

**HOUSING FINANCE REFORM: ESSENTIALS OF A  
FUNCTIONING HOUSING FINANCE SYSTEM FOR  
CONSUMERS**

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**HEARING**  
BEFORE THE  
**COMMITTEE ON**  
**BANKING, HOUSING, AND URBAN AFFAIRS**  
**UNITED STATES SENATE**  
**ONE HUNDRED THIRTEENTH CONGRESS**

FIRST SESSION

ON

EXAMINING THE EXPERIENCE OF CONSUMERS THROUGHOUT THE  
HOUSING FINANCE SYSTEM FROM ORIGINATION TO SERVICING

—————  
OCTOBER 29, 2013  
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# **HOUSING FINANCE REFORM: ESSENTIALS OF A FUNCTIONING HOUSING FINANCE SYS- TEM FOR CONSUMERS**

**TUESDAY, OCTOBER 29, 2013**

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

The Committee met at 10:05 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.

For many Americans, home ownership is a lifelong dream and is often the biggest purchase a consumer will ever make. However, as became clear during the financial crisis, consumers face a complex housing finance system that may stack the odds against them. From steering consumers into higher-cost products in the “originate to distribute” model to poor servicing practices leading to improper foreclosures, the crisis exposed major flaws in the system for consumers.

The Wall Street Reform Act included key reforms to protect consumers from abusive mortgages—one being the creation of the Consumer Financial Protection Bureau. The CFPB has worked hard to address these problems and, this year, finalized rules on mortgage servicing and defining how a lender should evaluate a consumer’s ability to repay a mortgage. However, as the ongoing foreclosure settlements and recent CFPB report show, issues remain for consumers.

Consumers today face tight credit conditions as only borrowers with pristine credit histories are able to receive loans. Yet history has shown that a substantial share of first-time homebuyers has lower credit scores and that the majority pay on time. We must be mindful of the impact that strict underwriting standards will have on the ability of creditworthy borrowers to access the mortgage market, particularly in rural or underserved areas, and on the economic recovery. Many factors feed into an individual’s ability to repay a loan, and no one factor will guarantee repayment.

Last week, five Federal agencies released guidance to lenders on making loans in compliance with fair lending laws, and the Federal Reserve released a report showing that a high number of minorities may be impacted by stricter underwriting standards. These actions highlight the importance of being thoughtful in constructing new

standards to ensure that the mortgage market is accessible to all responsible borrowers.

I look forward to hearing our witnesses explain the home purchase process for consumers—including their interaction with the realtor, underwriting of the mortgage, pre- and post-purchase counseling, and servicing. They will also discuss the current challenges in each area and their recommendations for clearer standards and better consumer protections in the housing finance system.

Most consumers are not experts in mortgage lending, but our witnesses here today help them navigate the complex process. I believe their testimony will help inform the Committee as we decide how to best ensure access to credit for creditworthy borrowers. As we have learned in recent hearings, current reform proposals do not fully address important topics, such as multifamily, PLS, and as we will explore today, making sure a new system will function better for consumers purchasing homes. Any bill moving forward must seriously consider these issues.

With that, I turn to Senator Crapo for his opening statement.

#### **STATEMENT OF SENATOR MIKE CRAPO**

Senator CRAPO. Thank you, Mr. Chairman.

Today's hearing will focus on the consumer experience in a reformed housing finance system. Home ownership is central to our Nation's economy, offering financial and social benefits for families, communities, and the country as a whole. The policies we choose to adopt during this process will determine not only the sustainability of a robust housing market, but also the future economic opportunities for millions of American families and individuals.

A reformed housing finance system can help consumers achieve their dream of home ownership, but this must be done responsibly. Doing this in a sustainable manner requires strong underwriting as well as real estate contracts which can be expected to protect the rights of all parties. Failing to meet these two critical objectives will increase the risks and costs to both taxpayers and consumers.

One of the major causes of the financial crisis was a significant deterioration in underwriting standards. Many mortgages turned out to be unaffordable, and a large number of these mortgages were guaranteed by Fannie Mae and Freddie Mac. Staggering losses were ultimately paid for by taxpayers after the Federal Government bailed out Fannie Mae and Freddie Mac in July of 2008.

In addition to the lessons Fannie's and Freddie's failures, the Federal Housing Administration has further demonstrated the importance of returning to responsible underwriting. Last year's actuarial report found that the FHA insurance fund's net worth was a negative \$16 billion, and last month the FHA required a nearly \$2 billion Federal bailout, the first in its history.

With these experiences in mind, if we are going to consider options for reforming the housing finance system that include a taxpayer guarantee, we must ensure that the taxpayer is only guaranteeing mortgages that meet strong, basic underwriting standards.

A bipartisan coalition of the Banking Committee Senators has introduced S.1217. This legislation required a number of compromises to secure support from Members of both sides of the aisle. One important compromise is that in exchange for including an ex-

PLICIT Government guarantee of mortgages, private capital would take a strong first-loss position and loans would need to have a minimum downpayment of 5 percent while meeting the CFPB's qualified mortgage definition. Fannie's and Freddie's current underwriting standards for guaranteeing loans are generally more difficult to meet than a QM loan with a 5-percent downpayment.

Further, to my knowledge, no one is proposing to prohibit lenders from making loans that do not meet this standard. Existing proposals merely affirm that taxpayers will not be on the hook if those loans fail.

In addition to protecting taxpayers, it is also important that the future housing system ensures there is adequate liquidity in the market so that qualified borrowers have ample access to mortgage credit. An essential element of ensuring that credit availability is preserving our system of secured lending in which a borrower's home is seen as adequate collateral for the mortgage that the borrower seeks.

Some have proposed very prescriptive laws and regulations regarding how a mortgage can be serviced, including numerous restrictions on how the collateral could be obtained in the regrettable event that a borrower could not maintain his or her obligations.

Currently servicing reforms are already being implemented. The CFPB issued new servicing rules earlier this year, and the National Mortgage Settlement last year established new service standards for the Nation's largest servicers. None of us like the idea of any borrower losing his or her home, and none of us have forgotten nor excused legal and contractual violations of the past. However, if we take actions that call into question whether mortgage contracts are viewed as adequately secured lending, homeowners across the country could pay a very considerably higher rate.

I look forward to hearing from today's witnesses and working with the Chairman and the other Members of this Committee as we address these critical issues, and again, I thank you, Mr. Chairman, for holding this hearing.

Chairman JOHNSON. Thank you, Senator Crapo.

Are there any other Members who would like to give brief opening statements?

[No response.]

Chairman JOHNSON. I would like to remind my colleagues that the record will be open for the next 7 days for additional statements and other materials.

Our first witness is Mr. Eric Stein, who is senior vice president of the Center for Responsible Lending and its affiliate Self-Help.

Mr. Rohit Gupta is president of Genworth Financial, USMI.

Mr. Gary Thomas is the president of the National Association of Realtors.

Mr. Laurence Platt is a partner at K&L Gates LLP.

Next is Analyses Cohen, staff attorney at the National Consumer Law Center.

And, finally, we have Mr. Lautaro Diaz, vice president of housing and community development at the National Council of La Raza.

We welcome all of you here today and thank you for your time. Mr. Stein, you may proceed.

**STATEMENT OF ERIC STEIN, SENIOR VICE PRESIDENT,  
CENTER FOR RESPONSIBLE LENDING**

Mr. STEIN. Thank you, Chairman Johnson, Ranking Member Crapo, and Members of the Committee. My name is Eric Stein, and I am senior vice president at the Center for Responsible Lending. Thank you for inviting me to testify today.

The mortgage market in the U.S. is a \$10 trillion market, and there is a lot at stake in getting things right. As an initial matter, I agree with the emerging consensus, as reflected in S.1217, that taxpayer risk must be insulated by private capital and that a Government guarantee must be explicit and paid for to prevent future taxpayer bailouts. I have six recommendations for the Committee about how to design a housing finance system that will work for borrowers, private investors, and the economy.

First, in order to fix the misaligned incentives at Fannie Mae and Freddie Mac, I recommend requiring mutual ownership of joint issuer-guarantor entities instead of stock ownership. One of the key reasons that Fannie and Freddie ended up in conservatorship is because private shareholders pushed for short-term gains and quarterly earnings. In the face of declining market share, because of private label securities competition, management weakened credit standards to compete for Alt-A business. This decision proved disastrous as Alt-A loans were 10 percent of loans in 2008 yet 50 percent of losses. Mutual ownership would reduce the chasing market share problem and promote longer-term sustainability. Lenders would need to join one or more mutuals to sell loans to the conforming secondary market and invest equity commensurate with the amount that they sell. The pooled capital from all members would stand in first-loss position ahead of any Government reinsurance.

Second, in order to give smaller lenders a level playing field, legislation should permit direct access to the secondary market through a cash window. Housing finance reform should not require smaller lenders to go through their larger competitors. If this happened, rural and underserved communities could face reduced access to credit.

Third, secondary market entities should be required to serve a national market and accept all eligible lenders. Allowing the market to fragment where one entity serves California, another serves the Southeast, and no one effectively serves a predominantly rural State would exacerbate regional economic downturns as well as leaving borrowers behind.

Fourth, while I am encouraged that S.1217 includes an explicit and paid-for Government guarantee, I recommend that this guarantee not be available for the kinds of private label securities that predominated during the subprime boom. These securities should be able to access a common securitization platform, but they do not provide enough systemwide benefits to warrant a Government guarantee and would make effective regulation impossible.

Fifth, a future system needs to be able to complete successful loan modifications by retaining a portfolio for distressed-then-modified loans with a Government backstop in times of economic stress.

Finally, legislation I believe should not hard-wire underwriting standards such as a 5-percent downpayment mandate. Some bor-



rower contribution should be required, but the amount and how compensating factors should be used should be left to the regulator, bond guarantors, and lenders. Enshrining in statute who can get a mortgage in a future system would be harmful, I believe, for three reasons:

First, it would dramatically reduce the number of families who could qualify for a mainstream loan. Younger families, African American, and Latino families are the future of our housing market, but they have lower levels of household wealth. Those with compensating factors who can afford the monthly payments on a loan should not be excluded. Many are better credit risks than borrowers with 5 percent to put down but who do not have these other factors.

Second, downpayment requirements harm the housing market by reducing the pool of available buyers. Excluding creditworthy families would harm existing homeowners and reduce their equity. Who will buy the house of an elderly couple needing to move to a continuing care facility?

Third, borrowers in well-underwritten, low-downpayment mortgages can succeed. CRL's affiliate, Self-Help, has purchased \$4.7 billion of mortgages made to low-wealth families in 48 States—50,000 loans. Two-thirds of these borrowers had mortgages with downpayments of less than 5 percent. These homeowners have had median annualized return on equity of 27 percent and built an average of \$18,000 in wealth as a result. This is even through the crisis. Good underwriting requires looking at a number of factors, and legislation should not push out borrowers on account of just one, be it downpayment or debt-to-income ratios or FICO scores.

In closing, if we learn what went wrong with Fannie Mae and Freddie Mac and fix those problems, and if we build on what has and is working, we can build a sturdy secondary market that will put private capital first in line, support the economy, and provide opportunities for all Americans.

Thank you for the opportunity to testify today, and I look forward to your questions.

Chairman JOHNSON. Thank you.

Mr. Gupta, you may proceed.

**STATEMENT OF ROHIT GUPTA, PRESIDENT, GENWORTH  
FINANCIAL, U.S. MORTGAGE INSURANCE**

Mr. GUPTA. Thank you, Chairman Johnson and Ranking Member Crapo. My name is Rohit Gupta, and I am the president of Genworth Financial's U.S. Mortgage Insurance business. We are headquartered out of Raleigh, North Carolina, and we operate in all 50 States. I appreciate the opportunity to be here today to talk about the issue of affordability and availability of credit for home buying and the role of private mortgage insurance to help with those issues.

At its core, our business is evaluating and managing mortgage credit risk on prudent and sustainable low-downpayment mortgages. We put our own capital at risk in a first-loss position on every loan we insure. Today home prices are the most affordable they have been in years, and interest rates remain at historical

lows. But mortgage credit is still very tight. That is why I am grateful that this Committee has convened this hearing.

Congress has done a great deal to make our housing finance system safer and more sustainable in recent years. The final qualified mortgage rule is a significant milestone and one that we and our partners in the Coalition for Sensible Housing Policy applaud. QMs are exactly the kind of mortgages that our system should encourage.

Now, I want to get right to the issue of downpayments since that is at the heart of current policy discussions.

The amount of downpayment matters, but low-downpayment loans did not cause the crisis, and they should not be a barrier to buying a home moving forward. It is our job as mortgage insurers to understand mortgage credit risk. In fact, MIs are often referred to as a second set of eyes in the mortgage system. That is because MIs use our own set of credit policy guidelines to evaluate a loan.

When I look at a loan, I want to see more than the downpayment. I want to see a stable employment record, a strong credit history, manageable debt ratios, a credible appraisal, and more. That is what responsible credit underwriting is all about.

As mortgage insurers, we make sure low-downpayment borrowers with sound credit get the best loans with the best terms. Our underwriting guidelines are sound but not overly restrictive. Today lender and investor overlays and fees mean that our credit guidelines are not being fully utilized.

As I am sure the Committee knows, the biggest hurdle for many homebuyers is the downpayment, especially for first-time homebuyers and borrowers with lower to moderate incomes. When you consider that it takes an average working family about 7 years to save for a 10-percent downpayment or that half of the first-time homebuyers who got GSE loans made downpayments of less than 20 percent or that nearly one-quarter of the mortgage market over the last 15 years was loans with low downpayments, that is nearly \$8 trillion in mortgages that have performed well through good cycles and bad. Only then can you appreciate how important it is for consumers and the U.S. economy to keep low-downpayment lending at a viable option in home buying.

In fact, I would guess that a majority of homeowners in this room today bought their first house with less than a 20-percent downpayment. MIs take first-loss risk, and we do it in a way that borrowers can afford and lenders can execute.

Turning to the question of housing finance reform, we are encouraged by the hard work being done by this Committee. We were pleased to see S.1217 includes private MI at today's standard coverage levels for low-downpayment loans. Standard coverage MI puts private capital at risk ahead of any Government exposure. We think that is essential in any reform effort. It provides meaningful amounts of credit loss protection, it is well understood by investors and lenders, and it does not introduce any new borrower costs in the housing finance equation.

If the GSEs only had lesser charter coverage and not deeper standard MI, MI companies would have been asked to pay less claims, and U.S. taxpayers would have had a much bigger burden to pay. Consider that mortgage insurers have paid nearly \$40 bil-

lion of claims to Fannie Mae and Freddie Mac through the cycle. That is a very significant amount of money that was taken off the shoulders of the GSEs, the Congress, and the taxpayers. The reason we could pay those claims is because we hold significant countercyclical capital and reserves against every loan we insure, and we are working closely with regulators and counterparties to make those requirements even stronger moving forward.

The Committee has also asked if we believe mortgage underwriting standards should be fixed in statute. We do think that broad underwriting standards could be written into statute. For us, the most important thing is a clear mandate for prudently underwritten low-downpayment loans as part of a reformed system. When thinking about statute versus regulation, we need to keep in mind that mortgage credit underwriting is dynamic. Too detailed of an approach could limit credit availability or make it hard to fine-tune underwriting in the future.

We also encourage the Committee to look beyond the traditional role that mortgage insurers have played in providing credit enhancement. For instance, there is no reason why our MI could not also substitute for bond guarantee coverage. The most important thing is that there be a level playing field that relies on well-regulated, well-capitalized, consistent credit enhancement.

In closing, I want to commend the Committee for tackling this complex and emotionally charged issue. Keeping the interests of consumers and taxpayers in the forefront will help you arrive at a stronger and more resilient housing finance system. I applaud the provisions for private MI at standard coverage levels in S.1217 look forward to working with the Committee as your important work continues.

That concludes my opening statement, and I look forward to answering any questions you might have.

Chairman JOHNSON. Thank you.

Mr. Thomas, you may proceed.

**STATEMENT OF GARY THOMAS, 2013 PRESIDENT, NATIONAL ASSOCIATION OF REALTORS**

Mr. THOMAS. Chairman Johnson and Ranking Member Crapo and Members of the Committee, on behalf of the 1 million members of the National Association of Realtors who practice in all areas of residential and commercial real estate, thank you for the opportunity to present our views on housing finance reform and the essentials of a functioning housing finance system for consumers. I am Gary Thomas, president of the National Association of Realtors, and I have more than 35 years of experience in the real estate business.

The recovery of the housing market has been instrumental in pulling the economy out of the Great Recession. In the past year, home prices have increased 11.7 percent. Home sales were 10.7 percent higher over the same period. While this is very welcome news, the market has not fully recovered, as evidenced by the fact that home sales are still stuck in the 2001 levels. Moreover, roughly 7.1 million homeowners are still underwater.

These sobering statistics remind us that the housing market remains far from healthy and is facing certain headwinds. Access to

mortgage credit continues to be tight as lenders remain leery of taking on risk as a result of new lending regulations that will go into effect early next year. Specifically, new ability-to-repay requirements along with uncertainty regarding the proposed risk retention rules have caused bankers to be apprehensive in issuing new loans.

The changing regulatory landscape compounded with growing student debt will limit consumers' access to credit and contribute to an already tight lending environment by imposing standards that are even more stringent. At the same time, rising interest rates combined with meager increases in household income will continue to squeeze the affordability of home ownership.

As Congress looks to reform our housing finance system, lawmakers must ensure the affordability and availability challenges faced by creditworthy borrowers are addressed, and realtors believe this can only be achieved through a secondary mortgage market upheld by an explicit Government guarantee.

Moreover, realtors agree taxpayers should be protected. Private capital must return to the housing finance market, and the size of the Government participation in the housing sector should be decreased if the market is to function properly.

With that being said, realtors believe it is extremely likely that any secondary mortgage market structure without a Government guarantee backing would foster mortgage products that are more aligned with business goals than the best interests of consumers. If the secondary mortgage market were to be fully privatized, we believe the greatest casualty would be the elimination of the 30-year fixed-rate mortgage, thus increasing the cost of mortgages to consumers. The 30-year fixed-rate mortgage is the bedrock of the U.S. housing finance system. Now more than ever, consumers are seeking fixed-rate 30-year loans because they are easily understood and offer a predictable payment schedule.

We applaud Senators Corker and Warner for introducing the Housing Finance Reform and Taxpayer Protection Act of 2013, which includes many of our suggested reform elements. The legislation provides for an explicit Government guarantee which should ensure the availability of the 30-year mortgage going forward.

We do, however, have some concerns about the legislation. The 5-percent downpayment requirement is problematic because it will preclude creditworthy borrowers who have an issue saving the required amount from buying a home they could otherwise afford. Rather than focusing on downpayments, we are generally supportive of CFPB's qualified mortgage rule and believe this standard should be used to define qualified residential mortgage in any future housing finance system. This underwriting approach achieves the twin objectives of protecting the marketplace while ensuring borrowers have access to safe mortgages.

NAR is also concerned with mandating a covered security to have a credit risk sharing structure under which private investors have to take at least a 10-percent first-loss position. Realtors are worried this arbitrary first-loss percentage will inhibit private investors from participating in the secondary mortgage market, especially during periods of economic distress.

Finally, NAR opposes lowering loan limits at this time, especially because it unfairly discriminates against consumers living in high-cost markets. Lowering the loan limits restricts the liquidity and makes mortgages more expensive for households nationwide.

The U.S. housing sector is in the midst of recovering from the worst economic downturn since the Great Depression. Any restructuring of the secondary mortgage market must make certain that mortgage capital is available in all markets at all times under all economic conditions. Furthermore, we look forward to working with the Committee to ensure that the future reform of the secondary mortgage market will protect and preserve the American dream of home ownership for all responsible, hard-working taxpayers.

Thank you.

Chairman JOHNSON. Thank you.

Mr. Platt, you may proceed.

**STATEMENT OF LAURENCE E. PLATT, PARTNER, K&L GATES  
LLP**

Mr. PLATT. Good morning, Chairman Johnson, Ranking Member Crapo, and Members of the Banking Committee. My name is Larry Platt. I am a consumer finance lawyer at the global law firm of K&L Gates LLP. Thank you for allowing me to participate today. I am appearing today in my personal capacity and not on behalf of either my law firm or any of the clients of my law firm.

I want to focus on whether S.1217 should impose outcome-based loss mitigation requirements on servicers and owners of securitized residential mortgage loans. By way of background, mortgage loan servicers are independent contractors. They work for the owners of the loans and the securities for a fee to collect and remit mortgage loan payments and enforce the loan documents.

S.1217 presently does not impose outcome-based loss mitigation requirements on servicers for the benefit of consumers, in connection with either the Federal Mortgage Insurance Company or any uniform securitization agreement that may be created. I think that is the right approach.

Earlier this year, the Consumer Financial Protection Bureau issued comprehensive loan-servicing regulations that take effect this January and that I believe are sufficient for this purpose. Some of the new regulations implement the provisions of the Dodd-Frank Act; others, though, are derived from earlier initiatives from the Government, such as the 2009 HAMP program of the Department of Treasury and the April 2012 global foreclosure settlement involving the Department of Justice, 49 State Attorneys General, and 5 major banks.

The result is that defaulting borrowers already have significant Federal Government protections to seek to avoid foreclosure, including in some cases a Federal private right of action to sue to stop a foreclosure.

The CFPB regs comprehensively address, in my opinion, virtually all of the common servicing complaints of consumers and regulators that lead to claims of wrongful or unfair foreclosures. For example, they impose detailed requirements for responding to customer complaints and resolving alleged servicing errors. They impose early intervention requirements on servicers to attempt to

establish live contact with borrowers shortly after delinquency. They require servicers to maintain a continuity of contact with delinquent borrowers to provide access to personnel. They require servicers to follow detailed procedural requirements to evaluate borrowers for available loss mitigation options, such as notifying borrowers if their applications are incomplete; promptly evaluating them for their eligibility for a modification; timely notifying them of the modification decision, including any rights to appeal; and prohibiting servicers from initiating foreclosures within a time-frame after delinquency or from initiating a final foreclosure while loss mitigation discussions are continuing.

But despite these broad protections, the CFPB made a deliberate decision not to require servicers to offer or to require loan holders to accept specific forms of loss mitigation at all or on any specific terms. Many consumer advocacy groups questioned this approach. They asked in notice and comment for the CFPB to require servicers and loan holders to provide loan modifications that pass a positive net present value test to qualified borrowers. The CFPB rejected this approach. It acknowledged in the preamble of the final regs that those who take the credit risk on a mortgage loan do so in part in reliance on the security interests and the collateral. The CFPB wrote that it did not believe it presently could develop rules that are sufficiently calibrated to protect the interests of all parties involved in the loss mitigation process given their differing perspectives. And it expressed concern that overreaching loss mitigation requirements could have a material adverse effect on the availability and the cost of credit if creditors in the secondary market would no longer be able to establish their own criteria for determining when to offer loss mitigation to a defaulting borrower.

Similarly, the recent final risk retention regulations abandoned the original 2011 proposal that would have tied the availability of the qualified residential mortgage exemption to requiring the servicer in the underlying mortgage loan documents to provide loan modifications regardless of the wishes of the loan holder.

I think the robust requirements of the CFPB regulations, which go live in a little over 2 months, are sufficient. They came out following substantial input of virtually all interested stakeholders. I think S.1217 should follow the lead of the CFPB and not impose additional loss mitigation requirements that are outcome-based for consumers in default.

Thank you for the opportunity to appear today. I look forward to questions.

Chairman JOHNSON. Thank you.

Ms. Cohen, please proceed.

**STATEMENT OF ALYS COHEN, STAFF ATTORNEY, NATIONAL  
CONSUMER LAW CENTER**

Ms. COHEN. Good morning, Chairman Johnson, Ranking Member Crapo, and Members of the Committee. Thank you for the opportunity to testify today on the key components of housing finance reform for consumers.

Congress and the Nation face an important crossroads in the life of the housing finance system. While the housing market has im-

proved somewhat from the height of the crisis, more needs to be done to restore a functioning and fair housing market.

Communities without access to affordable credit become vacuums that can be filled by predatory lenders. When sustainable loans are unavailable, borrowers are susceptible to tricks and traps because they have no other options.

In addition to properly funding the National Housing Trust Fund and the Capital Magnet Funds, the new system should promote broad access to lending by inhibiting credit rationing and “cream-ing” of the market. Lenders should be required to serve all population segments, housing types, and geographical locations.

Yet any statute should not dictate specifics of underwriting that would result in less flexibility to meet these broad access goals. Housing finance legislation should leave open the specifics of downpayment requirements, credit scores and debt-to-income ratios. Downpayment requirements are keyed directly to wealth, which itself varies widely by demographics and is not always tied to creditworthiness or ability to repay.

Debt-to-income ratios also are an incomplete measure of lending capacity. Credit scores often do not provide a reliable picture of a borrower’s credit profile and often differ substantially by race.

Housing finance reform also should support a healthy mortgage-servicing system. Foreclosure rates are still higher than at the onset of the economic collapse in 2008. Servicer incentives currently result in inflated fees and unnecessary foreclosures. Despite the creation of several programs and the recent adoption of procedural regulations by the CFPB, specific additional measures are needed.

First, the new housing finance system must require affordable loan modifications that are consistent with investor interests. The CFPB, while it has issued a series of procedural requirements for servicers, has declined to issue such a mandate. Yet the data show that almost all delinquent homeowners still get no modification at all. Those homeowners lucky enough to receive a modification seldom get one with the best terms available. A clear, specific mandate can be crafted that provides the market the flexibility and predictability that it needs.

Second, homeowners seeking loan modifications should not be faced with an ongoing foreclosure while they are processing their loan modification request. Doing so raises costs and results in wrongful foreclosures. Instead, such foreclosures should be put on temporary hold rather than subjecting the homeowner to the dual track of foreclosure and loss mitigation. Substantial flaws in existing requirements must be addressed, and the GSE system should continue its role as a leader in market developments.

Third, the new housing finance corporation should be authorized to directly purchase insurance, including force-placed insurance. The current system, in which the GSEs reimburse servicers for force-placed hazard and flood insurance, has resulted in vastly inflated prices for borrowers and, when borrowers default, the GSEs and taxpayers.

The new housing finance system also should promote transparency and accountability. An Office of the Homeowner Advocate should be established to assist with consumer complaints and com-

pliance matters. Loan-level data collection and reporting should include demographic and geographic information to ensure that civil rights are protected.

Finally, any new Federal electronic registry for housing finance must be available to the public, mandatory, with sanctions for non-compliance, and supplemental to State requirements. A national registry should include records of servicing rights, ownership of mortgages and deeds of trust, as well as ownership of the promissory notes themselves.

There has been much discussion about electronic mortgages, instruments entirely created and stored electronically. Electronic instruments must be permitted only when there is sufficient security to ensure authenticity. The records must actually be signed only by the homeowners, and the records must be maintained in such a way to ensure that the terms cannot be changed.

Thank you for the opportunity to testify today. The Nation's housing finance system is in need of a revived sense of public purpose. Loan origination and servicing mechanisms should ensure broad and sustainable access to credit throughout the life of the loan. I will be happy to take any questions you may have.

Chairman JOHNSON. Thank you.

Mr. Diaz, please proceed.

**STATEMENT OF LAUTARO LOT DIAZ, VICE PRESIDENT, HOUSING AND COMMUNITY DEVELOPMENT, NATIONAL COUNCIL OF LA RAZA**

Mr. DIAZ. Chairman Johnson, Ranking Member Crapo, and distinguished Members of the Committee, thank you for inviting me to appear this morning on behalf of the National Council of La Raza, the largest national Hispanic civil rights and advocacy organization. I am Vice President for Housing and Community Development and have worked for years in the community development field with programs to serve low- and moderate-income families. I appreciate the opportunity to provide expert testimony before the Committee.

For more than two decades, NCLR has engaged in public policy issues such as preserving and strengthening the Community Reinvestment Act and the Home Ownership Equity Protection Act. Also, for the last 13 years, we have supported local housing counseling agencies through NCLR's Homeownership Network, which is comprised of 49 community-based counseling providers that work with over 50,000 families annually and that has nurtured more than 30,000 homebuyers since its inception. Following the financial crisis, the NHN responded to the Latino community's needs by shifting its focus to helping families stay in their homes.

My testimony today will focus on pre- and post-purchase counseling and the ways counseling assists the mortgage industry provide credit access to hard-to-serve markets. It also supports loss mitigation of individual mortgages by ensuring borrowers' readiness and ensuring they understand the process involved with mortgage delinquency. I will conclude my remarks with an observation of the necessity of preserving access to affordable housing finance options.



Pre-purchase counseling, which helps families purchase a home, and post-purchase counseling, which assists after a family has closed on their mortgage or in the event of a mortgage delinquency, are the types of housing counseling most relevant to GSE reform legislation being considered.

A counselor providing pre-purchase counseling does five important things: it educates the borrower on all aspects of the homebuying process; it analyzes the client's credit, savings, and family budget to help them understand what they can afford; it ensures that obligations and essential practices are understood; it assists the family in understanding the documents they are signing; and, finally, it provides community resources to address issues that could impact the long-term ability for them to manage their mortgage loan. These five steps help ensure prudent decision making by the client because they are fully aware of the obligations they are undertaking. Loan performance is demonstrably greater when a family obtains a loan with this kind of support.

How pre-purchase counseling supports credit access can be seen in an example of an Ohio family who had filed bankruptcy at the height of the economic downturn. The family, however, still aspired to become homeowners despite their personal turmoil. The NHN counselor advised them to enroll in a homebuyer education class to start the process, and after completing an action plan developed with the housing counselor, the family successfully qualified for a VA loan and purchased a home.

In instances when a client is confronting mortgage delinquency, they are better served with a counselor than facing the challenge alone. A situation of a Miami family illustrates this point. The family received a trial mortgage modification while working with an NHN counseling organization. The family had continued to make their payments on the trial modification on a timely basis but was unaware that the bank still continued the foreclosure proceedings. The property was sold, prompting the housing counselor to involve legal aid to try to reverse the sale. A judge ruled in the client's favor, but without the support of the counseling agency, the client would have lost their home.

In addition to this anecdotal evidence I have provided, there is considerable research demonstrating the extent that housing counseling works. One 2013 pre-purchase counseling study by NeighborWorks found that borrowers with pre-purchase counseling and education were one-third less likely to be over 90 days delinquent on their mortgage than those who did not. And a 2012 NeighborWorks report to Congress showed that homeowners who received counseling were nearly twice as likely to obtain a mortgage modification than those who did not receive counseling.

NCLR believes counseling is an important part of the mortgage system to ensure access to credit to all communities, as well as to support safeness and soundness in the system. Without an obligation to serve all markets, communities of color in particular will find it extremely difficult to access mortgage credit. Without a duty to serve, private capital will gravitate to the cream of the crop, those with traditional borrowing profiles. This will result in an unsustainable housing finance market where creditworthy but lower-wealth and lower-income buyers, especially minorities, will

be underserved. This is already evident today; the private market overwhelmingly caters to the traditional borrowers in well-served locations.

More information on preserving access and affordability as well as NCLR's specific recommendations can be found in my written comments. Thank you again for the opportunity to appear before this Committee. I would be glad to answer any additional questions you may have.

Chairman JOHNSON. Thank you all for your testimony.

As we begin questions, I will ask the clerk to put 5 minutes on the clock for each Member.

Mr. Thomas, we have heard that consumers face tight credit conditions today. If new legislation includes stricter underwriting, such as a minimum downpayment, what impact would that have on home borrowers and the housing market?

Mr. THOMAS. Well, it would be very restrictive. We feel that it would impede the first-time homebuyer and the underserved. The problem that we are facing with a tighter credit box is that you are really shutting out the first-time homebuyers. When you do that, that then has implications on the move-up market. It will stall the market completely and could reverse all of the trends that we have had so far. So if we make it more and more difficult by having an exact downpayment and make it more difficult for them, it is going to be much more problematic.

You know, the 5-percent downpayment is not just 5 percent. If you add closing costs on top of that, you are getting closer to 6 to 7 percent. And so you have to take that into consideration. Downpayment is not always the most predictive analytic of whether a borrower is going to be able to repay. Just take a look at the VA loan and how well they have performed over the years with no downpayment. So I think you have to look at the underwriting criteria to make sure that the borrower can afford to make the payments and has the ability to repay rather than just downpayment.

Chairman JOHNSON. Mr. Stein, Self-Help has been successful in underwriting and servicing home loans to borrowers with low credit scores and low downpayments. What factors are most relevant to a borrower staying current on a home loan? How could the structure of housing finance be improved to better serve consumers?

Mr. STEIN. Thank you, Chairman Johnson. Self-Help's program that I mentioned, where we purchased \$5 billion worth of mortgages, you are correct had lower downpayments, and our loss rate has been approximately 3 percent, so they have performed well through a very tough time. But average income of the borrowers was around \$31,000, so it is not the wealthy who received these loans.

Why these loans performed well is not rocket science. They are all retail originated by lenders, fully documented income and assets, 30-year fixed-rate loans, amortizing, escrowed taxes and insurance, fully prepayable, low fees—basically meet all the Wall Street Reform Act requirements and QM requirements where there is full underwriting to make sure that the individual's credit issues and incomes are sufficient to repay the mortgage and use compensating factors where one is weak, others are stronger.

In terms of structural features for the mortgage market, we believe that a joint issuer-guarantor model for pass-through TBA securities is the way to go. That is how our mortgages were securitized, through pass-through securities. Second, private capital in first-loss position as ours was—we were taking the risk—is important. Third, providing small lenders direct access to the secondary market through a cash window is important. Fourth, national coverage by accepting all eligible lenders; we purchased loans in 48 States. Many of them were going through a tough time, but we think it should be a national market. And, finally, a portfolio for modified loans, it was much easier for us and I think any lender if the loan is on Fannie Mae's balance sheet when it comes time to do a modification that is still net present value positive.

Chairman JOHNSON. Mr. Diaz and Ms. Cohen, consumers who experience problems in loan repayment may turn to their servicers for help. How does counseling help consumers if this happens? And do you think that existing servicing standards do enough to fix the servicing issues we saw during this crisis?

Mr. DIAZ. I will take that. Relationship with servicers during the crisis changed as time went on. Initially counselors were seen as unnecessary players because they were in between the servicer and the consumer. As servicers had difficulty in collecting documents, underwriting the family, and reaching the family, counseling organizations played a more critical role. Servicers incorporated them into many of their processes, so the relationship improved over time.

The essential problem—initially the volume of troubled mortgages—the difficulty in trying to orient the modification program a servicer had, and the consumer's ability to understand it was really, really tough. The counselors, when they were used in the best way, really closed that gap and brought the consumer up to the program's understanding of it. The servicer and the consumer could then finish the process they were engaged in.

So it is almost like translating language and being able to advocate for the consumers. If a paper got lost, which was common, if there was a misinterpretation of income, which was common, there was another player who knew the process that was able to advocate and speak the language of a servicer to allow the modification to go through.

So I think counselors played a really critical role, and I also believe the CFPB servicing standards are definitely an improvement. But, counselors still have this ability of being able to communicate with the servicer. And while we do not know the shape of the new market, my experience over the years has been that the market has never worked as designed. And so another advocacy point for the consumer I think is a really critical element to housing finance reform.

Chairman JOHNSON. Ms. Cohen, do you have any follow-up?

Ms. COHEN. My follow-up would be on the second part of your question about whether the standards are adequate. Before the Treasury's Home Affordable Modification Program was launched, most loan modifications increased payments and were very hard for homeowners to satisfy. And right now, although we have that tem-

porary program, we have absolutely no permanent standards for what modifications should look like throughout the market.

The cure rates are still very low, and it is clear that many people who need modifications are not getting them. So there are two things that have not yet been done that need to be done: one, modifications need to be assured to be affordable for homeowners; and, second, if they are consistent with investor interests, they should be required by the servicers because servicers tend to make money even if they do not and sometimes because they do not provide those modifications to homeowners, especially in a timely fashion.

It is not going to change the costs in the market significantly because NPV positive loan modifications are good for all of the relevant stakeholders. They can be done in a predictable fashion and still provide control for the servicer and the investor over some of the details of how the modifications are done. And the CFPB situation is different because their rules are, A, procedural; and, B, in the context of a very particular statute, the GSEs have the ability to issue guides and to oversee what the loan modification process looks like. It is what they do now, and we hope it is what you will do in the statute.

Thank you.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman.

Mr. Gupta, as we are looking at housing finance reform, one thing that we need to accomplish if we are to consider a taxpayer guarantee is to ensure that adequate private capital exists in all phases of the mortgage process. And this private capital must include a mix of borrower equity, private insurance and investment, and adequate Government reserves.

How important do you consider the borrower equity to be in this context?

Mr. GUPTA. Thank you, Senator Crapo. Borrower equity is very important. We obviously are in the business of low-downpayment lending so we take into account every single factor. But low-downpayment loans are not the reasons for this downturn, and they should not be actually held back as we come out of this downturn and actually create the new housing reform.

We look at the loan, we look at the three factors, which is credit, capacity, and collateral. So instead of just looking at a downpayment, we would look across the file and see that the borrower is a ripe borrower, not only can they get into the home but they can stay in the home long term.

Now, turning to Corker-Warner, S.1217, we really applaud the usage of mortgage insurance, deep mortgage insurance in that bill. And when we think about the standard coverage, the way it works is if a borrower comes in and puts 5-percent equity down, the mortgage insurance company puts additional coverage, that basically creates a remote coverage for the investor. So the investor is almost covered to 65 percent loan-to-value. So the home will actually have to really incur a loss of more than 25 percent for the investor to take a loss, which actually removes the burden from the taxpayers and could also reduce the amount of bond insurance and bond guarantees needed.

Senator CRAPO. All right. Thank you. You answered the next question I was going to ask about the role of mortgage insurance, so let me turn to you, Mr. Platt. Some people have argued that some more proscriptive servicing rules are necessary because servicers have an economic incentive to pursue foreclosures rather than loan modifications, even though in some instances the modifications might be economically more advisable.

Do you think that accurately describes the servicer's economic incentives?

Mr. PLATT. Thank you for your question. I do not agree with that assessment. I think servicers want to do the right thing. If they have the authority to modify and it makes sense to do so, they are willing. I do not believe that it is in their economic incentive to foreclose. I do not think that they have some nefarious plan to put money in their pockets at the expense of the borrower, and so I just completely disagree with that.

Senator CRAPO. We have heard some proposals that would restrict the ability of servicers to collect collateral in the event that a borrower defaults. Can you discuss how such restrictions would impact the cost of taking out a mortgage for the average borrower?

Mr. PLATT. Mortgage loans by definition are secured by a mortgage on the house. Unsecured loans have interest rates in the high teens; secured loans have interest rates 3 to 5 percent in large measure, but not exclusively, because of the value and the availability of the collateral.

If we reach a position where it is virtually impossible or practically infeasible to realize on the collateral of the home, as horrible as that could be for the individuals involved, I think what we essentially have done is invalidate secured loans as a method of offering consumer credit here. I think the natural consequence of that will be materially higher interest rates and lesser availability of credit.

Senator CRAPO. All right. Thank you. And one last question, Mr. Platt. Since 2010, a number of changes in servicing rules and practices have resulted from the National Mortgage Settlement, the interagency consent orders, the FHA Servicing Alignment Initiative, and then most recently the mortgage servicing rules from the CFPB. Can you discuss how these developments have impacted mortgage servicing practices, and especially—I assume that they have improved, but have they improved mortgage servicing practices?

Mr. PLATT. Well, first, the new regulations will not go into effect until January, and those are the first that will have common applicability across the entire industry. I do believe that both the 2011 consent orders with the Federal banking agencies and 14 banks as well as the global foreclosure settlement with the five major banks set a template for the way in which servicing will be done prospectively and really form the foundation in part for the CFPB regulations.

It is a slow process trying to implement those regulations. They focus on various things. So, for example, the OCC consent orders focus a lot on systems and personnel, whereas the global foreclosure settlements were much more micro and detailed, dictating

the way in which modifications and default servicing should be handled.

The CFPB decided to take, as has already been mentioned, an approach based more on process, that it decided that it should not dictate what an owner should be required to do if a borrower were to default. But it could dictate that borrowers are treated fairly, that they are made aware of the options that may be available to them, and that they are given prompt and effective notice and access to personnel. And I think that is going to have a lasting impact on the quality of servicing.

Senator CRAPO. Thank you.

Chairman JOHNSON. Senator Brown.

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

I was intrigued listening to Mr. Platt's testimony. Thank you. I appreciate the minority witness praising the CFPB for its work. Thank you for that.

Ms. Cohen, you say in your testimony that, "Getting mortgage servicing right must be a core piece of housing finance reform."

In 2011, Congressman Miller from Senator Hagan's State and I introduced legislation to address many of the problems in mortgage servicing. Since then, as Mr. Platt pointed out, several regulators and enforcement agencies have taken steps to correct some of the systemic deficiencies in the servicing industry, including the CFPB. But what we know the CFPB standards do not do is extending the Fair Debt Collection Practices Act to mortgage servicers, requiring loan modifications when they are beneficial to investors, prohibiting the so-called dual-track problem for mortgages, and the CFPB recently released the supervisory report over the summer that found systemic problems transferring accounts between servicers processing payments and engaging in loss mitigation.

Your testimony was pretty clear about the problems with mortgage servicing, that those problems are not behind us. Should some of these ideas and expanding the powers of the CFPB be part of this GSE reform legislation?

Ms. COHEN. Thank you for the question, Senator Brown. We do hope that some additional servicing measures will be part of the new legislation.

On the overall question about why it is important to have servicing in a bill that is about origination of loans, people do not just get loans and then go away. They keep those loans for long periods of time, and during those times they often face hardship—medical problems, divorce, unemployment. They also may have other financial changes in their situation, and so it is essential that once you are in a loan, you can maintain that loan, especially when the taxpayer and the Government are picking up the bill if you cannot stay in your loan. So if it is good for the Government, good for the investors, and good for the homeowner, that needs to be a big part of the picture.

In terms of your bill, there are definitely parts of your bill that have not been addressed by the CFPB, and they are key aspects of how homeowners will be able to stay in their homes, and with only procedural protections it is not clear that that will happen.

Senator BROWN. Thank you.

Mr. Thomas, welcome back. Thank you for your insight, which I think helped to have an impact 2 or 3 weeks ago when you were in front of this Committee, the impact to your members with the absolutely unnecessary Government shutdown.

Last week, I spoke with a number of your members, the Columbus Board of Realtors. About a hundred of them were there just to discuss some of these issues. The issue of short sales came up repeatedly. There is still concern about the lack of communications with servicers when they attempt to complete short sales. As you know, I have worked with Senator Murkowski on legislation to address this issue; Senator Reed from Rhode Island and Senator Menendez have also cosponsored.

The FHFA has taken steps toward implementing our bill, but more needs to be done for non-GSE mortgages, even though newly issued mortgages are very few private label bills—private label secondary market, but with the old mortgages, and those are ones that your members talked about last week.

Should we include these efforts, some of the language from the bill with Senator Murkowski, in the GSE reform package on short sales?

Mr. THOMAS. Well, short sales are obviously problematic. First of all, the name is incorrect. It is not “short.”

Senator BROWN. Long, yes.

[Laughter.]

Mr. THOMAS. So that is not a bad idea because it is problematic. The short sale process is fraught with difficulty. You know, having dealt with them myself, I know that you start down a path; very often they switch the person that is dealing with the short sale. You then have to deal with if there are secondary financing besides. You have to get those in line. You get an approval from one side. Then the other side drags their feet. You finally get the approval from the secondary, and then you have got to go back and get reapproval from the first. It is a can of worms. And so trying to get any kind of regulation around that, I would applaud that.

Senator BROWN. So the 60- to 90-day—the regulation, the new regulation for GSEs has been helpful—

Mr. THOMAS. Absolutely.

Senator BROWN. —but the problem is still persisting with older mortgages.

Mr. THOMAS. With the other mortgages it is still persistent, but with the GSEs, it has vastly improved it. It is much easier.

Senator BROWN. But the frustration levels were pretty palpable. I mean, to listen to realtors that do not get callbacks, I mean they so often cannot even find the right people to talk to let alone see buyers and sellers walk away—particularly buyers walk away from this process after 2 or 3 or 4 or 5 months.

Mr. THOMAS. That is correct. That is the problem. You hit the nail right on the head. Like I said, you can start off with one point of contact, and that can change three or four times during the process. And when that changes, it is almost like starting all over again.

Senator BROWN. Thank you, sir.

Chairman JOHNSON. Senator Tester.

Senator TESTER. Well, thank you, Mr. Chairman, and I want to thank you for holding this hearing and thank the folks who testified today. And I also want to thank the commitment from you, Mr. Chairman, and the Ranking Member to hold multiple hearings every week through Thanksgiving. I think that is a real commitment to getting something done and marked up before the end of the year and getting into the nitty-gritty specifics of what a housing finance system should look like. And so I very much appreciate that.

I am going to really focus my questions on the role of community-based institutions. I am going to start with you, Mr. Thomas, if I might. You represent an association, have worked with your members, been in the business for 30 years. As you said, you undoubtedly work with lenders of all sizes or have worked with lenders of all sizes. Could you discuss the important role that community-based institutions play in facilitating strong competition in mortgage markets and the impact that competition has on the consumer experience both in terms of service and in terms of cost?

Mr. THOMAS. Well, it absolutely does, and especially in rural communities. Rural communities depend on community-based banks, and so you have to have that in the mix.

The problem that we are getting to with such a tight credit box and the way we are—the path we are going down is that you are only going to be left with large major lenders, and that is a problem because that is going to dictate exactly what the consumer pays, how they pay it, and they are going to be very restrictive on who they loan to. You know, we have young people coming out of college with high student loans. We are going to have a problem getting them into the marketplace along with, if you look at the HMDA data for the last year, 51 percent of the African American borrowers were declined loans last year. So we are getting into a position where only the best can get loans, and that is a big problem for all of us in sustaining a mortgage process that, you know, promotes home ownership throughout the country.

Senator TESTER. Well, thank you. This is a question to any of the panel members who would like to respond, and I think as you folks know, the ability of smaller institutions, community-based institutions, to provide their customers with competitive pricing and product offerings I think relies significantly on their ability to access the secondary market, much more than their larger competitors.

Could any of you who wish highlight the importance of equal access both in fair pricing in the secondary market and facilitating vibrant and competitive mortgage markets? Go ahead, Mr. Stein.

Mr. STEIN. Thank you, Senator Tester. We do agree fully that having small lenders with direct access is very important. It is hard to create—if there are not lenders to serve a particular area, it is hard really to do much about that. But if there are lenders willing to make those loans, then it is very important that the secondary market be designed so that they have an outlet. And giving them direct access to a cash window so they do not have to go through their larger competitors and sell their servicing and potentially have their best customers poached is important. We think that that also says having the issuer and guarantor joined together for one-stop shopping for smaller lenders would be preferable. And



having a national mandate on those issuer-guarantors so that no part of the country is left behind, so that all eligible lenders would be able to join and participate, would also be important.

Senator TESTER. Anybody else like to comment on that? Yes, sir.

Mr. GUPTA. Senator Tester, I would add to this perspective. I think it is very important for community banks, credit unions, and smaller institutions to actually have access to credit across the board, and this is one place where private mortgage insurance companies in the current system and in the proposed system would actually facilitate availability of credit for low-downpayment loans in those markets. In the absence of an instrument like private mortgage insurance, that credit might not be available because the cost of capital market alternatives might not be predictable in the new finance system. So this is something where PMI, private mortgage insurance, can facilitate low-downpayment loans very actively, and that is a proven system.

Senator TESTER. Yes, OK. Would you agree that the current housing finance model really does not provide equal access because of the pricing due to volume?

Mr. GUPTA. There are certain disparities in the current housing finance system in terms of pricing. However, if you look at the number of lenders who originate high LTV loans or low-downpayment loans, there is broad access to low-downpayment loans across the board.

Senator TESTER. OK. Ms. Cohen, a couple questions for you. I want to talk a little bit about the role of community-based institutions and servicing and how critical it is to get these institutions to be able to continue to service mortgages and not be forced to relinquish their servicing rights. Can you just speak specifically about the quality of servicing when you compare community-based institutions to those of the large servicers? Is there a difference? And if so, what is that difference?

Ms. COHEN. We speak to attorneys and other advocates around the country daily who represent primarily low-income consumers seeking loan modifications, and I personally get calls weekly. And in our experience, the largest servicers have the most difficult time addressing the needs of people in a timely and comprehensive way. Local institutions that have relationships with people in the community do do a better job. Sometimes they face challenges as well. You can set up a system in which they are able to have some input into how they structure their NPV analysis or other things. However, the basic things about communication still need to be done by mail and other methods like that because in general it is not going to be a face-to-face thing. But it is in our experience that the biggest problems are the biggest servicers.

Senator TESTER. Well, thank you for that, and I want to once again thank you all for your testimony. I very much appreciate it. It is very helpful.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Hagan.

Senator HAGAN. Thank you, Mr. Chairman and Ranking Member Crapo. Thanks for holding this hearing today.

Mr. Stein, I wanted to start with you for a question, and thanks for being here, and I really do appreciate the tremendous work that

the Center for Responsible Lending does, and Self-Help, to serve the people in North Carolina and around the country.

In your testimony, you highlighted that since the financial crisis, the average borrower that was denied a GSE loan had a FICO score of 734 and was willing to put 19 percent down, and that the housing finance system should not push lower-wealth families and communities to FHA or high-cost products.

If the GSEs and FHA are not the right way forward, what is? And would you agree that a reformed housing finance system that provides an explicit and paid-for Government guarantee protects taxpayers with private capital and explicitly supports affordable housing? Could that possibly be the right path? If you could expand on that.

Mr. STEIN. Thank you, Senator Hagan. I fully agree with all the last three points that you made, that whatever we do we need the explicit, fully paid-for Government guarantee, and private capital to come first. I fully agree with that, and it is true that the credit box for the GSEs I believe is too tight. A number of panelists have mentioned it, that there are people who can pay a mortgage, but they are having difficulty getting one because of one factor or another.

I think what that means for the future, as I mentioned before, not to be repetitive, but we should not hard-wire individual underwriting criteria in the legislation, because if someone is weak on one point but strong on the others, they are actually a better risk than someone who is strong on whatever that point is that you pull, which could be downpayment, but weaker on the others. So that would be the first point.

I think making sure that the new system is in all markets at all times, Mr. Thomas mentioned that. It needs to be a national system, and I think that means it cannot be a fragmented system. If you have national entities that are issuer and guarantor together and they are required to accept every eligible lender, they have minimum qualifications for lenders, but that way no part—western North Carolina for example—will not get left behind in that situation.

Direct access to a cash window as opposed to having to go through larger competitors, and we think that having a mutual is an effective way to keep prices down as well.

Senator HAGAN. Thank you.

Mr. Gupta, I know that over the last 5 years the mortgage insurance industry has paid claims to cover losses, and we have discussed this recently. How much has the industry paid in claims? And can you put that in a financial perspective?

Mr. GUPTA. Absolutely. Thank you, Senator Hagan.

So as I mentioned earlier, mortgage insurance industry through this cycle worked exactly the way it was supposed to work. Our industry is based on a regime where we actually accumulate capital in good times and then use that capital in bad times to pay claims. So prior to this cycle, we actually accumulated a lot of capital by keeping 50 cents of every dollar of premium that we received in a reserve. Through this cycle, we served our role and we paid all those claims.

So in financial terms, we paid close to \$45 billion of claims out of which \$40 billion were paid to Fannie Mae and Freddie Mac—

Senator HAGAN. Over what period of time?

Mr. GUPTA. This is through the cycle, from 2008 through 2013, second quarter. So \$40 billion of claims paid against Fannie Mae and Freddie Mac, thus taking the burden off from the GSEs, the taxpayers, and the Congress. And moving forward, the industry continues to serve its purpose in terms of writing new business, because in the last 5 years the industry is close to underwriting and insuring half a trillion of mortgages within the last 5 years, since 2009 to 2013.

Senator HAGAN. And can you expand a little bit more on the capital position of the industry today?

Mr. GUPTA. Absolutely. So as I said, the industry has served its role and worked exactly the way the industry was intended to work. As the industry goes through a bad cycle, the industry uses its loss reserves—or its reserves to pay its losses, and that is what we did. You would expect a mortgage insurance company to actually deplete its reserves as it is going through the cycle, and as we exit the cycle, we start replenishing our reserves. And if you look at the cycle, MI industry has raised \$9 billion of additional capital out of which \$2 billion of capital was raised within the last 12 months. And the industry continues to have extra capacity on the sidelines, so if needed, we can raise additional capital from either capital markets or from reinsurance markets.

Senator HAGAN. From this most recent recession, have you changed that model in any way?

Mr. GUPTA. I think there have been learnings from this most recent cycle for all industry players. We are working on a stronger capital regime with all the regulators together. We are talking to the FHFA, the GSEs; we are talking to the Federal bank regulators; and we are talking to the National Association of Insurance Commissioners to work on industry capital standards that will make the industry more solvent and stronger coming out of the cycle.

The second learning that we are also trying to incorporate is make that capital risk based, so when a market participant takes on more risk, then they are basically taking that with the capital set-aside for that risk.

Senator HAGAN. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman.

As you all know, in 2012 the four biggest banks originated more than half of all the mortgages in the country. So I am concerned that if we open up the secondary mortgage market to private capital but impose no meaningful requirements to protect smaller lenders, then the primary market dominance of the four biggest banks may lead to their dominance in the secondary market. And in turn, their dominance in the secondary market may help them become even more dominant in the primary market and allow them to further crowd out the small lenders.

So I am worried about this. I know many of my colleagues are worried about this. So what I wanted to start with is, Mr. Stein, do you think that consolidation is a serious risk? And if there is

more consolidation, what do you think will be its impact on access and affordability, particularly with lower-income borrowers and rural borrowers?

Mr. STEIN. Thank you, Senator Warren. I do think it is an issue. I think that it is fine for lenders to pick their business strategies and decide where they are going to lend to. But there are smaller lenders who are making loans in rural communities and underserved communities, and it is important to promote that and provide an outlet for those loans. So I think having a diversified primary market competition is the most important thing to make sure of, so I agree with your premise.

Senator WARREN. You mentioned in your testimony that you and your organization support more mutuals as a replacement for Fannie and Freddie and that they would be responsible for issuing and guaranteeing more mortgages. Could you explain exactly how it is that mutual would make sure that there was adequate market access?

Mr. STEIN. Sure. We would turn Fannie Mae and Freddie Mac into mutuals that would be owned by the lenders that sell to them, just like the Federal Home Loan Bank system is; you have to put capital in before you can get capital out. And we think that would provide a seat at the table for smaller lenders in decision making to make sure their interests are considered. Large lenders are always going to have more influence, but this would provide smaller lenders with more influence, and we would require equal pricing. We think that that would do two things for access and affordability.

First, it would align incentives since equity is at risk, so that the entity is less likely to go crazy in terms of buying Alt-A mortgages, for example, and they can be more careful. But on the other hand, lenders want to sell loans and earn origination fees, so there is going to be an offsetting focus on the credit box. We think that both sides of that would be covered. You need to get a good credit box to serve people.

And, second, we do believe it would keep rates down for consumers. We primarily want competition at the primary market level. At the secondary market level, it is going to be an economies of scale business. There is not going to be a million of these entities, most likely, and understock ownership, the mission is to create value for shareholders. And so to the extent it is possible, there is going to be some oligopolistic behavior. With a mutual, members are not just trying to make money from the equity that they have invested. They are trying to provide a low-cost funding mechanism that earns them origination fees. So there is a countervailing pressure to keep prices down, and mutuals do tend to require a lower return on equity, which would translate to lower prices for borrowers.

Senator WARREN. Good. Thank you very much. I think it is critically important, as we think about the housing finance structure, that we focus on the access question and make certain that there is access all across the country and across different income levels for potential home borrowers. Thank you.

I want to ask about another question, too, and that is, Fannie and Freddie's charters require them to promote access to mortgage

credit throughout the Nation, including central cities, rural areas, and underserved areas. The broad duty to serve the entire market plays a critical role in making sure mortgages are affordable and available in all parts of the country. And it creates secondary market demand for loans that otherwise might not get written, even though people receiving these loans are perfectly creditworthy.

So, Ms. Cohen, if Fannie and Freddie are replaced by secondary market entities that have no such duty to serve the entire market, what kind of impact do you think that will have on mortgage access and affordability in low-income communities and rural communities?

Ms. COHEN. Thank you for the question, Senator Warren. The reason these hearings are happening now is because the market is quite restricted. It is mostly only a market for people who have wealth and who have the highest credit scores, even though there are many other people who are creditworthy. And so if we set up a system that does not provide a duty to serve, we are basically going to have a market like the one we have today where very many people who need housing cannot get the kind of housing that will build wealth. We have got many communities where wealth was gutted by the foreclosure crisis, and it is urgent that we get those people back into—

Senator WARREN. Thank you. And I know I am out of time, but if I could just ask Mr. Diaz to comment very quickly, particularly on the impact on Hispanic borrowers, if you could.

Mr. DIAZ. Yes, I think access to credit has always been a problem for low-income and minority communities. Without CRA, for instance, a lot of the early lending in the 1990s and 2000s would have been very difficult to orchestrate because we had to prove that low-wealth, low-income borrowers could be good credit risks.

If you take that away, what is going to be the incentive for lenders to go that extra mile? It is completely uncertain to me. I worry we are going to turn back versus trying to strengthen a market that works. The market collapsed for reasons having nothing to do with low-wealth, low-income borrowers, but these borrowers again are going to bear the brunt of access to credit. There is no constituency really that is going to protect these consumers' interests.

Senator WARREN. Well, thank you very much. Given the importance of home ownership and wealth building, I think this is just a critical feature.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Menendez.

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

Mr. Thomas, some commentators have argued that relatively low reported interest rates on jumbo mortgage loans provide evidence that families who would be pushed out of a conforming loan market and into the jumbo market by a reduction in the conforming loan limits would not face materially higher costs. But as I read it, most reports show that the current jumbo market is only serving a very narrow and exclusive subset of borrowers who have very high incomes, lots of assets, very large downpayments, and very low debt.

So wouldn't it be a mistake to view these loans as representative of what most families in the conventional market would face if they

were pushed into the jumbo market by a reduction in the loan limits?

Mr. THOMAS. Thank you, Senator, and you are absolutely correct. Those that are getting those jumbo loans are putting quite a bit down and have very high FICO scores, and so it is not representative of what would happen if we lowered the loan limits and then placed those people that were now left out of the conforming loan limits into the jumbo market. They could not compete in that market under the circumstances that we have right now. So you are absolutely correct. Higher downpayments, much higher, 30 percent down, and you are normally going to have very high FICO scores, too.

Senator MENENDEZ. So, for the record, Mr. Chairman, I am not talking about households with bad credit who cannot afford a loan in the conforming market. I am talking about regular families with normal credit who can afford to responsibly pay their mortgage under the current system, but who might not meet the extreme bar to qualify for special treatment in the jumbo market. And I think that needs to be corrected.

Let me ask you another question, Mr. Thomas, using your expertise in the field. There have been some proposals made to reduce the maximum size of loans that Fannie and Freddie Mac or whatever replaces them in a new system can guarantee. Couldn't a reduction in these conforming loan limits disproportionately harm homeowners and homebuyers in high-cost areas?

Mr. THOMAS. Oh, absolutely, and it is not only high-cost areas, Senator. The lowering of the upper limit happens to the high-cost areas as well as the normal. You know, what is being proposed right now would be to lower the high cost to 600 and the normal down to 400. Well, that affects everybody across the country, not just the high-cost areas, and so it would have a bad effect on home ownership.

We have calculated that it would remove all of the intended—or what we calculate as being the run-up of additional buyers next year, it would wipe that amount out, so we would be back to the same levels we are at today.

Senator MENENDEZ. So in addition to hurting new homebuyers, reducing the conforming loan limits also hurts existing homeowners by lowering demand and, therefore, reducing the value of their home.

Mr. THOMAS. Absolutely. It has that effect as well.

Senator MENENDEZ. Let me ask—and I am not picking on you, but you have expertise here that I am looking for. FHA Acting Director DeMarco last week announced his intention to unilaterally reduce the maximum size of mortgages guaranteed by Fannie and Freddie. And Senator Isakson, myself, and a group of bipartisan legislators, including Senator Schumer and Senator Warren, urged him not to do this, and I believe that your organization has sent him a similar letter, as well as others. And it seems to me a little bizarre for the FHFA to be making such a unilateral change while Congress is working on housing reform legislation. It is a topic that I believe clearly should be left to Congress to determine, particularly when our housing market and our economy still are recovering from the financial crisis and the recession that followed.

Would you agree that it is a bad policy for FHFA to reduce unilaterally the loan limits? And with data showing that the larger loans under the current loan limits tend to perform better than other loans when you control for other factors, wouldn't reducing the loan limits to exclude these loans seem to be in direct contravention to FHFA's mandate as a conservator to improve the financial conditions of the GSEs?

Mr. THOMAS. I would agree, and I commend all of you for writing that letter. I also met with the Director and gave him our thoughts on it and why we felt it was a bad idea. And I might remind you that in 2011 he testified that he did not think he had the power to do it.

Senator MENENDEZ. That is something to pursue, Mr. Chairman. Thank you very much.

Chairman JOHNSON. Senator Heitkamp.

Senator HEITKAMP. Thank you, Mr. Chairman and Ranking Member. I think these hearings are just so valuable for us to gather information, because one thing that I have learned coming here is that you do not often get a chance—I mean, we will not do this and then come back in a couple years. That is not how it works. And so whatever we do has to be done correctly.

I obviously very much appreciate the ongoing comments, how we can improve what we have in front of us. Obviously there is some advocacy here for continuing the current structure. I think that there is probably a broader consensus that we need to look at a new structure and how that would work and making sure that consumers are protected and that access to the market for all borrowers is available—not guaranteed but available. And so housing, 20 percent of what we do, but we know that it is more than that. Home ownership is the bedrock of really our political philosophy, also the bedrock of wealth creation for many, many middle-class families. And so this has got to be done right.

And, Mr. Thomas, thank you for your excellent testimony a couple weeks ago on the debt limit and what that would mean for borrowers. I think it had a huge impact. I think we were able to change public opinion about what that meant, and I think your contributions were greatly appreciated. I share Senator Brown's comments in that direction.

But I want to throw you a little curve ball because we were talking about a lot of discrete and unique groups, but in my State, one of the most acute housing problems we have, other than rural housing, is Native American housing. It presents some real challenges for lenders because of how property is organized. It presents real challenges in terms of the legal structure just based on whether normal legal rules of foreclosure would apply. And I want to ask all of you, any of you, if you have thought about the unique challenges for Native American borrowers to improve the quality of housing and access to first-time homeowners or access to single-family housing on the reservations.

[No response.]

Senator HEITKAMP. There we go. That answers my question. I make that point because we spend a lot of time talking about access, and we spend a lot of time talking about unique issues, and I will tell you, for me—and I know for the Chairman—we have

seen it in our communities. It is a growth area. We desperately need to be thinking about how we protect consumers, how we get access to those markets. Yes, Ms. Cohen.

Ms. COHEN. Thank you for the question. I would point out that Native Americans are part of a community of low-wealth borrowers who face a lot of hardship in paying their bills on a regular basis, and the legal services network around the country serves Native American communities in certain States and sees the problems with the initial issuance of a loan and also the problems that people face once they get a loan. And part of creating a housing finance system going forward that works for all borrowers, middle-class and working-class low-wealth borrowers, is to create that flexibility not only in the underwriting but also in how servicing is done to make sure that people do get a solution and they get a solution that works for them. People who have very few dollars in their pocket do not really fit with the traditional DTI ratios.

Senator HEITKAMP. And I would agree with you in terms of off-reservation. But we have a unique situation as it relates to on-reservation housing and on-reservation borrowing. And so just put that thought into each one of your heads as you are thinking about how we can, in fact, meet some kind of standard there.

My last question is to Mr. Gupta. Mortgage insurance obviously is key for many families, and especially first-time homeowners who are trying to buy a home. We see with student lending a lot of folks who were not qualified, cannot save a downpayment. The only access they are going to have is through some kind of mortgage insurance. We want to make sure we get this piece right in this bill.

Are you satisfied that the mechanics that have been outlined in this bill will basically help maintain a robust mortgage insurance market?

Mr. GUPTA. Thank you, Senator Heitkamp. We completely agree with the outline of what has been recommended in the bill in terms of mortgage insurance and usage of mortgage insurance for deep coverage. In addition to that, what we would add is there is no reason that mortgage insurance can also not participate in the bond guarantor role. At the end of the day, mortgage insurance companies are credit managers for mortgages only. By law, we are required to only participate in the mortgage insurance business. We do not insure auto loans. We do not insure credit card loans. So this is a collateral class that we know how to manage. And it would be a good opportunity and a sustainable opportunity in terms of borrower economics, in terms of sustainable housing, to actually have mortgage insurance companies not only provide the deep coverage which actually sits in front of the taxpayers, but also provide bond insurance coverage right behind it.

In addition to that, I would say we continue to have dialogs with the FHFA, with the GSEs, with the Federal bank regulators, as well as State regulators on strengthening the industry and making sure that the industry continues to be more solvent and stronger coming out of this cycle.

Senator HEITKAMP. Thank you.

Chairman JOHNSON. Thank you again to all of our witnesses for being here today. I also want to thank Senator Crapo and all my colleagues for their ongoing commitment to this important topic.



This hearing is adjourned.  
[Whereupon, at 11:32 a.m., the hearing was adjourned.]  
[Prepared statements and responses to written questions supplied for the record follow:]

**PREPARED STATEMENT OF ERIC STEIN**  
 SENIOR VICE PRESIDENT, CENTER FOR RESPONSIBLE LENDING  
 OCTOBER 29, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for inviting me to testify today about housing finance reform and its impact on borrowers.

I am Senior Vice President at the Center for Responsible Lending (CRL), which is a nonprofit, nonpartisan research and policy organization dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, a nonprofit community development lender that creates ownership and economic opportunity, for which I also serve as Senior Vice President. Self-Help has provided \$6 billion in financing to 70,000 homebuyers, small businesses and nonprofits and serves more than 80,000 families through 30 retail credit union branches in North Carolina, California, and Chicago.

Housing finance reform has obvious consequences for consumers. It will impact which families are able to access mainstream mortgage credit and how expensive that credit will be. We agree with the emerging consensus, as reflected in S.1217, the Housing Finance Reform and Taxpayer Protection Act of 2013, that taxpayer risk must be insulated by more private capital, that an explicit and paid for Government guarantee is necessary, that additional funds should be created to support affordable housing, and that mortgage-backed securities (MBS) provided through bond guarantors must support the "to-be-announced" (TBA). We also support current Federal Housing Finance Agency (FHFA) efforts to develop a common securitization platform, undertake experiments to test the market's willingness to purchase credit risk from the GSEs, wind down their investment portfolio, and hopefully move toward a common security.

In my testimony today, we provide two sets of recommendations. First, we recommend ways to structure a reformed housing finance system and how different approaches, including S.1217, would impact borrowers. Second, we recommend against hard-wiring underwriting criteria, such as a downpayment mandate, into reform legislation, because this would needlessly restrict access to credit. Instead, a reformed housing finance system should allow the regulator, bond guarantors and lenders to use traditional underwriting practices, including compensating factors, for lower-wealth borrowers.

The mortgage market in the United States is a \$10 trillion market, and housing finance reform must be undertaken with care to ensure that it does not inadvertently harm the housing market and economy. If legislation fixes what was broken and builds on what has and is working, we can create reform that will support economic growth, provide loans to creditworthy families in good times as well as bad, and reduce Government's role in the mortgage market.

**The Infrastructure of a Reformed Housing Finance System Will Have a Significant Impact on Borrowers**

Our recommendations on how to structure a reformed housing finance system include requiring mutual ownership of entities that both issue and guarantee conforming securities. Additionally, we recommend retaining cash window access for smaller lenders, maintaining a national market by requiring secondary market entities to serve all eligible lenders, and prohibiting structured securities from accessing a Government guarantee. Lastly, we recommend allowing secondary market entities to have a portfolio for distressed-then-modified loans and to provide a Government backstop for this portfolio so these modifications can continue in times of economic stress.

*Secondary Market Entities Should Have Mutual Ownership Structure:* In order to properly align incentives, we recommend requiring mutual ownership of secondary market entities instead of stock ownership. Our proposal does not call for a specific number of secondary market entities, but, like the 12 Federal Home Loan Banks, we believe that they should all be mutually owned. We also support requiring each of these mutually owned entities to do two things: issue securities and guarantee those same securities.

One of the key reasons that Fannie Mae and Freddie Mac ended up in conservatorship is because their incentives were skewed toward short-term gains. Shareholders looked to steady or increasing quarterly earnings reports. Therefore, in the face of declining market share because of growing numbers of private-label securities packaging subprime and Alt-A loans, Fannie Mae and Freddie Mac management decided to weaken credit standards to compete for the Alt-A business. This decision proved disastrous. While these Alt-A loans were roughly 10 percent of

Fannie Mae's outstanding loans in 2008, they were responsible for 50 percent of its credit losses.<sup>1</sup>

By not having private shareholders, mutual ownership of secondary market entities would curb incentives for short-term and volatile equity returns over long-term sustainability. Under a mutual model, lenders wanting to sell conforming loans into the secondary market would be required to make a capital investment in one or more of these mutually owned companies. This pooled capital would then stand in a first-loss position ahead of any Government reinsurance. (Borrower equity, private mortgage insurance for high loan-to-value mortgages, private investment in jumbo loans, and MBS investors taking on the interest rate risk of mortgages are the four additional primary ways that private capital would stand in front of Government reinsurance.) The combination of this equity investment and the absence of private shareholders would reduce the chasing-market-share problem that Fannie Mae and Freddie Mac exhibited pre-2008. Similarly, management would not be compensated based on quarterly stock prices, which would also result in fewer incentives for excessive risk taking.

Requiring mutual ownership of secondary market entities would benefit consumers. Not only would the secondary market system be more stable, but it would also limit secondary market entities from driving up prices to lenders and borrowers. Securitizing and guaranteeing loans is inherently a scale business. Since the mission of shareholder owned entities is to increase shareholder value, they would undertake oligopolistic behavior to increase prices to the extent possible. For a mutual, on the other hand, lender-members have an interest in getting the best possible price and have influence to make this happen. Because the mutual would provide a low-cost funding source for lender-members to use to fund originations and earn origination income, return on equity invested would not be the only return from joining the mutual, as it would with shareholders. A recent paper highlights how the incentives created by mutually owned entities result in lower rates for borrowers.<sup>2</sup>

*Smaller Lenders Should Continue To Have Direct Access to the Secondary Markets Through a Cash Window:* Housing finance reform should ensure that smaller and regional lenders—which often provide credit in rural and underserved communities that are overlooked by larger lenders—remain competitive in the secondary mortgage market. The current system provides smaller lenders with direct access to sell their loans to Fannie Mae and Freddie Mac, and a reformed system should retain this approach. The GSEs provide a “cash window” that gives smaller lenders an upfront cash payment—instead of a small interest in a security—in exchange for whole loans. This cash window access allows smaller lenders to avoid going through an aggregator, who could be a larger competitor. It also provides smaller lenders with the option of retaining servicing rights or selling those rights. Keeping servicing rights helps these lenders hold onto their best customers, rather than passing on customer contact information to larger competitors serving as aggregators.

Reform proposals that would split the system into separate issuer and guarantor companies, such as S.1217, threaten to jeopardize this direct secondary market access for smaller lenders. Among other concerns, splitting the market in this way would allow larger lenders to create affiliated issuers. And, if they decided to, these lenders could also pool loans from other lenders. These affiliated issuer-companies could make business decisions about the kind of mortgage products to aggregate and pool, how to price loan purchases from other lenders, and whether to require a transfer of servicing rights. The end result would be that larger institutions could control their own destiny, but smaller lenders would be at the mercy of competitors.

In the event that Congress decides to bifurcate the system into separate issuer and bond guarantor companies, then it should prohibit lenders from being affiliated with or purchasing stock in either, except through mutual ownership, in order to protect small lenders. In addition, these separate entities should be prohibited from offering volume discounts to avoid discriminatory pricing in favor of larger sellers.

*Secondary Market Entities Should Be Required To Serve a National Market:* A reformed housing finance system should continue to fulfill a national role where it serves all markets at all times, including rural and underserved areas. One of the relatively unnoticed success stories of the current housing finance system is the creation of a stable national housing market that can weather regional or even national economic cycles. Although we believe they could have done more to prevent overly

<sup>1</sup>See, Federal National Mortgage Association, SEC Form 10-Q, June 30, 2008, at 6; Federal Home Loan Mortgage Corporation, SEC Form 10-Q, June 30, 2008, at 71.

<sup>2</sup>Patricia Mosser, Joseph Tracy, and Joshua Wright, “The Capital Structure and Governance of a Mortgage Securitization Utility”, Federal Reserve Bank of New York Staff Report no. 644, at 18, 32–38 (October 2013).

constrained credit in recent years, the fact is that Fannie Mae and Freddie Mac have kept the housing market going during the worst economic crisis since the Great Depression.

There is a risk that housing finance reform will jeopardize this national housing market, splintering the system so that anywhere between one entity to some 500 companies might act as issuers and another 5 to 10 as bond guarantors. Whatever the exact number, these companies could align their business models with specific lenders serving parts of the country—for example, only the Southeast or California. This would lead to a market with niche and regional players but no entity mandated to serve the entire market or filling the gaps. The regulator would be powerless to compel any individual company to purchase loans from lenders in certain States or communities.

We have two recommendations to maintain a national market. First, we recommend having secondary market entities perform both issuer and guarantor functions. This will reduce market complexity, assist small lenders in accessing the secondary market, and make it easier for the regulator to assess whether the secondary market is not leaving parts of the country behind. Second, we recommend requiring secondary market entities to serve all eligible lenders across the country. This way, the housing finance system would be unable to ignore lenders serving rural areas or parts of the country facing a regional downturn. It is entirely appropriate for individual lenders to have business strategies that focus on specific regions or communities. But, reform legislation should not assume that these individual business judgments are an adequate substitute for a system that supports a national market.

*Structured Securities Should Be Prohibited From Accessing Government Reinsurance:* We have two recommendations about the kind of securities that should be eligible for Government reinsurance. First, housing finance reform should preserve the pass-through securities currently used in the “to-be-announced” (TBA) market, which is also called the forward market. Investors commit to these transactions before the security is pooled together, meaning the individual loans in the pool are not “announced” until 1 to 3 months later. This is a unique way for a capital markets system to function, and it produces a number of benefits, including widespread liquidity, reduced borrowing costs for borrowers, countercyclical access to credit, and broad availability of the 30-year fixed-rate mortgage.

Second, we also urge this Committee to prevent structured securities from obtaining a Government guarantee. These securities should be able to access a common securitization platform, but they do not provide sufficient benefits to warrant a Government guarantee. Structured securities were the kind used in private-label securities during the subprime boom years, and they involve slicing securities into subordinate tranches (taking losses first) and senior tranches (taking losses last). This requires examining the individual loans packaged into each pool in order to finalize the tranches and find appropriate investors, which makes it incompatible with the in-advance approach used in the TBA system.

This incompatibility with the TBA system means that structured securities are unable to deliver the same benefits that come from pass-through securities. For example, structured securities would increase mortgage costs for all borrowers because of lowered liquidity, and borrowers at the edge of the credit box would have additional costs on top of this. Borrowers in certain geographies would get penalized further still. Additionally, structured securities would reduce access to the 30-year fixed-rate mortgage, because subordinate investors would be more inclined to invest in securities with shorter-term and/or adjustable-rate mortgages. And, structured securities would cripple the regulator’s ability to fulfill supervision and oversight duties, because it would turn the regulator into a huge ratings agency to ensure that every senior position in every structured security in the country had sufficient and real subordinate coverage. (The new regulator should have safety and soundness authorities similar to FHFA’s in order to supervise bond guarantor/issuers.)

*Portfolio Capacity and Government Backing in Times of Economic Stress Are Needed for Successful Loan Modifications:* One part of housing finance reform that seems at risk of being overlooked is the infrastructure needed to facilitate successful loan modifications. In order to prevent unnecessary and costly foreclosures that would put Government reinsurance at risk, housing finance reform should preserve the ability of Fannie Mae and Freddie Mac to modify distressed loans. This involves a portfolio capacity to hold distressed-then-modified loans and a Government liquidity backstop to support this portfolio in times of economic stress when modifications

are most needed.<sup>3</sup> In addition, we support servicing standards that require a standardized and publicly available net-present-value test for modifications.

Comparing the loan modification process for Ginnie Mae and GSE securities highlights the misaligned incentives that occur without a portfolio. Both Ginnie Mae and the GSEs use pass-through securities, and distressed loans must be purchased out of the portfolio in order to make investors whole. While the GSEs are able to pull distressed loans onto their portfolio and, as a result, do affordable modifications, servicers are required to purchase distressed loans out of Ginnie Mae pools. Because servicers have no economic incentive to hold modified loans on their balance sheet, they complete shallow modifications that can be res securitized along with new loans. However, this results in higher redefault rates than more affordable GSE modifications. For loans modified in 2011, 19 percent of Fannie Mae loans had 60-day redefault rates 24 months after the modification compared with 49 percent of Government-guaranteed loans.<sup>4</sup>

### **Housing Finance Reform Should Allow the Use of Compensating Factors in Underwriting**

GSE reform legislation should not prohibit lenders from using compensating factors to make more informed decisions about credit risk. In the wake of the financial crisis and while under conservatorship, the GSEs have become overly conservative—only the most pristine borrowers can get a conventional mortgage. The average borrower denied a GSE loan had a FICO score of 734 and was willing to put 19 percent down.<sup>5</sup> Purchase originations are at their lowest levels since the early 1990s.<sup>6</sup> There is a risk of enshrining or exacerbating this narrow market as part of housing finance reform, which would result in pushing young and lower-wealth borrowers into a separate and more expensive system.

However, a dual market approach has never served the country well. For example, a dual market existed during the recent mortgage boom, when half of all African American families were steered into high-cost, abusive subprime mortgages, while most white borrowers received prime loans. Going forward, lower-wealth families and communities should not be pushed into FHA as a housing reform solution. Rather, families able to succeed in a mainstream mortgage should be able to access the mainstream market.

A reformed housing finance system must serve the full universe of creditworthy borrowers that can afford a responsible loan. This will not only ensure that lower-wealth families have the opportunity to build wealth through home ownership, but it will also support the overall housing market. To this end, Congress should not hard-wire downpayment mandates, as is done with a 5 percent downpayment mandate in S.1217.

*Downpayment Mandates and Other Hard-Wired Underwriting Criteria Would Needlessly Restrict Access to Credit:* Including downpayment mandates in housing finance reform legislation would unnecessarily restrict access to credit for lower-wealth families. As an initial matter, these mandates overlook the fact that borrowers must also save for closing costs—roughly 3 percent of the loan amount—on top of any downpayment required. And, the mandates would increase the number of years that borrowers would need to save for a downpayment. Using 2011 figures that include closing costs, it would take the typical family 17 years to save for a 10 percent downpayment and 11 years to save for a 5 percent downpayment.

Persistent wealth disparities for African American and Latino households would make downpayment mandates particularly harmful for these communities. In addition to taking years longer to save for a downpayment, the wealth gap makes it less likely that African American and Latino families could get financial help from family members. This combination could leave many individuals—who could be successful homeowners—with restricted access to credit.

Similar obstacles exist with younger families. Downpayment burdens and other obstacles are preventing these families from joining the mortgage market, and their participation is necessary for a thriving economy. According to former-Governor Duke of the Federal Reserve Board, “Staff analysis comparing first-time homebuying in recent years with historical levels underscores the contraction in

<sup>3</sup> While new entities should not be permitted to hold investment portfolios, they also need the ability to hold loans for a maximum of 6 months to aggregate cash purchases from lenders. Without a Government backstop, this function will also disappear in times of financial stress.

<sup>4</sup> “OCC Mortgage Metrics Report, Disclosure of National Bank and Federal Savings Association Mortgage Loan Data, Second Quarter 2013”, at 35 (September 2013).

<sup>5</sup> See, Kenneth Harney, “Mortgage lenders set higher standards for the average borrower”, *The Washington Post* (September 28, 2012).

<sup>6</sup> See, Governor Elizabeth A. Duke, “Comments on Housing and Mortgage Markets at the Mortgage Bankers Association”, at 2 (March 8, 2013).

credit supply. From late 2009 to late 2011, the fraction of individuals under 40 years of age getting a mortgage for the first time was about half of what it was in the early 2000s.<sup>7</sup>

On top of harming lower wealth and younger borrowers, imposing downpayment mandates would also be harmful for the housing market overall. According to the Joint Center for Housing Studies at Harvard University, households of color will account for 70 percent of net household growth through 2023. Considering that many of these and younger households have limited wealth, downpayment mandates could significantly reduce the number of future first-time homebuyers.<sup>8</sup> This reduced pool of buyers could lead to lower home prices, more difficulty selling an existing home, and even some existing borrowers defaulting on their mortgage. This would also harm older homeowners needing to sell their houses and use their home equity to pay for retirement, move to a managed-care facility or to a smaller house.

Not only is there a huge cost to putting these restrictions into law, but there is also a limited benefit in terms of reducing default rates. When looking at loans that already meet the basic requirements of the Dodd-Frank Act and product requirements for a Qualified Mortgage, a UNC Center for Community Capital and CRL study shows that these requirements cut the overall default rate by almost half compared with loans that did not. Layering on a downpayment requirement on top of these protections produces a marginal benefit.<sup>9</sup> This makes sense because risky product features and poor lending practices caused the crisis by pushing borrowers into default, and the Dodd-Frank Act reforms address these abuses such as high fees, interest-only payments, prepayment penalties, yield-spread premiums paid to mortgage brokers, lack of escrows for taxes and insurance for higher priced mortgage loans, teaser rates that spiked to unaffordable levels, and outlawing no-doc loans.

Given the parameters set by the Dodd-Frank Act's mortgage reforms, Congress should not go further and hard-wire specific underwriting criteria into legislation, especially since borrowers in well-underwritten loans can succeed in mortgages with lower downpayment amounts. Laurie Goodman of the Urban Institute points out that a hard 5 percent cutoff is not the best way to address default risk, since compensating underwriting factors are more important. Analyzing Fannie Mae data, she found that:

The default rate for 95 to 97 percent LTV mortgages is only slightly higher than for 90 to 95 LTV mortgages, and the default rate for high FICO loans with 95 to 97 LTV ratios is lower than the default rate for low FICO loans with 90 to 95 percent LTV ratios. . . . For mortgages with an LTV ratio above 80 percent, credit scores are a better predictor of default rates than LTV ratios.<sup>10</sup>

In addition, for the last 17 years, CRL's affiliate Self-Help has run a secondary market home loan program, which has purchased 52,000 mortgages worth \$4.7 billion originated by 35 lenders in 48 States. Borrowers in 68 percent of these mortgages made less than a 5 percent downpayment and 32 percent put less than 3 percent down and the median income of these borrowers was less than \$31,000. In addition, 38 percent of borrowers received help with the downpayment and closing costs from another party, and use of assistance was not correlated with higher default when controlling for other factors. The vast majority of these loans did not have private mortgage insurance. These borrowers saw a 27 percent median annualized return on equity, which increased \$18,000 even through the crisis.<sup>11</sup> This high loan-to-value program resulted in Self-Help's cumulative loss rate of approximately 3 percent, which includes performance during the recent foreclosure cri-

<sup>7</sup> See, Governor Elizabeth A. Duke, Comments on Housing and Mortgage Markets at the Mortgage Bankers Association at 2 (March 8, 2013).

<sup>8</sup> See, "The State of the Nation's Housing, Joint Center for Housing Studies", at 3 (2013) ("Proposed limits on low-downpayment mortgages would thus pose a substantial obstacle for many of tomorrow's potential homebuyers.")

<sup>9</sup> Roberto G. Quercia, Lei Ding, Carolina Reid, "Balancing Risk and Access: Underwriting Standards for Qualified Residential Mortgages", Center for Responsible Lending and UNC Center for Community Capital (Revised March 5, 2012).

<sup>10</sup> See, Laurie Goodman and Taz George, "Fannie Mae Reduces Its Max LTV to 95: Does the Data Support the Move?", The Urban Institute, MetroTrends Blog (September 24, 2013).

<sup>11</sup> See, Allison Freeman and Janneke Ratcliffe, "Setting the Record Straight on Affordable Home Ownership" at 48 (May 2012); see also, Christopher Herbert, Daniel McCue, and Rocio Sanchez-Moyano, "Is Home Ownership Still an Effective Means of Building Wealth for Low-Income and Minority Households? (Was it Ever?)" Joint Center for Housing Studies, Harvard University, at 48 (September 2013) (Overall, owning a home is consistently found to be associated with increases of roughly \$9,000-\$10,000 in net wealth for each year a home is owned.)

sis and would have been substantially lower if the loans had had private mortgage insurance.

Similarly, legislation should not contain credit score or debt-to-income cutoffs either. Private companies' proprietary scoring models should not be enshrined into legislation; we learned that lesson with the ratings agencies. Further, each loan is a combination of numerous factors and if one is factor is enshrined by legislation, that will reduce the pool of potential borrowers with strong compensating factors who could succeed as homeowners. Underwriting is multivariate and complex. It is not susceptible to legislation and should be left to the regulator, bond guarantors, and lenders through traditional compensating factors.

**Conclusion**

Thank you for the opportunity to testify today. Attached as an appendix to my testimony is a recent CRL Working Paper on GSE reform that goes into these recommendations in greater detail. I look forward to answering your questions.



## A Framework for Housing Finance Reform:

### *Fixing What Went Wrong and Building on What Works*

Center for Responsible Lending Working Paper

Eric Stein and Carrie Johnson

Updated October 28, 2013

This paper provides a framework for housing finance reform. The mortgage market in the United States is a \$10 trillion market, and the health of this market significantly impacts the country's overall economy. While we agree with the emerging consensus that taxpayer risk must be insulated by more private capital, housing finance reform must be undertaken with care to ensure that it does not inadvertently harm the housing market. This could have devastating economic consequences for the country.

The best way to determine what reforms to undertake, we believe, is first to identify what went wrong with Fannie Mae and Freddie Mac (also collectively called "the GSEs") before conservatorship and to fix these problems. The next step is to consider what has worked well with Fannie Mae and Freddie Mac and then build on these parts.

What to fix	What to build on
Replace stock ownership with mutual ownership for issuer-guarantor entities, which facilitates long term stability	Ensure equal treatment for small lenders through direct access to the secondary market
Put private capital in first-loss position at increased levels	Serve all markets at all times nationally and serve borrowers through traditional underwriting and compensating factors
Provide an explicit - and paid-for - government guarantee	Preserve 30-year fixed-rate mortgages via the TBA market and do not extend government guarantee to structured securities
Put in place a strong regulator	Promote cost-effective loan modifications through limited portfolio.
Prevent arbitrage investment portfolios	

*The Center for Responsible Lending (CRL) is a non-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices.*

*CRL is an affiliate of Self-Help, one of the nation's largest non-profit community development financial institutions. Self-Help has provided \$6 billion in financing to 70,000 homebuyers, small businesses, and non-profits and serves more than 80,000 mostly low-income families through 30 retail credit union branches in North Carolina, California and Chicago.*



Our paper is structured as follows. First, we propose a set of reforms that correct five core causes of what led Fannie Mae and Freddie Mac to pursue excess risk and harmful business practices:

1. **Adopt a Mutual Ownership Model Instead of Stock Ownership:** Require issuer-guarantor entities to have a mutual ownership structure instead of stock ownership. This structural change would align incentives for long-term stability instead of being tilted toward stockholder interests, market share and quarterly earnings reports.
2. **Put Private Capital in a First Loss Position and at Increased Levels:** Put private capital in a first loss position and subject it to strong capital standards.
3. **Provide an Explicit – and Paid-For – Government Guarantee:** Provide an explicit government guarantee that is paid for upfront and actuarially determined.
4. **Put in Place a Strong Regulator:** Create a strong federal regulator of issuer-guarantor entities empowered with authorities comparable to safety and soundness regulators of depository institutions.
5. **Prevent Issuer-Guarantor Entities from Holding Investment Portfolios:** Prevent issuer-guarantor entities from holding arbitrage portfolios of individual mortgages and mortgage-backed securities, while still permitting a limited purpose portfolio with government backstop to support aggregating loans of small lenders and to prevent foreclosures through loan modifications.

The second part of this paper recommends building on four parts of the current housing finance system, instead of discarding them, that work for homeowners and the housing market:

1. **Equal Treatment for Smaller Lenders:** Smaller lenders should have equal access to the secondary markets, as they currently do through the GSE “cash window,” and should not be forced to access the capital markets through their larger competitors. Secondary market entities should not be split into separate issuer-companies and bond guarantor-companies, because so doing would jeopardize this smaller lender access.
2. **Serve All Markets at All Times:** The housing finance system must both serve a national housing market, including rural areas, and must ensure that creditworthy borrowers are able to access the mainstream system. The system should not be weakened by allowing secondary market entities to fragment into regionalized pieces without a national mandate. Also, legislation should not hardwire down payment mandates and, instead, should let the new system address risk through traditional underwriting standards, including compensating factors.

3. **Preserve and Maintain the TBA Market for 30-Year Fixed Rate Mortgages:** The current system is built around the to-be-announced (TBA) market for 30-year fixed-rate mortgages. This system provides broad access to credit for borrowers and widespread liquidity for investors, and the infrastructure supporting the TBA market must be maintained. Government reinsurance should also not be available to the senior tranches of structured securities, which are incompatible with the TBA market. These securities fail to provide benefits comparable to the TBA system and introduce excessive risks to the government guarantee.
4. **Promote Cost-Effective Loss Mitigation:** Servicers will not facilitate loan modifications – even when it is more profitable than foreclosure – if they are forced to hold modified loans on to their books. To facilitate loan modifications, as happens currently with Fannie Mae and Freddie Mac, GSE reform should retain a targeted and very limited portfolio capacity through a backup government line of credit.

While the failure of Fannie Mae and Freddie Mac points to changes that must be made as part of housing finance reform, there are fundamental parts of the system that work. In fact, the system has provided \$6.3 trillion of loans during the worst economic crisis since the Great Depression,<sup>1</sup> compared with \$39 billion of mostly pristine jumbo loans contributed by private label securities.<sup>2</sup> If legislation fixes what was broken and builds on what works, we can create reform that will support economic growth, provide loans to creditworthy families in good times as well as bad, and reduce government's role in the mortgage market.

**Analysis of S. 1217:** Throughout this paper, we include an analysis of S. 1217 – the Housing Finance Reform and Taxpayer Protection Act of 2013 introduced on June 25, 2013 and co-sponsored by Senators Corker (R-TN) and Warner (D-VA) – and how it compares with the priorities and recommendations made here. We support core parts of S. 1217, including the proposition that increased levels of private capital should be in a first loss position, with an explicit, paid-for government reinsurance backstop. Additionally, S. 1217 correctly allows issuers to have limited portfolios to aggregate loans and prohibits investment portfolios. Further, we support the bill's grandfathering of the GSE portfolio of modified loans. The bill would also continue the use of bond guarantors, which would support an ongoing TBA market that provides broad access to 30-year fixed-rate mortgages. The legislation appropriately charges the regulator with ensuring fair pricing to smaller institutions (i.e., no volume discounts), although we support strengthening these pricing protections. We support, but would build on, the concept in Title IV of funds so that the new housing finance system can better serve a range of housing needs. We also support that issuers and guarantors can be within the same company, continuing FHFA's moves toward a common securitization platform, and, hopefully, a common security.

<sup>1</sup> See eMBS and Urban Institute's Housing Finance Policy Center (2013).

<sup>2</sup> See Inside Mortgage Finance and Urban Institute's Housing Finance Policy Center (2013).

However, we also think that S. 1217 should be modified to require mutual ownership of secondary market entities, rather than permitting the same stock ownership of secondary market players – and continuing the same misaligned incentives – that existed in the lead up to the crisis. S. 1217's mutual issuer for smaller lenders is a step in the right direction; however, limiting it to smaller lenders only will make it unable to compete with larger lenders.

Additionally, we believe that S. 1217 adopts some positions that would disrupt parts of the existing housing finance system that provide benefits for investors, homeowners and the overall housing market. This legislation would:

- Fragment the market into a number of entities that specialize in either issuing securities or providing a guarantee on these securities; we support making combined issuer-guarantors mandatory. If issuers and guarantors are, indeed, allowed to split into separate companies, lenders should not be allowed to have an affiliation with either.
- Lead to a regionalized housing market that could ultimately leave some states or communities, particularly rural ones, with limited access to credit since bond guarantors and issuers lack a duty to accept all eligible lenders nationally.
- Prevent direct cash window access to the secondary market by smaller lenders, harming their ability to compete.
- Harm access to credit through preventing the traditional use of compensating factors by hardwiring down payment mandates into legislation.
- Allow government reinsurance to apply to senior tranches of structured securities. This should be prohibited since it is inconsistent with the TBA market, is unnecessary, puts the government reinsurance at excessive risk, and makes the job of the regulator impossibly complex.
- Overcorrect the issue of how much private capital is needed for bond guarantors, though we support significantly increasing capital levels.
- Weaken the federal regulator overseeing the secondary market system.
- Create incentives that push borrowers toward foreclosure instead of net present-value positive loan modifications by eliminating a portfolio capacity targeted for foreclosure prevention purposes, as well as to aggregate loans.

#### **I. Fixing the Problems with Fannie Mae and Freddie Mac and Designing the Housing Finance System for Long-Term Stability.**

Housing finance reform should be designed for long-term stability. In the years leading up to the crisis, Fannie Mae and Freddie Mac were a perfect storm of misaligned incentives: shareholders and management looking for high stock returns and market share, extremely low capital requirements, an implicit and unpaid for government guarantee, a structurally weak and underfunded regulator, and a large hedge fund-style arbitrage portfolio funded by government-



backed debt. In order to make housing finance reform successful, each of these five problems must be addressed by:

1. **Adopt a Mutual Ownership Model Instead of Stock Ownership:** Require issuer-guarantor entities to have a mutual ownership structure instead of stock ownership. This structural change would align incentives for long-term stability instead of being tilted toward stockholder interests, market share and quarterly earnings reports.
2. **Put Private Capital in a First Loss Position and at Increased Levels:** Put private capital in a first loss position and subject it to strong capital standards.
3. **Provide an Explicit – and Paid-For – Government Guarantee:** Provide an explicit government guarantee that is paid for upfront and actuarially determined.
4. **Put in Place a Strong Regulator:** Create a strong federal regulator of issuer-guarantor entities empowered with authorities comparable to safety and soundness regulators of depository institutions.
5. **Prevent Issuer-Guarantor Entities from Holding Investment Portfolios:** Prevent issuer-guarantor entities from holding arbitrage portfolios of individual mortgages and mortgage-backed securities, while still permitting a limited purpose portfolio with government backstop to support aggregating loans of small lenders and to prevent foreclosures through loan modifications.

#### 1. Adopt a Mutual Ownership Model Instead of Stock Ownership.

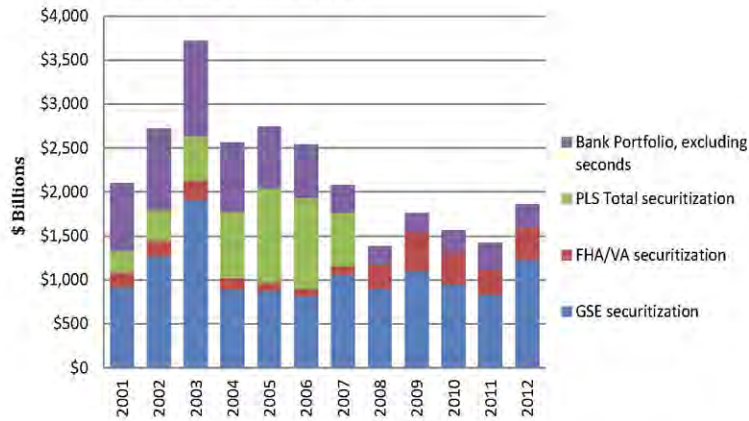
In the years leading up to the 2008 financial crisis, the financial incentives at Fannie Mae and Freddie Mac drove these companies to chase market share by loosening underwriting guidelines, particularly for Alt-A no doc loans. This increased risk-taking led to larger credit losses that ultimately pushed the GSEs into conservatorship. As part of housing finance reform, future secondary market entities should be converted to mutual ownership in lieu of stock ownership. This will provide the right balance of preventing excessive risk taking while maintaining access to credit.

##### A. The Misaligned Incentives of Fannie Mae & Freddie Mac's Stock Ownership Model.

Prior to entering conservatorship in 2008, both Fannie Mae and Freddie Mac had implicit government backing combined with private shareholders seeking market share to drive high quarterly gains and returns on equity. In the years leading up to the crisis, GSE market share and profits were put at risk in the face of growing private-label securitizations competition. As the subprime and Alt-A markets grew in size from 2001 through 2006, the percentage of loans

eligible for purchase by Fannie Mae and Freddie Mac under their traditional underwriting standards – also called conforming loans – decreased significantly. From 2003 to 2006, the GSE and government share of the MBS market (Fannie Mae, Freddie Mac and Ginnie Mae) fell from 78 percent to 44 percent while the private label securities share rose from 22 percent to 56 percent.<sup>3</sup> It is no coincidence that this 34 percent swing in favor of private label securities occurred during the worst period of lending in American history since the Great Depression.<sup>4</sup>

**Figure 1: First Lien Origination Volume**



Source: Inside Mortgage Finance  
Credit: Urban Institute's Housing Finance Policy Center

In response to this declining market share and harm to quarterly earnings targets, both Fannie Mae and Freddie Mac decided to ease their underwriting standards and begin guaranteeing Alt-A mortgages – generally loans that did not fully verify income and assets – that were previously

<sup>3</sup> Over this time, mortgage-backed securities accounted for roughly 69 percent of the entire mortgage market. See CRL calculations based on data provided in 2011 Mortgage Market Statistical Annual, Inside Mortgage Finance (Volume II: Secondary Market) (2011).

<sup>4</sup> See e.g., The Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, at 105 (January 2011) [hereinafter "FCIC Report"] (stating that "[s]imultaneously, underwriting standards for nonprime and prime mortgages weakened. Combined loan-to-value ratios—reflecting first, second, and even third mortgages—rose. Debt-to-income ratios climbed, as did loans made for non-owner-occupied properties. Fannie Mae and Freddie Mac's market share shrank from 57% of all mortgages purchased in 2003 to 42% in 2004, and down to 37% by 2006. Taking their place were private-label securitizations—meaning those not issued and guaranteed by the GSEs.") (available at [http://fcic-static.law.stanford.edu/cdn\\_media/fcic-reports/fcic\\_final\\_report\\_full.pdf](http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf)).

outside of the GSE credit box. While these Alt-A loans constituted roughly 10 percent of Fannie Mae's outstanding loans in 2008, they were responsible for 50 percent of its credit losses.<sup>5</sup>

Additionally, the GSEs purchased large amounts of securities bundled with subprime loans that had risky product features for their own portfolio in order to obtain higher financial rates of return.<sup>6</sup> This race to the bottom in order to shore-up returns for shareholders proved disastrous. These loans soon resulted in high default rates and generated substantial losses that the entities lacked the capital to cover. Although the GSEs were not the instigators of this abusive lending, their follow-the-leader approach hurt borrowers and led them into conservatorship.

#### B. A Mutual Ownership Model.

In order to properly align incentives, entities serving issuer and guarantee functions should be required to have a mutual ownership structure. In fact, Freddie Mac was a mutual that was part of the FHLB system from its creation in 1970 until it was changed to a shareholder owned corporation in 1989.<sup>7</sup> The future system could have multiple secondary market entities, but all of them should have a mutual ownership structure. By eliminating private shareholders, the mutual entities would curb incentives for short-term and volatile equity returns over long-term sustainability. While not identical, such an approach would share similarities with the Federal Home Loan Bank (FHLB) system. FHLBs currently have \$450 billion of loans (called "advances") outstanding to member depository institutions under this ownership structure.<sup>8</sup>

<sup>5</sup> See Federal National Mortgage Association, United States Securities and Exchange Commission Form 10-Q, for the quarterly period ended June 30, 2008, at 6 (available at <http://www.fanniemae.com/ir/pdf/earnings/2008/q22008.pdf>);

Federal Home Loan Mortgage Corporation, United States Securities and Exchange Commission Form 10-Q, for the quarterly period ended June 30, 2008, at 71 (available at <http://www.freddie.com/investors/>).

<sup>6</sup> See e.g., Written Testimony of Martin Eakes, CEO, Center for Responsible Lending and Center for Community Self-Help, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Hearing: Preserving the American Dream: Predatory Lending Practices and Home Foreclosures (February 7, 2007) (stating that "[c]urrently Fannie Mae and Freddie Mac are purchasing the senior tranches of mortgage-backed securities backed by abusive subprime loans. By doing so, they are essentially supporting and condoning lenders who market abusive, high-risk loans that are not affordable. This is clearly counter to the mission of those agencies. The agencies should cease purchasing the securities, the Office of Federal Housing Enterprise Oversight (Ofheo) should prohibit their purchase, and the U.S. Department of Housing and Urban Development (HUD) should stop providing credit for these securities under HUD's affordable housing goals.") (available at <http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/martin-testimony.pdf>).

<sup>7</sup> See *The Cooperative Model as a Potential Component of Structural Reform Options for Fannie Mae and Freddie Mac*, GAO-11-33R Fannie Mae and Freddie Mac, at FN4 (November 15, 2010) (available at [www.gao.gov/assets/100/97175.pdf](http://www.gao.gov/assets/100/97175.pdf)).

<sup>8</sup> See *Federal Home Loan Banks Combined Financial Report for the Quarterly Period Ended June 30, 2013*, Federal Home Loan Bank Office of Finance, at F-22 (August 13, 2013) (available at [http://www.fhlb-of.com/ofweb\\_userWeb/resources/13Q2end.pdf](http://www.fhlb-of.com/ofweb_userWeb/resources/13Q2end.pdf)).



Becoming a member of an issuer-guarantor would have both benefits and responsibilities for lenders. The upside of becoming a mutual owner would be access to the secondary market through that entity. Only members would have the ability to sell loans that are then packaged into securities eligible for government reinsurance. The corresponding responsibilities of these lenders would be making a capital investment in the issuer-guarantor – with this capital in a first loss position. Each institution’s capital level would depend on the volume of loans they sold into the secondary market system through the issuer-guarantor, just as a lender’s capital paid in to the FHLB system depends on the volume of advances received.

These benefits and responsibilities would provide the right checks and balances to prevent excessive risk taking on the one hand and being overly conservative on the other. With all members investing their own capital into the issuer-guarantor entity (and without private shareholders looking for the next quarterly earnings report), this will exert downward pressure on the chasing-market-share problem described above with Fannie Mae and Freddie Mac. Similarly, management would not be compensated based on quarterly stock prices, nor would they receive stock options, which would result in fewer incentives for excessive risk taking.

Additionally, mutual ownership would limit these entities from driving up prices to lenders and borrowers. This differs from companies with stock ownership. The mission of shareholder owned entities is to increase shareholder value, which would lead it to undertake oligopolistic behavior to increase prices to the extent possible. Under shareholder ownership, economies of scale will govern and inherently lead to secondary market consolidation. Such a structure makes the possibility of monopolistic behavior much more likely.

However, mutual ownership means that the member/sellers have a say on pricing, and they have an interest in being able to get the best price. A recent paper by staff at the Federal Reserve Bank of New York examines the behavior of financial mutuals and concludes that mutuals have a reduced emphasis on earnings and market share and exhibit lower risk profiles than shareholder-owned financial corporations. The authors explain that the mutual structure provides member-lenders with more benefits than just a pure equity return, namely that all shareholders get access to a lower-cost funding channel through which to earn origination fees and lower risk-weighted capital costs to hold mortgage assets as MBS. This paper demonstrates how mutuals’ lower required return on equity translates directly to lower rates for borrowers. The other major determinant of borrower rates is the absolute level of equity required for the corporation.<sup>9</sup> In addition, a mutual will also lack incentives to use its market power to move into activities that primary market members engage in and would have incentives to eliminate redundancies and cut costs that stock ownership lacks.

<sup>9</sup> See Patricia Mosser, Joseph Tracy, and Joshua Wright, *The Capital Structure and Governance of a Mortgage Securitization Utility*, Federal Reserve Bank of New York Staff Report no. 644, at 18, 32-38 (October 2013) (available at [http://www.newyorkfed.org/research/staff\\_reports/sr644.pdf](http://www.newyorkfed.org/research/staff_reports/sr644.pdf)).

Mutual ownership would also help appropriately define the credit box for approved loans. Because member-lenders would have capital at risk, this would create an incentive to have a narrower credit box with lower losses. However, because lenders would have an interest in selling their loans to the secondary market through the issuer-guarantor entity, the issuer-guarantors would face a countervailing pressure to avoid an overly restrictive credit box. Any system will need to strike the right balance between having a credit box that is either too loose or too tight, and a mutual structure provides an effective way to strike the right balance.

## 2. Put Private Capital in a First Loss Position and at Appropriate Levels.

In order for a future housing finance system to be sustainable in the long run, it is essential to put private capital in a first loss position and to mandate an appropriate capital level.

### A. Fannie Mae and Freddie Mac's Dangerously Low Capital Requirements.

Prior to entering conservatorship, Fannie Mae and Freddie Mac had a legislated minimum capital requirement of only 45 basis points – which is less than one-half of one percent – for loans they guaranteed. For a period of time the Office of Federal Housing Enterprise Oversight (OFHEO) required Fannie Mae and Freddie Mac to hold an additional 30% capital above this minimum level.<sup>10</sup> By any account, both of these levels were unconscionably low. Instead, Fannie Mae and Freddie Mac would have needed approximately 4 percent capital to withstand the 2008 financial crisis and resulting recession – more than 8 times higher than the minimum level.<sup>11</sup> In 2008, Congress passed the Housing and Economic Recovery Act (HERA),<sup>12</sup> which gave the new GSE regulator, the Federal Housing Finance Agency (FHFA), broad authority to increase capital requirements in order to preserve the safety and soundness of the institutions.<sup>13</sup> However, once the GSEs entered conservatorship, they have not been subject to capital requirements as they otherwise would be.

### B. Putting Private Capital in a First Loss Position.

<sup>10</sup> See *Fannie Mae and Freddie Mac Capital*, Mortgage Market Note 08-2, Office of Federal Housing Enterprise Oversight (July 17, 2008) (available at <http://www.fhfa.gov/webfiles/1243/MMNOTE082.pdf>).

<sup>11</sup> See Written Testimony of Mark Zandi, Chief Economist and Co-Founder Moody's Analytics, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Hearing: Essential Elements of Housing Finance Reform, at FN 15 (September 12, 2013) (available at [http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=e11b481b-1c9f-49f8-acd5-b062387038a7](http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=e11b481b-1c9f-49f8-acd5-b062387038a7)).

<sup>12</sup> Housing and Economic Recovery Act of 2008, Public Law 110-2889, Section 1110 (July 30, 2008).

<sup>13</sup> See 12 U.S.C. § 4611.



The mutual ownership model described above would put private capital in a first position to absorb losses and make investors whole. Lenders would be required to invest capital in issuer-guarantors in order to sell their loans. When available, the mutual would provide these members with dividend returns, as happens in the FHLB system.

There would be significant private capital at risk before government reinsurance occurs. In addition to the equity of the issuer-guarantor, risk will be borne by borrower down payments (as set by the regulator and market participants using compensating factors) and accumulated equity, private mortgage insurance company equity for loans above 80 percent loan-to-value, purely private capital for loans above a certain size (jumbo loans), and mortgage-backed securities investors taking on interest rate.

Only after all of this private capital is exhausted should government reinsurance step in to cover any additional losses.<sup>14</sup> This government guarantee should be funded through an actuarially priced guaranty fee that would be held in an account overseen by the regulator. Such an account would be comparable to the Deposit Insurance Fund overseen by the FDIC.

As a matter of transitioning to a new system, Fannie Mae and Freddie Mac should be dissolved followed with charters for new corporate entities for the two companies having mutual ownership, putting their assets to continued productive use. These new mutuals could then be permitted to retain earnings. This would enable the new mutual to establish a nest egg of capital during a multi-year transition period, with lenders required to pay in additional equity. Going forward, additional issuer-guarantors – also having a mutual structure – could be established in addition to the initial two entities. In addition, a Federal Home Loan Bank securitization affiliate

<sup>14</sup> Rather than government reinsurance being used only when the mutually owned issuer-guarantor becomes insolvent, staff from the Federal Reserve Bank of New York suggest that the reinsurance should apply to vintages of loans. Under this structure, the government would ensure that investors receive principal and interest due if losses exceeded the required capital of the entity for a particular book of loans, say one year's production. The same equity level would apply to each book of loans, in their example, 3 percent. The virtue of this approach would be that market participants, particularly seller/members, would still be willing to participate in times of stress going forward without fear that new invested equity would be wiped out by being applied to past losses, since losses of prior years would be walled off from current purchases, and the entity could therefore continue originating in a countercyclical manner. After 3 years, if delinquency trends make clear that losses from a particular vintage of loans will not exceed the required capital level, the regulator could approve releasing past years' capital to take risk against future vintages of loans. See Toni Dechario, Patricia Mosser, Joseph Tracy, James Vickery, Joshua Wright, *A Private Lender Cooperative Model for Residential Mortgage Finance*, Federal Reserve Bank of New York Staff Report no. 466, at 10-12 (August 2010) (available at [http://www.newyorkfed.org/research/staff\\_reports/sr466.pdf](http://www.newyorkfed.org/research/staff_reports/sr466.pdf)) and Patricia Mosser, Joseph Tracy, and Joshua Wright, *The Capital Structure and Governance of a Mortgage Securitization Utility*, Federal Reserve Bank of New York Staff Report no. 644, at 10 - 13 (October 2013) (available at [http://www.newyorkfed.org/research/staff\\_reports/sr644.pdf](http://www.newyorkfed.org/research/staff_reports/sr644.pdf)).

could also be established.

### C. Setting the Right Capital Level in a Reformed Housing Finance System.

Setting the right capital requirement is critical to GSE reform. Clearly the 45 basis point level before the crisis was insufficient, and a future system must provide an appropriate and significantly higher level of private capital at risk ahead of government reinsurance. Additionally, protections must be in place to ensure that capital levels cannot be chipped away in future years as memories of the 2008 crisis fade. Yet, as is detailed below, policymakers should also be concerned about overcorrecting and requiring more capital for bond guarantors than necessary to support the mortgages securitized through this system.

**Capital Levels in S. 1217:** The provisions in S. 1217 would impose an across the board 10 percent capital requirement – both for bond guarantors and for structured securities<sup>15</sup> – which would be about 2.5 times more capital needed to survive the most recent crisis for bond guarantors.<sup>16</sup> The legislation seems to allow supervised deals where bond guarantors could sell off part of this credit risk to third parties through the capital markets. S. 1217 would permit the regulator to change the required capital level during times of economic stress, but just for six months every three years. The legislation would also set a 2.5 percent capital level for the government reinsurance fund. Additionally, under S. 1217, private mortgage insurance by outside companies, approved by FMIC, would be required for loans over 80 percent loan-to-value, so the capital under discussion is for losses that occur under this 80 percent level.

**Minimum Capital Levels and Regulator Stress Tests:** It is important to recognize that determining the capital requirements that should apply to bond guarantors is a fundamentally different analysis than that for structured securities, although S. 1217 treats them the same. Bond guarantors use the insurance principles of pooling risk – across time, geography and thousands of security issuances – which means that gains in one security can offset losses in another. On the other hand, every single structured security must stand on its own to cover potential losses. During the boom, 25 percent subordination was not sufficient to protect senior securities from losses on many subprime securities. Thus, the 10 percent capital requirement for structured securities will be low for particular deals.

When the 10 percent requirement is applied to bond guarantors, it is an overcorrection. If capital levels are set too high for bond guarantors, there is the real risk that investors will not

<sup>15</sup> Section II(3) address the problems in allowing structured securities to access government reinsurance.

<sup>16</sup> See Written Testimony of Mark Zandi, Chief Economist and Co-Founder Moody's Analytics, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Hearing: Essential Elements of Housing Finance Reform, at 2 and FN 15 (September 12, 2013) (available at [http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=e11b481b-1c9f-49f8-acd5-b062387038a7](http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=e11b481b-1c9f-49f8-acd5-b062387038a7)).

come forward with it, which could collapse the system dependent on the TBA market. If 10 percent capital is required for \$5 trillion of outstanding pass-through mortgage-backed securities, for example, that is \$500 billion of long-term capital required – almost 3 times more than was raised in the top ten initial public offerings in American history<sup>17</sup> – and it is unlikely that the market will come forward with that much risk-taking capital.

Calculations show that Fannie Mae and Freddie Mac’s total losses coming out of the financial crisis are 2.7 percent and, combined with losses from PMI companies, will amount to around 4 or 5 percent.<sup>18</sup> As a result, we suggest using around 4 percent as a statutory minimum capital amount for new bond guarantors, which would provide the entities with enough capital to survive a crisis comparable to the Great Recession. By way of comparison, Federal Home Loan Banks (which have interest rate risk and liquidity risk on top of credit risk) have a required leverage ratio of 4 percent of assets.<sup>19</sup> While several Federal Home Loan Banks made ill-advised and costly investments in subprime securities, their core lending business to depository institutions (called advances) survived the crisis well. In fact, no Federal Home Loan Bank has ever suffered a loss on an advance.<sup>20</sup>

In addition to a minimum capital threshold, legislation could also provide for increasing these capital thresholds, if necessary, based on stress tests conducted by the regulator. This authority would mirror the safety and soundness authority currently established for FHFA in HERA. In conducting these stress tests, regulators should incorporate variables such as the mix of loans being insured, how much risk the entity has sold off to the private market and how much this has reduced their risk, and potential economic conditions. And when a significant downturn occurs, the regulator needs the flexibility to change the “attachment point,” which is the level of private capital required before government reinsurance can kick in. This will facilitate countercyclical access to credit. The provision in S. 1217 allowing for a change in this attachment point for six months once every three years would have been insufficient for the country to

<sup>17</sup> See Mark Zandi and Cristian deRitis, *The Road To Reform*, at 1 (September 2013).

<sup>18</sup> See Mark Zandi and Cristian deRitis, *The Road To Reform*, at 5 (September 2013); Written Testimony of Mark Zandi, Chief Economist and Co-Founder Moody’s Analytics, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Hearing: Essential Elements of Housing Finance Reform, at 2 (September 12, 2013) (stating that “[a] substantial amount of first-loss private capital should stand in front of the government’s catastrophic backstop. A good benchmark for the appropriate amount of private capital is the amount of losses suffered in the Great Recession. This was the proverbial hundred-year flood. Fannie Mae, Freddie Mac, and the private mortgage insurers will ultimately have a combined loss rate of between 4% and 5% resulting from the recession. This would be a conservative capitalization rate in the future system since regulation would demand that guaranteed mortgages be of higher quality than those purchased by Fannie and Freddie before the recession.”).

<sup>19</sup> See Federal Home Loan Bank Capital, Mortgage Market Note 09-3, Federal Housing Finance Agency, at 2 (July 16, 2009) (available at <http://www.fhfa.gov/webfiles/14595/MMN093FHLCapital71609.pdf>).

<sup>20</sup> See Federal Home Loan Banks Office of Finance, Credit Ratings at [http://www.fhfb-of.com/ofweb\\_userWeb/pageBuilder/credit-ratings-31](http://www.fhfb-of.com/ofweb_userWeb/pageBuilder/credit-ratings-31) (last accessed on October 9, 2013).



recover from the recent housing crash.<sup>21</sup>

In conducting this analysis, the fact is that much of the GSE's losses were based on practices that would now be restricted or illegal. Half of their 2008 losses, which put them in conservatorship, were Alt-A loans that generally did not verify income or assets, while constituting just 10 percent of the overall loan pool. Further, abusive lending fueled a housing bubble that, when the housing market collapsed, resulted in home price declines, triggering further defaults and losses.<sup>22</sup> After the Dodd-Frank Act, all loans now must have verified income and assets, and Qualified Mortgages (QM) must be fully amortizing loans. Indeed, the QM product protections result in dramatically lower default rates than non-QM loans. The UNC Center for Community Capital and CRL analyzed a nationally representative group of 19.5 million loans originated from 2000 to 2008, including both prime and subprime loans, and found that the subset of loans in this pool meeting the Qualified Mortgage definition (not including the QM DTI cut-off, which would have reduced defaults further) reduced the overall default rate by nearly half.<sup>23</sup> Even when factoring in performance during the foreclosure crisis, total losses from this reduced

<sup>21</sup> In addition, S. 1217 wrongly requires "Extra Cost Accounting", which would balloon the budgetary impact of a government guarantee beyond what it will actually cost. See Section 702. The Federal Credit Reform Act of 1999 requires budgeting for credit programs to estimate the present value of future costs of a credit program, taking into account insurance payments coming in and losses going out, rather than, as was previously the case, just including the annual impact on the budget of inflows and outflows from the program. S. 1217 would add to the budget cost the risk premium that private actors would charge ON TOP OF estimated costs, which would be a phantom cost that the government doesn't actually pay. This budget technique is inappropriate because private parties and the government simply aren't the same: private actors are loss averse because they need their money back at a particular time, even if asset value declines, while government can issue more debt to get paid back later. This risk premium is therefore unnecessary. The question isn't one of uncertainty of costs, since there is uncertainty in all budgeting, such as weapons procurement; credit programs should not be treated differently and pretend that they are more expensive than they are. The risk that the program may be more expensive than estimated can be used for a cost-benefit analysis about whether to do the program, but should not be confused with what number to plug into the federal budget. See Kogan, Ven de Water, Horney, *House Bill Would Artificially Inflate Cost of Federal Credit Programs*, Center for Budget and Policy Priorities (June 18, 2013).

<sup>22</sup> See Adam J. Levitin and Susan M. Wachter, *Explaining the Housing Bubble*, 111 *The Georgetown Law Journal* 4, 1177 (2012) (available at <http://georgetownlawjournal.org/files/2012/04/LevitinWachter.pdf>).

<sup>23</sup> Roberto G. Quercia, Lei Ding, Carolina Reid, *Balancing Risk and Access: Underwriting Standards for Qualified Residential Mortgages*, Center for Responsible Lending and UNC Center for Community Capital (Revised March 5, 2012) (stating that "[l]oans consistent with the QM product features—which include both prime and subprime loans—have fared extremely well, with just 5.8 percent of loans either 90+ days delinquent, in the foreclosure process, or foreclosed upon as of February 2011. In comparison, the default rate for prime conventional loans in our sample was 7.7 percent, nearly two percentage points higher...[T]he rates for the subprime and Alt-A market segments [were] 32.3 and 22.3 percent, respectively." Assumed 50 percent loss severity, meaning half the balance is recovered at foreclosure sale.) (available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/Underwriting-Standards-for-Qualified-Residential-Mortgages.pdf>).

default rate would equal roughly 3 percent. Similarly, as discussed below, CRL's affiliate Self-Help's losses for its secondary market program for low-down payment loans have been approximately 3 percent, even through the downturn. And, the vast majority of these loans did not have private mortgage insurance, which would have reduced losses further.

In setting minimum capital requirements, it is also important to acknowledge the differences between capital requirements for a depository institution and for a bond guarantor under housing finance reform. Depository institution capital covers several kinds of risks (credit risk, interest rate risk, and liquidity risk), while bond guarantors only largely cover credit risk. Because bond guarantors do not face these additional levels of risk, there is no need for these capital requirements to be set at the same levels.<sup>24</sup> For depository institutions, interest rate risk is a very large risk for on-balance sheet assets. But, in the secondary mortgage market, investors assume responsibility for interest rate risk of 30-year fixed-rate mortgage-backed securities. This includes the risk that rates will rise and funding costs will exceed the mortgage rate. And, the risk that rates will fall and borrowers will prepay in order to get cheaper loans, leaving the bank or investor to reinvest the proceeds in low-yielding assets. Depository institutions also face the liquidity risk of their depositors and short-term funding sources withdrawing funds. But, bond guarantors will only have limited portfolios, which will reduce this liquidity risk substantially.

### 3. Provide an Explicit – and Paid for – Government Guarantee.

Fannie Mae and Freddie Mac acted with an implicit guarantee that the government would step in and cover credit losses in the event the GSEs themselves were ever unable to fulfill this obligation. In fact, this is what happened when the GSEs entered into conservatorship in 2008.

Housing finance reform should provide for an explicit government guarantee that kicks in after private capital has stood in a first loss position, as S. 1217 provides. This guarantee is needed, since the only two periods in American history where purely private housing finance capital dominated have ended disastrously. During the first such period before the 1930s, the country had financial panics every 5 to 10 years, culminating in the Great Depression. The presence of government guarantees beginning in the 1930s through 2000 stopped banking panics and

<sup>24</sup> It is also important to note that the off-balance sheet liabilities that bond insurers (and GSEs now) are responsible for are not the same as the structured investment vehicles (SIVs) that caused banks so many problems during the crisis. SIVs and other off-balance sheet vehicles were intended to transfer credit risk and liquidity risk away from the bank, enabling the bank to avoid holding capital against these assets, but in fact the bank retained both risks; in the case of a bond insurer, it explicitly holds the credit risk. In addition, it is important to distinguish bond insurers from the monoline bond insurers during the crisis. These entities, with very little capital, insured the senior bonds of subprime and Alt-A securities backed by very risky loans, including the bonds that got wiped out that were created by re-pooling the BBB bonds through collateralized debt obligations. See Pershing Square Capital Management, L.P., *Who's Holding the Bag* (May 2007) (available at <http://www.designs.valueinvestorinsight.com/bonus/pdf/IraSohnFinal.pdf>).

directed capital into safer, regulated entities. It also routed capital into consumer-friendly mortgage products that defaulted less often. The second period was the private-label securities period of the mid-2000s, when the shadow banking system bypassed guaranteed and regulated entities.<sup>25</sup>

While reform should alleviate unnecessary risk as much as possible, the reality is that the Federal government will bear the risk of stepping in during a housing market crash – as governments across the world, including the United States, have always done. Therefore, this risk should be accounted for up front and priced accordingly. As staff from the Federal Reserve Bank of New York put it, “[i]f pressures become serious enough, housing is too important – in terms of its effects on both household wealth and financial stability – for the government not to step in during a crisis.”<sup>26</sup> Virtually all legislation and proposals – with the notable exception of the PATH Act from the House Financial Services Committee – acknowledge the need to provide an explicit and paid for government guarantee in a reformed system.

#### 4. Put in Place a Strong Regulator.

Another key problem with Fannie Mae and Freddie Mac was the lack of a strong and independent regulator to oversee these entities. The Office for Federal Housing Enterprise Oversight was created under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 for the purpose of overseeing the GSEs. Although OFHEO was able to collect assessments from the GSEs, the law subjected OFHEO to the appropriations process in order to spend these funds on its operations. This left OFHEO with substantially less independence than the safety and soundness regulators of depository institutions, which do not require acts of Congress to fund their operations. OFHEO’s resources and ability to effectively regulate Fannie Mae and Freddie Mac were compromised by the GSEs’ political strength.<sup>27</sup> These weaknesses were addressed in reform legislation in 2008, and this progress should not be jeopardized. In 2008, Congress passed HERA, which disbanded OFHEO and created a new regulator, the Federal Housing Finance Agency. Fannie Mae and Freddie Mac were then put into conservatorship in September 2008 by FHFA, and this regulator has been overseeing the GSEs’ operations in the years since. FHFA has appropriate authority to oversee the safety and

<sup>25</sup> See David Min, *How Government Guarantees Promote Housing Finance Stability*, 50 *Harvard Journal on Legislation* (2013) (available at <http://www3.law.harvard.edu/journals/jol/files/2013/09/Min.pdf>).

<sup>26</sup> Patricia Mosser, Joseph Tracy, and Joshua Wright, *The Capital Structure and Governance of a Mortgage Securitization Utility*, Federal Reserve Bank of New York Staff Report no. 644, at 4 (October 2013) (available at [http://www.newyorkfed.org/research/staff\\_reports/sr644.pdf](http://www.newyorkfed.org/research/staff_reports/sr644.pdf)).

<sup>27</sup> See e.g., FCIC Report at 42 (stating that “James Lockhart, the director of OFHEO and its successor, the Federal Housing Finance Agency, from 2006 through 2009, testified that he argued for reform from the moment he became director and that the companies were “allowed to be . . . so politically strong that for many years they resisted the very legislation that might have saved them.”).



soundness of Fannie Mae and Freddie Mac, adjust their capital levels as needed, as well as collect assessments that are not subject to appropriations.

Moving forward, the housing finance system must have a strong regulator overseeing this market. The regulator should have the authority to approve entities that operate as issuer-guarantors and then to examine their safety and soundness.

While housing finance reform proposals universally agree on the need for a strong regulator, the federal regulator created under S. 1217 – the Federal Mortgage Insurance Corporation (FMIC) – has weakened authority compared to FHFA and would amount to a step backwards on this point. Instead of granting the FMIC with safety and soundness authority, the main power of the FMIC under S. 1217 would be to decide whether companies can be approved issuers, bond guarantors, private mortgage insurers, or servicers. Additionally, the FMIC’s authority to oversee these entities once they are approved would be limited. For example, after the FMIC approves a bond guarantor, the language in S. 1217 only permits the regulator to suspend this entity “if the Corporation is notified of or becomes aware of any violation.”<sup>28</sup> This authority is reactionary, and mostly limited to the extreme action of revoking an entity’s approved status, instead of being proactive and supervisory as should occur with a safety and soundness regulator.

To ensure that the FMIC regulator is able to successfully conduct safety and soundness oversight, S. 1217 should be revised to maintain FHFA authorities.<sup>29</sup> Further, as described below, structured securities should not receive a government guarantee, and, therefore, FMIC would not have to be stretched too thin overseeing every single PLS issuance in the country.

##### 5. Prevent Issuer-Guarantor Entities from Holding Investment Portfolios.

Through the 1990’s and 2000’s, Fannie Mae and Freddie Mac built extremely large balance sheets of mortgages and mortgage-backed securities funded by debt the companies issued. By 2004, for example, Fannie Mae’s mortgage-related assets were \$925 billion.<sup>30</sup> Since market perception was (correctly) that Fannie’s debt had government backing, it was able to borrow money from the capital market at near-Treasury rates. With high leverage provided by their low capital levels, the interest rate spread on their portfolio generated high earnings. This benefitted shareholders and management while also introducing risk to the system. The interest rate risk

<sup>28</sup> S. 1217, Section 1214(d).

<sup>29</sup> For authorities necessary to oversee mutual issuer-guarantors, see Patricia Mosser, Joseph Tracy, and Joshua Wright, *The Capital Structure and Governance of a Mortgage Securitization Utility*, Federal Reserve Bank of New York Staff Report no. 644, at 44 - 45 (October 2013) (available at [http://www.newyorkfed.org/research/staff\\_reports/sr644.pdf](http://www.newyorkfed.org/research/staff_reports/sr644.pdf)).

<sup>30</sup> See Federal National Mortgage Association, United States Securities and Exchange Commission Form 10-K, for the fiscal year ended December 31, 2007, at 89 (available at [http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2007/form10k\\_022708.pdf](http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2007/form10k_022708.pdf)).

caused by their portfolios did not cause the GSEs to repeat the 1980s Savings and Loan problem of funding costs exceeding mortgage earnings. But, when Alt-A losses mushroomed and the market recognized that the GSEs lacked the capital to cover their credit losses, questions arose about their ability to roll over their high levels of short-term debt, and FHFA stepped in as conservator.

New issuer-guarantors, which would be backed by government reinsurance, should not be permitted to act as hedge funds and build arbitrage portfolios. Not having an arbitrage portfolio, however, does not logically mean that there should not be portfolio capacity for other legitimate reasons.

In fact, future issuer-guarantors should be permitted to aggregate loans, particularly for smaller lenders. Ensuring that aggregation does not slide into arbitrage can be enforced by putting a 6-month time limit on holding individual loans, as S. 1217 does for issuers. In addition, it will be important for the new issuer-guarantors (or guarantors if they are not joined with issuers) to have a limited portfolio for modified loans in order to minimize losses to the entities and maximize the chances that borrowers can avoid foreclosure.<sup>31</sup> These limited-purpose portfolios need to be backed up by a government liquidity source, just as banks are backed by FDIC deposit insurance and access to the Federal Reserve's discount window, or they will evaporate just when they are needed most, which is in times of stress.

## **II. Building on Existing Infrastructure That Benefits Homeowners and the Overall Housing Market.**

Given the risks involved to the housing market and economy from secondary market reform, we would be well served by understanding what has worked well with the current system and building on these pieces. To this end, we discuss four parts of the housing finance system that should be retained. First, housing finance reform should provide equal treatment for smaller lenders by giving them cash window access to combined issuer-guarantor entities, just as they currently have with the GSEs. While S. 1217's mutual issuer is a good attempt at filling this need, it could not compete with larger players. Second, reform should require issuer-guarantors to serve all markets at all times by providing access to all qualified lenders nationally. Additionally, the regulator, bond guarantors and lenders should be allowed to use compensating factors when determining an approved credit box rather than hardwiring down payment or other underwriting criteria in legislation.

Third, reform should preserve the TBA market for 30-year fixed-rate mortgages, which strongly

<sup>31</sup> See § II(4). If the entities also guarantee multi-family loans, there is a role in a limited portfolio of small, heterogeneous multi-family loans, since liquidity will be so small that interest rates on resulting securities will be high.



benefits borrowers, lenders and the economy. To this end, reform should not provide government reinsurance for the senior tranches of structured securities. Among other reasons, such a guarantee is unnecessary and makes the regulator's job too difficult to police every structured deal in the nation. Finally, reform should promote cost-effective loss mitigation by providing a government liquidity backstop for modified loans, as the GSEs have now, as well as for the entities' cash window to aggregate loan purchases by smaller lenders.

### 1. Providing Equal Treatment for Smaller Lenders.

A reformed mortgage finance system should encourage competition by enabling smaller and regional lenders to have equal access to the secondary market. Smaller lenders fill a unique role in the mortgage marketplace because they are tied to their communities, they provide access to credit in underserved areas of the country that larger lenders may bypass, and they provide protection against higher costs for borrowers through market competition.<sup>32</sup>

This section first highlights how the “joint issuer-guarantor” model currently used for Fannie Mae and Freddie Mac has provided certainty and market access for smaller lenders and larger ones alike. Second, it explains why the different structure allowed under S. 1217 would harm this smaller lender access. Third, it details why S. 1217's smaller-lender issuer would be uncompetitive, and why having a mutual with both larger and smaller lenders would provide better access for smaller players.

#### A. Current Model Provides Smaller Lenders with Fair Secondary Market Access.

The current system provides smaller lenders with direct access to sell their loans to Fannie Mae and Freddie Mac. This “cash window” gives smaller lenders an upfront cash payment – instead of a small interest in a security – in exchange for whole loans. This cash window access prevents smaller lenders from having to sell their loans to an aggregator, who could be a larger competitor, in order to access the secondary market. It also means that smaller lenders can get an upfront price for selling this loan in one transaction, instead of getting the return back over time through the security or needing to sell that security to an investor (and develop a costly secondary market and trading operation). Lastly, both Fannie Mae and Freddie Mac provide smaller lenders with the option of retaining servicing rights or selling those rights. Keeping servicing rights helps these lenders hold onto their best customers, rather than passing on customer contact information to larger competitors serving as aggregators.

There are two aspects of the current system that make competitive pricing through a direct cash window access possible. First, because Fannie Mae and Freddie Mac perform both issuer and

<sup>32</sup> See Independent Community Bankers of America, *Housing Finance Reform: A Community Banking Perspective* (September 2013).

bond guarantor functions, they have certainty when deciding to purchase individual loans that these loans are acceptable for yet-to-be issued securities. This certainty facilitates the cash window, because issuers might be reluctant to put cash on the table when the bond guarantor commitment is unclear or needs to be coordinated. Second, smaller lenders are not required to go through their larger competitors in order to access this secondary market. While future secondary market entities should have mutual ownership, the current system does not have the problem of enshrining larger lenders as gatekeepers to the secondary market.

#### B. S. 1217 Would Jeopardize Smaller Lender Access to the Secondary Market.

A system with separate issuer-companies and bond guarantor-companies, as is proposed in S. 1217, would weaken access for smaller lenders. First, when setting out to aggregate loans, a standalone issuer might not have any certainty about whether a bond guarantor will agree to back those loans or at what price. To minimize this risk, standalone issuers might be unwilling to purchase loans for cash instead giving the originator a share of the future security, or raise the price. As a result, cash window access might be absent or inconsistent. Second, splitting these two functions into separate companies would allow larger lenders to create affiliated issuers.<sup>33</sup> And, if they decided to, these lenders could also pool loans from other lenders. These affiliated issuer-companies would be entitled to make business decisions about the kind of mortgage products to aggregate and pool, how to price loan purchases from other lenders, and whether to require a transfer of servicing rights. The end result would be that larger institutions could control their own destiny, but smaller lenders would be at the mercy of competitors.

**The Ginnie Mae System:** Some have pointed to Ginnie Mae as a model for a future housing finance system, and it is instructive to highlight both how this system impacts smaller lenders and compares to S. 1217. The Ginnie Mae system involves securities that are bundled with FHA, VA and USDA loans (which have the full faith and credit of the federal government). Ginnie Mae provides a government guarantee on these securities. They also approve companies to act as issuers, and there is currently a network of approximately 365 approved issuers.<sup>34</sup> Many approved issuers are loan originators and use their status to pool their own originations. For smaller lenders without issuer status, their main access to the system is through one of their possible competitors.

One key difference between the Ginnie Mae system and the one contemplated in S. 1217 is that Ginnie Mae-approved issuers have certainty that the loans they aggregate have a credit

<sup>33</sup> These lenders are unlikely to become bond guarantors because of the impact it would have on their balance sheet based on true sale accounting rules, but creating a standalone issuer would not have the same impact.

<sup>34</sup> See Ginnie Mae, Approved Single-Family Issuers (available at [http://www.ginniemae.gov/doing\\_business\\_with\\_ginniemae/issuer\\_resources/approved\\_issuers\\_document\\_custodians/Pages/single\\_family.aspx](http://www.ginniemae.gov/doing_business_with_ginniemae/issuer_resources/approved_issuers_document_custodians/Pages/single_family.aspx)).

guarantee, and there is no separate process required to gain guarantee status besides being FHA, VA or USDA approved. As described above, the same might not be the case under S. 1217.

Another difference worth highlighting is the fact that smaller lenders generally have to access the Ginnie Mae system through competitors, whereas that is not the case with the Fannie Mae and Freddie Mac cash window. While the number of Ginnie Mae issuers has increased in recent years, it pales in comparison to the thousands of lenders that have direct cash window access to the secondary market through the GSEs. Even in Ginnie Mae's multi-issuer securities (called Ginnie Mae IIs), the access point for these pools is still through approved issuers. While the Ginnie Mae II model is an advancement toward a common securitization platform and common security, it does not provide the same direct access as Fannie Mae and Freddie Mac's cash window.

**Other Improvements to S. 1217:** In the event that Congress decides to bifurcate the system into separate issuer-companies and bond guarantor-companies, then it should prohibit lenders from being affiliated with or purchasing stock in any issuer or guarantor, except through mutual ownership in order to protect small lenders. In addition, all of these separate entities should be prohibited from offering volume discounts to avoid discriminatory pricing in favor of larger sellers.

#### C. A Separate Mutual for Smaller Lenders Would Not Be Competitive.

S. 1217 attempts to address the competitive disadvantage of smaller lenders by establishing a mutually owned issuer for smaller lenders. Specifically, the FMIC – the new federal regulator established under S. 1217 – would charter the FMIC Mutual Securitization Company to serve as an issuer for depository lenders under \$15 billion in assets and non-depository lenders. This smaller lender mutual could purchase infrastructure and technology from Fannie Mae and Freddie Mac, and would be able to purchase whole loans for cash from member-lenders. However, given that there would be no government liquidity source acting as backstop (as the GSEs have now and banks have through deposit insurance and access to the Federal Reserve's discount window), this cash window function would disappear in times of crisis.

Despite the best intentions of this provision, this approach would result into a two-tiered system. The core problem is that even when banded together as a mutual, smaller lenders would still have difficulty going up against their larger competitors, for two main reasons. First, the smaller lender mutual won't be able to compete on volume. An issuer serving bigger lenders with larger volume will have more liquid securities than a smaller lender mutual. This liquidity disadvantage will ultimately result in less competitive pricing for smaller lender securities. It would also result in a higher cost of debt to provide a cash window and to buy loans out of securities. Second, the smaller lender mutual would have a substantial number of counterparties to contract with and oversee, because the membership would comprise many individual lenders. Compared to a larger lender with an affiliated issuer and few to no



counterparties, the smaller lender mutual will have much higher operating costs.

These disadvantages would prevent the FMIC Mutual Securitization Company from effectively competing in the marketplace. As a result, smaller lenders could end up still selling their loans to larger competitors who could aggregate these loans. This approach ends up back at square one with smaller lenders in jeopardy of losing access to a cash window, getting less favorable pricing, and not having the option of retaining servicing rights.

The problem with this approach is not the use of a mutual ownership structure, but having one system for larger lenders and a second for the smaller ones and then expecting these two to be on even footing.<sup>35</sup> Instead, there should be mutual ownership of entities that serve all lenders *and* perform both issuer and guarantor functions. In addition to aligning incentives for long-term sustainability, this kind of mutual would put larger entities and smaller ones on a more level playing field. Mutual ownership would provide all institutions with representational board membership, which would ensure that smaller institutions have a seat at the table when decisions are made about business strategy, risk management and governance.<sup>36</sup> Additionally, mutually owned entities would be required to offer equal pricing to all members, regardless of size. Using a mutual ownership model does not eliminate the fact that larger institutions have more market share and ultimately more market power, but it does prevent them from having as much dominance in the secondary markets as they would otherwise.

While we believe that all secondary market entities should all be mutual issuer-guarantors, if that option is not selected, we would support removing the asset limit on participating in the FMIC Mutual Securitization Company to permit any lender to join. This would be a step forward in increasing the competitive position of smaller lenders by permitting them to benefit from the economies of scale provided by larger lenders, as they do in the Federal Home Loan Bank system.

## 2. Serve All Markets at All Times.

A reformed housing finance system must continue to fulfill a national role where it serves all markets at all times. This section addresses two prongs of this requirement. First, from the lender perspective, the housing finance system must support lenders operating in all parts of the country, including rural areas. Second, from the borrower perspective, the system should permit traditional underwriting through compensating factors to provide creditworthy

<sup>35</sup> S. 1217 also permits the Federal Home Loan Bank System to create an issuer, which would in effect also be mutually owned. While we are supportive of this provision, we do not expect it to become large enough to fundamentally change market dynamics.

<sup>36</sup> See Michael Murphy, *Fannie Mae and Freddie Mac: Legal Implications of a Successor Cooperative*, DePaul Business & Commercial Law Journal (Winter 2012).

borrowers who can afford a mortgage access to a mainstream mortgage and avoid pushing certain communities into higher cost products.

#### A. Serving All Eligible Lenders in a National Market:

One of the relatively unnoticed success stories of the current housing finance system – both before the crisis and in the years under conservatorship since – is the creation of a stable national housing market that could weather regional or even national economic cycles. While they have overly constricted their credit box in the years since the crisis, Fannie Mae and Freddie Mac have provided stable liquidity during a crisis period in our economic history. Without these two entities continuing to provide \$6.3 trillion of liquidity under conservatorship, the Great Recession would have slid into another true depression; private securitizations have contributed just \$39 billion in mostly pristine jumbo loans.

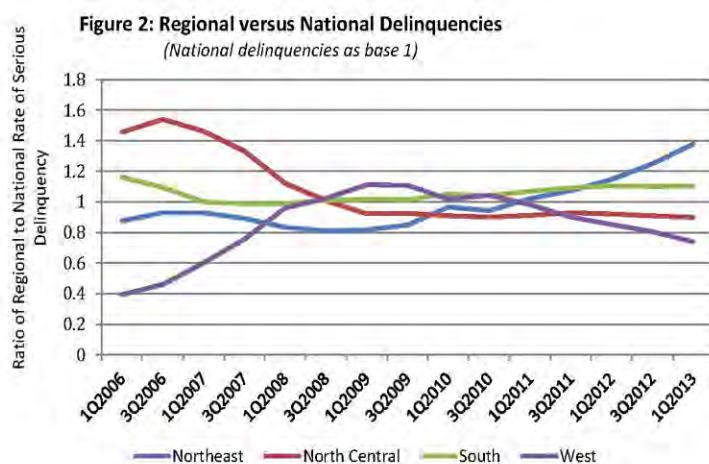
Two components of the GSEs’ national role are worth highlighting. First, the GSEs have an obligation to serve all markets at all times. The GSE charter states that they must “promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.”<sup>37</sup> Much attention has been paid to the Enterprises’ numerical affordable housing goals, but this responsibility to serve a national role should not be underestimated when evaluating access to credit. Second, having a manageable number of national entities – as opposed to a multitude of niche players – is what makes it feasible to oversee this national market obligation.

**Joint Issuer-Guarantor Companies are Important to Enforce a National Market:** In addition to helping smaller lenders, having entities perform both issuer and guarantor functions would also facilitate a national market obligation. For example, in today’s system with Fannie Mae and Freddie Mac, the limited number of entities makes it possible to assess whether they are providing secondary market access to all lenders and communities. The alternative model offered in S. 1217 would splinter the system so that anywhere between one entity to some five hundred companies might act as issuers and another five to ten as bond guarantors. Whatever the exact number, these companies could align their business models to serve specific lenders that might not cover the entire country. S. 1217 has a 15 percent market share cap for issuers that accept loans from other lenders, which would require at least seven entities and make it impossible to enforce a national market mandate. Individual lenders should be able to pursue a regional or local business model; however, that business decision should not drive the overall flow of credit through the U.S. housing market.

**Requirement to Serve All Eligible Lenders:** In addition, housing finance reform should require that all joint issuer-guarantors provide membership to all lenders wanting to join who meet

<sup>37</sup> 12 U.S.C. § 1716(4).

eligibility requirements, regardless of whether they primarily serve rural areas or parts of the country facing a regional downturn. As Figure 3 below demonstrates, some areas of the country, at different times, lag others. A fragmented secondary mortgage market system might ignore lending in certain states or communities. Such a gap would translate to many communities not receiving sufficient access to mortgage credit, given that lender portfolio capacity is inherently limited. A future system cannot be allowed to break into distinct pieces, with one entity serving the Southeast, another serving California, and no one serving Mississippi or South Dakota. In the current system, if Fannie Mae and Freddie Mac decide not to buy loans from lenders serving Mississippi or South Dakota, it is clear who FHFA should tell to do so – both entities. If instead there were multiple issuers and guarantors playing niche roles in the secondary market, there would be no entity to enforce this obligation against. An “all eligible lender” requirement makes this fragmentation much less likely.



Source: Mortgage Bankers Association National Delinquency Surveys, 2006-2013

#### B. Permit Use of Compensating Factors in Underwriting.

Just as a reformed system should not leave lenders serving certain states or neighborhoods behind, the future system must not become overly narrow in terms of the borrowers it serves. We believe that GSE reform legislation should not prohibit lenders from using compensating factors to make more informed decisions about credit risk. Any good underwriter knows that some borrowers who can only put 3 percent down are a lower credit risk than others who can



put 20 percent down, but legislation is unable to make this kind of determination across the board.

In the wake of the financial crisis and while being under conservatorship, the GSEs have become overly conservative – only the most pristine borrowers can get a conventional mortgage. According to the analysis firm Ellie Mae, the average borrower denied a GSE loan had a FICO score of 734 and was willing to put 19 percent down.<sup>38</sup> Purchase originations are at their lowest levels since the early 1990s.<sup>39</sup> There is a risk of enshrining or exacerbating this narrow market as part of housing finance reform, which would result in pushing lower-wealth borrowers into a separate and more expensive system.

However, a dual market approach has never served the country well. For example, a dual market existed during the recent mortgage boom, when half of all African-American families were steered into high-cost, abusive subprime mortgages, while most white borrowers received prime loans. Going forward, lower-wealth families and communities should not be pushed into FHA as a housing reform solution. Rather, families able to succeed in a mainstream mortgage should be able to access the mainstream market.

Instead, a reformed housing finance system must serve the full universe of creditworthy borrowers that can afford a responsible loan. This is will not only ensure that lower-wealth families have the opportunity to build wealth through homeownership, but it will also support the overall housing market.<sup>40</sup> To this end, Congress should not hardwire down payment

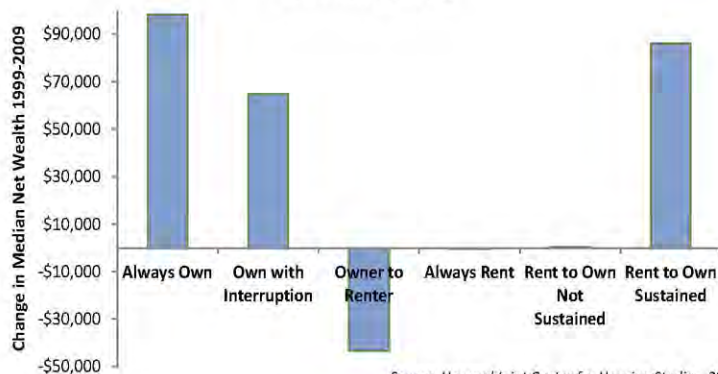
<sup>38</sup> See Kenneth Harney, *Mortgage lenders set higher standards for the average borrower*, The Washington Post (September 28, 2012).

<sup>39</sup> See Governor Elizabeth A. Duke, *Comments on Housing and Mortgage Markets*, At the Mortgage Bankers Association Mid-Winter Housing Finance Conference, at 2 (March 8, 2013) (available at <http://www.federalreserve.gov/newsevents/speech/duke20130308a.htm>).

<sup>40</sup> See Christopher Herbert, Daniel McCue, and Rocio Sanchez-Moyano, *Is Homeownership Still an Effective Means of Building Wealth for Low-income and Minority Households? (Was it Ever?)*, Joint Center for Housing Studies, Harvard University, at 48 (September 2013) (stating that “[o]verall, owning a home is consistently found to be associated with increases of roughly \$9,000-\$10,000 in net wealth for each year a home is owned. . . . Even after the tremendous decline in housing prices and the rising wave of foreclosures that began in 2007, homeownership continues to be a significant source of household wealth, and remains particularly important for lower-income and minority households. As has become painfully clear, owning a home is not without risk. But even during a time of excessive risk taking in the mortgage market and extreme volatility in house prices, large shares of owners successfully sustained homeownership and created substantial wealth in the process (at least through 2009). While African-American and lower income households were somewhat less likely to sustain homeownership, these groups also experienced sizeable gains in net wealth on average that was associated with owning, while renters saw few gains. Owners who failed to sustain homeownership did suffer substantial loss in wealth, but much of the wealth was associated with the move into homeownership, so these households essentially fell back to their initial wealth levels. At least in terms of household wealth, failed attempts at

mandates, as is done with a 5 percent down payment mandate in S. 1217.

**Figure 3: Homeownership Provides Greatest Opportunity to Grow Household Wealth**



Source: Harvard Joint Center for Housing Studies, 2013

**Down Payment Mandates and Other Hardwired Underwriting Criteria Would Needlessly Restrict Access to Credit:**

Including down payment mandates in housing finance reform legislation would unnecessarily restrict access to credit for lower-wealth families. As an initial matter, these mandates overlook the fact that borrowers must also save for closing costs – roughly 3 percent of the loan amount – on top of any down payment required. And, the mandates would increase the number of years that borrowers would need to save for a down payment. Using 2011 figures that include closing costs, it would take the typical family 17 years to save for a 10 percent down payment and 11 years to save for a 5 percent down payment. Looking at a subset of data for African Americans and Latinos, in Table 1, these years to save figures increase dramatically.<sup>41</sup>

owning do not appear to leave the typical household worse off than when they started.”) (available at [http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/hbtl-06\\_0.pdf](http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/hbtl-06_0.pdf)).

<sup>41</sup> CRL years-to-save calculations are based on purchase of a 2011 median priced house (\$173,600) by borrower with median income in 2011 (\$50,502). Assumes an annual savings rate dedicated for down payment of 2.6%. Median income for 2011 is from American Community Survey. Savings rate assumption is derived from the Bureau of Economic Analysis’s (the 1-year average of the BEA’s personal savings rate from July 2012-July 2013 is 4.9 percent; the 20-year average was 5.0 percent). However, the BEA’s the BEA’s rate is based on take home, not gross, income, and therefore, a 5.0 personal savings rate translates to a 3.6 percent rate for gross income, assuming a combined federal, state and local tax rate of 28 percent (see effective tax burden for the middle [http://www.nytimes.com/2012/11/30/us/most-americans-face-lower-tax-burden-than-in-the-80s.html?pagewanted=all&\\_r=2&](http://www.nytimes.com/2012/11/30/us/most-americans-face-lower-tax-burden-than-in-the-80s.html?pagewanted=all&_r=2&)). Assumes that, of this 3.6 percent, 1 percentage point must be used by families for retirement, college, and emergencies, leaving 2.6% available for homeownership savings.



**Figure 4: Years-to-Save for a Down Payment Mandate for Families with Median Incomes**  
(2011 figures)

	5% Down Payment Mandate + Closing Costs	10% Down Payment Mandate + Closing Costs
Median Income for All Households (\$50,502)	11 Years	17 Years
Median Income for White Households (\$55,305)	10 Years	16 Years
Median Income for Latino Households (\$39,232)	13 Years	22 Years
Median Income for African-American Households (\$33,232)	16 Years	26 Years

Persistent wealth disparities for African-American and Latino households would make down payment mandates particularly harmful for these communities.<sup>42</sup> In addition to taking years longer to save for a down payment, the wealth gap makes it less likely that African-American and Latino families could get financial help from family members.<sup>43</sup> This combination could leave many individuals – who could be successful homeowners<sup>44</sup> – with restricted access to credit.

Similar obstacles exist with younger families. Down payment burdens and other obstacles are preventing these families from joining the mortgage market, and their participation is necessary for a thriving economy. According to former-Governor Duke of the Federal Reserve Board, "[s]taff analysis comparing first-time homebuying in recent years with historical levels underscores the contraction in credit supply. From late 2009 to late 2011, the fraction of individuals under 40 years of age getting a mortgage for the first time was about half of what it was in the early 2000s."<sup>45</sup>

On top of harming lower wealth borrowers, imposing down payment mandates would also be

<sup>42</sup> See e.g., Thomas Shapiro, Tatjana Meschede, and Sam Osoro, *The Roots of the Widening Racial Wealth Gap: Explaining the Black-White Economic Divide*, Institute on Assets and Social Policy (February 2013) (available at <http://iasp.brandeis.edu/pdfs/Author/shapiro-thomas-m/racialwealthgapbrief.pdf>).

<sup>43</sup> See *The State of the Nation's Housing*, Joint Center for Housing Studies, at 3 (2013) (available at <http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/son2013.pdf>).

<sup>44</sup> See *Setting the Record Straight on Homeownership*, UNC Center for Community Capital, Research Brief (2012).

<sup>45</sup> See Governor Elizabeth A. Duke, *Comments on Housing and Mortgage Markets*, At the Mortgage Bankers Association Mid-Winter Housing Finance Conference, at 2 (March 8, 2013).

harmful for the housing market overall. According to the Joint Center for Housing Studies at Harvard University, households of color will account for 70 percent of net household growth through 2023. Considering that many of these households have limited wealth, down payment mandates could significantly reduce the number of future first-time homebuyers.<sup>46</sup> This reduced pool of buyers could lead to lower home prices, more difficulty selling an existing home, and even some existing borrowers defaulting on their mortgage. For example, if property values decrease and a homeowner then has a life event – such as divorce, illness, or job loss – they would face the dual problem of 1) being unable to make monthly payments and 2) have difficulty selling the home to pay off the mortgage in full. This would also impact older homeowners needing to sell their houses and use their home equity to pay for retirement, move to a managed-care facility or to a smaller house.

Not only is there a huge cost to putting these restrictions into law, but there is also a limited benefit in terms of reducing default rates. When looking at loans that already meet the product requirements for a Qualified Mortgage, a UNC Center for Community Capital and CRL study shows that these requirements cut the overall default rate by almost half compared with loans that did not.<sup>47</sup> Layering on a down payment requirement on top of these protections produces a marginal benefit.<sup>48</sup> This makes sense, because risky product features and poor lending practices caused the crisis by pushing borrowers into default, and the Dodd-Frank Act reforms address these abuses. The Qualified Mortgage and Ability to Repay reforms restrict risky features such as high fees, interest-only payments, prepayment penalties, yield-spread premiums paid to mortgage brokers, lack of escrows for taxes and insurance for higher priced mortgage loans, teaser rates that spiked to unaffordable levels even with constant interest rates, and outlawing

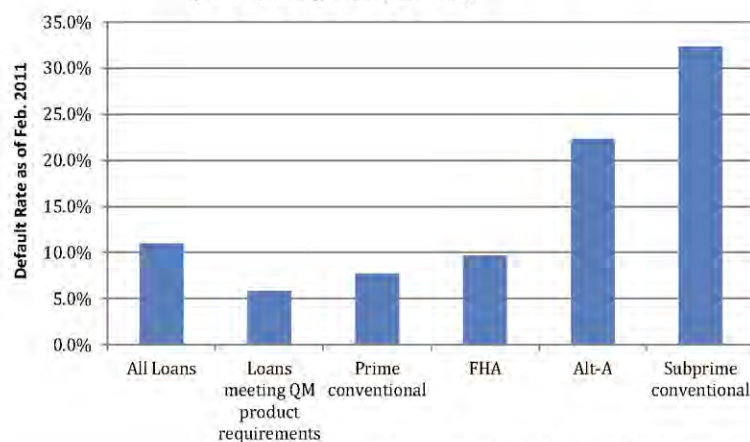
<sup>46</sup> See *The State of the Nation's Housing*, Joint Center for Housing Studies, at 3 (2013) (stating that “[m]inorities—and particularly younger adults—will also contribute significantly to household growth in 2013–23, accounting for seven out of ten net new households. An important implication of this trend is that minorities will make up an ever-larger share of potential first-time homebuyers. But these households have relatively few resources to draw on to make downpayments. For example, among renters aged 25–34 in 2010, the median net wealth was only \$1,400 for blacks and \$4,400 for Hispanics, compared with \$6,500 for whites. Even higher-income minority renters have relatively little net wealth, with both blacks and Hispanics in the top income quartile having less than half the average net wealth of whites. Proposed limits on low-downpayment mortgages would thus pose a substantial obstacle for many of tomorrow’s potential homebuyers.”).

<sup>47</sup> Roberto G. Quercia, Lei Ding, Carolina Reid, *Balancing Risk and Access: Underwriting Standards for Qualified Residential Mortgages*, Center for Responsible Lending and UNC Center for Community Capital (Revised March 5, 2012) (stating that “[l]oans consistent with the QM product features—which include both prime and subprime loans—have fared extremely well, with just 5.8 percent of loans either 90+ days delinquent, in the foreclosure process, or foreclosed upon as of February 2011. In comparison, the default rate for prime conventional loans in our sample was 7.7 percent, nearly two percentage points higher...[T]he rates for the subprime and Alt-A market segments [were] 32.3 and 22.3 percent, respectively.”) (available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/Underwriting-Standards-for-Qualified-Residential-Mortgages.pdf>).

<sup>48</sup> *Id.*, at 18.

no-doc loans. These reforms address the unaffordable and abusive loan products that caused the crisis.<sup>49</sup>

**Figure 5: Default Rates for QM-Like Loans Are Substantially Lower**  
(2000-2008 Originations, All Loans)



Source: UNC Center for Community Capital and CRL, 2012

Given the parameters set by the Dodd-Frank Act's mortgage reforms, Congress should not go further and hardwire specific underwriting criteria into legislation, especially since borrowers in well-underwritten loans can succeed in mortgages with lower down payment amounts.<sup>50</sup> Laurie Goodman of the Urban Institute points out that a hard 5 percent cutoff is not the best way to address default risk, since compensating underwriting factors are more important. Analyzing Fannie Mae data, she found that:

The default rate for 95 to 97 percent LTV mortgages is only slightly higher than for 90 to 95 LTV mortgages, and the default rate for high FICO loans with 95 to 97 LTV ratios is *lower* than the default rate for low FICO loans with 90 to 95 percent LTV ratios. . . . For

<sup>49</sup> See Debbie Gruenstein Bocian, Wei Li, Carolina Reid, and Roberto G. Quercia, *Lost Ground, 2011: Disparities in Mortgage Lending and Foreclosures*, Center for Responsible Lending and UNC Center for Community Capital (November 2011) (available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/Lost-Ground-2011.pdf>).

<sup>50</sup> See *Setting the Record Straight on Homeownership*, UNC Center for Community Capital, Research Brief (2012).



mortgages with an LTV ratio above 80 percent, credit scores are a better predictor of default rates than LTV ratios.<sup>51</sup>

In addition, for the last 17 years, CRL's affiliate Self-Help has run a secondary market home loan program, which has purchased 52,000 mortgages worth \$4.7 billion originated by 35 lenders in 48 states. Borrowers in 72 percent of these mortgages made less than a 5 percent down payment and 32 percent put less than 3 percent down. In addition, 38 percent of borrowers received help with the down payment and closing costs from another party, and use of assistance was not correlated with higher default when controlling for other factors.<sup>52</sup> Forty-one percent of borrowers were female-headed households, 40 percent were from households of color and the median income of these borrowers was less than \$31,000. All of these mortgages would meet the Qualified Mortgage product requirements legislated in Dodd-Frank, and the vast majority of these loans did not have private mortgage insurance. These borrowers saw a 27 percent median annualized return on equity, which increased \$18,000 even through the crisis through 2011.<sup>53</sup> This high loan-to-value program resulted in Self-Help's cumulative loss rate of approximately 3 percent, which includes performance during the recent foreclosure crisis and would have been substantially lower if the loans had private mortgage insurance.

Similarly, legislation should not contain credit score or debt-to-income cutoffs either. Private companies' proprietary scoring models should not be enshrined into legislation; we learned that lesson with the ratings agencies. Further, each loan is a combination of numerous factors and if one factor is enshrined by legislation that will reduce the pool of potential borrowers with strong compensating factors who could succeed as homeowners. Underwriting is multivariate and complex. It is not susceptible to legislation and should be left to the regulator, bond guarantors and lenders through traditional compensating factors.

**Market Access Fund, Housing Trust Fund and Capital Magnet Fund:** In addition to ensuring that a reformed housing finance system broadly serves the market, we support the creation and funding of a multi-purpose fund that builds on Title IV of S. 1217 so that the new housing finance system can further serve a range of housing needs. In particular, we support assessing all mortgage backed securities (not just guaranteed securities) a 10 basis point annual user fee (i.e., a "strip") that would be used to support a Market Access Fund and the two funds created under HERA – the Housing Trust Fund and the Capital Magnet Fund. These funds, each of which uses a different mechanism to serve very different housing purposes, would be administered,

<sup>51</sup> See Laurie Goodman and Taz George, *Fannie Mae reduces its max LTV to 95: Does the data support the move?*, The Urban Institute, MetroTrends Blog (September 24, 2013) (available at <http://blog.metrotrends.org/2013/09/fannie-mae-reduces-max-ltv-95-data-support-move/>).

<sup>52</sup> See Allison Freeman and Jeffrey J. Harden, *Affordable Homeownership: The Incidence and Effect of Downpayment Assistance*, UNC Center for Community Capital Working Paper (February 2013).

<sup>53</sup> See Allison Freeman and Janneke Ratcliffe, *Setting the Record Straight on Affordable Homeownership* at 4-8 (May 2012).

respectively, by a separate office within the federal guarantee agency, HUD and the Treasury's CDFI Fund. We suggest that percentage allocations to the three funds provided in Title IV be reconsidered to assure that the allocations more closely reflect the needs that each fund addresses.

### 3. Preserve the TBA Market for 30-Year Fixed Rate Mortgages.

Today's secondary mortgage market for Fannie Mae and Freddie Mac securities revolves around the "to-be-announced" (TBA) market – also called the forward market. The name comes from the fact that investors commit to a transaction before the security is pooled together, meaning the individual loans in the pool are not "announced" until one to three months later. This is a unique way for a capital markets system to function, and it produces a number of benefits, including widespread liquidity, countercyclical access to credit and broad availability of the 30-year fixed-rate mortgage.

The question for housing finance reform is how best to maintain this system. In answering this, Congress should decide to continue the infrastructure that makes today's secondary market work, which involves bond guarantors providing credit guarantees on pass-through securities packaged with mortgages meeting specified underwriting standards. In choosing this "bond guarantor" model, Congress should also reject allowing structured securities to receive government reinsurance, as S. 1217 permits.

This section compares these two models<sup>54</sup> – the bond guarantor model and the structured securities model – and highlights six ways that the structured securities model would fail to deliver the same kind of benefits as the bond guarantor approach. First, because they are sliced into unique tranches, structured securities are incompatible with the forward market. Second, by going on a deal-by-deal basis, they would not provide the same kind of widespread liquidity and would increase borrower costs. Third, while 30-year fixed-rate mortgages would be available at some level, access to these mortgages would be substantially curtailed with structured securities. Fourth, structured securities would recognize losses on a security-by-security basis, resulting in the government reinsurance being at risk for each deal. Fifth, even with government insurance of senior tranches, subordinate tranche investors would flee in times of economic stress, thus restricting access to credit when it is most needed. Sixth, having large numbers of individual securities would overwhelm the regulator, and essentially turn it into a very large ratings agency. As a result of these comparative disadvantages, structured securities should not be able to access a government guarantee for senior tranche investors.

<sup>54</sup> See Remarks as Prepared for Delivery Edward J. DeMarco, Federal Reserve Bank of Chicago 49<sup>th</sup> Annual Conference on Bank Structure and Competition, *Housing Finance, Systemic Risk, and Returning Private Capital to the Market* (May 9, 2013) (available at <http://www.fhfa.gov/webfiles/25170/ChicagoFedBankStructureSpeechFinal.pdf>).

Figure 6: Bond Guarantor Model vs Structured Securities Model

Bond Guarantor Model	Structured Securities Model
<b>Preserves “forward market”</b> for loans not yet originated. Enables lenders to offer interest rate locks to borrowers on mortgages while hedging this interest rate risk.	<b>Incompatible with forward market</b> , because loans are pooled and assigned to specific tranches after origination.
<b>Highly liquid securities</b> due to standardized underwriting and streamlined investment process of pass-through securities. Liquidity of securities reduces borrower interest rates 10-25 basis points or more.	<b>Lower liquidity</b> because little standardization of securities and fewer investors for subordinate tranches.
<b>Widespread availability of 30-year, fixed rate mortgages</b> due to credit guarantee and standardized terms.	<b>Limited availability of 30-year fixed rate mortgages</b> due to subordinate investors holding credit risk and no fungible securities.
<b>Less likely to require government reinsurance</b> ; since it only applies if there are net losses on guarantor’s entire book of business.	<b>More likely to require government reinsurance</b> because there is no pooling of risk across securities – i.e., losses on any individual security could trigger the need for government reinsurance.
<b>Provides countercyclical access to credit</b> , because the credit guarantee and TBA market structure provides certainty for investors.	<b>Limited access to credit during times of economic stress</b> or in down regional housing markets.
<b>Regulator can effectively supervise</b> since there would be limited number of bond guarantors that must be regulated for safety and soundness.	<b>Impossible to supervise</b> since regulator would need to supervise every single private label security issuance in country, turning the government into big ratings agency.

#### A. Structured Securities are Incompatible with the Forward Market.

**The Bond Guarantor Model:** As mentioned, the TBA market allows investors to buy securities before those securities are even formed. Transferring the actual securities happens up to 90 days after the investments are committed to. Bond guarantors (currently, Fannie Mae and Freddie Mac) provide a credit guarantee for the securities processed through the TBA market, and a reformed system should ensure that there is explicit and paid-for government reinsurance. These securities are pass-through securities, which means that all investors receive a pro-rata share of all principal and interest payments. Additionally, no class of investor is forced to take a share of credit losses, and the security’s cash flow is not sliced and diced differently for various investors. Instead, all investors are on equal footing, with the only difference being the relative size of each investment. Thus, investors only willing to take on interest rate risk – but not credit risk – can invest in these securities and be guaranteed a full return of their principal.

Because of this system, lenders are able to offer borrowers a rate lock, which is a commitment to fund a loan at a specific interest rate for a specified number of days – such as a 4.5 percent rate commitment for 60 days. This allows the potential homebuyer to decide on a price range



based on the locked-in interest rate, which facilitates negotiations among buyers and sellers. At the same time, the forward market gives the lender an ability to commit to sell the rate-locked loan on the secondary market before it has been originated. This benefits the lender, because it hedges the risk that interest rates will rise before closing the loan. Furthermore, this hedging happens in a simple manner available to less sophisticated lenders lacking complicated derivatives operations.

**The Structured Securities Model:** Expanding the government guarantee to structured securities would produce securities that are incompatible with the TBA market, because these securities are not streamlined or fungible. Structured securities are individual deals that pool mortgages and then subdivide them into tranches or slices, as was done with private-label securities packaged with subprime and Alt-A loans during the lead up to the financial crisis. These tranches are ordered by level of seniority, with senior positions taking losses last and the subordinate positions taking losses first. The subordinate tranche investors put their private capital at risk because those credit losses are not backed by any entity or guarantee. Accordingly, this process requires examining the individual loans packaged into each pool in order to finalize the tranches and find appropriate investors. This timing is incompatible with the in-advance approach used in the TBA system. As a result, there can be no large-scale forward market with structured securities.

**B. Structured Securities Would Not Provide Widespread Liquidity and Would Lead to More Expensive Loans.**

**The Bond Guarantor Model:** The TBA market is the backbone of a highly liquid capital market for mortgage-backed securities. The key to this liquidity is having standardized pass-through securities and a streamlined investment process.<sup>55</sup> All pass-through securities provide a credit guarantee to investors, pro-rata payments to investors, and only include mortgages meeting common underwriting standards. In addition, the system uses a standard set of upfront disclosures for investors.<sup>56</sup> When taken together, this standardization makes securities highly fungible and, therefore, liquid.

<sup>55</sup> For a discussion of the TBA market and factors contributing to homogeneity among securities, see James Vickery and Joshua Wright, *TBA Trading and Liquidity in the Agency MBS Market*, Federal Reserve Bank of New York Economic Policy Review (May 2013) (available at <http://www.newyorkfed.org/research/epr/2013/1212vick.pdf>); see also Written Statement of Thomas Hamilton, Managing Director, Barclays' Capital, Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Securities, Insurance, and Investment, Hearing: Examining the Housing Finance System: The To-Be-Announced Market (August 3, 2011).

<sup>56</sup> This format includes six pieces of data: "issuer, maturity, coupon, price, par amount, and settlement date." There's also a set timeline for finalizing TBA deals along with standardized documents and conventions. See James Vickery and Joshua Wright, *TBA Trading and Liquidity in the Agency MBS Market*, Federal Reserve Bank of New York Economic Policy Review, at 5 (May 2013).

Liquidity gives investors the ability to trade these securities in an active marketplace. This means that investors are not locked in to the investment over time and forced to take a potentially substantial loss upon deciding to sell. This flexibility attracts a high level of investment and further contributes to market liquidity. Additionally, because the TBA market serves as a market standard, financial institutions and investors use it as a way to hedge other investments, such as jumbo mortgages that are outside the guidelines for Fannie Mae and Freddie Mac.

The liquidity and efficiency of the TBA market also enables borrowers to get better mortgage rates. One estimate shows that borrowers get an interest rate that is 10-25 basis points lower simply due to the liquidity benefits of the TBA system, and this benefit rises in times of economic stress.<sup>57</sup> For example, a borrower would save \$2,500 from a 25 basis point reduction in a \$200,000 loan that he or she stays in for roughly five years.

**The Structured Securities Model:** Opening up the government guarantee system to structured securities would result in a less liquid market for two reasons. First, as described above, because they slice the pools into different tranches, structured securities lack standardization. Not only are investors in the same security treated differently based on their relative seniority in the deal, but individual securities would also vary from one another. The differences include the way the securities could be tranced or the pricing for different loan pools. These collective differences make the loans less fungible and, therefore, much less liquid.

Second, there are a limited number of investors willing to take credit risk by investing in the subordinate tranches of a security. Almost all MBS investors are rate investors such as foreign investors or pension funds and not credit risk takers. In fact, during the subprime boom, the lack of subordinate investors led firms to repackage the subordinate tranches from multiple securities into new pools, known as collateralized debt obligations (CDOs). These new pools were then sliced again into new senior and subordinate tranches, with senior CDO tranches getting pristine credit ratings when they were actually backed by risky tranches backing risky loans.<sup>58</sup> Only by transforming B grade investments into AAA rated securities through the CDO process were firms able to attract a larger number of investors for these subordinate pieces. Finding investors for AAA paper did not present a problem. Providing a government guarantee on the senior tranches of structured securities would not help obtain subordinate investors, because these investors would still need to take on credit risk, and is, therefore, unnecessary.

### C. Structured Securities Would Provide Restricted Access to 30-Year Fixed-Rate Loans.

<sup>57</sup> See James Vickery and Joshua Wright, *TBA Trading and Liquidity in the Agency MBS Market*, Federal Reserve Bank of New York Economic Policy Review, at 2 (May 2013).

<sup>58</sup> See e.g., Pershing Square Capital Management, L.P., *Who's Holding the Bag* (May 2007) (available at <http://www.designs.valueinvestorinsight.com/bonus/pdf/IraSohnFinal.pdf>).



**Bond Guarantor Model:** Because of the bond guarantor structure, the TBA market can also facilitate broad availability of the 30-year fixed-rate mortgage. This product provides borrowers with affordable monthly payment amounts by eliminating refinancing risk (i.e., the 30-year term) and payment stability (i.e., the fixed interest rate). This combination has opened the door of homeownership to many borrowers and then allowed them to successfully make their payments during the life of the loan, regardless of rate moves and economic conditions.

The 30-year fixed-rate mortgage is also positive for the housing market and overall economy. Financial institutions and investors – who have access to interest rate swaps, options and other derivative instruments to hedge this risk – are in a better position to handle interest rate risks than families. There is evidence that placing interest-rate risk with investors instead of families makes the financial system less susceptible to boom and bust cycles as a result of changing interest rates.<sup>59</sup> After all, it was the widespread move to adjustable-rate mortgages packaged in private label securities that precipitated the recent housing market decline.

Two main factors facilitate the broad availability of the 30-year fixed-rate mortgage. First, the credit guarantee available for Fannie Mae and Freddie Mac mortgages takes the credit risk of such a long-term investment off the table. This allows rate investors to invest in these securities. Second, because it is large, streamlined and standardized, the TBA market makes this mortgage product more widely available than it otherwise would be. Crucially, the commitment to purchase the pools is done before the investor knows where the loans are geographically located, ensuring a national market of uniform pricing.

**Structured Securities Model:** It's true that a 30-year fixed-rate product could exist in a system without the TBA market (or even without a credit guarantee), but it would exist at much lower levels and at much higher rates than it does today. Even with a guarantee on the senior tranches, the investors committing to a subordinate piece of a security would be taking on credit risk for 30 years in addition to interest rate risk. This would result in a larger number of adjustable-rate mortgages or shorter-term mortgages (or both) to minimize the risk of these losses. The end result would be securities filled with pristine mortgages (as is currently the case in today's private-label jumbo market<sup>60</sup>) that present little risk, but also do little to provide broader access to credit. Given this reality, it would be hard to justify opening up the government guarantee to structured securities.

<sup>59</sup> See David Min, *How Government Guarantees Promote Housing Finance Stability*, 50 *Harvard Journal on Legislation*, 437 (2013) (available at <http://www3.law.harvard.edu/journals/jol/files/2013/09/Min.pdf>).

<sup>60</sup> See Written Statement of Adam Levitin, Professor of Law, Georgetown University Law Center, Before the Senate Committee on Banking, Housing, and Urban Affairs, Hearing: Housing Finance Reform: Fundamentals of a Functioning Private Label Mortgage Backed Securities Market, at 6-7 (October 1, 2013) (available at [http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=89141657-5cb2-41f3-b987-4d9b8a848ee8](http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=89141657-5cb2-41f3-b987-4d9b8a848ee8)).

In addition, unlike bond guarantors, structured securities would lead to geographic creaming in addition to borrower creaming. Since the subordinate investor does not agree to take on the credit risk until after the pool is fully assembled, they price securities differently based on where the loans are located. By penalizing perceived higher-risk areas of the country, such as Southern or Western states or rural areas, through requiring higher rates, these securities could create a self-fulfilling prophecy of regional economic hardship and dismantle today's national market.<sup>61</sup>

#### D. Structured Securities Have a Greater Likelihood of Needing Government Reinsurance.

**Bond Guarantor Model:** In addition to benefiting investors and borrowers, the bond guarantor model is also less likely to need government reinsurance than the structured securities model. With a bond guarantor, government reinsurance (that is explicit and paid for upfront) should only kick in if there are net losses on the guarantor's entire book of business. This means that a guarantor could offset losses on one security with gains on another security. And, the equity invested in the bond guarantor would stand in a first loss position to absorb net losses. Only if these losses exceed the bond guarantor's capital would government reinsurance be needed.

**Structured Securities Model:** By comparison, every single individual structured security would put the government reinsurance at risk of being used. Any security facing losses that exceeded the subordinate tranche would require government reinsurance in order to make the senior investors whole. The percentage of subordination can only be evaluated after the fact, so the amount of capital required to protect the government reinsurance fund cannot be readily determined up-front.

#### E. Structured Securities Would Not Provide Countercyclical Access to Credit.

**Bond Guarantor Model:** The ongoing \$6.3 trillion investment in Fannie Mae and Freddie Mac securities over last five years and during the worst housing downturn and economic crisis since the Great Depression demonstrates that the bond guarantor model can successfully provide countercyclical access to credit. In fact, this ongoing investment in securities has prevented an even more dramatic decline in both the housing market and the overall economy. Both the liquidity of this market and the underlying guarantee on the credit risk of these investments have propelled the TBA market during this time.

**Structured Securities Model:** The structured securities model is inherently pro-cyclical, since the capital markets fund the risk capital for each deal. In times of economic stress or in a down housing market, investors will be unlikely to take this credit risk. Without investors for the subordinate tranches of these securities, the deals cannot be completed and the market would

<sup>61</sup> *Id.*, at 15.

collapse (regardless of whether the senior tranches have a government guarantee). In fact, this is exactly what has happened in recent years with the exception of a \$39 billion of private-label securities for mostly pristine jumbo loans. The government guarantee should not be available for securities where capital will become scarce just when it is most needed.

#### F. Structured Securities Would Frustrate Regulatory Oversight.

**Bond Guarantor Model:** As discussed earlier, it is critical to have a strong safety and soundness regulator in a reformed housing finance system. While a future system does not need to be limited to two bond guarantors (as is currently the case with Fannie Mae and Freddie Mac), there will not be a multitude of these entities either. Even if the recommendations made here about requiring a national focus and having the same company perform both issuing and bond guarantor functions are not adopted, the bond guarantee business requires economies of scale. Having a system with a reasonable number of entities – and where it is possible to assess each entity’s capital level – is critical for having a successful regulator that is able to undertake intensive, proactive safety and soundness oversight and require changes in business practices where necessary.

**Structured Securities Model:** Allowing structured securities to access the government reinsurance guarantee would cripple the regulator’s ability to fulfill supervision and oversight duties. The regulator would be in a position of evaluating individual deals to ensure that every senior position in every security receiving government reinsurance in the country had sufficient and real subordinate coverage. This would be an overwhelming task requiring likely thousands of employees, effectively turning the regulator into a huge ratings agency. It would also distract the regulator from the important prudential task of supervising bond guarantors.

#### 4. Promote Cost-Effective Loss Mitigation.

The still ongoing foreclosure crisis shows that distressed borrowers will be pushed into foreclosure – even when loan modifications are more cost effective for investors – when there are not the right structural incentives to complete these modifications. Servicing standards in housing finance reform legislation should include a requirement for a standardized and publicly available net-present-value test where modifications would be required. In addition, reform efforts must also ensure two key structural requirements: 1) that bond guarantors have a limited portfolio capacity in order to hold modified loans and 2) that this portfolio has government backing to ensure that there is liquidity during times of economic stress, when the entities might otherwise be unable to finance a portfolio for this limited purpose.

The government has recognized these priorities repeatedly in our history. Fannie Mae and Freddie Mac have such a portfolio now, and the federal government created one through the Home Owner Loan Corporation after the Great Depression to restructure a million three- and



five-year bullet loans into more affordable long-term, fixed-rate and amortizing loans.<sup>62</sup>

**A. A Targeted Portfolio Capacity – with a Government Backstop – Leads to Better Performing Loan Modifications.**

Comparing the loan modification processes for Ginnie Mae securities and GSE securities highlights the misaligned incentives that occur without a targeted portfolio capacity that has a government backstop. Both Ginnie Mae and the GSEs use pass-through securities with no credit risk to investors, meaning that investors are promised stable payment terms that are not altered from a modification. As a result, distressed loans packaged in a pass-through security must be purchased out of the portfolio in order to make the investor whole. To the investor, payment for distressed loans is equivalent to a borrower refinancing their mortgage – the principal is prepaid in full. However, Ginnie Mae and the GSEs differ in the mechanics of purchasing the loan out of the pool, and this has a significant impact on the affordability and performance of the loan modification.

**Ginnie Mae Modifications:** Ginnie Mae requires the *servicer* to buy a non-performing loan out of the pool, take the loan onto its balance sheet, and then modify the mortgage. In times of financial stress, no company will tie up scarce liquidity or dilute capital in modified loans for 30 to 40 years. Instead, they will sell them if they can get their money back or they will foreclose and collect on the loan-level insurance. Currently, the way FHA servicers avoid holding distressed-then-modified loans on their books is by repackaging these newly modified loans into pass-through securities of new loans. This results in modifications that mimic new production terms – i.e., current interest rates and new 30-year terms. In this way, the *servicer/lender* can immediately re-securitize the loans without taking an uncompensated loss. However, by only modifying loans in order to re-pool them into current production, servicers are unable to make modifications (that would still be net-present-value positive) as affordable as they otherwise could be, even with partial claim authority.<sup>63</sup> This affordability limitation significantly increases re-default rates.

**GSE Modifications:** GSE borrowers are able to obtain more affordable modifications because the GSEs purchase the non-performing loans out themselves, repay the investor in full as promised, and then hold the non-performing loan on their portfolios. Under conservatorship, the GSEs are able to use a limited portfolio capacity backed by government-guaranteed debt for this targeted purpose. S. 1217 appropriately grandfathers this loss mitigation portfolio, which totals

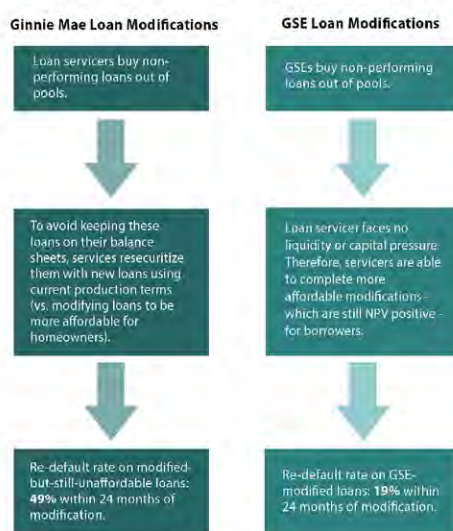
<sup>62</sup> See e.g., Richard K. Green & Susan Wachter, *The American Mortgage in Historical and International Context*, 19 J Econ. Persp. 93, 94-97 (2005).

<sup>63</sup> See Trial Payment Plan for Loan Modifications and Partial Claims under the Federal Housing Administration's Loss Mitigation Program (ML 2011-28).

approximately \$220 billion just for Fannie Mae.<sup>64</sup> Under the GSE model, the servicer does not have the same liquidity and capital pressure to either re-securitize or foreclose, resulting in the appropriate incentives to modify the loan. As a result, under HAMP, GSE modifications are able to go to a 2 percent interest rate and a new 40 year term, making them much more affordable to borrowers while still being net present value positive for taxpayers.

Less affordable FHA modifications have resulted in significantly higher re-default rates when compared to modified GSE loans. The recent OCC Mortgage Metrics report showed that for loans modified in 2011, 19 percent of Fannie Mae loans had 60 day re-default rates 24 months after the modification compared with 49 percent of government-guaranteed loans, fully two and a half times more.<sup>65</sup> A recent Wells Fargo Home Mortgage paper also highlights the disparity, pointing out that “GSE mods, relative to FHA mods, result in greater payment reduction and a corresponding reduction in redefault.”<sup>66</sup>

**Figure 7: Ginnie Mae vs. GSE Loan Modifications**



<sup>64</sup> See Federal National Mortgage Association, United States Securities and Exchange Commission Form 10-Q, for the quarterly period ended June 30, 2013, at 37 (available at <http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2013/q22013.pdf>).

<sup>65</sup> OCC Mortgage Metrics Report, *Disclosure of National Bank and Federal Savings Association Mortgage Loan Data, Second Quarter 2013* (September 2013) at 35 (available at <http://www.occ.gov/publications/publications-by-type/other-publications-reports/mortgage-metrics-2013/mortgage-metrics-q2-2013.pdf>).

<sup>66</sup> Wells Fargo Home Mortgage, *FHA Loss Mitigation and Ginnie Mae Restructuring*, (August 2013).



**B. Failure to Facilitate Successful Loan Modifications Would Lead to More Foreclosures and Higher Losses.**

As demonstrated by the different modification and performance outcomes between Ginnie Mae and GSE loans, housing finance reform must include a targeted portfolio capacity with a government backstop for times of economic stress. This backstop could be provided by either government-guaranteed debt to enable a guarantor to hold modified loans on its balance sheet or a backup government line of credit. An option would be the Federal Reserve's discount window or a new facility provided by the FMIC, which the new secondary market entities could draw on in times of stress if necessary to buy and hold non-performing loans.

The alternative is pushing borrowers to foreclosure or toward a shallow modification, even when an effective modification returns more to the bond guarantor. An unnecessary foreclosure that costs 40 or 50 cents on the dollar would eat into the private entity's capital and, therefore, increase the risk on the government's reinsurance fund. Additionally, loans with shallow modifications that result in the borrower redefaulting also produce increased losses. By contrast, a successful modification – with a positive net-present-value – preserves private capital, making it less likely to need government reinsurance. While providing affordable modifications has been particularly important through the crisis, and would be in future crises, lowering these losses is also important in normal times.

In addition to the better financial outcome for bond guarantors and the government reinsurance fund, successful loan modifications prevent the broader harms that come from unnecessary foreclosures, such as: displacing families out of their homes and neighborhoods, ruining consumer credit scores, destabilizing neighborhoods with vacant and vandalized houses, reducing the home equity wealth of neighbors, starving municipalities for property tax revenue, and disrupting education for children forced to move.<sup>67</sup>

In addition, this targeted portfolio capacity for distressed-then-modified loans would not allow the housing finance system to recreate the same arbitrage opportunities that occurred at Fannie Mae and Freddie Mac before conservatorship. Just as S. 1217 has provided limited portfolio capacity for issuers to act as aggregators, although without government liquidity as an essential backstop, and as it grandfathers the existing GSE loss mitigation portfolios, housing finance reform legislation must also provide for a targeted and limited portfolio or backup line of credit to facilitate successful loss mitigation.

<sup>67</sup> See 2013 Update: *The Spillover Effects of Foreclosures*, Center for Responsible Lending (August 19, 2013) (available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/2013-spillover-costs-of-foreclosure.html>); Debbie Bocian, *State of Lending in America & its Impact on U.S. Households: Mortgages*, Center for Responsible Lending, at 37-43 (December 2012) (available at <http://www.responsiblelending.org/state-of-lending/reports/3-Mortgages.pdf>).

### Conclusion.

As detailed in this paper, we believe that housing finance reform's greatest chance of success is to first identify Fannie Mae and Freddie Mac's failures leading up to conservatorship and to then fix these problems. The second step is to understand what has worked well with the current system and build on these strengths, rather than discard them. In making these recommendations, we suggest a path forward that embraces significant reforms without putting the entire housing market – or parts of it – at risk.

To summarize, the fixes to the five fundamental flaws that led the GSEs into conservatorship are to require issuer-guarantor entities to have mutual ownership – rather than stock ownership – to avoid misaligned incentives to produce short-term earnings targets rather than focusing on long-term stability. Additionally, the mutual must have capital in a first loss position and at significantly higher (but not overcorrected) levels than before the crisis. There must be an explicit and paid for government guarantee along with a strong safety and soundness regulator of issuer-guarantor entities similar to FHFA. Lastly, the entities must be prevented from holding arbitrage portfolios.

Additionally, we recommend using four parts of the existing housing finance system as a foundation for reform efforts. First, provide equal treatment for smaller lenders by giving them direct cash window access to combined issuer-guarantor entities. Second, ensure that all markets are served at all times by requiring issuer-guarantors to serve all eligible lenders nationally. Furthermore, permit the regulator, bond guarantors and lenders to use traditional compensating factors to determine the credit box rather than hardwiring down payment or other underwriting criteria. Third, preserve and maintain the to-be-announced market for 30-year fixed-rate mortgages, which strongly benefits borrowers, lenders and macroeconomic stability. Additionally, reject allowing government reinsurance for the senior tranches of structured securities. Fourth, and finally, promote cost-effective loss mitigation by providing a government liquidity backstop for modified loans, as the GSEs have now, as well as for the entities' aggregation function.

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**PREPARED STATEMENT OF ROHIT GUPTA**  
PRESIDENT, GENWORTH FINANCIAL, U.S. MORTGAGE INSURANCE

OCTOBER 29, 2013

Chairman Johnson and Ranking Member Crapo, my name is Rohit Gupta, President of Genworth Financial's U.S. Mortgage Insurance business in Raleigh, North Carolina. Genworth is one of seven private mortgage insurers active in the U.S. today. We operate in all 50 States, and are part of Genworth Financial, a global insurance company with established mortgage insurance platforms in the U.S., Canada, Australia, and Europe. I am pleased to be here today to discuss the role of private mortgage insurance in ensuring consumer access to mortgage credit as part of housing finance reform. Private mortgage insurers' sole business is insuring lower downpayment mortgages. We make sustainable home ownership possible for many first time homebuyers, homebuyers with moderate incomes and members of underserved communities.

Mortgage insurers enable home-ready borrowers to safely buy homes without having to take as long as a decade to save for a high downpayment. As others testifying before you today will affirm, even a 10-percent downpayment requirement would have the effect of making home ownership impossible for many creditworthy, responsible borrowers. That is not to say that the amount of a downpayment has no effect on the way a loan is expected to perform. When lower downpayment loans default, the risk of loss to the lender or investor is greater. However, that is precisely where mortgage insurance comes into play. Our role is to mitigate that loss, and to make home ownership attainable on terms that are affordable over the life of the loan. A majority of our business is insuring 30-year, fixed-rate mortgages—mortgages that are central to the functioning of a stable housing finance system (including a strong TBA market). We do this with a product that is understood and widely used in the market, available across cycles and affordably priced. We have decades of experience—and data—focused on understanding and managing mortgage risk. Our independent credit underwriting criteria helps to bring greater risk discipline to the mortgage market via the MIs' "second set of eyes." If a loan is not sustainable, the capital of a mortgage insurance firm is at risk because it must pay a claim—that is a strong incentive to maintain risk and price discipline.

Congress and regulators have taken important steps toward ensuring that residential mortgages will be safe and sustainable. Dodd Frank's QM and QRM provisions were designed to make sure that one of the key lessons of the housing crisis—risky mortgages make for bad housing policy—would be embedded in our housing finance system going forward. The final QM rule published by the CFPB represents a significant milestone, and we, along with other members of the Coalition for Sensible Housing Policy, are pleased that the rule discourages risky products and encourages sound credit underwriting and access to credit. When properly underwritten and with appropriate loan level credit enhancement, QMs (and likely, QRMs, assuming that the final rule aligns QRM with QM) are the types of mortgages that our system should always encourage.

In this testimony, I will discuss (i) the current affordability and availability of credit for single family homes, (ii) the impact housing finance proposals will have on affordability and the cost of mortgage finance for consumers, including the role that private mortgage insurance can play in ensuring affordability and access for consumers, and (iii) whether underwriting criteria should be established in statute. In addition, I will provide background on the role of MI and the fundamentals of the mortgage insurance business model, including an update on the state of the industry following the housing crisis.

**Mortgage Credit Today**

Today, as a result of historically low home prices and interest rates, we are still at record levels of affordability in the U.S.<sup>1</sup> And yet, many borrowers who are "home ready" are finding it hard to get a mortgage.<sup>2</sup> For others, the costs are prohibitively high or their only affordable option is an FHA loan—which puts even more housing risk on the Government's balance sheet. Mortgage credit remains overly tight, and certain investor fees are adding significant costs for borrowers. Some of this is because lenders remain concerned about buy back demands from in-

<sup>1</sup> According to the National Association of Realtor's Home Affordability Index, home affordability for both first time and repeat home buyers remains well above historical averages.

<sup>2</sup> According to FHFA's Quarterly Performance Report of the Housing GSEs for the Second Quarter of 2013, Fannie Mae and Freddie Mac average LTVs are 68 percent, and average FICO scores are above 750 (excluding HARP loans). Available at <http://www.fhfa.gov/webfiles/25515/2Q2013QuarterlyPerformanceReport091913.pdf>.

vestors. Many mortgage market participants are struggling to understand and implement an unprecedented amount of new regulation. In addition, GSE loan level fees remain very high, and guarantee fees are being increased as part of their Conservator's strategy to deemphasize their role in housing finance. These fees add to borrower costs. Another factor is GSE credit policy, such as the decision to stop purchasing loans with LTVs above 95 percent, even when backed by private MI.

For housing to continue to recover, we must do more to incent responsible mortgage financing. Genworth and others in our industry understand this and we are doing our part. Our credit policy guidelines are prudent but not prohibitive. Our underwriting takes into consideration a range of compensating factors to ensure that responsible borrowers can get affordable, sustainable mortgages. This is exactly the kind of underwriting that should be part of our housing finance system going forward. But the reality is that if investors refuse to purchase certain loans, then those loans will not get made, even if an MI is willing to insure them.

#### **Lower Downpayment Lending and The Role of MI**

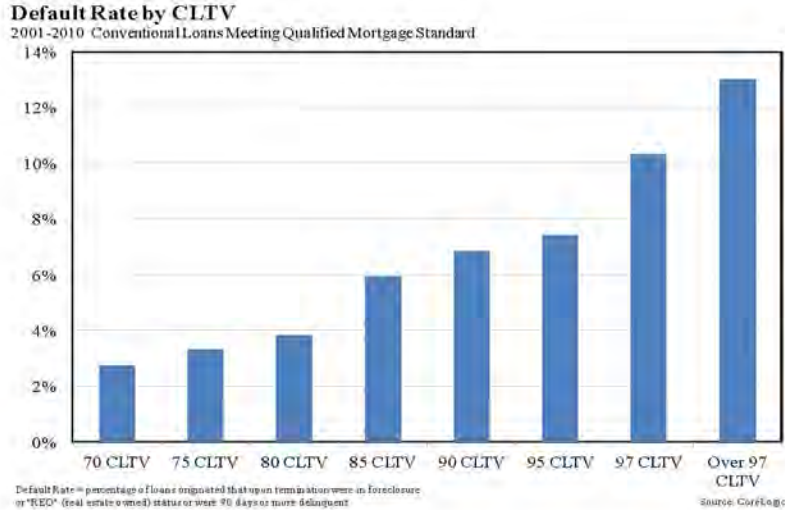
The biggest hurdle for most home-ready consumers considering buying a home is whether they will be able to get a mortgage they can afford without having to amass a prohibitively large downpayment. For decades, our housing finance system has ensured that consumers have that access in large part by relying on private mortgage insurance to mitigate credit loss by assuming a first loss position in the event of a default. MI does this in a cost effective, consistent way that works seamlessly for originators, investors, and servicers. Even during the worst of the housing crisis, Genworth and other MIs continued to insure new mortgages in all 50 States.

Because mortgage insurers are in the first loss position, our interests are aligned with those of borrowers, lenders and mortgage investors. Our business model relies on insuring mortgages that are well underwritten (which is why we rely on our own credit underwriting guidelines). We assume first risk of loss, so our business revolves around our ability to understand and manage credit risk. Our goal is to make sure that borrowers get mortgages that are affordable on day one and throughout their years of home ownership, including 30 year fixed rate mortgages that are central to our housing finance system.

Having access to lower downpayment mortgages is especially important for first time homebuyers, moderate income homebuyers and members of underserved communities. For example, half of first time homebuyers with loans purchased by Fannie Mae and Freddie Mac made downpayments of less than 20 percent, and over 90 percent of those first time homebuyers made downpayments of less than 30 percent. Almost half of borrowers who received loans with private MI in 2012 had low-to-moderate incomes.<sup>3</sup>

As seen in the chart below, the data make it very clear that the amount of a downpayment does matter when it comes to loan performance. Loans with higher combined loan to value ratios (CLTVs) experience higher default rates than lower CLTV loans. But the data also make it very clear that there is a responsible way to offer high CLTV loans. The key is to make sure that they are prudently underwritten and have the benefit of credit loss mitigation (usually MI) in the event of default. This kind of lending is not new or exotic—in fact, it is how many of us in this room today first became homeowners. Over the past 15 years, nearly one quarter of the mortgage market has relied on loans with downpayments of less than 20 percent—representing over \$8 trillion of mortgages that performed well across good and bad cycles. Lower downpayment loans are especially important to ensuring that creditworthy first time homebuyers and underserved borrowers have access to home ownership.

<sup>3</sup>Fannie/Freddie first time homebuyer data based on data published by Fannie Mae and Freddie Mac for GSE MBS issued between July 2012 and September 2013. MI data based on MICA industry data for 2012.



### Housing Finance Reform

Historically, detailed underwriting criteria have been established through regulation, investor guidelines and market practice, and generally have not been set in statute. The unprecedented housing crisis has caused some policy makers to question this approach. Genworth believes that today, regulators have a much clearer legislative mandate that will help them guard against a repeat of the bad products and lax standards that led to the housing crisis. In addition, certain broad underwriting criteria that define the “outer edges” of loans with a Government backstop could be written into statute (such as limiting the term of a mortgage, requiring a minimal downpayment so that all borrowers have some “skin in the game”, or including a limitation on very high debt to income ratios (DTIs)). We caution however, that an overly prescriptive approach could have the effect of unnecessarily limiting credit for responsible borrowers. Also, locking too many underwriting requirements into statute could make it cumbersome to make appropriate adjustments to underwriting over time; as a result, a clear grant of regulatory discretion to make such adjustments should be included with any hard-wired statutory requirements. Many proposals for housing finance reform contemplate requiring a “QM” or “QRM” standard for loans subject to Government support. Genworth generally agrees with this approach, with the caveat that it will be important to have credit enhancement such as private MI assuming first loss on lower downpayment loans in order to ensure that the likelihood of calling upon any Government support is truly remote.

In the current system, the GSE charters require credit enhancement for loans with a downpayment of less than 20 percent, and private mortgage insurance is the means most often used to meet this requirement. To satisfy the charter, the MI coverage must be sufficient to reduce remaining exposure to a maximum of 80 percent. This minimum coverage option is known as “charter coverage” because it is set at levels that satisfy the legal charter requirement.

However, while charter coverage is legally sufficient, it does not afford any additional economic protection against loss from default, and is not commonly used in the market today. Instead, the GSEs and their regulator require greater coverage (generally referred to as Standard Coverage) in amounts that vary based on LTVs, but that are always greater than minimal coverage mandated in the GSE charters.<sup>4</sup> Standard coverage provides significant protection even in the event of housing market downturns. During the housing crisis, home prices in many markets declined more than 30 percent from the market peak. If there had only been “charter coverage” on most loans, there would have been far less private capital in a first loss

<sup>4</sup>The GSEs charge significant Loan Level Price Adjustments in those limited instances when only shallow charter level mortgage insurance is obtained.



position, and far less economic protection for Federal taxpayers (and Fannie and Freddie).

MI at standard coverage is the prevailing form of credit enhancement in the market today. Standard coverage MI is relied upon by large and small lenders, by national banks, community banks, and by credit unions. And it enables consumers to get affordable lower downpayment mortgages.

Genworth strongly supports S.1217's (the Housing Reform and Taxpayer Protection Act of 2013) inclusion of standard coverage MI. Private mortgage insurance at standard coverage levels can and should be an important part of a reformed housing finance system because it will ensure that there is meaningful private capital ahead of any Government exposure. At standard coverage levels, an investor's loss exposure for a 90 percent LTV loan goes down to 67 percent. That means that, if that loan defaults, an investor is better off with that 90 percent LTV MI loan than it would be on an 80 percent LTV loan without MI. Private MI promotes market stability, especially when compared to other forms of credit enhancement that can be subject to volatile pricing and rapid market retreats. And private MI has minimal impact on consumer economics.

As this Committee continues to work on housing finance reform, we urge you to consider the role the USMI industry can play not only through standard coverage loan level MI, but also by providing credit enhancement at the MBS level, whether in connection with S.1217's bond guarantor provisions or other similar approaches. Sound housing finance policy should encourage reliance on well-capitalized entities on a level playing field. Borrowers, investors, lenders, and taxpayers will all benefit when the right kinds of credit protection play a meaningful role in the new system.

### **MI Regulation**

Private mortgage insurers are subject to extensive State insurance regulation specifically tailored to the nature of the risk insured—long-duration (our insurance remains in place until loans amortize down to specified levels), long-cycle (housing market performance generally performs in 10-year cycles) mortgage credit risk. State laws impose loan-level capital and reserve requirements that are held long term. In addition, MI providers are subject to strict limits on investments and limitations on dividend payments, and to provisions designed to address potential operational risk. Many States have adopted a version of the National Association of Insurance Commissioners (NAIC) Model Mortgage Guaranty Insurance Act (the "Model Act"), which, in addition to imposing strong financial controls, requires that mortgage insurers only engage in the business of mortgage insurance, and imposes limitations on risk concentrations. The NAIC is in the process of updating the Model Act, including reconsideration of existing capital and reserving requirements.

State Departments of Insurance have significant power of oversight. They perform regular, detailed examinations of mortgage insurers, and monitor and enforce insurers' compliance with financial standards. In addition, FHFA and the GSEs undertake regular assessments to determine which mortgage insurers are eligible to provide MI for the mortgages the GSEs purchase or guarantee with LTVs above 80 percent. Accordingly, they provide additional oversight of a mortgage insurer's operational risk capacity, credit underwriting standards and claims paying ability. Other federally regulated financial institutions also evaluate the financial condition and operational expertise of insurers that provide MI for their loans.

There are two primary regulatory capital requirements for mortgage insurers. First, a mortgage insurer must maintain sufficient capital such that its risk-to-capital ratio (ratio of risk-in-force to statutory capital (which consists of its policyholders' surplus and contingency reserve)) cannot exceed 25:1 or it may not write any new business absent the consent of the applicable State insurance regulator. Second, in addition to the normal provision for losses,<sup>5</sup> mortgage insurers are required under insurance statutory accounting principles to post contingency reserves, which are funded with 50 percent of net earned premiums over a period of 10 years. The contingency reserve is an additional countercyclical reserve established for the protection of policyholders against the effect of adverse economic cycles.

The risk to capital ratio is one of many tools State insurance regulators use to evaluate MI providers. The comprehensive nature of State regulatory oversight enables regulators to retain the flexibility to exercise appropriate discretion regarding the ongoing operations of insurers subject to their jurisdiction. In recent years, several States have used that discretion to issue revocable, limited duration waivers of the 25:1 cap on the risk to capital ratio. Those decisions were made based on ex-

<sup>5</sup> MIs are required to provision for (i) case basis reserves for loans that are currently delinquent and reported as such by the lender or loan servicer and (ii) incurred but not reported loss reserves (for loans that are currently delinquent but not yet reported as such).

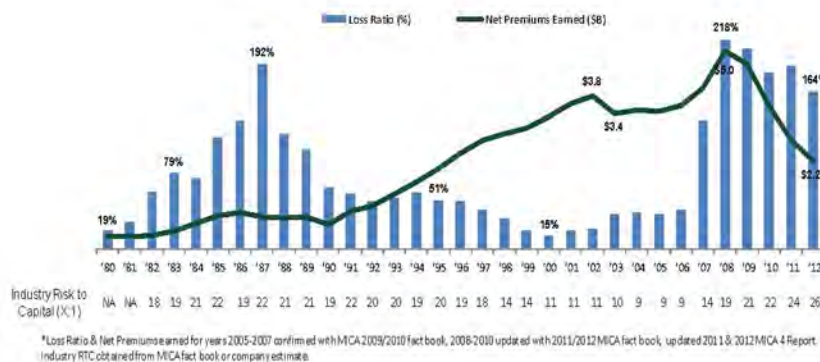
tensive actuarial analysis conducted under the supervision of the State of domicile to assess our ongoing solvency. States still retain the ability to deem an MI provider to be in “hazardous financial condition.” A finding of hazardous financial condition could lead to the revocation of an MI provider’s license to insure new business. State Departments of Insurance, including North Carolina, Genworth’s State of domicile, actively monitor MI providers’ operations and financial condition.

These countercyclical capital and reserve requirements mean that the MI industry holds significant capital against each loan insured throughout the time a loan is outstanding, and should have the resources necessary to pay claims. In this regard, MI is significantly different from other types of investment and credit enhancement. One of the lessons learned from the housing crisis is that housing markets are not well served by capital markets instruments and other credit enhancement structures that encourage short-term investment without adequate regulatory oversight and capital and reserve requirements. MI represents material amounts of private capital and reserves in a first-loss position that are committed for the long term.

### The MI Model and Experience Across Cycles

Mortgage insurance premium income, capital and reserve requirements combine to provide countercyclical protections against housing downturns. As illustrated in the graph below, during times of market stress (for example, the “Oil Patch” in the mid 1980s), mortgage insurers experience high levels of losses and their risk to capital ratios rise accordingly. As markets stabilize, higher earned premiums and lower claims paid typically enable the industry to replenish its capital base. This countercyclical model was severely tested by 2008’s unprecedented crisis, and, as expected, risk to capital ratios rose in the face of unprecedented losses. In recent years, housing markets have begun to recover, loan performance has improved, and revisions to mortgage insurance guidelines and pricing have taken effect. Those factors, together with recent capital raises, have resulted in improved risk to capital ratios. Today, the mortgage insurance industry is well positioned, with the capital to pay claims and to write new business.

### Countercyclical Capital Model



Private mortgage insurers (unlike the FHA) do not insure against 100 percent of loss. Typically, mortgage insurance provides first-loss coverage of approximately 25–30 percent of the unpaid loan balance (plus certain additional expenses) of a defaulted loan. By assuming a first-loss position, private mortgage insurance dramatically offsets losses arising from a borrower default. By design, however, the product does not completely eliminate the risk of loss. Private mortgage insurance is designed to be “skin in the game” that offers real economic benefit to lenders and investors while still incenting them to carefully underwrite mortgage loans and holding them accountable for fraud, misrepresentation, and lack of compliance in the origination process.

When a loan goes to foreclosure, the private mortgage insurer is responsible for paying a claim. As a result, mortgage insurers have a clear financial incentive to

work to keep borrowers in their homes. This directly aligns the interest of the mortgage insurer with the best interest of the borrower, and the MI industry has developed expertise in loss mitigation that is evidenced by its decades-long track record of actively working to keep borrowers in their homes. From 2008 through the second quarter of 2013, the industry facilitated loan workouts with approximately 660,000 borrowers on mortgage loans with an aggregate principal balance of approximately \$130 billion.<sup>6</sup> Genworth has invested significantly in resources, tools, and technology focused on keeping borrowers in their homes. We have workout specialists who work directly with borrowers and servicers to facilitate the best outcomes for homeowners at risk of foreclosure, and use programs that include borrower outreach as well as programs targeted to borrowers at risk of imminent default and borrowers who have received loan modifications and are at risk of redefault. From 2008 through the second quarter of 2013, Genworth has helped over 130,000 homeowners avoid foreclosure, facilitating nearly 105,000 home retention workouts and nearly 30,000 short sales and deeds-in-lieu of foreclosure.

#### **Mortgage Insurers Pay Claims Pursuant to the Terms of Their Master Policies**

Mortgage insurers paid approximately \$40 billion in claims from 2007 to 2012, \$35 billion of which was paid on loans purchased or guaranteed by Fannie Mae and Freddie Mac. In the first half of 2013, MIs paid an additional \$4 billion in claims to the GSEs. From 2007 through the second quarter of 2013, Genworth paid approximately \$5.4 billion in claims on nearly 120,000 defaulted mortgage loans.

It has always been Genworth's practice to pay claims in full when a loan was properly originated, underwritten, and serviced. We rescind coverage (and refund premiums paid) on loans that do not qualify for insurance; typically rescissions occur following review of a loan when it becomes seriously delinquent. The extraordinary circumstances that led to the collapse of the housing market, and the unprecedented levels of mortgage market fraud and misrepresentation in the years leading up to that collapse, increased the incidences of rescissions. Genworth, along with other MIs, has taken significant steps in recent years to clarify our claims paying practices, providing greater clarity and transparency for lenders and investors.

#### **MI Claims Paying Policy Going Forward**

Notwithstanding the extraordinary experience of the housing crisis, the MI industry has attracted over \$8.9 billion in new capital since 2008, including capital raised by two new entrants, both of which have filed registration statements with the SEC for initial public offerings. The recent capital inflows to the industry are indicative of investor confidence in the business model and its regulatory construct.

#### **Conclusion**

Genworth commends the hard work of the Senate Banking Committee to tackle one of the most complex and emotionally charged issues that legislators have faced in many years. We believe that keeping the interests of home buying consumers and taxpayers in the forefront of deliberations will help us all arrive at a plan for a sustainable and fair housing finance system. We applaud the 10 Senators on this Committee who have crafted and supported S.1217. The provisions regarding private MI thoughtfully incorporate a prevailing market standard that is well known and easy to execute for consumers, lenders and investors. Importantly, this approach does not introduce any new costs for consumers, while at the same time it helps distance future losses from the Federal Government backstop. We at Genworth and other USMI companies appreciate the work of this Committee, and look forward to continuing to engage with you as your important work continues.

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<sup>6</sup>Based on Mortgage Insurance Companies of America (MICA) member company data.

**PREPARED STATEMENT OF GARY THOMAS**  
2013 PRESIDENT, NATIONAL ASSOCIATION OF REALTORS  
OCTOBER 29, 2013



500 New Jersey Avenue, N.W.  
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Gary Weaver, Vice President  
Scott Reiter, Vice President  
Joe Ventrone, Vice President  
Jamie Gregory, Deputy Chief Lobbyist

**STATEMENT OF**

**GARY THOMAS**  
**2013 PRESIDENT**  
**NATIONAL ASSOCIATION OF REALTORS®**

**TO THE**

**UNITED STATE SENATE COMMITTEE ON BANKING, HOUSING  
AND URBAN AFFAIRS**

**HEARING TITLED**

**HOUSING FINANCE REFORM: ESSENTIALS OF A  
FUNCTIONING HOUSING FINANCE SYSTEM FOR CONSUMERS**

**OCTOBER 29, 2013**

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### INTRODUCTION

Chairman Johnson, Ranking Member Crapo, and members of the Committee, my name is Gary Thomas. I am a second generation real estate professional in Villa Park, California. I have been in the business for more than 35 years and have served the industry in countless roles. I currently serve as the 2013 President of the National Association of REALTORS® (NAR).

I am here to testify on behalf of the one million members of the National Association of REALTORS®. We thank you for the opportunity to present our views on housing finance reform and the essentials of a functioning housing finance system for consumers.

### STATE OF HOUSING

It is no secret that real estate is the linchpin of our nation's economy. The housing sector accounts for roughly 18 percent of GDP and research has shown the social and financial benefits to all Americans. As our economy slowly improves from the Great Recession, the U.S. housing market will be key to this recovery. Our nation will not return to full employment and robust economic health unless the real estate market makes a broad-based and lasting comeback. Fortunately, the U.S. housing market recently has shown some promising signs.

Housing has been instrumental in pulling the economy out of the Great Recession, substantially contributing to our nation's economic growth since 2011. Home sales, housing prices, and residential construction have increased during this time, supported by low mortgage rates and improved consumer confidence in both the housing market and overall economy. In the past two years, home prices have gone up 20 percent, pushing up the value of household real estate to \$18.6 trillion at the end of the 2<sup>nd</sup> quarter of this year. Additionally, home sales were 10.7 percent higher in September 2013 than a year earlier with 5.29 million homes sold, but were well below the 7.23 million homes sold in August 2005, delinquency and foreclosure rates remain well above the historic norms, and more than 7 million homeowners remain under water on their mortgages. Also, the residential construction industry has recovered almost half a million jobs of the 2.3 million lost during the recession; however, it continues to lag behind as a job creation engine.

While these figures are promising, the housing market clearly remains far from healthy. Maintaining momentum in the housing market is particularly crucial right now. Sustaining the housing market rebound will increase economic and job growth, as it has in past U.S. economic recoveries.

### CHALLENGES FACING THE HOUSING RECOVERY

While home prices have increased 14.7 percent over the 12-month period ending in August 2013, they are still 7.6 percent lower than in August of 2006. Today, home prices have led to positive gains in the net worth of homeowners, \$18.6 trillion of which is saved up in residential real estate. Rising home prices have enabled many owners to refinance into more stable positions and cut the number of underwater homeowners by nearly half, but have also put pressure on potential home buyers who have not yet completed their home purchase. Home sales rose 13.2 percent from August of 2012 to August of 2013, but are 24.2 percent below the level from August of 2006.

In addition to increases in home prices, mortgage rates have begun their ascent from historically unprecedented lows. While mortgage rates have stabilized recently due to the Federal Reserve's delay in the tapering of asset purchases, expectations for a healing housing market and recovering economy point to higher mortgage rates ahead. These two factors combined with meager increases in family income are squeezing the affordability of homes. Affordability has plunged 18 percent to the lowest level since 2006. While affordability remains above historic levels, a swift reduction will undoubtedly have an impact on buyer options and psychology.



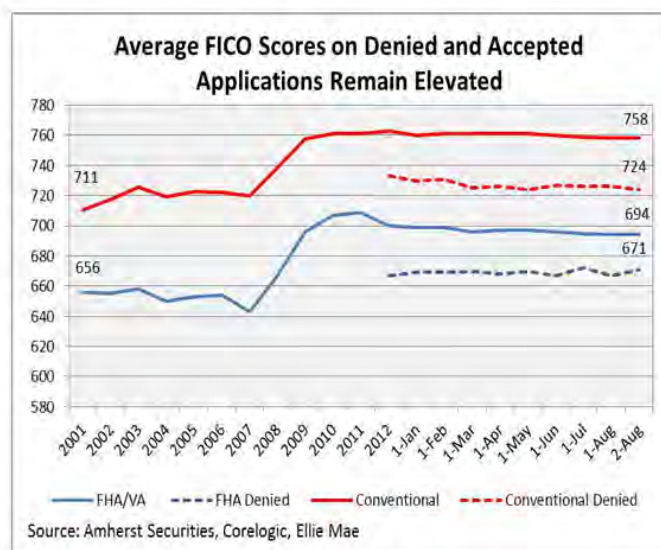


Figure 1

Access to credit continues to be tight as lenders remain leery of taking on risk. While the average FICO score on conventional, purchase mortgages crept lower in recent months, this partially reflects the increased willingness of private mortgage insurers to back high FICO, high LTV mortgages. However, the average accepted FICO on FHA purchase production has fallen as well, while the average FICO for a rejected loan in both spaces increased. This pattern suggests that these changes are linked to a shift of production from the FHA to the GSE, but not an expansion of the credit box. As depicted above, the average FICO scores for accepted applications of both conventional and FHA production remain roughly 50 points higher than in 2001, a period predating the loosening of underwriting standards.

What is holding back credit? There is already turbulence in the regulatory environment for mortgage lending. In January 2014, many changes stemming from the Dodd-Frank Act will go into effect, including the “ability-to-repay” requirements. The risk retention (QRM) regulations remain in flux. Adding even more confusion and uncertainty in this environment runs the risk of reversing progress being made in the economic recovery. The non-pecuniary costs of adverse impacts to reputation have weighed on lenders. Another significant factor has been the uncertainty surrounding the use of representation and warranty clauses by both private market investors as well as the Government Sponsored Entities (GSEs) to indemnify against loan defaults, even for minor errors. The result has been a pull back by lenders to a position where the probability of default is far lower than historic norms.

NAR is also very concerned with the impact that growing student loan debt will have on the ability of consumers to access mortgage credit, particularly impacting first time homebuyers. Specifically, the changing regulatory landscape of mortgage finance compounded with increased student debt will contribute to an already tight lending environment by imposing standards that are even more strict.

Americans burdened with growing monthly debt payments will have restricted access to mortgage credit under the QM rule. Though the rule includes a reasonable 43 percent total debt-to-income standard, rising

student debt payments and a weak labor market may have a long term impact on the ability of first time homebuyers to qualify for a mortgage under this standard.

An additional concern is that consumers unable to save for a down payment due to growing debt burdens will be denied access to the most reasonable loan terms under the proposed "QRM+" definition that imposes a minimum 30 percent downpayment requirement and rigid credit standards will deny millions of Americans access to the lowest cost and safest mortgages.

**BARRIERS TO HOMEOWNERSHIP FOR MINORITIES & FUTURE BUYERS**

As depicted below, the decline in homeownership between 2004 and 2012 was disproportionately borne by African Americans, buyers aged 44 and under, and families earning less than or equal to the median family income. As homeownership is one of the main vehicles for building equity over one's lifetime, the decline in homeownership will have a lasting effect on access to education, healthcare, and retirement for these groups.

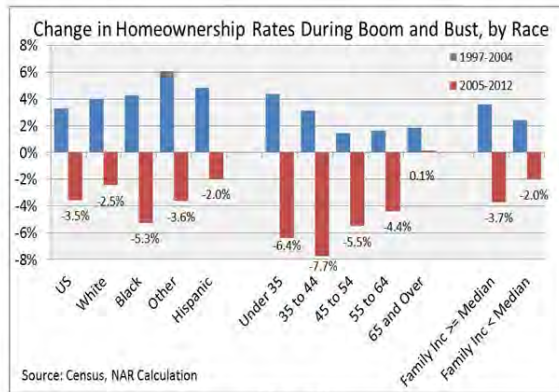


Figure 2

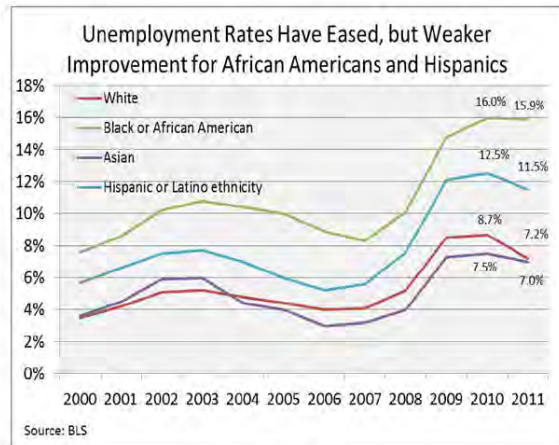


Figure 3

Furthermore, the recession took a toll on all racial groups, but between 2010 and 2011, the decline in unemployment was skewed toward Whites and to a lesser extent Asians, but both of those groups were at lower levels of unemployment. The unemployment rate for African Americans only fell 0.1 percent over this period and was at more than double the unemployment rate. Likewise, income growth has also been a problem. The median real income for Whites fell 6.2 percent between 2007 and 2012, while it fell 10.7 percent for Blacks and 11.0 percent for Hispanics.<sup>1</sup>

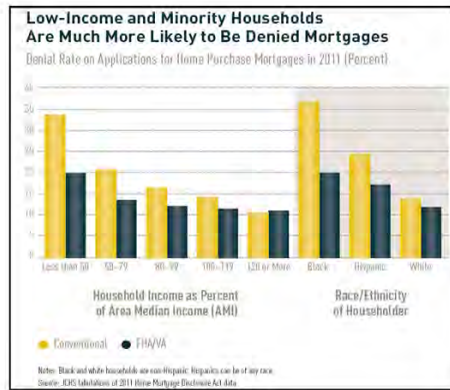


Figure 4

As noted earlier, credit conditions tightened dramatically in the post-recession environment for structural reasons. As depicted above, rejection rates on mortgages applications in 2011 were disproportionately higher for African Americans, Hispanic Americans and lower income earners, particularly those earning less than half of the area median income. While rejection rates improved modestly in the 2012 HMDA data, the wide gap between racial groups was persistent with non-Hispanic Whites’ rejection rate of 11.6 percent less than half the 32.0 percent rate for African Americans and the 20.5 percent for Hispanic Whites. The sharp drop in employment and incomes combined with lender overlays on loans financed by the US government or through Fannie Mae or Freddie Mac have constrained access to credit and the housing recovery for minorities, young buyers, and low and moderate earners. In short, these groups are missing out on the strongest affordability conditions in decades and this pattern may persist going forward.

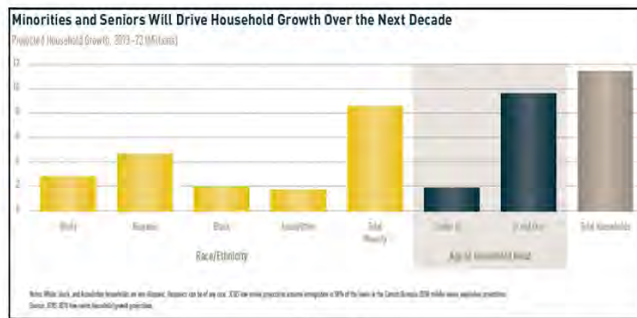


Figure 5

<sup>1</sup> US Census Bureau (2012).

There is a strong correlation between household formation and the choice to purchase a home. Researchers at the Harvard Joint Center for Housing Studies<sup>2</sup> estimate that the number of households will grow by nearly 12 million between 2013 and 2023. Of these, more than 8 million or nearly 70 percent will be minority households. Given the sharp decline in homeownership, slow improvement in employment conditions, and disproportionate impact of tight underwriting, these groups will face headwinds to participation in the housing and homeownership recovery over the coming decade.

#### PRINCIPLES FOR A ROBUST U.S. HOUSING MARKET

Some of the challenges we face today were caused and perpetuated by a flawed housing finance system, which REALTORS® agree needs to be reformed. We applaud the Committee for beginning the discussion on housing finance reform. As policymakers decide how to restructure the secondary mortgage finance market, it is critical that the future system continue to be a reliable and affordable source of mortgage capital for creditworthy consumers in all types of markets and to avoid a major disruption to the nation's economy that would result from a collapse of the private housing finance sector. In order to achieve these goals, the future housing finance system should embody the following elements:

- **An efficient and adequately regulated secondary market is essential to providing affordable mortgages to consumers.** The secondary market, where mortgages are securitized, 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, a poorly functioning secondary market will impede both recovery in housing sector and the overall economy.
- **The old GSE system with private profits and taxpayer loss must be replaced.** The current GSEs (Fannie Mae and Freddie Mac) should be replaced with government-chartered, non-shareholder owned entity(s) 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 to support long-term mortgage financing and protect the taxpayer.
- **Reforms should ensure a strong, efficient financing environment for homeownership and rental housing.** The mission of the new entity must include providing access to mortgage financing for consumers who have the demonstrated ability to sustain homeownership. Creditworthy consumers require a steady flow of mortgage funding that, during economic downturns, only government participation in the secondary mortgage market can provide.
- **The government must clearly, and explicitly, offer a guarantee of mortgage instruments facilitated by the entity(s) that meet the Qualified Mortgage (QM) standards.** This is essential to ensure qualified, creditworthy borrowers have access to affordable mortgage credit. Without government backing, consumers will pay much higher mortgage interest rates and mortgages may at times not be readily available at all—as has happened in the jumbo and commercial real estate loan sectors. Taxpayer risk would be mitigated through the use of mortgage insurance on loan products with a loan-to-value ratio higher than 80 percent, or through other fees paid to the government.
- **The new entity(s) should guarantee or insure a wide range of safe, reliable mortgage products.** These mortgage products include 15-year and 30-year fixed rate loans, traditional adjustable-rate mortgages (ARMs), and other products that have stood the test of time and for which American homeowners have demonstrated a strong “ability to repay.”

<sup>2</sup> Harvard Joint Center for Housing Studies, “The State of the Nation’s Housing 2013.”

- **The new framework should provide a self-sufficient mechanism whereby safe, sound, transparent, and insured Mortgage Backed Securities (MBS) may be packaged and sold.** There must be an option for an explicit government guarantee of insurance for all offered MBS within the secondary mortgage market. The creation of a not-for-profit “utility” facility is needed to receive, package, sell and guarantee MBS. The entity should operate with similar insurance and enforcement components as the FDIC. This option must minimize taxpayer exposure.
- **Sound and sensible underwriting standards must be established.** It is critical to establish standardized, sound underwriting principles and products that provide the foundation for responsible, credit worthy borrowers to be able to achieve homeownership goals. For additional safety, these standards must also be applied to securities (MBSs) purchased for portfolio (to a limited extent).
- **The entity(s) should price loan products or guarantees based on risk.** In addition, the new entities must set standards for the MBS they guarantee that ensure transparency and verifiability for loans within the MBSs.
- **A structure must ensure that solid, verifiable, current loan level data is available to investors that empowers and enables them to conduct their own risk analysis.** There is a strong consensus among multiple market participants that solid loan level data is the essential foundation on which to rebuild the private mortgage security industry. Investors want to be able to conduct their own analysis. With properly structured loan level data the mortgage collateral supporting a regulated, securitized instrument can be evaluated in terms of a verifiable, current predictable instrument of cash flow and thus will attract private capital.
- **The reformed entities must have a separate legal identity from the federal government but serve a public purpose.** Given the appropriate structure, the entities will have considerable political independence and be self-sustaining unlike a federal agency.
- **The new entity(s) should remain politically independent.** Political independence of the entities is mandatory for successful operation. CEOs should have fixed terms so they cannot be fired without cause, and they should not be allowed to lobby. Additionally, the entities should be self-funded instead of receiving ongoing appropriations.
- **To increase the use of covered bonds, particularly in the commercial real estate arena, the entities should pilot their use in multifamily housing lending.** The entities should explore the use of covered bonds as an additional method to provide additional 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.** The new entities should be overseen by the Federal Housing Finance Agency (FHFA) or a successor agency that would make timely reports to allow for continual evaluation of the entities’ performance.
- **The new system must restore investor confidence and trust in the Representations and Warranties via the standardization of pooling and servicing contracts.** Standardization of Representations and Warranties is imperative. Pooling and Servicing Agreements (PSAs) must be simple with clear terms and definitions so they are easily understood by investors. They must have clear disclosures of any deviations from “Federal Best Practice Standards”, clearly define “buy back” rules, and servicer operational policies must be consistent with their fiduciary duties to the investor.



### GOVERNMENT GUARANTEE

As indicated on a number of occasions, NAR supports a comprehensive approach to restructuring the secondary mortgage market, including winding down Fannie Mae and Freddie Mac (the government sponsored enterprises, or GSEs), but believes any new secondary market entity replacing the enterprises must have an explicit government guarantee to ensure the availability of affordable credit products for all creditworthy individuals and families.

REALTORS® agree with lawmakers that taxpayers should be protected, private capital must return to the housing finance market, and that the size of government participation in the housing sector should decrease if the market is to function properly. However, REALTORS® believe that it is extremely unlikely that any secondary mortgage market structure that does not include government backing could support the existing mortgage funding needs of the United States housing sector. Make no mistake; the tremendous size of this systemically important market can neither be supported solely by lending from insured bank deposits nor from private investors that would be required to take on additional risk.

Legislation that relies only on private guarantees to operate the secondary mortgage market will find that, in extreme economic conditions, private capital will retreat from the market. A federal guarantee is essential to ensure borrowers have access to affordable mortgage credit. Without government backing, creditworthy consumers will pay much higher mortgage interest rates and mortgages may at times not be readily available — as has happened in jumbo and manufactured housing real estate loan markets in the aftermath of the crisis.

In both instances, non-government backed mortgage capital became nearly non-existent, which prohibited qualified borrowers from access to the funds required to purchase a home. Although private capital is slowly returning to these markets, it has taken many years.



*Figure 6*

The lack of financing put downward pressure on home values, increasing the number of homeowners whose mortgages exceed the value of their home, and increasing foreclosures. As illustrated in Figure 6, if no government-backed entity existed as private mortgage capital fled to the sidelines in recent years, the housing market would have come to a complete halt and thrown our nation into a deeper recession, or even a depression.

When the economy turns down, private capital flees the marketplace, and should that occur in the residential market it would come to an abrupt and nearly complete halt. Should that happen in a fully private 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.

REALTORS® believe that full privatization is not an effective option for a secondary market because private firms' business strategies will focus on optimizing revenues and profits. 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 interests of the nation's housing policy and consumers.

Homeownership is a significant driver of employment opportunity. Jobs are created in the numerous businesses that are all part of the housing industry (e.g. home renovation, remodeling, and furnishing). We must endeavor to support this founding pillar of our society and economy so that our nation can begin to move toward recovery, instead of lingering in our current economic malaise.

#### THE 30-YEAR FIXED-RATE MORTGAGE

Unique to the U.S. housing finance sector is the availability of affordable, long-term fixed-rate mortgages. The 30-year fixed rate mortgage is the bedrock of the U.S. housing finance system. And now, more than ever, consumers are seeking fixed rate 30-year loans because they are easily understood and offer a predictable payment schedule.

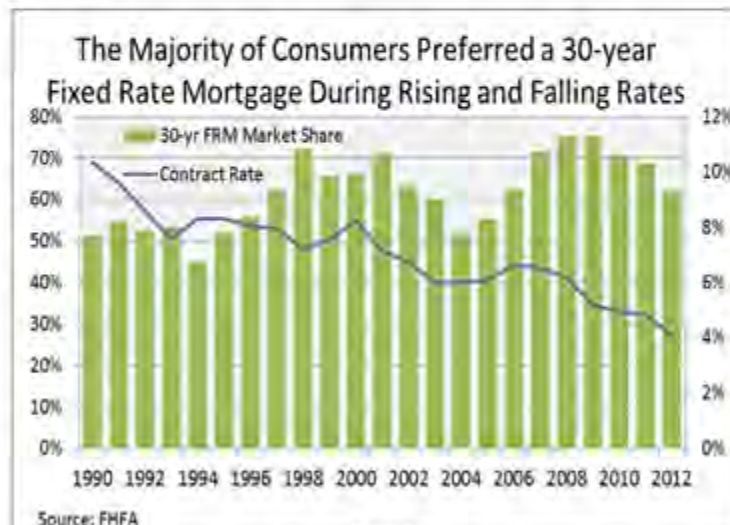


Figure 7

As discussed above, REALTORS® believe that full privatization is not an effective option for our secondary mortgage market because private firms' business strategies will focus on optimizing their revenue/profit generation. We believe that this would lead to the elimination of long-term, fixed rate mortgage products (e.g. 30-year fixed-rate mortgage), and an increase in the costs of mortgages to consumers. At this time, when our economic recovery teeters on the edge of full recovery, activities that force further construction of economic activity should be even more strongly resisted.

According to research by economist Dr. Susan Woodward, there is no evidence that a long-term fixed-rate residential mortgage loan would arise spontaneously without government auspices. Dr. Woodward points out that a few developed countries have encouraged the use of amortizing long-term loans, but in nearly all instances (save for Denmark) where they do exist, the loans have adjustable rates and reset every 5 years or require large down payments and significant prepayment penalties. She goes on to point out that the United States is unique in having a residential mortgage that is long-term, amortizing, fixed-rate and pre-payable, 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 quickly abandoned that position.

We are particularly concerned by data that suggests that, should the 30-year fixed rate mortgage cease to be available, older owners who tend to stay in their home longer, would be the most affected. Rising interest rates for these homeowners (who are also paying for their children's college, saving for retirement, or living on a fixed income) would then also cause them to suffer from higher mortgage payments. While the average tenure in a home has hovered around 6 years, that statistic has increased to 9 years since 2010 and is likely to increase as mortgage rates increase and make it more difficult for owners to trade up and undermine incentives to move.

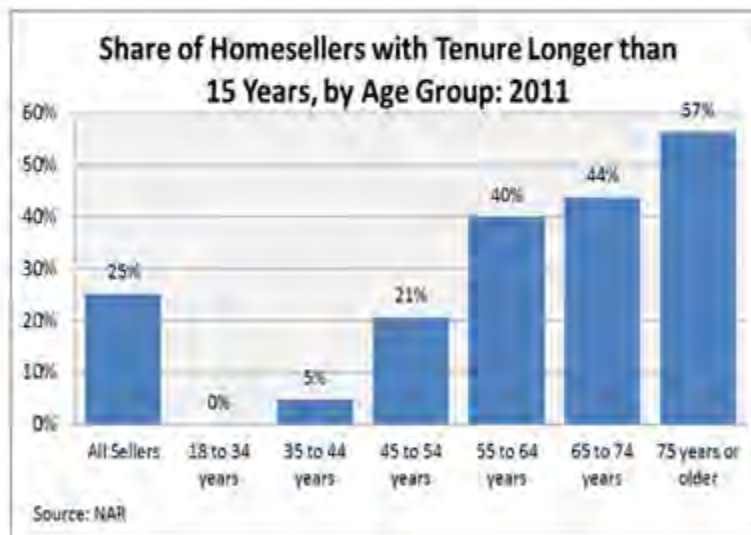


Figure 6

Additionally, while others have suggested that a 30-year mortgage builds equity slower, borrowers forced into a mortgage with a shorter duration face a significant loss in purchasing power. Consider an individual earning approximately \$52,000 who purchases a \$208,000 home (the May 2013 median home price) with 10 percent down:

Duration	Interest Rate	Payment (PITI)
30 year	4.07%	\$1,160
15 year	3.17%	\$1,340

With a 30-year mortgage, the consumer's total mortgage debt to income (DTI) would be 26 percent, with a 15-year mortgage, this measure of affordability jumps to 35 percent. To achieve the same DTI with a 15-year mortgage, the purchase price would have to be reduced to \$144,444.

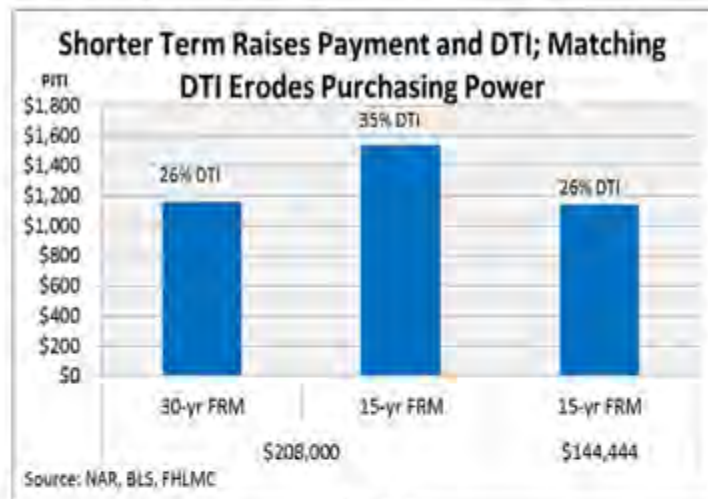


Figure 9

#### NAR UNDERWRITING RECOMMENDATIONS

REALTORS® share the goal of attracting private capital to the mortgage market while ensuring that creditworthy families, including those unable to afford a large down payment, are not unnecessarily excluded from homeownership opportunities. Rather than focusing on down payments, NAR believes Congress should center its attention on strong underwriting standards, which are vital for a robust housing finance market.

We are generally supportive of the Consumer Finance Protection Bureau's (CFPB's) Qualified Mortgage (QM) rule and believe this standard should be used to define the Qualified Residential Mortgage (QRM) in any future housing finance system. We believe this approach achieves the twin objectives of protecting the marketplace while ensuring borrowers have access to safe mortgages. Investors will remain confident they can rely on the quality of mortgages underlying securitizations and creditworthy borrowers will be able to obtain access to conventional financing for safe, sustainable mortgages. At the same time, it also assures that loans with the highest risk – those with the product features explicitly excluded by QM – will also be subject to the risk retention rules for asset backed securities. In releasing the re-proposed rule, regulators expressed valid concerns that establishing divergent standards for QM and QRM loans could result in an increase in complexity, regulatory burden and compliance costs that will be passed on to borrowers in the form of higher interest rates and restrictive credit standards.

NAR strongly opposes the alternative "QRM+" approach in the proposed rule, which would require borrowers to make a 30 percent down payment to obtain a QRM loan. Such a restriction along with unduly difficult credit standards will restrict access to mortgage credit for far too many creditworthy borrowers.



In contrast, the data below indicates that the underwriting and loan product limitations that are mandated for QM loans effectively limit the risk of default without excluding large numbers of creditworthy borrowers. For this reason, those standards also protect investors and should be the QRM standard as well.

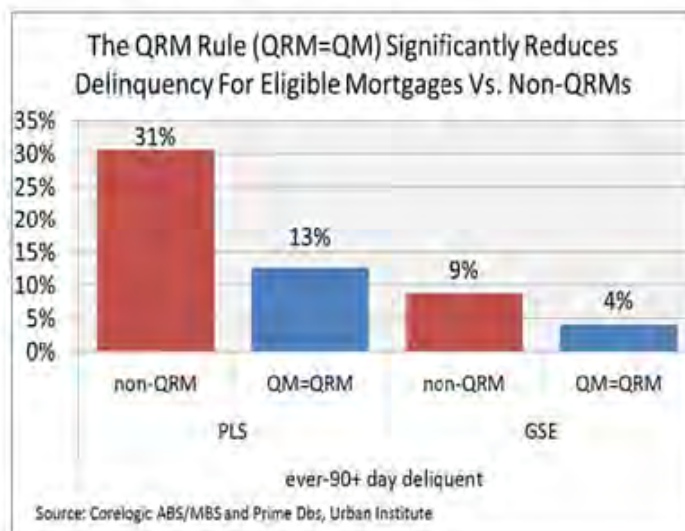
**Current Rule: Proper Balance**

In August 2013, the six Federal Regulators published a revised proposed rule that would equate QRM with the soon-to-be implemented “ability-to-repay” Qualified Mortgage (QM) and underwriting standards issued by the CFPE.

Under the QM standard, which was finalized earlier this year and will take effect in 2014, loans must meet product features and underwriting standards to qualify. Borrowers must document the income used to qualify for a loan, and creditors must verify this and other important borrower qualifications. Borrowers cannot have debt-to-income ratios above 43 percent (unless it meets Fannie Mae, Freddie Mac, or Federal Housing Administration underwriting criteria for seven years or until GSE reform). Loans with risky product features most closely associated with the housing crisis such as negative amortization, interest-only payment features, or loans with amortizations longer than 30 years are excluded from the QM definition.

In synchronizing both definitions, the revised rule encourages safe and financially prudent mortgage financing while also ensuring creditworthy homebuyers have access to safe mortgage financing with lower risk of default. In addition, consistency between both standards reduces regulatory burden and gives mortgage professionals much-needed clarity and consistency in the application of the important mortgage standards required pursuant to Dodd-Frank.

By equating the QRM with the QM, regulators have provided clear rules that allow for robust markets that meet the needs of creditworthy borrowers in a safe and sound manner. The new proposed QRM will reduce the risk of default and delinquency as illustrated below.



**Figure 10**



An Urban Institute analysis<sup>3</sup> of mortgages in private label securities originated in or prior to 2013 found that the “ever 90-day delinquency rate” (loans that have ever been 90 days or more delinquent) for all loans that did not meet the re-proposed QRM standard was 30.6 percent.

The delinquency rate for purchase and refinance loans that met the new QRM proposal was nearly two thirds lower at 12.6 percent.<sup>4</sup> Loans purchased by Freddie Mac and Fannie Mae that met the re-proposed QRM standard had default rates of 4.1 percent as compared to 8.7 percent for mortgages that did not qualify for QM status.

The study’s authors point out that using an alternative measure of performance such as the 180-day delinquency rate or a measure of default would more accurately portray borrower behavior. The delinquency rates for PLS and GSE mortgages originated over this same period that fell 180 days or more delinquent were 7.87 percent and 1.43 percent, respectively. Furthermore, as pointed out by researchers at the UNC Center for Community Capital, several recent studies of performance for QM and non-QM loans vary in scope by time frame and mortgage features included, but all indicate that the QM standard significantly reduces risk, while providing broader access to credit than a QRM that includes a down payment requirement.<sup>5</sup>

The alignment of the QM definition with the QRM definition results in a construct that excludes risky product features and low or no-documentation lending that are closely correlated with increased probability of default. Appropriately, the definition of QM is not limited based on down payment. Although data shows that the risk of default increases somewhat as down payments decrease, this correlation is not significant enough to necessitate the inclusion of a downpayment requirement in QRM. Much like the private market operates today, investors can choose to package QRMs based on down payments if they choose to. Aligning QRM with QM allows market participants to assess and allocate risk within boundaries that will ensure stability to the market and a wide degree of credit access.

Recent market trends show that the QRM rule is unlikely to lead to a flood of zero down payment loans, as some critics of the proposed rule have suggested. Creditors currently are requiring borrowers to put significant amounts down in order to qualify for a loan before any risk retention rules are in effect. Both Fannie Mae and Freddie Mac recently raised their minimum down payments for most loans to five percent, and charge significant premiums and require mortgage insurance for those with down payments below 20 percent. The inclusion of a down payment requirement in the QRM rule is therefore unnecessary. Nonetheless, if it were included it would set a rigid standard not amenable to adjustment by individual securitizers based on experience and market trends. Moreover, it would give the government’s imprimatur to an underwriting factor. That was not Congress’s intent and would exclude far too many borrowers from QRM loans.

As Laurie Goodman of the Urban Institute states, “The default rate for 95 to 97 percent LTV mortgages is only slightly higher than for 90 to 95 LTV mortgages, and the default rate for high FICO loans with 95 to 97

<sup>3</sup> See Laurie Goodman and Ellen Seidman and Jun Zhu, “QRM, Alternative QRM: Loan default rates,” The Urban Institute, MetroTrends Blog (October 17, 2013) (available at [http://blog.metrotrends.org/2013/10/qm-alternative-qm-loan-default-rates/?utm\\_source=feedburner&utm\\_medium=feed&utm\\_campaign=Feed%3A+MetrotrendsBlog+%28MetroTrends+Blog%29](http://blog.metrotrends.org/2013/10/qm-alternative-qm-loan-default-rates/?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+MetrotrendsBlog+%28MetroTrends+Blog%29)).

<sup>4</sup> To account for prepayment penalties, the authors of the Urban Institute’s study filtered from their QM definition mortgages with prepayment penalties incurred more than three years after origination, but they were unable to screen those mortgages with penalties that exceeded the limit of 2 percent of the amount prepaid. Likewise, data limitations precluded their ability to screen hybrid ARM products for a maximum rate reset in the first 5 years. Mortgages with these features may have been screened from the QM definition for other reasons, but some were likely included and thus estimates for delinquency rates should be considered conservative.

<sup>5</sup> Reid, Carolina and Quertia, Roberto, “Risk, Access, and the QRM Reproposal.” UNC Center for Community Capital, September 2013.

LTV ratios is *lower* than the default rate for low FICO loans with 90 to 95 percent LTV ratios. . . . For mortgages with an LTV ratio above 80 percent, credit scores are a better predictor of default rates than LTV ratios.”<sup>6</sup>

**Alternative: A Step Backwards**

In the revised proposal, the regulators ask for comment on the merits of adding a 30 percent down payment and credit requirements in addition to QM as an alternative for QRM. This proposal is a response to the overwhelming opposition voiced to the original proposed rule’s requirement for a 20 percent down payment, as well as its proposed question of a 10 percent alternative.

However, combining the definitions of QM and QRM together will make thorough underwriting and low risk mortgages the overwhelming standard in the market, without imposing down payment requirements above and beyond what lenders, insurers and investors will already continue to require. Large down payment requirements would raise the cost of credit<sup>7</sup> for a large pool of would-be homebuyers.

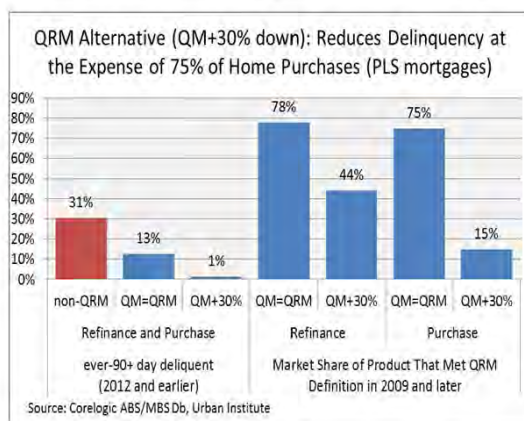


Figure 11

As the graph above indicates, for mortgages in private label securities overlaying the 30 percent down payment and additional credit requirements on top of generally defining QRM as QM would reduce the risk of default for QRMs from 13 percent to one percent but it would significantly reduce the portion of the market that is QRM and exempt from the higher cost of risk retention, particularly on the purchase side which would decline from 75 percent to 15 percent.

<sup>6</sup> See Laurie Goodman and Taz George, “Fannie Mae reduces its max LTV to 95: Does the data support the move?,” The Urban Institute, MetroTrends Blog (September 24, 2013) (available at <http://blog.metrotrends.org/2013/09/fannie-mae-reduces-max-ltv-95-data-support-move/>).

<sup>7</sup> See 78 Fed. Reg. 183, 58013 (September 20, 2013).

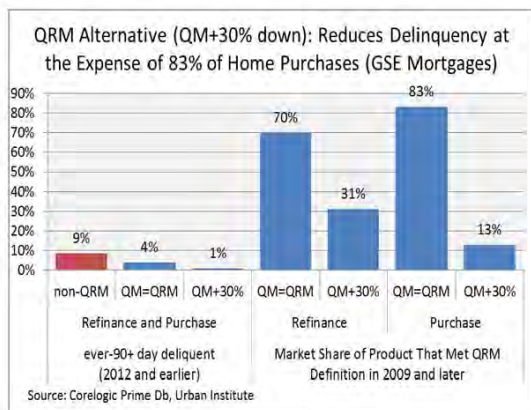


Figure 12

Likewise, as depicted above the delinquency rate for purchase and refinance originations purchased by the GSEs that met the alternative QRM requirement was 4.1 percent as compared to 1 percent for mortgages that just met the QM standard. However, the impact on market share of purchase mortgages originated after 2009 is more dramatic as the eligible share of the market falls from 83 percent to 13 percent.

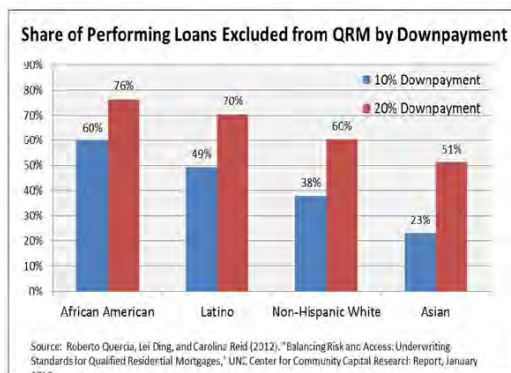


Figure 13

Furthermore, as highlighted in prior research, the impact of a 10 percent or 20 percent down payment would be disproportionately borne by borrowers of color. The impact would only increase for a 30 percent down payment. First time buyers are also constrained by down payments. On average, 92 percent of first time home buyers put down less than 30 percent between 2006 and 2012.



Figure 14

As indicated by the proposed rule, a cost of up to 30 basis points would be passed onto the consumer under the proposed alternative. While some dispute this estimate as being understated, even this cost could add up to billions of dollars on an annual basis, constraining consumer spending and homeownership, which would have implications for the greater economy. Alternatively, consumers might opt for a cheaper 100 percent government guaranteed FHA alternative, which instead of drawing more private capital back into the mortgage market – a stated goal of the Administration and many in Congress – would have the unintended consequence of driving more activity to the government-insured program. For those potential buyers who choose to save the required down payment, the time to save is staggering as indicated in the chart below.



Figure 15

**Summary**

Should the proposed 'preferred' QRM rule that tracks the QM rule be finalized, federal regulators would take a big step forward in strengthening the housing market and economy while also adequately addressing the root causes of the crisis (i.e. lapses in solid underwriting and the introduction/misuse of complex loan products). The proposed alternative that requires borrowers to put down 30 percent to qualify for a QRM loan will constrain the availability of private mortgages for many creditworthy borrowers. Additionally, the

high down payment requirement in the alternative proposal would limit access to otherwise high quality mortgages with lower down payments, restricting credit that will be needed to meet the housing credit needs of a rising generation of new households, without providing a commensurate increase in risk reduction for investors.

In summary, by synchronizing the definition of QRM with QM, the revised rule will encourage safe and financially prudent mortgage lending, while also creating more opportunities for private capital to reestablish itself as part of a robust and competitive mortgage market. Most importantly, it will help ensure creditworthy homebuyers have access to safe mortgage financing with lower risk of default in any new housing finance system.

#### PROPOSED CORKER-WARNER LEGISLATION

We applaud Senators Corker (TN) and Warner (VA) for laying the foundation for housing finance reform with the introduction of S. 1217, the "Housing Finance Reform and Taxpayer Protection Act of 2013," which includes many of our suggested reform elements. The legislation provides for an explicit government guarantee, which should ensure the availability of long term fixed-rate mortgage products such as the 30 year fixed-rate mortgage. NAR appreciates this significant step forward in the reform discussion because Corker-Warner is a move away from principles, and delves into the inner workings of the system that must be addressed in order for real reform to occur. With that said, we recognize that this proposed legislation is a work in progress and additional issues must be addressed. In that spirit, there are pieces of the legislation that do offer some concern to REALTORS®.

Below are the areas of the legislation that concern NAR members:

- The 5 percent down payment requirement;
- Significant reduction in loan limits;
- The issue of who will step in to ensure that lending continues when an economic downturn occurs should private capital decide not to take the first loss position of the credit-risk sharing mechanism developed by the FMIC;
- Ensuring access to the system for small lenders and credit unions and that their costs are in-line with those of the larger lenders;
- The reduction to zero of the entities portfolio; and
- Using fair value accounting principles for evaluating the mortgage insurance fund.

#### Increased Downpayment

REALTORS® believe that there should be flexibility in down payment for purchasing a home. Having a hard and fast requirement for how much downpayment someone needs to have, could preclude creditworthy borrowers who have an issue saving the required amount, from purchasing a home they could otherwise afford. Therefore, we believe the 5 percent down payment requirement should be removed from the legislation.

While the size of the downpayment does have an effect, the relationship is small and pales in comparison with the magnitude to other factors such as underwriting, product features, and credit scores. Increasing the downpayment, however, does have a significant impact on the ability of households looking to buy a home to do so. In theory, a higher downpayment should help to protect the lender or insurer against the potential default by requiring more "skin in the game" from the buyer. However, an analysis by researchers at the Urban Institute<sup>8</sup> has shown that loans with lower downpayments performed better than some high

<sup>8</sup> See Laurie Goodman and Taz George, "Fannie Mae reduces its max LTV to 95: Does the data support the move?", The Urban Institute, MetroTrends Blog (September 24, 2013).



downpayment mortgages over the period from 1999 to 2012. As depicted in Figure 16, mortgages with LTVs between 97 percent and 95 percent and credit scores above 700 significantly outperformed mortgages originated with credit scores below 700, but which had down payments greater than 20 percent. Furthermore, mortgages with down payments less than 5 percent performed roughly the same or better than those with a downpayment of 5 percent to 10 percent.

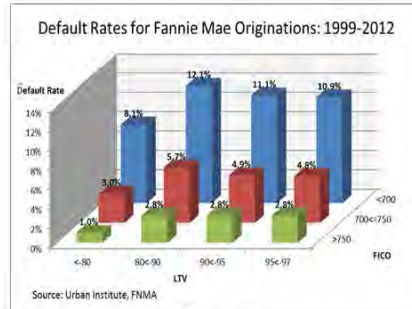


Figure 16

A small increase in downpayment can have a large impact on a borrower at the margin. Borrowers already must commit 3.5 percent cash (FHA) at closing in addition to closing costs, which is nearly \$6,000 for a median priced home sale. Increasing the downpayment will remove homeownership options for many American families.

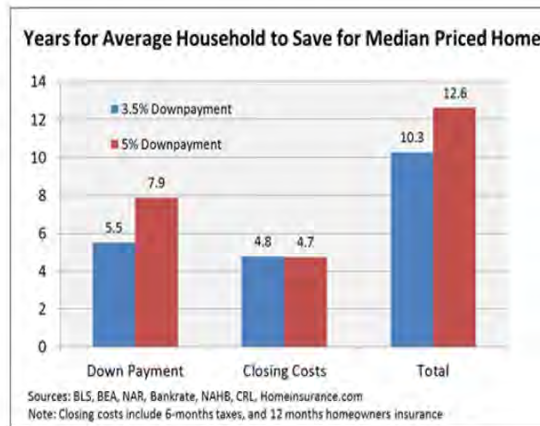


Figure 17

The size of the required downpayment also has a significant impact on the timing of a family's home purchase. At a 3.5 percent downpayment, the average buyer has to save 10.3 years to come up with the necessary downpayment for a median priced home. A simple increase in required downpayment from 3.5 percent to 5 percent will require the average buyer to save for an additional 2.3 years (from 10.3 years to 12.6 years). This estimate assumes that life events like having children, or taking care of family members don't divert their savings. (See Figure 17)

Homeownership is an important means for building wealth through structured equity payments for most households. However, recent trends towards higher downpayment in the traditional market have resulted in a higher share of home buyers using funds designated for retirement (such as IRAs, pensions, and 401ks) as a means of funding their downpayment. (See Figure 18)

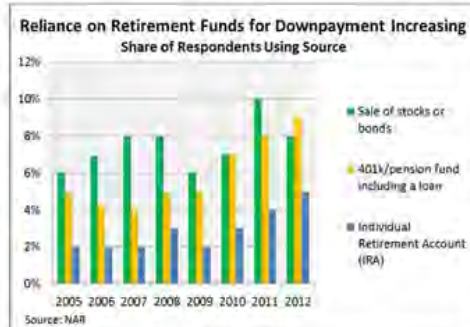


Figure 18

The impact of increasing the downpayment is greater on minorities than on whites, who are more likely to have received an inheritance or assistance from their family. A study by researchers at the University of North Carolina's Center for Community Capital demonstrated that for loans made during 2004 – 2008, a 10 percent down payment would have made a mainstream mortgage out of reach for 60 percent of African-Americans and 50 percent of Latino borrowers who were current on their mortgage.<sup>9</sup> More than 52 percent of African Americans and 45.8 percent of Hispanics relied on a downpayment less than 5 percent, compared to only 33.4 percent of other purchasers. (See Figure 19)

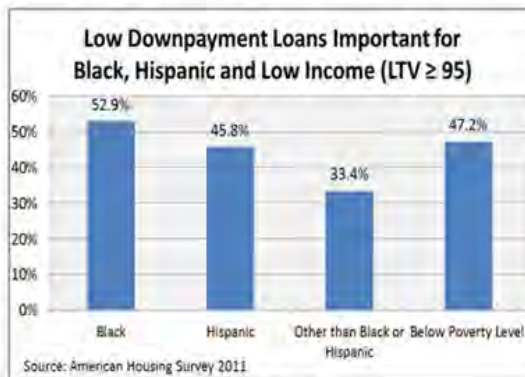


Figure 19

Low downpayments are not just important for first-time buyers. Repeat buyers also use low-downpayment loans, and could also be disenfranchised by this legislation. (See Figure 20)

<sup>9</sup> Roberto G. Quercia, Lei Ding, Carolina Reid. "Balancing Risk and Access: Underwriting Standards for Qualified Residential Mortgages." UNC for Community Capital. January 2012.

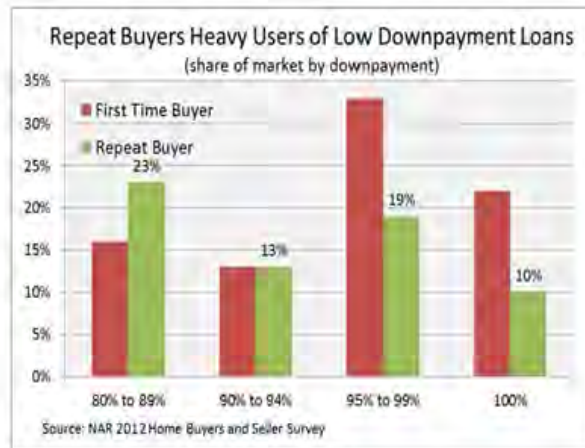


Figure 20

#### Loan Limits

NAR strongly opposes lowering of the loan limits at this time, especially in high cost markets. Lowering the loan limits to exclude very high cost markets will leave a significant number of first-time home buyers, middle income, and middle market relocation consumers at the mercy of a jumbo loan market that typically require substantially higher down payments at higher costs than the conventional conforming space.

Moreover, lowering the loan limits restricts liquidity and makes mortgages more expensive for households nationwide. Without the additional liquidity created by maintaining 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.

#### First Loss Position of Private Capital

In addition to the 5 percent downpayment provision in the Corker-Warner legislation, we are concerned with mandating a covered security to have a credit risk-sharing structure under which private investors' first loss coverage is no less than 10 percent of the value of the security. While NAR wants to see more private capital at risk in the housing finance system, we are concerned the arbitrary first loss percentage will inhibit private investors from participating in the secondary mortgage market, especially during periods of economic distress. We have seen what happens first hand during the current economic crisis, and without the current government support, lending would be near non-existent.

Well known economists such as Mark Zandi,<sup>49</sup> Phillip Zwagel, and Laurie Goodman have suggested that 4-5 percent is more than adequate to weather future economic downturns, while preserving lower mortgage rates for borrowers. However, these findings are of limited value since they do not examine whether private capital will flee the market in the event of another downturn as it has consistently done throughout history.

We recommend striking the mandatory 10 percent first loss position and replacing it with language directing the Federal Mortgage Insurance Corporation (FMIC) to study and determine, in conjunction with all market participants, the appropriate level for private investors' first loss position. Language in this section must also

<sup>49</sup> Mark Zandi has stated 5 percent is a sufficient first loss position for private investors.

provide for some form of a government guarantee, if private capital decides not to be in the first loss position and lending falls below levels prior to enactment of this legislation.

#### **Access for Small Lenders**

The Corker-Warner legislation requires the FMIC to establish a cooperative called the FMIC Mutual Securitization Company, whose purpose is to securitize eligible guaranteed loans and provide a cash window for smaller lending institutions. However, this does not assure that this will work in practice due to factors such as the difficulty in capitalizing the co-op or in operating it in a way that provides for a competitive outlet. We recommend that language be added to the Corker-Warner bill that ensures the cooperative provides a competitive cash window for small lenders. Steps may include alternative efforts to capitalize the co-op or to directly have the federal government operate a securitization outlet.

We also suggest including language that establishes transparency in the capital requirements for approval of issuers. It is a rational concept that issuers have sufficient capital to ensure that they can carry out their responsibilities. However, such standards should be transparent and should be reasonably related to the financial responsibilities and not set indiscriminately at excessive levels.

In addition, we recommend the addition of language that references small originators to ensure issuers serve smaller lenders in addition to traditional banks.

We also suggest that further discussion take place and language be considered to prevent mortgage market concentration, to ensure there are a sufficient number of issuers. The legislation requires the FMIC to ensure that there is at least one issuer approved to serve securitization needs for smaller lenders. To protect against several large lenders dominating the market, the FMIC should be required to ensure that there are a "sufficient number" of issuers that serve smaller lenders.

Lastly, we believe the cap on issuer market share should be removed and be replaced with language allowing the FMIC Director to make the determination of whether a cap is necessary. This will ensure for competition amongst all potential market participants in the federally guaranteed securitization market, while not precluding those who make a business determination to take a broader role in serving the mortgage market.

#### **Portfolio Reductions**

We oppose completely eradicating the portfolio of the GSEs as it will leave product that does not meet investor requirements with no market, thus no liquidity. Manufactured housing fits in this space; since the collapse of the ABS market in which that product traded, there has been limited activity. The manufactured housing market is still recovering, and will be gravely hampered if no one/mechanism is in place to provide liquidity to that specialized, yet affordable, housing product.

#### **Fair Value Accounting**

Finally, NAR opposes the use of Fair Value Accounting to determine the cost of the Mortgage Insurance Fund. Market conditions change and, therefore, a fair value accounting analysis is only as good as the day it is performed and only if the assets were to be sold at fire-sale prices. We would strike this section and recommend the FMIC to be required to use the same method utilized by OMB to account for the asset value of the mortgages held by the GSEs. This will provide continuity, and a more accurate assessment of the product insured by the facility.

### **CONCLUSION**

The U.S. housing sector is in the midst of recovering from the worst economic downturn since the Great Depression. Home prices and sales, as well as household wealth, are all up from a year ago. While this industry continues to face many headwinds such as higher interest rates, affordability challenges, and

increased government regulations, maintaining the housing recovery will be key to boosting economic and job growth, as it has in past recoveries.

Any restructure of the secondary mortgage market must ensure that there is mortgage capital in all markets at all times and under all economic conditions. We believe the only way to achieve this goal is through a secondary mortgage finance system that includes an explicit government guarantee that safeguards the availability of long-term, fixed-rate mortgage products such as the 30 year fixed-rate mortgage.

We believe the Corker-Warner legislation provides a good framework for reform in our housing finance market, which is necessary to encourage private capital and ensure creditworthy Americans always have access to affordable mortgage capital. We look forward to working with the Committee to ensure any future reform of the secondary mortgage market will protect and preserve the American Dream of homeownership for all responsible and hardworking Americans.



**PREPARED STATEMENT OF LAURENCE E. PLATT**

PARTNER, K&amp;L GATES LLP

OCTOBER 29, 2013

Good morning Chairman Johnson, Ranking Member Crapo, and Members of the Banking Committee.

My name is Larry Platt. I am a consumer finance lawyer at the global law firm, K&L Gates, LLP. I have been involved in housing finance issues for over 30 years. Thank you for allowing me to participate in the consideration of this important subject. I am appearing today in my personal capacity and not on behalf of either my law firm or any client of my law firm. All views expressed today are my own.

I have been asked to discuss whether the Housing Finance Reform and Taxpayer Protection Act of 2013 (the "Proposed Act") should impose stringent loss mitigation standards on servicers and owners of securitized residential mortgage loans for the benefit of consumers. Mortgage loan servicers are independent contractors, which for a fee paid by the mortgage investor pursuant to a servicing agreement, collect and remit mortgage loan payments and enforce the mortgage loan documents.

I understand that the Proposed Act presently addresses loan servicing in two ways. First, a newly created Federal Mortgage Insurance Company (FMIC) would establish servicing standards for the residential mortgage loans within its purview. Second, a uniform securitization agreement with uniform servicing standards would be created for use by the FMIC and potentially by investors in private securitizations. Neither provision presently imposes detailed loss mitigation requirements for the benefit of borrowers in default. I believe the newly enacted loan servicing regulations of the Consumer Financial Protection Bureau are sufficient for this purpose and no new law is required.

Over the last 4 years, the Federal Government has imposed increased obligations on residential mortgage loan servicers to avoid home foreclosures. For example, in March 2009, the U.S. Department of Treasury implemented President Obama's Home Affordable Modification Program requiring eligible borrowers to be provided loan modifications for loans originated prior to the financial crisis. The Federal banking agencies imposed loss mitigation obligations on the 14 banks that signed servicing-related consent orders in 2011. Fannie Mae and Freddie Mac expanded the loss mitigation requirements in their new default servicing guidelines in 2011. The April 2012 global foreclosure settlement between and among the five largest banks, the Department of Justice, 49 State attorneys general and various other branches of Federal and State Government incorporated detailed default loan servicing standards, including loss mitigation requirements.

Drawing on all of these initiatives as well as provisions in the Dodd Frank Act, the Consumer Financial Protection Bureau (the "CFPB") earlier this year promulgated final loan servicing regulations (the "CFPB Regulations") that take effect in January 2014. Of course, there is a myriad of new State laws also requiring servicers to offer loss mitigation to delinquent borrowers, including California's recent Homeowner's Bill of Rights, which codifies into State law various provisions from the global foreclosure settlement's national servicing standards. The result is that defaulting borrowers already have or will have significant Government protections to seek to avoid foreclosure under Federal law.

The CFPB Regulations are complex and comprehensive. They materially expand the national standards for the residential mortgage servicing industry by amending Regulation X under the Real Estate Settlement Procedures Act (RESPA) and Regulation Z under the Truth in Lending Act (TILA) on nine major topics.<sup>1</sup> Enforcement by the CFPB and in some cases by individual consumers in private rights of action ensures that the new provisions have sharp teeth.

The CFPB Regulations directly address common complaints of consumers and regulators that led to claims of wrongful or unfair foreclosures. Imposing procedural requirements for responding to written information requests or complaints of errors is one example. The rule requires servicers to comply with the error resolution procedures for 10 types of errors:

- Failing to accept a conforming payment;
- Failing to apply an accepted payment;

<sup>1</sup> The nine major topics included in the final rule are: 1. Periodic Billing Statements; 2. Interest Rate ARM Adjustments; 3. Payment Crediting and Payoff; 4. Force-placed Insurance; 5. Error Resolution and Requests for Information; 6. General Servicing Policies and Procedures; 7. Early Intervention Continuity of Contact; 8. Loss Mitigation. *[sic]*

- Failing to credit a payment to a borrower's account in violation of TILA requirement;
- Failing to pay taxes and insurance in a timely manner as required by RESPA or failing to refund an escrow account balance;
- Imposing a fee or charge that the servicer lacks a reasonable basis to impose upon a borrower (i.e., not bona fide fees);
- Failing to provide an accurate payoff balance;
- Failing to provide accurate information regarding loss mitigation and foreclosure (in accordance with other provisions of the rule);
- Failing to transfer accurately and timely information to transferee servicer;
- Making the first notice or filing for foreclosure in violation of other provisions of the RESPA rule;
- Moving for foreclosure judgment or sale in violation of other provisions of the RESPA rule; or
- Any other error relating to the servicing of a consumer's mortgage loan.

Establishing or making good-faith efforts to establish live contact with borrowers by the 36th day of their delinquency and promptly informing such borrowers, where appropriate, that loss mitigation options may be available is a second requirement of residential mortgage servicers. This early intervention requirement also mandates that a servicer provide a borrower a written notice with information about loss mitigation options by the 45th day of a borrower's delinquency.

A third requirement under the CFPB Regulations is continuity of contact with delinquent borrowers, commonly referred to as "single point of contact." This requires residential mortgage servicers to maintain reasonable policies and procedures to provide delinquent borrowers with access to designated personnel to assist them with loss mitigation options where applicable.

Residential mortgage servicers also are required to follow certain procedural requirements regarding their evaluation of borrowers for loss mitigation under the CFPB Regulations. "Dual tracking" (where a servicer is simultaneously evaluating a consumer for loan modifications or other alternatives at the same time that it prepares to foreclose on the property) is prohibited. Loss mitigation requirements include:

- If a borrower submits an application for a loss mitigation option, acknowledging the receipt of the application in writing within 5 days and informing the borrower whether the application is complete and, if not, what information is needed to complete the application.
- Exercising reasonable diligence in obtaining documents and information to complete the application.
- For a complete loss mitigation application received more than 37 days before a foreclosure sale, evaluating the borrower within 30 days for all loss mitigation options for which the borrower may be eligible in accordance with the investor's eligibility rules.
  - This includes both options that enable the borrower to retain the home (such as a loan modification) and nonretention options (such as a short sale).
  - Servicers are free to follow "waterfalls" established by an investor to determine eligibility for particular loss mitigation options.
- Providing the borrower with a written decision, including an explanation of the reasons for denying the borrower for any loan modification option offered by an owner with any inputs used to make a net present value calculation to the extent such inputs were the basis for the denial.
- Authorizing a borrower to appeal a denial of a loan modification program so long as the borrower's complete loss mitigation application is received 90 days or more before a scheduled foreclosure sale.
- Prohibiting a servicer from making the first required foreclosure notice or filing until a mortgage loan account is more than 120 days delinquent.
- Even if a borrower is more than 120 days delinquent, prohibiting a servicer from starting the foreclosure process if a borrower submits a complete application for a loss mitigation option before a servicer has made the first required foreclosure notice or filing unless:
  - The servicer informs the borrower that the borrower is not eligible for any loss mitigation option (and any appeal has been exhausted);
  - A borrower rejects all loss mitigation offers; or

- A borrower fails to comply with the terms of a loss mitigation option.
- If a borrower submits a complete application for a loss mitigation option after the foreclosure process has commenced but more than 37 days before a foreclosure sale, prohibiting a servicer from moving for a foreclosure judgment or order of sale, or conduct a foreclosure sale, until one of the same three conditions has been satisfied.

The CFPB went to great pains to focus on the procedures that need to be followed rather than on the result in any one case. The CFPB Regulations do not require servicers to offer specific forms of loss mitigation at all or on any specific terms. During the notice and comment period for the CFPB Regulations, many consumer advocacy groups asked the CFPB to (i) mandate specific home-saving strategies, with affordable loan modifications ranked first and with an order of priority among types of modifications; (ii) require all servicers to offer affordable, net present value-positive loan modifications to qualified homeowners facing hardship; and (iii) establish rules for determining what constitutes an affordable modification by establishing a maximum or target debt-to-income ratio. The CFPB declined to be this prescriptive. The preamble to the final CFPB Regulations explains why.

In deciding to reject prescribed modifications, the CFPB focused on the nature of a mortgage loan, the legitimate needs of mortgage investors, the difficulty in developing a “one size fits all” approach, and the potential impact on credit availability. For example, the CFPB acknowledged that, as with any secured lending, those who take the credit risk on mortgage loans do so in part in reliance on their security interest in the collateral. Indeed, what separates lower-interest residential mortgage loans from higher-interest unsecured consumer loans is that a mortgage loan is secured by the borrower’s home. While it may be in the interest of the holder to explore loss mitigation alternatives, foreclosure needs to remain a viable option.

Different creditors, investors, and guarantors have differing perspectives on how best to achieve loss mitigation, explained the CFPB, based in part on their own individual circumstances and structures and in part on their market judgments and assessments. The CFPB did not believe it presently could develop rules that are sufficiently calibrated to protect the interests of all parties involved in the loss mitigation process. Expressing its concern that an attempt to do so may have unintended negative consequences for consumers and the broader market, the CFPB concluded that mandating specific loss mitigation programs or outcomes might adversely affect the housing market and the ability of consumers to access affordable credit.

The CFPB emphasized that overreaching loss mitigation requirements could have a material adverse impact on the availability and cost of credit. It speculated that creditors who were otherwise prepared to assume the credit risk on mortgages might be unwilling to do so or might charge a higher price (interest rate) because they would no longer be able to establish their own criteria for determining when to offer a loss mitigation option in the event of a borrower’s default. Purchasers of whole loans and mortgage-backed securities might similarly reduce their purchases or prices, posited the CFPB, which could result in creditors charging higher interest rates to maintain the same yield. The burden of complying with prescribed criteria for evaluating required loss mitigation outcomes could substantially increase the cost of servicing. Under these circumstances, the CFPB declined to prescribe specific loss mitigation criteria and instead required servicers to maintain policies and procedures reasonably designed to identify all available loss mitigation options of their principals and properly consider delinquent borrowers for all such options.

Other Federal agencies have shared in this public policy reluctance to obligate specific loss mitigation outcomes. On August 28, 2013, a consortium of U.S. banking, housing, and securities regulators (the “Agencies”) repropoed the joint regulations to implement the risk retention rules under Section 15G of the Securities Exchange Act of 1934, including the exemption for “Qualified Residential Mortgages.” When first proposed in 2011, the Agencies conditioned the “Qualified Residential Mortgage” exemption on the inclusion of loss mitigation requirements in the underlying mortgage loan documents. Specifically, the proposed provision called for the “Qualified Residential Mortgage” loan documents to require the servicer to take loss mitigation actions, such as engaging in loan modifications, in the event the estimated net present value of such action exceeds the estimated net present value of recovery through foreclosure, without regard to whether the particular loss mitigation action benefits the interests of a particular class of investors in a securitization. Several commentators objected to this proposal, which effectively would have given a defaulting borrower a contract right to a permanent principal reduction regardless of the willingness of the loan owner to do so at the time of the default. In the repropoal the Agencies abandoned this requirement.

Other than requiring servicers to offer specific forms of loss mitigation on specific terms, it is not clear what more the Proposed Act would or could do in the area of loss mitigation. The CFPB and the Agencies explicitly rejected this approach in their 2013 rulemaking activities. Issued pursuant to notice and comment rulemaking, the robust requirements of the CFPB Regulations go live in a little over 2 months. While I may not agree with all of the provisions in the CFPB Regulations, they were fully vetted and reflect substantial input of virtually all interested stakeholders. Given the potential for the undesired consequences identified by the CFPB if its regulations were to mandate loss mitigation outcomes on mortgage loan investors, I believe the Proposed Act does not need to impose additional loss mitigation requirements for the benefit of consumers.

Thank you again for the opportunity to appear today.

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**PREPARED STATEMENT OF ALYS COHEN**  
STAFF ATTORNEY, NATIONAL CONSUMER LAW CENTER

OCTOBER 29, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to testify today on the key components of housing finance reform for consumers.

I am a staff attorney at the National Consumer Law Center (NCLC).<sup>1</sup> In my work at NCLC, I provide training and technical assistance to attorneys across the country representing homeowners who are facing foreclosure, and I also lead the Center's Washington mortgage policy work. Prior to my work at the National Consumer Law Center, I focused on mortgage lending issues as an attorney at the Federal Trade Commission's consumer protection bureau, where I was involved in investigations and litigation regarding lending abuses, and where I drafted the Commission's first testimony regarding predatory mortgage lending in the late 1990s. For over 15 years I have worked to address the harms caused by predatory mortgage lending and have seen firsthand the harms caused in communities nationwide. I testify here today on behalf of the National Consumer Law Center's low income clients and the National Association of Consumer Advocates.<sup>2</sup> On a daily basis, NCLC provides legal and technical assistance on consumer law issues to legal services, Government and private attorneys representing low-income consumers across the country.

Congress and the Nation face an important crossroads in the life of the housing finance system. At a moment when many communities are still devastated from high foreclosure rates and when access to credit remains too scarce, the contours of a new housing finance system will determine the future of home ownership—who gets it, who doesn't, and how fairly it is distributed. Home ownership and housing finance contribute to family stability, stronger neighborhoods, and economic growth. The new system must incorporate mechanisms to assure access and affordability for a wide array of homeowners, including those hardest hit in the recent foreclosure crisis and currently marginalized in today's lending market—communities of color, low-income homeowners, and residents of rural areas. This sustainability must apply to the entire life cycle of a loan, including loss mitigation available during periods of hardship.

My testimony today will provide a brief overview of the state of the housing market and the essential components of a new housing system's approach to lending to consumers while focusing primarily on one key aspect of housing refinance reform, mortgage servicing.

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<sup>1</sup>Since 1969, the nonprofit National Consumer Law Center® (NCLC®) has used its expertise in consumer law and energy policy to work for consumer justice and economic security for low-income and other disadvantaged people, including older adults, in the United States. NCLC's expertise includes policy analysis and advocacy; consumer law and energy publications; litigation; expert witness services, and training and advice for advocates. NCLC works with nonprofit and legal services organizations, private attorneys, policymakers, and Federal and State government and courts across the Nation to stop exploitive practices, help financially stressed families build and retain wealth, and advance economic fairness. NCLC publishes a series of consumer law treatises including Mortgage Lending, Truth in Lending and Foreclosures. NCLC attorneys provide assistance on a daily basis to the attorneys and housing counselors working with distressed homeowners across the country. This testimony is based on the field experience of these advocates as well as our knowledge and expertise in mortgage origination and servicing.

<sup>2</sup>The National Association of Consumer Advocates (NACA) is a nonprofit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

### Current Trends Highlight the Need for Better Access and Affordability Throughout the Loan Cycle

While the housing market has improved somewhat from the height of the crisis, more needs to be done to restore a functioning and fair housing market. Approximately two-thirds of mortgage originations in the second quarter of 2013 were for refinancing, not home purchases.<sup>3</sup> The percentage of home purchases by investors has increased substantially. While investor purchases may support housing prices and perhaps even inflate them,<sup>4</sup> it is not a structure that builds a sound and broadly accessible housing finance system. Moreover, the wealth gap between whites and both Latinos and African Americans is larger than it has been since data on the size of the gap were first collected, nearly 30 years ago.<sup>5</sup> The wealth of an entire generation has been eliminated. As these communities begin to rebuild their wealth, home ownership is likely to continue to be a cornerstone of their wealth acquisition.

While much of the discussion has moved to restoration of the lending market, many homeowners are still facing foreclosure. In the second quarter of 2013, 2.13 percent of prime loans and 11.01 percent of subprime loans were in foreclosure.<sup>6</sup> These rates are still higher than the percent of loans in foreclosure at the onset of the economic collapse in 2008,<sup>7</sup> a year into the subprime mortgage meltdown,<sup>8</sup> and are much higher than any we have seen since before the turn of the current century.<sup>9</sup>

Moreover, most homeowners with access to loss mitigation still do not get the best modifications available to them, and many who qualify get no modification at all. While HAMP loan modifications have the best results, with post-modification delinquency rates at half of other modifications,<sup>10</sup> most homeowners receive either a proprietary modification with less advantageous terms or no modification at all. In fact, 3 percent of delinquent homeowners in the second quarter of 2013 received non-HAMP modifications, while only 1 percent received HAMP trial modifications and another 1 percent received HAMP permanent modifications. The remaining 95 percent of delinquent homeowners received no modification.<sup>11</sup>

Even for those who receive loan modifications, they often are not adequately keyed to affordability. Homeowners who receive loan modifications with substantial reductions in loan payments fare much better than those with increased payments or even those with small payment decreases.<sup>12</sup> Yet, there is insufficient standardization of payment reductions and post-modification debt-to-income ratios. Modifications that reduced monthly principal and interest payment by 20 percent or more

<sup>3</sup> Julia Gordon, Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs (Sept. 12, 2013), *citing* U.S. Department of Housing and Urban Development and U.S. Department of Treasury, “The Obama Administration’s Efforts To Stabilize the Housing Market and Help American Homeowners”, (2013), available at <http://portal.hud.gov/hudportal/documents/huddoc?id=hudjulynat2013scd.pdf>.

<sup>4</sup> Julia Gordon, Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs (Sept. 12, 2013), *citing* Susan Berfield, “A Phoenix Housing Boom Forms, in Hint of U.S. Recovery”, *Bloomberg Businessweek*, February 21, 2013, available at <http://www.businessweek.com/articles/2013-02-21/a-phoenix-housing-boom-forms-in-hint-of-u-dot-s-dot-recovery>.

<sup>5</sup> R. Kochhar, et al., “Wealth Gaps Rise to Record Highs Between Whites, Blacks, Hispanics” (July 26, 2011), available at <http://www.pewsocialtrends.org/2011/07/26/wealth-gaps-rise-to-record-highs-between-whites-blacks-hispanics/>.

<sup>6</sup> Mortgage Bankers Association Delinquency Survey, Second Quarter, 2013.

<sup>7</sup> Mortgage Bankers Association Delinquency Survey, First Quarter, 2012, at 12.

<sup>8</sup> See, e.g., Staff of the Jt. Econ. Comm., 110th Cong., 1st Sess., “The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values, and Tax Revenues, and How We Got Here” (2007).

<sup>9</sup> See, National Consumer Law Center, *Foreclosure Prevention Counseling* 7 (2d ed. 2009) (showing rates of subprime and prime foreclosures dating back to 1998).

<sup>10</sup> OCC Mortgage Metrics Report for the Second Quarter of 2013, at 36.

<sup>11</sup> These calculations are based on data from the MHA Performance Reports, the NDS Data, and the OCC Mortgage Metrics Report. According to the NDS Survey, 2,393,322 homeowners were 90+ days delinquent during the second quarter of 2013. We adjusted that data to reflect the NDS coverage of the market at 80 percent. Adding the numbers of new HAMP trial and permanent modifications for April–June 2013, we get a total of 50,000 and 46,077, respectively, or 1 percent and 1 percent of the delinquencies. The OCC Mortgage Metrics data reports an additional 90,341 proprietary modifications during the same period or 3 percent.

<sup>12</sup> Roberto G. Quercia, et al., Ctr. for Cmty. “Capital, Loan Modifications and Redefault Risk: An Examination of Short-Term Impact” (2009), available at [http://www.ccc.unc.edu/documents/LM\\_March3\\_%202009\\_final.pdf](http://www.ccc.unc.edu/documents/LM_March3_%202009_final.pdf); “Modified Current Loans Are Three Times as Likely To Default as Unmodified Current Loans”, *Moody’s ResiLandscape* (Moody’s Investors Service), Feb. 1, 2011, at 10; Laurie S. Goodman, et al., Pew Ctr. on the States, “Modification Effectiveness: The Private Label Experience and Their Public Policy Implications” 6-7 (2012), available at [http://www.pewstates.org/uploadedFiles/PCS—Assets/2012/Goodman\\_et\\_al\\_%20Modification\\_Effectiveness.pdf](http://www.pewstates.org/uploadedFiles/PCS—Assets/2012/Goodman_et_al_%20Modification_Effectiveness.pdf).



have, since 2008, consistently had the lowest 60-day delinquency rates in the first quarter of 2013, compared to other modifications.<sup>13</sup> For loans modified in 2012, the 6-month 60+ day delinquency rate for loans with payment reductions of at least 20 percent was 8.8 percent, while modifications with payments reduced by less than 10 percent showed delinquency rates at 22.1 percent.<sup>14</sup> Modifications where monthly payments were increased showed the highest redefault rates at 29 percent, more than three times as high as the rates for payment reductions of 20 percent or more.<sup>15</sup> HAMP, with its target DTI of 31 percent, has produced deeper payment reductions and more sustainable loan modifications than industry modifications without a standard measure of affordability.<sup>16</sup> Moreover, even HAMP has failed to take into account the impact of back-end DTI, which can trigger redefault.

### **A New Housing Finance System Should Be Focused on Access and Affordability**

Focusing the new housing finance system on access and affordability for homeowners across the country will benefit homeowners, communities, lenders, and investors. The role of the secondary market is to provide housing to our Nation's families. However, lenders generally cater their loans to the preferences of their investors (which is how the abuses that caused the recent crisis developed—loans were made for investor profits at the expense of sustainability for homeowners). A secondary market focused on access and affordability will be more likely to produce an inclusive market.

Communities without access to affordable credit create vacuums that can be filled by predatory lenders. Those abuses generally have had a disparate impact in low-income communities and communities of color. Subprime mortgage products were sold disproportionately to lower-income homeowners.<sup>17</sup> Studies show that low-income homeowners are denied credit more often, even after adjusting for credit score and affordability.<sup>18</sup> Thus, lower-income families are forced of necessity to seek higher-cost forms of credit. A higher-cost product sold overwhelmingly to lower-income homeowners will, by definition, have a disparate impact on borrowers of color, whose incomes (and assets) lag far behind that of whites—even further behind as a result of the recent crisis. One example of the cumulative disparate impact is that white neighborhoods typically experience housing costs 25 percent lower than similar neighborhoods with a majority of African American residents.<sup>19</sup>

The Nation's housing finance system must include mechanisms to ensure that equal housing opportunities are provided in places where sustainable lending has been harder to find. This should be done through several complimentary mechanisms. In addition to properly funding the National Housing Trust Fund and the Capital Magnet Funds, the new system should promote broad access to lending by inhibiting credit rationing and "creaming" of the market. Lenders should be required to serve all population segments, housing types, and geographical locations.

Yet, any statute should not dictate specifics of underwriting that would result in less flexibility to meet these broad access goals. Housing finance legislation should leave open the specifics of downpayment requirements, credit scores, and debt-to-income ratios. Downpayment requirements are keyed directly to wealth, which itself varies widely by demographics and is not always tied to creditworthiness or ability to repay.

Debt-to-income ratios are an inadequate measure of lending capacity. For some borrowers with very low income, the 43 percent debt-to-income ratio in the CFPB Qualified Mortgage rule will still result in inadequate cash to cover basic living expenses. Yet the requirement of a 43 percent debt-to-income ratio also excludes some borrowers who can afford higher payments. Compensating factors and residual in-

<sup>13</sup> OCC Mortgage Metrics Report for the Second Quarter of 2013, at 39.

<sup>14</sup> OCC Mortgage Metrics Report for the Second Quarter of 2013, at 38.

<sup>15</sup> Id.

<sup>16</sup> Compare MHA Performance Report Through April 2012 (median HAMP permanent modification has resulted in a 37 percent payment reduction) with OCC Mortgage Metrics Report for the First Quarter of 2011, at 32 (in the fourth quarter of 2011 payment reductions for proprietary modifications were less than half those offered in HAMP, only 14.7 percent).

<sup>17</sup> Center for Responsible Lending (CRL), "Lost Ground", p. 26 (2011); Ira Goldstein, "Bringing Subprime Mortgages to Market", Harvard Joint Center for Housing Studies, p. 4; Ginny Hamilton, "Rooting Out Discrimination in Mortgage Lending" (Testimony before House Financial Services Committee) (2007).

<sup>18</sup> Christian Weller, Center for American Progress, "Access Denied: Low-Income and Minority Families Face More Credit Constraints and Higher Borrowing Costs", p. 1 (August 2007).

<sup>19</sup> Ojeda, "The End of the American Dream for Blacks and Latinos 11" (June 2009), available at [http://www.wcvi.org/data/pub/wcvi\\_whitepaper\\_housing\\_june\\_2009.pdf](http://www.wcvi.org/data/pub/wcvi_whitepaper_housing_june_2009.pdf).

come<sup>20</sup> are difficult measures to calibrate and should be left to the regulatory process.

Credit scores often do not provide a reliable picture of a borrower's credit profile. They often contain errors and otherwise reflect disparate access to sustainable credit—a legacy of decades of redlining. Moreover, credit scores cannot predict if any particular person will actually engage in any particular behavior. In fact, often the probability is greater that a particular low-scoring person will not engage in the behavior. For example, a score of between 500 and 600 is generally considered to be a poor score.<sup>21</sup> Yet at the beginning of the foreclosure crisis in 2007, only about 20 percent of mortgage borrowers with a credit score in that range were seriously delinquent.<sup>22</sup> Thus, if a score of 600 is used as a cut-off in determining whether to grant a loan, the vast majority of applicants who are denied credit would probably have not become seriously delinquent. A study by Federal Reserve researcher and a Swedish scientist, based on Sweden consumers, similarly found that most consumers with impaired credit did not engage in negative behavior.<sup>23</sup>

Credit scores also differ substantially by race. Congress should not enshrine these racial disparities into the law by mandating the use of scores. Requiring the use of scores does not just permit a practice with disparate impact—it actively mandates it. Studies showing racial disparities in credit scoring include: a 2012 study by the CFPB, which found that the median FICO score for consumers in majority minority ZIP codes was in the 34th percentile, while it was in the 52nd percentile for ZIP codes with low minority populations;<sup>24</sup> a 2007 Federal Reserve Board report to Congress on credit scoring and racial disparities in which, for one of the two models used by the Federal Reserve, the mean score of African Americans was approximately half that of white non-Hispanics (54.0 out of 100 for white non-Hispanics versus 25.6 for African Americans) with Hispanics faring only slightly better (38.2);<sup>25</sup> and a 2006 study from the Brookings Institution which found that counties with high minority populations are more likely to have lower average credit scores than predominately white counties.<sup>26</sup>

There should be flexibility going forward for determining underwriting requirements for the Nation's housing finance system. Without it, the promise of access and affordability would be empty.

#### **Housing Finance Reform Should Contain Key Essentials of a Healthy Mortgage Servicing System, Including a Requirement for Servicers To Provide Loan Modifications That Benefit the Taxpayer and the Homeowner**

Following the recent economic crisis, new mortgage servicing rules have been adopted in an effort to improve loss mitigation outcomes for homeowners facing foreclosure and for the investors in those loans. Despite the creation of the Home Affordable Modification Program (HAMP), changes to FHA and GSE servicing regimes, and the National Mortgage Settlement, the mortgage servicing companies have continued to circumvent existing requirements at the expense of investors, homeowners, and communities. While the CFPB issued regulations creating long-term procedural rules on default servicing, additional work is needed. A new GSE

<sup>20</sup> For a discussion of why residual income can be a better measure of affordability than a straight debt-to-income ratio, see, Michael E. Stone, et al., "The Residual Income Method: A New Lens on Housing Affordability and Market Behaviour" (2011), available at [http://works.bepress.com/michael\\_stone/8](http://works.bepress.com/michael_stone/8).

<sup>21</sup> FICO, "myFICO Insider's Guide to 2010 Credit Card Reform and New FHA Mortgage Rules" (2010), (noting that under the Federal Housing Administration rules, "it may be difficult for a borrower to even begin the process [of getting a mortgage] with FICO scores below 600."), available at [www.myfico.com/Downloads/Files/myFICO\\_Guide\\_CCFHA.pdf](http://www.myfico.com/Downloads/Files/myFICO_Guide_CCFHA.pdf) (visited Sept. 29, 2013).

<sup>22</sup> Yuliya Demyanyk, "Did Credit Scores Predict the Subprime Crisis", *The Regional Economist* (Federal Reserve Bank of St. Louis Oct. 2008), available at [www.stlouisfed.org/publications/re/articles/?id=963](http://www.stlouisfed.org/publications/re/articles/?id=963) See also, VantageScore Solutions, L.L.C., "VantageScore 2.0: A New Version for a New World", 2011 (consumers with VantageScore of 690-/710, or borderline between "C" and "D" grade, have about a 9 percent risk of default).

<sup>23</sup> Marieke Bos and Leonard Nakamura, Federal Reserve Bank of Philadelphia, Working Paper No. 12-19/R, "Should Defaults Be Forgotten? Evidence From Quasi-Experimental Variation in Removal of Negative Consumer Credit Information", Apr. 2013, at 1, available at [www.philadelphiafed.org/research-and-data/publications/working-papers/2012/wp12-29R.pdf](http://www.philadelphiafed.org/research-and-data/publications/working-papers/2012/wp12-29R.pdf).

<sup>24</sup> Consumer Financial Protection Bureau, "Analysis of Differences Between Consumer- and Creditor-Purchased Credit Scores", at 18, Sept. 2012, available at [http://files.consumerfinance.gov/f/201209\\_Analysis\\_Differences\\_Consumer\\_Credit.pdf](http://files.consumerfinance.gov/f/201209_Analysis_Differences_Consumer_Credit.pdf).

<sup>25</sup> Board of Governors of the Federal Reserve System, "Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit" 80–81 (Aug. 2007).

<sup>26</sup> Matt Fellowes, Brookings Inst., "Credit Scores, Reports, and Getting Ahead in America" 9–10 (May 2006).

system should systematize loss mitigation that benefits investors while avoiding unnecessary foreclosures. Mortgage servicers often benefit from pursuing foreclosure over loss mitigation. Housing finance reform should realign incentives to maximize beneficial outcomes.

Getting servicing right must be a core piece of housing finance reform. The Nation's housing finance system should not only make home lending broadly accessible but ensure that the entire life of the loan is supported. Routine processing of loan and insurance payments must not result in errors or abuse that lead to unnecessary costs, defaults, and foreclosures. Homeowners facing genuine hardship who can still make loan payments that benefit the investor or taxpayer must have options to save their homes. Properly functioning servicing infrastructure is good for individual families, communities, and the system as a whole.

*Servicers' Incentives Incline Them Toward Modifications With Increased Fees and Foreclosures Over Sustainable Modifications*

Once a loan is in default, servicers must choose to foreclose or modify. A foreclosure guarantees the loss of future income, but a modification will also likely reduce future income, cost more in the present in staffing, and delay recovery of expenses. Moreover, the foreclosure process itself generates significant income for servicers.<sup>27</sup>

Servicers do not make binary choices between modification and foreclosure. Servicers may offer temporary modifications, modifications that recapitalize delinquent payments, modifications that reduce interest, modifications that reduce principal or combinations of all of the above. Servicers may demand up-front payment of fees or waive certain fees. Or servicers may simply postpone a foreclosure, hoping for a miracle.

For servicers, the true sweet spot lies in stretching out a delinquency without either a modification or a foreclosure. Income from increased default fees and payments to affiliated entities can outweigh the expense of financing advances for a long time. This nether-world status also boosts the monthly servicing fee and slows down servicers' largest noncash expense, the amortization of mortgage servicing rights, since homeowners who are in default are unlikely to prepay via refinancing.<sup>28</sup> Finally, foreclosure or modification, not delinquency by itself, usually triggers loss recognition in the pool. Waiting to foreclose or modify postpones the day of reckoning for a servicer. But delay can cost a homeowner the opportunity to obtain a modification.

These dynamics require a housing finance system that promotes sustainable loss mitigation that benefits investors and homeowners. Without aligning the incentives of servicers with those of other stakeholders, public monies, and the welfare of communities will be jeopardized.

Recent experience with GSE loss mitigation confirms the need to incorporate a stronger system of servicer accountability into the structure of a new housing finance system. While the U.S. Treasury Department's Home Affordable Modification Program established substantial loan modification rules keyed to affordability, the GSE program lagged behind in several significant ways. Homeowners with GSE loans facing hardship had no effective appeals process when servicers disregarded GSE requirements; yet many homeowners found that servicer noncompliance with GSE rules was endemic. Additionally, GSE rules regarding access to loan modifications for homeowners in bankruptcy (particularly the Fannie Mae rules) have lagged behind other programs. GSE rules allow and even incentivize servicers in many instances to pursue foreclosure while a homeowner is seeking a modification. Finally, the GSE standard modification is not keyed to affordability based on a debt-to-income ratio but rather to a percent of payment reduction that may or may not result in a payment that is affordable.

<sup>27</sup>A fuller treatment of servicer incentives may be found in Diane E. Thompson, Nat'l Consumer L. Center, "Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior" (Oct. 2009), available at <http://www.nclc.org/images/pdf/pr-reports/report-servicers-modify.pdf>.

<sup>28</sup>See, e.g., Ocwen Fin. Corp., Annual Report (Form 10-K) 30 (Mar. 12, 2009): Servicing continues to be our most profitable segment, despite absorbing the negative impact, first, of higher delinquencies and lower float balances that we have experienced because of current economic conditions and, second, of increased interest expense that resulted from our need to finance higher servicing advance balances. Lower amortization of MSRs [mortgage servicing rights] due to higher projected delinquencies and declines in both projected prepayment speeds and the average balance of MSRs offset these negative effects. As a result, income . . . improved by \$52,107,000 or 42 percent in 2008 as compared to 2007.

*Housing Finance Reform Should Include Several Key Improvements to Existing Mortgage Servicing Rules*

The new housing finance system must require affordable loan modifications that are consistent with investor interests. The CFPB, while it has issued a series of procedural requirements for servicers, has declined to issue such a mandate. Yet, the data show that almost all delinquent homeowners still get no modification at all. Those homeowners lucky enough to receive a modification seldom get one with the best terms available. The housing finance system should promote proven regimes for modifying loans with optimum loan performance. This should also include limited, Government-backed portfolio capacity to hold modified loans.

Second, homeowners seeking loan modifications should not be faced with an ongoing foreclosure while they are processing their loan modification request. Instead, such foreclosures should be put on temporary hold rather than subjecting the homeowner to the “dual track” of foreclosure and loss mitigation. This is the most crucial procedural protection for homeowners. Homeowners dealing with a foreclosure often face skyrocketing costs and the challenge of repeatedly rescheduling foreclosure sales—as well as the danger and sometime occurrence of the home being sold before the loss mitigation review is complete. While CFPB rules provide some protections for homeowners who have not yet been put into foreclosure, many homeowners seeking assistance after the foreclosure has begun are locked out of a reasonable chance to save their homes. Homeowners in foreclosure should be able to obtain a temporary pause to a foreclosure to promote efficient evaluation of a loan modification application. Additionally, dual track protections must be keyed to the homeowner’s initial application in order to promote timely loan modification reviews over foreclosures. Requirements keyed to a “complete application” invite manipulation of the process based on a subjective determination of an application’s status.

While existing regulations provide some level of protection against dual tracking, stronger GSE rules are nevertheless appropriate. Because a pause in the foreclosure process during a loss mitigation review is the key procedural protection that stands between a homeowner and an unnecessary foreclosure, substantial flaws in existing requirements must be addressed. Moreover, the GSE system has long been a leader in market developments. The housing finance system should promote the highest standards for loss mitigation, as it has for home lending. Such progress would promote broader market changes and demonstrate the viability of sustainable loan modification reforms.<sup>29</sup>

Third, the new housing finance corporation should be authorized to directly purchase insurance, including force-placed insurance. The current system, in which the GSEs reimburse servicers for force-placed hazard and flood insurance, has resulted in vastly inflated prices for borrowers and, when borrowers default, the GSEs and taxpayers. An investigation by the New York Department of Financial Services found that “premiums charged to homeowners for force-placed insurance are two to ten times higher than premiums for voluntary insurance, even though the scope of the coverage is more limited.”<sup>30</sup> It also found that “insurers and banks have built a network of relationships and financial arrangements that have driven premium rates to inappropriately high levels ultimately paid for by consumers and investors.”<sup>31</sup> Fannie Mae’s Request for Proposal on lender placed insurance in 2012 highlighted the reverse competition typical of this market and the effect on investors and the taxpayer. The proposal noted that “[t]he existing system may encourage Servicers to purchase Lender Placed Insurance from Providers that pay high commissions/fees to the Servicers and provide tracking, rather than those that offer the best pricing and terms to Fannie Mae. Thus, the Lender Placed Insurers and Servicers have little incentive to hold premium costs down.”<sup>32</sup> A mechanism allowing the new housing finance corporation to purchase force-placed insurance—as well as title insurance and private mortgage insurance—directly from insurers would decrease costs for borrowers and the corporation by circumventing the kickbacks to servicers that drive up insurance prices.

<sup>29</sup>The GSE guides are a more appropriate locus for some of the other details regarding mortgage servicing. While legislation can take on the structural issues and key needed changes, the regulatory process is the locus for more calibrated treatment of mortgage servicing (as well as lending).

<sup>30</sup>Memorandum from Benjamin M. Lawsky, Superintendent, New York Department of Financial Services to State Insurance Commissioners, Reforming Force-Placed Insurance (Apr. 5, 2013).

<sup>31</sup>*Id.*

<sup>32</sup>Fannie Mae, “Request for Proposal: Lender Placed Insurance, Insurance Tracking, Voluntary Insurance Lettering Program” (Mar. 6, 2012).

Fourth, the new housing finance system should promote transparency and accountability. An Office of the Homeowner Advocate should be established to assist with consumer complaints and compliance matters. This would help remedy the current situation in which noncompliance problems with GSE loans often go unaddressed. Moreover, loan level data collection and reporting should include demographic and geographic information, to ensure that civil rights are protected and equal opportunity to avoid foreclosure is provided. Aggregate information about complaints and the data about loss mitigation must be publicly available, as HMDA data is. Work to develop the new housing finance system, and to administer and oversee it, should include stakeholders such as community groups and representatives of homeowners, in addition to the corporate stakeholders on the lending and servicing sides. Finally, in order to ensure that the housing system meets its goals, there must be strong regulatory levers for securing compliance, including robust monitoring, reporting and supervision.

#### **Any Federal Electronic Registry Must Be Transparent, Mandatory, and Supplemental to State Rules**

Any new, Federal electronic registry for housing finance must be available to the public, transparent, mandatory, and supplemental to State requirements. Only a public, supplemental system will assure homeowners of access to key information in the foreclosure process while allowing States to continue their role as primary regulators of their own foreclosure procedures and land records.

There are several important reasons why any Federal registry should be supplemental to State systems. First, local registries provide a unified system of records for all interests affecting a particular property: judgments, tax liens, assessments, divorce decrees. A national mortgage registry is unlikely to duplicate this. Second, in many States, such as Massachusetts, the mortgagee holds legal title to real property and the mortgage conveys a distinct property interest. The land registries establish property interests by guaranteeing title to recorded interests such as mortgages. Third, many State foreclosure laws, particularly in nonjudicial States, incorporate requirements to record documents in land records in order for a nonjudicial sale to convey valid title. These include various notices of default and sale, and even affidavits of compliance with State loss mitigation laws. Several States, such as Oregon and Minnesota, require that mortgages be recorded before a nonjudicial sale can take place. There has been disagreement about whether a nominee system like MERS (which designates a straw party to serve as a placeholder regardless of who owns the loan) can comply with one of these recording requirements. Even if the registry name is allowed to substitute for the real owner, use of a universal straw party nominee name destroys transparency. Finally, local land records are fully public and available to all who come to the examine records.

A national registry system should include records of servicing rights, ownership of mortgages and deeds of trust, as well as ownership of the promissory notes themselves. All records should comply with Federal e-sign requirements to ensure there is only one authoritative electronic record. The system should assign each security instrument and related promissory note a unique identification number. Participation in the registry system must be mandatory. Enforcement of registry system requirements should include a schedule of sanctions for noncompliance, as well as a private right of action, and attorney's fees, for homeowners with noncompliant loans (with the recoupment serving as a setoff against the loan). Recent history has made clear that without the specter of private litigation noncompliance is common and too often goes unaddressed.

#### **Conclusion**

Thank you for the opportunity to testify today. The Nation's housing finance system is in need of a revived sense of public purpose. Loan origination and servicing mechanisms should ensure broad and sustainable access to credit throughout the life of the loan. I will be happy to take any questions you may have.

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#### **PREPARED STATEMENT OF LAUTARO LOT DIAZ**

VICE PRESIDENT, HOUSING AND COMMUNITY DEVELOPMENT, NATIONAL COUNCIL OF  
LA RAZA

OCTOBER 29, 2013

#### **Introduction**

Chairman Johnson, Ranking Member Crapo, and distinguished Members of the Committee, thank you for inviting me to appear this morning on behalf of the National Council of La Raza (NCLR), where I serve as the Vice President for Housing



and Community Development. I have worked for over 25 years in the community development field, serving low-income families, and I appreciate the opportunity to provide expert testimony about the work on which I have built my career and that has been a fundamental part of NCLR's mission.

NCLR is the largest national Hispanic civil rights and advocacy organization in the United States, an American institution recognized in the book *Forces for Good* as one of the best nonprofits in the Nation. NCLR works with a network of nearly 300 Affiliates—local, community-based organizations in 41 States, the District of Columbia, and Puerto Rico—that provide education, health, housing, workforce development, and other services to millions of Americans and immigrants annually.

For more than two decades, NCLR has actively engaged in public policy issues such as preserving and strengthening the Community Reinvestment Act and the Home Ownership Equity Protection Act, supporting strong fair housing and fair lending laws, increasing access to financial services for low-income families, and promoting home ownership in the Latino community. As evidence of our commitment to housing-related policy and programmatic research, NCLR has recently published a number of reports on Latinos' interaction with the market, including:

- *Puertas Cerradas: Housing Barriers for Hispanics*, published by NCLR and the Equal Rights Center (July 19, 2013)
- *Making the Mortgage Market Work for America's Families*, published by NCLR and the Center for American Progress (June 5, 2013)
- *Latino Financial Access and Inclusion in California*, published by NCLR (June 4, 2013)

In addition to policy research, NCLR has for the last 13 years supported local housing counseling agencies. The NCLR Homeownership Network (NHN), comprised of 49 community-based housing counseling providers, works with over 50,000 families annually and has nurtured more than 30,000 first-time homebuyers since its inception. Following the financial crisis, the NHN responded to the Latino community's need by shifting the focus to helping families stay in their homes. NCLR's combination of housing-related policy research and local community experience with the NHN gives us a unique perspective on how Latino families interact with the mortgage market, their credit and capital needs, and the impact of Government regulation on financial services markets.

With this background, my testimony today will begin with a discussion of the impact of the housing crisis on low- and moderate-income families, focusing on Latinos, which is the target of NCLR's work. My remarks will provide a framework to better understand the extent to which pre- and post-purchase housing counseling helps increase access to credit in hard-to-serve markets. It is also a critical loss mitigation tool to ensure that families are ready to buy and that they completely understand the processes involved in the event of delinquency. Finally, I will conclude my testimony with observations on the necessity of preserving access to affordable housing finance options, based on client interactions. It is my hope that this testimony will assist in clarifying some commonly held misconceptions about the origination of the housing crisis and, by extension, what policies are needed to remedy these issues.

### **Impact and Origination of the Housing Crisis**

We are now 5 years after the collapse of the subprime mortgage market and the ensuing financial crisis, and the Nation's housing market remains broken. An estimated 2.7 million homeowners lost their homes to foreclosure and many more are still at risk of foreclosure. Communities of color, and the Latino community in particular, were hit hardest by this crisis and suffered an extreme loss of wealth. While it will take considerable time to fully understand the implications of this recent economic and housing crisis, it is clear that these communities have borne the brunt of the impact. For example:

- Hispanic families lost 44 percent of their wealth between 2007 and 2010; by contrast, black families lost 31 percent and white families lost 11 percent.<sup>1</sup>
- From 2005 to 2009, the median level of home equity held by Latino homeowners declined by half—from \$99,983 to \$49,145. At the same time, home ownership rates among Hispanics also fell, from 51 percent to 47 percent. A disproportionate share of Hispanics live in California, Florida, Nevada, and Arizona, the

<sup>1</sup> Signe-Mary McKernan, Caroline Ratcliffe, C. Eugene Steuerle, and Sisi Zhang, "Less Than Equal: Racial Disparities in Wealth Accumulation" (Washington, DC: The Urban Institute, 2013).

States that experienced the steepest declines in housing values during the crisis.<sup>2</sup>

In the run-up to the financial crisis, the mortgage market did not serve these communities of color particularly well. More specifically, Latino and immigrant borrowers are prone to unique profiles, including a lack of traditional credit history, multiple coborrowers, and cash income, qualities that make them unattractive to lenders who rely on automated underwriting. This standardization in many instances does not capture a borrower's true credit risk, particularly in the aforementioned cases. While prime lenders, the Federal Housing Administration (FHA), and the Veteran's Administration (VA) offered loans designed to accommodate these unique profiles, the majority of private sector lenders referred these loans to their subprime affiliates or simply did not advertise in these communities at all. As a result of this market failure, a vacuum emerged that subprime and predatory lenders quickly filled, leading to a record-high foreclosure rate in Latino and minority communities. When compared to whites, Latinos were 30 percent more likely to receive high-cost loans at the height of the housing bubble when purchasing their homes.<sup>3</sup>

Today the market is not serving communities of color significantly better. Even though housing prices are on the rise, the market remains broken. Housing prices in many urban markets with heavy minority populations are once again rising faster than income. At the same time, the so-called credit box continues to tighten. Creditworthy, low-income homebuyers cannot meet the overcorrection in today's lending standards that have stemmed from the housing collapse. As a result, mortgage credit currently serves only the most pristine customers with FICO scores over 760, with downpayments above 20 percent, and with the capacity to buy jumbo loans.<sup>4</sup> These trends point to an unsustainable housing market that has not yet fully recovered.

Housing counseling was created in part as a response to many of the problems underscored by the most recent housing crisis. More than simply increasing financial literacy, counseling is a tool to combat some of the unethical and at times illegal practices employed by a number of subprime lenders targeting of communities of color.

As a result, local housing counseling agencies are on the front lines witnessing these macro trends firsthand and providing assistance to families in traditionally underserved communities. In essence, the services provided by counselors are designed to correct the precise market failures that were integral to the economic downturn. Yet, as I will speak to in a moment, support for this work has not kept pace with demand. Housing finance reform must commit to integrating and strengthening the counseling infrastructure, which will help ensure that these services are widely available to expand access to credit in hard-to-serve markets. It would also combat foreclosures by helping future homebuyers fully understand the implications of their mortgage terms and avoid predatory lending practices.

### **Housing Counseling**

Within this framework of a true market failure to serve low- and moderate-income buyers, housing counseling plays a critical role in the today's housing market. I will describe how housing counseling works, the communities it serves, and its proven effectiveness in helping families stay in their homes.

The Department of Housing and Urban Development's (HUD) Housing Counseling Program funds a number of housing counseling organizations—a total of 277 local agencies, 22 State Housing Finance Agencies, and 27 national and regional intermediaries. As a national intermediary, NCLR distributes funding to its network of 49 housing-focused community organizations based on work plan, goals, and outcomes. To support our network's local operations, we provide quality control and training, build capacity, facilitate industry partnerships, pioneer products, and offer technology support. All organizations compete for funding on an annual basis, and NCLR works closely with HUD to expand the availability of counseling services to new communities and promote the nonprofits that serve them. HUD has comprehensive standards on how housing counseling is conducted and must certify all agencies

<sup>2</sup> Rakesh Kochhar, Richard Fry, and Paul Taylor, "Wealth Gaps Rise to Record Highs Between Whites, Blacks, Hispanics" (Washington, DC: Pew Research, 2011).

<sup>3</sup> Debbie Gruenstein Bocian, Keith S. Ernst, and Wei Li, "Unfair Lending: The Effect of Race and Ethnicity on Price of Subprime Mortgages" (Durham, NC: Center for Responsible Lending, 2006).

<sup>4</sup> Neil Bhutta and Glenn B. Canner, 2013, "Mortgage Market Conditions and Borrower Outcomes: Evidence From the 2012 HMDA Data and Matched HMDA-Credit Record Data", Federal Reserve Bulletin (Forthcoming). [http://www.federalreserve.gov/pubs/bulletin/2013/pdf/2012\\_HMDA.pdf](http://www.federalreserve.gov/pubs/bulletin/2013/pdf/2012_HMDA.pdf). Accessed on October 25, 2013.

that receive funding. To ensure compliance, HUD audits housing counseling agencies every 2 years to measure adherence to the standards. Only audited agencies or agencies within intermediary networks are deemed “HUD certified” and therefore eligible for funding.

Creating home ownership opportunities in low- and moderate-income Latino communities has been a particular priority of NCLR’s for well over a decade. HUD-certified housing counselors play a crucial role in these efforts as third parties that offer unbiased information and advice to homebuyers, renters, victims of predatory lending, and families facing a financial emergency. NCLR’s NHN counselors emphasize one-on-one counseling—in-person whenever possible—which has proven a more effective way of generating positive outcomes for Latino families specifically.<sup>5</sup> This approach helps the family feel more comfortable, allows them to have private questions answered, and gives the counselor an opportunity to evaluate their situation and develop tailored solutions for the family’s personal finances. As the foreclosure crisis hit, this same method was used for at-risk homeowners.

Along with the aforementioned face-to-face counseling, our network also uses classroom instruction and telephonic counseling where easy access to a counseling organization may prove difficult. Recently, counseling over the Internet using Skype has extended the geographic reach of individual organizations. Whether assisting a family with rental housing, a first-time home purchase, or mortgage delinquency, all HUD-approved counseling has to follow pre-specified comprehensive guidelines. These guidelines dictate that all counselors must advocate for the best interest of the client and not for a proprietary interest. This fiduciary duty in tandem with vital education on housing credit processes are the central factors contributing to housing counseling’s effectiveness.

HUD counseling agencies assist with an array of housing crises faced by members of their respective communities. The primary counseling services that impact today’s Government-sponsored enterprise (GSE) reform discussion are pre-purchase counseling that helps families purchase a home, and post-purchase counseling after a family has closed on their mortgage or in the event of a mortgage delinquency. Not only are these services beneficial to the client, the lender and investor also benefit from having a more informed consumer.

A housing counselor providing pre-purchase counseling does five important things: (1) educate the borrower on all aspects of the home-buying process, including the various private interests integral to this process; (2) review the client’s income, credit, savings, and family budget to help them understand what they can and cannot afford; (3) ensure that the obligation and essential practices that are central to owning a home are understood; (4) assist the family in understanding the documents they are signing and the obligations implied; and finally (5) provide community resources to address any issues that could impact the long-term ability to manage the mortgage loan. These steps are codified in HUD’s guidelines and upheld by the members of NCLR’s network. Furthermore, these five steps also help to ensure prudent decision making by the client because they make clients more fully aware of the obligations they are undertaking. Loan performance is demonstrably greater when a family obtains a loan with this kind of support, as opposed to loan performance without it.

For example, an Ohio-based counseling agency worked with a family who had filed for bankruptcy at the height of the economic downturn. This family, however, still aspired to become homeowners despite their financial turmoil. The counselor advised them to enroll in an education class. After following an action plan developed with a housing counselor, the family shortly thereafter successfully qualified for a VA loan; they purchased a home.

In instances when a client is confronting delinquency, they are better served with a counselor than facing the challenge alone. In this circumstance, counseling follows an almost identical rubric to pre-purchase processing with an emphasis on helping clients fully understand their options and ushering them through whatever process they decide is best for their financial situation.

As a concrete example of post-purchase counseling, one of our counseling agencies reported a story about a family seeking help after falling behind on their mortgage as a result of traumatic medical debt. The economic downturn left the family with

<sup>5</sup>Ryan M. Johnson and Elsa Macias, “Home To Own: A New Model for Community-Based Low-Income Mortgage Lending” (Arizona: Morrison Institute for Public Policy, 1995). *See also*, Brenda Muniz, “Financial Education in Latino Communities: An Analysis of Programs, Products, and Results/Effects” (Washington, DC: National Council of La Raza, 2004); Janis Bowdler, “Financial Literacy and Education: The Effectiveness of Governmental and Private Sector Initiatives” (Washington, DC: National Council of La Raza, 2008); and Eric Rodriguez, “Licensing and Registration in the Mortgage Industry” (Washington, DC: National Council of La Raza, 2005).

little to no emergency savings. The family was facing foreclosure proceedings and they were understandably frightened and upset, having lived in their home for a number of years. The counseling agency reviewed all necessary documentation and worked with the bank in advance of a settlement conference to get a trial mortgage modification that could lead to a permanent modification. This case is illustrative of a best-case scenario where the bank was quick to confirm receipt of paperwork and generally responsive.

Frequently, however, the post-purchase counseling process is less supportive. For example, a Miami family working with a counseling agency had negotiated a trial mortgage modification with their loan servicer. Even though the client had continued to make their payments on the trial modification, the bank had continued foreclosure proceedings. The property was sold, prompting the housing counselor to involve legal counsel to reverse the sale. A judge ruled in the client's favor, but without the support of a counseling agency the client would have lost their home. There are countless examples like this from our NHN organizations where counselors must help families confront lengthy and complex processes and work with unresponsive banks—issues that are all the more complicated when there are language barriers.

The NHN and similar counseling organizations are delivering mortgage-ready borrowers by following the processes outlined. All of the NHN counseling agencies focus on the atypical borrower—lower-income individuals with barriers to entering the market. Of particular importance to NCLR, our bilingual counselors play a critical role in helping future homeowners overcome language barriers to understand and access information. Housing counselors provide their clients with access to information about products and standards available in the current marketplace, information they may have never obtained without third-party assistance.

### **The Benefits of Housing Counseling**

The positive impact of individuals having access to housing counseling services is significant for the mortgage industry. Housing counseling supports safety and soundness for several reasons and should be more fully integrated into the credit process by encouraging borrowers to utilize this service through pricing discounts or as a compensating factor for higher-risk borrowers.

A better-prepared borrower makes the entire housing system safer and more secure. Prior to the increased participation of private hedge funds and the dramatic increase in liquidity eager to create and buy mortgage-backed securities in the mid-to-late 1990s, lenders exercised intense scrutiny to ensure that a borrower was prepared for their mortgage obligations. At that time, NCLR's work focused less on mortgage modifications and more on creating lender pilot programs. These programs were designed to assure the lending community that a family who received HUD-certified housing counseling was fully educated and prepared for their mortgage obligation, which would decrease the risk of default; these efforts demonstrated that low-income borrowers with the right knowledge and tools posed acceptable credit risk. This changed dramatically in the period leading up to the foreclosure crisis.

The 21st century ushered in an era of shoddy mortgage underwriting and the conventional wisdom that “if you can breathe, you can get a mortgage.” While a majority of lenders exercised responsible underwriting practices, pressure to create ever more originations by the capital in the market generally drove down underwriting standards. In the late '90s, the FHA also fell prey to this pressure when it discontinued discounts on the insurance premium for borrowers who received homebuyer education. Due to weaker underwriting standards, counselors began to see overly flexible products that allowed borrowers to take on more risk with less stringent underwriting standards. This in turn spurred some of the escalation in housing prices and was a prime driver of the foreclosure crisis that depleted so much wealth in communities throughout the country.

Essentially, a family that goes through a HUD-certified housing counselor is doubly underwritten, with a clear understanding of the true risk of each individual borrower. Housing counselors do not start the conversation with rates or features of a mortgage product; instead, they start by building a client's financial profile in order to determine an individual's readiness to borrow. Only after reviewing income, credit, savings, and family expenses in a structured way will the counselor recommend client preparedness. We believe that a borrower who has completed this process is less at risk of default, and research that I'll highlight later confirms this.

The foreclosure crisis presented a different challenge for lenders who were ill prepared to manage the ever-growing number of defaults. Loan servicers were faced with a collapsing housing market, and thousands of borrowers had to contend with not only their underwater mortgages but also higher rates of unemployment or underemployment. The housing counseling community responded by offering other avenues for distressed borrowers to obtain relief. For instance, counselors very early

in the crisis raised concerns of nonfunctioning and inadequate modification programs and also helped educate clients about emerging Federal and private modification plans. Many worked to provide servicers with assessments of their clients' financial capability to qualify them for programs that would best keep them in their homes whenever possible. One example of ways counselors helped distressed borrowers was through an active effort to distill information regarding common programs like HAMP and HARP or other private label programs. Many clients were confused, did not know if they could qualify, or were even unaware of available programs.

While the role of the counselor is ultimately to find optimal solutions for clients in times of need, the scale of the crisis and an initial reluctance from servicers to incorporate housing counselors into the modification process limited the reach of counseling at a time when foreclosures peaked. Insufficient resources to support counseling further exacerbated this shortcoming. As the number of foreclosures decline, however, and the market shifts back toward home ownership, the role of housing counselors in determining a borrower's readiness for a mortgage will be ever more critical.

Evidence that counseling helps borrowers continues to mount, though there is the limiting factor of the difficulty in having to identify loans held by a borrower receiving homebuyer education, pre-purchase counseling, or both. In addition to the anecdotal evidence I have provided, there is considerable research demonstrating the extent to which housing counseling works. Whether the consumer is a first-time homebuyer navigating the pitfalls of predatory lending or a distressed homeowner trying to stay in their home, housing counseling produces noticeably better outcomes. For example, a 2013 study measuring the impact of pre-purchase counseling and education provided by the NeighborWorks housing counseling network on 75,000 loans originated between October 2007 and September 2009 found that borrowers with pre-purchase counseling and education were one-third less likely to be over 90 days delinquent than those who did not receive counseling.<sup>6</sup>

Similarly, a 2012 NeighborWorks report to Congress showed that homeowners who received National Foreclosure Mitigation Counseling (NFMC) were nearly twice as likely to obtain a mortgage modification than those who did not receive this counseling. Moreover, NFMC clients who modified their mortgages were at least 67 percent more likely to remain current on their mortgage 9 months after this modification. Through counseling efforts, the report estimated that local governments, lenders, and homeowners saved roughly \$920 million in 2008 and 2009.<sup>7</sup>

Several other studies all conclude that access to pre-purchase counseling lowered delinquency rates, prevented the likelihood of foreclosure (in part through greater education about subprime loans), and had long-term economic benefits on a family's ability to manage future household economic shocks.

### Access and Affordability

After decades of working to help low-income Latino families become homebuyers, I have a few observations on the importance of preserving access and affordability for low- and moderate-income families, as well as protecting a duty to serve.

As I discussed, there remains a prevalent narrative that blames the foreclosure crisis on the affordability goals and mandated duty to serve in the Community Reinvestment Act. Yet this narrative is not borne out by existing research. A number of studies have established no causal connection between duty to serve and the housing crisis, including the Financial Crisis Inquiry Commission's report which found that the cause of the crisis flowed from a regulatory failure.<sup>8</sup> Similarly, a 2012 independent study published through the Research Division of the Federal Reserve Bank of St. Louis found no evidence that affordable housing mandates of the GSEs played a role in the crisis.<sup>9</sup>

<sup>6</sup> Neil Mayer and Kenneth Temkin, "Pre-Purchase Counseling Impacts on Mortgage Performance: Empirical Analysis of NeighborWorks® America's Experience".

<sup>7</sup> Neil Mayer, Peter A. Tatian, Kenneth Temkin, and Charles A. Calhoun, "National Foreclosure Mitigation Counseling Program Evaluation: Preliminary Analysis of Program Effects" (Washington, DC: Urban Institute, 2010).

<sup>8</sup> Financial Crisis Inquiry Commission. 2011. "Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States". [http://fcic-static.law.stanford.edu/cdn\\_media/fcic-reports/fcic\\_final\\_report\\_full.pdf](http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf). Accessed on October 25, 2013.

<sup>9</sup> Hernandez-Murillo, Andra C. Ghent, and Michael T. Owyang. 2012. "Did Affordable Housing Legislation Contribute to the Subprime Securities Boom?" Federal Reserve Bank of St. Louis Working Paper Series, No. 2012-005B. <http://research.stlouisfed.org/wp/2012/2012-005.pdf>. Accessed on October 25, 2013.

These findings are critical because without an obligation to serve all markets, communities of color in particular will find it extremely difficult to access mortgage credit. Without a duty to serve, private capital will gravitate to the cream of the crop: those with traditional borrowing profiles. This will result in an unsustainable housing finance market where creditworthy but lower-wealth and lower-income buyers, especially minorities, will be underserved. This is already evident today; the private market overwhelmingly caters to traditional borrowers in well-served locations.<sup>10</sup>

This trend does not just harm borrowers in minority communities, but rather the whole housing sector. Although Hispanics and blacks are already significant segments of the housing market, they are projected to be an even larger portion of the market over the next 10–20 years. According to the Joint Center for Housing Studies at Harvard, minorities will account for 70 percent of net new households over this period and 33 percent of all households by 2020. These households will be younger than traditional borrowers and will likely have lower incomes and less credit history. These new borrowers will therefore need access to affordable housing credit to become homeowners. Without affordable access to credit for these prospective buyers, there will be a large supply of housing stock left unsold, leading to decreasing prices and wealth. As a result, the retirement prospects of many Americans depending on income from the sale of their homes will be threatened.<sup>11</sup>

Similarly, when it comes to underwriting, there has been an overcorrection in underwriting standards. Although it has been widely acknowledged that tightening the so-called credit box was necessary to prevent harmful products, such as low documentation loans, from being marketed to consumers, today the credit box remains overly restrictive. The majority of loans to low- and moderate-income families since 2007 have been FHA or GSE-backed loans due to lack of private capital. Since 2009, the typical GSE-issued loans have a loan-to-value ratio under 80 percent with FICO scores over 760. This is indicative of the trend I spoke to earlier in which those with traditional credit profiles are being served. Moreover, FHA loans have become more expensive and harder to obtain in minority communities. The result of these factors taken together is that many creditworthy minority borrowers are effectively barred from participating in today's housing market. Any housing finance legislation must not include provisions that exacerbate today's dire credit conditions for minorities. For instance, proposals to raise downpayment requirements in a move to reduce mortgage lending risk would severely limit access to mortgage finance for future generations of creditworthy young households, with little to none of the desired reduction in systemic risk.<sup>12</sup>

### Recommendations and Conclusion

As I have emphasized throughout my testimony, HUD-approved housing counselors have a proven track record of pairing consumers with an appropriate mortgage. Buyers working in tandem with a counselor are more likely to have lower mortgage delinquency rates,<sup>13</sup> and in the event of foreclosure, are more likely to get a loan modification to prevent default.<sup>14</sup> Thus, any housing finance proposal should encourage increased access to housing counseling. In an October 11, 2013, letter from the National Housing Resource Center to this Committee,<sup>15</sup> there are three main principles that reform should address:

1. Improve the effectiveness of HUD-approved housing counseling agencies by integrating housing counseling into the programs of the Federal Mortgage Insurance Corporation (FMIC), or other entity that replaces Fannie Mae and Freddie Mac. Some options within this broad category would involve the inclu-

<sup>10</sup>Neil Bhutta and Glenn B. Canner, 2013, "Mortgage Market Conditions and Borrower Outcomes: Evidence From the 2012 HMDA Data and Matched HMDA–Credit Record Data", Federal Reserve Bulletin (Forthcoming). [http://www.federalreserve.gov/pubs/bulletin/2013/pdf/2012\\_HMDA.pdf](http://www.federalreserve.gov/pubs/bulletin/2013/pdf/2012_HMDA.pdf). Accessed on October 25, 2013.

<sup>11</sup>Joint Center for Housing Studies of Harvard University. 2013. "The State's of the Nation's Housing", Harvard University. <http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/son2013.pdf>. Accessed on October 25, 2013.

<sup>12</sup>Joint Center for Housing Studies of Harvard University. 2013. "The State's of the Nation's Housing", Harvard University. <http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/son2013.pdf>. Accessed on October 25, 2013.

<sup>13</sup>Neil Mayer and Kenneth Temkin, "Pre-Purchase Counseling Impacts".

<sup>14</sup>Neil Mayer, Peter A. Tatian, Kenneth Temkin, and Charles A. Calhoun, "National Foreclosure Mitigation Counseling Program Evaluation".

<sup>15</sup>The National Housing Resource Center is a 501(c)(3) organization that advocates for the nonprofit housing counseling community, as well as for housing consumers, for communities of color, for the elderly, and for underserved populations. NCLR is a board member of the organization. More information is available on [www.hsgcenter.org](http://www.hsgcenter.org).



sion of housing counseling data fields in the Uniform Mortgage Database; the inclusion of housing counseling as a risk reduction tool in evaluations by the Office of Underwriting; and the inclusion of housing counseling as an eligible activity in the Housing Trust Fund.

2. Increase access and affordability in the mortgage market. While there are a number of ways to do this within proposed legislation, the establishment of strong affordability requirements is paramount. Additionally, affordability and accessibility ought to be made explicit purposes, duties, and responsibilities of FMIC or any other entity replacing the GSEs. This entity ought to be required to approve originators. A distinct Market Access Fund, similarly, to address home ownership and rental housing for low- and moderate-income people would add value, as would a focus on programs to reach traditionally underserved markets. Finally, in support of this principle, legislators should not mandate downpayment requirements in underwriting standards.
3. Incorporate measures to help homeowners at risk of default recover and return to timely payment or exit gracefully, and to improve mortgage-servicing standards. To achieve this end, servicers ought to be required to work with and support HUD-approved housing counseling agencies; homeowners should be provided with access to all loss mitigation options; and servicers must be required to stop improper servicing practices such as dual tracking.

The letter offers additional specifications on each of these pillars.

My testimony this morning was designed to examine the effectiveness of pre- and post-purchase housing counseling and its proven record in helping low- and moderate-income families, particularly in underserved and hard-to-serve communities, stay in their homes. As I have emphasized throughout, NCLR's on-the-ground experience and research show that housing counseling services help homebuyers avoid scams, particularly with mortgage modification schemes and predatory lending practices that frequently target precisely these communities. As legislation to overhaul our housing finance system moves forward, it is important to keep in mind the root causes of the crisis and understand that housing counseling is a critical buttress against these.

Thank you again for the opportunity to appear before this Committee. I would be glad to answer any additional questions you may have.

**RESPONSES TO WRITTEN QUESTIONS OF  
CHAIRMAN JOHNSON FROM ERIC STEIN**

**Q.1.** What factors better predict default than downpayment? Are there certain product features or servicing practices that are more linked to high default rates than downpayment?

**A.1.** At its core, the foreclosure crisis was caused by risky product features and poor underwriting. Loans that failed in large numbers had harmful mortgage features, such as built in payment shock and costly prepayment penalties that stripped away borrower equity. Abusive lending practices such as loans with little to no documentation and broker compensation driven by yield-spread premiums also contributed to high loan failure rates. A 2011 CRL report, *Lost Ground: Disparities in Mortgage Lending and Foreclosures*, highlighted the link between risky mortgage features and foreclosure rates.<sup>1</sup> For mortgages originated between 2004 and 2008, this report showed that loans originated by a mortgage broker, containing hybrid or option ARMs, having prepayment penalties, and featuring high interest rates (i.e., subprime loans) had much higher foreclosure rates than loans without these features. *Lost Ground* also demonstrated that, while the majority of foreclosures have affected white borrowers, African Americans and Latinos have suffered foreclosure rates roughly twice that of whites, likely reflecting the fact that borrowers of color were much more likely to receive loans with risky features, even after controlling for credit scores.

Further research demonstrating the relationship between these risky mortgage features and lending practices and defaults is substantial. Ambrose, LaCour-Little, and Husza find elevated rates of default attributable to the initial payment adjustments of 3/27 Hybrid ARMs.<sup>2</sup> Pennington-Cross and Ho also find a positive and significant association between hybrid ARMs and default rates.<sup>3</sup> In addition, they find significant increases in defaults for loans with limited documentation levels. The impact of reduced documentation levels is further supported by LaCour-Little and Yang, who find a significant increase in defaults associated with stated income loans and no documentation loans.<sup>4</sup> Jiang, Nelson, and Vytlačil find, after controlling for other risk factors, higher default rates for broker-originated loans.<sup>5</sup> They suggest this is the result of the misaligned compensation structure of brokers. The authors also find a positive and significant association between low documentation and default. A 2011 report by the University of North Carolina at Chapel Hill conducted an analysis of the relative risk rates of subprime loans compared with Self-Help's portfolio of purchased

<sup>1</sup>Debbie Gruenstein Bocian, Wei Li, Carolina Reid, and Roberto Quercia, "Lost Ground, 2011: Disparities in Mortgage Lending and Foreclosures", 2011 (available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/Lost-Ground-2011.pdf>).

<sup>2</sup>Brent Ambrose, Michael LaCour-Little, and Zsuzsa Huszar, "A Note on Hybrid Mortgages", 2004 (available at <http://ssrn.com/abstract=591660>).

<sup>3</sup>Anthony Pennington-Cross and Giang Ho, "The Termination of Subprime Hybrid and Fixed-Rate Mortgages", *Real Estate Economics*, 38.3. 2010 (available at <http://ssrn.com/abstract=1660737> or <http://dx.doi.org/10.1111/j.1540-6229.2010.00271.x>).

<sup>4</sup>Michael LaCour-Little and Jing Yang, "Taking the Lie Out of Liar Loans", 2009 (available at [http://www.fhfa.gov/webfiles/15048/website\\_lacour.pdf](http://www.fhfa.gov/webfiles/15048/website_lacour.pdf)).

<sup>5</sup>Wei Jiang, Ashlyn Aiko Nelson, and Edward Vytlačil, "Liar's Loan? Effects of Origination Channel and Information Falsification on Mortgage Delinquency" (available at [http://www.columbia.edu/wj2006/liars\\_loan.pdf](http://www.columbia.edu/wj2006/liars_loan.pdf)).

loans to low-income families for a comparable set of borrowers.<sup>6</sup> The researchers found that the subprime loans had worse performance because they were more likely to be originated by brokers and had a higher incidence of adjustable rates and prepayment penalties. All of these links were confirmed by the Department of Housing and Urban Development in its final report to Congress on the causes of the crisis. This report found that, while softening housing prices were clearly a triggering factor, the foreclosure crisis itself was “fundamentally the result of rapid growth in loans with high risk of default—due both to the terms of these loans and to loosening underwriting controls and standards.”<sup>7</sup>

The Qualified Mortgage and Ability to Repay reforms included in the Wall Street Reform and Consumer Protection Act address the kind of risky features and abusive loan practices that caused the housing crisis. These reforms outlaw no-doc loans, require that lenders consider the borrower’s ability to repay the loan, and restrict high fee loans, interest-only payment loans, and loans with prepayment penalties. Further, yield-spread premiums paid to mortgage brokers must be counted in points and fees, loan originator compensation cannot vary with the terms of the loan, and higher priced mortgage loans must have escrow accounts for taxes and insurance. Lastly, loans can no longer have built in payment shock. These reforms address the unaffordable and abusive loan products that caused the crisis.

Research confirms how strong the impact of these protections are on reducing defaults. The 2012 report *Balancing Risk and Access* by the Center for Community Capital at the University of North Carolina at Chapel Hill and CRL analyzed nearly 20 million mortgages made between 2000 and 2008.<sup>8</sup> The study found that, while the loan pool as a whole had an aggregate default rate of 11 percent, loans that met Qualified Mortgage standards had a default rate of 5.8 percent, lower than that for conventional prime loans (7.7 percent) and a fraction of that of subprime loans (32.3 percent).

Pursuing downpayment mandates as part of housing finance reform would result in learning the wrong lesson from the foreclosure crisis. Loans with risky product features and originated using harmful practices caused the foreclosure crisis, not lower-downpayment loans.

Underwriting is an inherently multivariate process. For many lenders, this involves using compensating factors to assess a borrower’s creditworthiness. However, if one underwriting factor—such as a downpayment mandate—is enshrined in legislation, this will limit the ability of lenders to use compensating factors to make loans to borrowers who are strong in other areas and may have a lower propensity to default than borrowers who have the required downpayment but are weaker in other areas. Ultimately, this will

<sup>6</sup>Lei Ding, Roberto G. Quercia, Wei Li, and Janneke Ratcliffe, “Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Model”, *Journal of Real Estate Research* 33.2, 2011 (available at <http://ecc.unc.edu/contentitems/risky-borrowers-or-risky-mortgages-disaggregating-effects-using-propensity-score-models/>).

<sup>7</sup>U.S. Department of Housing and Urban Development, Office of Policy Development and Research 2010. Report to Congress on the Root Causes of the Foreclosure Crisis (2010) p. 29. (available at [http://www.huduser.org/Publications/PDF/Foreclosure\\_09.pdf](http://www.huduser.org/Publications/PDF/Foreclosure_09.pdf)).

<sup>8</sup>Roberto Quercia, Li Ding, and Carolina Reid, “Balancing Risk and Access: Underwriting Standards for Qualified Residential Mortgages”. January 2012 (available at [http://ecc.sites.unc.edu/files/2013/02/QRM\\_Underwriting.pdf](http://ecc.sites.unc.edu/files/2013/02/QRM_Underwriting.pdf)).

cut individuals who could succeed as homeowners out of the housing market and harm the ability of current homeowners to sell their homes. As a result, housing finance reform legislation should not reduce underwriting to a single variable. Instead, reform should allow the future regulator, bond guarantors, and lenders to use compensating factors in the underwriting process.

**Q.2.** What role do common mortgage servicing standards and pooling and servicing agreements play in increasing the fungibility of mortgage-backed securities for investors? Should the future public mortgage finance system include common servicing standards and pooling and servicing agreements?

**A.2.** The TBA market is the backbone of a highly liquid capital market for mortgage-backed securities. The key to this liquidity is having standardized pass-through securities and a streamlined investment process. All pass-through securities provide a credit guarantee to investors, pro-rata payments to investors, and only include mortgages meeting common underwriting standards. In addition, the system uses a standard set of up-front disclosures for investors. When taken together, this standardization makes securities highly fungible and, therefore, liquid.

The standardization and fungibility of the TBA market must be preserved as part of housing finance reform, including the creation of a common securitization platform. Just as FHFA sets standards for servicers of GSE loans, a reformed housing finance system should require the future regulator to establish common servicing standards for Government backed loans. Additionally, maintaining standardization for key components of master contracts for loans subject to Government reinsurance will also promote liquidity and fungibility.

Structured securities should not be able to access Government reinsurance, but should be able to access a common securitization platform. The platform can offer standardized terms for structured securities. The liquidity benefits of using a common securitization platform would be an incentive for PLS issuers to use the platform.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED  
FROM ERIC STEIN**

**Q.1.** In an earlier hearing, Martin S. Hughes, Chief Executive Officer of Redwood Trust Incorporated, recommended that we establish servicer performance triggers to serve as benchmarks and as objective means for possible removal of the servicer. This is similar, but not identical, to a provision I pushed in the FHA Solvency Bill which was cleared by this Committee thanks especially to Chairman Johnson, Ranking Member Crapo, Senators Brown, Merkley, and Warren. Could you please discuss why servicer performance triggers would be helpful to consumers?

**A.1.** Servicer performance has obvious impact for borrowers, particularly when borrowers are in financial distress. Just as FHFA currently has a responsibility to set servicing standards and to oversee servicers, a reformed housing finance system should also provide the future regulator with the authority to set servicer standards and enforce them, though these complicated benchmarks

should not be hard-wired in legislation. This could lead to unintended consequences in the event of a future economic downturn or spike in borrower delinquencies. Reform legislation should also allow the regulator and bond guarantor to hold servicers accountable in meeting these standards by being permitted to remove servicing from one that is nonperforming and transfer servicing, including to a specialty servicer.

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**RESPONSES TO WRITTEN QUESTIONS OF  
CHAIRMAN JOHNSON FROM ROHIT GUPTA**

**Q.1.** You stated in your testimony that mortgage insurers would be interested in acting as bond insurers in a new system. As a bond guarantor, do you anticipate that your company would be able to, or interested in, guaranteeing 100 percent of principal and interest payments associated with the mortgage-backed securities it guarantees?

**A.1.** Thank you for the opportunity to expand on the testimony I offered in the October 29 hearing before the Committee on “Essentials of a Functioning Housing Finance System for Consumers.” Genworth believes it is able to provide coverage that guarantees the timely payment of principal and interest to MBS holders, and if the Committee determines to include private bond guarantee protection ahead of a Government guarantee, we would be very interested in participating in that market. Our initial assessment is that we could do so either through structured “pool” mortgage insurance that backstops an all of the collateral that securitizes an MBS, or through a separate entity that would be organized and capitalized as a State regulated bond insurer.

In considering whether to require a separate, private sector bond guarantee as part of housing reform, it is important to recognize the difference between the role of a mortgage insurer and that of a bond guarantor (whether organized as a licensed insurer or some other type of entity). Loan level mortgage insurance protects against losses stemming from mortgage defaults. MI providers assess mortgage credit risk on individual loans and insure against credit related losses, and we are required to hold capital and reserves against each loan we insure. Typically, mortgage insurance is provided on a loan level basis, although we also can provide insurance on a pool of loans. Traditionally, pool insurance provided by private MI companies protects against losses arising in the event a mortgage loan goes into foreclosure. But we do think pool coverage could be structured to guarantee payment of principal and interest to MBS holders.

The “standard” MI coverage provisions in Corker Warner build upon the well-established market practice of requiring private MIs to assume first loss arising from foreclosure, with meaningful levels of insurance coverage offered at pricing that is affordable and transparent. This approach to credit loss protection mitigates the exposure of lenders and investors, and also ensures that the housing market benefits from the risk oversight that is central to the MI business model. As a reminder, MIs are in the business of underwriting and managing mortgage credit risk. We assume first loss position when a loan goes into foreclosure, and we rely on our

own, independent mortgage credit risk guidelines when making the insurance decision. An MI's book of insured loans benefits from diversity of risk across geographies, lenders, and origination years.

Bond insurers, on the other hand, guarantee payments of principal and interest to holders of mortgage backed securities. The obligation of a bond insurer arises only when cash flows from the pool of loans that collateralize a security is insufficient to pay bondholders, regardless of the reason for the cash flow shortfall. While an MI has an obligation to pay a claim whenever a loan goes into foreclosure, that same foreclosure may not trigger any obligation for a bond insurer, because cash flows from other pooled mortgages may be sufficient to make timely payment of principal and interest. Because bond insurers are not exclusively insuring against credit losses, they may lack the same incentive that an MI has to impose independent credit risk guidelines on the loans serving as collateral.

In the U.S., mortgage insurers are regulated as "monoline" insurance companies. As a matter of state law, we are not permitted to engage in any business other than providing mortgage insurance. In the event Congress includes a role for private bond guarantee coverage as part of housing reform, we believe mortgage insurers could provide that coverage through pool insurance that was structured to guarantee timely payment of principal and interest. In the alternative, an MI could create a separately organized, separately capitalized entity licensed as a bond insurer. We believe an MI's mortgage expertise makes it well suited to operate a separate bond guarantee company, and there may also be some operational efficiencies that would make an MI especially well suited to offer reliable, cost efficient bond guarantee protection. To the extent that a housing reform proposal contemplates the use of bond insurance ahead of a Government backstop, it will be important to make sure that the amount of any bond guarantee be calculated after giving effect to the benefits of loan level mortgage.

**Q.2.** From 2007 to 2013, how many States granted mortgage insurance companies waivers from their capital requirements?

**A.2.** Following the downturn in the housing market in 2007, Genworth's main U.S. mortgage insurance subsidiary, GEMICO, received explicit waivers of the 25:1 risk to capital requirement from 13 States. Another 34 States deferred to our state of domicile, North Carolina, which had granted us a waiver. Given that risk-to-capital is a very simple measure of an insurer's capital, State regulators performed extensive analysis of our claims paying capabilities before they granted waivers, and they continue to update those analyses.

GEMICO's risk to capital ratio is 23.2 to 1 (as of September 30, 2013), so we do not currently require waivers to continue writing new business.

**Q.3.** From 2007 to 2013, how many mortgage insurance companies paid out 100 percent of the claims to policy holders? How many mortgage insurers issued deferred payment obligations to pay claims?

**A.3.** Of the eight mortgage insurance companies insuring new business in 2007, five companies continue to write new business and



have full regulatory authority to pay 100 percent of claims consistent with the terms of our master policies (Genworth, MGIC, Radian, United Guaranty and CMG (which is in the process of being acquired by Arch Reinsurance)).<sup>1</sup> Three MIs ceased writing new business (went into “run off”): Triad, PMI and RMIC. RMIC’s parent, Old Republic, elected not to infuse additional capital into RMIC to permit them to continue insuring new business. The MIs that are in run off continue to pay claims, partially in cash, and partially via a deferred payment obligation. Triad currently pays 75 percent of claims in cash, PMI pays 55 percent and RMIC pays 60 percent. Each of those MIs has increased the amount of claims being paid in cash since they initially went into run off, and it is possible that the ultimate disposition to policy holders will be even greater than their current “pay rate.”

**Q.4.** Does your business use a “one size fits all” standard in deciding whether to insure a loan, or do you look at a variety of factors in an individual loan application? What factors?

**A.4.** Our decision of whether to insure a loan is driven by a dynamic assessment of a loan file that includes a variety of factors. We consider those factors in a “holistic” way that allows us to fully consider the “three Cs” of underwriting: credit history, collateral and capacity to pay. In particular:

- Genworth looks at a range of factors, including loan type, level of documentation, property type, source of downpayment, appraised value, loan-to-value ratio, loan amount, credit score and credit history, and debt to income ratio (DTI).
- Our underwriting is not simply formulaic; we often evaluate a loan giving consideration to compensating factors. For example, a higher DTI might be acceptable for a borrower with significant cash reserves or relatively high disposable income. Conversely, a borrower with a high credit score but other indicia of weak credit might not be approved for mortgage insurance.
- To ensure that we are appropriately assessing and managing credit risk, Genworth conducts formal monthly reviews of our insured business to monitor actual experience compared to a set of risk metrics that are designed to serve as an early warning system for potential shifts in risk within our book of business.
- Our underwriting guidelines are complemented by our pricing approach, which varies based on certain key criteria such as loan type and downpayment amount. In this regard, private MI differs from FHA’s “one size fits all” pricing.

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**RESPONSES TO WRITTEN QUESTIONS OF  
CHAIRMAN JOHNSON FROM ALYS COHEN**

**Q.1.** We saw during the crisis that the interests of servicers, investors, and consumers were not always aligned, partially due to servicer compensation or servicers holding second liens on mort-

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<sup>1</sup> MI companies do deny claims payments in the event an insured party has not complied with its contractual obligations. Claims denials are typically the result of fraud or misrepresentation.

gages that they serviced. Have these issues related to incentive alignments been addressed in existing standards? If not, how should housing finance legislation address these issues?

**A.1.** The foreclosure crisis, and the failure of servicers to provide efficient, affordable outcomes for qualified homeowners facing hardship, demonstrate the lack of alignment between servicer interests and those of homeowners, investors, and the economy at large. A foreclosure guarantees the loss of future income to the servicer, but a modification also will likely reduce future income, cost the servicer more in the present in staffing, and delay the servicer's recovery of expenses. Moreover, the foreclosure process itself generates significant income for servicers. Income from increased default fees and payments to affiliated entities can outweigh the expense of financing advances for a long time. A dragged out foreclosure process also boosts the monthly servicing fee and slows down servicers' largest noncash expense, the amortization of mortgage servicing rights, since homeowners who are in default are unlikely to prepay via refinancing. Finally, foreclosure or modification, not delinquency by itself, usually triggers loss recognition in the pool. Waiting to foreclose or modify postpones the day of reckoning for a servicer. But delay can cost a homeowner the opportunity to obtain a modification.

The lack of alignment between servicers and other market players has not been addressed by existing standards and thus housing finance legislation should include several key elements to ensure that servicer interests are aligned with the rest of the market. First, the new housing finance system must require servicers to provide affordable loan modifications that are consistent with investor interests. The housing finance system should promote proven regimes for modifying loans with optimum loan performance and should include a standardized, publicly available net present value analysis. This approach should also include limited, Government-backed portfolio capacity to hold modified loans. The modification mandate should be included both in the servicer approval requirements and in uniform securitization agreements.

Second, homeowners seeking loan modifications should not be faced with an ongoing foreclosure while they are processing their loan modification request. Instead, such foreclosures should be put on temporary hold rather than subjecting the homeowner to the "dual track" of foreclosure and loss mitigation. Homeowners in foreclosure should be able to obtain a temporary pause to a foreclosure to promote efficient evaluation of a loan modification application. Additionally, in order to promote timely loan modification reviews over foreclosures, dual track protections must be triggered by the homeowner's initial application. A system that brings protections into play only when the homeowner submits a "complete application" invites manipulation of the process based on the servicer's subjective determination of an application's status.

While existing regulations provide some level of protection against dual tracking, stronger GSE rules are nevertheless appropriate. The housing finance system should promote the highest standards for loss mitigation, as it has for home lending. Such progress would promote broader market changes and demonstrate the viability of sustainable loan modification reforms. Dual track

protections in GSE reform legislation should be included both in the servicer approval requirements and in the uniform securitization agreements.

Third, the new housing finance corporation (or the bondholders themselves) should be authorized to purchase insurance directly, including force-placed insurance. A mechanism allowing the purchase of force-placed insurance—as well as title insurance and private mortgage insurance—directly from insurers would decrease costs for borrowers and the corporation by circumventing the kickbacks to servicers that drive up insurance prices.

Fourth, the new housing finance system should promote transparency and accountability. An Office of the Homeowner Advocate should be established to assist with consumer complaints and compliance matters. This would help remedy the current situation in which noncompliance problems with GSE loans often go unaddressed. Moreover, loan level data collection and reporting should include demographic and geographic information, to ensure that civil rights are protected and equal opportunity to avoid foreclosure is provided. Aggregate information about complaints and the data about loss mitigation must be publicly available, as HMDA data are. Work to develop the new housing finance system, and to administer and oversee it, should include stakeholders such as community groups and representatives of homeowners, in addition to the corporate stakeholders on the lending and servicing sides.

Finally, in order to ensure that the housing system meets its goals, there must be strong regulatory levers for securing compliance, including robust monitoring, reporting, and supervision.

**Q.2.** Post-crisis, there have been a number of actions taken related to mortgage servicing, including the CFPB rule, the FHFA's mortgage servicing alignment initiative, the FHFA's servicing compensation discussion paper, and enforcement actions by the prudential regulators. Please comment on the effectiveness of these efforts, and whether there are recommendations or findings from these actions that should be incorporated into housing finance legislation.

**A.2.** While a number of Government actions and initiatives have called attention to the need for reform of the mortgage servicing industry and have in many cases moved the ball forward, the results have been incomplete at best. Below I review the various actions individually. What they have in common is that they leave several important pieces of work undone. As noted above, important work still to be done includes: a mandate to provide affordable NPV-positive loan modifications to qualified homeowners facing hardship, a full pause in foreclosure for homeowners seeking loan modifications until such review is completed, and a dismantling of the reverse competition that characterizes the force-placed insurance system. Broader systemic changes relating to transparency and accountability also are still needed.

The Consumer Financial Protection Bureau should be commended for initiating a significant set of rules governing mortgage servicing. The new rules, set to take effect in January, address a wide array of servicer duties. Yet, while the rules provide substan-

tial procedural protections to homeowners, including the requirement to review a completed loan modification application prior to initiating a foreclosure, they still subject many homeowners already in foreclosure to the “dual track” of foreclosure and loan modification. The rule also relies on a servicer finding that a “complete” application has been submitted—a term that easily can be gamed by servicers, who are the party defining that term. The CFPB also declined to include the key component needed to align servicer incentives with those of the rest of the market: a mandate for servicers to provide homeowners with affordable loan modifications when doing so is consistent with investor interests. While the CFPB rules include some enhanced protections on force-placed insurance, a new GSE system is uniquely positioned to affect how such insurance is bought and administered. Finally, even where the CFPB protections are strong, the rules appear to apply only the first time a person faces hardship in the life of a loan. Many homeowners will face more than one hardship over the decades they may be repaying a loan.

Various enforcement actions by State and Federal agencies, including State Attorneys General and the prudential regulators, have been able to substantially increase the amount of principal reduction offered by mortgage servicers and to provide limited direct compensation to homeowners harmed by abusive servicer practices. Moreover, the National Mortgage Settlement was the first action that established substantial standards for servicer conduct. These Federal and State measures, however, have been primarily retrospective and the standards themselves are temporary.

FHFA’s work touches servicing in several ways. First, the FHFA Servicing Alignment Initiative, like the CFPB rules, requires loan modification reviews to be completed prior to foreclosure while still allowing homeowners in foreclosure to be subjected to foreclosure during many loan modification reviews. It also goes beyond what the CFPB has established by setting up a modification waterfall. Yet the GSE guidelines for “standard” modifications, while providing flexibility by not being keyed to a net present value (NPV) analysis, are not adequately focused on homeowner affordability because they operate based on a percentage of payment reduction not a target debt-to-income ratio. Second, with regard to force-placed hazard and flood insurance, the current system, in which the GSEs reimburse servicers for force-placed hazard and flood insurance, has resulted in vastly inflated prices for borrowers and, when borrowers default, the GSEs and taxpayers. Lender-placed insurers and servicers do not have the incentives to control premium costs. A new GSE system is well situated to address problems in the insurance market through the direct purchase of insurance. FHFA recently had an opportunity to improve this situation and declined.

Third, FHFA announced that it will be charging more for mortgages in States with long foreclosure timelines. We believe this policy is misguided (and the incoming FHFA director Mel Watt has announced that he will delay implementation of the policy pending further study). While some States with better consumer protections have longer foreclosure timelines, in most cases the protracted timeframe is not due to a delay mandated by the rules themselves,

but by the unwillingness of servicers to follow those rules. Better consumer protection rules prevent avoidable foreclosures, which ultimately saves money both for the GSEs and for communities while protecting home values and the housing market. It does not appear, however, that FHFA factored the long-term savings achieved in States with stronger homeowner protections into their cost calculations. Homeowners engaging in prospective borrowing in those States should not be penalized on the front end for living in a State with better foreclosure protections, and for the failure of servicers to properly comply with those protections. Moreover, delay in foreclosure is multilayered. Rather than penalizing consumers, FHFA should continue encouraging servicers to process loan modification and foreclosures expeditiously, particularly as consumers are hurt by foreclosure delays, while servicers are not.

Finally, FHFA has failed to reform how servicers are compensated. FHFA worked with the GSEs and HUD to propose changes to the structure of servicer compensation but failed to make any changes. Moreover, the joint proposal did not address the misaligned incentives in the current compensation system. Nothing in the proposal tied servicer compensation closely to either the actual cost of servicing loans or the performance of the loans. Servicers under the current regime profit from their own bad behavior because they are permitted to retain all ancillary fees. Any new system should promote a modified fee-for-service model, coupled with rigorous servicing standards and limited ancillary fees. Such a model could improve servicing for both homeowners and investors, as long as it also restricts the incentive to push a loan into default servicing in order to recover enhanced compensation and fees.

**Q.3.** S.1217 specifies that a new Government agency, the Federal Mortgage Insurance Corporation (FMIC), will approve mortgage servicers for participation in the Government-guaranteed secondary mortgage market, and may suspend their approval if certain minimum standards are not met. What role should the FMIC have in the ongoing regulation of servicers? Should the FMIC have enforcement, supervisory, or examination powers?

**A.3.** Homeowners are unable to choose their mortgage servicer. Thus, the FMIC's role in approving mortgage servicers takes on even greater importance because it is the primary means for assuring that servicers comply with appropriate standards. These standards should include requirements for servicers to provide sustainable loan modifications consistent with investor interests and to otherwise structure their loss mitigation operations to align servicer incentives with those of investors, homeowners, and communities. In order to provide the FMIC with the necessary tools to promote these outcomes, it should have enforcement, supervisory, and examination powers and should also coordinate with prudential regulators. In order to promote timely responses to compliance challenges, the FMIC also should house the Office of the Homeowner Advocate, which would serve as a locus at FMIC for consumer complaints and resolution of individual compliance-related matters. While enhanced Government authority would promote better outcomes, legislation also should provide homeowners with

a private right of action to enforce their rights to proper mortgage servicing on FMIC-insured loans.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED  
FROM ALYS COHEN**

**Q.1.** In an earlier hearing, Martin S. Hughes, Chief Executive Officer of Redwood Trust Incorporated, recommended that we establish servicer performance triggers to serve as benchmarks and as objective means for possible removal of the servicer. This is similar, but not identical, to a provision I pushed in the FHA Solvency Bill which was cleared by this Committee thanks especially to Chairman Johnson, Ranking Member Crapo, Senators Brown, Merkley, and Warren. Could you please discuss why servicer performance triggers would be helpful to consumers?

**A.1.** While homeowners are able to choose their lender, the servicer is designated by the owner of the loan and the homeowner has no choice in the matter. Thus, when a servicer does not properly fulfill its duties a homeowner does not have the option of terminating the relationship with the servicer in favor of one who provides better customer service. While servicers work for investors, a variety of circumstances, including a collective action problem, often make it difficult for investors to hold servicers responsible for noncompliance with servicer duties. In a newly reformed GSE system, the FMIC or similar corporation is in the best position to hold servicers accountable for performance on an individual and systemic basis. The contractual relationship between the servicer and FMIC gives the FMIC the ability to establish parameters concerning servicer performance. By establishing triggers to be used as benchmarks for performance and potential removal of a servicer, the FMIC would be able to implement a transparent and uniform system of accountability. Such a setup would benefit consumers who otherwise have little leverage to address servicer misconduct. Moreover, the market in general would benefit because servicer conduct and incentives would be better aligned with other stakeholders.