share a little known fact about the units financed by Fannie Mae and Freddie Mac over the last 15 years. Fully 90 percent of these units, more than 10 million in total, were affordable to families at or below the median income for their community without requiring Federal appropriations and at no taxpayer risk. In other words, workforce housing for teachers, nurses, and first responders.

In conclusion, the liquidity provided by the Government-supported secondary multifamily mortgage market lowers the cost of capital to borrowers, which encourages the construction of more multifamily housing. This increased supply forces owners to provide this market-rate housing at a rent level that makes it more affordable to the Nation's workforce. Without it, higher interest rates and debt service costs would mean fewer multifamily units and higher rents.

I once again ask Congress, as it looks at reforming the housing finance system, that it do nothing that would jeopardize the construction, financing, and availability of multifamily housing.

I thank you for this opportunity to present the views of NMHC and the National Apartment Association.

Chairman JOHNSON. Thank you, Mr. Parrell.

Mr. Heerde, please proceed.

STATEMENT OF GREG HEERDE, MANAGING DIRECTOR, AON BENFIELD AND AON BENFIELD SECURITIES

Mr. HEERDE. Good morning, Chairman Johnson, Ranking Member Shelby, and Members of the Committee. I am Greg Heerde, Managing Director of Aon Benfield and Aon Benfield Securities, and I am here today to discuss the role of private capital in supporting lenders' credit risk through the provision of mortgage insurance.

Aon Benfield is the world's largest reinsurance intermediary, and Aon Benfield Securities is an investment banking firm providing advisory services to insurance and reinsurance companies, including capital raises, risk transfer securitization, and mergers and acquisitions.

Private mortgage insurance provides protection to lenders, investors, and most importantly, taxpayers by standing in the first loss position in the event that a borrower stops making payments. Private mortgage insurance also expands home ownership by allowing qualified borrowers with less than the 20 percent prescribed down payment to purchase a home. Private mortgage insurance is also an alternative to the Federal Housing Administration mortgage insurance program.

Mortgage insurers underwrite the underlying quality of the prospective borrowers' creditworthiness and the supporting collateral, and thereby ensuring higher quality mortgages are issued. This protects not only the lenders and investors, but the prospective borrowers by ensuring that the home is affordable at the time of purchase.

Private mortgage insurers also have clear incentives to mitigate losses once loans become in default. As foreclosure results in the highest likelihood of lost payment under the insurance policy, mortgage insurers' goals are to work with borrowers to avoid foreclosure and keep them in their homes.

U.S. private mortgage insurers have already paid approximately $25 billion in losses during the current housing downturn without Government or taxpayer support. The largest beneficiary of these payments has been and will be Fannie Mae and Freddie Mac, thereby reducing a material amount of exposure to the taxpayer.

Reinsurance is another form of capital available to the insurance industry. Reinsurers' capacity stands ready to be deployed more broadly going forward to support the U.S. mortgage insurers. Aon Benfield estimates that global reinsurance capital totaled $470 billion at December 31, 2010, representing a 17 percent increase over 2009 and the largest amount of capital in the history of the industry.

Private reinsurers also play an important role in supporting mortgage insurance in a number of other countries, including Australia, Canada, and the United Kingdom. These countries have mortgage finance systems that are each unique with varying Government roles, but it is important to note that private reinsurance plays some part in all of these.

Since the beginning of the financial crisis, new capital has come into the sector in the form of a new start-up mortgage insurer and as significant contributions to existing carriers. To date, approximately $8 billion of new capital has been raised.

In addition to the capital that was raised, Aon Benfield Securities represented a qualified management team in 2009 seeking to form a new mortgage insurance company. This plan was ultimately shelved as the capital providers witnessed the substantial growth of the Federal Housing Administration, coupled with the uncertainty surrounding the future of Fannie and Freddie, which was viewed as weakening the demand for the mortgage insurance product and, therefore, the need for new companies.

There were other efforts during the same period to introduce new mortgage insurance companies in various forms, some of which received indications that they would not receive approval from Fannie and Freddie to write business, resulting in these efforts being shelved, as well.

If a decision is made to reduce the role of Fannie over time, and that decision results in increased demand for private mortgage insurance at commercially responsible terms, we are confident that sufficient private capital would be available to support that increased demand. Reinsurers are also eager to underwrite new risks, and reinsurance capacity is clearly available to support the mortgage insurers by providing capacity that will allow them to insure more loans as the housing market rebounds and demands for mortgage insurance grow.

As consideration is given to the reduced Government role in supporting mortgages, another area that will require private capital is in covering earthquake exposure. GSEs currently require underlying mortgages to be insured against most perils, including fire, hurricane, and flood, as applicable. No such requirement exists for the earthquake peril, representing a multi-billion-dollar subsidy currently provided by the taxpayers. Private capital retaining the underlying mortgage risk is likely to require all underlying insurable risk to be covered. We are pleased to report that there is ample insurance and reinsurance capacity to absorb this risk.

In closing, as this Committee considers proposals impacting the future of the housing finance system, we are encouraged to report that private capital providers have upheld their commitments made through the mortgage insurance channel and additional private capital is available to inject fresh capital as needed. Thank you.

Chairman JOHNSON. Thank you, Mr. Heerde.

Mr. Hughes, please proceed.

STATEMENT OF MARTIN S. HUGHES, PRESIDENT AND CHIEF EXECUTIVE OFFICER, REDWOOD TRUST, INC.

Mr. HUGHES. Good morning, Chairman Johnson, Ranking Member Shelby, Members of the Committee. I am Marty Hughes, CEO of Redwood Trust. I sincerely appreciate the opportunity to testify here today. My testimony is narrowly focused on what is it going to take to bring back private financing for residential mortgages.

By way of background, Redwood is not a bank, is not an originator, and is not a servicer. We have a long history of sponsoring and investing in prime jumbo mortgage-backed securitizations. As part of our business model, we have always held risk retention. We hold the bottom tranches. In regulatory parlance, we have held a horizontal slice.

We have completed the only two private transactions backed by new issue residential mortgages since the freeze began. We hope to complete two more transactions by year end. Our two transactions were quickly and well oversubscribed. It did not happen by accident.

We work with AAA investors, insurance companies, banks, lenders, to meet their needs. Their needs are pretty straightforward. Enhanced transparency—they want skin in the game, safe and simple structures, and strong and enforceable representations and warranties. We believe, based on the success of these transactions, but beyond that, in conversations with fixed-income investors who are awash with liquidity looking for safe, attractive investments, we believe that they will come back into the private prime jumbo space. The speed at which they come back is the biggest question.

In my opinion, the biggest impediment to the speed coming back is the outsized role of the Government in supporting 90 percent of the U.S. mortgages. It is crowding out the private sector. There is no sense of urgency, especially by traditional bank securitizers. They can sell 90 percent of their originations to an attractive Government bid and then easily retain the remaining 10 percent. There is just no financial urgency to get anything moving.

We would note, postcrisis, the ABS markets for credit cards, auto loans, and now commercial loans are up and working and functioning, while the private residential markets barely have a pulse. If we look at how they recovered, it is success breeds success. Issuance velocity leads to more issuance velocity. There are just too few prime loans available to securitize to gain any velocity.

Government subsidies need to be scaled back to allow the private markets to flourish and to reduce the burden on taxpayers. We are ready to securitize any prime loan of any size once the playing field has been leveled.

We strongly advocate moving ahead with the Administration's plan to safely and on a measured basis and begin to test the private market's ability to step into the breach. It is going to take a period of time, we believe 5 years, but we believe if loan limits are reduced, if guarantee fees are moved up to market rates, it will allow the private sector time to gain standardized practice procedures and, most importantly, confidence.

There are other impediments. We need to get through regulatory reform and know the rules of the road. Servicers have some fence mending to do. They need to rebuild confidence. We need uniform standards for servicers that clearly set out their responsibilities, the procedures they are supposed to follow, and how to resolve conflicts of interest. Securitization sponsors are going to have to follow best practices as demanded by AAA investors. They are going to have to develop, adopt, and they are going to have to embrace it. That is the only way you are going to end up getting the trust back. We would say the recent Redwood Trust transactions provide a pretty good road map.

One kind of gaping hole that is still out there is the unresolved threat from second mortgages. It is a significant factor that led to the housing and mortgage crisis. The first and most important level of skin in the game is at the borrower level. If the borrower can immediately withdraw their skin in the game through a second mortgage, it greatly increases the risk of default on the first mortgage. Left unchecked, we believe this would be a very disappointing result for investors.

In terms of mortgage rates, we do believe as the Government recedes, mortgage rates will go up. We believe they will go up modestly, in our opinion, perhaps 50 basis points. In our deal, the fixed-rate loans were 50 basis points above the conforming rate, but really, it is not just looking at that deal. It is also talking to investors. Again, they are awash. There is $2.5 trillion in fixed-income funds searching for yield. To the extent that they have confidence that private-label residential mortgages are there and they can buy them and they can earn a premium over agency securities, we believe there would be a very active market. Done correctly, a wind-down of the Government's role can be replaced by a smarter, less risky private-label market.

Thank you for allowing me to testify.

Chairman JOHNSON. Thank you, Mr. Hughes.

Mr. Rutenberg, please proceed.

STATEMENT OF BARRY RUTENBERG, FIRST VICE CHAIRMAN OF THE BOARD, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. RUTENBERG. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today. My name is Barry Rutenberg and I am NAHB's 2011 First Vice Chairman of the Board and a builder from Gainesville, Florida. NAHB represents 160,000 corporate members representing for sale and rental housing as well as remodeling.

NAHB strongly supports efforts to modernize the Nation's housing finance system, including reforms to the Government Sponsored Enterprises Fannie Mae and Freddie Mac. NAHB believes strongly that a Federal backstop is needed to ensure the continued availability of affordable mortgage credit, specifically 30-year fixed-rate mortgages and affordable financing for multifamily housing.

The housing finance system is under a cloud of uncertainty. For over a year now, NAHB has been actively involved with Congress in discussions on changes to the financing framework for homebuyers and producers of housing. Since then, Congress has passed the Dodd-Frank Act. Regulators are now busy implementing this massive law that has the potential to reduce the availability and increase the cost of housing credit. In addition, Congress and the regulators are piling on layers of regulations in an attempt to plug gaps in the system of mortgage regulation and prevent a recurrence of the recent mortgage finance problems.

Caught up in the wave of uncertainty, criticism has been directed toward the Federal Government's role in housing finance markets through the FHA and the housing GSEs. Currently, these sources of housing finance account for nearly all mortgage credit flowing to homebuyers and rental properties, yet this is exactly the role that these systems were designed to fill during times of economic uncertainty. And even with the current heavy dose of Federal backing, fewer mortgage products are available and loans are being underwritten on much more stringent terms.

This is not an arrangement that can continue indefinitely and there is no clear picture of the future shape of the conforming conventional mortgage market. One thing is clear. Certainty must be returned to the housing market.

The housing landscape has been little changed during this period, as the housing market remains extremely weak. In fact, while economic growth has been weak by historic standards for an economic recovery, housing performance has been even weaker. Unlike the last two economic recoveries, when at this point in the recovery, housing had already grown 25 and 45 percent to lead the country out of recession, housing is still down 18 percent since this recession ended in June 2009.

Adding to the current housing crisis, decisions about comprehensive structural reforms to the U.S. housing finance system are stuck in a quagmire, despite the Administration's recent report outlining options for reforming the housing finance market.

There is a way forward. Recently, NAHB has joined a coalition with 15 other organizations that developed principles for restoring stability to the Nation's housing finance system. These principles highlighted the need for a continuing and predictable Government role in housing finance, to promote investor confidence, and ensure liquidity and stability for home ownership and rental housing. NAHB believes that it is critical that any reforms be well conceived, orderly, and phased in over time.

In contrast, proposals offered by some would effectively wind down the operations of Fannie Mae and Freddie Mac without offering a clear vision for the future of the housing system. We need a thoughtfully designed path for a transition to the new framework that will not disrupt the housing market even further and push the Nation back into a deep recession.

America's home builders urge policy makers and the Administration and Congress to move forward comprehensive GSE reform legislation that seeks an appropriate Federal role to maintain a healthy mortgage marketplace for single and multifamily housing. Housing can be a key engine in job growth that this country needs, but it cannot fill that vital role if reform legislation moves forward that does not include a predictable Government role in the secondary mortgage market to preserve financial stability in the market and maintain a stable housing sector.

Thank you for the opportunity to testify today. I look forward to your questions.

Chairman JOHNSON. Thank you, Mr. Rutenberg.

Mr. Phipps and Mr. Rutenberg, one of the ways that the Administration and others have suggested to reduce Government involvement in the housing finance market is by increasing the down payments required by Fannie Mae and Freddie Mac. How would this impact future borrowers and current homeowners? Mr. Phipps.

Mr. PHIPPS. Senator, part of the frustration that we as REALTORS® have is that when you look at the modeling, down payment does not necessarily prevent or preclude default. If you look at programs like VA in particular, in which you can have 100 percent financing, it has one of the lowest rates of default across the board. What we know is that if you use rigorous underwriting standards and have traditional predictable mortgage instruments, meaning—30 years is a great instrument because the consumer knows what they are getting into. By definition, you will have better outcome.

Our concern is when we look at the analysis of increasing from the down payment at 3.5 or 5 percent or 10 percent to a 20 percent threshold, you are going to preclude many, many borrowers from being able to finance to be able to obtain mortgages. As I said in my opening statement, that is a huge problem.

The other footnote is that when we talk about the amount of money down, we ignore the fact that the consumer typically has to come up with more than the 3.5 or 5 or 10 percent down. They have something called closing costs, which can be 3 to 5 percent more, plus prepaids. Those are insurance, taxes, *et cetera.* So there is more money in the dynamic.

But suffice it to say that if we really make it particularly difficult, we retard the recovery of the housing market and we make it harder for people to get in that first rung of home ownership. So we really disagree with it.

Chairman JOHNSON. Mr. Rutenberg.

Mr. RUTENBERG. Thank you, Mr. Chairman. Not only is it the first rung to move up, the first-time buyer, but it is also the move up, because if the first-time buyer cannot sell his house after several years, then they cannot move up. So there is a chain that interacts all the way up and down.

The qualified residential mortgages that have been envisioned from the Dodd-Frank bill, we have been told by some of the Senators that the current version is not exactly what they had expected it to be. It has a great possibility of unsettling it. I have seen estimates that 50 to 65, 70 percent of the mortgages that were approved last year could not be approved under the new rules, and I keep hearing that the newer mortgages are performing much better as far as any delinquencies and being paid on time.

There are different provisions in them. Not only is there the 20 percent, which may take 10 to 15 years to accumulate, but you now have a 20 percent PITI provision, 36 percent for total debt. You cannot have had any kind of miss on your credit for 60 days late in the previous 2 years. It has an unsettling, and I believe that one of the reasons that housing is not selling better now is a lack of confidence and uncertainty. As we can work together to make it more certain, then the market will return. It will help stabilize our housing market and our housing values.

Chairman JOHNSON. Ms. Ludwig and Mr. Parrell, the Committee has talked about the need for a capital source that will be available to all markets at all times. Can you elaborate about what you think would happen to availability and price of rental housing in America, such as New York City, compared to Aberdeen, South Dakota, if there were not a Government backstop or guarantee for multifamily financing? Ms. Ludwig.

Ms. LUDWIG. Certainly. Thank you. That is a really important question for the work that Enterprise does directly, and we feel that it is critically important to ensure that all communities have access to credit, and in our work, one of the important places we work is in rural communities. We think that in this case, if we move to a wholly private system, that certain underserved markets may not be effectively served. And when we think about those markets, we think about places like rural America. We also think about certain segments of our population.

But the liquidity and the stability provided by the GSEs have ensured that all these communities, rural, suburban, urban, have all had access to credit. So, for example, we provided about, at Enterprise, almost a billion dollars worth of capital to rural communities. Much of that was in partnership with GSEs in some form, whether it was through the debt financing or through the Low-Income Tax Credit, and so we think it is vitally important, particularly in communities that do not have as active capital markets, that we make sure that there is some sort of Government backstop.

Chairman JOHNSON. Mr. Parrell.

Mr. PARRELL. I would just follow up on the prior speaker's comments. From personal experience, I can tell you that the private markets are ready and willing to take credit risks, specifically the life insurance companies and a few other sources, as it relates to certain popular coastal markets like Washington, DC, Boston, New York, Southern California, Seattle, and Northern California.

We just recently tried to refinance a 15-year-old property in Scottsdale, Arizona, a very nice asset, pretty low leverage, about 60 percent of the value, and had absolutely no takers from the life insurance companies after soliciting bids from 40 of them. One of the GSEs will finance that asset for us. When we did the same thing in the San Francisco Bay area with about 20, 25-year-old properties, we had no difficulty whatsoever obtaining excellent life insurance company interest.

So the private market is there, but it is very selective. And not only would it ignore, in my view, or mostly ignore Aberdeen, South Dakota, it would ignore a great deal of other places, like Fresno, California. And they are interested right now in a very specific subset of markets, and they have been interested in a subset, that specific subset, for quite a while.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you.

I was interested in what Ms. Ludwig said in her testimony about multifamily, and the default rate was basically 1 percent as opposed now to 11.5 percent in single-family homes. Is that because of more skin in the game, more down payment, better underwriting standards and so forth? Because that is a big difference there. What are we all interested in? I think we are interested in providing opportunities for home ownership. It will not be for everybody. We pushed all that probably too much and pushed people into homes that they could not afford with nothing down. I think that day is gone.

But I do believe—and I think Mr. Phipps has a different opinion—that there is a connection, a correlation between putting something down, putting skin in the game on anything, and the likelihood of default, because the more risk if it goes to the taxpayers or if it is in the private market, which we are trying to produce, they are going to look at risk because they are managing risk, you know, as they—what is the likelihood of default. Isn't that what we are really getting at? And if we are ever going to create another private market like we had. I thought for a long time, before it was all abuse and misused, that securitization was good for America, and Fannie Mae and Freddie Mac were not the only people involved in that, as you well know. But it was abused and misused, and we are where we are today, which is a bad situation. We understand the plight of housing. We have got just too many houses, you know. There has to be an equilibrium between supply and demand, and it is tough on everybody around it.

But what is wrong with some skin in the game, Mr. Phipps? What is wrong with a down payment? This is anecdotal, but I remember many years ago when my wife and I were very young, and we were going to build a house. We wanted as much down payment as we could rake and scrape to keep the payment low because we had no intent of walking from it. You know, the underwriting standards were tough. It was a conventional loan and so forth. But what is wrong with skin in the game?

Mr. PHIPPS. Senator, the——

Senator SHELBY. Because we are thinking about the taxpayers right now. Since Fannie Mae and Freddie Mac are basically the only people in this game right now, the secondary market.

Mr. PHIPPS. The short answer is there is skin in the game when you have 3.5 to 5 percent down. That is skin in the game, and, frankly, the house itself, the asset, is skin in the game. When most American families in our opinion get housing, they want to have sustainable home ownership. The lessons—if you look at the performance of the mortgages and the underwriting that has happened in the last 2 years, we have analyzed the risk, and the fact that the default rate now is negligible *versus* what we had go on in the 3- to 5-year period of ridiculous underwriting or nonunderwriting or blind underwriting, we have corrected for that.

We look to have confidence in the market, and the consumer is looking right now and watching what we are doing here and watching the things with great anxiety that housing values are not stabilized in their market area. The sources of money are very limited and very difficult. They want to have confidence that we figured it out and we have identified a measured risk for the future.

Senator SHELBY. How do we bring back an appetite in the private market for mortgage-backed securities? I think that is what we all need because, my God, you would have greater opportunities. But how do we do that?

Mr. PHIPPS. We are for that—I think from our perspective what we do is we create the principles by which we engage; we acknowledge the need for an explicit Government guarantee, and we create other entities that are successors that will not make the mistakes that Fannie and Freddie made. I think that is really what we are looking——

Senator SHELBY. So you are not advocating here that you want a Government guarantee for everything in the real estate industry bills, are you?

Mr. PHIPPS. No. What we are looking for is the backstop, Senator.

Senator SHELBY. OK.

Mr. PHIPPS. The ultimate protection. But we are looking for private markets and private capital to step back into the market.

Senator SHELBY. But it has not come yet, has it?

Mr. PHIPPS. It just has not come, and in the interim, the housing market lives on this river of capital, we need that capital for transactions to happen, for houses to be built, for there to be a future of housing and also a future for American home ownership.

Senator SHELBY. But isn't it basically true, whether we like or not, that we have got in a lot of areas a glut of real estate. Let us be honest about it. And we are going to have to absorb that. The market always absorbs the excess. Maybe it is very painful to all of us—to me, to you, and to a lot of participants. But isn't it going to have to be absorbed?

Mr. PHIPPS. It will have to be absorbed——

Senator SHELBY. To get an equilibrium?

Mr. PHIPPS. We want to get back to equilibrium, and, frankly, as we move along and resolve issues like QRM, *et cetera,* so that the consumer knows what the rules of the road are, then I think they will step in and absorb that excess inventory.

Senator SHELBY. Mr. Hughes, what is your opinion or what is your judgment on the impact on interest rates if the conforming loan limits were gradually reduced? Gradually reduced.

Mr. HUGHES. So if we look for the next scheduled reduction, which is 725 to 625—729 to 625, it represents 2 percent of the market today. The difference in the loan rates for the jumbo conforming rate is 4.75; the jumbo rate you can get at a bank today with similar underwriting is 5 percent. So there has been a lot said that mortgage rates are going to skyrocket. The payment that a mortgage person would make today on a $720,000 mortgage at today's rate would be $3,765. If we rolled back the limits to 625 and that has to seek financing from a bank, the payment would go up by $109.

Senator SHELBY. It would also depend on what you put in the down payment, wouldn't it?

Mr. HUGHES. Correct.

Senator SHELBY. I mean, you know, if you are getting a big loan, say $700,000 or $650,000, that is a pretty good size loan for the average American, whether it is in Alabama, South Dakota, or Montana, or maybe not in certain areas of California or New York or Miami, you name it. But should that be our housing policy up here to worry about the people at the upper end that can access the market, can put their own money in without a Government guarantee?

Mr. HUGHES. I think that market should be supported by the private sector. It is $720,000—you are talking about a $900,000 house. I do not believe that is a house that should be subsidized by taxpayers.

Senator SHELBY. Thank you.

Chairman JOHNSON. Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you all for your testimony.

I wanted to keep dwelling on this issue of the potential impact of a qualified residential mortgage line at 10 or 20 percent. I must say that in my work in affordable housing, developing affordable housing, and my former work with Habitat for Humanity working with low-income families striving to become homeowners, what I often saw was that folks who were renting and paying at that time, 20 years ago, $500 to $700 a month in rent could buy a house for $500 to $600, and that was before they got any tax benefits, and they took enormous, enormous pride in the fact that they finally had the stability and a piece of the American dream, that they had ownership, that they could decide what color to paint the house, they could decide what rhododendrons and azaleas they were going to plant in the yard. And the attitude of the children changed with the notion of the parents saying, "No, you cannot do that because we have to fix it. There is no landlord to call to fix it."

This is my deep concern, that we are going to throw the baby out with the bath water, and that essentially what has happened is we had predatory mortgage practices with "liar loans" and prepayment penalties that locked people into predatory loans and steering payments that encouraged originators to put people into predatory loans. And we fixed all that, and now that we fixed it, we are looking and analyzing the data—and I really appreciate the analysis, Mr. Phipps, that you all have gone through to compare mortgages that met certain standards. And as I understand it, when you looked at that situation and said, OK, let us see what happens with different down payments when we have fair mortgages, where there is documented income, where it is either a fixed rate or a 7-year ARM, when there is no negative amortization, no-interest loans, no balloon payments, 41 percent debt to income, private mortgage insurance if it is over 80 percent loan to value, and you found a very small impact on the amount of the down payment on the default rate.

Am I capturing that correctly?

Mr. PHIPPS. Exactly right.

Senator MERKLEY. So I was doing a little back-of-the-envelope number here, and I think you found in the vicinity of a 0.02-percent increase in the default rate.

Mr. PHIPPS. Correct.

Senator MERKLEY. So the basic setup is this. Let us say we have a million people buying homes, and by increasing the down payment from 5 to 10 percent, we proceed to have 10 percent fewer families—or I think the range you had was 7 to 15, but I am taking kind of the center point. So 100,000 fewer families gained access to home ownership because you are going to have 2,000 more defaults. Basic math.

So I was trying to capture the profit on those 100,000 successful homeowners *versus* those 2,000 defaults, and I will be happy to share the numbers later, but let me just say it is more profitable for the banking industry to have those 100,000 owners and it has very little impact on the interest rate, and we will have families that will be successful in all kinds of ways because of their ability to be homeowners. So I appreciate your analysis.

Mr. PHIPPS. Correct. And the piece that I would add, too, is that home ownership is in the national best interest because the average family that owns a home, all 75 million of them, even after the market corrections, have a family net worth of about $180,000. The average family with obvious demographic difference that rents a house has a family net worth of $4,600. So we want self-reliance. Home ownership should be something that is a priority in our national agenda.

Senator MERKLEY. Well, absolutely, and many of the families I was working with in the early 1990s were buying homes. At that point the market price in the community for your basic home was around $60,000. Those homes are $250,000 to $300,000 today. Those families are in a completely different position. They have come close to now paying off their loans, and while they will still have taxes, it is cheaper than renting the rest of their life.

And I think about the basic plan in America. We have very few employment settings anymore that have a defined benefit pension; that is, after you retire you will get X amount per month. So families are relying on buying a home, having that equity, and getting Social Security, and as two fundamental principles, and we cannot allow the mistakes we made with mortgages over the last 10 years to drive us down the road.

And I would really like to note that we have got to tackle this issue of foreclosures at the same time because not only are the families being affected when a family is unable to stay in the home, but the market—how can the market recover if there are empty houses being sold at fire-sale prices? Of course, Oregon makes a lot of lumber. Who is going to buy lumber if you are not building houses? We have a huge nursery industry, but people buy plants when they buy homes.

So there has been an enormous focus on Wall Street and fixing institutions. We have got to work to make sure that the mechanics of mortgages work for homeowners.

I have gone over my time. I had lots of questions, but I will yield back to my colleagues. Thank you.

Chairman JOHNSON. Mr. Heerde, your testimony states that the private insurance market and reinsurance market could fill the role of a Government guarantee. If there were no Government backstop and the private mortgage insurance provided the backstop, what would the insurance cost?

Mr. HEERDE. Well, the insurance market would set the rate based on the underlying risk of the mortgages. So when you look at the factors, and listening to the testimonies of the other witnesses as well, there are a number of factors, including down payment, past credit history, earnings to—debt-to-earnings ratios and so on. Those rates would be set based on the predictable default pattern of the underlying borrower.

Chairman JOHNSON. Reinsurance stepped in after Hurricane Katrina to assist insurance companies. Given that the housing market is a multi-trillion-dollar market, would reinsurance be able to cover that amount in the event of another financial crisis like the one we just experienced? Mr. Heerde.

Mr. HEERDE. We believe that reinsurance could play a role. The likely outcome of a wind-down or decline in Fannie Mae and Freddie Mac and more loans being held on the balance sheets of the financial institutions, the underlying product would likely change significantly in that the banks would probably not ultimately require loan level mortgage insurance but, rather, maintain an acceptable level of risks on their own balance sheet and buy portfolio coverage. That would change the dynamic of the coverage. But because of the role the insurers and then, therefore, reinsurers would ultimately need to play, it would raise up their retention and it would probably provide more coverage at a higher level than the current system of individual loan level protection.

Chairman JOHNSON. Mr. Hughes, before the crisis, did Redwood securitize subprime loans? And what was the reason behind that decision?

Mr. HUGHES. Prior to the crisis, Redwood did not securitize any subprime loans. We have been in the prime jumbo space since that period of time.

Chairman JOHNSON. Would your investors be interested in deals that were backed by loans that did not have extremely low LTVs?

Mr. HUGHES. I think the investors would buy the loans today that are getting sold to Fannie Mae and Freddie Mac. Those loans, the loan-to-values for those, you know, everybody thinks are here and that there is 5 percent down. The loan-to-value on a jumbo securities offer by Fannie Mae today is 68 percent. So, yes, I think the prime market, in order to come back and private investors to come back, there is going to have to be a down payment. I do not think that 20 percent is what the private markets are going to require, but that is where Fannie and Freddie are today. It is a different market than where the FHA is.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. I would like to address this to, I guess, all of you, but I was thinking about the home builders and the real estate people probably know this better than I. I am interested in this.

A lot of people, we have seen—I have known a lot of them anecdotally—they will buy more than one home. They will be owing money on all of them. They will have a home that they live in. Some of them buy a home at the beach in the South. Some buy a home in the mountains. I have known some that own the heck on all of them. But, you know, they are living a pretty good life, I guess.

Does the down payment apply in the mortgage—this 700, does that apply to if I want to buy a second home, so to speak? Mr. Rutenberg.

Mr. RUTENBERG. Senator Shelby, it has been my experience——

Senator SHELBY. I am just interested in what the policy is.

Mr. RUTENBERG. It has been my experience that there are different down payments for secondary homes than there are for primary homes. There are different down payments for jumbo loans than there are conforming loans.

Senator SHELBY. OK. And what are those down payments? It is not 3 percent for your second home, too, is it, or 3.5?

Mr. RUTENBERG. Right.

Senator SHELBY. I hope not.

Mr. RUTENBERG. I do not know the policy. I can tell you that my customers who are buying jumbo are normally putting down 30 percent. My customers who are buying——

Senator SHELBY. And what is the default rate in say, the jumbo loan area?

Mr. RUTENBERG. I will defer to someone else who has that data.

Senator SHELBY. OK. Mr. Hughes.

Mr. HUGHES. At least on the two transactions we have recently done, there are currently no losses, no delinquencies at all.

Senator SHELBY. Mr. Phipps, tell me what—if I wanted—let us say I owned a—I did not own but I was buying a home, and I bought one and I put 5 percent down.

Mr. PHIPPS. For your primary residence?

Senator SHELBY. Yes, primary residence. And then, say, 3 years later I found me a place at the beach or the mountains, somewhere else, what would I have to pay down to buy that house?

Mr. PHIPPS. My experience is that for a second home or a third home, you are typically looking at between 25 and 35 to 40 percent. The criteria is much more rigorous for nonprimary residence just by definition. I do not know what the default rate is, but I know it is more rigorous. In my market area, if you do not have 20 percent or 25 percent for the second home, you are going to be looking to the current owner to provide some assistance.

Senator SHELBY. OK. Thank you.

Chairman JOHNSON. The Committee did not reach a quorum at this hearing and, therefore, we did not vote on the nomination of Mr. Timothy Massad as was planned. We will attempt to hold this vote off the floor, off the Senate floor, before we leave for recess. The Committee clerk will send a message to alert Senators and staff regarding this vote.

Thanks again to all our witnesses for being here with us today. Reforming our housing finance system cannot take place without a thoughtful and intelligent dialog encompassing many different views and proposals. Your testimony today further helps the Committee as we continue to analyze the complex issues regarding the future of housing finance.

I look forward to the ongoing discussions with my colleagues here today as we continue to work toward creating a stable and sustainable housing market for American families.

This hearing is adjourned.

[Whereupon, at 11:41 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF SENATOR ROGER F. WICKER

I am glad we are having this hearing today to examine the state of U.S. housing finance. Housing remains an essential component of our economy, and I am convinced our Nation will not recover entirely from its economic struggles until the housing sector recovers. As we go forward, we must learn from the economic crisis of 2008 and promote policies that do not put taxpayers at risk.

As we learn from the 2008 crisis, I believe we must significantly reduce the role of Government in housing. Indeed, the Government has a poor track record in its involvement in housing finance. To date, the failure of Fannie Mae and Freddie Mac has cost U.S. taxpayers over $150 billion. The companies, which are in Government conservatorship and owned by the Government, could need additional taxpayer dollars to remain solvent. Laudable attempts by the Government to "solve problems," often create entirely new problems themselves. For example, I believe that intentions of promoting "affordable housing" eventually led us down the path of pushing homeowners into subprime mortgages. This worked temporarily. However, once the interest rate on these mortgages reset, these homeowners could no longer afford their mortgage payments. In this case, excessive Government involvement encouraged borrowers to over-borrow and lenders to over-lend and played an important role in Fannie Mae and Freddie Mac's failures.

This short-sighted and risky approach resulted in increased foreclosures across the Nation. In response to concerns about this trend, I supported legislation when I was a member of the House of Representatives in 2005 and 2007 to increase oversight of these dangerous markets. Both bills passed the House but were never considered by the Senate.

As we examine the housing finance, the question before us is this: What is the role of the private market and what, if any, is the role of Government? As this Committee considers housing reform, I hope we consider the need to limit Government involvement and promote the private sector.

PREPARED STATEMENT OF TERRI LUDWIG

PRESIDENT AND CHIEF EXECUTIVE OFFICER, ENTERPRISE COMMUNITY PARTNERS

MAY 26, 2011

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify this morning. I am Terri Ludwig, president and chief executive officer of Enterprise Community Partners (Enterprise). Enterprise is a national nonprofit organization that creates opportunities for low- and moderate-income people through fit, affordable housing and diverse, thriving communities. For nearly 30 years, Enterprise has provided financing and expertise to organizations around the country to build and preserve affordable housing and to revitalize and strengthen communities. Enterprise has invested more than $11 billion to create more than 280,000 affordable homes and strengthen hundreds of communities across the country.

Enterprise is a long-time provider of permanent debt financing, specializing in affordable multifamily rental housing. We have originated $560 million in loans on more than 17,000 affordable apartments and houses. We work with the Federal Housing Administration (FHA), Fannie Mae and Freddie Mac, and private lenders and partners. We are an FHA Multifamily Accelerated Processing (MAP) lender and Ginnie Mae issuer, a Special Fannie Mae Delegated Underwriting and Servicing (DUS) lender, a Freddie Mac Targeted Affordable Housing lender, and a U.S. Department of Agriculture Section 538 lender. In all of these programs, Enterprise underwrites and services loans on rental housing and either sells the loans to one of these entities or finances it with mortgage backed securities. This provides additional capital allowing us to undertake additional lending and development activities.

We greatly appreciate the leadership and initiative of Chairman Johnson, Ranking Member Shelby, and other Committee Members in convening these hearings and pressing for a thorough and comprehensive review of the housing market. Reforming the housing finance system in the wake of the recent financial crisis is of critical importance. The issues at hand are complex and have significant implications for the housing sector, the financial markets, and the broader economy.

For 20 years, I worked in the private sector in investment banking, partnering with groups like Enterprise and using capital markets to efficiently invest in affordable housing and community development. This experience taught me that public–private partnerships are absolutely critical to bringing capital profitably to working families in low-income communities. In countless communities across the country—

rural, urban and suburban—the combination of public and private financing is effectively producing quality affordable housing.

Enterprise strengthens communities by bringing public and private capital together to meet local needs. We work in communities that range from small rural towns to large cities, from Native American tribal communities to suburban job centers. We know that housing is more than just a physical building—it is the place where people build their lives, create networks, and send their children to school. Secure housing is best provided in communities with a diverse mix of affordable and market rate housing options; access to jobs and support; and strong commitments to the environment and civic participation. We work on holistic housing solutions so that people can live close to work or public transportation, in healthy and safe housing and in safe and vibrant communities.

We know that housing needs are not homogeneous. People in rural communities have different needs then those in urban centers. Some families need secure rental housing while others can benefit from sustainable home ownership. At Enterprise, we focus on local and community needs. We have helped to create communities with both stable home ownership opportunities for families and affordable and safe rental housing.

As the financial crisis has shown, America needs a spectrum of housing options. During the past 10 years, many borrowers had unsustainable home loans. The consequences have been disastrous. Millions of homeowners are underwater on their mortgages. Irresponsible lending coupled with high unemployment has led to unprecedented foreclosure rates and vacant homes creating neighborhood blight. This crisis is undermining decades of progress that Enterprise and our national and local partners have made in revitalizing neighborhoods and bringing economic development, jobs and community safety improvements to underserved and low-income communities.

As the pendulum swings back to a more balanced housing policy and more homeowners look to the rental market, either out of choice or necessity, it is critical that Congress and the Administration ensure that affordable housing is available—this means ensuring that there is a stable source of capital and liquidity for affordable home ownership and rental housing.

In considering the next stage of housing finance and the Government's role in it, we must maintain adequate capital flow, liquidity, and stability for the multifamily mortgage market, both subsidized and unsubsidized. Any shift away from the current GSE structure must be done carefully and must ensure that viable affordable housing options—both home ownership and rental—exist in all communities. We must do no harm and take time to truly understand the consequences of housing finance reform on all borrowers and communities and all market segments. We urge Congress to consider how any new structure will impact the availability of credit to affordable housing and to ensure access to capital for all communities. This does not mean that we support the *status quo.* However, the GSEs have played a critical role in ensuring the availability of capital for affordable housing—through their loan purchases and securitizations as well as their investments in the Low Income Housing Tax Credit.

The Nation's Serious Affordable Housing Needs

The need for affordable rental housing is acute. The Government cannot walk away from all Government support of this market segment. We must think carefully before proceeding with a quick wind down of the GSEs without a successor financing system in place.

To begin, consider that in the United States today, there are 38.6 million units of rental housing,[1] and 32.6 million of those units are unsubsidized. Sixty percent of the unsubsidized rentals are in properties with four units or fewer.[2] Forty percent of households—12.3 million in all—are in unsubsidized buildings with more than five units. By contrast, the United States has 6 million units of subsidized rental housing.[3] One-third of these subsidized units are in properties with less than four units, and 4.5 million of the subsidized rental stock is in buildings with more than five units. More than 16 million units, or 47 percent, of rental housing are in buildings with 5 or more units, with more than 40 million people living in this housing.[4]

[1] Joint Center for Housing Studies of Harvard University. America's Rental Housing (2011).
[2] Mortgage Finance Working Group, Center for American Progress; JCHS Rental Housing (2008).
[3] Census Bureau. 2009 American Housing Survey; JCHS (2008).
[4] MFWG CAP paper, p.9.

Eighty-three million people—a full one-third of the U.S. population—are renters. Only 25 percent of those eligible to receive housing subsidies actually receive any form of assistance. Thirty-eight percent of renters are cost-burdened, meaning they spend more than 50 percent of their monthly income on rent. And this number continues to grow: according to HUD, this population increased by 1.2 million, or 20 percent, between 2007 and 2009 alone. In general, renters have lower incomes than homeowners. The annual median income of a rental household is $28,400, while the median income for homeowners is $60,000. Half of all renters earn less than $25,000 a year, and a quarter live below the poverty line. There is no county in the United States in which a minimum wage worker can afford a one-bedroom apartment at the fair market rent.

The current stock cannot meet the demand for affordable housing, and the need continues to grow. According to the National Multi Housing Council, there will be an additional 6 million renter households between 2008 and 2015. Construction of and investment in multifamily properties has been severely curtailed amid the housing market crash. Multifamily housing starts in 2009 were just over 100,000, well below the annual average of 300,000 between 1995 and 2004. According to the Joint Center for Housing Studies at Harvard University, in 2009 there were 10.4 million extremely low-income renter households and only 3.6 million units affordable to those renters. Existing rental housing is older, and much is in need of rehabilitation and repair or outright replacement. There has been a steady loss of affordable units.

Financing Affordable Housing in the U.S.

This data demonstrates the tremendous need and demand for affordable housing in this country. Both the public and private sectors have critical roles to play in the affordable rental market. Without support from the GSEs, much of the supportive, affordable, and workforce housing built in the past decade would not exist. The GSEs have been a constant and reliable source for the much-needed liquidity for the multifamily housing sector. They have been a long-term, reliable source of financing, especially for complex real estate developments in hard-to-serve areas, including rural and Native American communities.

Since 1996, the GSEs have provided more than $535 billion in multifamily mortgage debt to finance more than 11 million apartments. During the past 2 years, the GSEs have provided $94 billion in mortgage debt for affordable housing at a time when many other capital sources have left the market.[5] According to the Center for American Progress, the GSEs purchased more than 84 percent of all multifamily loans originated in 2009 alone.

According to the Joint Center for Housing Studies' recent report " . . . The only net additions to outstanding multifamily debt since 2008 have come from Fannie Mae, Freddie Mac, and the FHA . . . while the volume for all other financing sources combined dropped by $40 billion." We understand that private sector capital must be brought back into the rental housing market.

As the single-family market has struggled in recent years and even under Government conservatorship, the GSEs' multifamily portfolios have performed well and are profitable. Between 2005 and 2009, Fannie Mae and Freddie Mac's share of delinquent or foreclosed single family loans rose from approximately 3 percent to 11.5 percent. During the same period, the GSEs' share of delinquent or foreclosed multifamily loans remained at less than 1 percent.[6]

Fannie Mae and Freddie Mac have played a critical role in the Low Income Housing Tax Credit market. During the past decade, the LIHTC program has produced 90 percent of all affordable multifamily housing in the United States.[7] Annually, this program generates 140,000 jobs and $1.5 billion in State and local taxes and other revenues. Before the financial crisis, the GSEs provided 40 percent of LIHTC investments, producing countless rental homes. But the financial crisis has meant the withdrawal of Fannie Mae and Freddie Mac, along with other financial institutions, from the LIHTC market. The shock of this caused investments in LIHTC to drop by 50 percent in 2008 from the $9 billion invested in 2007.[8] This has meant serious challenges for the affordable housing industry as we seek to preserve and build housing affordable to working families and vulnerable populations, including homeless Americans, seniors, and those with disabilities. While the private market

[5] Robert Dewitt, NHMC and NAA. House Financial Services Committee Hearing on the Future of Housing Finance. March 23, 2010.

[6] Michael Bodaken, National Housing Trust. House Financial Services Committee Hearing on the Future of Housing Finance. September 29, 2010.

[7] National Council of State Housing Agencies.

[8] Buzz Roberts, "Strengthening the Low Income Housing Tax Credit Investment Market". Cascade: Federal Reserve Bank of Philadelphia. Fall 2009.

has moved in somewhat, the market remains volatile and there is a serious and real need for a stable entity to weather the storms of the market.

I would like to take a moment to explain what these numbers mean for some of your constituents. Jordan's Gate, located in rural Opelika, Alabama, provides 48 affordable rental homes for families earning up to 60 percent of the area median income—a little more than $13,000 a year. It was made possible in part by permanent debt originated by Enterprise and purchased by Fannie Mae, as well as Low Income Housing Tax Credit equity that was purchased in part by Freddie Mac through an Enterprise multi-investor fund. Residents have access to playgrounds and computer centers. Importantly, residents also have access to a day care center, providing a safe place for children while their parents are at work. Were it not for the support from the Government-sponsored secondary market, this development and many others would not exist.

Principles for Housing Finance Reform: Liquidity, Stability, and Affordability

Any new housing finance system must provide liquidity, stability, and affordability. Access to capital for underserved communities—whether small rural towns, tribal communities, or low-income urban neighborhoods—must be preserved. In general, we believe that the Government should have a role, albeit more limited, in the housing system.

CDFIs, small community banks, credit unions, regional banks, large national banks, State Housing Finance Agencies, the Federal Home Loan Bank System, and national intermediaries are all needed in a robust housing finance system. Any new housing finance system should ensure choices and access to capital for all communities and for all lenders. A return to the redlining of the 1970s is not acceptable—no one should have to pay more for a mortgage because they live in a certain place.

Our guiding principles are as follows:

- The Government must play a role in housing finance to ensure liquidity, stability, and affordability.
- The Government's role should be focused and targeted on affordable housing, including both rental and home ownership housing.
- Mortgage financing should be available to creditworthy borrowers in all communities. Rural areas and economically distressed areas should have access to capital for affordable sustainable home ownership and rental housing through both the primary and secondary markets.
- Secondary market entities that enjoy Federal support should carry an affirmative obligation to finance affordable and sustainable homes and to reach underserved people, markets and needs, including low- and moderate-income people; low-income communities and rural areas; and our most vulnerable populations.
- Responsible, sustainable mortgage products are critical to ensuring that all Americans have access to affordable home ownership.
- FHA provides an important mechanism for Government involvement in the housing market, particularly as a countercyclical resource available to take on risk that the private sector cannot or will not. However, to ensure a robust secondary mortgage market and appropriate risk-sharing, other ways to provide mortgage securitization are necessary. Further, changes are needed in structure, personnel rules, and risk-sharing programs to make FHA an optimally effective provider of capital for affordable housing.
- A small assessment on mortgage-backed securities should be used to fund affordable housing, through mechanisms such as the National Housing Trust Fund and the Capital Magnet Fund, and through risk sharing and credit enhancements to leverage participation in meeting specific needs through secondary market investments.
- Any new housing finance system must ensure a purposeful presence in the market for multifamily housing. We cannot rely on the private sector alone to provide financing or to continue to invest in the Low Income Housing Tax Credit (LIHTC) and other proven, efficient public–private programs.
- Credit channels for multifamily housing must remain open during the transition period between the current and any future system.

Conclusion

Any movement from the current GSE structure must be done carefully and over time to avoid a further weakening of the housing market. The GSEs are imperfect partners, but served an important role in providing access to credit that would otherwise not be available. We are working to develop more specific recommendations for the future of the housing finance system.

However, we are clear on the three main principles that should serve as the basis for any new system: (1) maintaining liquidity for the multifamily mortgage market; (2) doing no harm to the aspects of the housing finance system that are working; and (3) protecting affordability and the underserved. Our principles outline the most important considerations from Enterprise's perspective as a national intermediary that has invested in affordable housing and community development for nearly 30 years. Above all, we support a housing finance system that provides liquidity, stability, and affordability. We look forward to working with you as you further consider changes to our housing finance system. I appreciate the opportunity to testify and look forward to your questions.

PREPARED STATEMENT OF RON PHIPPS

President, National Association of Realtors®

May 26, 2011

Introduction

On behalf of the 1.1 million members of the National Association of REALTORS® (NAR), thank you for holding this hearing on the need to reform our Nation's secondary mortgage market infrastructure.

My name is Ron Phipps, and I am the 2011 President of the National Association of REALTORS®. I am proud to be part of a four-generation, family owned residential real estate business in Rhode Island. As I have mentioned to you during prior testimony, my passion is making the dream of home ownership available to American families. I am proud to testify today on behalf of the more than 1.1 million REALTORS® who share that passion, and the 75 million Americans who own homes and the 310 million Americans who require shelter.

REALTORS® agree that the existing housing finance system failed and that reforms to our secondary mortgage market are needed. We applaud the Committee's caution as you take up this very important and complex issue. You are truly heeding the words of Treasury Secretary Timothy Geithner and the Committee's Ranking Member, Senator Richard Shelby when they said earlier this year that " . . . Federal housing policies must be adequately assessed, and proper homework must be done before action is taken."

Housing Mission and the Secondary Mortgage Market

REALTORS® are fervent in their belief in "free markets," and the need for private capital to reduce the Federal Government's financial support of the housing sector if the housing finance system is to right itself. However, REALTORS® are also practical and understand that in extreme economic conditions, private capital will retreat from the market, requiring the participation of entities that will participate in the marketplace regardless of economic conditions. The Government-sponsored enterprises (GSEs) were created to support this specific mission within the secondary mortgage market, and any replacements must meet this criterion as well. Future secondary mortgage market entities must be created with this mission as their basis in order to ensure that citizens will always have access to affordable mortgage capital.

REALTORS® agree that taxpayers should be protected, open-ended bailouts should end, private capital must return to the housing finance market, and that the size of the Government participation in the housing sector should decrease if the market is to function properly. Where we disagree with some is "how" these aspirations should be accomplished. When reviewing current legislation that effectively constrains, or shuts-down, Fannie Mae and Freddie Mac and relies only on private capital to operate the secondary mortgage market (*e.g.,* S. 693, the "GSE Bailout Elimination and Taxpayer Protection Act"), one need only examine the miniscule activity in the jumbo and manufactured housing mortgage markets in order to understand the implications of just having private capital form the foundation of the housing market. In both instances, mortgage capital became nearly nonexistent, which prohibited qualified borrowers from access to the funds required to purchase a home.

Congress chartered Fannie Mae and Freddie Mac to expand home ownership and provide a solid foundation for our Nation's housing financial system. Unlike private secondary market investors, Fannie Mae and Freddie Mac remain in housing markets during downturns, using their Federal ties to facilitate mortgage finance and support home ownership opportunity for all creditworthy borrowers.

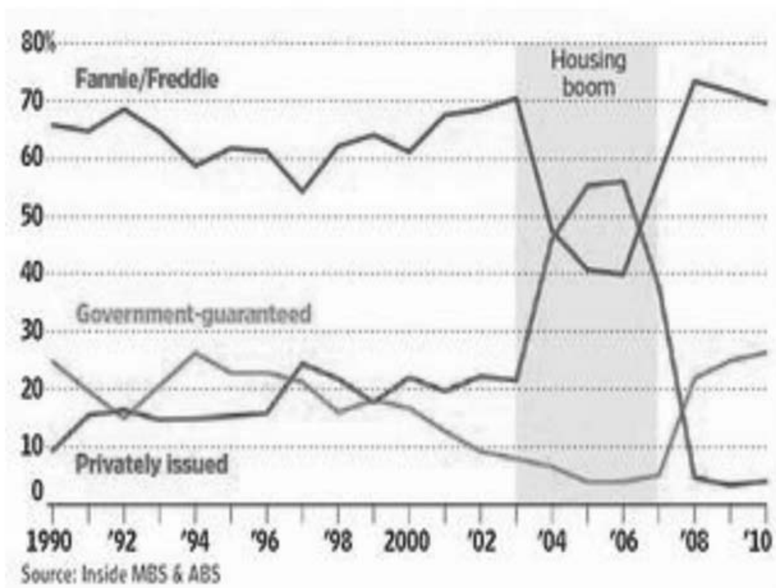
REALTORS® believe that the GSEs' housing mission, and the benefits that are derived from it, played a vital role in the success of our Nation's housing system, and continue to play that role today. Without Fannie Mae and Freddie staying true to their mission of providing affordable mortgage capital during the current market disruption, there would have been a more serious disruption to the market.

Since being placed in conservatorship, NAR has closely monitored the impact of the current market turmoil on both Fannie Mae and Freddie Mac. As previously mentioned, REALTORS® are extremely aware that the role of the GSEs is crucial to housing consumers' ability to obtain fair and affordable mortgages, which stimulate real estate transactions, and thus the overall U.S. economy.

As the market turmoil reached its peak in late 2008, it became apparent that the role of the GSEs, even in conservatorship, was of utmost importance to the viability of the housing market as private mortgage capital effectively fled the marketplace.

Table 1

Share of Mortgage Securitization Market By Segment



As you can see from the above chart, if no Government-backed entity existed as private mortgage capital fled to the side lines, the housing market would have come to a complete halt and thrown our Nation into a deeper recession, or even a depression.

REALTORS® believe that reform of the U.S. housing finance system must be a methodical, measured, and comprehensive effort based on practical market experience, and not just theory.

Earlier this year, NAR signed onto an industry letter that espouses the fundamental principles that we all believe are required to ensure a viable secondary mortgage market going forward (*see,* Appendix). NAR believes that the industry letter's basic principles, in concert with our own, form a good foundation on which the secondary mortgage market can be reformed. NAR's principles are as follows:

Key GSE Reform Points Based on NAR's Principles

- An efficient and adequately regulated secondary market is essential to providing affordable mortgages to consumers. The secondary market, where mortgages are securitized and/or combined into bonds, is an important and reliable source of capital for lenders and therefore for consumers.

  Without a secondary market, mortgage interest rates would be unnecessarily higher and unaffordable for many Americans. In addition, an inadequate secondary market would impede both recovery in housing and the overall economic recovery.

- We cannot have a restoration of the old GSEs with private profits and taxpayer loss system. The current GSEs should be replaced with Government chartered, nonshareholder owned entities that are subject to sufficient regulations on product, revenue generation and usage, and retained portfolio practices in a way that ensures they can accomplish their mission and protect the taxpayer.
- Government-chartered entities have a separate legal identity from the Federal Government but serve a public purpose (*e.g.,* the Export-Import Bank). Unlike a Federal agency, the entities will have considerable political independence and be self-sustaining given the appropriate structure.
- The mission would be to ensure a strong, efficient financing environment for home ownership and rental housing, including access to mortgage financing for segments of the population that have the demonstrated ability to sustain home ownership. Middle class consumers need a steady flow of mortgage funding that only Government backing can provide.
- The Government must clearly, and explicitly, guarantee the issuances of the entities. Taxpayer risk would be mitigated through the use of mortgage insurance on loan products with a loan-to-value ratio of 80 percent or higher and guarantee or other fees paid to the Government. This is essential to ensure borrowers have access to affordable mortgage credit. Without Government backing, consumers will pay much higher mortgage rates and mortgages may at times not be readily available at all (as happened in jumbo and commercial real estate loans)
- The entities should guarantee or insure a wide range of safe, reliable mortgages products such as 30- and 15-year fixed-rate loans, traditional ARMs, and other products that have stood the test of time and for which American homeowners have demonstrated a strong "ability to repay."
- For additional safety, sound and sensible underwriting standards must be established for loans purchased and securitized in MBSs, loans purchased for portfolio, and MBS purchases.
- The entities should price loan products or guarantees based on risk. The organization must set standards for the MBS they guarantee that establish transparency and verifiability for loans within the MBSs.
- Political independence of the entities is mandatory for successful operation (*e.g.,* the CEOs will have fixed terms so they cannot be fired without cause, they should not be allowed to lobby, and the authorities should be self-funded—no ongoing appropriations).
- In order to increase the use of covered bonds, particularly in the commercial real estate arena, the entities should pilot their use in multifamily housing lending and explore their use as an additional way to provide more mortgage capital for residential housing. The entities should be allowed to pave the way for innovative or alternative finance mechanisms that meet safety criteria.
- There must be strong oversight of the entities (for example, by the Federal Housing Finance Agency—FHFA or a successor agency), that includes the providing of timely reports to allow for continual evaluation of the entities' performance.

Private Capital Participation, But Not a Fully Private Secondary Mortgage Market

REALTORS® believe that full privatization is not an effective option for a secondary market because private firms' business strategies will focus on optimizing their revenue/profit generation. This model would foster mortgage products that are more aligned with the business' goals (*e.g.,* based upon significant financial risk-taking) than in the best interest of the Nation's housing policy or the consumer. This situation, we believe, would lead to the rescinding of long-term, fixed-rate mortgage products (*e.g.,* 30-year fixed-rate mortgage products), and an increase in the costs of mortgages to consumers, or both.

According to research by economist Dr. Susan Woodward, there is no evidence that a long-term fixed-rate residential mortgage loan would ever arise spontaneously without Government urging. Dr. Woodward points out that a few developed countries have encouraged the use of amortizing long-term loans, but in all instances (save for Denmark), the loans have adjustable rates and recast every 5 years. She goes on to indicate that the United States is unique in supporting a residential mortgage that is long-term, amortizing, fixed-rate and prepayable, and that Americans have come to view this product as one of their civil rights. Dr. Woodward points out that in early 2000, when Former Federal Reserve Chairman, Alan Greenspan, hinted at its abandonment, the public outcry was such that he eagerly abandoned that position.

Second, the size of the U.S. residential mortgage market is also a consideration. Currently, the U.S. residential mortgage market stands at $10.6 trillion, with the GSEs owning or guaranteeing $5 to $6 trillion of mortgage debt outstanding and providing capital that supports roughly 70 percent of new mortgage originations. REALTORS® believe that it is extremely unlikely that enough purely private capital—without Government backing—could be attracted to replace existing mortgage funding, assume the GSEs market share, or make mortgage lending available in all types of markets.

Finally, our members fear that in times of economic upheaval, a fully private secondary mortgage market will largely cease to exist as has occurred in the jumbo mortgage, the commercial mortgage, and the manufactured housing mortgage markets. When the economy turns down, private capital understandably flees the marketplace. Should that happen in the residential mortgage market space, the results for the entire economy—because of the plethora of peripheral industries that support and benefit from the residential housing market—would be catastrophic.

Reasonable Qualified Residential Mortgage Definition

Another issue that will dramatically impact the future of housing finance and the secondary mortgage market is the definition of what constitutes a qualified residential mortgage (QRM). NAR believes that Federal regulators should honor the intentions of the concept's authors, Senators Isakson, Hagan, and Landrieu, by crafting a qualified residential mortgage (QRM) exemption from the risk retention requirements of the Dodd-Frank Act that includes a wide variety of traditionally safe, well underwritten products such as 30-, 15-, and 10-year fixed-rate loans, 7–1 and 5–1 ARMs, and loans with flexible down payments that require mortgage insurance. A QRM policy that does not heed their intention will displace a large portion of potential homebuyers, which in turn will slow economic growth and hamper job creation.

Strong evidence shows that responsible lending standards and ensuring a borrower's ability to repay have the greatest impact on reducing lender risk. A balance must be struck between reducing investor risk and providing affordable mortgage credit. Better underwriting and credit quality standards will greatly reduce risk. Adding unnecessarily high minimum down payment requirements, overly stringent debt-to-income ratios, and onerous payment performance criteria, will only exclude hundreds of thousands of homebuyers, despite their creditworthiness and proven ability to afford the monthly payment, because of the dramatic increase in the wealth required to purchase a home.

According to a white paper compiled by a cross-section of housing and consumer lending groups titled, "Proposed Qualified Residential Mortgage Definition Harms Creditworthy Borrowers While Frustrating Housing Recovery of Housing" (2011): [1]

> The impact of the proposed rule on existing homeowners is also harmful. Based on data that the coalition received from CoreLogic Inc., nearly 25 million current homeowners would be denied access to a lower rate QRM to refinance their home because they do not currently have 25 percent equity in their homes (Table 2). Many of these borrowers have paid their mortgages on time for years, only to see their equity eroded by a housing crash and the severe recession. Even with a 10 percent minimum equity standard, more than 16 million existing homeowners—many undoubtedly with solid credit records—will be unable to obtain a QRM. In short, the proposed rule moves creditworthy, responsible homeowners into the higher cost non-QRM market.

[1] Qualified Residential Mortgage Coalition, "Proposed Qualified Residential Mortgage Definition Harms Creditworthy Borrowers While Frustrating Housing Recovery", May 2011.

Table 2

Equity Position of U.S. Homeowners with Mortgages

47.9 million U.S. homeowners with mortgages:	30% equity	25% equity	20% equity	10% equity
# with less than...	27.5 million	24.8 million	21.9 million	16.3 million
% with less than...	57%	52%	46%	34%

Source: Community Mortgage Banking Project; based on data from CoreLogic Inc.

As now narrowly drawn, QRM ignores compelling data that demonstrate that sound underwriting and product features, like documentation of income and type of mortgage have a larger impact on reducing default rates than high down payments.

A further analysis of data from CoreLogic Inc. on loans originated between 2002 and 2008 shows that boosting down payments in 5 percent increments has only a negligible impact on default rates, but it significantly reduces the pool of borrowers that would be eligible for the QRM standard. Table 2 shows the default performance of a sample QRM based on the following attributes of loans: Fully documented income and assets; fixed-rate or 7 year or greater ARMs; no negative amortization; no interest only loans; no balloon payments; 41 percent total debt-to-income ratio; mortgage insurance on loans with 80 percent or greater loan-to-value ratios; and maturities no greater than 30 years. These QRM criteria were applied to more than 20 million loans originated between 2002 and 2008, and default performance is measured by origination year through the end of 2010.

As shown in Tables 2 and 3, moving from a 5 percent to a 10 percent down payment requirement on loans that already meet the defined QRM standard reduces the default experience by an average of only two- or three-tenths of 1 percent for each cohort year. However, the increase in the minimum down payment from 5 percent to 10 percent would eliminate from 7 to 15 percent of borrowers from qualifying for a lower rate QRM loan. Increasing the minimum down payment even further to 20 percent, as proposed in the QRM rule, would amplify this disparity, knocking 17 to 28 percent of borrowers out of QRM eligibility, with only small improvement in default performance of about eight-tenths of one percent on average. This lopsided result compromises the intent of the QRM provision in Dodd-Frank, which is to assure clear alignment of interests between consumers, creditors and investors without imposing unreasonable barriers to financing of sustainable mortgages.

Table 3
QRM: Impact of Raising Down Payments Requirements on Default Rates and Borrower Eligibility

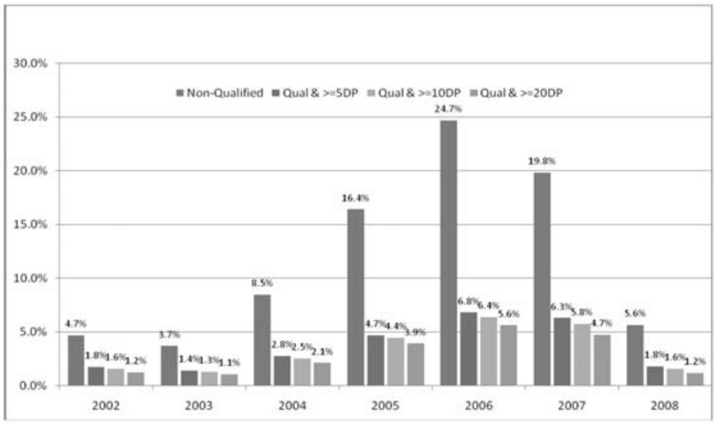
Origination Year	2002	2003	2004	2005	2006	2007	2008
Reduction in default rate* by increasing QRM down payment **from 5% to 10%**	0.2%	0.1%	0.3%	0.3%	0.2%	0.5%	0.2%
Proportion of borrowers **not eligible** for QRM at 10% Down	7.6%	6.6%	9.0%	8.4%	10.9%	14.7%	8.4%
Reduction in default rate* by increasing QRM down payment **from 5% to 20%**	0.6%	0.3%	0.7%	0.8%	0.8%	1.6%	0.6%
Proportion of borrowers **not eligible** for QRM at 20% Down	19.2%	16.7%	23.0%	22.9%	25.2%	28.2%	20.7%

* Default = 90 or more days delinquent, plus in process of foreclosure, plus loans foreclosed.

Source: Vertical Capital Solutions of New York, an independent valuation and advisory firm, conducted this analysis using loan performance data maintained by First American CoreLogic, Inc. on over 30 million mortgages originated between 2002 and 2008.

Importantly, this analysis takes into account the impact on the performance of the entire cohort of defined QRMs that would result from moving from a 5 percent minimum down payment on QRMs in that cohort, to a 10 percent and a 20 percent minimum down payment. As such, it shows the broad market impact of a QRM with a 5 percent down payment requirement compared to a QRM with a 10 percent or 20 percent down payment requirement, rather than simply comparing default risk on 5 percent down loans to 20 percent down loans. Clearly, moving to higher down payments has a minor impact on default rates market-wide, but a major adverse impact on access by creditworthy borrowers to the lower rates and safe product features of the QRM.

Table 4
IMPACT OF INCREASING MINUMUM DOWNPAYMENT ON DEFAULT RATES FOR LOANS THAT MEET QRM STANDARDS
Low Down Payments not a Major Driver of Default when Underwritten Properly

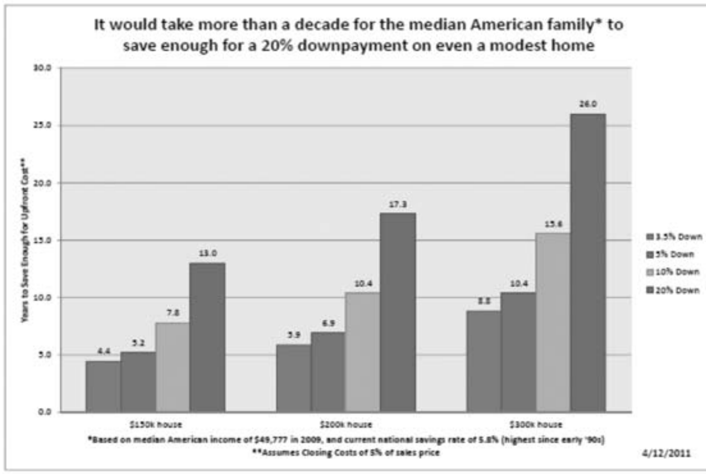


Source: Vertical Capital Solutions of New York, an independent valuation and advisory firm conducted this analysis using loan performance data maintained by First American CoreLogic, Inc. on over 30 million mortgages originated between 2002 and 2008. The qualified mortgage in this analysis is based on fully documented income and assets; fixed-rate or 7-year or greater ARMs; no negative amortization; no interest only loans; no balloon payments; 41% total debt-to-income ratio; mortgage insurance on loans with 80% or greater loan-to-value ratios; and maturities no greater than 30 years.

NAR is concerned that a narrowly defined QRM will also require severe tightening of FHA eligibility requirements and even higher FHA premiums to prevent huge increases in its already robust share of the market, adding additional roadblocks to sustainable home ownership.

Lastly, saving the necessary down payment has always been the principal obstacle to buyers seeking to purchase their first home. Proposals requiring high down payments will only drive more borrowers to FHA, increase costs for borrowers by raising interest rates and fees, and effectively price many eligible borrowers out of the housing market.

Table 5
Number of Years Needed to Save Required Down Payments
By Home Price and Down Payment Level



Source: National Association of REALTORS®

Mortgage Loan Limits

NAR strongly supports making permanent the GSE and FHA mortgage loan limits that are currently in effect. The GSEs and FHA have played a critical role in providing mortgage liquidity as private financing has dried up. The current loan limits are set to expire in just a few months, on September 30, 2011. In early 2010, when the limits temporarily expired, many communities saw dramatic declines in mortgage liquidity. More than 612 counties in 40 States and the District of Columbia saw their limits fall. The average decline in the loan limits was more than $51,000.

In today's real estate market, lowering the loan limits and changing the formula on which they are calculated further restricts liquidity and makes mortgages more expensive for households nationwide. FHA and GSE mortgages together continue to constitute the vast majority of home financing availability today, which makes it particularly critical that the current limits be extended. Without the additional liquidity created by maintaining these loan limits at current levels, families will have to pay more to purchase homes, face the possibility that they will not be able to obtain financing at any price or find it more difficult or impossible to refinance problematic loans into safer, more affordable mortgages.

GSE Dividend Payments

Since August 2010, NAR has requested that the punitive dividend payments placed on the GSEs be reduced from 10 percent to 5 percent, in line with other Federal financial support recipients. Such a move is necessary in order to relieve the unnecessary drag that this assessment imposes on the housing industry's recovery. We believe that reducing the current punitive dividend will enhance the GSEs' ability to eliminate losses, which will be further enhanced as the housing markets continue to stabilize and recover. This will give the GSEs the flexibility to adjust their underwriting standards to take into account reasonable lending risks, which will benefit the consumer and the entire economy, without further risk of additional cost to the consumer.

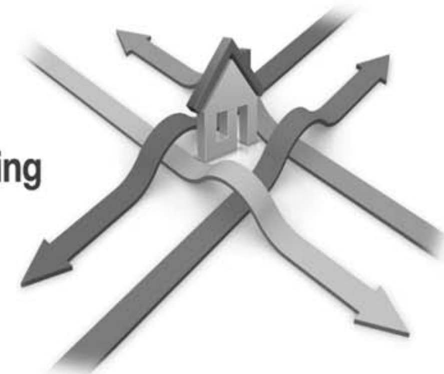
More importantly, it makes no apparent sense for the Treasury Department to transfer amounts to the GSEs so they, in turn, will have enough money to make the dividend payment back to the Treasury. If the GSEs were not required to pay the 10 percent dividend, which significantly increases each of their quarterly losses, it would reduce the amount of capital Treasury is called upon to provide them. It would make more sense to charge the GSEs an amount equal to the Treasury borrowing cost, or borrowing cost to the GSEs based on the current Federal assurance that they will maintain a positive net worth. Both of these amounts are far less than 10 percent.

Conclusion

The National Association of REALTORS® supports a secondary mortgage market model that includes some level of Government participation, but protects the taxpayer while ensuring that all creditworthy consumers have reasonable access to mortgage capital so that they too may attain the American Dream—home ownership. We believe that the key points that we mentioned will help Congress and our industry partners design a secondary mortgage model that will be in all of our Nation's best interest today, and in the future.

I thank you for this opportunity to present our thoughts on reforming our housing finance system, and as always, the National Association of REALTORS® is at the call of Congress, and our industry partners, to help continue the housing and national economic recovery.

APPENDIX



Restoring Stability to the Nation's Housing Finance System

An Open Letter to Members of Congress and to the Administration

The nation's housing finance system is at a historic crossroad. As policymakers debate options to restore vitality, integrity and stability to the secondary mortgage market, including an appropriate role for the federal government in supporting homeownership and rental housing, it is essential that care is taken in weighing the choices ahead. The policy decisions in this area will have profound implications for the nation's economic recovery and for generations of future home buyers and renters, with broad-ranging social and economic consequences.

The undersigned organizations, representing a variety of stakeholders in single- and multifamily housing, believe the following principles should help guide efforts to restore and repair the nation's housing finance system:

- A stable housing sector is essential for a robust economic recovery and long-term prosperity. Housing, whether through homeownership or rental, promotes social and economic benefits that warrant it being a national policy priority.
- Private capital must be the dominant source of mortgage credit, and it must also bear the primary risk in any future housing finance system.
- Some continuing and predictable government role is necessary to promote investor confidence and ensure liquidity and stability for homeownership and rental housing.
- Changes to the mortgage finance system must be done carefully and over a reasonable transition period to ensure that a reliable mortgage finance system is in place to function effectively in the years ahead.

Private investment capital is critical for a robust and healthy mortgage marketplace, and the current government-dominated mortgage system is neither sustainable nor desirable. However, investors must be confident that they understand the risks and rules that can affect them. As policymakers move forward with Dodd-Frank Act rulemakings and similar regulatory efforts, it will be important to provide clarity and certainty to the marketplace in a manner that promotes recovery and growth. As such, the future mortgage system should seek to ensure a workable balance between sound underwriting principles, consumer protection and the need for responsible innovation and risk-taking.

As critical as it is to attract private money to the mortgage markets, an appropriate and clearly defined role for the government is essential to preserving financial stability. Government support through various insurance and guarantee mechanisms is especially important to facilitate long-term fixed-rate mortgages, affordable financing for low- and moderate-income borrowers, and financing rental housing in all parts of the country including rural areas. While the goal should be to move toward a largely private secondary market, the private and public sectors should work as partners in creating a variety of financing options to ensure the availability of safe, stable, and affordable financing.

Accomplishing all of these goals will require an ongoing dialogue between policymakers and other key stakeholders, including industry and consumer groups. Our organizations stand committed to being part of this process.

American Bankers Association

American Financial Services Association

Community Mortgage Banking Project

CRE Finance Council

Housing Policy Council of the Financial Services Roundtable

Independent Community Bankers of America

Manufactured Housing Institute

Mortgage Bankers Association

Mortgage Insurance Companies of America

National Affordable Housing Management Association

National Apartment Association

National Association of Home Builders

National Association of Realtors

National Council of State Housing Agencies

National Multi Housing Council

The Real Estate Roundtable

Securities Industry and Financial Markets Association

PREPARED STATEMENT OF MARK J. PARRELL

EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, EQUITY RESIDENTIAL, ON BEHALF OF THE NATIONAL MULTI HOUSING COUNCIL AND NATIONAL APARTMENT ASSOCIATION

MAY 26, 2011

Chairman Johnson, Ranking Member Shelby, and distinguished Members of the Committee, my name is Mark Parrell, Executive Vice President and Chief Financial Officer of Equity Residential. Equity Residential (EQR) is an S&P 500 company focused on the acquisition, development, and management of apartment properties in top U.S. growth markets. Equity Residential owns or has investments in more than 450 properties with 117,286 units in 17 States and the District of Columbia. I am testifying today on behalf of the National Multi Housing Council (NMHC) and its joint legislative partner, the National Apartment Association (NAA).

NMHC and NAA represent the Nation's leading firms participating in the multifamily rental housing industry. Our combined memberships are engaged in all aspects of the apartment industry, including ownership, development, management, and finance. NMHC represents the principal officers of the apartment industry's largest and most prominent firms. NAA is the largest national federation of State and local apartment associations, with 170 State and local affiliates comprised of more than 50,000 multifamily housing companies representing more than 5.9 million apartment homes.

I appreciate the opportunity to be here today to present the industry's perspective on the role of the Government Sponsored Enterprises (GSE), specifically Fannie Mae and Freddie Mac, and how the multifamily market works and is different than the single-family market. I will also discuss the benefits derived from the GSEs' presence in the multifamily market and why we believe there will be a continued need for Federal involvement even after they are phased out.

Before I do that, however, allow me to describe some key aspects of the apartment market and how the changing demographics will demand a continued flow of capital into this sector if we are to meet the future housing needs.

Currently, one-third of Americans rent their housing, and nearly 14 percent—17 million households—call an apartment their home. Americans are changing their housing preferences. Married couples with children represent less than 22 percent of households, and that number is falling. By 2030, nearly three-quarters of our households will be childless. Echo boomers are starting to enter the housing market, primarily as renters, and baby boomers are beginning to downsize, and many are choosing the convenience of renting. Rental housing offers them a maintenance free lifestyle with amenities, social opportunities and often walkable neighborhoods. In this decade, renters could make up more than half of all new households—more than 7 million new renter households. Because of these changes, University of Utah Professor Arthur C. Nelson predicts that half of all new homes built between 2005 and 2030 should be rental units.

Apartments are not just shelter. They are also an economic powerhouse. The aggregate value of this apartment stock is $2.2 trillion. Rental revenues from apartments total almost $120 billion annually, and management and operation of apartments are responsible for approximately 550,000 jobs. Moreover, the construction of apartment communities in the last 5 years has added an average of 210,000 new apartment homes per year, providing jobs to over 270,000 workers.

Finally, apartments also produce societal benefits; not only are they environmentally sustainable, resource- and energy-efficient, they also help create a mobile workforce that can relocate to pursue job opportunities.

I highlight these important changes in housing choice, supply and demand as well as the economic and social contributions apartments make to society to encourage Congress to consider the unique needs of the apartment industry as you pursue reform options.

The bursting of the housing bubble exposed serious flaws in our Nation's housing finance system. However, fixing the single-family housing finance system should not come at the expense of the much smaller and less understood, but vital, multifamily sector. The GSEs' multifamily programs did not contribute to the housing meltdown, and without adequate attention to this segment of the housing market we risk becoming collateral damage. We believe a fully functioning secondary market, backstopped by the Federal Government is absolutely critical to the multifamily sector and our industry's ability to continue to meet the Nation's demand for market-rate, workforce and affordable housing.

I have been invited here today to talk about what works in the current GSE system of mortgage finance. Regardless of what you hear and read relative to the perceived evils of the GSEs and their contribution to the housing meltdown, when it comes to financing multifamily housing, quite a lot works. Let me be clear, I am not here to defend the GSEs or to suggest that they be continued in their current form. However, I would like to highlight for the Committee those elements of the system that worked well for multifamily lending and, most importantly, at no cost to the taxpayer. It is our hope that these elements of success can be incorporated into whatever you design to replace Fannie Mae and Freddie Mac.

Multifamily Performance: A Success Story

It is hard to imagine a success story coming out of the worst housing crash in recent history, but the performance of the GSEs' multifamily portfolio stands in stark contrast to that of the single-family business. In short, the multifamily programs were not part of the meltdown and are not broken.

Overall loan performance remains strong with delinquency and default rates at less than 1 percent, a tenth of the size of the delinquency/default rates plaguing single-family. They have outperformed CMBS, commercial banks and even FHA. In addition, since the Federal Government placed the GSEs in conservatorship, the multifamily portfolio has managed to net approximately $2 billion in profit for the Federal Government.

Not only are the GSEs' multifamily programs operating in a fiscally sound manner, they are doing so while offering a full range of mortgage products to meet the unique needs of the multifamily borrower and serve the broad array of property types. This includes including conventional market rental housing, workforce rental housing and targeted affordable (*e.g.,* Project-based Section 8, properties subsidized by State and local Government and Low-Income Housing Tax Credit (LIHTC)) properties.

The GSEs' multifamily programs adhere to a business model that includes prudent underwriting standards, sound credit policy, effective third-party assessment procedures, risk-sharing and retention strategies, effective loan portfolio management, and standardized mortgage documentation and execution. In short, the GSEs' multifamily models hit the mark. They have attracted enormous amounts of private capital; helped finance millions of units of market-rate workforce housing without direct Federal appropriations; sustained liquidity in all economic climates; and ensured safety and soundness of their loans and securities. As a result of the liquidity provided by the GSEs, the United States has the best and most stable rental housing sector in the world.

Federal Credit Guarantee: Meeting the Needs When Private Capital Disappears

This most recent crisis underscores the need for a capital source that will be available in all economic climates. In the last 2 years, the GSEs have provided $94 billion in mortgage debt to the apartment industry when virtually every other source of capital left the market. They served a similar role during the 1997–1998 Russian financial crisis and in the post-9/11 recession of 2001.

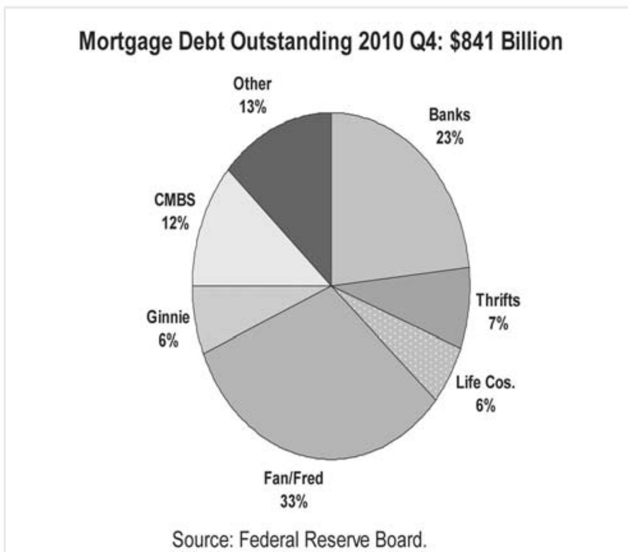
Their share of the multifamily mortgage market has varied considerably over time, increasing at times of market dislocation when other sources of capital are scarce and scaling back during times when private credit is widely available. For example, when private capital left the housing finance market in 2008, the apartment industry relied almost exclusively on Fannie Mae, Freddie Mac, and FHA/ Ginnie Mae for its capital sources.

If not for the GSEs' multifamily programs, I would most likely be telling a different story today. It would be one of higher default and delinquency rates because owners would be unable to secure capital to refinance maturing, but otherwise performing, mortgages. The consequences for renters nationwide would have been severe. Multifamily may only represent 10 percent on average of the GSEs' mortgage debt, but the GSEs currently provide nearly 90 percent of multifamily mortgage capital.

Historically, the apartment industry enjoys access to mortgage capital from a variety of credit sources, each with its own focus, strengths, and limitations. In addition to the GSEs, these sources include commercial banks, life insurance companies, CMBS, and pension funds. Prior to the financial crisis, these combined capital sources provided the apartment sector with $100–$150 billion annually, reaching as high as $225 billion to develop, refinance, purchase, renovate, and preserve apartment properties.

We are encouraged by the thawing in the private capital markets and support a return to a marketplace dominated by private capital. But even in healthy economic times, the private market has not been able or willing to meet the full capital needs of rental housing. The following highlights some of the capital sources, limitations, and level of participation in the multifamily market:

- Banks are limited by capital requirements and have never been a source of long-term financing. They currently hold 31.2 percent of outstanding multifamily mortgage debt. Between 1990 and 2010, they provided 24 percent ($136.49 billion) of the total net increase in mortgage debt but have provided limited amounts of capital to the industry since the financial crisis.
- Life insurance companies target very specific product, *i.e.,* newer, luxury high-end properties. They tend to enter and leave the multifamily market based on their investment needs and economic conditions. They currently hold just 5.6 percent of outstanding multifamily mortgage debt. Between 1990 and 2010, they accounted for just 3 percent ($18.3 billion) of the net increase in multifamily mortgage debt.
- FHA has exceeded its capacity to meet the sector's capital demands and their capital targets construction lending. FHA/Ginnie Mae currently hold 14 percent of outstanding multifamily mortgage debt. From 1990 to 2010, they accounted for 10.7 percent ($59.6 billion) of the total net increase in mortgage debt.
- The private-label CMBS market is unlikely to return to the volume and market share it reached a few years ago. It peaked at 16.5 percent of the market ($17.6 billion a year) in the housing bubble years of 2005–2007. The CMBS market now holds 12.2 percent of the outstanding multifamily mortgage debt.
- While covered bonds might provide some additional liquidity to apartment borrowers, they are unlikely to provide the capacity, flexibility, and pricing superiority necessary to adequately replace traditional sources of multifamily mortgage credit, including the GSEs.



Federal Credit Guarantee Creates Workforce Housing without Federal Appropriations

Federal Credit Guarantee Creates Workforce Housing Without Federal Appropriations

It is important to note that nearly ALL of the multifamily funding provided by the existing GSEs helped create workforce housing (not just the capital they provided to properties designated "affordable"). Fully 90 percent of the apartment units financed by Fannie Mae and Freddie Mac over the past 15 years—more than 10 million units—were affordable to families at or below the median income for their community. This includes an overwhelming number of market-rate apartments that were produced with no Federal appropriations, and with virtually no risk to the taxpayer.

The ability to serve renters at or below area median income is dependent on the liquidity provided by the Government-supported secondary multifamily mortgage market. It lowers the cost of capital to borrowers who provide workforce market-rate housing. Without this support, interest rates and debt service costs would rise, rents would increase to cover these costs, and fewer renters would be able to enjoy the pricing at area median income levels.

Not only does the presence of a Government-supported secondary multifamily mortgage market lower the cost of capital, it also works to leverage private capital to support affordable housing. We are convinced that removing the Government guarantee of multifamily mortgages or mortgage-backed securities will put the supply of affordable housing at risk. Other capital sources will simply not fill the gap, and with a severe supply shortage already existing in many markets and steadily forecasted to worsen, vacancy rates will most certainly decrease and rents will rise. This most recent crisis underscores the need for a capital source that will be available in all markets, whether it is New York City, Sioux Falls, South Dakota, or Birmingham, Alabama, and at all times.

Multifamily Loan Maturity Risk Depends on Active and Functioning Securitization and a Secondary Market

A federally backed secondary market is critical not only for the long-term health of the industry but also to help refinance the estimated $300–$400 billion in multifamily mortgages that will mature by 2015. Unlike residential mortgages, which are typically for 30-year terms, most multifamily mortgages are for a period of 7 to 10 years. This ongoing need to refinance apartment mortgages makes it imperative for the industry to have access to reliable and affordable capital at all times, in all markets and in all market conditions.

When credit markets have been impaired for reasons that have nothing to do with multifamily property operating performance, the federally backed secondary market has ensured the continued flow of capital to apartments. As I mentioned earlier, without this source of liquidity during the most recent and prior financial crises, performing properties could have been pushed into foreclosure or bankruptcy when their loans matured. The disruption in the housing system in such a scenario would be potentially devastating to millions of renters and the economy as a whole.

Growing Importance of Rental Housing, Experts Forecast Supply Shortage

As noted previously, the U.S. is on the cusp of a fundamental change in our housing dynamics. Changing demographics and new economic realities are driving more people away from the typical suburban house and causing a surge in rental demand. Tomorrow's households want something different. They want more choice. They are more interested in urban living and less interested in owning. They want smaller spaces and more amenities. And increasingly, they want to rent, not own. Unfortunately, our housing policy has yet to adjust to these new realities.

Our society is changing in meaningful ways that are translating into new housing preferences. Beyond just changing demographics, there is also a much-needed change in consumer psychology underway that favors more long-term renters in the future. The housing crisis taught Americans that housing is shelter, not the "sure thing" investment once believed. That awareness is freeing people up to choose the housing that best suits their lifestyle. For millions, that is an apartment.

While there may be an oversupply of single-family housing, the Nation could actually see a shortage of multifamily housing as early as 2012. The shortage is particularly acute in the area of workforce and affordable housing. The Harvard Joint Center for Housing Studies estimates a nationwide affordable housing shortfall of three million units. (Addendum II of my testimony provides further information on the inherent affordability of apartments.)

This context is particularly important in understanding why it is vital that as Congress looks to reform housing finance, it do nothing that would jeopardize the construction, financing, and availability of multifamily housing. Without a functioning securitzation process and a backstop of Government credit support for multifamily mortgages or mortgage-backed securities to ensure a steady and sufficient source of capital going forward, the apartment industry will not be able to meet the Nation's housing needs and Americans will pay more for workforce housing.

I am attaching the NMHC/NAA "Key Principles for Housing Finance Reform" as Addendum I of my testimony.

National Housing Policy

In closing, I would like to take a moment to address our national housing policy more broadly. I feel it underscores the importance of explicitly considering the multifamily component in a restructured secondary mortgage market.

For decades, the Federal Government has pursued a "home ownership at any cost" housing policy, ignoring the growing disconnect between the country's housing needs and its housing policy. We have seen the devastating effects of such a policy. If there is a silver lining in this situation, it is the opportunity we now have to learn from our mistakes and rethink our housing policy. Housing our diverse Nation means having a vibrant rental market along with a functioning ownership market. It's time we adopt a balanced housing policy that doesn't measure success by the level of home ownership.

I thank you for the opportunity to present the views of NMHC and NAA.

ADDENDUM I: KEY PRINCIPLES FOR HOUSING FINANCE REFORM

The apartment industry urges you to consider the following key points for inclusion in any reform measure:

1. Do No Harm: Preserve Multifamily Lending Programs

The multifamily sector produces the vast majority of this Nation's affordable, workforce housing. Therefore, there is an appropriate public mission for the Government to provide an effective financing system to ensure the Nation's housing needs are met. In addition, the multifamily sector, and more specifically the GSEs' multifamily programs, did not contribute to the housing meltdown. Therefore, as policy makers "fix" the problems in the single-family sector, they should not do so at the detriment of the multifamily industry.

2. Protect the Taxpayer: Look to Proven Multifamily Models

The taxpayer is footing the bill for the breakdown of the single-family housing sector, and that should never happen again. The GSEs' multifamily programs can serve as a model for a reformed housing finance system. They have performed extraordinarily well and have less than a 1-percent delinquency rate. Historically, they have been well capitalized, have covered all their losses through the loss reserves they collected and have earned a profit. Even during conservatorship, the GSEs' multifamily programs have earned net revenues of $2 billion.[1] Their success is the result of strong business models that use retained risk and stringent underwriting criteria.

To protect the taxpayer going forward, these models should be carefully studied for a broader application within the larger housing finance system. Specifically, the Government must ensure strong regulatory oversight. It should consider implementing some level of retained risk by mortgage originators and servicers and adequate capital standards to fund loan-loss reserves. These steps would preserve the strong mortgage loan performance and track record seen in the multifamily sector and protect the taxpayer.

3. Federal Government Involvement Necessary and Should Be Appropriately Priced

Even after we transition to a new housing finance system, there will be an ongoing need for an explicit Federal Government guarantee on multifamily mortgage securities and portfolio-held loans. Over the past 40 years, there have been numerous occasions when the private sector has been unable or unwilling to finance multifamily loans. There is a legitimate concern that the private sector cannot be counted on, from both reliability and capacity standpoints, to consistently finance the majority of multifamily borrowers' needs. Hence, it is hard to envision a reformed housing finance system without some form of Federal credit enhancement. However, that credit should be priced at an appropriate level that reflects the mortgage risk and the value of the Government's credit enhancement, and in such a way that it complements, but does not unfairly compete with, private debt capital.

4. Liquidity Support Should Be Broad and Available at All Times, Not Just "Stop-Gap" or Emergency

Any Federal credit facility should be available to the entire apartment sector and not be restricted to specific housing types or specific renter populations. Narrowing any future credit source would remove a tremendously important source of capital to a large portion of our industry, namely market-rate developers who actually pro-

[1] Source: GSE SEC filings. This does not include write downs of Low-Income Housing Tax Credit holdings that the firms have been prohibited from selling and liquidating.

vide a large volume of unsubsidized workforce housing. Such a facility should also be available at all times to ensure constancy in the U.S. housing market throughout all business cycles. It would be impossible to turn on and off a Government-backed facility without seriously jeopardizing capital flows.

5. Mission Should Focus on Liquidity, Not Mandates

The public mission of a federally supported secondary market should be clearly defined and focused primarily on using a Government guarantee to provide liquidity and not specific affordable housing mandates. Such mandates create conflicts within the secondary market and are partially responsible for the housing crisis because of the distortions the mandates introduced into the GSEs' business practices. Instead of mandates, the new housing finance system should provide incentives to support the production and preservation of affordable multifamily housing. Absent incentives, the Government should redirect the affordability mission to HUD/FHA and the Low-Income Housing Tax Credit program.

6. Retain Portfolio Lending While Expanding Securitization

Securitization must be used to attract private capital for multifamily mortgage capital. However, unlike single-family loans, multifamily loans are not easily "commoditized." Without the ability to hold some loans in portfolio, multifamily lending activities will be significantly curtailed. In addition, securitizing multifamily loans is not always the best way to manage credit risk. Portfolio capacity is also required to aggregate mortgages for a structured securities sale.

7. Create Certainty and Retain Existing Resources/Capacity During the Transition

To avoid market disruption, it is important that policy makers clearly define the role of the Government in a reformed system and the timeline for transition. Without that certainty, private capital providers (*e.g.,* warehouse lenders and institutional investors) are likely to limit their exposure to the market, which could cause a serious capital shortfall to rental housing. In addition, during the transition years, we believe it is critical to retain many of the resources and capacity of the existing GSEs. The two firms have extensive personnel and technology expertise as well as established third-party relationships with lenders, mortgage servicers, appraisers, engineers, and other service providers that are critical to a well-functioning secondary market.

We appreciate the opportunity to present the views of the apartment industry and look forward to working with you to build a world-class housing finance system that meets the Nation's changing housing needs while also protecting the taxpayers.

ADDENDUM II: THE INHERENT AFFORDABILITY OF APARTMENTS

Many areas of the country are suffering from a severe shortage of workforce and affordable housing. In February 2011, the U.S. Department of Housing and Urban Development (HUD) found that "worst case housing needs" grew by nearly 1.2 million households, or more than 20 percent, from 2007 to 2009 and by 42 percent since 2001. "Worst case housing needs" are defined as low-income households who paid more than half their monthly income for rent, lived in severely substandard housing, or both. The increase in the extent of worst case housing needs represents the largest 2-year jump since HUD began reporting this segment of the rental market in 1985.

A separate study by the Harvard University Joint Center for Housing Studies found that falling incomes and the Great Recession have pushed both the number and share of renters facing severe cost burdens (those spending more than 50 percent of income on rent and utilities) to all-time highs and that nearly half of all renters face at least moderate housing cost burdens.

The growing incidence of renter payment burdens reflects a growing shortage of affordable and workforce housing and underscores the importance of ensuring a continued capital flow to the rental housing industry because apartments are inherently affordable.

An NMHC/NAA-commissioned study by MPF Research examined 5.6 million apartment units (without direct Federal subsidy) and found that 94 percent of the units surveyed were affordable to households earning 100 percent of area median income (AMI). Fully 85 percent were affordable to households earning 80 percent of AMI, and 60 percent were affordable to those earning 60 percent of AMI.

Multifamily Rental Housing Affordability

March 2011

Unit Affordability - US			
Units at 100% AMI	Number of Affordable Units	Total MPF Sample	Percentage of Sample
0 BR	135,859	150,871	90.0%
1 BR	2,213,497	2,348,549	94.2%
2 BR	2,457,294	2,614,979	94.0%
3BR	452,369	482,526	93.8%
4BR	26,600	37,415	71.1%
Total	**5,285,619**	**5,634,340**	**93.8%**

Unit Affordability - US			
Units at 80% AMI	Number of Affordable Units	Total MPF Sample	Percentage of Sample
0 BR	119,292	150,871	79.1%
1 BR	2,016,186	2,348,549	85.8%
2 BR	2,222,279	2,614,979	85.0%
3BR	400,913	482,526	83.1%
4BR	18,798	37,415	50.2%
Total	**4,777,468**	**5,634,340**	**84.8%**

Unit Affordability - US			
Units at 60% AMI	Number of Affordable Units	Total MPF Sample	Percentage of Sample
0 BR	91,671	150,871	60.8%
1 BR	1,416,485	2,348,549	60.3%
2 BR	1,553,158	2,614,979	59.4%
3BR	263,925	482,526	54.7%
4BR	12,650	37,415	33.8%
Total	**3,337,889**	**5,634,340**	**59.2%**

Source: MPF Research, March 2011.

PREPARED STATEMENT OF GREG HEERDE

MANAGING DIRECTOR, AON BENFIELD AND AON BENFIELD SECURITIES

MAY 26, 2011

Good morning Chairman Johnson, Ranking Member Shelby, and Members of the Committee. I am Greg Heerde, Managing Director of Aon Benfield and Aon Benfield Securities, and I am here today to discuss the role of private capital supporting lender's credit risk through mortgage insurance. Aon Benfield is the world's largest reinsurance intermediary, and Aon Benfield Securities, Inc., is an investment banking firm providing advisory services to insurance and reinsurance companies including capital raising, risk transfer securitization, and mergers and acquisitions. Combined, we have a high level of visibility into all forms of capital available to support the mortgage insurance industry. The goal of this testimony is to communicate:

1. The significant role that private mortgage insurance currently plays in supporting residential housing transactions and the stabilization of the housing market postcrisis;
2. The role for private reinsurance to support the mortgage insurance market;
3. The availability of additional private capital in various forms to support the future of the housing market as needed.

1. Role of Private Mortgage Insurance

Private mortgage insurance provides protection to lenders, investors, and most importantly, taxpayers by standing in the "first loss position" in the event that a borrower stops making mortgage payments. When a borrower defaults, private mortgage insurance pays the lender or investor 20–25 percent of the loan amount, mitigating a significant (and in many cases all) portion of the loss on the loan. Private mortgage insurance also expands home ownership by allowing qualified borrowers with less than the 20 percent prescribed down payment to purchase a home. Private mortgage insurance is an alternative to the Federal Housing Administration (FHA) mortgage insurance. Key differences from the FHA coverage include private mortgage insurance is generally lower cost, as it covers the top portion of the loan whereas FHA insurance covers 100 percent of the loan, and private mortgage insurance is available on a wider variety of loans with no maximum loan amount.

Mortgage insurers underwrite the underlying quality of the prospective borrower's creditworthiness and the supporting collateral thereby ensuring higher quality mortgages are issued. This protects not only the lenders and investors but the prospective borrowers by ensuring that the home is affordable at the time of purchase. Private mortgage insurers also have clear incentives to mitigate losses once loans are in default. As foreclosure results in the highest likelihood of loss payment under the insurance policy, mortgage insurers' goals are to work with borrowers to avoid foreclosure and keep them in their homes.

The mortgage insurance industry in the U.S. is over 50 years old and has paid claims in a variety of adverse economic cycles. For example, more than $6 billion of mortgage insurance claims were paid in the 1980s, when the U.S. experienced double-digit interest rates and inflation. Similarly, in the early 1990s, mortgage insurers paid more than $8 billion of losses primarily in California and the Northeast.[1]

U.S. private mortgage insurers have already paid approximately $25 billion in losses during the current housing downturn, without Government or taxpayer support, and the annual loss payments continue to climb. The largest beneficiary of these payments has and will be Fannie Mae and Freddie Mac, thereby reducing a material amount of the exposure to the taxpayer. U.S. mortgage insurers are currently meeting their insurance obligations and most continue to write new mortgage insurance business, supporting the stabilization of the housing sector. In short, U.S. mortgage insurance is acting exactly as intended and continuing to pay significant losses without Government support in the wake of the most severe housing downturn in U.S. history.

2. Role of Reinsurance

Reinsurance is another form of capital available to the insurance industry. Reinsurance is the transfer of insurance risk by an insurance company to a third party referred to as a reinsurer. Transferring insurance risk reduces the total amount of volatility the insurer is exposed to, and therefore the amount of capital required to absorb that volatility. Reinsurers, for example, have paid some losses associated with the current housing crisis.

Despite these losses, reinsurance capacity stands ready to be deployed more broadly going forward to support U.S. mortgage insurers. Aon Benfield estimates that Global Reinsurer Capital totaled $470 billion at December 31, 2010, representing a 17 percent increase over 2009 and the largest amount of capital in the history of the reinsurance industry. The total represents a full recovery following losses from natural catastrophes such as Hurricanes Katrina, Rita, and Wilma in 2005 and earthquakes in Chile and New Zealand in 2010. Reinsurers in 2011 to date have experienced additional losses from earthquakes in Japan and the second New Zealand event, along with severe weather in the United States. The Aon Benfield Aggregate, which is a subset of Global Reinsurer Capital (representing approximately 53 percent of the total), currently has reported loss estimates from first quarter events totaling $12.4 billion, with some companies still to comment on the extent of their exposures. However, Aon Benfield believes the losses to date fall within expected annual income and therefore will represent an earnings loss event rather than a capital loss event for the reinsurance industry.

Private reinsurers also play an important role supporting mortgage insurance in a number of other countries including Australia, Canada, and the United Kingdom. These countries have mortgage financing systems that are each unique, with varying Government roles, but it is important to note that private reinsurance plays some part in all of them.

3. Availability of New Capital To Support the Housing Sector

The insurance industry by its nature protects against various sources of volatility. Through adequate risk pricing and risk selection, the industry is able to achieve a level of diversification required to produce acceptable returns to capital providers. Following each major insured loss from man-made and natural catastrophes, reinsurers have brought material new and lasting capacity to the market. For example, after hurricane Katrina, over $30 billion of new capital was raised to form new insurers and reinsurers. This capital meant that insurers were able to continue renewing policies that they would have otherwise not been able to renew.

Since the beginning of the financial crisis, new capital has come into the sector in the form of a new start-up mortgage insurer and as significant contributions to support existing carriers. To date, approximately $8 billion of new capital has been raised,[2] which by industry standards could enable the sector to support $200 billion of insurance exposure. In addition to the capital that was raised, Aon Benfield Secu-

[1] Source is Mortgage Insurance Companies of America reports.
[2] Source is Mortgage Insurance Companies of America reports.

rities represented a qualified management team in 2009 through early 2010 seeking to form a new mortgage insurance company. This plan was ultimately shelved as the capital providers witnessed the substantial growth of the FHA during the period coupled with the uncertainty around the future of Fannie and Freddie, which was viewed as weakening the demand for mortgage insurance and therefore the need for new companies. Ultimately, the capital providers concluded that the existing mortgage insurers and the introduction of the one new company formed were sufficient to satisfy current and short term future demand. There were other efforts during the same time period to introduce new mortgage insurance companies in various forms, some of which received indications that they would not receive approval from Fannie and Freddie to write business resulting in those efforts being shelved as well. As such, a transparent path to achieving approval from Fannie and Freddie would further encourage private capital investment.

If, as a result of the review of various proposals for the future of the housing finance system, a decision is made to reduce the role of Fannie and Freddie over time, and that decision results in an increased demand for private mortgage insurance at commercially responsible terms, we are confident that sufficient private capital would be available to support that increased demand. Should the demand be sufficient to warrant the introduction of new mortgage insurance companies, and the necessary approval of qualified new mortgage insurers be attainable, we are equally confident that capital would form such new entrants. In addition, such a change in dynamics would likely result in more innovation in the underlying mortgage insurance product, which may ultimately result in a more competitive product as a benefit to both lenders and borrowers.

As indicated above, reinsurers are enjoying record levels of capital while total reinsurance premiums over the past few years have declined. Given the greater capital base chasing fewer premium dollars, reinsurers are eager to underwrite new risks. The lack of such new exposures has resulted in reinsurers returning capital to shareholders in the form of dividends and share buybacks (the companies comprising the Aon Benfield Aggregate returned $17.6 billion, or approximately 73 percent of their 2010 net income to shareholders). Reinsurance capacity is clearly available to support mortgage insurers by providing capacity that will allow them to insure more loans as the housing market rebounds and demands for mortgage insurance grow as well as to limit mortgage insurers exposure to severe losses and help ensure the ability of the mortgage insurance market to effectively meet a range of potential future loss scenarios. Mortgage insurance is generally not highly correlated to most other significant reinsurance exposures and therefore represents an attractive source of diversification for the industry.

Concluding Remarks

As this Committee considers proposals impacting the future of the housing finance system, we are encouraged to report that private capital providers have upheld their commitments made through the mortgage insurance channel, and additional private capital is available to inject fresh capital as needed. Further, reinsurers stand ready to assist in mitigating a portion of the mortgage insurance risk as long as prudent underwriting standards and reasonable pricing characterize the marketplace.

PREPARED STATEMENT OF MARTIN S. HUGHES

PRESIDENT AND CHIEF EXECUTIVE OFFICER, REDWOOD TRUST, INC.

MAY 26, 2011

Introduction

Good morning Chairman Johnson, Ranking Member Shelby, and Members of the Committee. My name is Marty Hughes, and I am the CEO of Redwood Trust, Inc., a publicly traded company listed on the New York Stock Exchange. I appreciate the opportunity to testify regarding the Future of the Housing Finance System and look forward to responding to your questions.

Overview

My testimony is focused on restoring a fully functioning private-sector residential mortgage finance market. Currently, about 90 percent of all new mortgage originations rely on Government support.[1] Given the fact that there is $9.6 trillion of out-

[1] 2011 Mortgage Market Statistical Annual, Volume I , p. 19.

standing first mortgage debt,[2] this level of public subsidization is simply not sustainable. That being said, reducing the current level of governmental support, whether immediately or gradually over time, will have severe consequences for the housing market if the private sector is not prepared to step in with investment capital to replace a diminished level of Government backing.

The consequences of failing to attract sufficient private-sector capital to this market include a contraction in the availability of credit to homebuyers, an increase in mortgage rates, and continued decreases in home prices. Furthermore, these consequences in the housing market may have broader negative effects on the overall economy.

The main sources of private-sector capital that previously financed residential mortgages include banks, mutual funds, pension funds, and insurance companies. For the nonbanks, the transmission mechanism for providing this financing was through their investments in triple-A rated residential mortgage-backed securities (RMBS). My testimony will recommend how to bring these "triple-A investors" back to this securitization market, thereby enabling the Government to reduce its role in the mortgage market without negative consequences.

I realize that this and other hearings may devote considerable attention to ideas for new Government guarantees of mortgages in a post-GSE world. My testimony today is not focused on discussing these different alternatives. That debate may continue for years. My focus is on steps the Government can take today to spur a full return of the private mortgage securitization market. A broad return of the private market may also help the Committee to realize that it has more policy options on the Government's future role, or nonrole, than would appear in today's Government dominated market.

Background on Redwood

Redwood commenced operations in 1994 as an investor in residential mortgage credit risk. We are not a direct lender or mortgage servicer. Our primary focus has been on the prime jumbo mortgage market, or that portion of the mortgage market where the loan balances exceed the limits imposed by Fannie Mae and Freddie Mac (the "GSEs") for participation in their programs. Similar to the GSEs, Redwood also provides credit enhancement, but our focus is on the prime jumbo mortgage market. We provide credit enhancement by investing in the subordinate securities of private-label residential mortgage securitizations, which enables the senior securities to obtain triple-A ratings. From 1997 through 2007, Redwood securitized over $35 billion of mortgage loans through 52 securitizations.

Recent Securitization Activity

In April 2010, Redwood was the first company, and is so far the only company, to sponsor a securitization of newly originated residential mortgage loans without any Government support since the market froze in 2008. The size of that first transaction was $238 million. In March 2011, we completed a second securitization of $295 million, and we hope to complete two more securitizations this year.

Completing these transactions required that we address the concerns and interests of triple-A investors who, in the wake of the financial crisis, had lost confidence that their rights and interests would be respected and, consequently, that their investments would be safe and secure. We worked hard to regain their trust by putting together transactions that included even more comprehensive disclosure, better structure, and a new enforcement mechanism for representation and warranty breaches. In addition, Redwood retained meaningful exposure to the transaction's future performance—*i.e.,* through risk retention or "skin-in-the-game"—and, in doing so, aligned our interests with those of investors. Investors responded with significant demand to acquire the triple-A rated securities, as evidenced by the fact that the first offering of those securities was oversubscribed by a factor of six to one. The second securitization was also quickly and fully subscribed.

To be clear, Redwood Trust has a financial interest in the return of private sector securitization for residential mortgages. We hoped that our decision to securitize loans in 2010 would demonstrate to policy makers that private capital would support well-structured securitizations that also have a proper alignment of interests between the sponsor and the triple-A investors. We are proud of our history of sponsoring residential mortgage securitizations and our more recent role in helping to restart the private securitization market, and are pleased to have the opportunity to share our insights and observations with the Committee.

[2] Federal Reserve Flow of Funds of the United States, Fourth Quarter, Tables L.217 and L.218.

The Private Mortgage Securitization Outlook for 2011

The outlook for nongovernment or private-label residential mortgage securitization volume backed by newly originated mortgage loans (new securitizations) in 2011 remains very weak by historical standards. Year-to-date through April 30, 2011, only one new securitization totaling $295 million has been completed, and that was our deal. We hope to complete two more securitizations in 2011 and securitize between $800 million and $1.0 billion for the year, and to build upon that volume in 2012. There are no good industry estimates for new private securitization volume in 2011, as the market is still thawing from its deep freeze. While we would welcome other securitizations in 2011 to provide additional third-party validation of the viability of securitization, the yearly volume will almost certainly be a small fraction of the $180 billion average annual issuance completed from 2002 through 2007, when the market began to shut down.[3]

Major Hurdles to Private Mortgage Securitization Activity

Before I outline the major impediments to reviving private residential mortgage securitization, I would like to comment on the often cited lack of investor demand or interest as the primary reason for the dearth of private MBS issuance. We strongly disagree. Today, there is a vast amount of global investment capital from bank balance sheets, insurance companies, and mutual funds to non-U.S. financial institutions, hedge funds, and even real estate investment trusts searching for ways to generate safe, attractive risk-adjusted returns.

Based in part on the success of our two recent mortgage securitizations and ongoing discussions with triple-A investors, we have confidence that the private market will invest in safe, well-structured, prime securitizations that are backed by "good" mortgage loans. We consider "good" loans as loans on properties where the borrowers have real down payments, capacity to repay, and good credit. Well-structured securitizations will be those that meet the new demands of triple-A investors around disclosure transparency, alignment of interests, loan quality, structural investor protections and standards for servicer functions and responsibilities. To the extent these criteria are met, we believe that over time, traditional triple-A investors in private residential securitizations will regain their confidence and return "en masse."

Some market participants have been very vocal about the potential negative impact on mortgage rates as a result of the proposed new regulations and/or the phase out of the GSEs. Recent news articles have speculated that mortgage rates will rise dramatically, by as much as 300 basis points. We do not agree. Worldwide competition for returns is too great to allow such a rise in mortgage rates, assuming their safety conditions are met.

We do believe residential mortgage rates could rise modestly—by perhaps 50 basis points—as the Government withdraws from the market. We note the average spread between the conforming and jumbo market from 2000 through 2007 prior to the financial crisis was 31 basis points.[4] The Government support effectively subsidizes borrowing rates and it is reasonable to expect these rates to rise somewhat as the subsidy is withdrawn. We nevertheless expect borrowing rates to remain attractive. On May 24, 2011, for loans with comparable prime quality underwriting, 3D-year, fixed-rate conforming mortgage rates were 4.625 percent, conforming jumbo rates were 4.75 percent, and private jumbo rates were 5.00 percent. We note the spread between conforming and nongovernment guaranteed or private jumbo mortgages was only 0.375 percent.

For context, in our most recent deal, the average mortgage interest rate for 30-year fixed-rate loans backing the securitization was 0.46 percent above the Government-guaranteed rate. As the number and diversity of loans available for private label securitization increases, thereby lowering risk, it is possible that residential mortgage rates could rise by less than 50 basis points relative to Government rates.

1. Crowding Out of Private Sector

As a result of the financial crisis, through the GSEs and the Federal Housing Administration (FHA), the Government has taken the credit risk on about 90 percent of the mortgages originated in the U.S. without passing on the full cost of the risk assumed. Government subsidies must be scaled back to permit a private market to flourish. We note that postcrisis, the private asset-backed securities markets for auto loans, credit cards loans, and now commercial real estate loans are up and

[3] 2011 Mortgage Market Statistical Annual, Volume II, p. 31.

[4] Data from Banxquote. The average spread from 2000 through April 2011 is 0.46 percent, which includes 2008 and 2009 when the average spread increased to 1.25 percent during the financial crisis.

functioning, while the private-label RMBS market barely has a pulse. The difference is the pervasive below-market Government financing in the residential mortgage sector that is crowding out traditional private market players.

Critics will argue that Redwood's transactions were backed by unusually high quality jumbo mortgage loans and are therefore not representative of the market. We disagree on this point as the loans backing our two securitizations had similar loan-to-value and credit scores as the loans guaranteed by Fannie Mae since the beginning of 2010.[5] In fact, that argument proves the point that the Government is crowding out private label securitizations, by maintaining an abnormally high conforming loan limit and by subsidizing the guarantee fees that the GSEs charge issuers. No private sector securitizer can compete with that—we can only securitize the small volume of prime quality loans beyond the Government's reach. We are ready to purchase and securitize prime mortgage loans of any loan amount, and can do so at an affordable rate once the Government creates a level playing field.

2. No Financial Urgency To Challenge the Status Quo

We note that keeping the *status quo* effectively prevents the creation of any sense of urgency to restore private securitization, especially by traditional bank securitization sponsors. These major banks benefit by selling 90 percent of their mortgage originations into a very attractive Government bid, and they have ample balance sheet capacity to easily portfolio the remaining jumbo loans and earn an attractive spread between their low cost of funds and the rate on the loans. There is simply no financial incentive at this juncture for banks to sell loans through a nonagency securitization.

During the onset of the financial crisis, it was essential for the Government to increase its support of the mortgage market. Today, that crisis level of support and the ongoing burden on taxpayers to support 90 percent of a $10 trillion market is simply untenable. We strongly advocate that the time has come to more broadly demonstrate the private market's ability to replace Government-dependent mortgage financing, and do so on a safe and measured basis to prevent negative consequences to the housing market.

The first step would be to allow the scheduled reduction in the conforming loan limit in high cost areas from $729,750 to $625,500 to occur as scheduled in September 2011. This reduction would represent only about 2 percent of total industry originations, a conservative first step.[6] The potential lenders for the mortgages over $625,500 are the same lenders, mainly banks, who are currently providing loans over $729,750. With $1.5 trillion of excess liquidity in the banking system,[7] there is certainly ample liquidity in the banking system to enable banks to step into the breach, while financing through private residential mortgage securitization regains its footing.

Additionally, the Administration should follow through on its plan to increase guarantee fees to market levels over time to eventually level the playing field between the private market and the GSEs. A gradual Government withdrawal from the mortgage market over a 5-year period will enable time for a safe, attractive, robust private label market to develop.

As the housing market begins to recover, we support further measured reductions on a periodic basis in the conforming loan limit as a means to increase the share of the mortgage market available to the private sector. We note that with housing prices now down in excess of 30 percent from their peak in mid-2006,[8] it would seem logical to consider reducing the conforming loan limit by a similar amount over time.

3. Regulatory

In the wake of the Dodd-Frank Act, there are many new regulatory requirements and market standards out for comment, but they are not yet finalized. The resulting uncertainty keeps many market participants out of the market. Once the rules of

[5] The weighted average original loan-to-value and FICO scores for the loans guaranteed by Fannie Mae in 2010 and the first quarter of 2011 were 69 percent and 763, respectively, per the company's First Quarter Credit Supplement. The weighted average original loan-to-value and FICO scores for Redwood's securitizations (SEMT 2010-H1 and SEMT 2011-1) were 59 percent and 771. The average loan size for Fannie Mae was $212,793 and for Redwood was $957,945.

[6] According to the National Mortgage News citing the Federal Housing Finance Administration's Mortgage Market Note. Fannie Mae and Freddie Mac originated just over $30 billion of conforming jumbo loans in 2010, compared to $1.57 trillion of total industry originations.

[7] Federal Reserve H.3 report dated May 19, 2011.

[8] S&P/Case-Shiller Home Price Index press release dated April 26, 2011.

the road are known, market participants can begin to adjust their policies, practices, and operations.

A. Dodd-Frank Act Implementation Overview

We recognize joint regulators had a very difficult task in establishing, writing, and implementing the new rules as required by the Dodd-Frank Act. Before noting some specific concerns, we would like to offer some high level observations on the joint regulators' notice of proposed rulemaking on risk retention (NPR).

The NPR as written has some technical definitional and mechanical issues that need to be fixed. In particular, how the premium capture account works. This issue has been the source of much debate market participants. We are hopeful that appropriate corrections will be made after all comment letters are received and reviewed.

We also note that regulators took a well intentioned approach to crafting a new set of risk retention rules to cover the entire mortgage securitization market—*i.e.,* both the prime and subprime markets. In theory, this comprehensive approach should be a more expedient method for restarting securitization. However, there are complex differences between the prime and subprime markets and their unique securitization structures that make it very difficult to apply a one-size-fits-all set of new rules.

The details are too complex for this testimony, but to over-simplify, the proposed rules are effectively subprime centric. While the rules do a good job of addressing and deterring abuses relating to subprime securitization structures, they are overly and unnecessarily harsh when applied to prime securitization structures. This is meaningful since prime loans are approximately 90 percent of the overall market. If the proposed rules are adopted as written, prime borrowers whose loans are financed through private securitization will face unnecessarily higher mortgage rates.

In Redwood's comment letter to the NPR, we intend to propose a more tailored approach that would keep intact the necessary safety protections, but eliminate the unnecessary structural inefficiencies that would lead to higher prime mortgage rates.

We believe that focusing first on restoring the prime segment of the market in a safe yet efficient manner would bring the greatest benefit to the largest number of stakeholders (borrowers, lenders, investors, and taxpayers) and would become more effective and productive than attempting to craft one all-encompassing regulatory solution that is likely to be challenging given the complexities of the nonprime segment of the market.

B. Form of Risk Retention

We are strong advocates of requiring securitization sponsors to retain risk in order to properly align their interests with those of investors. We support the intent of the joint regulators' NPR on this issue. In fact, it has always been Redwood's operating model to retain the first-loss risk in our securitizations.

The NPR proposes four forms of risk retention: (1) a horizontal slice consisting of the most subordinate class or classes; (2) a vertical slice with *pro rata* exposure to each class; (3) a combination of horizontal and vertical slices; and (4) a randomly selected sample of loans.

Redwood believes the most effective form of risk retention is the horizontal slice and that other forms are much less effective. The horizontal slice requires the sponsor to retain all of the first-loss securities and places the sponsor's entire investment at risk. Only that approach will provide the required incentive for a sponsor to ensure that the senior securities are backed by safe and sound loans, which will benefit borrowers as well as investors.

The other forms of risk retention result in substantially less of the sponsor's investment in the first risk position, which reduces the incentive to sponsor quality securitizations. Over time, we believe investors will vote on the best form of risk retention and reward sponsors that retain horizontal "skin-in-the-game."

C. Qualified Residential Mortgages

We support the intention of the proposed definition of a qualified residential mortgage (QRM), but we believe it is a bit too restrictive. We support the concept of "common sense" underwriting, similar to the standards used by the GSEs for so many years prior to the period leading up to the credit bubble. These standards resulted in low credit losses for many years.

D. Servicer Functions and Responsibilities

We believe that the well-publicized mortgage servicing issues are an impediment to broadly restarting private residential mortgage securitization. Beyond the issue of lost documents and foreclosure practices, servicers have been on the front lines throughout the recent crisis. Focusing more narrowly on their role in the securitization structure, they have sometimes been placed in the position of having to interpret vague contractual language, ambiguous requirements, and conflicting direction. In their role, they are required to operate in the best interest of the securitization and not in the interest of any particular bond holder. In practice, without any clear guidance or requirements, they invariably anger one party or another when there are disagreements over what is and is not allowed—with the result of discouraging some triple-A investors from further investment in RMBS. We propose that uniform standards governing servicer responsibilities and conflicts of interest be established and that a credit risk manager be established to monitor servicer performance and actions. We have discussed this servicing issue in greater detail and have proposed recommendations in our "Guide to Restoring Private-Sector Residential Mortgage Securitization", which is available on our Web site.

4. Second Mortgages

If we really want to restore a safe securitization market, we also need to address second mortgages. One of the significant factors that contributed to the mortgage and housing crisis was the easy availability of home equity loans. Plain and simple, the more equity that a borrower has in his or her home, the more likely that borrower will continue to make mortgage payments. Home equity loans often result in the borrower having little or no equity in their homes.

Although the proposed QRM standard will encourage lenders to originate loans to borrowers who have a minimum 20 percent down payment, there is no prohibition against the borrower immediately obtaining a second mortgage to borrow back the full amount of that down payment. The addition of a second mortgage that substantially erodes the borrower's equity and/or substantially increases a borrower's monthly debt payments increases the likelihood of default on the first mortgage. Many of the current regulatory reform efforts are centered on creating an alignment of interests between sponsors and investors through risk retention or "skin-in-the-game." However, the first and most important line of defense is at the borrower level. If the borrower can take his or her own "skin" out of the game through a second mortgage, what have we really accomplished? The answer is very little. We believe any failure to address borrower skin-in-the-game will be very discouraging not only to private-label RMBS investors, but all mortgage investors.

To prevent the layering of additional leverage and risk, it is common in other forms of secured lending (including commercial and corporate lending) to require either the consent of the first mortgage holder to any additional leverage or to limit the new borrowing based on a prescribed formula approved by the first mortgage holder. We recommend extending this concept to residential mortgages.

Specifically, we recommend enactment of a Federal law that would prohibit any second mortgage on a residential property, unless the first mortgage holder gives its consent. Alternatively, a second mortgage could be subject to a formula whereby the new combined loan-to-value (based on a new appraisal) does not exceed 80 percent.

Conclusion

Looking ahead to the long-term future of housing finance, I see a number of positives emerging: safer mortgages that borrowers can afford, the return of loan loss rates to historically low norms for newly originated prime loans, and private capital willing to fund residential mortgages at affordable rates for borrowers through responsible, safe securitization. The first step is to give the private sector a chance by following through on the Administration's plan to reduce the conforming loan limits and increase the GSE's guarantee fees to market rates at a safe and measured pace.

Thank you for the opportunity to testify before the Committee today. I would be happy to answer your questions.

PREPARED STATEMENT OF BARRY RUTENBERG

First Vice Chairman of the Board, National Association of Home Builders

May 26, 2011

Introduction

Chairman Johnson, Ranking Member Shelby, and Members of the Senate Banking Committee, I am pleased to appear before you today on behalf of the National Association of Home Builders (NAHB) to share our views on the long-term future of the housing finance system. We appreciate the invitation to appear before the Committee on this important issue.

My name is Barry Rutenberg and I am NAHB's First Vice Chairman of the Board and a home builder from Gainesville, Florida. NAHB represents over 160,000 member firms involved in building single family and multifamily housing (including participants in the Low Income Housing Tax Credit program), remodeling, and other aspects of residential and light commercial construction. Each year, NAHB's builder members construct about 80 percent of all new housing in America.

Credit is the life's blood of the housing sector. A reliable and adequate flow of affordable funds is necessary in order to achieve the Nation's housing and economic goals. Establishing a finance system that provides liquidity for the housing sector in all markets throughout the economic cycle is a prerequisite to achieving housing policy objectives. In fact, achieving affordability in credit for single and multifamily housing reduces the resources required to address the Nation's housing needs. A stable, effective, and efficient housing finance system is critical to the housing industry's important contribution to the Nation's economic performance and to the achievement of America's social goals.

The housing finance system currently is under a cloud of uncertainty. The Federal Government, through the Federal Housing Administration (FHA) and Fannie Mae/ Freddie Mac, is currently accounting for nearly all mortgage credit flowing to homebuyers and rental properties. Even with the current heavy dose of Federal support, fewer mortgage products are available and these loans are being underwritten on much more stringent terms. In addition, Congress and the regulators are piling on layers of regulations in an attempt to plug gaps in the system of mortgage regulation and to prevent a recurrence of the mortgage finance debacle that is still playing out.

This is not an arrangement that can continue indefinitely and there is no clear picture of the future shape of the conforming conventional mortgage market. One thing that is clear is that the *status quo* cannot be maintained. Policy discussions are underway on what should become of Fannie Mae and Freddie Mac following the current, still-indefinite conservatorship period, and what, if anything, should change in the structure and operation of the Federal Home Loan Banks (FHLBanks). A key consideration is how to get from the current structure to a future arrangement without undermining ongoing financial stabilization efforts and disrupting the operation of the housing finance system.

NAHB has been actively involved in discussions on changes to the financing framework for homebuyers and producers of rental housing. In the past year, NAHB has developed a detailed plan outlining our thoughts on the future of the housing finance system and shared this extensively with Congress. In the meantime however, Congress has passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). Regulators are now busy implementing this massive law that has the potential to reduce the availability and increase the cost of housing credit. The housing landscape has seen little change during this period as the housing market remains extremely weak and decisions about the future of the housing finance system are stuck in a quagmire, despite the Administration's recent report outlining options for Reforming America's Housing Finance Market.

NAHB strongly supports efforts to modernize the Nation's housing finance system, including reforms to the Government-sponsored enterprises Fannie Mae and Freddie Mac. We cannot go back to the system that existed before the Great Recession, but it is critical that any reforms be well-conceived, orderly, and phased in over time. Short-term proposals to reduce the support Fannie Mae and Freddie Mac provide for the housing finance system represent a piecemeal approach to reform that would disrupt the housing market and could push the Nation back into a deep recession. These proposals, along with similar plans announced by the Obama administration in February, show that many policy makers have clearly forgotten housing's importance to the economy.

America's home builders urge policy makers in the Administration and Congress to consider the potential consequences of their proposals. Do not move forward with policies that would further destabilize a housing market that is already struggling. Housing can be the engine of job growth this country needs, but it cannot fill that vital role if Congress and the Administration make damaging, ill-advised changes to the housing finance system at such a critical time.

NAHB's testimony today will expand on these thoughts within the context of current housing market conditions and other recent developments affecting the housing finance system.

Housing Market Conditions

The housing market has not experienced the same tentative growth path that the rest of the economy is experiencing. Overall economic growth has been weak by historic standards for an economic recovery, but housing's performance has been even weaker. Unlike the last two economic recoveries, when housing grew 25 and 45 percent at this point after the end of the recession, housing is still down 18 percent since the end of the recession in June 2009.

The early months of 2011 have not provided any positive news for housing. New home sales have been stuck at record lows since the expiration of the homebuyers' tax credit in April 2010.

Housing construction has reflected the poor sales performances as total building permits in 2011 have been the lowest on records going back to 1960. Single family housing starts have been among the lowest ever recorded.

House prices continue to fall in many locations as foreclosed and distressed sales continue to absorb what little demand there is. Oddly, low mortgage rates and very affordable house prices should be a stimulus to home buying, but the consumer remains uncertain about future Government moves against housing. Mortgages are affordable, but credit standards and down payment requirements are keeping many potential homebuyers out of the market.

Proposals To Reform the Housing Finance System

In February, the Obama administration released its report on *Reforming America's Housing Finance Market* (Report). As required by the Dodd-Frank Act, the Report provides recommendations for ending Fannie Mae and Freddie Mac's conservatorship and the proper role of the Federal Government in the Nation's housing finance system. The report lays out a path toward transition that will significantly reduce the Government's role in housing finance by winding down Fannie Mae and Freddie Mac and, over time, restoring the private sector's role in mortgage finance. The Administration stresses that the transition should be a careful and deliberative process that will take several years to implement.

During the transition, the Administration proposes a number of steps to reduce Government support including lower loan limits, increased down payment requirements and higher fees for conforming and FHA-insured mortgages. As Fannie and Freddie's role in the housing market is reduced, FHA's presence would be scaled back to its precrisis role as a targeted provider of credit access for low—and moderate income and first-time homebuyers. Program changes at FHA would ensure that the private market—not FHA—would pick up new market share as the Fannie/Freddie role is reduced. Reforms at the FHLBanks would include restricting member banks to only one FHLBank, capping the level of advances for any institution and reducing the FHLBanks' investment portfolios.

The Administration proposes three options for the long-term framework of the housing finance system, but does not endorse a specific option:

- Option 1 would establish a privatized system of housing finance with Government support limited to assistance by FHA, USDA, and VA for a narrowly targeted group of borrowers.
- Option 2 is a similar to Option 1, but would provide a Federal Government guarantee for private mortgages that would be triggered only during time of economic stress.
- Option 3 would permit the Government to provide catastrophic Federal reinsurance for the securities backed by a targeted range of mortgages that are already guaranteed by private insurers.

NAHB believes that changes to the housing finance system should be comprehensive, coordinated, and undertaken in a careful and deliberate manner that does not unnecessarily disrupt the struggling housing recovery. While we support housing finance reform, and look forward to working with this Committee and Congress on broad reform efforts, we have serious concerns on several of the legislative proposals put forward so far in the 112th Congress.

On March 31, 2011, legislation was introduced by Senators John McCain (R-AZ) and Orrin Hatch (R-UT), S. 693, *the GSE Bailout Elimination and Taxpayer Protection,* that would effectively wind down the operations of Fannie Mae and Freddie Mac without offering a clear vision for the future housing system and a thoughtfully designed path for a nondisruptive transition to a new framework. NAHB opposes S. 693, as well as identical legislation introduced in the House earlier this year, H.R. 1182, introduced by Representatives Jeb Hensarling (R-TX) and Spencer Bachus (R-AL). Similarly, NAHB is opposed to the growing list of legislative proposals introduced by members of the House Financial Services Committee that are aimed at reducing the activities of Fannie Mae and Freddie Mac absent comprehensive reform that would continue to provide a Federal backstop ensuring a reliable and adequate flow of affordable housing credit in all economic and financial conditions.

While NAHB agrees that private capital must be the dominant source of mortgage credit, the future housing finance system cannot be left entirely to the private sector. The historical track record clearly shows that the private sector is not capable of providing a consistent and adequate supply of housing credit without a Government backstop. NAHB therefore believes that it is premature to begin dismantling the current housing finance system, as represented in both these legislative approaches, until there is a clear vision for the future of the housing finance system.

NAHB is nevertheless pleased to see new legislative efforts being introduced and developed in the House of Representatives that would take a very different tack from the proposals mentioned previously. Recently bipartisan legislation, H.R. 1859, was introduced by Representatives John Campbell (R-CA) and Gary Peters (D-MI), which would replace Fannie Mae and Freddie Mac with five private companies that would issue mortgage-backed securities and have Government backing. This approach differs greatly from the previously mentioned proposals that would move towards full privatization of the GSEs and slowly diminish Federal support for the current housing finance system. Similarly, NAHB is aware of legislation currently under development by Representative Gary Miller (R-CA) that would likewise include a predictable Government role in the secondary mortgage market to preserve financial stability in the market and maintain a stable housing sector.

NAHB views the introduction of H.R. 1859, as well as the direction of Rep. Miller's legislative proposal, as a very positive development as the debate on the future of the housing finance system moves forward in the 112th Congress. In addition to NAHB's own detailed proposal on how a future housing finance system can be structured (outlined later in this statement), NAHB looks forward to working with all members of the House and Senate to move forward comprehensive GSE reform legislation seek an appropriate Federal role to maintain a healthy mortgage marketplace.

NAHB Position on Housing Finance Reform

Key Principles

NAHB has had a strong and longstanding interest in the maintenance of an efficient secondary mortgage market and the role of the GSEs in facilitating the flow of capital to housing. NAHB, along with a number of other housing and financial trade associations, including some that are on this panel, have developed Principles for Restoring Stability to the Nation's Housing Finance System, which were released on March 28. We believe the following principles should help guide efforts to restore and repair the Nation's housing finance system:

- A stable housing sector is essential for a robust economic recovery and long-term prosperity. Housing, whether through home ownership or rental, promotes social and economic benefits that warrant it being a national policy priority.
- Private capital must be the dominant source of mortgage credit, and it must also bear the primary risk in any future housing finance system.
- Some continuing and predictable Government role is necessary to promote investor confidence and ensure liquidity and stability for home ownership and rental housing.
- Changes to the mortgage finance system must be done carefully and over a reasonable transition period to ensure that a reliable mortgage finance system is in place to function effectively in the years ahead.

We agree with the Administration that private investment capital is critical for a robust and healthy mortgage marketplace, and the current Government-dominated mortgage system is neither sustainable nor desirable. As critical as it is to attract private money to the mortgage markets, an appropriate level of Government support is essential to preserving financial stability. To facilitate long-term fixed-rate mortgages, affordable financing for low- and moderate-income borrowers, and financing affordable rental housing—particularly during times of crisis and illiquidity—it is important to establish a clearly defined role for the Federal Government in developing effective insurance and guarantee mechanisms. While the goal should be to move toward a largely private secondary market, the private and public sectors should work as partners in creating a variety of financing options to ensure that safe, stable, and affordable financing is available to all creditworthy borrowers.

NAHB Proposal for New Secondary Market System

NAHB believes that it is crucial for the Federal Government to continue to provide a backstop for the housing finance system to ensure a reliable and adequate flow of affordable housing credit. The need for such support is underscored by the current state of the system, where Fannie Mae, Freddie Mac, the FHLBanks, FHA and Ginnie Mae are the only conduits for residential mortgage credit. NAHB feels the Federal backstop must be a permanent fixture in order to ensure a consistent supply of mortgage liquidity as well as to allow rapid and effective responses to market dislocations and crises.

A workable system must be established to perform the basic roles served by Fannie Mae and Freddie Mac. These GSEs should not be converted to Government agencies, nor should their functions be completely turned over to the private market. Last year NAHB presented this Committee a proposal recommending major changes in the structure and operations of the secondary mortgage market. The operation of the new secondary market for conforming conventional mortgages is illustrated in the diagram attached to this statement.

NAHB's proposal is similar to the Administration's third option for the long term structure of the housing finance system. Key features of NAHB's proposal are summarized below.

- Private entities, called conforming mortgage conduits, would purchase and securitize mortgages but would receive no direct or implicit Federal Government support.
- The Federal Government would guarantee the timely payment of principal and interest of the mortgage-backed securities issued by the conforming mortgage conduits.
- Conforming mortgage conduits would have significant capital requirements (minimum and risk-based requirements) and also would be required to contribute to a fund to cover losses on the mortgages they pool and sell.
- Therefore, the Federal Government would incur only catastrophic risk beyond the risk covered by securitizers' capital and fund.
- Primary mission of conforming mortgage conduits would be to provide mortgage market liquidity through securitization activities.
- These conduits would be permitted to maintain limited portfolios to facilitate transactions as well as to hold loans that do not have a secondary market outlet.
- Conforming mortgage conduit activities should be directed at a broad range of housing market needs to enable Americans at all income levels to achieve decent, safe, and affordable housing. (No specifics on affordable housing requirements.)
- Conforming mortgage conduits would deal in mortgages with well-understood and reasonable risk characteristics (including standard 30-year fixed-rate loans, ARMs, and multifamily mortgages).

Impact on the Federal Home Loan Bank System

Discussion of housing finance system reform has focused almost exclusively on the future of Fannie Mae and Freddie Mac. While this is understandable given the magnitude of problems facing those companies, their open-ended line of support from the U.S. Treasury, and their ongoing operation under conservatorship, attention must also be accorded to the FHLBank System.

NAHB also views the FHLBank System as an essential component of the U.S. housing finance framework that has served as a key source of liquidity for institutions providing loans to homebuyers and home builders as well as credit for community and economic development. The FHLBanks are significantly different from Fannie Mae and Freddie Mac in structure and operations and these differences should be acknowledged and respected during the consideration of the future structure of the housing finance system.

NAHB urges policy makers to undertake any changes to the housing finance system in a manner that will not diminish the favorable cost of funds for the FHLBanks or impair the role of the FHLBanks in supplying liquidity to institutions providing mortgage and housing production credit, support for community and economic development, and resources to address affordable housing needs. The FHLBanks should continue their current activities to serve as an ongoing key liquidity source for institutions providing housing credit.

Transition Considerations

The housing sector is struggling to regain its footing and begin contributing to a recovery in economic output and jobs. The current environment is rife with instability and uncertainty. Many markets throughout the country, however, have returned to a position where consumers are shopping for new homes and housing production can begin to move back to more normal levels.

It is critical that the housing finance system facilitate this emerging recovery rather than stifle it. Under these circumstances, finding a means of moving to a new secondary market framework may be as great, or greater, a challenge as developing the new conforming conventional secondary market structure. NAHB urges Congress to carefully consider and address the short-term, unintended consequences that could occur during the transition to a new housing finance system.

Any changes should be undertaken with extreme care and with sufficient time to ensure that U.S. homebuyers and renters are not placed in harm's way and that the mortgage funding and delivery system operates efficiently and effectively as the old system is abandoned and a new system is put in place. Every effort should be made to reassure borrowers and markets that credit will continue to flow to creditworthy borrowers and that mortgage investors will not experience adverse consequences as a result of changes in process.

Impact on 30-Year Fixed-Rate Mortgage

NAHB believes that any new housing finance system must support the continued availability of the 30-year, fixed-rate mortgage (FRM). Borne out of the Great Depression, the 30-year FRM has played a pivotal role in helping to increase the national home ownership rate so that today two out of three Americans own a home of their own.

It has become an industry standard for several reasons:

- *Affordability.* These loans are geared toward affordability; 30-year terms lock in low monthly payments, allowing households with average incomes to comfortably budget for their home loan.
- *Inflation protection.* Knowing their monthly housing costs will remain the same year in and year out regardless of whether interest rates rise provides households with a sense of financial security and also acts as a hedge against inflation.
- *Long-term planning.* Many young buyers know that as their incomes rise, their housing costs will stay constant and become less of a burden, enabling them to prepare for other long-term obligations, such as college tuitions and retirement savings.
- *Tax advantages.* In most instances, all of the interest and property taxes borrowers pay in a given year can be fully deducted from their gross income to reduce taxable income. These deductions can result in thousands of dollars of tax savings, especially in the early years of a 30-year mortgage when interest makes up most of the payment.

The key to the sustainability of the 30-year FRM is a securitization outlet because originators (banks and thrifts) do not have the capacity to hold such long-term assets which are funded with short-term deposits. Fannie Mae and Freddie Mac provided the securities vehicle along with an implicit Government guarantee for investors. It is not clear whether a private housing finance system would be capable of supporting this type of product without some Government backing. At a minimum, the cost of 30-year FRMs would increase under a private system.

The Administration's Report analyzes the impact of its three options on the cost and availability of the 30-year FRM to assess the impact of each option on the housing finance market. Option 1 would likely eliminate the 30-year FRM for non-FHA mortgages. Under Option 2, the 30-year FRM could be preserved, but would be very expensive. The 30-year FRM would be most likely to survive under Option 3, but it would be more expensive than at present.

As the private market transitions to assume a greater role, a strong Federal backstop is necessary to maintain a stable and adequate supply of credit for homebuyers and ensure that the 30-year FRM remains readily available to first-time homebuyers and working American families. Otherwise private financial institutions will turn the 30-year mortgage into a luxury product, with high interest rates, fees, and down payments that would price millions of middle-class households out of the market.

Multifamily Financing

The focus of the discussion on the future of housing finance reform largely has been on single-family home ownership. Less attention has been paid to the multifamily rental housing segment of the housing finance system, even though almost one-third of Americans live in rental housing, and demand for rental housing in the future is expected to increase.

In particular, NAHB estimates that the aging of the "echo boom" generation will result in demand for between 300,000 and 400,000 multifamily housing units on average per year over the next 10 years. The timing of this demand will depend on the pace of economic recovery, but the housing needs of these households will not be postponed indefinitely. The current average pace of multifamily housing starts of less than 120,000 annually is insufficient to meet this demand. Production of multifamily housing will undoubtedly increase above the current extraordinary low levels. It is important that the financing mechanisms to support that production are available.

In spite of the crisis affecting single-family housing, the multifamily sector has performed well. Multifamily loans held or guaranteed by Fannie Mae and Freddie Mac have very low default rates, and both businesses are profitable. In addition, the multifamily business of the GSEs finances a wide range of multifamily rental properties, which provide housing for very-low to middle income households. The FHA multifamily mortgage insurance programs also fill a need in the multifamily rental market, although its loan volume capacity is limited.

Private market sources of capital for multifamily financing are not available for all segments of the multifamily market. Life insurance companies tend to focus on large projects in the strongest markets and typically serve the highest income households. Once they meet their own portfolio investment targets, life insurance companies retract their lending. Banks do not provide long-term financing and are subject to significant restrictions in terms of capital requirements. While the commercial mortgage backed securities (CMBS) market was significant at one time, it has not recovered from the financial crisis and is not expected to resume its past levels of volume.

These facts point to the need to maintain a viable, liquid, and efficient secondary market for multifamily rental financing where the Federal Government continues to play a role. In addition, the secondary market must be structured to ensure that the appropriate range of products is available to provide the capital needed to develop new and preserve existing rental housing, as well as to refinance and acquire properties. An adequate flow of capital will ensure that demand for rental housing is met and that affordable options are available for a range of households.

As we suggest for the single family market, on the multifamily side, the Federal Government should provide an explicit guarantee of the timely payment of principal and interest on securities backed by conforming conventional mortgages, in the same manner that Ginnie Mae now provides guarantees for investors in securities representing interests in Government-backed mortgages. Again, the Federal Government should only be called on to support the conforming conventional mortgage market under catastrophic situations when the capital and self-funded insurance resources of private secondary market entities are exhausted.

However, multifamily loans do not lend themselves to standardization as easily as single-family loans, which points to the need to retain the ability to hold some volume of multifamily loans in portfolio.

NAHB Concerns With the Administration's Proposal for Multifamily Financing

The Administration's report emphasizes that Americans must have access to a range of affordable housing options, whether they own or rent. The report notes that renters face significant affordability challenges and says that the housing finance system must promote liquidity and capital to support affordable rental options that alleviate high rent burdens on low-income households.

The report states that, in the near term, the Administration will begin to strengthen and expand FHA's capacity to support both lending to the multifamily market and for affordable properties that are underserved by the private market. Options include risk-sharing with private lenders and development of programs dedicated to hard-to-reach segments, such as small rental properties. However, NAHB believes that the current structure, staffing levels and resources available to the FHA may not be sufficient to take on such additional responsibilities, nor does FHA have the institutional flexibility to respond to the range of market needs quickly and efficiently. If the role of FHA is to change, much more discussion is needed in this regard.

Of particular importance, the report states that the Administration is committed to finding more effective ways to provide financing for small rental properties, underserved markets and rural areas. NAHB is pleased that this proposal is included in the report, as financing for such properties continues to be a challenge.

However, NAHB is concerned that less thought has been given to a future financing system that will meet the needs of moderate- and middle-income renters. The Administration acknowledges that Fannie Mae and Freddie Mac have developed expertise in providing financing to the middle of the rental market, where housing is generally affordable to moderate income families. But the Administration does not suggest any alternatives to this model, nor does it set forth a viable transition plan as Fannie Mae and Freddie Mac are wound down. NAHB believes that it is critical to find ways to maintain funding to this segment of the market, and more thought needs to be devoted to solving this aspect of the housing finance system.

Also of concern to NAHB is the continued heavy reliance on nonprofit partnerships to address the needs of low- and moderate-income renters. Unfortunately, there has been a long-standing bias favoring nonprofits for expertise on these issues. This has been true in this and other Administrations. NAHB believes the criteria in selecting program participants should be based on their competence and capacity for producing housing in the most cost-effective way. For-profit businesses are successful, and the Government should look to partner with for-profit businesses when appropriate.

Recent Regulatory Developments—QRM

Of great concern to NAHB at present are the credit risk retention rules required by Section 941 of the Dodd-Frank Act, which were unveiled on March 29, 2011, by the six agencies charged with implementing that section of the law. NAHB believes the proposed rules contain an unduly narrow definition of the important term "Qualified Residential Mortgage" (QRM), featuring a minimum down payment of 20 percent, which would seriously disrupt the housing market by making mortgages unavailable or unnecessarily expensive for many creditworthy borrowers. By stipulating such a large down payment for a loan to be considered a QRM, the Administration and Federal agencies are preempting congressional efforts to reform the housing finance system by imposing a narrow and rigid gateway to the secondary mortgage market.

This extreme proposal could not have been put forward at a less opportune time. The housing market is still weak, with a significant overhang of unsold homes, and an equally large shadow inventory of distressed loans. A move to a larger down payment standard at this juncture would cause renewed stress and uncertainty for borrowers who are seeking or are on the threshold of seeking affordable, sustainable home ownership. We believe a more balanced QRM exemption is imperative in light of the enormous potential impact it would have on the cost and availability of mortgage credit at this precarious point in the housing cycle.

Risk retention is intended to align the interests of borrowers, lenders and investors in the long-term performance of loans. This "skin in the game" requirement, however, is not a cost-free policy option. Borrowers who can't afford to put 20 percent down on a home and who are unable to obtain FHA financing will be expected to pay a premium of two percentage points for a loan in the private market to offset the increased risk to lenders, according to NAHB economists. This would disqualify about 5 million potential homebuyers, resulting in 250,000 fewer home sales and 50,000 fewer new homes being built per year. Such a drastic cutback would have a disproportionate impact on minorities and low-income families who are struggling to achieve the dream of home ownership.

The exclusion of FHA and VA and, at least temporarily, Fannie Mae and Freddie Mac from the risk retention requirement provides some short-term cushion to the impact of the proposal but that relief would be short-lived and is eroded by the tighter underwriting and higher costs already imposed by those agencies. Further exacerbating the situation, the Obama administration has announced its intention to shrink FHA's share of the marketplace, lower FHA and conventional conforming loan limits, and further increase fees on FHA, Fannie Mae, and Freddie Mac home loans. These changes, combined with the effects of an overly restrictive QRM, would make it even more difficult for buyers to access affordable housing credit.

It appears to NAHB that the agencies did not give sufficient weight to statutorily required considerations in formulating their QRM proposal, which directed that the definition be based on objective, empirical data rather than subjective presumptions. The statute also requires a multifactor approach to establishing the parameters of the QRM in order to promote sound underwriting practices without arbitrarily restricting the availability of credit. The agencies have admitted that they deliberately selected an extremely conservative approach to create a very limited QRM basket.

Creating an inordinately narrow QRM exemption would cause significant disturbances in the fragile housing market. Today's credit standards are tougher than they have been in decades. As a result, credit availability is extremely tight even for very well qualified borrowers. NAHB strongly urged the banking regulators to consider the negative ramifications of setting further limits on the availability of credit through a comparatively narrower QRM exemption. Under the proposed standard, millions of creditworthy borrowers would be deemed, by regulatory action, to be higher-risk borrowers. As a result, they would be eligible only for mortgages with higher interest rates and fees and without the protections required by the statutory QRM framework that limit risky loan features.

An overly restrictive QRM definition also would drive numerous current lenders from the residential mortgage market, including thousands of community banks, and enable only a few of the largest lenders to originate and securitize home loans.

This sharp dilution of mortgage market competition would have a further adverse impact on mortgage credit cost and availability.

A QRM definition that is too narrow would prohibit many potential first-time homebuyers from buying a home especially if the definition includes an excessively high minimum down payment requirement. Repeat buyers and refinancers also would be adversely impacted if the QRM includes exceedingly high equity requirements. In other words, the important goal of clearing historically high foreclosure inventory—a necessary condition for a stabilized housing market—will be undermined.

The purpose of the QRM is to create a robust underwriting framework that provides strong incentives for responsible lending and borrowing. Loans meeting these standards will assure investors that the loans backing the securities meet strong standards proven to reduce default experience. The exemption also will keep rates and fees lower on QRMs, which will provide incentives for borrowers to document their income and choose lower risk products. In turn, the market will evolve to establish the appropriate mixture of QRM to non-QRM borrowing.

The majority of industry participants (lenders, home builders, realtors, mortgage insurers) and the sponsors of the QRM language in Dodd-Frank support a broad QRM definition that would encompass the bulk of residential mortgages that meet the lower risk standards of full documentation, reasonable debt-to-income ratios and restrictions on risky loan features. In addition, most believe that loans with lower down payments that have risk mitigating features, most notably mortgage insurance, should be included in the QRM exemption.

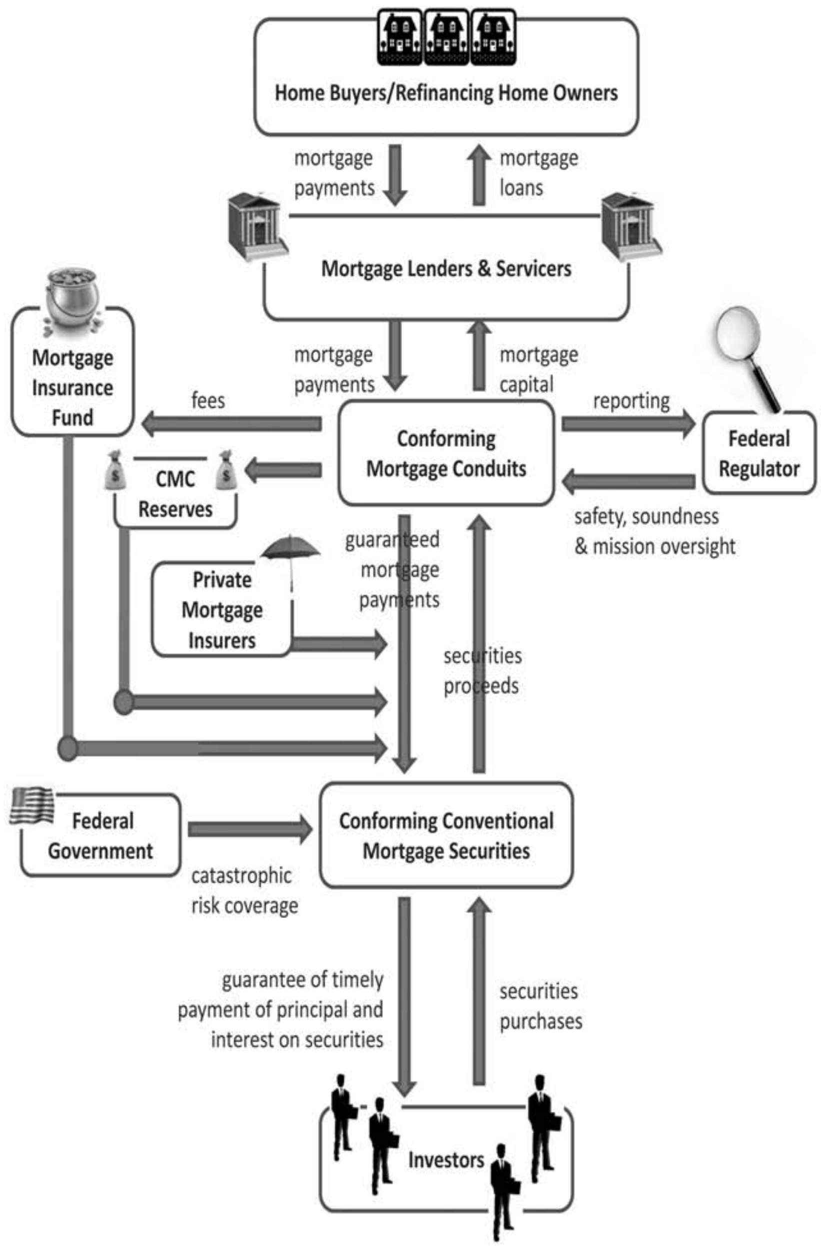
NAHB recommends the broadest criteria possible should be utilized in defining a QRM exemption that will ensure safe and sound operation of the mortgage market while accommodating a wide range of viable mortgage borrowers.

Given the substantial impact that the QRM rule will have on the availability and costs of mortgage credit for years to come, a thorough response to the Proposed Rule will require significant data development, analysis, and validation that cannot reasonably be completed by the June 10, 2011 comment deadline. For this reason and others, NAHB joined with 14 other organizations representing consumers and the real estate and financial services industries to request an extension of the comment deadline. Specifically, we asked that the comment deadline on the QRM proposal be synchronized with that of the rulemaking on the Ability to Repay and Qualified Mortgage provisions under Dodd-Frank so that comments are due no earlier than July 22, 2011. NAHB respectfully requests the Committee's support for this request and urges the Committee to encourage the regulatory agencies that drafted the QRM rule to grant the extension of the comment deadline.

Conclusion

Thank you for the opportunity to participate in this important and timely hearing. NAHB looks forward to working with all stakeholders to develop an effective as well as safe and sound means to provide a reliable flow of housing credit under all economic and financial market conditions.

Conforming Conventional Mortgage Secondary Market



RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM TERRI LUDWIG

Q.1. In your testimony, you call for continued Federal support of the secondary mortgage market to help provide affordable housing and lower cost mortgage financing in all markets.

Can you unequivocally state that your plan has accounted for all of the risks that led to a taxpayer bailout of Fannie Mae and Freddie Mac? In other words, can you tell us with any certainty that if your plan was adopted that taxpayers would not once again have to bail out the mortgage industry?

A.1. In my testimony before the Senate Committee on Banking, Housing, and Urban Affairs, I urge Congress not to fully withdraw from the housing market and to look at ways to continue support for affordable rental housing options. Enterprise Community Partners has not endorsed a specific plan for reform of the housing finance system; however, given the large role that the Government-sponsored enterprises have played in multifamily affordable housing, we believe that there needs to be some Federal role in this market.

We agree with you that any system established to provide guarantees must better protect taxpayers and the Federal Government. Unlike the single-family sector, the multifamily portfolio of the GSEs has performed incredibly well, with low default rates and continued profitability. This is not to say that the Government's involvement should remain as is, but that guarantees in the multifamily sector have worked well, and should be continued at some level. We understand that risks and benefits need to be considered and weighed, and results should be transparent. Any guarantees should be paid for, and the fees should be risk based, so that taxpayers are protected. We look forward to working with you to ensure that any new system protects taxpayers while helping to support affordable housing.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM MARTIN S. HUGHES

Q.1. In your testimony you discuss how the Federal Government is crowding out the private sector from the secondary mortgage market by aggressively expanding the market share of the GSE's and FHA. You point out that "postcrisis, the private asset-backed securities markets for auto loans, credit cards loans, and now commercial real estate loans are up and functioning, while the private-label RMBS market barely has a pulse."

In other words, the markets with the least Government involvement have been the fastest to recover and return to normal.

What lessons do you think this Committee should learn from this situation as we embark on housing finance reform?

A.1. The old saying goes, "Necessity is the mother of invention." If you really need to figure something out—figure it out. Without a Government-backed financing alternative, participants in the non-residential ABS markets were motivated to restart private financing through securitization.

When you look at how these ABS markets recovered, you see that success has bred further success and issuance velocity has led to further velocity. These ABS markets restarted slowly allowing industry practices to evolve and investor trust and confidence to gain momentum. For example, the first postcrisis CMBS transaction for $716 million was completed in June of 2010. Industry estimates for 2011 CMBS issuance volume are approximately $50 billion.[1] In addition, AAA credit spreads have tightened. It's been a win for borrowers and investors.

We are the first to acknowledge that the RMBS market faces comparatively far more complex regulatory and investor issues. Having acknowledged that, it is also the case that there is little financial urgency on the part of RMBS market participants to prioritize solving the issues and developing best practices to woo back AAA investors. Major banks now benefit from selling 90-plus percent of their originations into an attractive, Government-subsidized bid and can easily portfolio the remainder. There are too few loans outside the Government's reach to allow the private RMBS market to develop. Until the Government levels the playing field, by decreasing the size of mortgages eligible to be purchased by Fannie Mae and Freddie Mac and increasing their guarantee fees, the current *status quo* is at risk of becoming institutionalized. That would mean practices which were originally intended to be temporary will become the new normal, the high burden on taxpayers will persist, and the private sector's ability to finance home mortgage borrowing through securitization will further atrophy.

Q.2. In your testimony you address the perception that there is not adequate investor demand in the private MBS market. This critique is often cited by those arguing for the continuation of a Government guarantee.

Based on your experience, is there an investor appetite for private mortgage-backed securities?

What are the most important policy changes that would further encourage investors to return to the private MBS market?

A.2. We would agree that there are many angry residential AAA investors and some have sworn they will never again buy a private-label RMBS. Against that backdrop, today, there is over $2.5 trillion in fixed income funds. Investors are awash with investment capital in search of safe, attractive, risk-adjusted yields. We believe there would be significant investor demand to invest in private RMBS (and earn a premium over agency securities) provided their rights are protected and their demands for safety, alignment of interests, and transparency are met.

There is already a robust dialogue and debate going on regarding implementing the Dodd-Frank Act provisions that require a definition of a qualified residential mortgage loan (QRM) and the implementation of risk retention rules. We believe that if a common sense definition of a QRM is established and if meaningful risk retention rules are implemented, it will go a long way towards incenting strong mortgage loan underwriting.

However, it will take more than the Federal regulators getting these two concepts right to attract investors back to this market. We believe several additional changes to law and regulation are

[1] Source: Wells Fargo Securities, "Changing Dynamics in Commercial Real Estate Investments", May 19, 2011.

needed in order for investors to return to this market *en masse.* A high level summary of these key additional policy changes is outlined below. Discussion of other suggested changes is set forth in our recently published *Guide to Restoring Private-Sector Residential Mortgage Securitization.*

Proposed Changes to SEC Regulations Governing RMBS Issuance

Expand disclosure requirements to include:

- Increased transparency and investor access to data as contemplated by the SEC's proposed amendments to Regulation AB
- Disclosure of variances from specified industry standard loan-level representations and warranties
- Clear disclosure regarding:
  - The servicer's role, responsibilities, and compensation
  - Any servicer conflicts of interest
  - The process for identifying potential breaches of loan level representations and warranties and the dispute resolution process for resolving any alleged breaches
- Disclosure of the resolution of borrower defaults, including the servicer's analysis of the relative merits of foreclosure, short sale, and loan modification

Condition the use of Form S-3 registration statements on:

- Transaction documentation that:
  - Incorporates specified industry-standard terms and securitization structures that are straightforward and already familiar to securitization investors
  - Utilizes standardized robust loan-level representations and warranties that the various Federal regulatory agencies have approved (with the Fannie Mae/Freddie Mac standard representations and warranties to be considered by the regulatory agencies as a model)
  - Includes binding arbitration, nonbinding predispute mediation, or a similar nonjudicial process, as a dispute resolution process for any disputed claim of a breach of loan-level representations and warranties
- A credit risk manager being appointed to monitor the servicer's compliance with transaction documentation and periodically report to securitization investors

Proposed Federal Legislation

Enact Federal legislation to:

- Standardize servicing standards and duties to investors
- Resolve any uncertainty relating to documentation of mortgage assignments and the use of MERS, which legislation would respect State law governing liens on real estate and subject MERS to Federal regulation

- Give first mortgage holders the ability to contractually limit the ability of borrowers to reduce the equity they have in their home through a second lien loan or home equity line-of-credit without the consent of the holder of the first mortgage lien

In addition to the proposals I've listed above, there is another step the Government can take to help bring investors back to this securitization market: establish and adhere to public criteria that govern emergency interventions into the mortgage market and at whose expense such interventions will be made. Investors are skittish about this market not only because of the well-documented shortcomings of many of the participants in this market during the housing boom, but also because of a concern that future Government intervention into this market will unfairly be at their expense. For example, in the recent past, the Government created incentives for servicers to modify mortgage loans. Investors rely on servicers to fairly evaluate the relative merits of modifications *vs.* foreclosures and object to interventions of this kind by the Government.

Q.3. Many of the plans discussed here today incentivize borrowing through Federal guarantees and other subsidies. Some experts have argued that if the Federal Government is to subsidize home ownership, it should be done through direct, on-budget subsidies reducing the price of the home to the buyer, not by making the borrowing of additional money more attractive. The former approach would seem to have the added benefit of making the resulting mortgages more liquid in the secondary market, as lower LTVs would be more attractive to investors.

Mr. Heerde and Mr. Hughes, how would policies that encourage lower LTV loans affect the markets in which you work?

A.3. Investors have an appetite for high quality loans. The size of a borrower's down payment is a key determinant in the quality of a mortgage loan over its life. The higher the down payment (*i.e.,* the lower the loan-to-value ratio), the more likely any losses to investors will be low or nonexistent. Borrowers with more equity in their homes are better credit risks, all things equal.

Demand for securitizations backed by higher quality loans will be stronger than demand for securitizations backed by loans that are not quite as high quality. If there is stronger demand, investors in AAA-rated RMBS backed by higher quality loans are likely to be willing to accept slightly lower yields on their AAA-rated securities. Competitive market forces should translate these lower investment yields into lower mortgage rates for good borrowers.

Once the RMBS markets begin functioning again, investors will supply capital to a variety of types of borrowers over time. Borrowers who represent lower risk will get lower mortgage rates. We think securitization will provide capital to a range of borrowers. However, as part of this securitization market coming back to life and investors rebuilding their confidence in it, we expect high down payments will help facilitate investment in newly issued private label mortgage-backed securities.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM BARRY RUTENBERG

Q.1. Secretary Geithner warned this Committee of the difficulty in having the Government guaranteeing mortgage-backed securities. He cautioned:

> . . . guarantees are perilous. Governments are not very good at doing them, not very good at designing them, not very good at pricing them, not very good at limiting the moral hazard risk that comes with them.

Do you agree with Secretary Geithner?

If not, on what basis do you believe that the Government can accurately price risk?

A.1. NAHB observes that neither the private nor the Government sector did a very good job pricing risk in the run up to the housing crisis. Both sectors should use the lessons learned from the current crisis to develop better pricing mechanisms. There is no reason why the Government sector could not develop a pricing mechanism that is at least as accurate as the private sector.

Q.2. Many of the plans discussed here today incentivize borrowing through Federal guarantees and other subsidies. Some experts have argued that if the Federal Government is to subsidize home ownership, it should be done through direct, on-budget subsidies reducing the price of the home to the buyer, not by making the borrowing of additional money more attractive. The former approach would seem to have the added benefit of making the resulting mortgages more liquid in the secondary market, as lower LTVs would be more attractive to investors.

Mr. Rutenberg, do you feel it is preferable to subsidize debt over equity?

A.2. NAHB believes that it is crucial for the Federal Government to continue to provide a backstop for the housing finance system to ensure a reliable and adequate flow of affordable housing credit. NAHB feels the Federal backstop must be a permanent fixture in order to ensure a consistent supply of mortgage liquidity as well as to allow rapid and effective responses to market dislocations and crises. The Federal Government should provide an explicit guarantee of the timely payment of principal and interest on securities backed by conforming conventional mortgages, in the same manner that Ginnie Mae now provides guarantees for investors in securities representing interests in Government-backed mortgages. However, the Federal Government should only be called on to support the conforming conventional mortgage market under catastrophic situations when the capital and self-funded insurance resources of private secondary market entities are exhausted.