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HOUSING FINANCE—WHAT SHOULD THE NEW SYSTEM BE ABLE TO DO?: PART I—GOVERNMENT AND STAKEHOLDER PERSPECTIVES

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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HOUSING FINANCE—WHAT SHOULD THE NEW SYSTEM BE ABLE TO DO?: PART I—GOVERNMENT AND STAKEHOLDER PERSPECTIVES

Tuesday, March 23, 2010

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:03 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Waters, Maloney, Watt, Sherman, Capuano, Hinojosa, McCarthy of New York, Baca, Lynch, Miller of North Carolina, Green, Donnelly, Minnick, Peters, Maffei; Bachus, Castle, Royce, Paul, Manzullo, Biggert, Miller of California, Capito, Hensarling, Garrett, Neugebauer, Marchant, Posey, Jenkins, Paulsen, and Lance.

The CHAIRMAN. The hearing will come to order. Let me make an announcement—I don't know why I say, let me make an announcement—who's stopping me? I am now making an announcement. The President is signing the health care bill today. That is why there are so few Democrats here and why there may soon be fewer Democrats here because the signing is now. Ordinarily, I would have considered postponing the hearing, but this hearing has already been postponed once. We're about to go into recess. We have a crowded hearing schedule. We have hearings coming up on Lehman Brothers, on Greece, and on some other issues, therefore, I did not want to postpone this hearing, and so we're going to go ahead. And what I will do is proceed. Members will get a chance to ask questions if and when they come, but that's why we are somewhat thin, particularly on the Democratic side.

I also want to announce that we are, I think, close to some agreement—the gentlewoman from West Virginia and the gentleman from California have been working on the FHA reforms. I know there has been a lot of Minority/Majority cooperation there. And we were on track to have a markup on Thursday. We will now almost certainly—well, we won't be having a markup on Thursday, we have to give notice. We probably won't be here. But we will schedule that markup as soon as we come back, and I think we will have an agreement on an FHA bill to come to the Floor.

Finally, we are going to go ahead on Thursday with the hearing on the Federal Reserve's need to deal with the liquidity that they have provided and what they will ultimately do. Mr. Watt wants

to go ahead with that, and I agree with him. Once again, we have had postponements because of the snow and other reasons. So that hearing, the hearing on the Federal Reserve, will go forward on Thursday. The markup obviously will not happen since we almost certainly won't be here.

And with that, I recognize for the first opening statement—we have 8 minutes of opening statements under our agreement on each side—the chairman of the Subcommittee on Capital Markets, which has jurisdiction under our rules over the GSEs, the gentleman from Pennsylvania, Mr. Kanjorski.

Mr. KANJORSKI. Thank you very much, Mr. Chairman. Last June, the Capital Markets Subcommittee held the first hearing on housing finance in the 111th Congress to examine the present status and future structure of Fannie Mae and Freddie Mac.

Today, we continue with what will undoubtedly be a long-term negotiation about the prospective configuration of our Nation's housing finance system. As a result of considerable stress in our economy, and because of a need to maintain access to affordable mortgages, then-Secretary Paulson placed Fannie Mae and Freddie Mac under conservatorship in late 2008. Since then, the Treasury Department has committed to purchase more than $125 billion in preferred stock of the enterprises. Government agencies have also purchased in excess of $1.3 trillion in mortgage-backed securities. Together, these actions and others have helped to keep housing credit available for America's middle class and prevented a complete collapse of our housing markets.

Lawmakers also must now begin to grapple with what type of housing finance system we should construct for the future. In this regard, we have no shortage of ideas. While we must give a thoughtful consideration to each of these proposals, we must keep in mind the importance of why we created housing Government-Sponsored Enterprises in the first place, to increase liquidity and to improve the distribution of capital available for home mortgages.

My goals in this debate are: to establish a more stable, long-term funding source to help average Americans buy a home; to limit taxpayer risk through strong regulation; and to ensure that the housing finance system continues to support community bank and credit union lending. The task before us is not all that different from the one that engineers and policymakers faced in preparing for the "Big Dig," the enormous construction project that significantly structured how traffic flows through downtown Boston.

We must figure out what pieces of the old housing finance system worked and keep them. We also need to determine what parts of the infrastructure we need to eliminate. In order to ensure access to affordable mortgages in the interim, we must additionally work to keep capital moving through the financial pipelines during our legislative debates.

Finally, we must figure out how to pay for this enormous undertaking. As we kick off this year's deliberations, the Treasury Secretary has joined us. In the near future, we will also hear from the Secretary of Housing and Urban Development. After the completion of these initial proceedings by the full committee, the Capital Markets Subcommittee will renew its examinations of these matters by exploring more detailed and technical questions related to

Government-Sponsored Enterprises and our Nation's housing finance system.

In sum, Mr. Chairman, I appreciate your efforts in convening this hearing as we receive testimony regarding what functions a new housing finance system should be able to perform. We also have to work to do no harm to those parts of the housing finance system that have worked well, and to protect taxpayers from future losses. I look forward to a fruitful set of discussions.

The CHAIRMAN. The gentleman from Alabama—I am now reading from the Republican list—is recognized for 1 minute.

Mr. BACHUS. Thank you, Chairman Frank, for holding this very important, and I think long overdue hearing. It's unacceptable that more than 18 months after the GSEs were placed in conservatorship the Treasury Department still does not have a plan for Fannie and Freddie. Without reform, the bailouts will not stop, the housing market will not find its footing, and the American economy will not recover. But so far the response has been to pledge unlimited bailout aid and guarantee all the GSE debt, which has already cost the American taxpayers more than $127 billion.

The question posed is, what should the new system be able to do? The answer is simple: Protect taxpayers from further losses and bailouts in order to build a stable housing finance system based on private capital. While the Administration and Congressional Democrats have remained silent, Republicans have introduced legislative measures to immediately address the failures—I yield myself an additional 20 seconds—

The CHAIRMAN. The gentleman is recognized for 20 seconds, but it will all come out of the 8 minutes.

Mr. BACHUS. —and to put forth real solutions. Mr. Chairman, I hope today is the beginning of open dialogue between Congress and the Administration and that you follow the leadership of House Republicans and phase out Federal credit privileges and taxpayer support and guarantee of Fannie and Freddie. Thank you.

The CHAIRMAN. The gentleman has consumed 1 minute and 26 seconds. We are going to hold ourselves to this. So, the gentleman from California is recognized for 1½ minutes.

Mr. ROYCE. Thank you, Mr. Chairman. We are all well aware of the damage caused by the mortgage giants Fannie Mae and Freddie Mac. Because they were perceived to be government-backed, they were isolated from market forces that would have otherwise prevented the excessive risk-taking. As a result, they wiped out any form of competition and formed a duopoly over the prime secondary mortgage market and dominated much of the junk loan market.

As a matter of fact, between homeowners and flippers, 30 percent of the loans they held were flippers, you had over 10 million individual loans outstanding in 2008, held or guaranteed by Fannie and Freddie. Those junk loans accounted for 85 percent of their losses. They were at the heart of the housing bubble. The 1992 GSE Act, which included the affordable housing mandates, played a significant role in the accumulation of those junk loans. Going forward, these requirements should be repealed, as should any other mandate on financial firms that puts at risk the safety and soundness of the institution for a broader goal. They were over-

leveraged 100 to 1. I carried legislation on the House Floor that would have allowed the deleveraging of the institutions, would allow the regulators to do that. Never in the future should we allow that kind of arbitrage and overleveraging of institutions like this, and that's why I say the 1992 GSE Act with the affordable housing mandates frankly should be dropped. Thank you, Mr. Chairman.

The CHAIRMAN. The gentlewoman from Illinois, for 1 minute.

Mrs. BIGGERT. Thank you, Mr. Chairman. Since entering into conservatorship in the fall of 2008, Fannie Mae and Freddie Mac have lost $174 billion, and billions more in losses are anticipated. Taxpayers have loaned the Enterprises over $127 billion and are liable for over $5 trillion in outstanding mortgage obligations.

Edging out private sector mortgage market participants, Fannie Mae and Freddie Mac guaranteed or financed over three-fourths of new single family home mortgages in 2009. Taxpayers deserve to know where their dollars are going, what risks they are being exposed to, and how these institutions are being managed or mismanaged. Republicans have proposed reforms that will impose some commonsense accountability on these institutions and take immediate steps to wind down the immense risk they pose to the long-term stability of our housing market.

GSE reform is critical. I yield back.

The CHAIRMAN. The gentleman from California, Mr. Miller, for 1 minute.

Mr. MILLER OF CALIFORNIA. Thank you, Mr. Chairman. As we know, the government currently owns 80 percent of Freddie and Fannie. We can all agree that the current scenario is not one that should last indefinitely, but I must disagree with anyone who suggests that Freddie and Fannie were the cause of the current housing crisis and must be abolished immediately.

In California, Freddie and Fannie's serious delinquency rates are dramatically lower than the jumbo market, evidence that while many of their loans were bad, they are outperforming the rest of the market. Currently, Freddie and Fannie and FHA make up roughly 90 percent of the loans made today. I have yet to see a viable alternative from this Administration or this Congress. We must find a path to effectively return Freddie and Fannie to profitability, allowing the government to recoup its investment in the secondary firms and ensure that there is a viable secondary mortgage market while removing the government from the home loan business.

I look forward to hearing testimony from the witnesses today on how we should reform GSEs. Thank you. I yield back.

The CHAIRMAN. I now recognize myself for the remaining 4 minutes and 40 seconds on our side. I very much agree that this is a subject that has to be addressed. That's why I initiated the scheduling of this hearing. I regret the fact that constituency commitments of mine made us hold off a couple of weeks. We will have the Secretary of HUD coming forward. And I want to stress that I believe this should be seen as a hearing and as a legislative task, more importantly, not simply about Fannie Mae and Freddie Mac, but about housing finance.

We have a very complex housing finance system that was allowed to grow in bits and pieces without any overall vision. There is the FHA and Ginnie Mae, two Federal agencies. There is Fannie

Mae and Freddie Mac, hybrids as they were, public shareholder corporations given by a variety of congressional and presidential mandates from both parties directions to do good, which came into conflict in some ways with their private mandate.

There are the Federal Home Loan Banks, which should not be left out, which play a very important role in the housing finance. We will have two hearings here. We have a very large number of private sector witnesses, and I will say that many of them will be in agreement with what we just heard from the gentleman from California. We have two jobs here today. One is to figure out the best way to wind down Fannie Mae and Freddie Mac. But an equally important job is to decide what goes in their place.

Now when I say decide, much of that will be purely private. It will not be government-mandated. But there will be some role for government agencies in figuring out the interaction of all of these, who provides liquidity to the secondary mortgage market? Is there a role for subsidy? My own view has always been that it's a mistake for the government to heavily subsidize homeownership, and that we are much better off trying to subsidize rental housing because when you put people into decent rental housing, you do not confront the problems that we have seen from putting people inappropriately into homeownership. But there are some claims to be made for helping some working people get into homes after careful scrutiny. That may be partly the FHA, but it may be some other modes as well.

So, yes, it is important to put into place a way to wind down Fannie Mae and Freddie Mac. I believe the overwhelming consensus from people concerned about the economy in general and the role of housing in the economy—Realtors, home builders, mortgage bankers, bankers, advocates for various groups, advocates for minority groups, and advocates for lower-income people—all agree that simply abolishing Fannie and Freddie, as well as we do that, would not be enough for this committee's role. We also have to make decisions about what replaces it.

Now again, many of those replacement entities will be purely private and may need no role for us. I notice there was a piece in the Republican bill that said, well, any State or Federal Government can charter a corporation to do this. Sure they can. They already can. And we would expect that. But I think those who are going to be doing the purely private aspect have a right to know, what is the role of Fannie Mae going to be? Where will the Federal Home Loan Banks be?

So again I stress, and this is the beginning of this process, we will simultaneously, I hope, be figuring out how best to wind down Fannie Mae and Freddie Mac and make sure that before that is completed, we are ready to replace the functions they are now performing in the economy without leaving this great vacancy. It's the old story that says you can't really tear down the old jail until you build the new one. And that's partly where we are with regard to this effort.

We have a very important set of functions that are being performed, and it's important for us to deal with the replacement of Fannie Mae and Freddie Mac knowing that there will be a new set of institutions that will deal with housing and that will also deal

with the economy. And as I said, that's one of the things that we get from all of the participants in the economy who are coming forward.

The goal of this committee will be to, I hope, come out with legislation that does both of those jobs: winds down Fannie Mae and Freddie Mac; and appropriately puts the government into places where it should be and leaves room for the private sector where the government shouldn't be.

The gentlewoman from West Virginia is recognized for 1 minute.

Mrs. CAPITO. Thank you, Mr. Chairman, and I would like to thank you for this hearing today, something that needs immediate attention. Our Nation's housing finance system is slowly recovering, but the system is being dominated by the GSEs, and we need to work together to restore a strong private market presence.

As many of my colleagues know, the FHA is facing serious challenges with their capital reserve levels. I'm pleased that Secretary Donovan and Commissioner Stevens are taking a proactive approach in seeking a bipartisan consensus to resolve FHA's challenges, and we're still working through that process.

Unfortunately, the same commitment to reaching a consensus could not be said for the Administration's approach to the GSEs. Despite the complete collapse of Fannie and Freddie in 2008, and the massive taxpayer exposure, the Administration chose to barely mention the reform of these entities in their budget this year.

The time for action is now. Republicans on this committee have put a statement of principles forward. The Federal Government should not be playing this large a role in the Nation's housing finance system. We need to begin determining the roles of the GSEs and what the appropriate role for the government is in housing finance.

I look forward to hearing the testimony of the witnesses. Thank you.

The CHAIRMAN. Next, we have for 1 minute and 10 seconds, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. Of all the dumb regulation and legislation that caused our economic crisis, none was dumber than that which created the GSE monopolies and gave them ever-increasing affordable housing missions. In other words, the Federal Government told them, we will let you monopolize a market as long as you securitize and insure mortgages for people who cannot afford to pay them.

Regardless of many good motives and good people, ultimately the story of the GSEs is one of enriched executives, cooked books, political bullying, a massively inflated housing bubble, millions of home foreclosures, a shattered economy, and the mother of all taxpayer bailouts. The answer from the Administration to all of this, page 352 of the budget, quote, "The Administration continues to monitor the situation." It is unacceptable to protect the structural status quo to announce Christmas Eve multi-million-dollar bonuses for their executives and announce unlimited taxpayer exposure.

Republicans are attempting to lead. I'm attempting to be one of them. That's why I have introduced H.R. 4889, the GSE Bailout Elimination and Taxpayer Protection Act, that over a 5-year period would transition the GSEs to an innovative and competitive mar-

ketplace without taxpayer bailouts. I encourage members to consider it, and I yield back.

The CHAIRMAN. The gentleman from New Jersey, for 1 minute.

Mr. GARRETT. Thank you, Mr. Secretary. It has been 3 months since the Obama Administration lifted the $400 billion cap on Fannie and Freddie and also allowed to be paid out literally millions of dollars to executives whom a lot of people are saying simply losing the taxpayers' money. And today is simply our very first hearing on the topic, which I think is unbelievable. The ranking member and I sent a letter to the chairman immediately after that, saying we should have a hearing on this. It has been 3 months. We have had 20 hearings on other sundry issues, and it's only now that we're having this hearing today on one of the most important topics, over $400 billion in CBO estimates as far as the cost of it.

For a lot of these people, it's uncomfortable to discuss this issue because some of them played a supporting role in helping the demise of the GSEs, Fannie and Freddie. But, from your perspective, I know you said in the paper, AP has a story that says, if we rush, there's risk if we do not achieve enough and not get consensus or something on this, through sweeping enough. Rush? It has been almost 18 months—

The CHAIRMAN. The gentleman's time has expired.

Mr. HENSARLING. —since we have had this collapse. I don't think 18 months—

The CHAIRMAN. The gentleman's time has expired. The Minority is entitled to divide its time as it wishes. I'm not the one who says people should get 1 minute, but if you have 1 minute, you get to talk for 1 minute. The Secretary of the Treasury is now recognized for his statement.

STATEMENT OF THE HONORABLE TIMOTHY F. GEITHNER, SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary GEITHNER. Chairman Frank, Ranking Member Bachus, and members of the committee, thanks for giving me the chance to come before you again. I want to compliment many of you for pointing out that the challenge of reform of the GSEs requires a broad look at the full range of government institutions that operate in the housing market. This is a complicated, difficult question, but I think we're now at the point where we can begin a serious effort to build consensus on reform.

Fannie Mae and Freddie Mac played a significant role in this financial crisis. Over the past decade, they were allowed to take on excessive risk and leverage with inadequate capital and inadequate oversight. And by the fall of 2008, their potential collapse posed a threat to the entire American financial system. Fannie and Freddie operated with a perception of government backing, which allowed them to take on significant leverage and build up a retained portfolio to a size the market never would have allowed for a fully private enterprise.

Meanwhile, the government did not move quickly enough to put in place a set of restraints on their activities, restraints that would have protected the system from failure. This committee understands as well as anyone that these failures were not unique to Fannie and Freddie, which is why you moved late last year to pass

a comprehensive set of financial reforms for the rest of the American financial system.

The failures of Fannie and Freddie were symptomatic of failures in the financial system as a whole, failures made by people over a long period of time. As the GSEs were growing, they retained portfolios and taking on tremendous amounts of risk, there was a damaging erosion in underwriting standards and a buildup in leverage across the rest of the financial system.

Private companies, mortgage brokers, and large financial institutions with no government backstop and support were also becoming overleveraged. These institutions were offering credit that too many Americans could not afford and in many cases did not understand. And underlying all of this, of course, was the unrealistic assumption that housing prices would always go up. Together, these failures brought America to the edge of financial collapse.

Over the past year, the Administration, Congress, and this committee have made important progress towards comprehensive financial reform, and today this hearing marks the beginning of the next stage in the process of reform, evaluating how to bring reform to the GSEs and the entire housing finance system. Over the coming months, we're going to consult broadly across the public and private sector, across both sides of the aisle, working closely with this committee and your counterparts in the Senate to take a fresh, cold, hard look at the core problems in our system. We're going to consider a full range of options, a full range of alternative models to determine what role the government, and what role the private sector should play in promoting a stable and efficient housing finance system.

We believe any reform should meet the following broad objectives: to ensure broad and reliable access to mortgage credit; to provide financing for affordable rental housing and ownership for Americans; and to protect consumers and to safeguard the stability of our financial system.

Effective reform has to end the system in which the benefits of government support were captured by shareholders rather than homeowners and where the taxpayers were left with very substantial losses.

As we move forward, it's critical we facilitate a smooth transition to any new system, and I want to be clear. Treasury remains committed to supporting the continued activities of the GSEs in conservatorship. We will continue to make sure they have sufficient capital, the capital necessary to perform under any guarantees issued now or in the future, and to meet their debt obligations. And we will be very careful not to pursue policies or reforms that would in any way threaten to disrupt the function or liquidity of the securities they have issued or the ability of Fannie and Freddie to honor their obligations.

Thank you, Mr. Chairman, and I look forward to your questions.

[The prepared statement of Secretary Geithner can be found on page 126 of the appendix.]

The CHAIRMAN. I thank you, Mr. Secretary. And before I get to the questions, I do want to address some of the history. The gentleman from New Jersey raised some questions. First of all, he said that we have been waiting 3 months for the hearings. Well, as he

knows, 3 weeks of that came because I had it rescheduled on March 2nd, and had to postpone it, and this was the first day we could get. So I think the desire to make points here sometimes breaks out of the bounds of normal conversation. Yes, the hearing would have been 3 weeks ago, but I had a problem, and we do have other hearings that are scheduled. Many of those hearings, by the way, have been at the request of the Minority.

But he also then said that it was uncomfortable for some of us to talk about this because of our role in helping Fannie and Freddie. The gentleman from California, Mr. Royce, also mentioned his efforts to try and rein things in. Well, it's true. And again, the history gets forgotten here. The Republican Party controlled the House from 1995 through 2006. No legislation became law at that point. The House did pass a bill in 2005 under the chairmanship of Mr. Oxley to reform Fannie and Freddie. Most of the Republicans supported it. Some opposed it as too weak. It's true, the gentleman from New Jersey thought that was not a good bill, but it was a Republican bill in a Republican House.

So the notion that some of us on this side, I don't know whether the assumption is that we inhabited Mr. Oxley's body, that we somehow captured his mind, that we were working through Mr. DeLay, who was running the House at that point. I'm not sure what the—but it is true, the gentleman from New Jersey, Mr. Garrett, offered an amendment to strike the higher cost loan limits, and he did get some support. The gentleman from New Jersey mentions in 2005 under Republican control, he actually got 53 Republican votes. Of course, 168 Republicans voted against him. Those voting against him included my friend here, Mr. Bachus, Mrs. Biggert, the minority leader now, Mr. Boehner, Mr. Cantor. These are all apparently our tools. I have to tell you, you don't know how good we are that I got all these people to vote to undermine poor Mr. Garrett's valiant effort here.

So then Mr. Royce had his bill. He did a little better than Mr. Garrett. He got 70 Republicans and only lost 153 of them. And again, the same people voted against him: Mr. Oxley; Mr. Boehner; Mrs. Biggert; and Mr. Bachus. So this notion that it was the Democrats who stopped him. By the way, Mr. Garrett had previously said, well—

Mr. GARRETT. Would the gentleman yield on that?

The CHAIRMAN. I'll yield if I get unanimous consent for an additional 40 seconds, sure.

Mr. GARRETT. I think my words actually were to the Secretary that some members of this committee were uncomfortable with discussing this issue, and looking at my notes, I never mentioned Democrats once at all, so I think the chairman doth protest too much.

The CHAIRMAN. I don't know what "doth protest too much" means when someone is correcting something. I thought he had said people on the other side. But if in fact he was referring to Mr. Bachus and Mrs. Biggert and Mr. Castle and Mr. Boehner and Mr. Cantor, I accept my correction, and I appreciate his making sure that people know that he was criticizing them, not just some of us.

Mr. Royce got 70 Republican votes. The same group of people voted against it. By the way, the bill that the Republican House

passed was then denounced by the Republican President. Some will remember famously Mr. Oxley saying that he could have passed this legislation in 2005 if he hadn't gotten the one finger salute from the White House. The Secretary of the Treasury at the time, Mr. Snow, was in favor of going forward. What happened then was the Republican Senate and the Republican House had a fight and no bill passed.

Then comes 2006, and Mr. Paulson becomes Secretary of the Treasury, and as he reports in his book, he asked for permission to negotiate with the Congress. He got the President, whom he admires for doing this to let him do it, over the objection of many others in the White House. He then mentions in the book that he began negotiating with me and with the Democrats. In that next election, the Democrats got the Majority. He then points out in his book that we honored the agreements we had made and that in 2007. When we took office, we passed a bill that he said was far from perfect, but was still better than the Republican bill in 2005.

So I apologize to the gentleman from New Jersey. I thought he was saying that it was the Democrats who had done this. Instead, he was talking about Democrats and also the Republican leadership. I will say that previously the gentleman from New Jersey had said that, well, Republicans had tried—I do remember this; we can check the transcript—to fix the bill, but they were outvoted by the Democrats and some Republicans. In fact, in 2005, the records are all here, no amendment either in committee or on the Floor aimed at making the bill tougher on Fannie and Freddie that received a majority of Republican votes passed. In other words, the bill that passed committee and on the Floor was supported by a majority of Republicans in every single case. In no case did a majority of Republicans get overridden because a minority of Republicans voted with the Democrats.

Now that is the history, and we do have to go forward. I believe with regard to the current situation there is agreement that we need to replace Fannie and Freddie. There may be disagreement about whether doing that is enough or whether or not we need to also figure out if we need to restructure the Federal Home Loan Banks and Ginnie Mae and the FHA, and if we need to provide any more authority in terms of the liquidity of the secondary mortgage market. All of those subjects are before us. In some ways they are harder intellectually, and that's why we're here to deal with them.

The gentleman from Alabama.

Mr. BACHUS. Thank you. I guess there's a question in there someplace for Mr. Geithner.

The CHAIRMAN. No, no there wasn't.

[laughter]

The CHAIRMAN. The rules say—I'm sorry, this won't come out of the gentleman's time.

Mr. BACHUS. Oh, sure.

The CHAIRMAN. The rules say each member has 5 minutes.

Mr. BACHUS. Oh, you're right. You're absolutely right.

The CHAIRMAN. Sing a song if you want to.

[laughter]

Mr. BACHUS. Secretary Geithner, how can you say that the regulatory reform bill in the Senate is comprehensive when it doesn't

include the GSE's reform? And as Chairman Frank has just said, we all realize now that that's a critical part of financial reform.

Secretary GEITHNER. The reform of the housing finance system is going to be a critical part of overall financial reform. But for reasons I think you understand, we decided to do this in two stages, and we're now at the beginning of the next stage. This is going to be a very complicated consequential process, and we're going to have to take a careful look across again the full range of institutions that operate in these markets. There are parts of the system that worked very well over a long period of time, but there are parts—

Mr. BACHUS. Of course, Fannie and Freddie were not a part of the system that worked very well.

Secretary GEITHNER. No, I think that—I agree with you about that. I think that you can't—if you look over the past decade, a lot of things went wrong. The system did work relatively well for a long period of time, but things started to change at the beginning of this decade. At that point, you saw Fannie and Freddie start to build up these very large retained portfolios. There's a huge amount of risk in those portfolios. They also started to provide guarantees that ultimately resulted in them taking on more credit risks than they were charging for. Both of those mistakes were central to the problem.

Mr. BACHUS. All right. Mr. Secretary, I would have to disagree with you. In 1997, they started making loans without downpayments, and to people with questionable credit, so I think that it was a disaster waiting to happen. And I will say that several of us did speak on the House Floor at that time and resisted the Clinton Administration's efforts to relax those standards.

Secretary GEITHNER. Well, there was a—I was not a combatant in these debates in that period of time, but there was a long period of advocacy by people up here in the Congress on both sides of the aisle and in the Administration starting in the late 1990's designed to try to bring stronger oversight, greater constraints in them. But of course, ultimately, as many of you have said, those efforts were not successful and that was a very consequential failure of policy.

Mr. BACHUS. Right. And I think the time is now, not some second stage. Let me ask you this. Several alternatives have been suggested to reform them. One is to simply nationalize them and make the government guarantees explicit and permanent, and allow them to continue to have a line of credit with the Treasury and borrow from the Fed, and be exempted from State and local taxes.

Another is to create more GSEs to compete against each other, and this is the government competing against itself, but still with the government subsidy and guarantees and privileges. Isn't a better alternative to do what we Republicans are saying, at least long term, and let's phase out the government's subsidy and guarantee the duopoly over time, transition housing finance to a competitive market based environment and implement a withdrawal of all Federal Government support?

Secretary GEITHNER. I agree with you Congressman, that I do not think either of the two options you began with look particularly appealing at this stage. I think the two options you laid out at the beginning, full nationalization or creating a whole new class of

GSEs to compete with each other with the same basic model, those do not look like appealing options to me. I have not had a chance to look in detail at your proposed alternative, but I will, and I am happy to spend time working closely with you on that. I think you ended by saying transition to a world in which you phase out all government support in any form. Is that what you said?

Mr. BACHUS. Well, particularly the GSE that has a line of credit with the Treasury or ability to borrow from the Fed or exempt from State and local—

Secretary GEITHNER. I personally think, as I said in my testimony, that we need to end a system in which you have this awkward combination of private shareholders with a broad sense of explicit implicit support. I think that system was a terrible mistake. Those mistakes were very consequential. And when—as we work together to create a new system to replace our current one, we can at least agree we should not recreate that fatal mix of public and private shareholders in the same institution.

Mr. BACHUS. But I think as long as you have a government entity competing with the private market, if you subsidize them in any way, it's unfair competition, and I think it crowds out the private market, and I think we have seen the result of that.

Secretary GEITHNER. Well, I think, again, this—the heart of this debate will be to think about what is the appropriate role for the government in providing some form of guarantees to assure a more stable flow of housing finance, and what role should the private markets face. That's the fundamental question we face, and we should take a fresh, cold look at that. And that's going to be critical to reach consensus on before we figure out what the transition period should be—that transition pass should be to that new regime.

The CHAIRMAN. The gentleman from Pennsylvania.

Mr. KANJORSKI. Thank you very much. Welcome back, Mr. Secretary. It seems you have been remiss. You have not been here for at least a week.

Secretary GEITHNER. I have had the privilege of being before this committee many times over the last year, and I look forward to many more times.

Mr. KANJORSKI. Very good. And Mr. Secretary, it seemed we had some testimony the other day from Chairman Bernanke and former Chairman Volcker. And I thought part of Mr. Volcker's testimony was particularly enlightening insofar as he was calling the committee's attention to the difficulty of getting the regulators to regulate in accordance with their authority. To a large extent, I listened to the banter back and forth early. We are still, I guess, attacking each other as to who is at fault and why are they at fault. And I think you are taking the correct perspective there. That is history.

Now we have to go forward and do something, and we have to address and answer some very serious questions. I happen to agree with you that with all the errors that may have occurred at some time with Fannie and Freddie, the reality is for a period of 20 or 30 years, we had a relatively stable real estate market that functioned very well at poor times, so that we did not have stops and starts as we have had in prior decades.

The question I guess that comes to my mind is, what are we going to be able to do about when this Congress passes authoriza-

tion for someone like the Federal Reserve to create and control mortgages and how they are made, and who is allowed to get them, and they do not exercise that influence? And regardless of whether the Republicans were in power for the 10 years in which that failure occurred, or whether the Democrats were in power, we can see that sometime in the future, one party or the other will be in power, and we are not quite getting the anticipated results from regulators that at least in policy we pass here as a matter of law.

Should we start with that proposition and see—because it really does not matter what we do here if it is not implemented. What plans can you make, or are you intending to make, for better implementation of public policy as set by the Congress?

Secretary GEITHNER. I think you have to start by making sure that the entity that is responsible for constraining risk-taking over these institutions, for example, has the authority and the ability to put in place those constraints. And among the many failures of policy in this area was we did not give the responsible body, which used to be called OFHEO, the authority to constrain risk-taking, set capital requirements high enough, and protect the taxpayer from loss in those entities. I think that's the most important thing. If you don't have that, nothing's possible.

Of course, that may not be sufficient. You still need to make sure that Congress is holding those supervisors, those oversight bodies, accountable for performance over time. But I think you have to start again by making sure there is clear authority and accountability for constraining risks that can pose systemic damage to the financial system as a whole.

Mr. KANJORSKI. Are the independent regulators too independent in terms of when they seem to be going astray in what they are doing?

Secretary GEITHNER. Well, I—

Mr. KANJORSKI. Neither the Executive Branch nor the Congress can do much about it. They are independent, and—

Secretary GEITHNER. I think that we created a system that put a lot of challenge on the regulators for the following simple reason: Parts of the system were held to quite high standards for capital consumer protection underwriting standards. But there were vast parts of the system that were not held to similar standards and had no oversight or effective enforcement in place. And when you do that, what happens is risk tends to migrate from where it's constrained to where it is unconstrained. Risk tends to move to where regulations are weaker and the supervisor is more compliant or less experienced.

So a central feature to the bill this body passed and a central part of reforms moving through the Senate are to make sure you have a level playing field across the system with clear standards enforced evenly across institutions doing similar activities. If you do that, you make the job of the supervisor much easier. If you make it easy for firms to evade those protections, you make their job much more difficult. And if you look back over the history of Fannie and Freddie's role in the mortgage market where you saw—like you saw across the system as a whole, you saw mortgage underwriting business migrate from those institutions to parts of the system that were engaged in a competitive race to the bottom in

underwriting standards in consumer protection. And the most important thing we have to do in financial reform, and this will be true as we move to housing finance too, is to make sure there are clear standards set across the marketplace with clear accountability for enforcing those standards.

Mr. KANJORSKI. Thank you, Mr. Secretary. My time has expired, Mr. Chairman.

The CHAIRMAN. The gentleman from Delaware.

Mr. CASTLE. Thank you, Mr. Chairman. Mr. Secretary, I have about three questions here. I'm going to try to put them all together, so this might get a little complicated, but last month I asked Federal Reserve Chairman Bernanke whether Fannie Mae and Freddie Mac served their purpose and whether we should be looking at some different way to finance mortgages since the problems we had, the expense of them at this point. And he responded that the Fed has been very vocal on this issue for years. He said we need to very cautious about returning to the existing structure with potential conflicts between private shareholders and public objectives, and suggested either privatization with government guarantees or a public utility approach. My first question is, would you agree, or could you comment on that assessment?

My second question is, using the Federal Home Loan Bank model, is that something you could actually substitute for all this in terms of what we're doing or not doing as far as the future is concerned? They don't seem to have had the problems that the other GSEs have had.

And then my last question is, what about just eliminating all these support systems, just a system whereby institutions which are making loans have to stand on their own in terms of what they are doing? I'm not necessarily saying I advocate that or you do, I just would be curious about your comments on it.

Secretary GEITHNER. I agree with the quote you attributed to Paul Volcker about his diagnosis of what happened, what caused the problem in this context. He's absolutely right. And I think the two options you summarized there should be among the options we take a careful look at. I think the Federal Home Loan Bank System is not without challenge today. And I think as the chairman said at the beginning, when you look at the housing finance markets and reform of the GSEs, you have to look at the FHLB structure as well to make sure that it can play the role it's designed to play, again without leaving us with too much risk in the future that the government is going to have to come in, to step in to underwrite those losses.

You ended by asking, is it possible to advocate a system in which the government plays no role in providing support for mortgage finance market through explicit guarantees, subsidies, support for liquidity? And I think there is certainly a pure theoretical option in which that may make sense. But my own view is there's probably going to be a good economic case, good public policy case, for some continued provision of a carefully designed guarantee by the public sector going forward, because housing markets are so critical to overall economic activity. They play such a large role in people's wealth, the perception of wealth. They are very vulnerable to vola-

tility when you see—when you experience broader financial markets' shocks to the financial system.

And because of that unique role housing markets play, I think there's likely to be a good public policy case, good economic case, likely that both conservatives and liberals could agree on, for the design of a carefully calibrated guarantee, appropriately priced, that would continue in some form.

Mr. CASTLE. What do you think the timetable on all this is? We have had a lot of discussion, some hearings now and that kind of thing. Is this something that you feel needs to be addressed in the next 2 or 3 months, or within a year, or do you have any thoughts about the timetable of how quickly Congress and the Administration should move on these issues?

Secretary GEITHNER. I think realistically it's going to take several months to do a careful exploration of the problems, solutions, alternative models, and to try to shape legislation that could command consensus. And again, I think we're at the point now where we can start that process in earnest, and I think we should try and get it right. But I don't see why this should take years. I think really at the moment now where there is a huge, compelling need to make sure we design the successor system, and it's very hard, I think, for anybody to argue that we can live with the system as it now is indefinitely in the future.

I know people are worried that we're not going to take advantage of this moment together and put in place reforms, because many people tried in the past and failed to get consensus. But I don't think we face that risk now, frankly, because I think no one can look at the model we have today and say we can afford to live with that model going forward. So I suspect you're going to find very broad support for reform. The challenge is going to be just to design something that we think is going to work better in the future.

Mr. CASTLE. I would agree with you that it's going to take time to put it together, but I would hope that we could work on it together as rapidly as possible. There are a lot of dollars out there and a lot of correction which is needed. Thank you, Mr. Secretary.

I yield back, Mr. Chairman.

The CHAIRMAN. The gentlewoman from California.

Ms. WATERS. Thank you very much. Thank you, Mr. Secretary, for being here to discuss Fannie and Freddie, the GSEs that we depended on for many years to provide mortgage support, and mortgage financing for lower- and moderate-income homes. With the missteps of Fannie Mae and Freddie Mac into the subprime mortgage market during the past several years and the resulting conservatorships, they were given little credit for their decades of support for mortgage finance. They developed the fixed-rate, 30-year mortgage and consistent underwriting standards that made mortgage credit and homeownership available to millions of American families. These were the good aspects, and I won't run away from that. I know that since they have been in trouble and some of us have been accused of having given them so much support that people are sometimes hesitant to say that. I believe that they dove into the uncharted waters when they followed private firms into the subprime market in an effort to increase market share and earnings of as publicly held companies. This effort to meet earnings

targets may have been the fatal flaw in their structure. If they had not been so focused on quarterly earning reports, they may have weathered that storm.

Now having said that, we continue to have a great need for our low- and moderate-income housing in this country. This committee, led by our chairman and strongly supported by members of this committee, particularly on this side of the aisle, are supporting a $1 billion housing trust fund, national housing trust fund. That's important to us right now. And we thought we were going to get the resources from Fannie, Freddie, their profits, what have you. That's not possible at this time. Do you have any ideas about how we can support this housing trust fund? I would like to hear from you on that.

Secretary GEITHNER. Congresswoman, let me just start by saying I think what you said at the beginning is very important for people to understand. Our system, our housing finance system, did work remarkably well over a period of many, many decades. It was in many ways the envy of the world. Things started to change, though, in the late 1990's, and in the last decade you saw a dramatic increase in risk on their balance sheets, and a substantial erosion in underwriting standards more broadly. And as we know now, those mistakes caused a huge amount of damage. But I agree with you that it's important as we think about the future, to make sure we retain what was good in this system. I don't think, though, it's going to be tenable to try to recreate the system as it exists today in the future. I think we're going to have to do things. We're going to have to do a fundamental change if we're going to achieve the objective you laid out at the beginning.

We are, of course, prepared to work with you and your colleagues on the committee to find ways to provide continued support for the housing trust fund. I'm not in a position today to describe in precise detail how we can do that, but we're prepared to work with you on that, and we do have some suggestions.

Ms. WATERS. I appreciate that very much, and we look forward to working with you on that. As I wrap this up, I would just like to be clear about whether or not we're talking about Fannie and Freddie formulated perhaps in different ways to continue the mission without the risk, or are we talking about getting rid of them altogether? What are we talking about here?

Secretary GEITHNER. As many of your colleagues have already said, I don't think there is a credible argument that we can abolish, put out of existence these institutions today. That would not be responsible. One could not defend that. But I think we need to be very careful as we work together to design the future of the American housing finance system, that we preserve what was good, but we end what was too risky.

Ms. WATERS. That makes good sense. And in the interim, I appreciate your representation that you will help us to do what we can to fund this housing trust fund. We need something while we're trying to reorganize those GSEs. Thank you.

The CHAIRMAN. Will the gentlewoman yield?

Ms. WATERS. Yes.

The CHAIRMAN. You have 30 seconds left. I just want to stress again the Administration has committed to work with us on this.

We are talking primarily here about rental housing. I want to make that point clear. We're not ruling out homeownership, but many of us believe that we did too little in terms of rental housing, and the right rental housing financing avoids a lot of the problems we have gotten into in the past.

The gentleman from California, Mr. Royce.

Mr. ROYCE. Yes. Mr. Geithner, I want to thank you, and I also want to thank you for the period of time when you were at the Fed. I went back through my notes. I counted 15 times when the Fed came before Congress and warned us about the moral hazard with respect to the GSEs. And I admit we were in the minority, those of us—I think there were about 70 of us who listened to the Fed about this argument, about the overleveraging. But my amendment on the House Floor was not actually written by me. It was actually written by the Fed, just as over on the Senate side, Chuck Hagel's amendment which was brought forward, was at the behest of the Fed to allow them to deleverage the arbitrage that was going on at Fannie and Freddie. And it was Chairman Dodd who blocked that amendment of Hagel's or that bill that came out on the Floor.

The CHAIRMAN. Would the gentleman yield?

Mr. ROYCE. I will yield if you will yield me additional—

The CHAIRMAN. Yes. I would point out that at that time, Chris Dodd was not even the ranking Democrat. The Republicans were in control in the Senate at that time in 2005.

Mr. ROYCE. Right.

The CHAIRMAN. Paul Sarbanes was the ranking Democrat, so Chris Dodd was the second ranking Democrat in the Minority.

Mr. ROYCE. Yes. Right. And he objected on the House Floor to the bill going forward. But the point I'm making is that the Fed recognized the problem created in the housing market, but there's another aspect of this that economists have talked to me about. And we have also seen over the last 10 or 15 years the huge increase in the derivatives market, and this is where I'm going with this, with respect to the GSEs. How much of that was tied to the GSEs, especially since they trade in the derivatives market the same way they did in the housing market?

And I was going to ask you, Mr. Secretary, have you looked at this issue where GSEs were a large driver in the growth of the derivatives market and in the non-risk adjusted trading that went on in that market? In other words, the point I'm trying to make is that these entities, because of the presumption, because of the moral hazard, the same argument you were making to us, just like investors in their debt believed they were triple A, the counterparties here believed they were triple A. But here, it had additional significance. And so they played a big role, I think, in the growth of the derivatives market on Wall Street. How do we mitigate that going forward in the context of GSE reform? Thank you, Mr. Secretary.

Secretary GEITHNER. GSEs take on two types of risk: credit risk, the risk the homeowner defaults; and interest rate risk, because a lot of the mortgages are guaranteeing their 30-year, fixed-rate mortgages. They need the capacity to hedge those risks. They need to use derivatives markets to hedge the interest rate risk on their books. So I think what they did there was necessary. Again, the

central failure of oversight of the GSEs was not to force them to hold enough capital to back their commitments. They took on more risk than they had capital to support.

This committee has passed a sweeping set of reforms to establish oversight over the derivatives markets, and those reforms would make sure that you can force institutions that operate in those markets to hold capital against the commitments they write, would force standardized derivatives on to central clearinghouses where you can regulate and supervise margin, would give the SEC and CFTC the authority to police fraud and manipulation in those markets, and would bring broad transparency and disclosure to trading in those important markets. We think those reforms are central to reduce the substantial systemic risk that comes from the growth in those basic markets. And I think if we put those reforms in place, we will be doing a very important set of changes in building a more stable system.

Mr. ROYCE. I understand that argument, but there are two points: one, you still have the moral hazard problem because of the presumption of the government-backed guarantee; and two, they were the 800-pound gorilla. So when you, in the Fed then and Treasury now, come forward and say, "Well, we have to make sure they don't overleverage," they were overleveraged at a hundred to one. They were involved in arbitrage big time. And all the Fed was asking was for the ability to deleverage this portfolio, arguing that if we slowly did that, we would avoid the bust in the market, we would avoid the systemic risk that would otherwise hit us. And that systemic risk did hit us and the Fed turned out to be absolutely right about this.

But how do we overcome the fact that when you create a Government-Sponsored Enterprise, it becomes so powerful that it leans on the very institution that's supposed to regulate it?

Secretary GEITHNER. I would just say again, even without the many failures around the GSEs, what happened in derivatives markets posed systemic risk to the American financial system. And so even again without the challenges we face in the GSEs, we would have to bring about broad reforms, establish oversight over the derivatives market themselves. And you're of course right to emphasize again the heart of all financial crisis is when you have too much leverage, not enough capital to back commitments. That simple failure was pervasive across the financial system, not just in the GSEs.

Mr. ROYCE. Mr. Geithner, I have a few other questions for the record, and if you wouldn't mind getting back to me in writing, I would appreciate it. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, gentlemen. I thank them for having yielded, and I recognize the gentlewoman from New York, but I ask for 20 seconds, if you would yield to me?

Mrs. MALONEY. Absolutely.

The CHAIRMAN. Just to say that, yes, the Fed was complaining about Fannie and Freddie buying up mortgages. But the Fed was also at the time refusing to use authority that Congress had given it in 1994 to stop the bad mortgages from being made in the first place. So they were worried about the secondary market when they

were neglecting their opportunity to correct the primary market. If the Fed had used the authority that Congress granted them that Mr. Greenspan now acknowledges he could have used, you wouldn't have had those bad loans made in the first place for Fannie and Freddie to buy up.

The gentlewoman from New York.

Mrs. MALONEY. Thank you. Welcome, Mr. Secretary. In 2007, both Fannie and Freddie invested in a very successful affordable housing project in the district I'm honored to represent called Stuyvesant Town and Peter Cooper. Over 25,000 constituents live in this affordable, rent-stabilized rental housing. Fannie and Freddie were the senior debt holders in a $22 billion commercial mortgage-backed securities deal that included the Stuyvesant Town/Peter Cooper debt. It was well known in the press and by economists and people looking at the deal. They knew at the time that the rental income on the Stuy Town property would not be sufficient to meet the owner's debt service obligations. The owners knew that they would have to turn over or convert affordable housing to market rate units in order to increase the rental income and accelerate the rate of turnover. Hundreds and hundreds of my constituents, the tenants, were dragged into court to defend their homes on very frivolous lawsuits. Knowing this, Fannie and Freddie still invested in the debt.

And I would like to ask you, Secretary Geithner, what can be done to prevent GSEs from investing in properties that can only be profitable if you convert affordable housing to market rate by forcing out certain tenants? That certainly works against the mission of Fannie and Freddie to build or provide a base for affordable housing. I am working on legislation with the chairman and others to ensure that Enterprises cannot receive affordable housing goals credits for investments like the one they made in the Stuy Town debt. Do you believe they should receive housing goals credit for this type of investment where they know cannot continue to provide affordable housing?

Secretary GEITHNER. Congresswoman, I don't know, but I would be happy to spend some time talking to you and your staff about that particular problem and how we can prevent this kind of thing from happening again. I can't tell you now what is possible in that area. But I understand your concerns and I'm happy to work with you on it.

Mrs. MALONEY. Thank you. In this vein, New York City has a growing problem of overleveraged multifamily properties, including the Stuy Town project. What incentives can we put in place to encourage GSEs and community banks to work with local housing authorities to ensure troubled affordable multifamily buildings are sold to buyers who are in the business of preserving affordable housing? We're working so hard to build affordable housing and yet when it's sold, it is sold under an umbrella that absolutely makes it impossible to continue as affordable housing.

Secretary GEITHNER. Congresswoman, Secretary Donovan and my colleagues at Treasury have spent a lot of time looking just at exactly those issues, and again, I would be happy to have them come to you and talk through the range of options we think would be most productive in meeting that objective.

Mrs. MALONEY. And how do these securitized loans get detangled in a timely manner in order to protect tenants from a tumultuous foreclosure process, which is what we are now confronting with Stuyvesant Town and Peter Cooper? We can't even figure out who owns it now. So what are your ideas in that area?

Secretary GEITHNER. Again, I am happy to come spend some time talking to you about that. In the market we created for housing and finance, we have made it much more complicated in many ways, to work out economically sensible restructuring of loans backed by real estate than may have been possible in a more simple system in the past. You're citing just one example of that. There are thousands of examples across the country of that. And I think the reforms that this committee has put forward to try and improve the way the securitization markets work would be helpful in that area. But they will take some time coming, and they're not going to provide immediate relief to the problems you're facing, but we would be happy to spend some time talking with you about how to address the specific problems you refer to in New York.

Mrs. MALONEY. Thank you, and my time has expired.

The CHAIRMAN. The gentlewoman from Illinois.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Mr. Secretary, it seems like the GSEs have exposed the fallacy of bifurcating the mission or consumer protection regulation from the safety and soundness oversight. When HUD oversaw Fannie and Freddie's affordable housing mission and OFHEO served as its safety and soundness regulator, I think the result was a $227 billion bill for the American people.

Do you think the Administration is posed right now to make the same mistake by creating a consumer financial protection agency even if it's in the Federal Reserve or whether it's been some places have talked about it being a separate agency? Can you explain how the financial institution supervision would be? Or do you think it would be more effective if there's the one regulator to focus on both consumer protection and the safety and soundness?

Secretary GEITHNER. Congresswoman, that is a very important question, and I'm glad you raised it. We are now living with the consequences of a system which for many, many decades gave bank supervisors the responsibility to write and enforce rules for consumer protection, and that system did a terrible job for the country. It did a terrible job of protecting consumers, and it did not do an adequate job of protecting the safety and soundness of the banks in our country.

There were failures in both those two areas, and our judgment is you're going to get better outcomes in consumer protection and better outcomes in safety and soundness if you separate those functions. We propose that. I don't know if this helps the argument, but Secretary Paulson in 2006 in his Financial Blueprint—2008, maybe—proposed exactly the same, basic model, which is to separate consumer protection from safety and soundness supervision with the basic judgment that that would produce better safety and soundness regulation and better consumer protection.

Mrs. BIGGERT. So you would really advocate for separating them?

Secretary GEITHNER. Oh, absolutely, and, again, I do not believe. I have heard this argument a lot from bankers and supervisors,

and I do not believe it is a strong argument. Again, look at what that system produced—a colossal devastating failure. Let me try one simple example. Why should there be any conflict between rules designed to give consumers adequate disclosures so they can make choices of what type of mortgage product to take and rules designed to enforce sound underwriting standards for consumers?

I do not see the basis for conflict. Now, in the bill this committee passed in recognition of that concern, there are a careful set of checks and balances against the risks that the consumer agency would somehow write rules that could imperil the stability of the financial system. But I think those jobs are better separated. President Bush and Secretary Paulson had the same view in their proposal, and I think the record of the current system supports that judgment.

Mrs. BIGGERT. Well, wasn't it that the Federal Reserve was really responsible for writing the rules and regulation, the financial regulators?

Secretary GEITHNER. I think that's the point. Again, I think that you want bank supervisors worrying about risk management, about capital, about liquidity. You want them focused on those core things. You don't want them having to spend a bunch of time also having to worry about consumer protection if that job can be better done by an independent agency.

Mrs. BIGGERT. I guess I see it differently as with the GSEs and the banking industry, the consumer regulations, and the other regulators was separated and it didn't work.

Secretary GEITHNER. Again, I respect that view, but in fact, the GSEs played a generally quite responsible role in what they did in establishing standardized mortgage products; and, generally, they held to better underwriting standards than was true of the private market. So I don't see the failures and successes of the GSEs as undermining the argument for separating consumer protection from safety and soundness supervision and banks.

Mrs. BIGGERT. Does it create a duplication? What if the consumer protections with GSEs or with the banking industry that it's something that one way they propose that this will protect the consumers, and then the regulator with the safety and soundness, and they're in conflict?

Secretary GEITHNER. Well, again, if there's any risk of conflict, you can deal with that risk by making sure that you have a body that looks at conflict and can pass judgment on conflict. But I think it's very unlikely there would be any conflict.

The CHAIRMAN. The gentleman from California, Mr. Sherman.

Mr. SHERMAN. Thank you, Mr. Secretary.

Our housing market is to some extent broken. Thank God, the GSEs and FHA are really providing all the financing outside of Beverly Hills. The definition of median home price is distorted, because you may have a few arms-length sales, willing buyer, willing seller, home in good condition, and then you have tens and hundreds of thousands of foreclosure sales of homes in terrible repair, deeds in lieu.

Now, focusing on high-cost areas, including Los Angeles and the 10 largest or most expensive metropolitan areas, what would happen if at the end of the year, the maximum home limits for Fannie

Mae and Freddie Mac not only decline from $729,750, but not just to $625,000, but the government resets the loan to the current median price? I'm told in Los Angeles this means that the FHA limit drops from $729,000 to $376,000. The GSE limit, Fannie and Freddie, dropped from that $729,000 to $417,000. I don't expect that by the end of this year, we're going to have a robust, middle-class home finance market independent of the GSEs. What happens if you have that sudden inability to buy and sell a home anywhere in some of our country's remote, largest areas? What happens to the national economy? Could it cause a second dip in this recession?

Secretary GEITHNER. Congressman, that's a very important question. I don't have a judgment now about what Congress should do with those temporary increases and the conforming limits. I think it was very appropriate that Congress extended them. I fully supported that. I don't have a judgment yet. I would say the following, though. I think it was very important for people to understand that the basic mistakes most governments make in dealing with financial crises, real estate crises, is they tend to prematurely declare victory, say that the great risks are behind us, and they tend to walk-back support too quickly—not too slowly. And I think it's important to recognize that this housing crisis, the financial crisis has caused a huge amount of damage and it is going to take quite a long time for us to heal and repair that damage. I don't know how long it's going to take, but it's going to take some time still.

Mr. SHERMAN. Do you think we're ready by the end of this year to see the GSE limit drop in half in America's most important and largest cities without damaging the economy of the country?

Secretary GEITHNER. As I said, Congressman, I'm not in the position yet to make that judgment. We don't need to make that judgment yet. We'll have to make that judgment at some point this year, but not quite yet. But, again, I want to underscore I think your basic point is we have to be very careful that we are doing carefully designed, sensible things to help facilitate this process of repair and recovery.

Mr. SHERMAN. Let me move on to the next question. This one is just for the record, because I don't want to get you in trouble with the Senate. But a year ago today, the President nominated an Under Secretary for International Affairs, which is still on hold in the Senate after a year, as well as other major positions—the Under Secretary for Domestic Finance and the Assistant Secretary for Tax Policy. And so the question for the record is, do holds, filibusters, and the Senate practice of not allowing a nominee to work as an acting on a temporary basis until the confirmation, do those Senate practices lead to higher unemployment to companies not being able to find out what the tax regulations are because you don't have an Assistant Secretary for Tax Policy? And are there hundreds of thousands or tens of thousands of Americans unemployed today because of the perks and prerogatives of the other body? Don't answer that one for the record. Let me guess.

Secretary GEITHNER. Say. Can I just thank you for raising that concern and for pointing out that these three senior positions in the Treasury remain unoccupied today. It has now been 15 months since the President took office. And we have an amazingly talented,

dedicated, hard-working group of people at the Treasury doing a lot of important things for the country, but we need to get those people in place.

Mr. SHERMAN. Finally, we have disagreed on whether the Executive Branch should have permanent, unlimited bailout authority to make sure that the creditors and counterparties of major institutions on Wall Street can get bailed out only by the Executive Branch. Congratulations on convincing the Senate, at least this far, to give you that permanent, unlimited buy authority.

Secretary GEITHNER. Can I respond to that, Mr. Chairman? Actually, we agree on more than you think. As I said in the past in this hearing room, I would not support that, and neither your bill nor the Senate bill gives the Executive Branch the authority you describe. What it does do is make it clear that a large institution in the United States, if that institution in the future manages itself to the point where it gets to the edge of the abyss can no longer survive, then the government should have no option at that point except to put that institution into a form of receivership so it can be dismembered over time.

The CHAIRMAN. Mr. Secretary, at this moment of agreement among you, Mr. Sherman, and the Senate, we are going to move on. The gentleman from Texas, Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. Mr. Secretary, it is good to see you again. Given the unprecedented support that the Federal Government, both at the Federal Reserve and the Treasury has propped up, the securitization market for housing in this country, one of the things that concerns me is that the longer we keep this government presence, I think the longer that the private sector and private securitization sits on the sidelines. Because quite honestly, now, we do know that there is some activity pending out there, and there could be, but not to the level that we have had in the past, so what do we do?

And, you say—here you are saying—Congressman, I'm not really ready to do anything right now, but I am very concerned. It's kind of like a muscle. Like the doctors tell you the longer that you don't use a muscle and you keep your arm in the sling, which is where we have the housing finance market today—we have it in a sling—the harder it is to rehabilitate that arm once you take it out of the sling. How are we going to do that and what is your Blueprint to do that?

Secretary GEITHNER. Congressman, I worry a lot about that risk, and you are right to highlight it. But I think the main risk we face today is we still have an economy that has only now been growing now for three quarters. We have unemployment at around 10 percent, much higher in many parts of the country, a housing market still overwhelmingly dependent on the government, because there is no private will to provide financing for residential real estate, and it is going to take us a while to get through this and be confident that we have a recovery in place led by the private sector that could be self-sustaining over time.

The main risk we face today, still, is that there is still enormous damage caused by this crisis. You see it conspicuously in housing across the country. If you look at what we have done in the rest of the financial system, you can see we have been very, very careful

to unwind, to walk back to terminate and end the emergency programs that we no longer need to put in to keep in place, so we have ended the money market guarantee fund. The FDIC is no longer providing guarantees for the debt of bank holding companies.

We have replaced the overwhelming majority of public investments in our banking system with private capital. We are unwinding and trimming as the Fed is doing all those emergency programs, exactly for the risk you pointed out. We do not want these markets excessively dependent on government support in the future, and we want to see those private markets come back as quickly as we can.

Housing still has been so damaged. That process and repair is going to take a long time. But if you look at what we have done in those other areas, you can see we have been willing and careful and effective and walking back and unwinding the things that no longer play a useful, essential role in supporting recovery.

Mr. NEUGEBAUER. I hear what you are saying, and I agree with some of that as well. But one of the big problems here is that we really don't incentivize people to get into the securitization on the private side because of the interest rate levels that make borrowing very, very inexpensive. And so they can borrow very inexpensively. They can go out and buy the Freddie and Fannie products and the Ginnie Mae products, and so there's not a lot of incentive to go out and look for private demand in those markets.

Secretary GEITHNER. Again, I agree with that risk. I think if you look, you'll have a chance to talk to Secretary Donovan about this, but if you talk to him, or you talk to Ed DeMarco who runs the FHFA, you'll see that they have put in place a variety of changes already in underwriting standards and how they price their guarantees. It is designed to help promote the private sector coming back and replacing them as things start to heal, but that process is going to take some time. I think you're right to underscore its importance, and I will be fully supportive of that effort as we move to a transition where the private sector can play a larger role.

Mr. NEUGEBAUER. And one of the things I have heard also is, for example, PMI was an important part of the private securitization market. But what the PMI companies tell me is that they can't compete with the Federal rates, and so sometimes we have to bring a level playing field here so that there is a yield difference there that people are willing to say, I would rather have the higher yield here, and so I will move outside of the current parameters and move into the private securitization.

Secretary GEITHNER. Again, I agree with you about the objective. It's the question about how we do it; and, again, I just want to underscore that even though the economy is growing now and we have brought a measure of substantial stability back to the overall financial system and interest rates are much lower today than they were, there's a lot of challenge ahead still in the housing market and housing finance market. And we need to be very careful that we're still helping to facilitate this process of recovery as we transition to a new, better system.

Mr. NEUGEBAUER. One final, quick question: As Chairman Bernanke is wrapping up his purchase program of mortgages, what do you think that does to the market?

Secretary GEITHNER. I would leave that to the Chairman to describe, but again as the Fed does the careful responsible thing of winding down its emergency actions, we want to make sure again that the full complement of government policies in this area is helping facilitate this process of repair and recovery. And, it is getting better. We are making some progress in that area, but there is a lot of damage still out there.

The CHAIRMAN. Before getting to Mr. Capuano, I ask unanimous consent that a letter from the National Association of Federal Credit Unions be put into the record. Just, "GSEs allow credit unions to obtain the necessary liquidity to create new mortgages, despite their conservatorship, Fannie Mae and Freddie Mac have made it an important tool for credit unions to help free them up to make more loans; and they're a valuable resource for low-and moderate-income members. As Congress considers ways of reforming the current system, we believe it is important that safeguards are in place to make a very smooth transition, and the important roles that Fannie Mae and Freddie Mac play for credit unions not be capitalized."

That's from the National Association of Federal Credit Unions. The gentleman from Massachusetts is recognized for 5 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman. Thank you, Mr. Secretary.

Mr. Secretary, there have beeen a lot of big things talked about today, but I look at Fannie and Freddie maybe too simplistically, and I'm just curious. I'm not sure I know the exact number. Do you know the number of the general percentage of homeownership in this country prior to the existence of Fannie and Freddie? Am I right to think it was in the 30 to 40 percent range?

Secretary GEITHNER. You mean going back to the 1930's?

Mr. CAPUANO. Yes.

Secretary GEITHNER. I don't know, but a small fraction of where it is today. I agree with that.

Mr. CAPUANO. And today, it's around 70 percent, give or take?

Secretary GEITHNER. Today, it's about two-thirds.

Mr. CAPUANO. And I look at homeownership. Maybe I'm wrong, but I think it's probably the main financial aspect of this country that helped create and maintain the middle class. I come from a neighborhood where everybody I know, their way into the middle class was the purchase of a simple home, oftentimes a multifamily home. And I look at Fannie and Freddie as symbolic if not in fact responsible for that. Prior to Fannie and Freddie, how did people get mortgages? The private market alone? There was no government involvement.

Secretary GEITHNER. That's right.

Mr. CAPUANO. And for me, that's what this is all about. I guess I understand that Fannie and Freddie like everything else needs to be retooled. I have no problem with that, but as far as the current economic crisis, did Fannie and Freddie create the derivatives market?

Secretary GEITHNER. No.

Mr. CAPUANO. Did they participate in it any worse or any differently than a million other private entities?

Secretary GEITHNER. Differently, but I wouldn't say worse.

Mr. CAPUANO. And so they did some bad things, but no worse than many private entities of this country around the world.

Secretary GEITHNER. Well, I would say they were better than most private entities in these markets.

Mr. CAPUANO. And that is my problem. I'm not going to suggest that they don't need to be retooled. I'm not going to suggest that we don't need to revisit them. I'm certainly not going to suggest in any way that they don't need to be overseen or even destroyed and recreated in a different fashion. None of that bothers me, and that's why I haven't yet made up my mind exactly how I would like to approach this or like to seen it approach.

That's why I came today to listen to different ideas, but I will tell you that for me, subjecting homeowners or potential homeowners to nothing but the private market has been tried in this country for 150 years and failed to create a middle class. Since government got involved indirectly through Fannie and Freddie, we created the middle class, and we sustained the middle class. And when we are done with this, for me, that is the goal, the only goal.

As a matter of fact, anything short of that, my emotions might overcome me, and I might be tempted to scream out that someone or something or some group of people might be a homeownership killer, if they got rid of Fannie and Freddie, and I hope that doesn't happen. Thank you, Mr. Secretary.

The CHAIRMAN. The gentleman from Texas.

Let me just, before Mr. Hensarling, the Secretary has asked, and I think reasonably, to leave at 12:30. I would note all the members now here will be able to question him. Other members, if you plan to come over here about 12:15 to question the Secretary, have lunch instead and then come over and talk to the second panel. The gentleman from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman. Welcome again, Mr. Secretary.

I note that it was about 18 months ago that the President was elected. I think it was 13 months ago that the Administration decided to double taxpayer liability for the GSEs; 9 months ago that the Administration asked—

Secretary GEITHNER. Not to double the liability under the original preferred stock agreements.

Mr. HENSARLING. $100 billion per to $200 billion per?

Secretary GEITHNER. Under the law the Congress passed, you gave my predecessor unlimited authority to make sure Fannie and Freddie could meet their obligations. At that point, in effect, the government committed to make sure they had whatever capital was necessary to meet those obligations. All I have done is carried out that basic commitment using the authority that Congress gave my predecessor.

Mr. HENSARLING. Okay. Well, exercising that authority.

Secretary GEITHNER. It didn't change our liability.

Mr. HENSARLING. Mr. Secretary, please, I control the time here. It was 9 months ago that in the Administration's White Paper, we were told to expect some type of plan or option in the budget. We know what that plan was and that is you continue to monitor the situation. Three months ago, the Administration announced unlimited taxpayer exposure for Fannie and Freddie.

I just note, Mr. Secretary, in 18 months, the Administration has clearly found the time to put forth a plan that would provide substantial regulation for one-sixth of our economy of healthcare, extend more control over broker-dealers, investment banks, credit card companies, community banks, hedge funds, finance companies, payday lenders, pawn shops, and auto companies, but still no plan for the GSEs except seemingly unlimited taxpayer exposure.

So one Member's opinion, Mr. Secretary, with respect to the timing, I just thing the timing is unacceptable. But let's talk about the taxpayer exposure. Clearly, you're familiar with the numbers. CBO estimates over the next 10 years, $376 billion. We know that there's trillions more of exposure there; and, so, on the one hand, I see that Treasury continues to monitor the situation. I guess my greater concern is, is there in fact a de facto plan, perhaps not by design but perhaps by accident.

I note that the chairman of our committee in January stated that Fannie Mae and Freddie Mac are now "basically public policy instruments of the government." Charles Haldeman, Freddie Mac's chief executive has stated, "We're making decisions on loan modifications and other issues without being guided solely by profitability." Daniel Mudd, who is Fannie Mae's former CEO said, "The government is running Fannie and Freddie as an instrument of national economic policy, not as a business."

It appears to many of us, and I'll give you an opportunity to disabuse me of the notion or to accept the premise that what we now have is the GSE's or essentially an instrumentality of the Administration to fund taxpayer funds and to frankly fail foreclosures mitigation plan with nothing else in sight. So I'll yield to you, Mr. Secretary.

Secretary GEITHNER. Thank you, Congressman. Let me tell you what our strategy and our plan is. Our strategy is to fix this damaged housing finance market to make sure this economy recovers from the trauma caused by the recession. We're going to do that as carefully and quickly as we can.

As part of that process, we will be working with this committee to lay out a comprehensive set of reforms to the housing finance system, including the GSEs. But our obligation now and our priority now is to try to make sure that we heal what is broken in this housing finance system, and we help this economy dig out of this terrible mess.

Mr. HENSARLING. I understand that, Mr. Secretary, but there's still no timetable for that. Is that correct? As of today, there is still no timetable for a plan dealing with the GSEs?

Secretary GEITHNER. Again, we're looking forward to having this debate about reform. You are not going to care more about this than I am. I'm the one who has to preside over a set of broad commitments that I inherited from my predecessor, and we are going to do a careful, competent job.

Mr. HENSARLING. Mr. Secretary, it's just a simple question. Is there a timetable or is there not a timetable?

Secretary GEITHNER. We are going to do a careful competent job—

The CHAIRMAN. It is The gentleman from Texas' time.

Secretary GEITHNER. —of digging out of that mess and making sure that we work with you to put in place a set of reforms that will leave our country in a better position.

Mr. HENSARLING. Well in the little bit of time I have left, Mr. Secretary, in your mind, in the Administration's mind, is there any reason that inherently we must have a Government-Sponsored Entity to securitize mortgages in order to have stable homeownership in America, because I note many other nations do not have GSEs.

Secretary GEITHNER. This is the central existential question as you contemplate reform; and, as I said earlier in response to one of your colleagues, I think there is a quite strong economic case, quite strong public policy case for preserving designing some form of guarantee by the government to help facilitate a stable housing financing market. But it can't be the one we have today.

It can't be the one we have lived with over the last decade. It's going to be significantly different, but we will likely conclude as our predecessors have that there will be some rule for a guarantee of some sort.

The CHAIRMAN. Thank you, Mr. Secretary.

The gentleman from Texas, Mr. Hinojosa.

Mr. HINOJOSA. Thank you, Mr. Chairman. I want to also say welcome to our Secretary.

As you know, most of us and most of my colleagues are aware that April is National Financial Literacy Month. Throughout that month, special attention will be focused on efforts to increase the awareness of financial education and the importance of managing personal finances, increasing personal savings, and hopefully reducing personal debt in the United States.

I look forward to working on financial literacy education and capabilities issues with you, Mr. Secretary, as well as with Michelle Greene, your Deputy Assistant Secretary for Financial Education and Financial Access. I have listened very carefully to many of your responses, and I agree with you that the system for protecting consumers in the mortgage market was and remains fundamentally flawed, and consumers should have the information they need about the cost, terms, and conditions of their mortgages, which would be incorporated into legislation reforming the House Finance System.

I am sick and tired of listening to some of the folks who signed contracts and showing me the 20 or 25 items that were listed on fees, something very different than what it was years ago. I am pleased that the truth in lending and real estate settlement procedures will be placed under one roof in the Wall Street Reform and Consumer Protection Act. We should address my many concerns regarding the implementation of both of these acts.

Mr. Secretary, do you intend to provide housing counseling in languages other than English?

Secretary GEITHNER. Did you say "counseling?"

Mr. HINOJOSA. Yes.

Secretary GEITHNER. I believe that it is true today that the substantial support Congress has authorized to give in support of counseling agencies across the country now includes many nonprofits which provide those services in languages other than English, but I'll check that for the record.

Mr. HINOJOSA. I was pleased when I visited the Federal Reserve Branch in Dallas that they are very strongly supporting these financial literacy programs and have it in eight languages. In Texas, it's not uncommon to have school districts that have 40 or 50 languages spoken by some of the limited English-proficient students. So this is something that is very important, and I know some of my colleagues here in Congress don't want anything but English in materials that are used by some of our Federal agencies, and so I disagree with that.

I think that this is such a big investment that it's important to me that this concern be addressed. Fannie Mae and Freddie Mac as Government-Sponsored Enterprises are responsible for helping many middle-class families in my district in buying a home. So it's important to me that they survive through these difficult times. What actions will Treasury take to ensure that they survive?

Secretary GEITHNER. Oh, Congressman, as I said, we are going to do everything necessary to make sure they can not just meet their obligations, but they can continue to play an important role in supporting housing finance markets as we work on the design of a better, stronger, more effective housing finance system in the future.

We are completely committed to that and we will do everything necessary to make sure we allow them to continue to play the very important role they now play in providing a stable source of housing finance for this country as we try to dig out or repair what's broken in our financial system.

Mr. HINOJOSA. As you may well know, I have been a very strong proponent of community banks, because my district is one that has a very, very large number of community banks and that is one of the sources of borrowing. Some of them bought stock from Fannie Mae and Freddie Mac and took a huge loss. Is anything being considered to help them so that their balance sheets can look a little bit better because of the losses they took?

Secretary GEITHNER. Congressman, we have proposed legislation to the Congress that would establish what we call a Small Business Lending Facility. And this facility would make capital available to small community banks so that they have more financial resources to support lending to their customers as we come out of this recession. And this legislation would establish a $30 billion lending facility. It involves very, very modest costs and we think this is one of the most important things we can do to help small community banks continue to get through the very challenging period we still have—

Mr. HINOJOSA. What is the timetable to make that happen?

Secretary GEITHNER. The leadership of both bodies are considering taking up a small business bill which includes a set of tax provisions and financial credit support mechanisms like the one I described.

Mr. HINOJOSA. Thank you.

The CHAIRMAN. The gentleman from New Jersey, Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman. Thank you, Mr. Secretary. In your testimony, you briefly talked about an alternative to securitization and that is covered bonds. Paul Kanjorski is not

here right now, but he and I dropped in a bill this past week, H.R. 4884. I wonder whether you have looked at that?

Secretary GEITHNER. I haven't yet looked at it, but I will. And I would say that I understand. I know that you have been a long proponent of this issue of covered bonds. We do have a covered bond system in the FHLB today.

Mr. GARRETT. Right, but this is structured statutorily, so—

Secretary GEITHNER. Yes, it is. I would be happy to work with you on that, and I think looking at the covered bond model will be an important part of looking at the reform agenda.

Mr. GARRETT. And would that be something we would help if we can get that done sooner this year rather than later?

Secretary GEITHNER. It's possible. I don't know. Again, my basic feeling, like many argued when we were looking at financial reform of the private financial system in the United States, you want to look at comprehensively at the full complement of institutions, policy issues involved in this area. But again, I am happy to work with you on that part of reform.

Mr. GARRETT. Great. A couple of weeks ago, we—I'm back now to the GSEs, like everyone's talking about. We had the hearing here at the Budget Views and Estimates. I introduced an amendment that went down along party lines, which would basically put the GSEs on budget and applied $1.6 trillion of GSE debt, should be subject to the debt limit.

Secretary GEITHNER. Okay.

Mr. GARRETT. Back then, when Chairman Bernanke was here, I asked him his opinion of this, and I also asked him another question, and I'll ask you the same question, is the debt of the GSEs sovereign debt?

Secretary GEITHNER. Congressman, this is a very technical question, the appropriate accounting treatment of Fannie and Freddie and their obligations, so let me just give you two responses on this.

Mr. GARRETT. Yes and no?

Secretary GEITHNER. Determining the appropriate accounting treatment of these obligations, we have followed the advice of accountants. GAO agrees with the judgment we have made, and does not think it's appropriate for us to consolidate. We followed that basic model.

On your second question, let me repeat again what I said in both my written statement and my oral statement. We will do everything necessary to make sure these institutions have the capital they need to meet their commitments.

Mr. GARRETT. And I understand that from reading your statement. But it's really a basic question, and I'm not a Treasury Secretary or the Chairman of the Fed. And even Chairman Frank, not even, but the chairman also recognizes and he understands the difference because in his statement he says, "I—meaning the chairman—have noted that Fannie and Freddie debt did not have the legal standing as Treasury debt." So, he recognizes that there is a distinction between sovereign debt and GSE's debt.

Secretary GEITHNER. Absolutely, they are different, but again, I want to emphasize again in saying they are different that I want to make sure that you understand, again I say this as clearly as

possible, we will make sure that they have the financial resources necessary to meet their obligations.

Mr. GARRETT. Okay. I understand that. And the chairman says the same thing that he and many others want to make sure that is being done. Although, the chairman did say, I believe, throughout the debate, we will make sure that there are no implicit guarantees, hints, suggestions, or winks or nods, we will be explicit as to what is and what is not an obligation of the Federal Government. So, with the debt that we're incurring since this has all happened going forward, is that on the same standing as the existing debt that is out there? In other words,—

Secretary GEITHNER. That issue by the GSEs?

Mr. GARRETT. Yes.

Secretary GEITHNER. Yes.

Mr. GARRETT. It is? So, when he says that we should have no implicit guarantees, hints, suggestions, winks or nods, we are nodding and winking and guaranteeing about that, as well?

Secretary GEITHNER. No, no. We're not doing nodding and winking, we're saying very clearly, and I'll say it over and over again, we will make sure, using the authority Congress gave us that these institutions have the ability to meet their obligations present and future.

Mr. GARRETT. So, the chairman is incorrect when he states that there is a distinction between the debt that these have and sovereign debt?

Secretary GEITHNER. No, I don't think so. No, as I said, and of course, you know the answer to this question, they are different types of obligations. But again, I want to make it clear you understand that we will use the authority Congress gave us to make sure they can meet their commitments.

Mr. GARRETT. I do, and okay, so what I'm hearing is, it is not sovereign debt, but it is debt that we will stand behind.

Secretary GEITHNER. Well, I'll repeat it. I'll try and say it the same way every time I said it.

Mr. GARRETT. Is it sovereign debt?

Secretary GEITHNER. No, as I said, it's not sovereign debt in that—

Mr. GARRETT. Okay, that's good, that's really all I needed to know. It's not sovereign debt, but it's debt we're going to stand behind.

Secretary GEITHNER. I want to make sure—this is a very extensive issue. We're going to make sure that these institutions have the resources they need to meet their commitments, past and future.

Mr. GARRETT. Right. So, as I have heard it, and I understand it, it is not sovereign debt, but it is debt that we are going to stand behind, and because Congress has given you that authority to stand behind that—

Secretary GEITHNER. For very good reasons, yes.

Mr. GARRETT. Okay. And I still have 30 seconds left.

The CHAIRMAN. You had 3 seconds.

Mr. GARRETT. Excuse me?

The CHAIRMAN. You had 3 seconds left when you said that. We will make it 10 seconds more now.

Mr. GARRETT. Do you have any comment on the fact that Bloomberg is reporting that the bond market is saying that it's safer to lend to Warren Buffet than to this Administration right now because of the spreads?

Secretary GEITHNER. I don't agree with that comment. And I would say the following, which is that it is very important that the Congress work together to make sure we put in place over time a set of policies that will bring down our fiscal deficits to a more sustainable level. That's very important to the strength of this recovery. It's going to be very important to future growth of the American economy and we look forward to working with Members on both sides of the aisle to develop a political consensus to bring those deficits down to a sustainable level.

Mr. GARRETT. Thank you.

The CHAIRMAN. The gentleman's time has expired. The gentlewoman from New York.

Mrs. MCCARTHY OF NEW YORK. Thank you, and welcome again, Mr. Secretary. Watching, listening to the debate, I can't help wondering—many, many years ago, a lot of years ago, I bought my first home and I, a single woman starting out in nursing, which by the way, back then nurses didn't make much money, so every door was closed to me as far as buying a home. And it was my parents' home. I was a good risk. But, it was through the GSEs that actually I was able to get a loan. I never missed a payment, and I paid it off. So, there are a lot of us out there who certainly took advantage of it.

And from my understanding from a lot of these statistics, the majority of middle-income families will do everything they possibly can to make sure that they always pay their mortgage so they have a roof over their head. That's their dream. That was my dream. So, I was just curious, when we started going into this spiral downfall with the GSEs and also with the subprime lending crisis that we saw, who actually had the worst record? I know in New York City, we had a—I was reading somebody's testimony that 13,000 out of 20,000 loans defaulted. And that came through a housing agency. So, we need to look at things, how to change things, but I agree with my colleague that financial literacy is going to be an important part.

But, I just want to know now, what are we doing as far as the government to encourage more lenders to work towards loan modifications before people go into foreclosures?

Secretary GEITHNER. That is a very good question. The program that we put in place to make it possible for homeowners to restructure, modify their loans is now reaching more than one million Americans. And what this means is for those families, those one million Americans, they now have substantially lower monthly payments, which on average is putting $500 to $600 more in the pockets of those families than they had before the modifications. We're trying to make sure that as many of those as possible are translated into permanent modifications. And we're going to keep working to make sure this program reaches as many people as we can to make sure people who do not need to lose their homes can stay in their homes.

Mrs. MCCARTHY OF NEW YORK. Just one other question, too. With—obviously with the GSEs, and they have the backing of the Federal Government, on that, there are going to be a lot of homes that probably will not be, they're foreclosed now, they're sitting there. What are the chances of turning some of those homes over into rental properties where people are getting back on their feet again?

Secretary GEITHNER. Well, again, I think there are substantial opportunities for doing that. A lot of that is happening. And again, I would be happy to ask my colleagues, or my colleagues at HUD, or FHFA, to come brief you in more detail on what they can do in those areas.

Mrs. MCCARTHY OF NEW YORK. Thank you.

The CHAIRMAN. The gentlelady from West Virginia.

Mrs. CAPITO. Thank you. Thank you, Mr. Secretary. I would like to talk about this maybe a little more simplistically and a little more globally. I just got the report this morning that existing home sales are down again for the third straight month. Unemployment, as you mentioned in your opening statement, remains too high. We have witness after witness, particularly from the financial institutions, asking why they're not lending or why people aren't borrowing, lack of confidence, uncertainty.

My question is, is the lack of a certain plan forward with Fannie and Freddie leading to the uncertainty, as well? I'll just give you an example. Speaking with a community banker several weeks ago, asking him, why are you not getting into the mortgage market because the FHA has taken up so much more of the mortgage area? And he said, well, maybe if you would give me a loan guarantee, maybe I would get into that a little bit more.

Are we—because of this, all of the government involvement with Fannie and Freddie and dollars and just what you said, that we will back the debt of Fannie and Freddie, could that be part of—I know we need to do it slowly—but could it be part of the, maybe putting it in some mud and making it going slower, so that the confidence is not rebounding the way that we need it to in order to get out of this slump that we're in?

Secretary GEITHNER. I don't think so, but I'll give you my sense of this. I think if you talk to, as you do, and as we all do, community bankers across the country and you ask them what's happening on the lending side, generally what they say is the following: They say, loan demand is still very low; they say, the supervisors are being very tough on us; and to some extent, they say, they would like to know what the rules of the game are going to be in terms of broader financial reform.

So, for example, the bill that passed the House last December and the bill now moving its way through the Senate, they would like to know a little more certainty about what the rules of the game are going to be on capital, things like that, going forward.

I think those are the principal factors still affecting the lending conditions for small community banks and I think we can do something about those things. Again, we can, as the Chairman of the Fed, and the Chairman of the FDIC are doing, try to make sure that their examiners across the country are not overdoing it. We can make sure, as I said, to your colleague, that we provide capital

to small community banks so they can have a little bit of assistance to get through this that will help support lending. And if we pass financial reform, that will bring some clarity to the rules of the game, that would be helpful.

But I do not believe that what Fannie and Freddie and the FHA are doing now is overwhelmingly constructive to the process of repair of housing finance.

Mrs. CAPITO. But, at the base of a recovery, a good, solid recovery, is going to be this bouncing back of the housing market at the most fundamental part. Would you agree with that?

Secretary GEITHNER. It will, again, it's hard to tell the timing now, but part of recovery will be more durable stability in housing prices.

Mrs. CAPITO. Right.

Secretary GEITHNER. And as that happens, you're going to see the private market come back and take back some of the business of housing finance that is now dominated by Fannie and Freddie and the FHA.

Mrs. CAPITO. Okay, on a totally different topic, and we have talked about this a little bit, the Administration's Making Home Affordable modifications and refinancings, is that where we have done the $1 million dollar modification, is this affecting the bottom line of Fannie and Freddie at all? And are you concerned about the re-default rates on some of these re-modifications in terms of the ones that are held by Fannie and Freddie?

Secretary GEITHNER. No, it's not hurting the bottom line of Fannie and Freddie at all. The way this program works for both a private lender and for Fannie and Freddie is that they do the modifications if the economic value of the mortgage is better after being modified than it would be in foreclosure. So, because of that, that's what these modifications do. They put Fannie and Freddie in a better position, not a worse position than if no modifications were happening.

Mrs. CAPITO. But, we're still having re-default rates in those?

Secretary GEITHNER. Yes, absolutely. Again, given, as you said, how high unemployment is across the country still, you're going to still see re-default rates happen; it's just inevitable. We want to make sure we're doing as much as we can to help people who lose their jobs and face the risk of losing their homes, but you're going to see some risk of re-default rates across Fannie and Freddie and the banks who hold mortgages.

Mrs. CAPITO. All right. Thank you, Mr. Secretary.

The CHAIRMAN. Thank you very much. Now, we will hear from Mr. Lynch of Massachusetts.

Mr. LYNCH. Thank you, Mr. Chairman. Welcome, Mr. Secretary. I think one of the major weaknesses in our housing finance system is the securitization process, and I was happy to see that you called that out on page 5 of your testimony and devoted a really substantial section to that.

There was an article, I'm not sure if you saw it, in this past Sunday's New York Times by Gretchen Morgenson where she astutely points out that much of the difficulty with the mortgage-backed securities part of our crisis was rooted in the opacity of these products. And part of the problem, obviously, was that the ratings and

valuations that were assigned to these mortgage-backed securities were completely wrong. But, because of the complexity and the opacity, folks were induced to rely on just the rating. And that was a real problem.

As Ms. Morgenson points out, the Bank of England has just issued sort of an advisory, I think they call it a consultive report, and their Bank of England risk management division has recommended that—and they face the same problem, because in England, the collateral is being posted using these mortgage-backed securities and so, and at their discount window facilities, similar to what we're doing here. What they're recommending is that there be more useful information, additional information, supplied by those who, the issuers, the people who are creating these mortgage-backed securities, so that individual parties, the market, the banks, will be able to look through and actually vet them themselves rather than relying on Triple A and I think in our own situation with the Fed doing what they're doing, I think especially, they're posting collateral in much the same way. Is this something that, this is so important, this is such a critical part of credit formation here in this country, it's a great thing, the securitization, if it's properly used with proper standards.

Is this something that we need to look at, as well, in terms of getting more information to the markets so they can discern the proper valuation on a rolling basis, not just a static number or rating when the issue comes out, but ongoing.

Secretary GEITHNER. I completely agree with you. I think you said it very well, bringing more transparency to those structures so the investors can look through them, and understand the true risks in them is very important. It's also very important, as many of your colleagues know, to bring more transparency to the rating processes themselves, and we would like to see the rating agencies be compelled to disclose much more about the models used to underpin those ratings. We want to make sure that in the regulatory system that supervisors preside over, they're not creating incentives that encourage overreliance on ratings.

That set of changes, including most importantly, the one you began with, we think would make a big difference.

Mr. LYNCH. Let me ask you about that. In your report, it's a little bit vague about the reform of the rating agencies. You do mention it, but can you drill down on that a little bit?

Secretary GEITHNER. The reforms that this committee has embraced and which were the center of our proposals really had two pieces. One is to give the SEC the authority to police conflicts of interest because you don't want the judgment skewed by the model these firms have been operating with and in the future. You don't want their economic interests—

Mr. LYNCH. Right.

Secretary GEITHNER. —in the issuer altering their judgment, assigning excessively favorable ratings. That's very important.

Two, again, is to bring much more transparency to the rating process, make sure they have to disclose much more information about the inputs into their models into the rating and that way investors can bring an independent assessment about whether the ratings make any sense.

Again, the big mistake that underpinned almost everything that happened in our housing markets was that everyone made a judgment, almost everyone made a judgment that house prices would not fall in the future.

Mr. LYNCH. Yes.

Secretary GEITHNER. And the ratings were too favorable. Because of that, there was too much leverage, because of that, there was too little capital, because of that, it was a systematic failure across the GSEs and across private lenders. Transparency will help in that area but we also have to make sure we put in place stronger capital requirements, other things, so that we're aren't vulnerable to those kind of mistakes in the future.

Mr. LYNCH. Right. Thank you, Mr. Secretary. I yield back, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Lynch. Now, we'll hear from Mr. Marchant of Texas.

Mr. MARCHANT. Thank you, Mr. Chairman. My questions have to do with the projected losses, or the existing losses that are in Fannie Mae and Freddie Mac. Are you fairly confident, do you have any confidence that the loans that are being originated today and have been originated in the last year are high-quality loans and are not of the same quality as the loans that were originated in the previous 3 years?

Secretary GEITHNER. Congressman, my sense is that the underwriting standards today are much stronger than they were. And I think the people who have looked at this question carefully say if you look at what these institutions are doing today enters a new guarantees and how they're pricing them for those guarantees, means that the business is on a more stable footing, stand up footing today than it was.

Mr. MARCHANT. With respect to the ability in the long term of having Fannie or Freddie or a successor agency repaying or earning back the losses over a long-term horizon, do you see that as a possibility?

Secretary GEITHNER. I do not believe, Congressman, well, let me say it the other way around. I think the Government of the United States is likely to face substantial losses on the inherited commitments of these two institutions. It is very hard to judge what those scale of losses are, both the OMB and the CBO, as well as the FHA do a rolling assessment of those estimates. They're going to move around a bit, but they're going to be very substantial.

Mr. MARCHANT. I would like to explore the bridge, I call it a bridge loan, it's the loan that you're making from the Treasury to Fannie and Freddie every month to meet their obligations. And I would like to explore if in fact, the government or the Treasury, at some point, is going to have to take some kind of a loss on, eventually, some kind of a loss on these funds? Why would we, what went into the judgment call of charging Fannie and Freddie such a high rate on the loan that it's making to Fannie and Freddie, if in fact, that only adds to that long-term debt and in fact, may exacerbate that long-term debt? Why are we not dealing with a lower-cost facility? Because the cost of funds is—or is this money coming out of TARP? How is this income being booked? Those are—

Secretary GEITHNER. Those are very good questions. And this is under the authority we call the MAHRA authority, not under the TARP. And this was authority that again, President Bush asked for and received from the Congress. I have been carrying out the responsibilities that I inherited in that context.

What we're doing, Congressman, again, we're trying to make a careful judgment of how best to minimize the extent of losses the taxpayer ultimate bears, maximize the chance we carefully manage these institutions as we promote a recovery in the housing markets. We're trying to balance those objectives and we're going to do the best job we can. Again, I'm trying to make sure that we reduce the risk of future loss from these institutions and we'll look at the broader terms of our engagement through that basic objective.

Mr. MARCHANT. But, you see where a person—

Secretary GEITHNER. I do understand your point. It wouldn't make sense to charge a punitive rate if we're only charging ourselves for that, so you're making the right point.

Mr. MARCHANT. You go into a small bank and make a $10,000 car loan, and then each month, they loan you the money to make the car loan, then at the end of 3 years, you could have a $14,000 car loan, and I don't know what would have been accomplished in that, exactly.

Secretary GEITHNER. I understand the point you're making. We did take some actions at the end of last year to restructure those commitments in some ways, partly in response to that concern. But again, we're going to do what makes overall sense for the taxpayer, economically, in terms of reducing the risk of ultimate loss.

Mr. MARCHANT. Thank you.

The CHAIRMAN. The gentleman from Indiana, Mr. Donnelly.

Mr. DONNELLY. Thank you, Mr. Chairman. Thank you, Mr. Secretary for being here. I think one of the things that has caused continued housing problems is obviously the unemployment rate, that people can't afford to move into homes, to purchase homes. And a huge portion of the unemployment difficulties, at least in my area of the country, has been credit availability, and continues to be so.

I have business after business after business who, in trying to—they have had their lines of credit cut, lines of credit cut not because they have missed a payment, but because a covenant was missed because maybe their sales were down for a quarter during that time. And they have spent the last year in order to get down to that lower number of the line of credit, selling equipment, laying off employees, and telling me they could be adding employees if they weren't in this situation. We have jobs bill after jobs bill across the street. The real jobs bill, the folks in the shops tell me, is having a normal credit situation.

So, what can you tell me where we're going to be as we move forward on this?

Secretary GEITHNER. You're absolutely right. Many businesses across the country still are suffering from a very, very tight credit environment, even ones that have quite good businesses and have very good payment history. You're absolutely right. The bill I referred to a few minutes ago, which is a small business package of incentives and assistance, has three important components.

One is, as a series of tax measures for small businesses, zero capital gains rate on investment of small businesses, more favorable expensing depreciation, range of tax provisions which we think would be very helpful.

The second is, it includes expanded authority for the SBA to provide guarantees, both the size of guarantees and the economics of the guarantee. We think it would be very helpful.

And this is the critical thing, we propose a $30 billion small business lending facility that would make capital available to small banks so they can do a better job of meeting the loan demand of their customers.

We think giving capital to small banks is one of the most effective things we can do. It can happen very, very quickly if Congress gives us the authority. And that will help make sure a dollar of capital to a small bank means $8 to $10 in lending capacity. Without that capital, it's hard for many of them to raise capital in the private market, so they're going to have to reduce lending to their customers.

We think that mix of tax incentives, SBA support, and a small business lending facility would make a big difference.

Mr. DONNELLY. Here is the other conundrum, so to speak. I get emails from the businesses, from my friends who run businesses, and they say, the banks won't lend us anything. And the banks come in to the office and they say, we have money to lend and we're looking to make good loans.

So, how can we put these two sides together?

Secretary GEITHNER. I think what typically happens is, you have a bank that may have been a well-run bank, may have made a lot of good decisions over time but also may have gotten itself very exposed to commercial real estate. It has customers they have been working with for 30 years. They find themselves, because of a bunch of judgments in commercial real estate, having to reduce exposure to their customers and they, in explaining that to their customer, they frankly often say, it wasn't us, it's the supervisors who won't let us lend, forcing us to raise capital requirements.

As I said earlier, part of what's happening is supervisors are being tougher than they were. And that is making these problems worse. I think part of the solution is to try to make sure that Chairman Bair and Chairman Bernanke and Comptroller Dugan and their colleagues as supervisors are sending a more balanced message to their examiners across the country.

Mr. DONNELLY. And that is the message I would like to leave with you and those folks is, we want to make good loans. We don't want to make bad loans.

Secretary GEITHNER. Exactly.

Mr. DONNELLY. But at the same time, we want to have supervisors who are understanding the entire economic picture here that there are good loans that don't have to be extraordinary loans. And it is really choking the lifeblood out of a number of jobs that are available.

And when we get these jobs back, people will be buying homes again.

Secretary GEITHNER. I agree. I think there are businesses who see growing demand for their products now across the country. As

you start to see growth spread across the country, and they say they can't meet that demand because they can't get credit to add more equipment, add back payroll. So, you're absolutely right. It is a critical problem, but Congress has a chance to do something about it now and that would help alongside what the supervisors are trying to do, to send a more balanced message to their examiners.

Mr. DONNELLY. And I would suggest that the message is really, that's the best jobs program of all, because those are the jobs that were there before, that can come back, but they can't do it without the capital to run the business.

Secretary GEITHNER. And it's not expensive.

Mr. DONNELLY. No.

Secretary GEITHNER. It's the highest return on a dollar of taxpayer's money of, I think, any of the programs we have put in place over the last 15 months.

Mr. DONNELLY. And that's our small business guys making it happen instead of it having to happen out here.

Secretary GEITHNER. I agree.

Mr. DONNELLY. Thank you, Mr. Chairman.

Mr. KANJORSKI. [presiding] Thank you very much, Mr. Donnelly. We will now hear from the gentleman from California, Mr. Miller.

Mr. MILLER OF CALIFORNIA. Thank you, Mr. Chairman. Secretary Geithner, it's good to have you here again today. A lot of people in this country don't realize that Fannie and Freddie even hold their loan, which is interesting. And I come from a history in the real estate industry, being a builder and a Realtor myself, and 92 percent of the loans in this country are made by Freddie, Fannie, and FHA today. I'm looking at what would occur in this country in the housing market if they were not there.

I'm not here to defend them, but I'm looking at reality. Fannie and Freddie have made some tremendous mistakes, there's no doubt about it. But I'm looking at the serious delinquency rates in this country: Fannie has about 5.38 percent; Freddie has about 3.87 percent, but the private sector jumbo has about 9.6 percent. Fannie and Freddie are performing much better than the private sector in my district, the 42nd Congressional District. In LA County, Fannie and Freddie's delinquency rate is 3.9 percent; the jumbo market is 10.1 percent; and FHA and VA are 2.6 percent. In Orange County, Fannie and Freddie are 2.1 percent delinquent; jumbo is 8.9 percent; and FHA and VA are 1.4 percent. In San Bernardino County, Fannie and Freddie are up to 7.8 and that's alarming, but the jumbo market is 18.4 percent.

And I guess my question is, I have had arguments presented to me that we need to allow the private sector to completely control the secondary marketplace and get Fannie and Freddie out of it. But I'm concerned if there was a viable alternative to a GSE, where was it at in 2005, 2006, 2007? It wasn't there. At the same time the mortgage-backed security markets were blooming at that point in time, but the blooming part of the mortgage-backed security market was a group that sold terrible, terrible bundles to the private sector.

Many of Fannie and Freddie's losses today, in fact a majority of them, are because when they sell mortgage-backed securities, if

you have a nonperforming one, they take that nonperforming loan out and eat it themselves and replace it with a performing loan. Nothing Countrywide or anybody else ever did matches that because the way they bundle their securities, when investors bought them in good faith—these are not just rich people, these are people who have a moderate income, but they invested in the market—they bought absolutely worthless mortgage-backed securities.

So my concern is, if we're looking for a private sector alternative, might we be where we were with the mortgage-backed securities? I would appreciate an answer to that.

Secretary GEITHNER. I think you're exactly right. If you look at the record of what happened, the most appalling damaging erosion underwriting standards happened outside Fannie and Freddie, happened outside banks, happened in thrifts, mortgage finance companies, specialized finance companies. Fannie and Freddie's prime portfolio has better quality today than the average across the market, as you said, your statistics are absolutely right.

So I think you're right in the basic emphasis, and right now you're right to emphasize that the only games in town are Fannie and Freddie and the FHA. And it is very important again that they in this transition period, and it's not going to go on indefinitely, but for a period of time, they need to be able to continue to provide mortgage finance if we're going to heal what's still very damaged across the country, including in California.

Now I have not seen a ideal model yet for what to replace this current system, but as I said earlier, I think there's going to be—we're going to have to take a careful look at how to design a better form of guarantee and support than take the same risk—

Mr. MILLER OF CALIFORNIA. And I'm open to that. I'm not—say we have to have Fannie and Freddie. I want to know what we do if we don't have them. In fact, 9 years ago, the argument about conforming loan limits in high-cost areas has risen, and we talked about some oppose that. I started fighting for that 9 years ago, and I'm the one who always had the amendments out there that said we need to raise conforming in high-cost areas, and a few of my colleagues, including Mr. Hensarling, disagreed with me. But as I understand it, FHA and Fannie and Freddie, the best performing loans they're making today are in high-cost areas. Is that not true?

Secretary GEITHNER. I don't know if that's true, but I would be happy to check on that.

Mr. MILLER OF CALIFORNIA. The FHA told me it was true that they are best for loans. I guess I'm too—the question of what are the key structural improvements Treasury thinks are necessary to prevent government from distorting, and I'm saying distorting the marketplace because some have said that they're distorting the secondary marketplace as Fannie and Freddie have done. What can—do you think there's a distortion because of them? And if there is, what can we do to resolve that?

Secretary GEITHNER. Well, again, this is an unfair—this is a much more complicated problem than my answer will suggest, but there are two things that happen that we can prevent in the future, and we should prevent. One is, we should not allow institutions that operate with the expectation of government support to build up a huge retained portfolio.

Mr. MILLER OF CALIFORNIA. And I agree.

Secretary GEITHNER. With a lot of risk in it with no capital to support it.

Mr. MILLER OF CALIFORNIA. I agree.

Secretary GEITHNER. It's also true that I think, although economists disagree on the extent of this mistake, that Fannie and Freddie over time did provide guarantees for lower-quality mortgages without charging appropriately for that guarantee fee. Both those mistakes were consequential. The first, I think, was a much greater mistake. But whatever we do in redesigning the system, we need to avoid those two errors.

Mr. MILLER OF CALIFORNIA. And in closing, Mr. Chairman, I want to point out the fact that the only time Fannie and Freddie ever lost money other than this round was the year of 1985. Other than that, they were profitable, and maybe Congress did things to distort their mission and get them headed in different directions and we may need to go back to a time when that mission wasn't distorted, where they were making true conforming loans that met the criteria that they specified. I thank you for your patience, Mr. Chairman, and I yield back the balance of my time.

Mr. KANJORSKI. Thank you very much, Mr. Miller. And we will now hear from Mr. Posey of Florida.

Mr. POSEY. Thank you very much, Mr. Chairman. Mr. Secretary, during, I believe it was this committee's last meeting, we heard breaking news that said Fannie and Freddie executives received millions of dollars in bonuses all the while this meltdown was continuing. And I just wondered if you had any part in signing off on those bonuses when the FHFA met on December 24, 2009?

Secretary GEITHNER. The FHFA, as you said appropriately, is responsible as conservatorship for approving the compensation packages of these executives. They reached that decision in consultation with Ken Feinberg, whom I appointed to help establish stronger compensation standards across other institutions that were beneficiaries of the TARP.

Mr. POSEY. Is that a yes or a no?

Secretary GEITHNER. That gesture was made by the—

Mr. POSEY. Is that a yes or a no? Did you have any hand in that?

Secretary GEITHNER. I was not involved. It was—

Mr. POSEY. That's all I need. I don't have much time, so I'm going to ask my questions, and if you don't have time to answer them, I'm going to ask with the chairman's permission that you respond in writing. It seems like every time I ask somebody a question here, if I ask them what time it is, they start describing a clock, and we never get an answer.

I'm wondering why we're never able to get an answer from you on a comprehensive recovery plan. We have testimony. We hear the same old rehashing of what went wrong.

Secretary GEITHNER. For the GSEs?

Mr. POSEY. But we never have any real plan, comprehensive plan for recovery. I wonder how much longer we're going to have to wait for a plan, what information anybody could possibly still be waiting for to come forth with a plan. Clearly, the Administration has some serious credibility problems. They broke promises on space, they broke promises not to raise taxes, not to take over personal sov-

ereignty. The stimulus has failed to do what you said it would do. You said—

Secretary GEITHNER. I don't agree with that.

Mr. POSEY. —if the stimulus is passed, your words, it would not exceed 8 percent unemployment—

Secretary GEITHNER. That's not true.

Mr. POSEY. It's now over 10 percent.

Secretary GEITHNER. That's not true, Congressman.

Mr. POSEY. It's your chart, not mine. There are so many fair and legitimate questions that we just can't get answered, for example, when will Freddie and Fannie Mae's conservatorship end? I think there ought to be a legitimate estimate on that. I think a professional ought to say, with your experience and guidance, I think—this is today. This ought to be the target, and this is how we're going to go there. I don't think those are out of bounds at all. And I'm curious about to what extent our creditors—China—are worried about the failures of Fannie and Freddie. And of course I think it has been asked before, how do we prevent "too-big-to-fail" Freddie and Fannie, going forward? These are questions Congress has to know, and we can't wait forever to find out.

Secretary GEITHNER. You won't have to wait forever. And again, we're starting today the necessary process of figuring out what Congress and the Executive Branch would like to do to reform the housing finance system. But as you know, this is an enormously complicated question. We need to do it carefully, but we're beginning that process now and we look forward to working with you on how to fix what's broken in the system.

Mr. POSEY. What about the last year; what did they do?

Secretary GEITHNER. What did who do?

Mr. POSEY. Well, we have had a year to come up with a plan.

Secretary GEITHNER. Well, we—if you worry we have been idle, I would just point out that we inherited the worst financial crisis in 75 years since the Great Depression. We have been working—

Mr. POSEY. Who inherited it?

Secretary GEITHNER. This Administration did and this Congress did.

Mr. POSEY. This Congress has been run by the same Majority for 3 years. I'm sick and tired of hearing that we inherited it.

Secretary GEITHNER. Let's look forward. We are looking to move forward.

Mr. POSEY. We're looking to you for answers.

Secretary GEITHNER. I'm happy to move forward. We will work with you on how to reform the GSEs and our very damaged housing market, and I look forward to doing it.

Mr. POSEY. But no answers.

Secretary GEITHNER. Congressman, again, we have laid out a comprehensive, detailed set of objectives and principles. We laid out a comprehensive diagnosis of what was broken and what caused this housing crisis, and that is a good foundation on which to build and thinking about reforms. If we don't agree on what was broken, we can't begin the process, and we're going to go through a process with this committee to consult with people in the private sector, in the academic community, among Republicans and Demo-

crats. We'll look at alternative models, and we'll figure out the best way forward.

Mr. POSEY. So the reality is, we still don't have a plan.

Secretary GEITHNER. Congressman, again, you're asking us to design in the midst of again the worst financial crisis in generations.

Mr. POSEY. Listen, every business—

Secretary GEITHNER. Comprehensive reform.

Mr. POSEY. Every business in this country is suffering right now, and they're working on some kind of a plan for recovery. They're not doing it on a crisis—

Secretary GEITHNER. And we're working hard too, Congressman. We have been working hard too and we have done extraordinary things, and this economy is growing, and if you just want to go back, you say you don't want to go back to history, but when we came into office, when this Congress came into office, the economy was shrinking at a rate of 6 percent a year and three-quarters of—were losing their jobs every month. And today, because we actually acted as a country, the economy is now growing.

Things are dramatically better today than when we took office 15 months ago because of the actions we took and this House of Representatives has passed the most sweeping set of financial reforms contemplated since the Great Depression. We're on the verge of enacting those kind of reforms, and today, fortunately, we have a chance to begin the conversation about how we're going to reform the GSEs. And again, we look forward to working with you, and look forward to seeing your ideas. I expect you guys will have some ideas on your side of the aisle, and we'll take the best ideas on both sides and we'll propose something that we think will meet the test of reform.

Mr. KANJORSKI. The gentleman from Texas, Dr. Paul.

Dr. PAUL. I thank the chairman. Today, we're talking about reforms in the housing financial markets, which I think is crucial and very, very important. My concern is that there hasn't been a full explanation or an understanding of how we got into this mess. And from what I hear, the little bit we do hear, is that we will deal with the problems with more technical solutions and more regulatory solutions rather than looking at the fundamental causes.

To me, the fundamental causes are well understood by the Austrian free market economists because they predicted early on exactly what was going to happen, and it did. And they put the blame on three things. Fixing interests rates, price fixing, interest rates too low for too long, and also the line of credit that was—with the Federal Reserve, which was something the Congress did, even though it was $2 billion, it created a lot of moral hazard because even Mr. Greenspan admitted that there was probably about a $14 billion indirect subsidy to Fannie and Freddie which also encouraged the distortion. And on the books, it was legal for the Federal Reserve to buy mortgage debt. And, of course, there were no restrictions at all because it was done in secret about exactly how much credit will be created.

Because of my concerns and understanding of what was happening, in July of 2002, I was convinced that we were working on a financial bubble, and I introduced legislation that would have removed the line of credit from the Treasury as well as prohibited

the Fed from buying mortgage debt, which most people would object to: "No, we need them for the emergency." But that's what caused all the moral hazard. And I think it also existed for the benefit of us selling debt overseas. This encouraged foreigners to buy it, knowing the Treasury stands behind this, and the Federal Reserve stands behind this, and the whole cycle continues.

But when I introduced that legislation back in 2002, I said by transferring the risk of widespread mortgage default, the government increases the likelihood of a painful crash in the housing market. And the system could stave off the day of reckoning by purchasing GSE debt and pumping liquidity into the housing market, but this cannot hold off the inevitable drop in the housing market forever. In fact, postponing the necessary but painful market corrections will only deepen the inevitable.

Now that's not so much my statement coming about that on my own but because I endorse free markets, I endorse Austrian economics, and I don't see any understanding of that coming from our leadership in the Congress or the Fed or the Treasury, and I think it is so crucial that there is this understanding. So my question is, are you familiar with the explanation of the Austrian economist of the business cycle, how bubbles are formed and what we should do? And you shake your head, yes. If so, if you do understand that, which part of it don't you like, and why don't we look more carefully at those economists? They were right 10 years ago. I believe they're right now. Why aren't they consulted?

Secretary GEITHNER. Congressman, I agree with much of what you said. And as you and I have talked about in this hearing room before, I think you're right to point out that a long period of low real interest rates around the world played a major role in contributing to this financial crisis, this real estate boom, this credit boom. You're also right that moral hazard played a very important role, most dangerously in Fannie and Freddie. And those institutions were allowed to grow to enormous size, take on enormous risk, without capital to support those commitments, because of the expectation that the government would come in and protect them from the failures. I completely agree with you.

Dr. PAUL. Since my time is running out, I want to see if I can get one answer. My bill that was suggested years ago, would that be a proper thing to do now, to make sure that line of credit and this inevitable purchase of this kind of debt from the Fed, we should restrict that or remove it? Would you agree that was a good suggestion back then?

Secretary GEITHNER. I would have to go back and look at your bill, but as I said in my statement, I think when you think about what system should replace our current system, a critical part of that is to make sure you don't have institutions with private shareholders taking advantage of a subsidy from the government that leaves the taxpayer exposed to the risk of substantial losses.

So I agree that a centerpiece of future reform will be dealing with the moral hazard in the current framework.

Dr. PAUL. But doesn't the monetary system breed into the system the moral hazard? The Fed is designed to be the lender of last resort.

Secretary GEITHNER. No. I don't think that was—

Dr. PAUL. That's what it says. They are to be there to pick up the pieces.

Secretary GEITHNER. Not—GSEs were different, as you said, because there was a credit line and because this expectation built over time that the government would be there. That had nothing to do with the Fed. In fact, the Fed is—

Dr. PAUL. Our concerns bore out because that's what exactly happened. The government did pick up the pieces, and now we're in a bigger mess.

Mr. KANJORSKI. The gentleman from Illinois, Mr. Manzullo.

Mr. MANZULLO. Thank you, Mr. Chairman. Mr. Secretary, Hank Paulson, the former Treasury Secretary wrote in his book, "On the Brink," that in September of 2008, the Treasury issued, as you referred to on page 10 of your testimony, the preferred stock purchase agreements, encouraging banks to purchase these. And that this was done at the same time to help satisfy the Chinese government, which owned billions of dollars in Fannie and Freddie bonds, which were paid off in their entirety. And so now we have these banks that were intentionally misled, intentionally deceived to buy Fannie and Freddie preferred holdings, and then after the government said buy these, it's going to help out, the government just defaulted and stuck all those banks, big time.

At the same time, you mentioned there's a new $30 billion capital program being considered for community banks, and my question to you is, when I look at the objectives of reform, and this is a guideline, I don't see anything in there that addresses whether or not these community banks should be treated the same as the Chinese and be made whole when they were intentionally misled by the U.S. Government to buy these bonds that turned out to be worthless.

Secretary GEITHNER. Congressman, I cannot speak adequately to the judgments my predecessor made at that time—I cannot.

Mr. MANZULLO. I understand. I'm asking you, do you have a solution for these banks that got stuck?

Secretary GEITHNER. Well, again, I think that one of the most powerful things we could do to help community banks get through the challenges still ahead is to put in place a capital facility that gives them the ability to come to the Treasury and apply for capital support, small business lending. I believe that would help make a big difference.

Mr. MANZULLO. I understand that. But if they're made whole on their bonds, they're just getting back—if they're made whole in their preferred stock purchases, then they're simply getting back the money they paid in the first place and don't have to worry about another exotic program coming from the Federal Government.

Secretary GEITHNER. Again, I understand those concerns, but small banks across the country face a lot of challenges, not just those who held Fannie and Freddie preferred stock. And that's one of the reasons why small businesses across the country are still having a hard time getting credit, and I think it is a—

Mr. MANZULLO. Well, that, and the fact that the regulators have really tightened up the screws, even though the regulators say they

have not, and I believe them, but the people in the field have done that, to make what credit is available even tighter.

Secretary GEITHNER. You're right. I think—

Mr. MANZULLO. Here we have a situation where my question is, is the Treasury as part of its reform program interested or willing to treat the community banks in the same manner in which it treated the Chinese by making sure that they were indemnified on their bonds?

Secretary GEITHNER. Well, again, I would be happy to spend time with you, Congressman, in looking in more detail at that particular—

Mr. MANZULLO. Can you give me at least the basis of an answer on that?

Secretary GEITHNER. Congressman, we have put forward a very detailed—

Mr. MANZULLO. If you don't know, I would accept that.

Secretary GEITHNER. No. As I said, we think the most effective thing Congress could do to help small community banks now—

Mr. MANZULLO. I understand that. I'm asking, what can you do?

Secretary GEITHNER. What I can do is administer a program like that with authorization from the Congress, but I need authorization from the Congress for it to work.

Mr. MANZULLO. You need authorization—would you need authorization in order to honor those preferred stock purchases?

Secretary GEITHNER. I—

Mr. MANZULLO. That were issued in September of 2008?

Secretary GEITHNER. I would have to think about that and get back to you.

Mr. MANZULLO. Okay. That's fair enough. Thank you.

The CHAIRMAN. The Secretary is now dismissed. Well, "excused," I guess, is better than "dismissed."

[laughter]

The CHAIRMAN. With our thanks. The hearing has been useful. I thank the members. I think we had a very serious set of questions asked in a perfectly reasonable way, and we will now call the second panel.

People leaving, please leave. The panel will sit down. What are you running around the table for? There's no music. The hearing will begin. This is obviously a continuation of the hearing on the future of housing finance, and I'm going to be very clear. We are not talking only about the GSEs.

This is now the first of two hearings we'll be having because Secretary Donovan will be testifying, and I should note that there are some organizations and others, and groups and individuals who have a lot of relevant things to say. They will be in the next panel. I will just say that I think this is one of the most interesting intellectual issues that we have before us, and it obviously has a lot of policy implications. Some of those are more easily done than others. But getting right what the successor set of institutions should be in housing finance is very important.

We will begin with Sarah Rosen Wartell, who is the executive vice president of the Center for American Progress. I would just make one point. Please do not lean into the microphones. Move the microphone closer to you.

STATEMENT OF SARAH ROSEN WARTELL, EXECUTIVE VICE PRESIDENT, THE CENTER FOR AMERICAN PROGRESS (CAP)

Ms. WARTELL. Thank you, Mr. Chairman, and Representative Capito. I applaud you, and I appreciate the way you framed the purpose of this hearing for beginning this conversation. I should say my testimony benefits from 18 months of conversation with the Mortgage Finance Working Group, which is a group of affordable housing finance experts sponsored by CAP, although my remarks are mine alone.

I ask the Chair if my full statement and a statement of principles and a draft whitepaper that the working group has prepared could be included in the full record.

Let me leave you with just six points. First, the new system's goals should include liquidity, stability, and affordability. These objectives have served us well since the 1930's. The mistakes that led to the current crisis represent not the failure of this vision, but the failure to keep those objectives paramount.

The system also must better balance rental and homeownership, offering appropriate options for all kinds of families. Unfortunately, history suggests that the private market alone will not meet these objectives.

Second, the crisis stemmed from the unchecked growth of a shadow banking system of unregulated and irrationally priced private label MBS or private label securities. As investor demand for PLS grew, issuers demanded more subprime loans, and good lending practices would yield, driving down standards and distorting markets. The only cops on the street were the rating agencies, and they had an incentive to keep the party going.

An analogy may be helpful here. Imagine that there was suddenly great demand for hamburgers in the United States. Facing a shortage of Grade A meat, USDA inspectors would face pressure to let older, less healthy cows receive that Grade A designation. If we had a system in which they were paid by those whose meat they graded and there was no transparency on the standards, we might find ourselves waking up one day realizing that what we were eating in our hamburgers had changed. That's basically what had happened with the PLS market. Our investors were eating the equivalent of horse meat.

Figure 1 in the package of charts—there's a package of charts that I believe is on your table with the CAP logo—shows how dramatically credit quality declined with early delinquencies, growing from 5 to 25 percent in only 4 years. Going forward, we must not reproduce a bifurcated system, as the Secretary mentioned earlier, in which unregulated capital in one part of the market drives a race to the bottom. Our working graph proposal argues that the same system of rules must apply to both whatever receives government backing and the private market.

Third, we look at the GSE's role in the crisis. They were followers, not leaders. They made poor decisions with costly consequences for taxpayers. They came to the party late, were drawn in to the subprime market to regain lost market share, and chased what seemed like higher returns. And Figure 2 in that set of charts shows how their market share dropped as the private label securities share grew.

As others left that market, the GSEs stayed, and inexplicably doubled down while credit quality collapsed. The regulators also made significant errors in risk oversight and in awarding goals credit for unsustainable subprime purchases. While both the GSEs and the regulators made the problems worse, neither was the primary cause of the junk mortgages or the larger global financial meltdown.

Fourth, lending to low- and moderate-income and minority borrowers didn't cause this crisis, nor was it the result of longstanding policies like CRA and the housing goals that encouraged serving creditworthy borrowers. Figure 3 in your package shows how the MBS market followed the same bubble burst pattern as other asset-backed securities markets that had no affordable housing goals. If the GSE goals drove the subprime business, these patterns would diverge.

Fifth, while recent subprime lending was more detriment than benefit, we do know how to do affordable homeownership right. With sound lending practices, research shows, comparable borrowers are 3 to 4 times more likely to sustain homeownership as the fourth figure in the package shows. Communities have been stripped of equity by this foreclosure epidemic. It would be obscene if we first failed to prevent harmful subprime lending and then we let the hardest-hit communities be denied the fair and sustainable lending needing to recover. That must be a priority in reform.

Sixth, while we should not preserve the government's greatly expanded role any longer than necessary, policymakers must move cautiously. Even simple statements about the future might move markets, affect home values, and make domestic and overseas investors wary of agency securities, representing trillions of investment in the U.S. economy. And housing market deterioration could increase the taxpayer exposure from its existing obligations.

Over time, we must reduce the Federal role to one focused on serving the historical goals of liquidity, stability, and affordability, and creating the conditions in which private capital can better serve the market. The Federal backstop should be more target than it is today. Private and public capital under explicit rules and rigorous oversight can be paired to ensure that all appropriate Americans have access to long-term, fixed-rate homeownership opportunities and affordable rental housing.

Thank you.

[The prepared statement of Ms. Wartell can be found on page 178 of the appendix.]

The CHAIRMAN. Thank you, Ms. Wartell.

Next, Mr. Michael Berman, who is the chairman-elect of the Mortgage Bankers Association.

STATEMENT OF MICHAEL D. BERMAN, CHAIRMAN-ELECT, THE MORTGAGE BANKERS ASSOCIATION (MBA)

Mr. BERMAN. Thank you, Mr. Chairman, and Representative Capito, for the opportunity to testify.

I live in Newton, Massachusetts, and I have been in the real estate finance industry for over 25 years. I currently oversee all of my company's national loan programs, including multifamily programs with Fannie Mae, Freddie Mac, and the FHA. My company

has also been active in the commercial mortgage-backed securities arena as an investor, lender, issuer of securities, servicer, and special servicer.

Since the creation of Fannie Mae in the 1930's, the Federal Government has played a key role in providing stability to the secondary mortgage market. The current housing crisis has tested that role and led to calls for fundamental rethinking of the part played by the government in the housing finance system. To spearhead this thinking, in October 2008, the Mortgage Bankers Association formed the Council on Insuring Mortgage Liquidity, which I chair. This 23-member council is made up of industry practitioners from single family, multifamily, and commercial sectors of the real estate finance industry. Its mission has been to look beyond the current crisis to what a functioning, secondary mortgage market should look like.

Let me identify three principles that lie at the heart of our discussions. First, the secondary mortgage market transactions should be funded with private capital. Second, to promote uninterrupted market liquidity for the core mortgage market, the government should provide an explicit credit guarantee on a class of mortgage-backed securities backed by core, single family and multifamily mortgage products. This guarantee should not be free but should be financed with risk-based fees. And, third, taxpayers and the system should be protected through limits on the mortgage products covered, limits on activities, limits on portfolio size and purpose, strong risk-based capital requirements, and risk-based payments into a Federal insurance fund.

The centerpiece of MBA's plan is a new line of mortgage-backed securities. Each security would have two components: a security-level, Federal Government guaranteed wrap which would be backed by loan level guarantees from privately-owned, government-chartered, and regulated mortgage credit guarantor entities. The government guarantee would be similar to the one provided by Ginnie Mae, guaranteeing timely payments of interest and principal to bondholders and explicitly carrying the full faith and credit of the U.S. Government.

This government wrap will help provide affordable financing rates. These guarantees will be supported by a Federal insurance fund, capitalized by risk-based fees charged on the supported securities, which could also be a vehicle for an affordable housing fund. In supporting these loan level guarantees, the private entities would rely on their own capital as well as risk retention from originators, issuers and other secondary mortgage market entities such as mortgage insurers. MBS investors would not face credit risk, but would take on the interest rate risk from the underlying mortgages.

It's important to note that while MBS in this model would be guaranteed by the government, the companies backing these securities would not. The debt in equity issued by these entities would be purely private. As with other firms, investors would accept the potential risk of failure and loss. For this reason, we recommend that regulators charter enough entities to establish a truly competitive secondary market and to overcome issues associated with "too-

big-to-fail." At least initially, the number of entities should be two or three, and that number could increase as the market develops.

The framework we proposed is not intended to be the entire market. It's meant to focus on a narrowly defined set of core mortgage products that are essential to have available through all market conditions. Our proposal recognizes the need for a wider array of products through a re-emergence of the private market, including private label securities and covered bonds. We must also ensure that the transition from the current system to a new model is as seamless as possible.

Measures such as focusing the GSEs on a narrow range of mortgages and winding down their portfolios can be undertaken now. Additionally, the use of a good bank/bad bank strategy would help retain the best people, processes, and infrastructure from the GSEs. Identifying a clear path that will move forward to remove uncertainty and ensure that GSE's resources are of service now and in the future is essential.

Mr. Chairman, MBA's recommendations combine an acknowledgment that only a government guarantee can attract the depth and breadth of capital necessary for the market with a reliance on private capital and insistence on multiple layers of protections for taxpayers and a focus on ensuring a competitive, efficient secondary mortgage market. Our recommendations represent a clear and workable approach to ensuring liquidity in the mortgage market. These proposals were developed by industry practitioners who have been working on these issues for their entire careers.

We understand that capital markets have perspective on what will work. We welcome your thoughts and comments on our ideas. Thank you.

[The prepared statement of Mr. Berman can be found on page 75 of the appendix.]

The CHAIRMAN. Next, Mark Calabria, who is the director of financial regulation studies at the Cato Institute.

STATEMENT OF MARK A. CALABRIA, Ph.D., DIRECTOR, FINANCIAL REGULATION STUDIES, THE CATO INSTITUTE

Mr. CALABRIA. Chairman Frank, distinguished members of the committee, I thank you for the invitation to appear at today's hearing.

Before offering specific reform proposals, I think it's useful to start with a set of principles that I think should guide any restructuring of our mortgage finance system. The first and foremost of those principles is that I believe private, at-risk capital should serve as the foundation of our mortgage finance system. We simply must put an end to privatized profits and socialized losses.

Second, government policy should be structured to act in a countercyclical manner. Too much of our current structure magnifies the booms and busts in our housing markets, and we certainly should make every effort to dampen our housing cycles, we are unlikely to avoid them. So we should structure our housing finance system, keeping in mind that we will have booms and busts and our system should be robust to those booms and busts.

Just as we have booms and busts, we will have companies that fail, and we should structure our mortgage finance system with

that in mind so that our mortgage finance system is robust to the failure of a small number of companies. I think it's also important that the costs and benefits of that system should be transparent, understandable, and credible. All subsidies and contingent liabilities should be on budget. I believe the American public has a right to know what they're on the hook for. I also think policy should be tenure-neutral. Renting should be a respectable alternative, and to the extent that we encourage homeownership, it should be sustainable. And, additionally, I believe all homeownership policies should focus on housing as shelter and not housing as a speculative investment.

We should also reduce the current levels of leverage, the use of debt in our mortgage finance system, both on the part of financial institutions and on the part of households. Additionally, the level of maturity mismatch in our financial system should be reduced. But, with those principles in mind, I'm going to give a set of recommendations for reforming Freddie and Fannie. These recommendations should also apply to any entities that succeed Freddie and Fannie.

First and foremost, I think whatever entities we have funding our secondary mortgage market, we should have a lot of them. Concentrating the risk of our mortgage market into a few entities is simply a recipe for disaster. If we were to keep some version of Freddie and Fannie, I believe we need to break them up into at least a dozen pieces. Anything else would be viewed as implicitly backed by the government.

In keeping with the principle of transparency, if private sector debt is used to fund the secondary mortgage market, such debt should be explicitly not treated as government debt, should be subject to 33 and 34 Act disclosures, and we should remove references and statute treating it as government debt. I would emphasize the part of Freddie and Fannie that provided the substantial amount of liquidity for the mortgage market is essentially securitization of mortgages. Future activity should be limited to issuing mortgage-backed securities and prohibiting the holding of an investment portfolio.

Additionally, any securitization should be a true securitization where Freddie and Fannie or their successor entities transfer all the risk, including credit, to the holder of the MBS's. This would imply that their guarantee business be ended. We should also reduce the extent to which Freddie and Fannie debt and mortgage debt generally permeate our financial system. For instance, prior to the financial crisis, FDIC-insured depositories held GSE securities equal to over 150 percent of their tier 1 capital.

Investment banks and mutual funds were similarly full of Freddie and Fannie debt. There should be explicit concentration limits on financial holdings of GSE securities and such debt should be treated no better than commercial paper for the purposes of capital adequacy. But we must also recognize that the rescue of Freddie and Fannie was as much a foreign policy decision as it was an economic one.

If we were not going to let foreign governments or central banks such as the Chinese take losses on their GSE holdings, then we need to either have that reflected on budget or we need to prohibit

the sale of GSE securities to foreign entities. We should also consider a new ownership structure for Fannie and Freddie. I believe reconstituting Freddie and Fannie as a lender-owned cooperative could reduce the risk-taking and lower potential cost to the taxpayer. I say that, well aware of the many problems facing the Federal Home Loan Bank System.

But, despite those problems, I believe the Federal Home Loan Bank System has come through this crisis in better shape than Freddie and Fannie. I also believe it's appropriate to set minimal underwriting standards and loan requirements for whatever GSEs look like, such as requiring reasonable downpayments on the part of borrowers in addition to requiring all GSC loans to be full recourse.

At the core of any discussion of the U.S. mortgage market, stands the 30-year, fixed-rate mortgage. We must start with the very simple observation that someone must bear that interest rate risk. It will never simply go away. In normal times, the borrower or the lender bears some or all that risk, and in extreme market events, the taxpayer gets hit. I believe we should ultimately let the market decide where that falls.

In wrapping up, as the committee moves forward, I would strongly encourage the committee to hear from experts from other countries on the functioning of their mortgage markets. Despite the rhetoric during the bubble, our mortgage market is clearly not the envy of the world nor do we have the highest homeownership rates in the world. Several countries had even bigger housing bubbles with less ramifications, while other countries largely avoided a bubble, yet still maintain ownership rates similar to our own.

For instance, the Canadian system requires significant downpayments, full recourse, sizable prepayment penalties, and leaves significant share of the interest rate risk with the borrower. Yet, Canada has ownership rates similar to our own without the recent bubble.

I thank you, and wrap up there.

[The prepared statement of Dr. Calabria can be found on page 103 of the appendix.]

The CHAIRMAN. Next, Vincent O'Donnell, who is vice president of the affordable housing preservation initiative of LISC.

STATEMENT OF VINCENT F. O'DONNELL, VICE PRESIDENT, AFFORDABLE HOUSING PRESERVATION, LOCAL INITIATIVES SUPPORT CORPORATION (LISC)

Mr. O'DONNELL. Thank you, Mr. Chairman, and distinguished members of the committee for the opportunity to testify about where we go with our housing finance system.

I lead LISC's national efforts in supporting the preservation of affordable rental housing, but I speak today from the perspective of LISC as a whole. We work through partnerships with the private sector, including banks and GSEs and insurance companies, mostly through generating loans and investments. And we have seen at close hand in this work the best and the worst elements of the housing finance system and how it affects low-income, metropolitan, and rural communities and their residents.

We have seen effective public-private partnerships that foster the production and preservation of affordable rental homes and sustainable homeownership, fed by a fixed-rate, 30-year mortgage and prudent underwriting and innovation. Even in distressed urban and rural communities that were previously written off, private interest served the public interest safely, profitably, and successfully, not out of luck, but as a result of careful public policies that blended responsibility, opportunity, prudence, capacity, and accountability.

But we have also seen predatory lending ravage families and neighborhoods and we have seen public policies that oversell the genuine virtues of homeownership and ignore and neglect or even denigrate rental housing where a third of American households live. We have learned from this work that the long-term interests of consumers, lenders, investors, and communities in the financial system must fundamentally align rather than conflict. And we also must bring all communities—distressed, rural, and minority—into the mainstream of the financial system.

I want to set some context, but first state some basic guiding principles: first, the elements of the housing finance system should be better integrated in a number of ways; and second, private institutions that receive public benefits should also help address public objectives.

Just for perspective, our role is that of a community development financial institution. In that capacity, we make loans and equity investments to benefit people in a variety of circumstances. And, therefore, the functioning of the long-term housing finance market is critical to our success, because otherwise the investments we make will not pay off either in terms of financial return to us and recovery of our funds, or in the success of our mission. Our written testimony goes into some detail about how this interplay works. In particular, we use the example of affordable rental housing preservation to discuss the interplay between housing subsidies and the housing finance system, and the community development financial institutions like us that get these useful developments jump-started.

I do want to say that other parts of the system are addressing this interplay. Secretary Donovan is looking at the relationship between rental assistance and stable financing, and this committee is also doing that. I want to commend H.R. 4868, the Housing Preservation and Tenant Protection Act of 2010, which was filed last week by Chairman Frank and a number of cosponsors on the committee.

Now going back to the system, any reconsideration of the GSE role should note their current centrality to the housing finance system in the broad context. System fragmentation has increased risk, created unlevel playing fields, and reduced access to responsible credit. Any new system must assume the functions and capacities that the GSEs have developed and deal with transitional issues. We need coordination between primary and secondary markets. We need system-wide regulation, including regulation of the secondary markets, which are powerful drivers of the primary market. The painful subprime home mortgage crisis is evidence of how this can happen.

Both homeownership and rental housing are important. We need a balanced policy between both. We need policies to address both market rate and affordable housing, and we think it's a false dichotomy to suggest that the capital markets should address market rate housing and only the government should address affordable housing. We also need the system to understand and support both debt and equity. The secondary markets have been crucial to the equity market with low income housing tax credits, for example, and there needs to be a place for that.

The public policy objectives that we want to support, and we go into more detail in our written testimony, are that: we need liquidity in all economic conditions—upmarkets and downmarkets; we need long-term, fixed-rate mortgages for both homeowners and for rental housing; we need capital access for all communities, including economically distressed, low-income, rural, and minority communities on a fair and sustainable basis—not a return to redlining; and we need some approach to support the housing trust fund and the capital magnet fund. We recommend a small millage fee; by broadening the base, the impact on the taxpayers is reduced. I just want to say in conclusion that there will be an enormous, far-reaching consequence coming from this. Our perspective is that the system needs to serve all communities in this country, including low- and moderate-income families. And we thank you for your support.

[The prepared statement of Mr. O'Donnell can be found on page 159 of the appendix.]

The CHAIRMAN. Thank you.

Mr. DeWitt?

STATEMENT OF ROBERT E. DeWITT, VICE CHAIRMAN, CHIEF EXECUTIVE OFFICER, AND PRESIDENT, GID INVESTMENT ADVISERS LLC, ON BEHALF OF THE NATIONAL MULTI HOUSING COUNCIL AND THE NATIONAL APARTMENT ASSOCIATION

Mr. DEWITT. Chairman Frank, Ranking Member Capito, and distinguished members of the committee, I am Bob DeWitt, chief executive officer of GID Investment Advisers, testifying on behalf of the National Multi Housing Council and the National Apartment Association.

It's important to draw a clear distinction between the performance of the single family and multifamily sectors. The multifamily finance system has been an unqualified success for over 2 decades. As Congress crafts solutions to fix the single family problems, you should be mindful not to do so at the expense of the much smaller, less understood, but vital multifamily sector.

Since the early 1990's, apartment developers and owners have had access to reasonably priced capital throughout all economic cycles as a result of the secondary market. This has allowed them to produce millions of apartment units affordable to working families, those households at or below area median income in communities all across the country. We didn't overbuild, and those apartments produced within the system came at virtually no risk to the taxpayer. The two GSEs have had to foreclose on fewer than 100 apartment properties over the past 20 years.

Today, their delinquency and defaults remain under one-half of one percent, a tenth of the size of the delinquency and default rates plaguing single family. In normal times, GSEs finance approximately a third of the capital going to apartments. Banks, insurance companies, conduits, and other private players have made up the other two-thirds. However, the past 18 months have not been normal times. Those purely private players abandoned the market and have not and cannot yet return. As a result, Fannie and Freddie currently finance some 90 percent of the debt capital for apartments.

Clearly, this is not sustainable, nor desired; but, neither is the uncertainty regarding what role the private market can play in financing apartments. The apartment industry urges you to consider the following key points for inclusion in any reform measures.

Number one, mission: the public mission of the federally supported secondary market needs to be clearly defined and should be focused primarily on using the government guarantee to provide liquidity to the multifamily mortgage market. This liquidity will help meet the current and growing need for workforce housing.

Access to a steady stream of capital promotes affordability. Affordable housing is one of the Nation's most pressing needs and multifamily housing is inherently affordable. Fully 90 percent of the apartment units financed by the present system over the past 2 decades, literally millions of apartments, were affordable to families at or below area median income. This includes an overwhelming majority of market rate apartments with no direct Federal subsidy.

The Harvard University Joint Center for Housing Studies estimates that we already have a shortage of some 5 million units of affordable rental housing. Our industry cannot meet the Nation's current or future housing needs, or refinance the approximately $200 billion in mortgage debt coming due over the next 2 years without a fully functioning, secondary mortgage market.

Number two, the private market simply cannot meet 100 percent of the multifamily demand for capital. Any new or revised secondary market system must recognize the unique needs of the multifamily sector and create a capacity to fill the gap left by the private sector. There are structural impediments facing banks, insurance companies and conduits that preclude them from financing more than they traditionally have. As the GSEs shrink their overall presence in the markets during this transition, we expect them to continue to be the primary source of the apartment sector's mortgage capital.

Number three, private capital is preferable to federalization of the secondary market or the creation of a new Federal entity. Federalization will limit the broad range of finance products required to maintain a healthy and changing multifamily market. Attracting private capital based on the Federal Government guarantee allows for needed innovation and flexibility.

Number four, explicit guarantee: we believe that the transition to any new system should provide access to explicit Federal guarantees for multifamily mortgage securities and loan. We support a fee structure to support this backstop. Such a risk-based guarantee

on the underlying mortgage would provide reserves against mortgage losses, thus protecting and insulating the taxpayer from loss.

Number five, portfolio lending: securitizing multifamily loans is not always the best way to manage credit risk. Unlike single family loans, they are not easily commoditized, and therefore any new system should permit the ability to hold loans in portfolio.

And number six, secondary market infrastructure: during these transition years, we believe it is critical to retain many of the resources and capacities of the existing GSEs. The two firms have extensive personnel and technology expertise, and established third party relationships that are critical to a well-functioning, secondary market.

If I can leave you with one message today, it is that a government-supported secondary market is absolutely critical, at least during an appropriate transition period to the multifamily industry's ability to continue to meet the demand for safe, decent, and affordable rental housing. I thank you for the opportunity to be with you today to present the views of the apartment industry, and I look forward to your questions.

[The prepared statement of Mr. DeWitt can be found on page 110 of the appendix.]

The CHAIRMAN. Next, Janis Bowdler, who is the deputy director of the wealth-building policy project at the National Council of La Raza.

STATEMENT OF JANIS BOWDLER, DEPUTY DIRECTOR, WEALTH-BUILDING POLICY PROJECT, THE NATIONAL COUNCIL OF LA RAZA (NCLR)

Ms. BOWDLER. Good morning. Thank you. I am the deputy director of the National Council of La Raza's wealth-building policy project, and I would like to thank Chairman Frank, Mrs. Capito, and others for inviting NCLR to share a perspective on this issue.

Record foreclosures in communities of color have taught us painful lessons on the consequences of predatory lending. For decades, qualified borrowers of color have struggled to gain access to the same loans as their White peers. During the bubble years, many believed their homeownership dream came true, only to learn that they were sold second class products. As we consider how to revive our housing finance market, it must be shaped by the lessons of the past and built on principles of fairness and inclusion.

In my remarks, I will review important lessons from the old system. Then, I'll lay out a series of principles to create a system that promotes true ownership opportunities for communities of color. Let me start with the lessons. The bubble years have become infamous for a glut of inventive but devastating financial products; however, we can't lose sight of those innovations that really move the ball forward. As the housing counseling intermediary, NCLR has helped more than 135,000 families purchase their first home.

Based on our experience, there are three areas from the old system that we must incorporate moving forward. The first is housing counseling. Research has shown that families who attend counseling are less likely to default. With significant support from both sides of the aisle, and this committee in particular, the field of housing counseling has become increasingly sophisticated. The sec-

ond is flexible underwriting. The mortgage industry has learned how to underwrite various borrower characteristics without jeopardizing the bottom lines of banks or families. And the third is non-traditional credit. We also learned how to profile credit using data from rent, utility, and other monthly bills. Doing so opened the door for a whole new segment of borrowers. All too often, however, this work was overshadowed by risky yet profitable loans.

Under the old regime, industry players had little incentive to think past the commission they would earn at origination or securitization. Building on these lessons, NCLR has two primary goals. The first is to ensure that qualified Latinos can access a home loan at fair, equal, and affordable rates. And the second is to ensure that home will develop into an asset they can share with their children.

With that in mind, we would like to share with you six principles to guide the shaping of our housing finance market. The first is that there is a role for the Federal Government in providing liquidity and innovation. Whether directly or through quasi-public agencies, the government can help facilitate the flow of adequate capital. As a rule, they should bolster and not replace the private market and they should set a high standard for lending, secondary market credit, and rental financing. The second is that mortgage credit must be equally accessible and available to all qualified borrowers. Moving forward, policymakers must be careful not to exacerbate the tendency of the market to favor the easiest-to-serve borrowers. One way to do this would be to invest in lending tools that are unattractive to the private market, but for which there is strong public purpose.

The third is that sound and affordable mortgages should be the norm. The rise of subprime mortgages was driven by Wall Street's appetite for risky loans, not by borrower's demand on the ground. We need to restore balance so that the system reflects true demand from the bottom, not from the top.

The fourth is that diverse delivery and outreach channels must be incorporated. A key lesson from the financial fallout in 2008 is that prime banks did not compete well against more agile and less scrupulous competitors. Congress should look at how to maximize and reward those that are offering sound and sustainable loans.

The fifth is that predatory lending should be eliminated. Much of the best developments in the last 10 years were blocked from the borrowers who needed them most, and abusive lending routinely beat out the slow and steady practices on the ground that would have created sustainable ownership opportunities. And finally, our sixth principle is that affordable rental housing and ownership opportunities are linked. Unfortunately, these goals of creating affordable rental and helping low-income families achieve homeownership have been pitted against one another. Yet, families can build savings or prepare for a homeownership when their rent is too expensive.

Rental and ownership policy must be connected to create a clear national housing strategy. On a final note, NCLR strongly urges Congress to be data-driven. With unparalleled access to GSE portfolio data, we have the information we need to identify the strong tenants of affordable lending. There is a strong public demand for

a robust housing finance market that delivers a steady flow of affordable credit on fair terms to all corners of the country. History has shown that this is not likely to happen without targeted investment from the Federal Government.

We look forward to working with you to determine that role.

[The prepared statement of Ms. Bowdler can be found on page 94 of the appendix.]

The CHAIRMAN. Next, Professor Anthony Sanders from George Mason University.

STATEMENT OF ANTHONY B. SANDERS, DISTINGUISHED PROFESSOR OF REAL ESTATE FINANCE, SCHOOL OF MANAGEMENT, GEORGE MASON UNIVERSITY

Mr. SANDERS. Thank you, Mr. Chairman, Ranking Member Capito, and members of the committee.

The Federal debt at the end of 2009 stood at $8 trillion, but the Fannie Mae, Freddie Mac, and Federal Home Loan Bank debt and MBS stands at $8 trillion as well. This combined debt load for the United States is $16 trillion and represents 110 percent of our gross domestic product. This Grecian formula of debt issuance to fund housing goals is not sustainable. We simply have too much leverage in the housing finance system. To make matters worse, the Federal Government controls 95 percent of residential mortgages made with FHA insurance or Fannie Mae or Freddie Mac loan purchases. Stated differently, our financial institutions will not originate residential loans unless the Federal Government ensures or purchases them.

We need to take immediate action to get the financial institutions and the investment community back in the game and wind down the Federal Government's involvement. We have affordable housing missions at HUD and at Freddie and Fannie through affordable housing goals, and at financial institutions through the Community Reinvestment Act and numerous other State and local programs. Given the massive supply of vacant housing on the market, the shadow inventory of foreclosed homes at financial institutions, and the multifamily vacancy rates, perhaps it is high time that we consolidate the affordable housing missions under one tent. Historically, the Nation's affordable housing mission has been under HUD. Hence, I would recommend that any Federal affordable housing mission be housed there.

But the FHA, our low- to moderate-income mortgage insurance entity, is woefully antiquated in terms of technology, and is in desperate need of modernization. Thus, my first recommendation is a dramatic overhaul and modernization of the FHA. My second recommendation is to slim down Fannie and Freddie's role in the housing market. We can begin by: one, removing the affordable housing mission; two, unwinding the retained portfolios at an accelerated pace; and three, toughening the regulatory oversight of Fannie and Freddie by moving it to a stronger FHFA.

My third recommendation is to pass legislation governing a covered bond market similar to the market that exists in Denmark, and begin with the jumbo mortgage market as an experiment. Covered bonds potentially provide an excellent vehicle to fund the residential and commercial mortgage markets going forward.

My fourth recommendation is to repair the securitization model that is already in existence. Having lenders retain skin in the game of at least 5 percent of the loans originated is a good start. Our recent downturn in housing teaches us that 5 percent would have been grossly insufficient to cover the future downturns in housing prices. On the other hand, a private securitization market should be a buyer-beware market, so skin in the game would be pointless.

Lastly, we have to return to a 10 to 20 percent down or more downpayment standard for mortgage lending, and 10 percent in FHA programs. The housing bubble of the last decade was fueled mostly by low interest rates combined with low downpayment mortgages and exotic mortgages such as pay option ARMs. The much maligned subprime market was a convenient scapegoat for this crisis. Had lenders and GSEs adhered to 10 to 20 percent down standards, there would not have been a bubble in the first place and the subprime borrowers would not have defaulted in such numbers had the bubble not burst.

Mr. Chairman, I thank you for letting me share my comments and suggestions with you and the committee. Thank you.

[The prepared statement of Professor Sanders can be found on page 167 of the appendix.]

The CHAIRMAN. And our final witness, Mr. Vince Malta from the National Association of Realtors.

STATEMENT OF VINCE MALTA, 2010 VICE PRESIDENT AND LIAISON TO GOVERNMENT AFFAIRS, THE NATIONAL ASSOCIATION OF REALTORS

Mr. MALTA. Chairman Frank, and members of the committee, thank you for holding this hearing today. I am Vince Malta, the 2010 vice president of the National Association of Realtors. I am a third generation Realtor, and I am here to testify on behalf of more than 1.2 million Realtors who are involved in all aspects of the real estate industry.

As our members began exploring the question of how to improve the U.S. housing finance sector, and developing recommendations on what to do about Fannie Mae and Freddie Mac, there were a couple of significant issues for which they sought a solution. First, Realtors want to ensure that in all types of markets, there is always mortgage capital available for the creditworthy housing consumer. Second, and equally important, Realtors want to ensure that taxpayer dollars are optimally protected.

Among the models that our members considered were to make the secondary mortgage market entities either fully private or fully Federal. However, we believe neither option effectively addresses these two critical issues. Full privatization is not an effective option because a private firm's business strategy will focus on optimizing its revenues/profit generation. As a result, such an entity would foster mortgage products that are more aligned with business goals rather than the Nation's housing policy or consumers. Such a model could lead to the elimination of long-term, fixed-rate mortgage products and increase costs. We have also learned in the last few years that in extremely difficult markets, private lenders have not been willing to make loans without government backing.

On the other hand, full nationalization has its own share of problems. Either converting Fannie and Freddie to fully Federal agencies or merging them with Ginnie Mae would place taxpayers at significant risk. Realtors want to eliminate as much as possible any scenario that would place the taxpayer fully on the hook to protect these entities. Additionally, having only one secondary mortgage market entity would remove competition in the secondary market space and remove any incentive for innovation. Further, we fear that a combined secondary mortgage market entity could lose focus on its mission to serve low- and moderate-income families and to maintain liquidity in the mortgage markets.

Realtors believe that to ensure the flow of capital into the mortgage market regardless of the state of the housing market or the overall economy, Fannie Mae and Freddie Mac should become government-chartered, non-shareholder-owned authorities. These new entities should be subject to tighter regulations on product, profitability, and minimal retained portfolio practices in a way that ensures the protection of taxpayer monies. The new authority should focus on standard mortgage products that are the foundation of our housing finance market.

While such a focus may curtail some private participation in alternative products in this portion of the market, over time we believe private market participants will offer innovations that meet consumer needs. With the new entities focusing on standard, safe mortgage products, including 15- and 30-year, fixed-rate mortgages and traditional adjustable rate mortgages, we believe private capital will be free to compete for opportunities outside of that product window.

Finally, Realtors believe that regardless of the secondary mortgage market model selected, there is a place for the utilization of covered bonds. Our members do not believe that they can replace the liquidity tools of our existing system, but should be encouraged as an additional product to provide liquidity to the secondary mortgage market. Realtors recognize that this is but the first of many conversations regarding how we mend and improve a housing finance system that had served us well for many years. We believe that our recommendations, along with some key elements that we mentioned today, will help Congress and our industry design a secondary mortgage model that will serve America's best interests today and in the future.

I thank you for this opportunity to present our views. As always, the National Association of Realtors is ready to help you as you work to sustain the housing and national economic recovery.

[The prepared statement of Mr. Malta can be found on page 143 of the appendix.]

The CHAIRMAN. Thank you. I want to begin with an observation from before. There was a comment about the pressures of the Federal Reserve in warning about Fannie and Freddie, and that is true, but it should be coupled with a recognition that the Federal Reserve was given by the Congress in 1994 the responsibility for preventing irresponsible lending, whether it was inside or outside the banking system. And Mr. Greenspan, as he later acknowledged, refused to do it on ideological grounds.

So yes, the Fed was worried about Fannie and Freddie buying up mortgages, but the Fed was worried about Fannie and Freddie buying up mortgages that the Fed should have prevented from being made in the first place. It is important to remember that Fannie and Freddie were in the secondary market and they would not have, as a matter of fact, been impacted if there had not been problems in the primary market, although they may have encouraged it. So the Fed's record here is indeed a very mixed one.

Mr. DeWitt, I want to acknowledge—you made explicit the importance of separating out multifamily and single family, and that is relevant. Several people here talked about the importance of rental housing which was, I think, ignored, and part of the problem was a failure to understand that, and I agree with that. We will be very careful, and we ask you all to work with us, to make sure that it is not a failure to recognize that.

Let me just ask Mr. Calabria—I was struck, and I appreciate that you stated, I think, a very important point, that our policy shouldn't be based on the form of tenure, whether it is a rental or ownership. I'm just wondering if you would care to speculate about—and I would ask Mr. Malta to stay calm—the question of the home interest deduction on home mortgages. Would you change that at all?

Mr. CALABRIA. I would. I would ultimately, in a budget neutral way, get rid of it. I think our tax code in general encourages excess leverage on the part of households and corporations, so without a doubt, we should be phasing out the mortgage interest deduction.

The CHAIRMAN. Thank you. And Mr. Sanders, I appreciated your comments on a number of areas. On downpayments—and I was just checking—when you say having borrowers have skin in the game in subprime, would you mandate that in some way? I certainly agree with that. Should we mandate that?

I will tell you one of the things we did do with regard to securitization—and I will get to that in a minute on your comments there—we called for 5 percent as the norm, with the regulators going to 10 percent if it is a particularly risky thing. But it had gone down to zero, and we had in mind if they had a 30-year, fixed-rate mortgage with a 20 percent downpayment—not to mandate, but to incentivize. But would you go further? I very much agree on the desirability of the downpayment. Is there some way in public policy we should follow through on that?

Mr. SANDERS. There is no doubt about it. I think having the 3.5 percent down FHA, which was brought down to zero, is a—again, public policy viewpoint, I understand that side of it. On the other hand—again, in my report, you will see that the FHA insurance fund is suffering greatly—

The CHAIRMAN. I agree, and we are in fact in conversations now, and we will have a bill when we come back that I think is going to raise that. But the question is, what about non-FHA, would you do anything about that?

Mr. SANDERS. Well the non-FHA, and from a financial stability viewpoint, I think—as I put, 10 to 20 percent makes a lot of sense. Going back—

The CHAIRMAN. I understand that. Should public policy try to force that, to incentivize it? What should we do about it other than say it is a good thing?

Mr. SANDERS. I would actually include it as a requirement for financial institutions, yes.

The CHAIRMAN. Thank you. That is important, and that is in the private market.

A query here on the other thing, securitization. I wasn't sure if—you said the 5 percent is a good start, but then you said a private security market should be buyer-beware, so skin in the game would be pointless. I'm not sure I fully understand what your recommendation is with regard to securitization.

Mr. SANDERS. Yes, there are two sides to it. First of all, "skin in the game," which I have discussed with some people sitting at this table, is good in theory. On the other hand, on the securitization market, particularly the private label, I disagree with some of the characterizations that everyone was misled by it. I think in many cases, we have so many information systems and databases out there that investors in the market knew full well what was going on. So again, I'm not sure that would make that much difference.

The CHAIRMAN. Would you be for it or against it? If it doesn't make a difference, does it do any harm?

Mr. SANDERS. To have 5 percent down?

The CHAIRMAN. Correct—no, not down. Securitization on the lender now. Downpayment is on the borrower. I was assuming we were talking about a 5 percent requirement on the seller of the loan, who was the originator.

Mr. SANDERS. And again, Chairman Frank, that is a two-sided issue. We could ask for 20 percent. Then we would end up drying up—

The CHAIRMAN. I'm just asking for your recommendation. I don't mean to be intrusive, but you did come here as a witness.

Mr. SANDERS. You are—

The CHAIRMAN. What would your recommendation be?

Mr. SANDERS. 5 percent.

The CHAIRMAN. On the lender?

Mr. SANDERS. On the lender.

The CHAIRMAN. And 10 to 20 percent on the borrower. That is perfectly reasonable.

The gentlewoman from West Virginia.

Mrs. CAPITO. Thank you, Mr. Chairman.

Mr. Berman, from the Mortgage Bankers Association, correct?

Mr. BERMAN. Yes.

Mrs. CAPITO. You talk a lot about how MBA has suggested a framework for single and multifamily mortgage markets. The centerpiece would be for the Federal Government to support the secondary mortgage market through a new line of mortgage-backed securities. Do you think it is possible to have a fully functioning private secondary market without government support? This sort of is a theme I have heard from others as well, but what is your opinion on that?

Mr. BERMAN. The issue really is, how do we survive in terms of creating a liquid market through downturns? And it is the position of the MBA and the practitioners that were part of this council that

the depth of the market is not sufficient without this government wrap, Ginnie Mae-type wrap, in times of illiquidity such as we have today. And we have these 100-year floods about every 10 years, so this is not an uncommon event.

Mrs. CAPITO. Does anybody else have an opinion on that? Yes, Mr. Calabria?

Mr. CALABRIA. I would make two quick points. We largely actually had a private label securitization market in the 1920's, and granted we had a big housing bubble then too, so that is not a way to get out of it. But I would note that if we are going to accept the role of the Federal Reserve as a backer of asset markets in terms of the mess like we had with the asset-backed facilities in the—you could certainly have the Fed be the lender of last resort and buy mortgage-backed securities when you are hit with your 20-year flood. So if you are going to keep that, that is there, and we should recognize that is part of it.

Mrs. CAPITO. Mr. Malta?

Mr. MALTA. Yes, thank you. We couldn't get around the issue. When we first looked at this, we were hoping that the private sector could pick up what was needed in the marketplace. And as evidenced by the last 18 months, we have seen that the private side does not perform or does not provide the needed capital when the markets are as stressed as we have been experiencing. If it had not been for Fannie and Freddie and the FHA, where would this market have been if we had just relied on the private sector?

Ms. WARTELL. Yes, I think there are two different roles that we ought to be distinguishing here. The first is, what do you do when there is stress in the market, and when private capital loses confidence in housing? I hope we will not see ourselves back in the circumstance we are in now, but you do need a backstop.

The second is a different role, which is really to deal with the mismatch in durations, and Mark mentioned this in his policy, although I think we probably come to a different place on this—30-year, fixed-rate financing allows people to have a predictable level of their own expenses devoted to housing. It allows middle-class families to plan for their own financial futures. Investors are rarely willing to commit dollars for that period of time, and that mismatch is what the Federal intervention or some other mechanism is designed to provide. And it is that—if we want to have long-term, fixed-rate financing available, that seems to be where we ought to focus a Federal backstop.

Ms. BOWDLER. I just wanted to add that having a government provide some liquidity through whatever form is also very important for areas where the private market doesn't find the borrower attractive, and they don't find all borrowers equally and universally attractive. So rural areas, urban cores, moderate-income families don't always have access and may not get it if it isn't for some form of government intervention.

Mr. BERMAN. I would also just like to add that the MBA proposal is designed to continue to have the mortgage credit guarantor entities to have 100 percent skin in the game, if you will, throughout all the market variations. So in what we have proposed, we have this consistent alignment of interest. And again, the government

wrap is really to encourage bond holders to come into the market at those times.

Again, the emphasis we have is on private sector. We want to get private—we really don't want the Fed to come in if we can avoid that. We want to encourage private investors to come in, and we think that government guarantee of credit will enhance that probability through the downturns.

Mrs. CAPITO. Thank you.

The CHAIRMAN. The gentleman from North Carolina.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

We have looked a lot in this committee at how to revive bank lending, but securitization was roughly half of all lending before the financial crisis or before the foreclosure crisis really set in. And I understand that with respect to issues of stock, there are fairly elaborate rules for standardized disclosures, periods of time, waiting periods so that potential investors can do due diligence, they can take their own look at what they are getting, and that the standards or the rules for issuing mortgage-backed securities or any securitization—any securitized debts, but mortgage-backed securities in particular, were just starkly different.

Instead of having a period that investors could—instead of having standardized disclosures and allowing investors to sample the mortgages in the pool, it usually was the case that investors got a call saying, "We are going to market in 3 hours, are you in?" And not surprisingly, one of the reasons the securitization market has not bounced back, I understand, is that investors are leery of going back to that. They would like to know a little bit more about what they are buying. But the securitization industry has resisted greater disclosure.

Mr. Calabria, I am always surprised when a witness from the Cato Institute says something I agree with, but when you called for the requirements of the 1933 and 1934 Securities Acts to apply to GSEs, is that what you were calling for, and would you extend that call to private label securitizers as well?

Mr. CALABRIA. I would, and I would extend that as well to the Federal Home Loan Banks. I think it is very important that if we have the security disclosures, you have to get that with the MBS, and I think that is an important part of it.

I want to touch on something very related that Sarah mentioned, which is the credit rating agencies, and I think we need to go very far in forcing regulators and the market to do due diligence. We do need to end that quasi-monopoly status that the rating agencies have, but I would focus on that as a part of it. So yes, the 1933 and 1934 Acts, or whatever is coming forward in the future.

Mr. MILLER OF NORTH CAROLINA. I have never seen so many heads nodding from what is largely an industry panel to questions that I have had in this committee before.

Any other thoughts on this issue? And do you think that the SEC has the statutory authority now to issue rules to require this?

Mr. CALABRIA. Currently, under Freddie's and Fannie's charters and the Federal Home Loan Banks, they are exempt. I know that the recent reform act put them under the 1934 Act. They are still exempt from the 1933 Act. So that would take a change. And as I mentioned in my testimony, there are a variety of pieces through-

out Federal law where they are treated as "government securities." That would need to be changed.

Mr. MILLER OF NORTH CAROLINA. How about all the private label—well, there are perhaps not so many anymore, but we obviously want to return to the day when there are, but with better standards.

Mr. CALABRIA. Most of the private label was subject to the 1933 Act. They had gone through shelf registrations, and certainly I think it merits re-evaluating the shelf registration process to see whether that provided sufficient information to investors.

Mr. MILLER OF NORTH CAROLINA. Mr. Berman?

Mr. BERMAN. I think there are a number of issues here. One is transparency, which clearly is something that the Mortgage Bankers Association is in favor of. But it is not just transparency with respect to the entities or the securities, it is also transparency with respect to the rating agencies, and clearly the only reason that investors at the time were willing to make such quick decisions was their reliance on the ratings. I think it is important for the SEC to take a close look at how the rating agencies function, the transparency of their models, the transparency of their ratings. Restoring confidence is what it is all about, and without confidence in the rating agencies, we have a long way to go.

Mr. MILLER OF NORTH CAROLINA. Ms. Wartell—

Ms. WARTELL. Sure, go ahead.

Mr. MILLER OF NORTH CAROLINA. I'm kind of accustomed to having the Center for American Progress agree with me, but go ahead.

Ms. WARTELL. The only thing, I just wanted to emphasize your point, which is that our ability to attract private capital back into these markets will depend upon us giving markets confidence in the quality of private label securities. So the idea of looking at these proposals for comparability, whatever the government-backed market and the private market, really need to have rules that are consistent.

Mr. MILLER OF NORTH CAROLINA. I yield back, Mr. Chairman.

The CHAIRMAN. Let me use your remaining time briefly just to say, with regard to the rating agencies, I would like to make them better. Some of us are skeptical. And one thing I think was very important that Mr. Garrett and I collaborated on was to repeal all the statutory requirements that people rely on the rating agencies, because if we can't make them better, we can at least tell people, you are on your own, and don't hide behind them, and I think that was a very important, simple thing.

Further, I guess I would say to Mr. Calabria—and it is nice that we have had this agreement—do I take it from what you said that if Cato had been in existence 70 years ago, it would have supported the 1933 and 1934 Acts?

Mr. CALABRIA. I'm not certain that we would have. I would say that I think those standards need to be applied uniformly if you are going to have them.

The CHAIRMAN. If you are going to have them. Thank you.

Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman.

I appreciate the testimony of all the panelists. Frankly, it was helpful. It was illuminating. Particularly, Mr. Berman, and Mr.

Malta, on behalf of your respective organizations, I applaud you for, frankly, bringing a plan to the table, something the Administration hasn't done. Mr. Berman, I found your plan particularly interesting and comprehensive. I want to study it a little more. I still don't agree with it all. Mr. Malta, you have a thoughtful plan. I agree with it less, but it is a thoughtful plan nonetheless, and you should be applauded for bringing one to the table.

I believe we have to have a plan. The status quo is simply unsustainable, and I'm disappointed in the Administration for really maintaining the status quo. And I believe, Mr. Sanders, you pointed out that the exposure of the taxpayer to Fannie and Freddie after the Secretary of Treasury earlier today told us that it is not sovereign debt, but we are going to stand behind every penny of it—that is a paraphrase, not a quote—not sure how—I guess that was particularly illuminating. But when you think about the debt being at roughly $8 trillion and Fannie and Freddie exposure of roughly $8 trillion, it is really a staggering amount.

I also picked up this Bloomberg report that the gentleman from New Jersey alluded to earlier which stated, "The bond market is saying that it is safer to lend to Warren Buffett than Barack Obama. Two year notes sold by the billionaire's Berkshire Hathaway in February yield 3.5 basis points less than Treasuries of similar maturity according to data compiled by Bloomberg." And we know already that Moody's is threatening to lower our AAA rating. I find all of this quite staggering myself, and so again, to have the Administration proffer no plan I believe is simply inexcusable.

The first question I would like to ask the panel—I have been trying to study other housing markets, because I personally would like to see a GSE future for America. I haven't convinced myself—although I have come to this debate with an open mind, it is not an empty mind. But as I look around, I see countries like Ireland, the U.K., and Portugal that seem to have no GSEs, a high rate of homeownership to our own. Denmark, no GSEs, and although they have had a housing bubble themselves, there has been no surge in delinquencies and foreclosures. Certainly, there have been some.

I forget who it was—maybe it was you, Mr. Sanders, or maybe it was you, Mr. Calabria, who commented upon the Canadian system, which also has no GSEs, and frankly has a higher rate of homeownership there. Some of them use covered bonds. I do believe Canada has an FHA-like structure. I believe in Canada, you said that mortgages are fully recourse. I think there is a larger downpayment. I don't know if that is simply due to market forces or the government. I don't know the answer to that.

So the question for those of you who believe that ultimately we must have some form of GSE, which I believe includes you, Mr. Malta—am I missing something in these international examples? I'm sorry, I was calling to you, Mr. Malta. I thought you advocated we needed some, essentially, government-backing to our securitization market. I don't see that overseas, and so am I missing something?

Mr. MALTA. The United States and Denmark are the only two countries that have the 30-year, fixed-rate mortgage. And you look at Canada, for instance, their mortgages reset every 5 years.

Mr. HENSARLING. So you would advocate, then, that these are needed—you do not believe ultimately that the market would produce a 30-year, fixed-rate mortgage, and you believe in order to achieve your goal in homeownership that we would have to see the 30-year, fixed-rate mortgage, is that what you are advocating?

Mr. MALTA. That is correct. I think market incentives would say that we would have something less than the 30-year, fixed-rate or 15-year, fixed-rate mortgages. It would reset.

Mr. HENSARLING. I don't know—listen, I respect the opinion. You may or may not be right. I don't know the answer to that. I know that I have certainly seen a study from the Federal Reserve that says that ultimately at the end of the day, Fannie and Freddie provided 7 basis points advantage for homeowners given that the taxpayer is already out $125 billion, given that they are on the tab for much more, particularly trillions. It just reminds me—and I just think the American dream is not to buy a home, the American dream is to keep a home. And I'm not sure for 7 basis points increase in the interest rate that it was worth all the human misery, all the foreclosures. So I'm not completely sure that achieved our goal.

Mr. Calabria?

The CHAIRMAN. Quickly.

Mr. CALABRIA. The median life of a mortgage tends to be about 7 years. Few people live in their house for 30 years or keep that, so even a mortgage that has a 5-year, fixed-rate mortgage and resets like in Canada covers most of that risk. I do think the reason we would still see—and I touch on this in my testimony—30-year mortgages out there—if they weren't subsidized, we would just see the spread between adjustable and then higher, and maybe that is appropriate, that it reflects the full price of it.

The CHAIRMAN. Thank you. Having lived in this House for 30 years, I don't find that I'm getting to be able to pay anything off.

[laughter]

The CHAIRMAN. The gentleman from New Jersey.

Mr. LANCE. Thank you, Mr. Chairman.

Mr. Calabria, your testimony suggests breaking up the GSEs, as I understand it, into about a dozen equal-sized entities. Could you explain in a little more detail how that would work?

Mr. CALABRIA. Sure. You could go—and I will preface—my back of the envelope is certainly that comes with a cost, and I think mortgage rates would probably go up about 6 or 7 basis points if we reduce—

Mr. LANCE. How much would they go up, in your opinion? Six or seven—

Mr. CALABRIA. Basis points.

Mr. LANCE. Six or seven basis points.

Mr. CALABRIA. If we reduce the scale of the GSEs. There is certainly a cost to that. So what I would do is I would randomly take one every other 12th loan and the—and I think you need to set up a good bank, bad bank model. Take the bad loans, take the good loans, just randomly set them up in 12 different spots. The things I would avoid to do is I would not—

Mr. LANCE. Not geographic, I trust?

Mr. CALABRIA. Not geographic. I would not reproduce that part of the Federal Home Loan Bank System, nor would I make them cooperatively owned or jointly—I would make them just 12 independent entities.

As I touch on in my testimony, I think you need to allow the charters to be issued by the regulator, and if this is a model that works, and other entities want to come in and charter in that model, they should be allowed to. I would just as well say if this is a model that doesn't work, those entities should be able to apply their charters, go the OCC, and try to get a bank charter.

So I think it is important to let the number of these entities grow and let the market determine that. But I would emphasize if you only have two or three, the market is going to look at these as "too-big-to-fail" regardless of what we say.

Mr. LANCE. And then how would you wind down the current GSEs?

Mr. CALABRIA. Well, as I mentioned, I would set up a good bank/bad bank situation, which I will note the current receivership structure in the bill that was passed in 2008 allows the separation into a good bank/bad bank. So I would say you just have to set that up like a modern day RTC that resolves those bad assets.

Certainly, you want to ask a broader question, which is do we want to set up something like the REFCORP bonds where the Federal Home Loan Bank pays us back for some of the costs of the savings and loan crisis, whether in the future or these new entities pay us back for some of the losses from Freddie and Fannie. But all of that can be structured very similarly to what was set up with the Federal Home Loan Banks.

Mr. LANCE. Thank you. Is there anyone else on the panel who would like to comment on that proposal? Yes?

Mr. BERMAN. Yes, Congressman. The MBA proposal would agree with what Mr. Calabria said with respect to good bank/bad bank resolution of Fannie and Freddie in order to help leverage the important good assets that we have there, not just the physical assets, but the intangibles.

I think that the transition—and we have all agreed, I think, that transition is critical—might take a long time to get to 12. And again, I'm not suggesting that 12 is a good number or a bad number. But our thought is that creating two at the beginning is probably an easier way to a smooth transition. We have databases, origination systems, underwriting systems, and so on—

Mr. LANCE. Wouldn't that be "too-big-to-fail" if there were only two?

Mr. BERMAN. Well, again, two wouldn't be the end game, but I'm speaking about the transition. I think it would be very hard to wave a wand and create—

Mr. LANCE. And how long would you presume the transition should be?

Mr. BERMAN. I think that would be market determinative, which I agree with Mr. Calabria. It would—and up to the regulator to charter those. So we agree on those pieces.

Mr. LANCE. Thank you. Mr. Sanders, in your proposal regarding a covered bond approach, some have said that covered bonds are simply another complex financial instrument. Do you think we

should be cautious in facilitating the creation of such a market in the United States?

Mr. SANDERS. The answer to that is, of course, we would probably do it on a trial basis to begin with. But no, actually I think they are much more straightforward and clear cut. The banks make loans, they keep them on their balance sheet. If you have transparency, you have bondholders that will be receiving the cash flows from it. I think it is so straightforward it is shocking, and there is actually—as long as there is transparency, let me make that clear.

Mr. LANCE. And how would you assure transparency?

Mr. SANDERS. Again, you can write in what the average LTV interest rate, maturity of the mortgages are. Whatever product you are doing, making sure they are verifiable, that it is what the actual collateral looks like.

Mr. LANCE. Thank you. And to continue, Professor Sanders, how would you manage the GSEs retained portfolios?

Mr. SANDERS. What I recommend in my report was, at this point, wind them down as soon as possible, which in this market is a little more cumbersome than normal. But I would start with having three tiers of loans.

I would start off with the bad performing loans—not like a bad bank, but split them off into a securitization structure where we throw them out there and say, here is some risky paper, what are the bids on it? I would have a second tier, and the second tier would be all the loans that Fannie and Freddie probably shouldn't have purchased, such as the Alt-A mortgages, some subprime paper, bundle those as a second tier. And then the ones we can keep a little longer are the conforming loan pools, the way we used to do it a long time ago. That would be less—

The CHAIRMAN. The gentleman's time has expired.

Mr. LANCE. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from California.

Mr. ROYCE. Yes, I was going to ask Mr. Calabria a question. You were on the Senate Banking Committee at the time. Some of these issues that came up over the GSEs, Fannie and Freddie, and those were really the boom years when you were over there, in housing. And I would just ask you a question on the logic of what would have happened had the Fed come in and cracked down on Alt-A loans and subprime loans. How would that have been received on the Senate side? You had a chance to interact there with Members, and some of them, like Chris Dodd, weren't exactly in favor of clamping down on Fannie and Freddie, especially with respect to affordable housing. What do you think the reaction would have been in the Senate?

Mr. CALABRIA. I think there sure would have been some skepticism. I would certainly say one of the things that I think was constantly heard in efforts to reform Freddie and Fannie was that the housing market was carrying the economy, which it was. Certainly, the housing market was a very large part of the economy in 2004, and we certainly heard common refrain that we should not do anything to take the air out of the housing market.

I think, in my mind, it opens up a broader question, which is—and Sarah has said this, other people have said this—we need to

kind of make our mortgage finance system countercyclical, and part of that is a very real problem, which is we all love bubbles when they are going on. So how do you set up an incentive system that leans against that when the pressure is to keep a bubble going rather than to avoid the bubble in the first place?

Mr. ROYCE. Yes, I think a lot of this was viewed—I have my own view of this, but I think for a lot of members, they viewed this as a way to get people with less than perfect credit into a home. That is the way they were viewing the activity over there.

But since the failure of Fannie and Freddie, several former executives have explained that the GSEs entered into the subprime and Alt-A market to send a signal to the broader market, which was these were in fact safe loans. You and I might have considered them junk loans, but the perception or the intent was to send that signal, according to Fannie executives. I was going to ask you do you care to comment on this.

Mr. CALABRIA. It is important to start with two different distinctions, which is even on the loans that Freddie and Fannie bought directly as whole loans that I think most of us would say were subprime, they did have a variety of standards set to those. They did not apply those standards until very late in the game, after the bubble had already burst, to the mortgage-backed securities, the private label that they pushed—that they bought. So they had two different standards.

I think it is also important to look at—that if you look at the vintages of subprime loans that have performed the worst, which are 2005, 2006, 2007, that is the time when Freddie and Fannie entered the market in force and there were larger sources of liquidity for that market. So I think they were the marginal buyer during that time, and really ended up lowering the standards that we saw in the marketplace.

I would note that one of the things that I think would have been helpful if the second—I'm a little biased by saying it—but if the second Shelby bill with the portfolio restrictions had taken place, they would not have been able to buy those mortgage-backed securities that were subprime, and I think that is half the problem in terms of Freddie and Fannie's losses.

Mr. ROYCE. Thank you, and here is my last point. Both regulatory reform bills endorse the creation of a resolution process for failed or failing systemically important firms, and both bills label a group of institutions as "too-big-to-fail." They create a resolution fund and they draw a line from that fund to the U.S. Treasury. Is there an assumption here that creditors and counterparties will be on the receiving end of something more than what they would receive in the case of a liquidation process through bankruptcy?

In other words, are we recreating the moral hazard problem with Fannie and Freddie by allowing for the possibility that creditors and counterparties will be bailed out by the Federal Government? Because I think regardless of whether it comes from the industry or the taxpayer, there will be a breakdown in market discipline, and that is the fatal flaw in this approach. That is what has to change, or else we will repeat another mistake made in the Fannie and Freddie debacle.

Mr. CALABRIA. And I think it is very important to emphasize the market discipline role on the part of creditors. Any financial institution, it is 90 plus percent of their funding—is from the debt markets. For Fannie and Freddie, it was essentially 99 percent of their funding on a mark-to-market basis. So the market discipline has to come from creditors, and I do believe as long as there is a fund there, there will be a perception by creditors that they will be bailed out, and I think that is problematic.

I think you also have to look at what sort of discretion that the regulator has. For instance, in the most recent Senate bill—and I remember we spent lots of time on the Hill arguing about "may" versus "shall." It says the FDIC "may," so I do think you need to set some certainly so that the marketplace knows they will be—

Mr. ROYCE. Thank you, Mr. Calabria.

The CHAIRMAN. The witnesses are thanked, and the hearing is adjourned.

[Whereupon, at 1:40 p.m., the hearing was adjourned.]

A P P E N D I X

March 23, 2010

OPENING STATEMENT OF CONGRESSMAN PAUL E. KANJORSKI

COMMITTEE ON FINANCIAL SERVICES

HEARING ON THE FUTURE OF HOUSING FINANCE:
WHAT SHOULD THE NEW SYSTEM BE ABLE TO DO?

MARCH 23, 2010

Mr. Chairman, last June the Capital Markets Subcommittee held the first hearing on housing finance in the 111th Congress to examine the present status and future structure of Fannie Mae and Freddie Mac. Today we continue with what will undoubtedly be a long-term negotiation about the prospective configuration of our nation's housing finance system.

As a result of considerable stress in our economy and because of a need to maintain access to affordable mortgages, then-Secretary Paulson placed Fannie Mae and Freddie Mac under conservatorship in late 2008. Since then, the Treasury Department has committed to purchase more than $125 billion in preferred stock of the enterprises. Government agencies have also purchased in excess of $1.3 trillion in mortgage-backed securities. Together, these actions and others have helped to keep housing credit available for America's middle class and prevented a complete collapse of our housing markets.

Lawmakers also must now begin to grapple with what type of housing finance system we should construct for the future. In this regard, we have no shortage of ideas. While we must give thoughtful consideration to each of these proposals, we must keep in mind the importance of why we created housing government-sponsored enterprises in the first place -- to increase liquidity and improve the distribution of capital available for home mortgages. My goals in these debates are to establish a more stable, long-term funding source to help average Americans buy a home; limit taxpayer risk through strong regulation; and ensure that the housing finance system continues to support community bank and credit union lending.

The task before us is not all that different from the one that engineers and policymakers faced in preparing for the Big Dig, the enormous construction project that significantly restructured how traffic flows through downtown Boston. We must figure out what pieces of the old housing finance system worked and keep them. We also need to determine what parts of the infrastructure we need to eliminate. In order to ensure access to affordable mortgages in the interim, we must additionally work to keep capital moving through the financial pipelines during our legislative debates. Finally, we must figure out how to pay for this enormous undertaking.

As we kickoff this year's deliberations, the Treasury Secretary has joined us. In the near future, we will also hear from the Secretary of Housing and Urban Development. After the completion of these initial proceedings by the full committee, the Capital Markets Subcommittee will renew its examinations of these matters by exploring more detailed and technical questions related to the government-sponsored enterprises and our nation's housing finance system.

In sum, Mr. Chairman, I appreciate your efforts in convening this hearing. As we receive testimony regarding what functions a new housing finance system should be able to perform, we also have to work to do no harm to those parts of the housing finance system that have worked well and protect taxpayers from future losses. I look forward to a fruitful set of discussions.

Statement of Michael D. Berman, CMB

Chairman-Elect,
Mortgage Bankers Association

Before the

Committee on Financial Services

United States House of Representatives

Hearing on

"Housing Finance –
What Should the New System Be Able to Do?:
Part I – Government and Stakeholder Perspectives"

March 23, 2010

Chairman Frank, Ranking Member Bachus, thank you for inviting the Mortgage Bankers Association[1] to testify on the very important issue of the present and future status of the secondary mortgage market. My name is Michael D. Berman, CMB, and I am the Chairman-Elect of MBA. I have been in the real estate finance industry for over 25 years, and I am a founder and principle of CW Financial Services and the President and Chief Executive Officer of CWCapital. Headquartered in Needham, Massachusetts, CW is a national lender to the multifamily and commercial real estate industry, with over 340 employees in 13 offices throughout the United States. My responsibilities include overseeing the strategic planning and operations for all of the company's loan programs, including multifamily programs with Fannie Mae, Freddie Mac and the Federal Housing Administration (FHA). Also, CW has been active in the commercial mortgage-backed securities arena as an investor, lender, issuer of securities, servicer and special servicer for over 22 percent of all commercial mortgage-backed securities (CMBS) in the United States.

In the midst of the turmoil in the housing finance system, MBA advocated a three-step approach to government relief efforts. The key elements of this approach were a) stabilize the markets, b) assist homeowners facing difficulties with their mortgages, and c) prevent a recurrence of the problems that created the current crisis. Congress and the Administration have made great strides in all of these areas. Federal Reserve actions, the Troubled Asset Relief Program (TARP) program and federal support for Fannie Mae and Freddie Mac have brought a level of stability to a system that was in dire need of it. Programs like the Home Affordable Modification Program (HAMP), while unable to help all borrowers in all situations, have assisted many who otherwise would have had to surrender their homes. And regulatory reform and other legislation being discussed by this Committee and others can, if properly structured, provide key safeguards to reduce the chances that the country will face another credit crisis like that of the past two years.

As a result of these and other efforts, signs of recovery are appearing.

But the current dynamic in the secondary mortgage market is unsustainable. We cannot press reverse, and we cannot stay stagnant. Our only choice is to move

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[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,400 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

forward. Congressional action on the GSEs is needed to attract private capital back to the market and to re-establish a self-sustaining mortgage finance system. MBA has specific recommendations for a framework to ensure housing finance liquidity.

I have the privilege of chairing MBA's "Council on Ensuring Mortgage Liquidity." This 23-member council is made up of industry practitioners from the single-family, multifamily and commercial sides of the industry. It includes depository institutions, mortgage banking firms, mortgage insurers and others.

During a House Financial Services Subcommittee hearing, chaired by Congressman Paul Kanjorski last June, I testified that MBA had been considering various approaches to ensuring the long-term viability of the secondary mortgage market. Specifically, the Council on Ensuring Mortgage Liquidity had been evaluating what a functioning market should look like for the long-term.

At that hearing I spoke of the guiding principles the Council had developed to serve as a tool for evaluating proposals that may arise for restructuring the secondary market. Shortly after that hearing, MBA and the Council released a set of concrete recommendations for the future government role in the secondary mortgage market.

Before describing the specific recommendations, I will highlight some of their most important characteristics.

First, the recommendations are based on a key set of principles. MBA's Council on Ensuring Mortgage Liquidity has been examining these issues for more than a year and a half. The group took a deliberate approach to developing its recommendations, building from a set of key considerations to principles to the recommendations themselves. I believe the thoughtful approach is in evidence in the recommendations.

Second, the recommendations are grounded in pragmatism. They were developed by a council of industry practitioners who understand the capital markets and have perspective on what will and will not work. At this juncture, we cannot afford to pursue unworkable plans that do not take account of market realities.

Third, MBA's proposal is distinct in its focus on ensuring an efficient secondary mortgage market, its reliance on private capital and its insistence on multiple layers of protections for taxpayers. Keeping all three of these goals in mind is imperative.

MBA'S GUIDING PRINCIPLES

As I noted, before MBA developed its recommendations, it developed a set of principles by which a variety of proposals could be assessed. The full set of principles is attached to this testimony, but let me characterize a number of them in three general points.

First, secondary mortgage market transactions should be funded with private capital.

Second, in order to promote uninterrupted market liquidity for the core of the mortgage market, the government should provide an explicit credit guarantee on a class of mortgage-backed securities. This guarantee should be paid for through risk-based fees.

Third, taxpayers and the system itself should be protected through limits on the mortgage products covered, limitations on the types of activities undertaken, strong risk-based capital requirements, and actuarially fair payments into a federal insurance fund.

A key conclusion of this is that the government's guarantee should be at the security-level, not the enterprise-level. The existing system extended an implied federal backing to all the activities of Fannie Mae and Freddie Mac, including not only their mortgage guarantees, but also their portfolio investments, derivative counterparties and corporate bondholders. Some of those activities were clearly undercapitalized, underpriced and under-supervised. As you will hear, in our proposal the degree of federal backing would be greatly reduced, making explicit what is guaranteed and what is not, and establishing mechanisms to properly capitalize, price and supervise those activities.

MBA'S RECOMMENDED MODEL

Since I testified last June, the MBA and its Council have released a suggested framework for the government's involvement in the single-family and multifamily secondary mortgage markets. I will briefly describe some of the key elements in my testimony. I have attached the full recommendations for further reference. While clearly not the only potential framework for the future, the Council's recommendations represent a clear, concise and workable approach to ensuring liquidity to the mortgage market.

The centerpiece of MBA's recommendation for federal support for the secondary mortgage market is a new line of mortgage-backed securities. Each security would have two components: a) a security-level, federal government-guaranteed "wrap" (GG); which would in turn be backed by b) private, loan-level guarantees

from privately owned, government-chartered and regulated mortgage credit-guarantor entities (MCGEs). The government guarantee would be conceptually similar to that provided by Ginnie Mae by guaranteeing timely interest and principal payments to bondholders and explicitly carrying the full faith and credit of the U.S. government. These guarantees would be supported by a federal insurance fund, capitalized by risk-based fees charged on the supported securities. This government wrap will help provide affordable financing rates, as could risk-based fees. In supporting their own loan-level guarantees, the MCGEs would rely on their own capital base as well as risk-retention from originators, issuers and other secondary market entities such as mortgage insurers. Investors in the guaranteed mortgage-backed securities would face no credit risk, but would take on the interest-rate risk from the underlying mortgages.

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

MBA's proposal combines an acknowledgement that only a government guarantee can attract the depth and breadth of capital necessary for sustainable market liquidity through all economic cycles, with a reliance on private capital, insistence on multiple layers of protections for taxpayers and a focus on ensuring a competitive, efficient secondary mortgage market.

IMPORTANCE OF THE TRANSITION

Another key feature of MBA's position on the future of the GSEs is more operational than structural, but it is equally important. Any restructuring proposal must include consideration of, and measures to facilitate, the transition from the current to the future state. This is imperative because the market's condition is still quite fragile and even the most carefully deliberated plan could destabilize the market further if implemented hastily.

MBA recognizes the need for GSE reform. Further, we recognize the need to keep the market functioning through any transition and to minimize the costs of the clean-up of the GSEs. We believe that there are measures that can be undertaken now to begin moving these companies in the right direction on a number of fronts. For example:

- During the boom, the GSEs, along with all other players in the industry, took on too much credit risk. As a result of the crisis, credit underwriting has become more conservative across the industry, including at the

GSEs. Regulators can look to these tighter standards to gain important lessons with regard to defining "core products" for the market going forward. Now is the time to focus the GSEs on a narrower range of mortgage products, fully documented loans, and underwritten using conservative ratios. This core of the market is what needs to be protected throughout the country at all times.

- Many of the GSEs' unnecessary risks stemmed from their portfolio holdings. As originally proposed by former Treasury Secretary Henry Paulson, and as recently reiterated by Federal Housing Finance Agency (FHFA) Director Edward DeMarco, it is important to affirm plans to wind down the GSEs' portfolios to a *de minimis* level. FHFA should direct that effort, being cognizant of market conditions, and the supporting role that the portfolios could play in the near term.

- Clearly defining the path to a new role for the GSEs will have several benefits. Most importantly, we recognize that the GSEs have built valuable infrastructures, relationships, and intellectual capital that the industry needs to retain. Ideally, we would envision the use of a good bank/bad bank strategy to retain the best people, processes, and infrastructure from the GSEs as we move to the new MCGE framework. Identifying and laying out a clear path forward will remove much of the current uncertainty, and ensure that the GSEs' structural, operational and human resources remain of service in some form for the present and the future. MBA is closely studying issues related to the transition, and I would welcome the opportunity to come back and brief you on our work.

OTHER HOUSING FINANCE SYSTEM COMPONENTS

Any model contemplating the roles currently played by Fannie Mae and Freddie Mac must also contemplate how those roles integrate with other public and private components of the housing finance system.

The MCGE framework is not intended to be the entire market. It is meant to focus on a narrowly defined set of core mortgage products that should be available in all market conditions.

Private investors, whether through whole loans, private label securitization, covered bonds or some other means, are vital to a robust, sustainable secondary market. The MBA proposal recognizes this and supports a re-emergence of the private model. It is anticipated the private market will expand and contract with investor risk appetites.

MBA's recommended framework also complements existing government funding channels that provide direct support for affordable housing finance, such as FHA,

Ginnie Mae, the Veterans Administration (VA) and Rural Housing Service (RHS). Focusing government subsidies and other affordable housing programs through these channels minimizes market distortions and safety and soundness tensions that existed in the GSEs, while making government support more transparent, as befits such government expenditures. Additionally, as we note in our recommendations, the government guarantee entity could be an appropriate vehicle for an affordable housing fund.

OWNERSHIP OF THE GSEs' SUCCESSORS

In early discussions of the future of the GSEs, former Treasury Secretary Paulson, Federal Reserve Chairman Ben Bernanke and others laid out a spectrum of options for future models – ranging from a fully private mode, to a fully public model. It is important to note that these discussions focused less on what the successors to the GSEs should do, and more on how and by whom they should be owned.

MBA's deliberations focused on what they should do. As such, we have not delved deeply into the specific ownership structures. But in our discussions a few points became clear.

First, the fully private model would be unable to attract the depth and breadth of capital needed to fund the U.S. housing finance system through all market environments. At the end of the day, the U.S. government would still be expected to provide some level of backstop, for which it would have had no advance control, oversight or funding. We concluded this to be unacceptable.

Second, it will be important that any system utilize the private market, and its ability to assess, price and manage risk and efficiently operate within a known set of constraints. While we believe it is essential for a portion of the market to have a government guarantee to retain liquidity, it is also essential that private capital be at risk to ensure that lending is efficient, effective and responsive to market conditions. Additional concerns about capacity, funding, responsiveness and political distraction make it clear that a fully-government-based system would not be optimal.

Our conclusion is that any ownership system going forward must be able to attract private capital to serve as a buffer and reserve against losses. To do that, it must provide a competitive return on equity and debt capital. It must also ensure that those private investors shoulder the vast majority of risks.

CONCLUSION

I appreciate the opportunity to testify today and to present MBA's perspective. MBA's Council on Ensuring Mortgage Liquidity has been studying the issues

before this Committee for the past year and a half, but most of the members of the Council and the MBA have been working on them for our entire careers. Our deliberations on these topics continue. As we work on the economics of the business model for the MCGEs and the GG insurance fund, as well as a transition roadmap. I would welcome the opportunity to update you on our work.

In closing, I want to thank the Committee for holding this hearing. The topics before you are sometimes contentious, often complex, and always important. As the Committee continues its work, I would ask that you emphasize three more important concepts. First, recognize the importance of fixing the system. Second, emphasize getting it right. And last, minimize disruptions during the transition.

Thank you.

MBA's RECOMMENDATIONS FOR THE FUTURE GOVERNMENT ROLE

IN THE CORE SECONDARY MORTGAGE MARKET

INTRODUCTION

Since the creation of Fannie Mae in the 1930s, the federal government has played a key role in providing stability to the secondary mortgage market. The current housing crisis has tested the government's role and led to calls for a fundamental rethinking of how the government plays its part.

To provide information and insights to this rethinking, in October, 2008 the Mortgage Bankers Association (MBA) established the Council on Ensuring Mortgage Liquidity. The Council's mission has been to look beyond the current crisis, to what a functioning secondary mortgage market should like for the long term.

On November 19, 2008, the Council hosted a summit on the future of the secondary mortgage market and the GSEs that brought together leading thinkers from industry, academia and regulators to discuss what fundamental elements would be required for a functioning secondary market. The discussion led to the Council-issued report *Key Considerations for the Future of the Secondary Mortgage Market and the Government Sponsored Enterprises (GSEs),* which was released in January, 2009.

The Council's second task was to develop a set of guiding principles embodying the key considerations mentioned in the primer. The report *Principles for Ensuring Mortgage Liquidity* was released by the Council on March 19, 2009. The principles serve as a tool for evaluating proposals that arise for restructuring the secondary market.

As the policy spotlight has turned to the futures of Fannie Mae and Freddie Mac, the Council has taken on the questions of what an appropriate future government role in the core secondary mortgage market might look like. After thoughtful discussions and deliberations, we now present the Council's *Recommendations for the Future Government Role in the Core Secondary Mortgage Market.*

This report presents the Council's suggested framework for government involvement in the single-family and multifamily secondary mortgage markets, with a particular focus on the roles currently played by Fannie Mae and Freddie Mac. While clearly not the only potential framework for the future, the Council's recommendations represent a clear, concise and workable approach to ensuring liquidity to the mortgage market. The proposed framework carefully balances the government's ability to ensure liquidity with the need to protect taxpayers from credit and interest rate risks associated with mortgage finance. This and the other Council reports can be found at: www.mortgagebankers.org/CEML.

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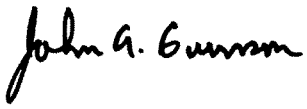
In the coming months, MBA and the Council will continue to study the critical issues related to the future of the secondary mortgage market, and will continue to provide information and insights to regulators, legislators and others involved in the policymaking process. We want to thank the members of the Council for their valuable service, and for helping define a workable model for the future government role in the secondary mortgage market.



John Courson
President and Chief Executive Officer
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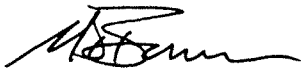

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1. OVERVIEW

The importance of housing in the economic and social fabric of the United States warrants a federal government role in promoting liquidity and stability in the market for mortgage debt. The size and scope of the U.S. housing market mean that, except in times of extreme duress, the federal government's role should be to promote liquidity for investor purchases of mortgage-backed securities, not to attempt to provide the capital for or absorb the risks itself.[1]

As a necessary component of this provision of liquidity and stability, a security-level credit guarantee backstop will be needed for the core mortgage market,[2] which should rely on security-level risk-based premiums paid into a federal insurance fund and loan-level guarantees provided by a small number of privately-owned, government-chartered and regulated mortgage credit-guarantor entities (MCGE). The government backstop should be explicit and should be focused on the credit risk and market liquidity of mortgage-related products, not any interest rate risk. The loan-level MCGE guarantee should be such that it absorbs all mortgage-related credit losses and that the federal insurance fund is called upon only in situations of extreme distress.

The centerpiece of federal support for the secondary mortgage market should be a new line of mortgage-backed securities. Each security would have two components: a) a security-level, federal government-guaranteed "wrap" (GG) like that on a GNMA security; which would in turn be backed by b) private, loan-level guarantees from privately owned, government-chartered and regulated mortgage credit-guarantor entities (MCGEs). The GG would be conceptually similar to the Ginnie Mae model and would guarantee timely interest and principal payments to bondholders, would explicitly carry the full faith and credit of the U.S. government and would be supported by a federal insurance fund, fueled by risk-based fees charged for the securities at issuance and on an ongoing basis. The MCGEs would in turn rely on their own capital base as well as risk-retention from originators, issuers and other secondary market entities such as mortgage insurers. Through these programs, the credit risk of the underlying mortgages would be removed from the securities issued, while the interest rate risk would remain with the security investor.

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2. MORTGAGE CREDIT-GUARANTOR ENTITIES (MCGE)

The MCGEs should be privately owned, mono-line institutions focused solely on the mortgage credit guarantee and securitization business. This business encompasses both single-family and multifamily residential mortgages. The loan-level MCGE guarantee would be backed by private capital held by the MCGEs which would be overseen by a strong regulator. The MCGEs would be required to manage their credit risk by using risk-based pricing, originator retention of risk (such as reps and warrants backed by sufficient capital to support them), private mortgage insurance (PMI) and risk transfer mechanisms including other risk-sharing arrangements, to ensure that there is a strong capital buffer before the GG and insurance fund would come into play. Loans would not be included in a GG security unless they were guaranteed by a MCGE.

In most cases the MCGEs would own the loans underlying the GG securities they issue, and in the event of foreclosure could own the real estate collateral.

The MCGEs would have standard corporate powers to raise debt and equity. Other than access to the related GG security they could issue, none of the corporate debt or equity the MCGEs issue would be guaranteed, either explicitly or implicitly, by the federal government. The corporate capital levels of the MCGEs must be actuarially sound and the entities should report regularly to the satisfaction of the GG, Treasury and the MCGEs' regulator.

The number of MCGEs should be based on the goals of a) competition, b) strong and effective regulatory oversight, c) efficiency and scale, d) standardization, e) security volume and liquidity, f) ensuring no one MCGE becomes "too big to fail" and g) the transition from the current government sponsored entity (GSE) framework. Initially, the number of MCGEs should be either two or three. The regulator would have the ability to increase that number over time, through the granting of charters, as the market develops. The ownership of at least one of the MCGEs could be in a co-op form with mortgage lenders as shareholders. The governance structure of the MCGEs should adequately represent both the multifamily and single-family mortgage markets.

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Allowable Mortgage Products of the MCGEs

The federally related securitization guarantee should support only "core" mortgage products with well-understood, well-documented risk characteristics. The federally related securitization guarantee should generally support: a) "conventional" single-family mortgage products traditionally supported by the GSEs, including those currently eligible for TBA funding; and b) multifamily mortgage products that fit the GSEs' published underwriting guidelines, including affordable multifamily rental housing mortgage products. If CRA-related loans are included in the definition of core products, the MCGEs and GG should provide a transparent and liquid market into which lenders can deliver them on a pricing and risk-adjusted basis.

In defining the products covered by the new guarantees, industry participants, the MCGEs, the GG and federal regulators should carefully review current product definitions and classifications to ensure maximum market transparency, efficiency and liquidity. New products would be proposed by the MCGEs, recommended by the GG and would require approval from the regulator. Thus new product development would be measured, prudently regulated and conservatively responsive to market demands.

Portfolio Authority

The key mission of the MCGEs should be to guarantee and securitize mortgages through the program described. The MCGEs should therefore hold only a *de minimus* portfolio of mortgage assets.[3] The portfolios' purposes would be to support securitization by allowing the MCGEs to a) aggregate allowable mortgages for securitization, b) manage loss mitigation through foreclosure, modifications and other activities, c) incubate mortgages that may need seasoning prior to securitization, d) develop new mortgage products through a strictly limited level of research and development prior to the development of a full-fledged securitization market and e) fund highly structured multifamily mortgages that are not conducive to securitization.

Regulator

The MCGEs' regulator should be strong, empowered and adequately funded through the GG insurance premiums.[4] The regulation regime contemplated would be similar to that of a public utility, with the MCGEs earning a conservative return on equity. The regulator should have the power to adequately oversee the MCGEs, specifically with regard to products, pricing and capital adequacy.

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3. FEDERAL GOVERNMENT GUARANTEED "WRAP" (GG) SECURITIES

GG securities would carry a guarantee of timely interest and principal payment, would explicitly carry the full faith and credit of the U.S. government and would be supported by a federal insurance fund, fueled by risk-based fees charged for the securities at issuance and on an ongoing basis. Ginnie Mae could potentially take on the responsibilities of the GG.

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

The GG is not intended to support the entire mortgage market, but rather only those products needed to keep the secondary market for core mortgage products liquid and functioning through all environments. There would continue to be key roles for FHA, VA, RHS and Ginnie Mae as well as for the fully private market, particularly as such roles evolve in support of public or social housing policy goals and objectives. FHA, VA, RHS and Ginnie Mae would continue to play critical roles in providing government credit support for affordable housing, while the fully private market would provide finance vehicles for mortgages that fall outside of core product profiles. Mortgages made outside of a federally guaranteed framework would rely entirely on private capital and management of risks, in as much as such mortgages may exhibit risk characteristics that would not be well documented or well understood (and therefore would not be allowable products eligible for inclusion in GG securities).

The mission of any federally related mortgage securitization and guarantee program should be explicitly limited to ensuring liquidity in the core mortgage market through the issuance and guarantee of mortgage-backed securities.[5] This important mission should not be distorted by additional public or social housing policy goals. To the degree additional objectives are desired, they should be pursued through FHA, VA, RHS, Ginnie Mae and direct federal tax and spending programs, which should be adequately funded and supported to meet these important objectives. The self-supporting GG federal insurance fund, which is likely to run surpluses in all but the most extreme circumstances, could be a potential source of funds for Congress when considering affordable housing expenditures.

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While the full faith and credit of the U.S. government should mean there will not be a need for a liquidity backstop, in times of extreme market distress, liquidity could be provided to the GG securities market through Treasury and/or Federal Reserve purchases of GG mortgage securities.[6] As a result, there would not be a need for the MCGEs portfolios to be sized and structured to take on the role of "liquidity providers of last resort."

4. TRANSITION

The infrastructure of the existing GSEs should be used as a foundation for new MCGEs, with the technology, human capital, standard documents and existing relationships that the GSEs have developed available to one or more MCGEs. Every effort should be made to transfer existing origination, servicing and other industry relationships from the GSEs to the new MCGEs so as not to strand originators and servicers with ties to the existing GSEs. Historical performance data and other information should be made available to originators, the MCGEs, regulators, rating agencies, investors and providers of credit support to enhance the efficiency of the market.

Decisions regarding the futures of the GSEs should be made expeditiously so as to reduce continued losses of talent at Fannie Mae and Freddie Mac. This will be important both to maintain the ongoing management of the GSEs' existing books of business as well as to fully leverage their infrastructures for use by the new MCGEs.

In order to facilitate a more rapid transition, to maximize the usefulness of the existing infrastructure of the GSEs and to allow the federal government to continue to use that infrastructure to address the current housing market challenges, a good bank/bad bank resolution of the GSEs, their assets and liabilities should be considered.

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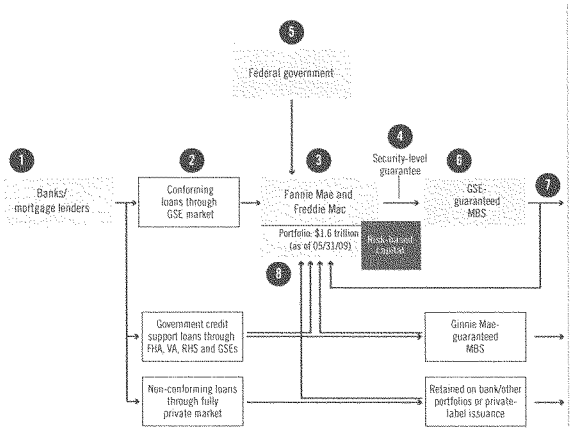
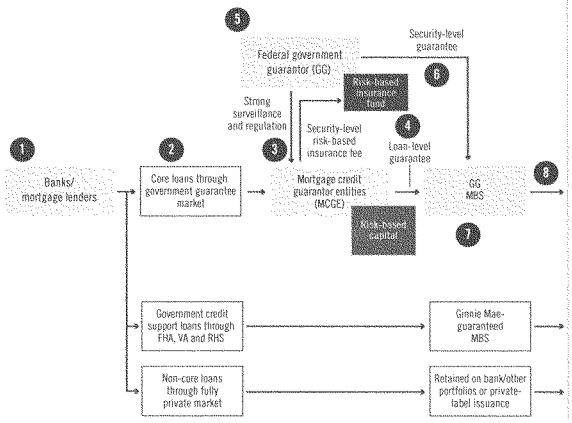
HIGH-LEVEL VIEW
CURRENT STATE: FANNIE MAE, FREDDIE MAC AND THE SECONDARY MORTGAGE MARKET



1. Mortgages are originated.
2. Mortgages are sold to Fannie Mae or Freddie Mac (FM).
3. FM prices and holds capital for the credit risk of the loans. FM either holds the loan in portfolio or includes it in MBS.
4. FM guarantees timely payment of principal and interest on MBS.
5. Federal agency provides oversight and regulation.
6. FM or mortgage lender issues FM-guaranteed security to the market.
7. Based on special status of the GSEs, security trades at a premium to other MBS.
8. FM may also purchase their own or other GSE-issued, Ginnie Mae or private label MBS as well as non-conventional government credit support loans to hold in portfolio, taking both the credit and interest rate risks.

HIGH-LEVEL VIEW
TARGET STATE: POTENTIAL ROLE OF THE FEDERAL GOVERNMENT IN THE CORE SECONDARY MORTGAGE MARKET



1. Mortgages are originated.
2. Mortgages are submitted to MCGE for credit underwriting and pooling.
3. MCGE prices and holds capital for the credit risk of the loans.
4. MCGE guarantees timely payment of principal and interest of the loans.
5. Federal agencies provide oversight, regulation and security-level guarantee in exchange for risk-based fee.
6. GG guarantees timely payment of principal and interest of the security.
7. MCGE or mortgage lender issues GG security to the market.
8. Based on the GG guarantee, security trades in equivalence to full faith and credit of the U.S. government; security buyer takes all the interest rate risk.

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NOTES

1. The Mortgage Bankers Association's Council on Ensuring Mortgage Liquidity. *Principles for Ensuring Mortgage Liquidity.* March 2009. "1.a. Except for times of extreme market stress, and except for the availability of a credit guarantee program as described in section 7 below, secondary market transactions should be funded by investors seeking market returns and who take on the credit, interest rate and/or other associated market risks for market-derived yields."

2. Ibid. "7. There is a role for a government credit-guarantee program to help attract investment to the residential secondary mortgage market."

3. Ibid. "7.c. Any government sponsored entity or program should preclude the creation of a GSE-like investment portfolio assembled for the purpose of arbitrage profits. A GSE or GSE-like entity may require a portfolio to support its securitization activities (i.e. aggregation, incubation, innovation), to accommodate limited amounts for highly structured products not conducive to securitization and/or to maintain an infrastructure for serving as a liquidity backstop for the market."

4. Ibid. "5.c. The regulator of any government sponsored/owned entity and other secondary mortgage market regulators should be strong, empowered and adequately funded."

5. Ibid. "8.a. The government should balance and coordinate any pursuit of social policy goals through the secondary mortgage market operations of government sponsored/owned entities with their implications for safety and soundness, the efficient operation of the secondary mortgage market and their consistency with primary mortgage market and / or other requirements. Such policy goals should be limited to residential housing in a way that does not contain market distortions."

6. Ibid. "10.a. In times of extreme market stress, the government should provide a mechanism to step into the secondary mortgage market as a liquidity provider of last resort by providing a liquidity backstop." MBA is currently developing a working brief discussing the merits of this approach.

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NCLR
NATIONAL COUNCIL OF LA RAZA

REBUILDING HOMEOWNERSHIP OPPORTUNITIES FOR LATINO FAMILIES: PRINCIPLES FOR REFORMING THE U.S. HOUSING FINANCE SYSTEM

Presented at

Housing Finance—What Should the New System Be Able to Do?
Part I—Government and Stakeholder Perspectives

Submitted to
U.S. House of Representatives Committee on Financial Services

Submitted by
Janis Bowdler
Deputy Director, Wealth-Building Policy Project

March 23, 2010

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Good afternoon. My name is Janis Bowdler. I am the Deputy Director of the Wealth-Building Policy Project at the National Council of La Raza (NCLR). NCLR is the largest national Hispanic civil rights and advocacy organization in the United States, dedicated to improving opportunities for Hispanic Americans. I oversee our research, policy analysis, and advocacy on issues critical to building financial security in Latino communities, such as homeownership, consumer credit, auto lending, and financial counseling. During my time at NCLR, I have produced a number of publications on housing issues important to the Latino community, my most recent being *The Foreclosure Generation: The Long-Term Impact of the Housing Crisis on Latino Children and Families*. In addition, I have served as an expert witness before Congress and the Federal Reserve. I would like to thank Chairman Frank and Ranking Member Bachus for inviting us to share our views on this important topic.

For more than two decades, NCLR has advocated for policies and programs that support sustainable Hispanic homeownership. NCLR conducts research and analysis on relevant public policy issues such as preserving and strengthening the Community Reinvestment Act (CRA) and the Home Ownership and Equity Protection Act (HOEPA), supporting strong fair housing and fair lending laws, and expanding access to credit. In addition, NCLR is the only U.S. Department of Housing and Urban Development (HUD) housing counseling intermediary focused on the Latino community. The NCLR Homeownership Network (NHN) provided first-time homebuyer and foreclosure prevention counseling to more than 50,000 families last year alone. NHN counselors are working closely with Federal Housing Administration (FHA) borrowers to ensure that they are prepared for homeownership and help them avoid predatory scams.

Historically, Hispanic families have struggled to achieve homeownership at the same rates as their White peers. In recent years, significant advances had been made in home financing that enabled millions of families to purchase their first home. While the bubble years have become infamous for the glut of damaging financial products invented—such as toxic mortgages and fee harvester credit cards—we must also take into consideration positive innovations that advanced homeownership in a sustainable manner. They should be the foundation on which we rebuild our mortgage finance market or consider reform.

Today's hearing should be the first in a series of dialogues on the important question of what is needed from a reformed or redesigned housing finance system. In my brief remarks I will lay out a series of principles to guide the reform in a way that will promote sustainable homeownership opportunities for communities of color. I will also address the specific questions put forth by the committee.

Background

NCLR has testified several times over the last five years and published a series of documents[1] on the unique challenges Latino families and other borrowers of color face when they enter the

[1] NCLR has published several reports and presented testimony before the U.S. House of Representatives and the U.S. Senate on these issues. These are available at www.nclr.org. Key publications include: Janis Bowdler, Roberto Quercia, and David Smith, *The Foreclosure Generation: The Long-Term Impact of the Housing Crisis on Latino Children and Families* (Washington, DC: NCLR and Center for Community Capital, 2010); Janis Bowdler, *The Role of FHA Mortgage Insurance in Revitalizing Latino Homeownership* (Washington, DC: NCLR, 2009);

mortgage market. In addition to the shortage of affordable housing, Latino families were often overlooked by conventional lenders unwilling to take the extra steps necessary to process loans that did not fit the narrow box created by automated underwriting. Instead, many were steered toward subprime loans, even when they had good credit. Moreover, the absence of strong competition from mainstream banks offering prime loans left a vacuum that subprime lenders and brokers quickly filled. In many neighborhoods of color, there were few credit options available, leaving borrowers dependent on subprime credit to pursue their goal of homeownership.

It is important to note that there is a role for a robust and competitive subprime market. However, during the bubble years, the secondary market's seemingly insatiable appetite for high-profit mortgages led to a flood of high-risk loans and, eventually, toxic securities backed by these loans. The result was predictable: exotic and risky mortgages flooded the market and became heavily concentrated in where borrowers were cut off from better options and reliable information and advice that could objectively warn them of the risks. Many relied on their mortgage professionals for advice about the home loan and, as it turns out, the real estate market. The vast majority of borrowers could not see the behind-the-scenes incentives built into the mortgage system that favored short-term profits over long-term sustainability. This proved a reckless combination, not just for Latino families, but for the national economy.

Still, there have been critical advances over the last ten years in mortgage finance that should not be lost. Using the standard 30-year fixed-rate mortgage as the foundation—once a groundbreaking innovation on its own—lenders have been able to bring more homeowners into the fold using flexible and innovative underwriting criteria, including nontraditional credit, homeownership counseling, and affordable yet sound mortgages with lower down payments. While Wall Street funded investments in toxic mortgages, the Community Reinvestment Act, mortgage insurance from the Federal Housing Administration and the Veteran's Administration (VA), and the affordable housing goals placed on Fannie Mae and Freddie Mac drove much of the investment in affordable and sustainable homeownership opportunities for low-income families and communities of color. Without these tools, there is little evidence that mainstream banks would have financed such home loans. In fact, in the current market, where credit comes

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Janis Bowdler, *Laying the Foundation for Equal Access to Credit: How Improved Financial Oversight Can Build Wealth for Hispanic Borrowers* (Washington, DC: NCLR, 2009); Janet Murguía, *Putting Our Communities on the Map: The Road to Economic Recovery for Latinos and Other Communities of Color* (Washington, DC: NCLR, 2009); Janet Murguía, *Laying the Foundation for Improved Access to Credit for Hispanic Families* (Washington, DC: NCLR, 2009); Graciela Aponte, *Putting an End to Predatory Lending in Minority and Latino Communities* (Washington, DC: NCLR, 2009); Graciela Aponte, *Principles for Reforming the Mortgage Market to Promote Sustainable Mortgages for Latino Families* (Washington, DC: NCLR, 2009); Janet Murguía, *Eroding a Generation of Wealth–Abusive Lending Practices Targeting Latino Communities* (Washington, DC: NCLR, 2008); Lot Díaz, *Leveraging the FHA Loans to Build Wealth in Latino Communities* (Washington, DC: NCLR, 2007); Janis Bowdler, *Challenges to Building Sustainable Homeownership in Latino Communities* (Washington, DC: NCLR, 2007); Beatriz Ibarra, *Eliminating Barriers to Credit and the Challenges of Credit Card Use for Latino Consumers* (Washington, DC: NCLR, 2007); NCLR and National Association of Hispanic Real Estate Professional, *Saving Homes, Saving Communities: Hispanic Brokers Speak Out on Hispanic Homeownership* (Washington, DC: NCLR and National Association of Hispanic Real Estate Professional, 2007); Janis Bowdler, *The Impact of the Home Equity Lending Market on Latino Consumers* (Washington, DC: NCLR, 2006); Janis Bowdler, *Jeopardizing Hispanic Homeownership: Predatory Practices in the Mortgage Market* (Washington, DC: NCLR, 2005).

at a premium, housing counselors are reporting much difficulty in securing conventional financing for qualified families.[2]

As a housing counseling intermediary, NCLR has helped more than 135,000 families purchase their first home, all with prime or FHA home loans. Based on our experience working with thousands of families over the last 12 years, there are three areas of innovation that are particularly important to communities of color:

- **Housing counseling.** Over the last ten years, the federal government has made a significant investment in housing counseling, mostly through the Housing Counseling Program at the Department of Housing and Urban Development and most recently through the National Foreclosure Mitigation Counseling program at NeighborWorks. Research has shown that families who attend one-on-one housing counseling before they purchase their home are far less likely to default than their peers.[3] In an independent evaluation of NCLR's program, the Morrison Institute found that the tailored advice borrowers received from trained counselors was a significant contributing factor to their ability to buy a home.[4] The field of housing counseling has evolved to become increasingly professional. HUD-certified agencies are audited every two years and commit to high industry standards regarding staff certification, client procedures, and relationships with the industry.[5] These high standards are necessary to ensure that these nonprofit resources remain objective and trusted in the community. However, despite these advances in this field and their clear value to low-income families and first-time homebuyers, housing counseling has not been well supported by the home finance market. Many conventional lenders dropped their requirements for first-time homebuyers to attend housing counseling before receiving certain loans, with Fannie Mae, Freddie Mac, and FHA quickly following suit. Each claimed that they were "forced" to do so to remain competitive in the market. The message was clear: the housing finance market had no time for the slow and steady development of mortgage-ready homebuyers. Housing counseling organizations were often seen as too small, not producing significant enough volume to be a serious market player, or worse, a nuisance that kept lenders from getting to clients faster. In the wake of record-setting foreclosure rates, housing counselors have become first responders in their neighborhoods, many hiring and training new staff to meet demand. This capital in the form of highly trained and sophisticated community-based institutions should not be lost in the next imagining of the housing finance market.

- **Flexible underwriting.** One of the most important advances in mortgage finance was the creation of FHA- and VA-insured mortgages that would allow borrowers who lacked

[2] Housing counseling survey conducted by NCLR in January 2010. Actual question: "With home values declining, many new homebuyers are looking to purchase their first home. How easy or difficult has it been for your clients to purchase a home in this market?" **Very Easy=2.2%, Easy=22.9%, Difficult=62%, Very Difficult=12.8%**

[3] Abdighani Hirad and Peter M. Zorn, *A Little Knowledge Is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling* (Cambridge, MA: Joint Center for Housing Studies, Harvard University, 2001).

[4] Ryan M. Johnson and Elsa Macias, *Home to Own: A New Model for Community-Based Low-Income Mortgage Lending* (Phoenix, AZ: Morrison Institute for Public Policy, Arizona State University, 1995).

[5] For more information, please visit www.homeownershipstandards.com.

cash but had significant income to purchase a home. Over time, the industry has learned more about how to accommodate different borrower profiles in a manner that does not jeopardize the financial safety and soundness of the family or the bank. For example, Latino borrowers are more likely than others to have a cash income, multiple co-borrowers on the same loan, or multiple sources of income, and they are less likely to have a traditional credit history. As the underwriting process became automated, these features became harder to process. Many community banks, credit unions, and mainstream lenders, as well as Fannie Mae, Freddie Mac, and state housing finance agencies, have been able to model these characteristics and create loan products that earn a return and still gave the family a fair deal. In addition to advice from their counselor, borrowers interviewed as part of the Morrison Institute's evaluation of NCLR's counseling pilot stated that they would not have been able to qualify for their home without the use of the flexible underwriting. Both the counseling and the underwriting criteria were ranked above down payment assistance in terms of what was the most helpful in purchasing their home. However, many of these products struggled to gain traction in local markets. In some cases, they were overlooked by loan officers in favor of a product that earned a higher profit. In other cases, the lenders offering the product lacked market share. Moving forward, the lessons learned from the pioneers of affordable lending should become a centerpiece for a revived lending system.

- **Nontraditional credit.** In 2002, one in five Latinos did not have enough information in their credit file to produce a score. Credit scores from the three mainstream bureaus—Experian, Equifax, and TransUnion—are built by the voluntary reporting of major creditors. However, individuals who do not use these products, or do not use them often enough (six months of inactivity will result in a score of zero), will not have a score mortgage lenders can use. To get around this barrier, several major data companies, including the credit bureaus themselves, have experimented with different data sources and the predictability of various trade lines. For example, regular payment for utilities, cell phones, child care, cable, and rent can be documented and analyzed. Many lenders had successful pilot programs using various methodologies and data providers, opening the doors to homeownership for a new segment of borrowers. Loan products that used nontraditional credit have dried up in the current market. Losing them altogether would unnecessarily decrease homeownership opportunities for qualified families.

All too often, these positive innovations were subsumed in the market by high-risk, high-profit loans and by industry players with little incentive to think past the commission they made at origination or securitization. As we consider how to strengthen our housing finance market, the advancements in underwriting and outreach discussed above should be built in the foundation.

Principles for the Future of Home Lending

The question of how to rebuild our mortgage finance market is timely and critical. The collapse of the credit markets and subsequent recession has thrown millions of families off their path to financial security. However, the silver lining of the burst housing bubble is that homes are now affordable for many that had been previously priced out of the market. Unfortunately, many borrowers of color, low-income families, and others are struggling to gain access to credit in this

tight credit market. For this reason, many market commentators persuasively argue that the pendulum has swung too far away from easy credit to the point of making it unavailable for those who need it most. Thus the timing is right to consider how to bring balance and opportunity back into the market.

NCLR has two primary goals for a revived homeownership market: 1) To ensure that qualified Hispanic families of modest means have the opportunity to access a home loan at fair, equal, and affordable rates; and 2) To ensure that their home purchase will develop into an asset they can share with their children. With that in mind, we have developed the following set of six principles to guide the shaping of the future home lending market.

- **The federal government has a role in providing liquidity and innovation in the mortgage market.** Of the market advances discussed above, none would have come to fruition absent some government intervention. Whether directly, through incentives and market interventions, or through quasi-public agencies, the federal government can help facilitate the adequate flow of mortgage and housing capital throughout the country. For many years this was the role of Fannie Mae and Freddie Mac, which drove the rise of the secondary mortgage market and served as a primary source of liquidity for lenders of all types. The need for capital and liquidity is even more important for certain geographic regions, such as urban cores and rural areas, underserved populations, and first-time homebuyers for which financing options have traditionally been limited. While the federal government should bolster—not replace—the private market, it should set the standard for innovative, affordable, and sustainable home loans, secondary market credit, and rental financing. This can be done by example through direct lending programs, or indirectly through market controls, regulation, and limits on capital investments or other benefits.

- **Mortgage and housing finance credit must be equally accessible and available to all communities and qualified borrowers.** There are a number of reasons why mortgage credit is not equitably distributed among creditworthy homebuyers; thus, the solutions are necessarily varied. Still, in reforming the mortgage financing market, policymakers must be careful not to exacerbate the tendency of the market to favor the easiest-to-serve borrowers. In fact, controls and investments will be necessary to ensure that those who are hard to serve, yet creditworthy, are able to access the same credit at the same rate as their similarly situated peers. One way to do this is to invest in lending tools that might be unattractive to private, primary lenders but for which there is a strong public purpose. For example, the federal government or a quasi-public agency should purchase loans from small institutions (nonprofits, community banks, credit unions, community development financial institutions (CDFIs) where the volume may be too small to attract the private market; issue, insure, or purchase loans with flexible underwriting criteria, such nontraditional credit histories, multiple co-borrowers, or multiple sources of income; and conduct robust pilot programs to test new products and further understand effective credit criteria, enhancements, and other tools in creating affordable and fiscally responsible loans. For example, pilot programs should test loans that do not require mortgage insurance, use homeownership counseling to accommodate lower credit scores, and criteria around nontraditional credit.

- **Standard, fiscally sound, yet affordable and sustainable mortgages should be the norm.** The share of subprime mortgages in the overall market grew in accordance with the secondary market's appetite for risky loans, not with real demand for such loans on the ground. Policymakers should seek to restore balance so that the mortgage financing system reflects true market demand from the bottom, not the top. Standard mortgages with flexible underwriting but without hidden traps or exotic features should be the first product offered to most homebuyers. In practice, this would mean that compensation incentives are aligned so that features designed to maximize affordability and long-term sustainability become the priority for lenders. Strong consumer protections are essential to provide a balance to the market's inherent preference for short-term profits at the expense of long-term societal interest. The federal government can play a role by ensuring market liquidity for standard mortgage products that promote sustainable homeownership, such as those insured by FHA and those purchased by Fannie Mae and Freddie Mac. Issuers of government-backed or government-insured mortgages must be governed by a strong duty of care. Those that perform poorly should risk the privilege to originate government-backed loans. Under no circumstances should federal investments of any kind further predatory or discriminatory lending.

- **Diverse delivery and outreach channels must be incorporated.** A key lesson from the financial fallout in 2008 is that prime retail banks did not compete well against their more agile, less scrupulous subprime competitors. The reasons for this are the subject of ongoing debate, but policymakers can prevent homeowners from suffering from lack of competition for their business by supporting origination opportunities through a wide array of delivery and outreach channels. The nonprofit community is an underused resource in this respect. Homeownership counseling agencies, credit unions, CDFIs, and other nonprofit lenders offer safe, affordable mortgage products but are unable to compete in the local lending market. They lack the marketing budget and brand recognition that national outlets have, and they often have more conservative underwriting or procedures that leave them at a competitive disadvantage. The federal government has played a critical role in supporting the growth and professionalization of the nonprofit sector. To capitalize on their investment, they must ensure that skilled nonprofits are weaved into the fabric of the revitalized homeownership market.

- **Predatory lending should be eliminated.** As has been referenced in several places so far, much of the best home financing innovation developed in the last ten years was blocked from the borrowers who needed it the most. Abusive practices routinely beat the "slow and steady" practices on the ground. Policymakers must avoid the trap of encouraging sustainable homeownership through a variety of mechanisms without following with a zero tolerance policy on discrimination and unethical lending.

- **Affordable rental housing is critical to creating sustainable homeownership opportunities.** In some respects, the goals of creating a steady stream of affordable rental stock and helping low-income families achieve homeownership have been pit against one another. On the contrary, it is nearly impossible for families of modest means to build a savings and prepare for homeownership if too much of their income

goes toward unaffordable rent payments or costly transportation expenses because the only affordable homes were miles from their place of employment. This is particularly important for Hispanic families, one-quarter of which dedicate at least half of their income to housing. Housing finance reform must be considered in light of a national housing agenda that weighs the needs of all families. The federal government can support affordable rental housing by fully funding the National Housing Trust Fund, as well as through direct appropriations, construction loans, loan insurance or other credit enhancements, pooling capital, and other tools.

In addition to being guided by the principles laid out above, NCLR strongly urges Congress to use a data-driven, empirical approach to reshaping Government-Sponsored Enterprises (GSEs) and other market reforms. For example, we encourage the testing of GSEs' loan products and loans held in portfolio to determine the combination of loan characteristics that have produced viable and sustainable mortgages. Policymakers should use their unique access to data to produce a study that examines lending across the system with the goal of promoting the most promising and successful elements of the old structure.

There is a strong public demand for a robust housing finance market that delivers a steady flow of affordable credit on fair terms in all corners of the country. History has shown that this is not likely to happen without targeted investment from the federal government. The private market will not adequately serve low-income, minority, senior, or immigrant borrowers on its own. As Congress debates the new role for the federal government and the GSEs in the mortgage market, it must adhere to these six principles. Moreover, it is important to note that the federal government has access to more data now than ever in the past.

In closing, NCLR makes the following recommendations on steps Congress can take in the near future to facilitate the recovery of the mortgage market:

- **Stop foreclosures.** NCLR thanks members of the Financial Services Committee for their dedication to this issue, having held hearings and voted to create or support programs that directly help families. Unfortunately, neighborhoods across the country are still reeling from high rates of foreclosure. Various measured steps to halt the steady stream of foreclosures and evictions have come up short. Congress can help families by creating a program to sustain unemployed homeowners until they find a job.

- **Continue the work of FHA and GSEs.** In 2008, 45% of Latino homebuyers relied on FHA financing. In some markets, GSE financing represents the bulk of capital available for home purchases. Without the work of these agencies, there would be little home lending market to speak of. We urge Congress to support the work of these agencies until more long-term reforms are put in place and the private market has recovered.

- **Invest in soft landing strategies.** By now it is painfully clear that not all delinquent homeowners will be able to avoid foreclosure. Yet servicing companies, investors, and neighborhoods are still unable to keep up with the volume of foreclosures. As a result, homes are abandoned, leading to crime and maintenance issues, furthering damaging surrounding property values. Congress and the administration should invest in "soft

landing" strategies that help owners transition out of their mortgage with less damage to their family, the neighborhood, and the investor. One example are programs that allow owners to stay in their homes as renters, perhaps even earning their way back to an ownership position.

Thank you for offering NCLR this opportunity to share our views. I would be happy to answer any questions.

Testimony of Mark A. Calabria, Ph.D.
Director, Financial Regulation Studies, Cato Institute
Before the
House Committee on Financial Services
On "Housing Finance – What Should the New System Be Able To Do?"
March 23, 2010

Mark A. Calabria, Ph.D. is Director of Financial Regulation Studies at the Cato Institute. Before joining Cato in 2009, he spent six years as a member of the senior professional staff of the U.S. Senate Committee on Banking, Housing and Urban Affairs. In that position, he handled issues related to housing, mortgage finance, economics, banking and insurance for Ranking Member Richard Shelby (R-AL). Prior to his service on Capitol Hill, Calabria served as Deputy Assistant Secretary for Regulatory Affairs at the U.S. Department of Housing and Urban Development, and also held a variety of positions at Harvard University's Joint Center for Housing Studies, the National Association of Home Builders and the National Association of Realtors. Calabria has also been a Research Associate with the U.S. Census Bureau's Center for Economic Studies. He holds a doctorate in economics from George Mason University.
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Chairman Frank, Ranking Member Bachus, and distinguished members of the Committee, I thank you for the invitation to appear at today's important hearing. I am Mark Calabria, Director of Financial Regulation Studies at the Cato Institute, a nonprofit, non-partisan public policy research institute located here in Washington, DC. Before I begin my testimony, I would like to make clear that my comments are solely my own and do not represent any official policy positions of the Cato Institute. In addition, outside of my interest as a citizen, homeowner and taxpayer, I have no direct financial interest in the subject matter before the Committee today, nor do I represent any entities that do.

Housing and Mortgage Market Principles

Any set of proposals to restructure our system of mortgage finance should begin, and be consistent, with a well defined set of principles. The principles which should guide the shape of our mortgage finance system are as follows:

- Private, at risk, capital should serve as the foundation of our mortgage finance system.
- To the extent that government provides insurance, guarantees or subsidies, those should be structured to act in a *counter-cyclical* manner. Too much of the current structure magnifies the booms and busts in our housing markets. Policy should dampen cycles, rather than exaggerate them.
- While policy should dampen housing cycles, we are unlikely to completely avoid property cycles – they remain a recurring phenomenon in our history. Accordingly, policy should explicitly recognize that housing booms and busts are likely to occur. Any policies based upon faulty assumptions, such as ever rising home prices and "it's always a good time to buy" – should be rejected.
- In planning for housing booms and busts, policies should also explicitly plan for the failure of institutions engaged in mortgage finance. While efforts should, of course, be made to reduce failures, the system should be robust to the failure of any one or two companies.
- Policies should avoid concentrating credit and interest rate risk into a small number of entities. As long as the risk is clearly understood, spreading that risk among many parties will reduce the impact of the failure of any one entity.
- The costs and benefits should be transparent and credible. Subsidies should be on-budget and easily understood. The American taxpayer has a right to know what they are obligated for; accordingly, subsidies and contingent liabilities must be properly accounted for.

- Housing policy should be tenure-neutral. The vast majority of benefits to homeownership accrue to the homeowners themselves and their immediate communities. The benefits to society at large have been grossly exaggerated and renting should be treated as a respectable alternative. Accordingly, policy should abandon any focus on a particular homeownership rate. Tenure-neutral, however, does not imply a "subsidies for everyone" approach.
- To the extent that policies encourage homeownership, that homeownership should be sustainable. Encouraging families to become owners with little or no equity ultimately harms the very families we wish to help.
- Housing policy should also focus on housing as shelter, not as a speculative investment.
- To the extent that subsidies are provided, they should be carefully targeted only to those who would not otherwise be able to have a home, or achieve homeownership. The vast majority of current subsidies go to households that would have owned without the subsidy. Subsidies should also be tied to incomes, not home prices or rents. A disproportionate share of subsidies currently goes to upper income households. There is no compelling policy rationale to provide housing subsidies of any kind to wealthy households.
- To the extent that subsidies are provided via the mortgage finance system, great care should be taken to insure that those subsidies end up with homeowners, and not simply passed along to the housing or mortgage industry.
- The current levels of leverage, both on the part of households and financial institutions, in our mortgage finance system should be reduced.
- The level of maturity mismatch in our mortgage finance system should be reduced.
- Elements of our mortgage finance system that are little more than disguised transfers of wealth should be rejected, including attempts to cross-subsidize high-risk borrowers.
- Policies whose impact is largely to run up housing prices should be rejected.
- Mortgage finance should be insulated from politics. During a boom, political pressures will generally favor further inflating the boom.

A mortgage finance recovery

Aside from addressing the future of mortgage finance is the immediate question of what to do about the current state of mortgage finance. While a variety of problems face the mortgage industry, the most important is the future direction of house prices, and the expectation of such. As long as there is a substantial chance of further declines in home prices, investors will have difficulty projecting losses on mortgage related securities. Accordingly, first Congress and the Administration should end all efforts to prop up house prices. The harm from a quick reduction in home prices, or even an over-shooting on the way down, is far less than the harm that results from holding prices above market-clearing levels. Once housing markets have reached the point where buyers and investors believe prices can fall no further, than both homebuyers and capital will return to the mortgage market in strength.

To encourage private capital to return to the mortgage market, Congress should strongly affirm the importance of respecting private contracts. Repeated calls for mortgage "cramdowns" and other threats of expropriation increase the difficulty of pricing mortgage investments and encourage investors to place their wealth elsewhere. As long as investors believe Congress may ex post re-write the terms of their investments, they will hesitate to invest at other than punitive rates. This is illustrated in the recent comments of a senior MetLife executive, who stated that "MetLife will not buy new securities until it knows what will happen to the current ones – and whether investors will have to absorb the resulting losses."[1]

As the financial crisis has receded, investors' flight to quality has also receded. The marginal investor is now again looking for higher yields. Once investors are certain that higher yields can be found in the mortgage market, and that such returns will not be subject to expropriation, then private money will return to the mortgage market in force. We are already witnessing the early stages of several private sector mortgage securitizations. Just as important is what we did not see: a shock to the mortgage market from the winding up of Federal Reserve purchases of agency MBS. For the right price, investors are willing to supply credit to the mortgage market. Current market difficulties are compounded when uncertainty as to credit risk is exasperated by political risk.

On the 30 year fixed-rate mortgage

Any discussion of reforming our mortgage finance system has to address the central role of the 30 year fixed rate mortgage. First we must begin with the very simple, yet critical, observation that someone, the homebuyer, the financial sector or the taxpayer, must bear the interest rate risk inherent in the 30 year fixed. A fixed rate mortgage does not eliminate interest rate risk, it simply transfers it. In the case of the savings and loan crisis, and the recent bailouts of Fannie and Freddie, much of that risk was involuntarily transferred to the taxpayer. It is worth remembering that most homeowners are taxpayers, so simply moving interest rate risk from homeowners to taxpayers does not make homeowners, as a group, better off. We may end up making homeowners, as taxpayers, worse off if they were not fully informed as to this transfer *ex ante*.

As the taxpayer bears some of the interest rate risk of the 30 year fixed, the price facing homebuyers is artificially low, relative to adjustable rate mortgages. Were the taxpayer no longer bearing this risk, I believe financial institutions would still offer 30 year fixed rate mortgages, however the spread of those mortgages would increase relative to adjustable rate mortgages. Historically the difference between the 30 year fixed and the 1 year ARM has been about 100 basis points. Without government support, my educated guess is that spread would increase to around 130 basis points. While this may seem like a major increase, it is 1) not large enough to adversely impact homeownership rates and 2) below some of the highs of earlier this decade – for instance in 2003, certainly a "strong" housing market, these spreads approached 240 basis points.

[1] Quote from Nancy Mueller Handal in Aline van Duyn "A Business Decision," *Financial Times* February 23, 2010 p.7.

Proposals for reforming Fannie Mae and Freddie Mac

While there are many important and critical issues to be decided in restructuring our mortgage finance system, no issue is more central than the future of Fannie Mae and Freddie Mac. Ultimate goal of any GSE reform should be to create a system, where in a time of mortgage market stress, a GSE can fail, without cost to the taxpayer or significant disruption to the financial and mortgage markets. To some extent, this will require making such markets less reliant on the GSEs and reducing the extent to which their securities permeate the financial system.

Consistent with the principles above, I recommend the following steps in reforming Fannie Mae and Freddie Mac:

- The more, the merrier. Whether purely public or purely private, having only two Fannie/Freddie like institutions guarantees that these entities will be bailed out if they become insolvent. The only way to make failure a credible option is to have several. I would suggest breaking up Fannie/Freddie into about a dozen, equal sized entities.
- Reduce ambiguity around debt status. Subject all GSE securities issues to requirements of 1933 and 1934 Securities Acts. Also remove all statutory treatment of GSE securities as "government" debt.
- Allow only issuance of MBS – no unsecured debt, no portfolio. Also eliminates risk of GSE default on money market mutual funds.
- Get GSEs out of guarantee business. MBS should represent a "true" securization, not a retaining of credit risk on balance sheet.
- Eliminate loan limits, set loan sizes based upon income, say 3 times median state income, also allows elimination of housing goals.
- Require bank regulators to treat bank holdings of GSE debt as non-governmental, corporate debt. Also limit any insured depository from holding more than a small percentage, say 5%, of its assets in GSE debt.
- Charters should be issued/removed by regulator, not Congress. Consistent with having more GSEs, allow regulator to issue new charters and conversion of other financial institutions into new GSE charter.
- Limit or bar holdings of GSE debt by foreign central banks. Fannie/Freddie bailout was as much a foreign policy decision as an economic one.
- Require all mortgages purchased by GSE to have a minimum cash downpayment of 10 percent – no piggybacks. To avoid disruptions to the mortgage market, this requirement could be phased in over a few years, starting with a cash requirement of 5 percent.
- Subject GSEs to bankruptcy code. Conservator/receiver model increases chance of bailouts, and reduces market discipline on the part of debtholders.
- New Fannie/Freddie privatization model *could* be based upon co-op model of the FHLBs. Require lenders selling loans to purchase equity, similar to FHLB advance model. This would better align incentives of lenders with the risks taken by Fannie/Freddie.

Toward a Countercyclical Mortgage Finance System

U.S. Housing Markets have tended toward a regular pattern of boom and bust. While some degree of cyclicality is likely unavoidable, federal mortgage policy has often contributed to these wide swings in housing activity. Mechanisms can be created that dampen the incentives for households and financial institutions to engage in bubble behavior. These mechanisms should, of course, be directly related to a national interest. Entities that do not pose a systemic risk to the financial system or receive backing from the taxpayer, implied or otherwise, should be free to innovate and succeed or fail.

Housing bubbles are driven foremost by the speculative behavior of households. Current federal and state policies encourage such speculation. For instance several states, such as California, require that residential mortgages be non-recourse. That is, in the case of a default, the lender can only pursue the house and not any of the borrower's other assets or income. Recent research from the Federal Reserve Bank of Richmond indicates that "recourse decreases the probability of default when there is a substantial likelihood that a borrower has negative home equity."[2] Not only does a lack of recourse increase defaults during the bust phase of the cycle, but such also likely increases the incentive of buyers to enter the market with greater speculative intent. Where there is a federal interest, all mortgages should contain recourse provisions and such provisions should be exercised.

The scholarly literature on speculative bubbles concludes that such bubbles are more likely to develop the lower are transaction costs and the lower is the required holding period of the asset in question[3]. It is for this reason that many countries, such as Canada, whose mortgage markets contain substantial pre-payment penalties, did not witness the same level of boom and bust as the U.S. housing market. We should reverse the policy trend toward eliminating pre-payment penalties and instead encourage significantly broader use of such. The ease of repeated re-financings, coupled with equity-extractions, greatly added to the severity of the boom and bust.

The most important predictor of mortgage default is equity, or lack thereof[4]. Owners that are underwater are significantly more likely to default than homeowners with equity. Requiring reasonable downpayments when the mortgage has a federal interest would significantly reduce the severity of housing cycles. Ultimately federal policy should work toward a cash downpayment of 10 percent. During booms this can be raised. For instance requiring a downpayment that is the higher of 10 percent or last year's national house price appreciation would greatly reduce housing cycles. Similarly the capital which financial institutions, including GSEs, are required to hold against residential mortgages should be linked to house price appreciation.

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[2] Ghent and Kudlyak **Recourse and Residential Mortgage Default: Theory and Evidence from U.S. States.** Federal Reserve Bank of Richmond. Working Paper WP09-10.

[3] Barlevy. "Economic theory and asset bubbles." *Economic Perspectives*. 2007. Federal Reserve Bank of Chicago.

[4] Kristopher Gerardi, Adam Hale Shapiro, and Paul S. Willen. **Decomposing the Foreclosure Crisis: House Price Depreciation versus Bad Underwriting.** Federal Reserve Bank of Atlanta Working Paper 2009-25

Systemic Risk and Mortgage Finance

While Fannie and Freddie were rescued for a variety of reasons, prominent among those is that fact that their securities, both equity and debt, permeate our financial system. For instance, more than 40% of money market mutual fund holdings were in the form of GSE securities. Were a receiver to impose substantial losses on short-term unsecured GSE debt, hundreds, if not thousands, of money market mutual funds would have "broken the buck." Same with insured commercial depositories. According to the FDIC, before the bursting of the housing bubble, holdings of government-sponsored enterprise (GSE) securities, bonds and mortgage-backed securities as well as preferred stock, constituted more than 150% of Tier 1 capital for insured depositories. If we thought bank losses from the reduced value of Fannie and Freddie preferred shares was a problem, these losses would have been rounding errors compared to bank losses from Fannie and Freddie debt. Sadly Wall Street was also infected. For instance, the Federal Reserve has reported that more than 50% of Maiden Lane One assets, the toxic assets that the Federal Reserve guaranteed in order to persuade JPMorgan to buy Bear Stearns, were GSE securities.

Our country has witnessed housing booms and busts before, although not one of this magnitude. The fallout from such a large bubble bursting was guaranteed to be painful and prolonged. However, the resulting financial crisis did not have to result. The financial crisis resulted from the fact that so much of the soundness of our financial system is build upon the sand of house prices.

Innovation, Standardization and the Unknowable Future

Given the clear role that many facets of our current mortgage finance system played in creating the housing boom and bust, it is tempting to proscribe a set of standards for the mortgage market and require all participants to meet those standards. Such would be a tragic mistake. The better path would be to allow essentially two systems: one for institutions that place the taxpayer and the financial system at risk, and one for non-depositories and non-banks that do not place the taxpayer and system at risk. Entities should be able to choose under which system they operate, ultimately allowing the free choice of individuals to determine the better system. Such a system would also allow innovations that improve consumer welfare without putting the financial system at risk.[5] We have already seen the result of concentrating mortgage risk into a small handful of entities; we must avoid repeating that mistake. In addition to avoiding the concentration of risk into a few entities, we should also avoid the concentration into a few business models. According, we should closely examine the possibility of utilizing various forms of mortgage finance, including, but not limited to covered bonds, portfolio lending, and mortgage backed securities.

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[5] See generally, "The Impact of Deregulation and Financial Innovation on Consumers: The Case of the Mortgage Market," with Paul Willen, Kristopher S. Gerardi and Harvey Rosen. *Journal of Finance*, forthcoming.

TESTIMONY BY

ROBERT E. DEWITT

VICE CHAIRMAN, CHIEF EXECUTIVE OFFICER AND PRESIDENT

GID INVESTMENT ADVISERS LLC

ON BEHALF OF THE

NATIONAL MULTI HOUSING COUNCIL

AND THE

NATIONAL APARTMENT ASSOCIATION

BEFORE THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

ON

HOUSING FINANCE REFORM

MARCH 23, 2010

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Chairman Frank, Ranking Member Bachus and distinguished Members of the Committee, I am Bob DeWitt, the Vice Chairman, Chief Executive Officer and President of GID Investment Advisers LLC ("GID"). Founded in 1960, we are a privately held, vertically integrated, diversified real estate operating company based in Boston, MA. In the multifamily sector, GID has acquired or developed over 40,000 units and currently has a 12,247-unit portfolio in 42 apartment communities in 14 states.

I am testifying on behalf of the National Multi Housing Council (NMHC) and the National Apartment Association (NAA).

NMHC and NAA represent the nation's leading firms participating in the multifamily rental housing industry. Our combined memberships are engaged in all aspects of the apartment industry, including ownership, development, management and finance. The National Multi Housing Council represents the principal officers of the apartment industry's largest and most prominent firms. The National Apartment Association is the largest national federation of state and local apartment associations. NAA is a federation of 170 state and local affiliates comprised of more than 50,000 multifamily housing companies representing more than 5.9 million apartment homes.

We applaud the Financial Services Committee for its efforts to begin deliberations on the future of a secondary mortgage market for the housing industry. Since the single-family mortgage meltdown, much has been written and discussed about the failure of our housing finance system. There is no mistaking that failures did occur and these failures caused significant dislocation to both the single-family sector and to other industries that were collateral victims of the financial crisis, such as the apartment industry.

Thus, we agree that reforms and corrections must be implemented to repair the damage and to restore credibility to the U.S. financial system. But we should remember that for the past 50 years, the U.S. housing system has been the envy of the world in attracting private capital to meet our nation's housing needs. As lawmakers redesign the secondary mortgage market, **we must be careful to retain the successful elements of our present system.**

Moreover, it is critical that this reform effort be undertaken very cautiously and deliberatively. The stakes here are very high. Currently the Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac hold $5 trillion in mortgage debt (in securities and portfolio loans). This is equal to nearly 42 percent of the $12 trillion federal debt.

It is also critical that reform efforts be guided by a thorough understanding of the unique needs of the apartment industry so that steps taken to address the problems with the single-family financing process do not inadvertently restrict the supply of multifamily capital.

If I can leave you with one message today it is that **a government-supported secondary market is absolutely critical to the multifamily sector and our industry's ability to continue to meet the nation's demand for affordable and workforce housing.** Multifamily may only represent 10 percent on average of the GSEs' mortgage debt, but they currently provide nearly 90 percent of multifamily mortgage capital.

Since 1996, the GSEs have provided more than $535 billion in multifamily mortgage debt. Having this reliable source of capital—in good markets and bad—has provided financing for more than 11 million apartments in that time. This most recent financial crisis underscores the importance of the GSEs to multifamily. Over the past two years, they have provided $94 billion in mortgage debt to our industry at a time when virtually every other capital source left the market.

That support will be even more critical going forward because America will increasingly rely on rental apartments to house our citizens. Currently one-third of families live in rental housing, and our industry provides safe, decent housing to over 17 million households or over 50 million Americans.

That share is likely to grow in the future because of fundamental changes in our society that are also changing the types of housing we need to build. The largest generation of children currently under the age of 20 in the history of the U.S. will be entering the housing market in the next few years, primarily as renters. Record numbers of legal immigrants, many of whom are long-term renters, and the foreclosure crisis have also increased demand for affordable rental housing.

In addition, up to 85 percent of our household growth between 2010 and 2019 will come from households who are not married couples with children. These new households will be seeking more and different choices than the generations before them, and many will be drawn to the affordability, flexibility and convenience of apartments. Housing expert Professor Arthur Nelson of the University of Utah projects that half of all housing built over the next 10 years will need to be rental housing to meet the dramatically changing landscape of demand.

The Harvard University Joint Center for Housing Studies estimates that we already have a shortage of some 5 million units of affordable rental housing. **Our industry cannot meet the nation's current or future housing needs—or refinance the approximately $200 billion in mortgage debt coming due over the next two years—without a fully functioning secondary mortgage market.**

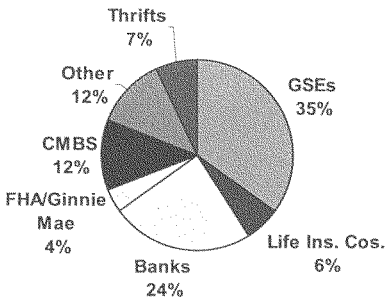
Fortunately, I am here today to tell you that the multifamily secondary market story is very different from the single-family story. The most consistently successful sector of the U.S. housing finance system has been multifamily. Our industry did not overbuild in the housing boom, and even now, default rates for GSE multifamily mortgages remain low. In short, the current government-supported secondary market programs have met the test: they have helped finance an enormous volume of affordable rental units; they have sustained liquidity in all economic climates; and they have ensured the safety and soundness in their multifamily loans and securities. We need to preserve the elements of their programs that led to this success story as we reform the secondary multifamily mortgage market.

I would like to take this opportunity to highlight for the Committee key policy issues that we believe should be considered as Congress examines the future of the residential mortgage market.

A GOVERNMENT-SUPPORTED SECONDARY MORTGAGE MARKET FOR MULTIFAMILY HOUSING IS CRITICAL

As I mentioned earlier, the nation will increasingly rely on the apartment sector to meet its housing needs. Without a government-supported secondary mortgage market, however, not only will we be unable to create additional housing, but we will be hard pressed to maintain the current stock of multifamily housing. Currently, just over half (51 percent) of outstanding multifamily capital is held in the secondary market (35 percent by the GSEs, 12 percent in CMBS and 4 percent in Ginnie Mae.)

Multifamily Mortgage Debt Outstanding 2009 Q3



Source: Federal Reserve Outstanding Mortgage Debt 2010

While our industry relies on other sources of capital, including thrifts, banks and life insurance companies, these are not sufficient to provide the capital necessary to keep the apartment sector functioning. Banks are limited by capital requirements. Life insurance companies have always been less than 10 percent of the market, lend primarily only to newer, luxury high-end properties and enter and leave the multifamily market based on economic and capital market conditions. The private-label CMBS market is unlikely to return to the volume and market share it reached a few years ago, and the FHA has exceeded its capacity to meet the sector's capital demands.

The following outlines why it is important to retain a government-supported secondary mortgage market for multifamily in any reform effort.

1. **Providing Affordable and Workforce Housing**

   Fannie Mae and Freddie Mac make immeasurable contributions to housing affordability through their multifamily programs. Between 1999 and 2007 they provided $104 billion in multifamily mortgage financing for apartments affordable to families at or below 80 percent of the area median income (AMI). That's 3.2 million units—half of all units financed during this period. Additionally, half of their mortgages financed during this period were in underserved targeted areas. **The GSEs' multifamily programs have always met and exceeded their special affordable multifamily goals.**

   They have been and can continue to be the single largest provider of credit enhancement for multifamily housing bonds used to finance affordable housing.[1]

[1] They continue to provide credit enhancement, but only for fixed-rate bonds as the variable-rate bond market is unstable and their regulator has prohibited them from taking the variable rate-bond market's liquidity risk.

But their contributions to workforce housing go beyond their affordable housing goals. Few people realize that fully 90 percent of the apartment units financed by Fannie Mae and Freddie Mac over the past 15 years—more than 10 million units—were affordable to working families at or below their communities' AMI. This includes an overwhelming number of market-rate apartment properties with no federal subsidies.

The message here is that nearly ALL of the GSEs' multifamily activities help create affordable and workforce housing, not just the capital they provide to properties designated as affordable.

The vast majority of non-subsidized apartments provide housing to people at or below area median income. That is because multifamily housing is inherently affordable. The median household income of all renters in 2007 was $25,500, well below the national median income of $47,000. The median income of renters in non-subsidized market-rate apartments was $30,000.

The conventional apartment industry's ability to serve renters at or below area median income is a result of the liquidity the sector has had access to for the past 20 years, and that liquidity is the result of a government-supported secondary multifamily mortgage market that has lowered the cost of capital to affordable AND market rate apartment providers. Without that government support, interest rates and debt service costs will rise, rents will have to increase to cover these costs and our market-rate industry will be less able to serve people at or below AMI.

Not only does the presence of a government-supported secondary multifamily mortgage market lower the cost of capital, it is important to understand that it also works to leverage private capital to support affordable housing.

Without a government guarantee of multifamily mortgages or mortgage-backed securities, rents will go up and the supply of affordable housing will go down because other capital sources cannot and will not fill the gap.

- Even if the life insurance companies expand their role in multifamily finance, they have no mandate to take on the additional risk of affordable housing. Their mortgage programs are based on maximizing profits for their investors and policyholders. They will also not step in to fill the financing needs of older properties, properties with subsidy, properties in weaker markets or properties with physical needs.
- A resumption of bank lending will also not fill the gap because stricter portfolio and accounting standards limit their ability to provide development and debt capital. Banks have never been a source of long-term financing (longer than three to five years).
- It is unclear when and to what extent the commercial mortgage-backed securities (CMBS) markets will be able to meet the multifamily sector's capital needs both in the short and long term. Private label CMBS provided 12 percent of net financing capital, or $1 billion a year, in the 10-year period from 1985 to 1994. It grew to 18 percent, or $6.3 billion per year, in the next 10-year period from 1995 through 2004 before peaking at 23 percent, or $17 billion a year, in the housing bubble years of 2005 through 2007. Since the bubble burst in 2007, private-label CMBS have had net flows of -$7.5 billion per annum (-22.3% of net multifamily financing flows) as the market shut down completely.

- The Federal Housing Authority (FHA) is likewise not a replacement, as it has exceeded its capacity to serve a material share of the market. It would take a substantial commitment from the government to fund significant changes to FHA's resources, systems and delivery process for FHA to meet the financing gap. Currently, FHA is changing its multifamily underwriting criteria to reduce, not expand, the number of loans it funds as a result of weakening portfolio performance.

2. Preserving Critical Housing Stock

Another important, and often overlooked, function of the GSEs has been to provide the capital necessary to preserve older apartment properties. Typically, institutional investors overlook "Class B" and "Class C" properties. These are older buildings with fewer amenities, in weaker markets and/or in need of improvements, and they are crucial to meeting the housing needs of millions of Americans seeking affordable decent and safe housing.

Capital for these properties has historically been provided by local banks (now extremely limited), CMBS (now absent), FHA (at or near capacity) and the GSEs through the Low-Income Housing Tax Credit (LIHTC) and other investment funds. Without a strong secondary multifamily mortgage market, there will be insufficient capital to preserve affordable multifamily housing. More rental units will leave the market or be converted/upgraded and the nation will lose more than the 132,000 apartment units it already loses each year to obsolescence.[2]

3. Supporting Industry Standardization

The GSEs have created extensive standardization in the legal, financial underwriting, physical assessment and environmental hazard management (e.g., lead-based paint, asbestos, operations and management protocols, etc.) of multifamily real estate. The banks and insurance companies also base their work on the GSEs' loan requirements and uniform mortgage documents.

This standardization has made multifamily financing more efficient, has helped lower the cost of capital, and has strengthened general underwriting in the apartment sector. The GSEs have been a leader in attracting worldwide capital sources to the housing industry.

4. Providing Liquidity with Strong Historical Performance

The U.S. housing finance system, with the GSEs playing a central role as the system developed and evolved over the last 60 years, worked extremely well. It allowed the U.S. to enjoy the highest homeownership rate in the world and helped create the broadest and best housing stock on earth. It was the envy of the world.

The secondary market created by the GSEs has repeatedly shown its value as a liquidity source to **ensure that the apartment sector had working capital in all market conditions.** When credit markets have been impaired for reasons that have nothing to do with multifamily property operating performance, the GSEs have ensured the continued flow of

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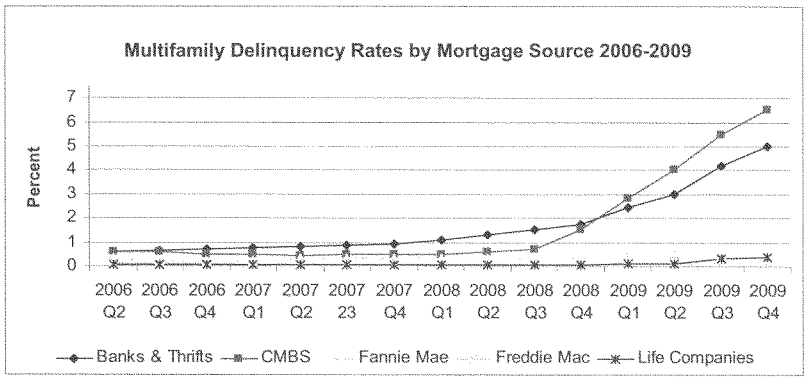
[2] Based on HUD's Components of Inventory Change (CINCH) data set. Over the last decade, losses to the stock have averaged 0.71 percent annually. This figure is applied to our estimated apartment stock of 17 million. Based on a total multifamily housing stock of approximately 17 million units, a loss rate of 0.5% would equal 85,000 units lost annually; a loss rate of 0.8% would equal 136,000 units lost annually.

capital to apartments. This was the case during the savings and loan crisis, the 1999 Russian economic crisis, and is the case today. This invaluable system has enabled our sector to continue to meet the nation's housing needs in good times and in bad, an important public policy goal.

Moreover, they have done it with strong historical portfolio performance. Over the past 20 years, their multifamily loan delinquency and defaults have been minimal—less than one fifth of one percent. At the end of 2009, the GSEs' delinquency rates were at or below one-half of one percent (45 bps). This is 14 times less than the CMBS market (6.5 percent) and 11 times less than commercial banks (5 percent). Even the government's FHA multifamily loan insurance program is experiencing higher levels of distress (1.2 percent) than the GSEs.



Note: Delinquency is defined as follows: Banks & Thrifts = 90+ days; CMBS = 90+ days; Life Insurance Companies = 90+ days; Fannie Mae = 60+ days; and Freddie Mac = 90+ day.

Sources: Realpoint Research, Fannie Mae, Freddie Mac, Mortgage Bankers Association, U.S. Department of Housing and Urban Development.

There are many reasons for the GSEs' strong performance, including, but not limited to:

- sound and effective credit policy;
- prudent underwriting and loan terms and mortgage requirements;
- effective third-party assessment procedures (as part of the loan underwriting and due diligence process);
- strong contractual agreements with their origination and servicing partners;
- risk-sharing with and risk-retention by origination and servicing partners;
- effective loan portfolio management and oversight;
- standard mortgage documentation; and
- geographic and loan product diversification.

In addition, multifamily loans are generally considered to be less risky than and are expected to outperform other commercial real estate loans. The Congressional Oversight Panel's February 2010 report of commercial real estate noted that overall mortgage defaults in multifamily were less than half of commercial real estate—3.58 percent for multifamily among banks compared to 8.74 percent for all commercial mortgages.

To be sure, the prolonged economic weakness continues to affect apartment firms, and the GSEs are expected to experience an increase in problem loans, delinquencies, defaults and even foreclosures. However, these losses will be quite small compared to their single-family losses, and they will be within manageable levels.

It is important to point out that the GSEs reserved against these losses. Unfortunately, those reserves were used to pay off single-family losses; otherwise, there would be no impact to the taxpayer for the GSEs' multifamily losses. Also important to note is that the multifamily finance business lines of Fannie Mae and Freddie Mac have provided steady and significant profits to the GSEs. **If they, or whatever replaces them, continue to manage their multifamily business as the GSEs have for the past 20 years, and continue to benefit from greater oversight, the risk to the taxpayer will be minimal.**

FUTURE SECONDARY MARKET CONSIDERATIONS FOR MULTIFAMILY HOUSING

Ensuring that a new or revised secondary market system will continue to serve the multifamily industry must be a key goal of any legislation and regulatory oversight. With other capital sources constrained by market conditions, regulatory requirements, impaired balance sheets or capacity issues, the GSEs will continue to provide 75 to 90 percent of the apartment sector's mortgage capital in the near term, and their participation will need to be significant in the long term as well.

Unfortunately, thus far most policy recommendations have been largely silent on multifamily mortgage activities. Those that are supportive of a continued multifamily role offer little detail or direction.

We advise you to be careful not to design solutions that "fix" the single-family problem at the expense of creating liquidity or capital access problems for the multifamily sector. We offer the following comments to help guide the creation of an effective and efficient active secondary multifamily mortgage market.

1) ***Active Secondary Multifamily Mortgage Market Needed at All Times***
   Some have argued that the reconstituted secondary market be restricted to a "stop-gap" role for only those occasions of illiquidity in the market. We think this is an ill-conceived proposal that would have potentially devastating consequences for the U.S. housing finance system. There needs to be a credible source of mortgage capital in all markets to preserve and expand the full range of apartment stock.

   The current multifamily secondary market has worked well and has provided stability to the market. The government's credit support has allowed for a growing and diverse portfolio of multifamily mortgages that meets the needs of millions of families and has permitted stability in the rental housing market. It has also reduced risk to the taxpayer through product, asset and geographic diversity.

2) ***Private Capital Preferable to a Government Entity***
   We do not support the creation of a publicly funded government entity or entities, but instead believe that private capital should be leveraged to support secondary market activities. The private-sector approach has served the multifamily marketplace well for many years and should be retained. Not only will private capital be necessary to meet the industry's capital needs, a private model also removes the limitations of government budget constraints and allows the reconstituted secondary market to adopt an entrepreneurial approach to meeting the industry's capital needs.

There is great concern that replacing Fannie Mae and Freddie Mac with a publicly funded government entity or entities would not only dilute the capacity and resources of the current secondary market, but also reduce the innovation that has been so vital to the multifamily mortgage market.

The industry's capital needs change as a result of changes in the marketplace and changes in the general financial sector, and the two firms have consistently created new (and safe) products to respond to those changes. Examples include their low-interest floating to fixed-rate mortgages that help stabilize new properties through long-term financing; acquisition and development products specifically designed to provide capital to renovate older properties; and a fixed-forward for LIHTC new construction loans to support that market.

These innovations are a large part of what has enabled the apartment industry to meet our changing housing needs and to create the affordable and workforce housing produced in the last 15 years.

3) ***Provide Explicit Federal Guarantees***

There is no empirical evidence and certainly no history to support the notion that the private market is willing and able to meet the apartment industry's liquidity needs in all economic climates. Therefore, the federal government needs to continue to play an active role in ensuring liquidity, and **the federal role in providing that backstop or guarantee should be explicit.**

The federal government should guarantee multifamily mortgage securities and portfolio-held loans. However, the "full faith and credit" of the U.S. government in accessing capital should be paid for at an appropriate price. Establishing a fee structure to support the government's backstop is reasonable and appropriate. Such a risk-based guarantee fee on the underlying mortgage would provide reserves against mortgage losses and subordinate any losses the federal government might incur in providing explicit guarantees.

The current GSE structure incorporates a risk-based pricing approach that has proven to be well managed and to cover losses. The GSEs' current losses resulted from their single-family business, not the multifamily business. The guarantees collected by the GSEs would have covered their multifamily losses if the reserves had not been used to cover single-family losses instead. Thus, we recommend that multifamily loan loss reserves and guarantee assignments be managed separately from other mortgage activities by any future secondary market entities.

4) ***Retain Portfolio Lending While Expanding Securitized Lending***

We support the federal regulatory push to convert the GSEs' business largely to a guarantor model wherein they assume the credit risk for mortgage-backed securities issuance. However, while single-family loans are fairly easily "commoditized" for a mortgage-backed securities business model, for their multifamily business there needs to be flexibility for the GSEs to use portfolio executions in select circumstances.

Multifamily mortgages are individually tailored to the borrower/owner, property and market. As a result of these unique characteristics as well as pre-payment provisions and other loan features, securitization is not always prudent in terms of managing credit risk on the multifamily side.

In the securitization model, the capital provider (buyer) cannot take action when loan performance issues arise because that would modify the terms of the security. We have seen this time and again in the CMBS market, and Freddie Mac had extensive problems with it in

the late 1980s. Therefore, select multifamily loans should be held in portfolio, including any aggregated loans that are not suitable for securitization. **Without the ability to hold some loans in portfolio, multifamily lending activities would be significantly curtailed and restricted.**

This should not create material credit issues for the reconstituted GSEs, however, as the volume of multifamily loans that would be held in portfolio should be small and the risks manageable.

5) ***Public Mission vs. Shareholder Value: Public Mission Should Focus on Liquidity***
One area that has been much debated is how much the GSEs' public mission contributed to their higher-risk lending activities so they could meet mandated affordable housing mortgage purchase goals.

However the secondary market is reconstituted, there should be no return to the built-in conflicts their original charter created between serving a public mission (by providing high-risk, low-return mortgages) and meeting investor expectations. We have learned that the "do it all" mandate for Fannie Mae and Freddie Mac—providing support for affordable housing, operating in a safe and sound manner *and* providing competitive returns to investors—is simply too much to accomplish.

We believe Fannie Mae's and Freddie Mac's public missions need to be clearly defined and should be focused primarily on using a government guarantee to provide liquidity to the multifamily mortgage market. As noted earlier, by virtue of providing liquidity to the multifamily sector, the GSEs are already supporting a public mission to advance affordability because multifamily is inherently affordable housing.

We do not believe that targeted affordable housing mortgage transactions should be mandated. Such goals or mandates create conflicts with private investment and add to the cost of all housing. We do believe in using private capital to augment the government's role in serving the needs of low- and very low-income households.

6) ***Incentives and Other Agencies to Support Public Mission Beyond Liquidity***
Instead of mandates, the reconstituted GSEs should be given incentives to support affordable multifamily housing. These incentives should be used to encourage **private** capital to participate in higher risk activities. For instance, the government could provide an increased guarantee by insuring some amount of portfolio debt that meets select criteria that advances affordability, such as small multifamily lending, subsidized federal affordable housing and subsidized state and local affordable housing.

Absent such incentives, the government should redirect the affordability mission to the HUD/FHA multifamily insurance program. One recommendation is to expand the current statutory provision for HUD risk-sharing. The current program is very limited and has not produced a material number of transactions.

Policymakers should focus efforts to expand targeted affordable multifamily housing through HUD programs such as HOME, HOPE VI, CDBG and the Housing Trust Fund. They should also bolster the beleaguered Low-Income Housing Tax Credit program and improve the Section 8 Housing Choice Voucher Program. All of these efforts will support affordable housing without creating conflicts within the secondary market.

7) ***Retain Resources and Capacity***

The GSEs' multifamily programs have been very successful in large part because the two firms have established and created extensive legal, credit and operating policies and procedures, technology and information management systems and have credible and effective human capital. This has allowed the multifamily programs to operate in a professional, effective, efficient and prudent manner to meet and effectively respond to market needs and changes.

Their resources go beyond personnel and technology and include extensive third-party relationships with lenders and mortgage servicers, appraisers, engineers, consultants, attorneys and others.

There is great risk that these critical resources will be diluted as the debate over the future of Fannie Mae and Freddie Mac continues. That said, there is also great opportunity to build on the infrastructure created by the entities and their lending partners to continue to deliver capital to multifamily owners and developers.

8) ***Retain Subordination and Risk-Sharing Model***

Fannie Mae's delegated underwriting and servicing (DUS) relationship has a strong, proven track record. Not only has the system allowed Fannie Mae to extend capital with lower structural resources, it has also reduced Fannie Mae's exposure to the credit risk associated with the loans through subordination of risk via a top-loss backstop by the loan originator and servicer. Though some accommodations will be needed for portfolio transactions and aggregation capacity (to effectively implement structured and other higher-credit risk transactions), the current delegated underwriting and servicing system should be closely evaluated as a means to reduce credit risk.

9) ***Number of Entities***

Included in the debate over the future of the GSEs is a question as to whether there should be more than two entities serving the secondary mortgage market to reduce the systemic risk associated with one entity.

This topic is of concern to the multifamily sector because the multifamily programs and staffing are a small component of the current system and they rely on a certain level of economies of scale to support many of their activities, such as capital markets, securities trading, legal, administrative and overhead. Creating similar multifamily programs in multiple entities would be costly and possibly inefficient and would likely increase borrowing costs, which would increase rents.

It is unclear whether having three, five or even ten entities providing comparable multifamily products would create increased competition or whether some entities would choose not to offer multifamily mortgage debt products.

Even in the CMBS market there were only a handful of conduit issuers and the market was very efficient and very competitive. There may be benefit due to systemic risk for the single-family business activities to have multiple entities, but it is unclear if this model would benefit the multifamily market.

TOMORROW'S HOUSING POLICY: NEW PRINCIPLES

I would also like to take a moment to address our national housing policy more broadly as I feel that it underscores the importance of explicitly considering the multifamily component in a restructured secondary mortgage market.

For decades, the federal government has pursued a "homeownership at any cost" housing policy, ignoring the growing disconnect between the country's housing needs and its housing policy. In the process, many people were enticed into houses they could not afford, which in turn helped fuel a housing bubble that ultimately burst and caused a global economic crisis.

The nation is now paying the price for that misguided policy and learning firsthand that there is such a thing as too much homeownership; that aggressively pushing homeownership was not only disastrous for the hardworking families lured into unsustainable homeownership, but also for our local communities and our national economy.

If there is a silver lining in this situation, it is the opportunity we now have to learn from our mistakes and rethink our housing policy. Housing our diverse nation means having a vibrant rental market along with a functioning ownership market. It's time we adopt a balanced housing policy that doesn't measure success solely by how much homeownership there is.

For many of America's most pressing challenges, from suburban sprawl to affordable housing, apartments are a much better solution. Apartments help create stronger and healthier communities by offering enough housing for the workers that businesses need, by reducing the cost of providing public services like water, sewer and roads and by creating vibrant live/work/play neighborhoods.

They will help us house our booming population without giving up all our green space and adding to pollution and traffic congestion. And they will help us reduce our greenhouse gas emissions by creating more compact communities that enable us to spend less time in our cars.

Elements of a Balanced Housing Policy

NMHC and NAA have joined together to advocate for a more balanced housing policy, one that respects the rights of individuals to choose housing that best meets their financial and lifestyle needs. We urge policymakers at all levels of government to work with the apartment industry to craft a smarter housing policy that:

- Assures that everyone has access to decent and affordable housing, regardless of his or her housing choice;
- Respects the rights of individuals to choose the housing that best meets their financial and lifestyle needs without disadvantaging, financially or otherwise, those who choose apartment living;
- Promotes healthy and livable communities by encouraging responsible land use and promoting the production of all types of housing;
- Recognizes that all decent housing, including apartments, and all citizens, including renters, make positive economic, political and social contributions to their communities; and
- Balances the expected benefits of regulations with their costs to minimize the impact on housing affordability.

We hope you agree with us that it is time to make rental housing a higher priority, and we look forward to working with the Financial Services Committee as you work legislatively to restore balance to our housing policy.

APPENDIX 1:

Housing Affordability of Rate Apartment Properties from Selected Public and Private Apartment Firms.

These tables summarize an analysis of 214,657 apartments in 812 properties located throughout the United States. The properties have no direct federal subsidy or rent regulatory restriction recorded with the local government. They were financed with secondary market mortgage capital and represent properties in large and secondary urban locations as well as suburban locations throughout the United States.

Apartment Affordability
Analysis of 812 Market-Rate Properties

UNIT AFFORDABILITY - TOTAL			
Units at 100% AMI*	Number of Affordable Units	Total Number of Leased Units	Percent of Total Units
0 BR	5,385	6,336	85.0%
1 BR	94,779	106,663	88.9%
2 BR	98,262	110,985	88.5%
3 BR	16,155	17,814	90.7%
4 BR	76	80	95.0%
Total	**214,657**	**241,878**	**88.7%**

UNIT AFFORDABILITY - EAST			
Units at 100% AMI*	Number of Affordable Units	Total Number of Leased Units	Percent of Total Units
0 BR	1,860	2,365	78.6%
1 BR	33,690	38,315	87.9%
2 BR	37,058	41,795	88.7%
3 BR	6,950	7,623	91.2%
4 BR	76	78	97.4%
Total	**79,634**	**90,176**	**88.3%**

UNIT AFFORDABILITY - SOUTH			
Units at 100% AMI*	Number of Affordable Units	Total Number of Leased Units	Percent of Total Units
0 BR	1,225	1,276	96.0%
1 BR	35,880	38,018	94.4%
2 BR	33,354	35,944	92.8%
3 BR	6,122	6,525	93.8%
4 BR	-	-	0.0%
Total	**76,581**	**81,763**	**93.7%**

UNIT AFFORDABILITY - MIDWEST			
Units at 100% AMI*	Number of Affordable Units	Total Number of Leased Units	Percent of Total Units
0 BR	219	220	99.5%
1 BR	3,459	3,545	97.6%
2 BR	3,670	3,709	98.9%
3 BR	166	166	100.0%
4 BR	-	-	0%
Total	**7,514**	**7,640**	**98.4%**

UNIT AFFORDABILITY - WEST			
Units at 100% AMI*	Number of Affordable Units	Total Number of Leased Units	Percent of Total Units
0 BR	2,081	2,475	84.1%
1 BR	21,750	26,785	81.2%
2 BR	24,180	29,537	81.9%
3 BR	2,917	3,500	83.3%
4 BR	-	2	0.0%
Total	**50,928**	**62,299**	**81.7%**

Notes:

* List of participating companies: ConAm, Archstone, Waterton, Avalon, GID, BRE, Post, Home, Camden, Greystar, Bozzuto, Laramar, UDR, Berkshire and Mid-America
* AMI is Area Median Income
* Analysis only includes properties using a form of Lease Rent Optimization such as LRO or Yieldstar in order to obtain effective, leased rents only
* Analysis does not include vacant or employee occupied units

3/18/2010

Apartment Affordability

Analysis of Per Unit Loan Amounts for Market-Rate Properties

PER UNIT LOAN MORTGAGE AMOUNT BY REGION			
Number of Properties that Have an Affordable Component at 100% of AMI*		Weighted Average Loan Per Unit	Average Maximum Loan
Region	# of Properties		
East	294	$125,566	$334,372
South	268	$76,725	$145,020
Midwest	21	$67,919	$102,012
West	212	$128,858	$284,820
Total	**795***	**$108,456**	**$216,556**

Notes:

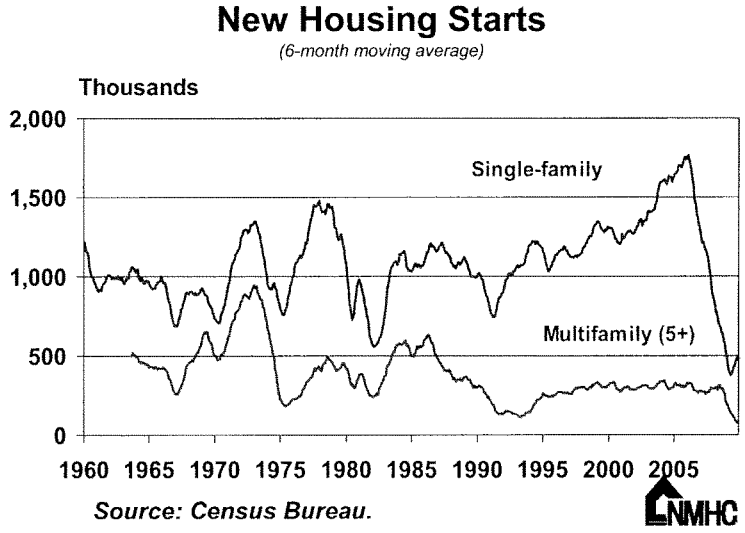
* List of participating companies: ConAm, Archstone, Waterton, Avalon, GID BRE, Post, Home, Camden, Greystar, Bozzuto, Laramar, UDR, Berkshire, and Mid-America
* Of 812 properties surveyed, 795 or 98% have an affordable component
* AMI is Area Median Income
* Analysis only includes properties using a form of Lease Rent Optimization such as LRO or Yieldstar in order to obtain effective, leased rents only
* Analysis does not include vacant or employee occupied units

APPENDIX 2:

New Housing Starts for Single-Family and Multifamily Properties (5+ Units) 1960-1998

This chart provides an analysis of U.S. Census data on new housing starts for single-family properties and multifamily properties with five or more units.

The data show the stark contrast between the single-family housing production/bubble and resulting housing crisis and the relatively constant level of new production in the multifamily housing sector during the same period.



Embargoed Until 10:00 a.m. EST, March 23, 2010

Secretary Timothy F. Geithner
Written Testimony
House Committee on Financial Services
March 23, 2010

Introduction

Promoting and maintaining stability in the housing market is critical to achieving economic recovery and sustainable long term growth. The Administration's broad housing policies, including support for the ongoing functions of the Government Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac, together with Treasury's and the Federal Reserve's purchases of mortgage-backed securities, have been crucial to restoring stability in the housing market and to maintaining the availability of mortgage credit. Private capital has not yet returned to provide the amount of funding that would be needed to allow families to get a mortgage to buy a new home or to sensibly refinance the house they already live in. Without the continued activity of the GSEs and the Federal Housing Administration (FHA) in the current environment, mortgage rates would be higher and homeowners would have a significantly harder time obtaining credit. While conservatorship, undertaken by the Federal Housing Finance Agency (FHFA) during the Bush Administration, pursuant to Congressional authorization under the Housing and Economic Recovery Act (HERA), and continued under the Obama Administration, was necessary, together we must begin the process of fundamental reassessment and reform.

The failure of Fannie Mae and Freddie Mac was part of a broader crisis that revealed structural flaws in the entire housing finance system. Housing markets are subject to booms and busts – a key issue is whether the system of housing finance acts to dampen such cycles or to worsen them. In this case the verdict is woefully clear. For many years, the housing finance system provided credit to households in a reliable and stable manner, setting appropriate standards for mortgage origination, and attracting diverse sources of capital though securitization. However, insufficient regulation and enforcement was unable to check increasingly lax underwriting, irresponsible lending and excessive risk taking. Increasing usage of complex products led to a growing misalignment of incentives facing mortgage brokers, originators, credit investors and borrowers. This fueled unsustainable debt levels and house price appreciation. The risk of a fall in home prices was ignored by most and there was too much leverage in every part of the system. These problems were worst in the least regulated non-bank sectors that fed private-label securitizations. Over time, problems associated with the absence of prudent underwriting standards and effective consumer protection migrated from these sectors to the more highly regulated channels of mortgage origination, including the banking sector.

The performance of the GSEs was symptomatic of this larger regulatory and oversight failure. They were allowed to earn private gains for many years, but ultimately the taxpayer subsidized their losses. They were allowed to expand and manage their investment portfolios without regard to the risk they posed to the system. Over time, the GSEs were permitted to guarantee riskier

mortgages and mortgage-backed securities. They were not required to hold adequate capital and employed inadequate risk management.

The housing finance system clearly cannot continue to operate as it has in the past. A broad reform process of the housing finance system must be undertaken to achieve comprehensive and effective reform that delivers a more stable housing market with stronger regulation, more effective consumer protections and a clearer role of government with less risk borne by the American taxpayer. Where guarantees or support is provided, it will be explicit and priced appropriately. There will be no ambiguity over the status or allowable activities of any private entity which enjoys any benefits or protections from the government.

Designing and implementing practical solutions to the problems in the housing finance system will not be simple. The residential housing market is one of the largest sectors in the US economy, and the US mortgage market is the second largest securities market in the world (after US Treasuries). For many American families, their home is their largest and most important financial investment. Over 67 percent of Americans live in their own home. The scale and complexity of the system and its problems require that reform be developed and implemented in a thoughtful and measured way to ensure that Americans have sustained access to affordable credit as the overall housing market continues to recover. Homebuilders, realtors, lenders and other market participants need stability in order to do their jobs.

As part of the reform process, the Administration intends to develop a comprehensive reform proposal for the GSEs role in the broader housing finance system through public consultation with a wide variety of constituents, market participants, academic experts, and consumer and community organizations. After reform, the GSEs will not exist in the same form as they did in the past. Private gains will no longer be subsidized by public losses, capital and underwriting standards will be appropriate, consumer protection will be strengthened and excessive risk-taking will be restrained.

While the form of the housing finance system will change, government has a key role to play in shaping the future of the nation's housing finance system and in setting housing policy goals. A new system must be designed to ensure that markets are more stable, consumers are protected, sustainable credit is widely accessible and important housing policies, such as affordable housing for low and moderate income families, are administered effectively and efficiently.

The Housing Crisis

Prior to considering any reform to the GSEs and the broader housing finance system, it is important to understand the circumstances that contributed to the current housing crisis.

While the structural problems in the mortgage finance market had been building for decades, it was not until the early part of the last decade that a combination of factors came together in a manner that set the country on a path towards an unsustainable housing and credit bubble. The forces that produce such bubbles are often present, but our system enabled and amplified them.

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Beginning in the unregulated, non-bank sector, underwriting standards were greatly relaxed. Rather than lending primarily against the credit quality of the borrower and assessing ability to pay, lenders increasingly underwrote mortgages based on the current and future expected value of the home. Borrowers were able to buy homes with little or no down payment through the expanded use of private mortgage insurance and "piggyback" second-lien mortgages (second mortgages originated at the same time as a first-lien mortgage). In some cases, borrowers were sold complicated loans they did not understand and could not afford. Non-bank actors developed these strategies, but over time the banking sector quickly adopted these practices and took the system to scale. A race to the bottom ensued.

Lenders increasingly offered alternative, non-conforming or non-"prime" mortgages, such as Alt-A and subprime products. Although these products first became available in the 1980s and 1990s, their use in the conventional market ballooned in the decade that followed. Exotic products – pay-option ARMs, interest rate only loans, negative amortization, 2/28 "bullets" and other such products – left their niches and became widely used in the Alt-A and subprime markets. Higher fees, yield spread premiums and prepayment penalties and the expectation of quick sales or refinancings made these products economically attractive for lenders in ways they had not been in the past. Private label securitizations, driven by investors chasing yield, fueled increased supply of high-cost products. Opaque structures, inflated triple-A ratings by credit ratings agencies and lack of "skin in the game" in the "originate to distribute" model helped to foster bad lending practices. Combined subprime and Alt-A mortgage origination increased from $125 billion in 2000 to over $1 trillion in 2006. At their peak in 2005, subprime and Alt-A mortgages together represented 32 percent of total mortgage origination.

The rate of credit expansion and house price appreciation ultimately proved unsustainable and higher prices and interest rates undermined affordability. An unprecedented increase in residential construction outpaced demand. By the beginning of 2006, the cycle began to turn. As home prices began to fall, households struggled to refinance their adjustable rate loans before they reset. Subprime and Alt-A borrowers began to default in higher numbers – foreshadowing eventual failures in the prime market. Lenders and borrowers began to re-evaluate core assumptions.

No one in the mortgage origination chain was prepared for a meaningful decline in housing prices. Too much leverage had built up in the system and equity cushions at all levels (borrower, lender, securitizer, investor) were inadequate to absorb even modest amounts of losses. Leverage, and in many cases leverage on leverage, had been built on a flawed foundation of assumptions and a thin capital base that left little room for error in the case of market deterioration.

Rising interest rates most acutely affected subprime, Alt-A and other non-conforming loan products, as such products frequently carried variable rates or short-term teaser rates and payment terms that reset into more punitive levels. In many cases, the borrower's ability to pay had not been evaluated by the lender on the basis of these higher rates, and many borrowers were simply never capable of affording the mortgages they had been sold.

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Securities backed by riskier mortgage products began to lose value as delinquency and default rates that had been historically low for many years began to increase, in some cases dramatically. When market values declined and these securities' ratings were downgraded, liquidations became commonplace and investors were often forced to sell these highly leveraged structured products. This further exacerbated the crisis.

According to FHFA/Haver Analytics, home prices that had risen by 85 percent in aggregate from 1997 to mid-2007, fell by 11 percent across the entire US by the end of 2009, of which three-fourths occurred in 2008 alone. In certain markets, home prices fell more than 25 percent. The subsequent contraction of credit across the financial system led to a further reduction of lending and liquidity and exacerbated home price declines.

The excess supply of housing stock fueled by the previous expansion continues to weigh on home prices. Lower home prices have contributed to tremendous loss of wealth and reduced consumer confidence and spending. Labor mobility has declined, as many homeowners owe nearly as much or often much more than their house is worth on the combination of their home mortgage and subsequent borrowing done through home equity loans (HELOCs), resulting in "home lock." Delinquencies and foreclosures have risen dramatically. Foreclosures have caused great harm to the social fabric of communities, particularly those in the most afflicted areas.

Vacant and foreclosed homes have a debilitating effect on neighborhoods and can lead to reduced property values, blight, and neighborhood decay. Studies have shown that spousal relationships, family unity, child behavior and academic performance all suffer in connection with home foreclosure. Furthermore, the lost stability of the ownership of a home and the stigma associated with home foreclosure in America is significant and can make recovering from a lost job, a divorce, an expensive medical event or another shock to an individual or family much harder. The housing crisis cannot be measured only in numbers and dollars, but must also take into account the real impact to Americans who are working hard to provide a better life for themselves and their families.

Origins of the Crisis

There are a large number of factors that contributed to the housing and credit bubble that emerged over the last ten years.

Macroeconomic Conditions Supportive of Home Price Appreciation. Coming out of the 2001 recession, the macroeconomic environment was conducive to a natural appreciation of home prices in the US. Accommodative interest rate policy and global imbalances combined to reduce financing and home ownership costs to historic lows for American households. Demand for housing in general increased due to higher rates of household formation. The start of this past decade was also marked by a psychological shift, as the declines in the equity market accompanying the end of the technology boom gave rise to the view that residential housing as an "asset class" was safer than other investment alternatives.

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As home prices began to rise at an increasing pace at the start of this decade, a belief that prices would only go up and never come down became embedded in the minds of nearly all actors in the housing market – borrowers, lenders, brokers, investors, developers, regulators and policy-makers. Prior to late 2007, national housing prices in the United States had not declined on a sustained basis since the Great Depression. The lack of a meaningful contraction in home prices during the 2001 recession furthered the perception that housing was a lower volatility asset class, with limited downside risk.

Flaws in the Securitization Market. Two trends in financial innovation reinforced and intensified these fundamental macroeconomic factors. First, there was a rapid expansion of lending generally that allowed many borrowers to access greater amounts of credit than they could have previously. Lenders relied on increasingly complex underwriting tools that incorporated risk management scoring and pricing systems to lend to a broader range of households. Furthermore, issuers were able to shop the rating agencies for the best ratings on their securities – conflicts of interest helped drive ratings, and there were insufficient checks on rating agencies' behavior. In many cases profits realized from these subprime and Alt-A lending activities exceeded those derived from traditional consumer and business lending activities.

Second, the rapid growth of structured credit products provided mortgage brokers with more direct access to capital markets, reducing the traditional role of banks and thrifts as the primary originator of mortgages to consumers. Moreover, securitizers, originators and mortgage brokers had little incentive to police standards more aggressively or to maintain an ongoing relationship with the borrower since they were not required to retain substantial risk in the products they sold to investors. Securitization, which moved core functions of lending off the balance sheets of major banks, came to represent nearly 50 percent of credit formation in the United States at its peak, with residential mortgages by far the largest credit product in this system. This parallel credit system, however, proved to be much less robust, more prone to manipulation and substantially more leveraged than the banks it replaced. The lack of proper transparency and clear rules and standards in the private-label securities (PLS) market made tracking and recognizing risk in the system difficult.

Reforming this key credit channel is important. The Administration's broader regulatory reform proposals include important provisions that reform the regulation of credit rating agencies, align incentives and create the basis for the preservation of securitization as a vital channel of credit provision going forward. Securitization, with the right standards and guidelines, can be an effective and sound source of credit formation and a method to allow for the broader distribution of mortgage risk beyond the banking sector.

Errors in Risk Management. Market participants made grave errors in risk measurement and management. They relied too much on the assumption that if diverse pools of mortgages were aggregated from borrowers across the country, problems affecting any one group of borrowers or limited to one part of the country would only represent a small loss to the broader pool of mortgages. And market participants assumed that by slicing these mortgage pools into different priority tranches they could create nearly riskless securities. This situation was exacerbated by

the faulty assumptions used by rating agencies, investors, and lenders to model and assess risk, in particular the correlation risk that arose due to lack of diversification. They assumed a period of nearly uninterrupted economic growth, rising home prices and increasing and continued access to credit for almost all borrowers. Investors and other market participants were too quick to assume that the positive performance of loan products during this period would continue going forward and that this stable environment would not end. Rating agencies also relied on models that were ill-equipped to assess risks or adjust for the lack of historical data on performance of many of these new types of loans. At a time when investors and ratings agencies should have increased their diligence with respect to the capacity and likelihood that borrowers could repay these loans, they did the opposite and condoned substantial reductions in underwriting and documentation standards. Even sophisticated market participants faced challenges assessing risk levels, as product complexity and several layers of intermediation obscured the full risks borne by lenders and investors

Failure of Regulatory Oversight. Absent in most of this narrative was the involvement of effective regulatory oversight or supervision. Evidence of deteriorating underwriting standards and excessive risk-taking was present early in the housing boom. There were many organizations and institutions that had the authority to respond, but failed to act. The growth of the less regulated sectors of the housing finance system applied pressure on the regulated sector, which resulted in a race to the bottom. The level of regulation and its application was inconsistent among supervisors and permitted forum shopping by lenders. Securitizers and investors were essentially able to opt-out of the parts of the system with heavier regulation and use whatever underwriting they saw fit. Some federal regulators imposed different standards than others, so firms that were interested in offering some of the more exotic products, such as Option ARMs or low-documentation loans, generally structured themselves to take advantage of more permissive supervision regimes.

Failures of Consumer Protection. The system for protecting consumers in the mortgage market was, and remains, fundamentally flawed. Fragmented and uncoordinated regulation allowed bad practices to develop in the under-regulated nonbank sector of independent brokers and lenders. When banking agencies failed to respond in a coherent way, these bad practices spread to the banking sector, which in turn legitimized the practices of the independents. Supervision of bank mortgage lending was fragmented over four different agencies, slowing responses to problems and inviting regulatory arbitrage. These flaws remain in place and still need to be addressed.

A Shift in Consumer Behavior. Borrowers also bear responsibility for their decisions to take on more debt. Over the last 20 years, in part due to a generally stable macroeconomic environment, the American people became more comfortable maintaining larger balances of debt on their homes, cars and credit cards. Homes were refinanced more frequently, "equity extraction" products like home equity lines of credit were increasingly utilized and homes were purchased with little or no money down. While the liberalization of access to credit had many benefits, consumers' desire to maximize spending power while minimizing monthly payments contributed to the crisis.

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The Role of the GSEs in the Housing Crisis

Fannie Mae was established in 1938 to create a secondary market for FHA-insured loans. Fannie Mae raised money in the capital markets and purchased FHA-insured loans from banks. This was a response to the failure of the many institutions that had held mortgage risk prior to the devastation of the Great Depression. After a period of fairly rapid growth, in 1954, Congress changed Fannie Mae's charter, effectively ordering it to liquidate its mortgage portfolio and focus solely on being a conduit for loans to the secondary market. At that time, Congress established Fannie Mae as a mixed-ownership government corporation on a gradual path towards private ownership of its stock. In 1968, Congress established Fannie Mae as a government-sponsored enterprise: owned by private stockholders who elected a majority of the board of directors, but with a limited charter of activities that were mandated by Congress.

In 1970, Congress expanded the role and scope of the GSEs in the housing market by adjusting Fannie Mae's charter to allow it to purchase conventional mortgage loans (i.e., non-FHA, non-VA mortgages) and established Freddie Mac as a new government chartered entity within the Federal Home Loan Bank System to provide a second source of liquidity for conventional loans.

The two companies initially followed different business models: Fannie Mae focused on building a large portfolio of mortgage loans, while Freddie Mac focused principally on guaranteeing mortgages. In the mid-1980s, in response to large losses in its portfolio stemming from the same interest-rate exposures that led to the failure of many thrifts, Fannie Mae expanded its guarantee business. In 1992, Congress established the Office of Federal Housing Enterprise Oversight (OFHEO), set formal capital requirements for the GSEs for their guarantee and portfolio activities, and refined the missions of the GSEs, effectively equalizing their charters and range of business activities.

To some degree the role that the GSEs came to play was an extension of the original function of the FHA. However, their ability to properly serve this function was undermined over time by the unhealthy combination of their pursuit of profits and their misuse of the perception of government support, which was condoned by a wide range of regulators and oversight bodies.

For a long period of time, the GSEs supported a well-functioning, efficient mortgage market and the existence of their underwriting standards acted as a guideline for responsible underwriting by lenders. They played a central role in the development of securitization of conventional mortgages. They established appropriate benchmarks for conforming loans and brought transparency and standardization to the housing finance system. Borrowers, lenders and investors benefited from the deep, liquid markets which were formed.

However, the mortgage guarantee business, while profitable, did not provide the GSEs with the same ability to grow earnings as the retained portfolio business. The features of the government charters (e.g., line of credit with Treasury, public mission requirements, limited competition) and exemptions from certain tax and regulatory requirements created a perception of a special status conveyed by the US government on these companies. This perceived guarantee lowered funding

costs substantially and made the portfolio business increasingly attractive relative to the guarantee business, particularly given the GSEs' statutory capital requirements, which were significantly lower than other private sector competitors. While the activities of the GSEs in theory should have resulted in lower borrowing costs for homeowners, a significant amount of the subsidy was not passed on to homeowners, but instead benefited GSE shareholders, managers, mortgage originators and other stakeholders.

As the housing boom picked up earlier in the decade and as private label securitization began to increase, the GSE's mortgage guarantee business continued to maintain reasonably strict underwriting standards. In some part, as a consequence, non-agency, or "private label", securitization took on a larger share of the market where standards were being relaxed, and, consequently, the market shares of the GSEs began to fall. With a smaller market share and less guarantee income, the GSEs sought to find a way to continue to provide attractive returns to shareholders. Rather than compete for market share with private securitizations in guaranteeing mortgages, the GSEs increasingly directed more of their capital and resources towards growing the more profitable retained portfolio business. As a result, they focused more intensively on portfolio growth and, as the housing bubble expanded, greatly increased their purchases of riskier assets for their portfolios, in part by using their affordable housing mission requirements to justify some of their subprime purchases. In 2000 the GSEs held very few private label securities backed by subprime or Alt-A loans; by 2007 these securities made up 23 percent of their combined mortgage security portfolios.

The GSE charters contained a fundamental misalignment of interests As private companies, the GSEs had a fiduciary duty to maximize profits. However, at times this duty conflicted with their public mission, which was relegated to a subordinate role. As the private, unregulated market grew, the GSEs, driven by profit motivation and maintaining market share, followed the private market's exuberance and contributed to the broad trends that perpetuated the boom. The GSEs thus became a pro-cyclical source of capital to the housing market and contributed to the housing bubble.

For decades, the GSEs consistently lobbied for lenient oversight and lower capital requirements. Although there were several attempts to limit their scope and scale and risk profile, entrenched interests and aggressive lobbying thwarted these efforts and critical reforms were not instituted.

One such critical reform would have been requiring the GSEs to hold more capital to protect against losses. The GSEs were allowed to operate with significantly lower capital requirements than other private sector competitors. Federally-regulated banks are required to hold 4 percent capital against their mortgages. Fannie Mae and Freddie Mac, however, were only required to hold 2.5 percent capital against their on-balance sheet mortgage portfolio, and only 0.45 percent against mortgages they guaranteed. Furthermore, it became clear over time that the perception of federal backing enabled the GSEs to borrow at a thin spread over Treasury securities that did not reflect their inherent risk. These advantages entrenched the market positions of the GSEs and pushed out competition. These low capital requirements allowed Fannie Mae and Freddie Mac to use unsustainable amounts of leverage and resulted in severe under capitalization, making

these enterprises extremely susceptible to shock, particularly given the undiversified nature of their business activities.

The bursting of the housing bubble was just such a shock. Similar to other market participants, the GSEs were unprepared for a fall in housing and mortgage-back securities prices. Even a credit event of this magnitude, however, would have been less disruptive to the GSEs if they had retained more of their profits and built up their capital base. However, the low statutory capital requirements had essentially allowed earnings to be distributed to shareholders and other stakeholders each year.

Many observers of the government's role in the housing finance sector rightly focus on the role of Fannie Mae and Freddie Mac, but a full perspective must also include an evaluation of the Federal Home Loan Bank System (FHLBs), FHA, and the Government National Mortgage Association (GNMA or Ginnie Mae). Each plays an important role in the housing finance market. While these institutions, not motivated by private profits, did do a better job of serving a counter-cyclical role, the crisis also exposed some of the flaws in these institutional structures. For example, some of the same incentive alignment issues became clear in the decisions by several of the FLHBs to make large investments in non-agency, subprime mortgage securities at the peak of the cycle. These decisions have greatly affected the health of several of the FHLBs.

The FHA (through GNMA) was largely driven out of the market during the credit boom due to its lower loan limits and stricter originator standards, and so the FHA's safer and more conservatively underwritten product for low down-payment borrowers—the 30 year fixed rate mortgage—was not used extensively. During this period, the FHA was adversely selected for loans to borrowers that included poor practices such as seller-financed down payments that resulted in no-money-down loans. Today, when the private market has pulled back from providing credit to the residential housing sector, FHA and GNMA (along with the GSEs in conservatorship) are playing an important countercyclical role. As broader reform is undertaken, it must be done with a view to the appropriate role of each of these institutions in the overall housing finance system.

The Collapse of Freddie Mac and Fannie Mae and Conservatorship

By the time the housing market began its collapse, extreme leverage was pervasive throughout the housing finance system – at the banks, at the GSEs, and with the homeowner. Almost every actor along the housing finance chain was overextended.

As long as housing prices continued to rise, the GSEs' exposure to risky non-prime loans remained manageable. With the bursting of the bubble, however, the underlying weaknesses and flaws of Fannie Mae and Freddie Mac emerged with force. In 2007, the GSEs reported combined losses of over $5 billion, the first full-year loss for Fannie Mae since 1985 and the first ever for Freddie Mac. The companies' share prices plummeted by 60 percent between July 2007 and July 2008. The GSEs ultimately reported combined 2008 losses in excess of $108 billion.

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A collapse of Fannie Mae or Freddie Mac would have had devastating consequences for the housing finance system and the broader economy. These two entities are deeply interconnected with the broader global financial system, and the potential of their collapse would define the notion of systemic risk. Between the two entities, the GSEs guaranteed over $5 trillion of residential mortgage-backed securities, which represented nearly 50 percent of the overall residential mortgage market. They had over $1.7 trillion of debt securities outstanding, held equally among foreign and domestic investors. At a time when the foundations of the financial system were being deeply shaken by the broadening financial crisis, a collapse of either of these institutions would have caused a breakdown in the mortgage securities market, a significant worsening of the breakdown of confidence across the markets and a likely pull-back of foreign investment. In the end, as confidence eroded, the government was left with few viable policy alternatives.

As a result of the substantial deterioration in the housing markets, and Fannie Mae's and Freddie Mac's rapidly rising credit expenses and their growing inability to raise new capital and access debt markets, FHFA placed the GSEs into conservatorship on September 6, 2008 under the authority provided by HERA. In conjunction with that action, Treasury agreed to provide financial support to the GSEs through the establishment of Preferred Stock Purchase Agreements (PSPAs). While this action was undesirable, it was necessary and required. Both companies were severely undercapitalized and would not have been able to meet their obligations without the intervention and financial support of the government.

Prior to the actions taken in September 2008, investors in the GSEs had relied on the perception of backing by the government. Through the establishment of the PSPAs, the perception of government backing became explicit capital support, and as a result, the entities were stabilized sufficiently to play their current role in supporting recovery.

To continue the necessary support of the GSEs as the financial markets and economy recover, Treasury announced several changes in advance of HERA's expiration in December 2009. Treasury agreed to amend the cap on Treasury's funding commitment to each GSE, replacing the fixed $200 billion cap with a formulaic cap that increases above $200 billion by the amount of any losses, and reduces by any gains (but not below $200 billion), over the next three years. The cap will become fixed at the end of three years and will represent the maximum Treasury exposure to either GSE going forward from that point. Fannie Mae and Freddie Mac were also provided some modest additional flexibility as they reduced their retained mortgage portfolios. Treasury also announced that it would end its program to purchase mortgage-backed securities (MBS) at the end of the 2009 and terminate a liquidity facility that had not been utilized.

Neither company was near the previous $200 billion per institution limit in December and neither is likely to exceed those caps even under a range of very conservative assumptions. These actions, however, were intended to provide greater certainty to the market going forward that, even in conditions that seem unlikely based on current trends, the GSEs in conservatorship will be able to continue to meet their obligations and play the vital role they are continuing to play during this current crisis. The change also ensures that each firm will have a more appropriate

cap given their specific facts and circumstances at the end of 2012. By providing certainty to market participants for these extreme conditions, these actions are designed to improve market stability today, making such adverse conditions even less likely.

Additional flexibility was also provided in meeting the requirement that the companies reduce their retained mortgage portfolios over time. Fannie Mae and Freddie Mac are not expected to be active buyers of securities to increase the size of their retained mortgage portfolios in this period, but neither is it expected that active selling will be necessary to meet the required targets. Treasury remains firmly committed to ensuring that the GSE's retained portfolios are substantially reduced.

Taken together, these actions represent the most effective way to protect financial stability and enable these institutions to continue to play a vital role in the housing market during this crisis, including by securing the benefits of historically low mortgage rates on economic recovery, while limiting the long-term cost of the housing market collapse to the taxpayer. Indeed, the economy and the taxpayers would be far worse off if Treasury had not taken action during the Bush Administration in 2008 or if it did not continue that support going forward under this Administration.

The need for this level of intervention is both unfortunate and undesirable. However, without the decisive actions taken by the government and the specific support for the GSEs, the mortgage market would have halted, making it nearly impossible for Americans to buy or sell their homes or to refinance the mortgage on their existing home. The result would have been a much more wrenching decline in housing prices, a more severe foreclosure crisis and a deeper economic downturn.

The GSEs' securitization and guarantee activities continue to play an important role in housing finance today, and they have helped to stabilize the housing market during this crisis. As a result of the near complete absence of private capital in the mortgage origination market, the GSEs financed or guaranteed over 70 percent of new single-family mortgage originations in 2009, as compared to just under 40 percent in 2006. The FHA, the Department of Veterans Affairs (VA), and the Department of Agriculture (USDA) accounted for another 25 percent of originations in 2009.

Treasury and the Federal Reserve have also supported the secondary market through direct purchases of agency MBS (with approximately $200 billion and $1.2 trillion of purchases, respectively, in 2009).

Supporting the GSEs' ability to support the funding of new home purchases and the refinancing of existing mortgages will provide an important and valuable bridge that should allow necessary reforms to be executed in a time of greater housing market stability, something the Administration believes is essential to a successful transition.

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Clear Need for Reform of Housing Finance System and the Role of Government

The housing finance system cannot continue to operate as it has in the past. The Administration has already put forth important proposals for the broader financial system as part of financial regulatory reform, which will help address many of the problems in the private residential mortgage credit markets. These proposals substantially enhance supervision, establish an agency dedicated to ensuring clear rules of the road for consumer financial markets and create new rules for the securitization market including a requirement that all originators retain some risk in the mortgages they underwrite. These are necessary reforms that will make the financial system safer for all Americans.

More, however, must be done to address the specific flaws of the housing finance system. Action is needed to ensure that markets are more stable, consumers are protected, credit is widely accessible and important housing policy objectives, such as affordable housing for low and moderate income families, are administered effectively and efficiently.

Government has a key role to play in that new system, but its role, and the role of the GSEs in particular, will be fundamentally different from the role played in the past. Private gains can no longer be supported by the umbrella of public protection, capital standards must be higher and excessive risk-taking must be appropriately restrained.

When considering the future role of government in housing finance and its organizational design, it is important to remember that Fannie Mae and Freddie Mac are only one part of a whole set of institutions that support housing finance, which also includes FHA, VA, USDA and GNMA, the Federal Home Loan Banks, commercial banks, thrifts, community banks, community development financial institutions, credit unions, private issuers of mortgage-backed securities, mortgage brokers, and a wide range of other stakeholders and market participants. Any restructuring of Fannie Mae and Freddie Mac must be done as part of a reform of the wider housing finance system and placed within the context of broader housing policy objectives to ensure that the functioning of the whole system is advanced.

Furthermore, as part of any broad review of government's role in the housing finance system, one must consider how other government programs and policies support housing. A reformed housing finance system should reflect a consideration of how these different policies and institutions are balanced to achieve overall housing policy objectives.

The Administration has defined a framework of objectives for reform of the mortgage finance system. A reformed housing finance system should deliver stability and efficiency to the housing market, while minimizing the risks and costs borne by the American taxpayer.

Objectives of Reform

In considering reform, the Administration will be guided by the view that a stable and well-functioning housing finance market should achieve the following objectives:

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- *Widely available mortgage credit.* Mortgage credit should be available and distributed on an efficient basis to a wide range of borrowers, including those with low and moderate incomes, to support the purchase of homes they can afford. This credit should be available even when markets may be under stress, at rates that are not excessively volatile.

- *Housing affordability.* A well-functioning housing market should provide affordable housing options, both ownership and rental, for low- and moderate-income households. The government has a role in promoting the development and occupancy of affordable single- and multi-family residences for these families.

- *Consumer protection.* Consumers should have access to mortgage products that are easily understood, such as the 30-year fixed rate mortgage and conventional variable rate mortgages with straightforward terms and pricing. Effective consumer financial protection should keep unfair, abusive or deceptive practices out of the marketplace and help to ensure that consumers have the information they need about the costs, terms, and conditions of their mortgages.

- *Financial stability.* The housing finance system should distribute the credit and interest rate risk that results from mortgage lending in an efficient and transparent manner that minimizes risk to the broader financial and economic system and does not generate excess volatility. The mortgage finance system should not contribute to systemic risk or overly increase interconnectedness from the failure of any one institution.

The housing finance system could be redesigned in a variety of ways to meet these objectives. However, the Administration believes that any system that achieves these goals should be characterized by:

- *Alignment of incentives.* A well functioning mortgage finance system should align incentives for all actors – issuers, originators, brokers, ratings agencies and insurers – so that mortgages are originated and securitized with the goal of long-term viability rather than short term gains.

- *Avoidance of privatized gains funded by public losses.* If there is government support provided, such as a guarantee, it should earn an appropriate return for taxpayers and ensure that private sector gains and profits do not come at the expense of public losses. Moreover, if government support is provided, the role and risks assumed must be clear and transparent to all market participants and the American people.

- *Strong regulation.* A strong regulatory regime should (i) ensure capital adequacy throughout the mortgage finance chain, (ii) enforce strict underwriting standards and (iii) protect borrowers from unfair, abusive or deceptive practices. Regulators should have the ability and incentive to identify and proactively respond to problems that may develop in the mortgage finance system.

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- *Standardization.* Standardization of mortgage products improves transparency and efficiency and should provide a sound basis in a reformed system for securitization that increases liquidity, helps to reduce rates for borrowers and promotes financial stability. The market should also have room for innovations to develop new products which can bring benefits for both lenders and borrowers.

- *Support for affordable single- and multifamily-housing.* Government support for multifamily housing is important and should continue in a future housing finance system to ensure that consumers have access to affordable rental options. The housing finance system must also support affordable and sustainable ownership options.

- *Diversified investor base and sources of funding.* Through securitization and other forms of intermediation, a well functioning mortgage finance system should be able to draw efficiently upon a wide variety of sources of capital and investment both to lower costs and to diversify risk.

- *Accurate and transparent pricing.* If government guarantees are provided, they should be priced appropriately to reflect risks across the instruments guaranteed. If there is cross-subsidization in the housing finance system, care must be exercised to insure that it is transparent and fully consistent with the appropriate pricing of the guarantee and at a minimal cost to the American taxpayer.

- *Secondary market liquidity.* Today, the US housing finance market is one of the most liquid markets in the world, and benefits from certain innovations like the "to be announced" (or TBA) market. This liquidity has provided a variety of benefits to both borrowers and lenders, including lower borrowing costs, the ability to "lock in" a mortgage rate prior to completing the purchase of a home, flexibility in refinancing, the ability to pre-pay a mortgage at the borrowers' discretion and risk mitigation. This liquidity also further supports the goal of having well diversified sources of mortgage funding.

- *Clear mandates.* Institutions that have government support, charters or mandates should have clear goals and objectives. Affordable housing mandates and specific policy directives should be pursued directly and avoid commingling in general mandates, which are susceptible to distortion.

Key Policy Choices for a New Housing Finance System

Since the 1930s, the U.S. government has played an important role in housing finance. Today, significant support for housing and homeownership is now common across many different countries. Intervention in this market has been generally defended on two grounds: (i) some government support, particularly through the provision of guarantees or insurance, can contribute to financial stability and help reduce booms and busts in home prices and (ii) direct subsidies can support the social benefits of home ownership and the availability of affordable housing to low

and moderate income families. Federal support for housing finance in the current system has at times conflated these two objectives. As part of any reform, it is important to ensure that the objectives and goals of government support are clear and well defined. Financial stability arguments have two components. First, stable access to mortgage credit is important for households and the economy. The largest financial asset for many households is the equity in their home. The housing sector also plays an important role in the overall economy. Residential construction is more volatile than other parts of the economy and consequently plays an important role in economic cycles. Changes in the value of real estate are an important source of variance for household wealth and consumption.

Second, housing finance can be severely affected when the financial system is disrupted. Mortgage loans are relatively small idiosyncratic credits. Underwriting mortgage loans responsibly, and investing in them, involves collecting and evaluating a substantial amount of information. A well functioning mortgage market requires institutions that develop and maintain the capacity to carry out this sort of analysis. When financial stress undermines existing financial institutions engaged in mortgage finance it can be difficult and take time to recreate that capacity.

The case for providing direct government support to stabilize mortgage credit would thus rest on the judgment that mortgage credit is particularly important to households and the economy overall. Moreover, the relative size of the housing market and high correlation of losses it can experience in times of financial distress means that government may be best suited to serve as a source of stability in a responsible manner. In the current crisis, mortgage credit that was not supported by either the GSEs or government programs collapsed highlighting the vulnerability of mortgage credit to financial stress. It is noteworthy that other forms of financial intermediation have fared much better (for example, the corporate bond market has recovered strongly over the past year). As the recent crisis has shown all too painfully, fluctuations in the supply of mortgages over boom and bust credit cycles can have a major impact on the economy. By supporting the availability of and access to mortgage credit, the government can ease the adverse effects of stress in the financial system on the broader economy.

Assuming government continues to play a meaningful role in the housing market for any of the reasons described above, there are a variety of mechanisms which could be employed to promote stability or convey a subsidy if desired.

In considering the various systems around the world, it is apparent that one of the key choices is whether or not government should provide explicit support or guarantees for the issuance individual mortgages or mortgage-backed securities to provide such stability. Government's involvement provides certainty in the value of the guarantee and can promote a stable supply of mortgage credit. Guarantees, together with appropriate regulation, can also form the foundation for promoting good underwriting standards, consumer protections, and the management of broad macroeconomic credit risk.

If some form of guarantee is to be explicitly provided or supported, a series of important questions would need to be answered about how best to achieve these objectives. First, what

should be the appropriate scale and scope of those guarantees and which borrowers and mortgage products should be eligible? Guarantees on mortgage-backed securities could be provided on a full or partial basis and there are a variety of criteria such as loan size, loan-to-value ratio, credit score and income-to-debt service ratio which could be used to set eligibility and provide benchmarks for standardization. Second, how should any guarantees that are to be provided be priced? In order to protect taxpayers, guarantees should be priced in a way that appropriately reflects the underlying risk assumed by the government. Third, where support or a guarantee are not available or are purposefully limited, how will the risk which is retained in the mortgage finance chain be managed and supervised?

Finally, how should any organization that provides such guarantees be structured and how should guarantees be distributed? Clearly the governance structure of the GSEs in the past, in particular the unhealthy combination of private ownership and implicit government support, proved to be a mistake. Careful choices are needed about organizational design to ensure that those providing any guarantees have the appropriate incentives and expertise.

Many countries provide significant government support for housing finance, but they do so in a variety of ways. Several countries have GSE-like entities that guarantee and/or hold mortgages, but in no other country are they as large as they are in the United States. In a number of countries governments underwrite mortgage insurance. In some cases countries governments provide a regulatory framework and set standards that promote liquid mortgage markets. Securitization does not play a major role in housing finance in all other high-income countries, and where it does exist, it takes different forms. Many European countries use so-called covered bonds to channel credit to housing. This diversity of international practice in housing finance can provide useful insights and examples to consider.

Transition to a New System

Transition presents several important challenges. There is a large stock of investments on the balance sheets of the GSEs, and financial markets are depending on the ability of the GSEs, in their current form, to perform on their obligations. The GSEs and the federal government, through the FHA and GNMA, are playing a larger role in the housing finance market today than they have since the Great Depression. Conditions must be created so that private capital will return in a substantial manner to the housing market. There are important infrastructure, capabilities and human resources at the GSEs that have great value and should continue to serve the needs of the housing market as reform moves forward. Maintaining these capabilities and retaining these personnel through the transition is important.

In conjunction with the Treasury's commitment to supporting the GSEs while in conservatorship, it should be clear that the government is committed to ensuring that the GSEs have sufficient capital to perform under any guarantees issued now or in the future and the ability to meet any of their debt obligations. The Administration will take care not to pursue policies or reforms in a way that would threaten to disrupt the function or liquidity of these securities or the ability of the GSEs to honor their obligations. The Administration recognizes the central importance the

mortgage finance market plays in the broader capital markets and will ensure that this market is not allowed to be disrupted. Recent amendments to the Preferred Stock Purchase Agreements should leave no uncertainty about Treasury's commitment to support Fannie Mae and Freddie Mac as they continue to play a vital role in the housing market during the current crisis. Maintaining the current securitization operational flow, TBA liquidity, secondary MBS market liquidity and the ability of the GSEs to issue debt during the transition will remain key priorities for the Administration.

Government's role in the housing finance system and level of direct involvement will change, however, and the Administration is committed to encouraging private capital to return to the housing finance market. The substantial direct support for the housing markets that has been put in place will be allowed to fade as the market recovers and fully stabilizes. In addition, through regulatory reform and other supervisory actions, the Administration is committed to clarifying the framework for new securitizations to restart these important markets. These steps should create the room necessary for private markets to re-emerge.

An effective transition plan will seek to maintain the extensive infrastructure, knowledge, personnel and systems of Fannie Mae and Freddie Mac. Designing an effective transition plan that leverages these resources and minimizes market disruption will be a critical component of reform.

Next Steps

To achieve these goals, the Administration intends to develop a comprehensive reform proposal for delivery to Congress. To ensure that input is provided by all stakeholders, Treasury and HUD will submit a list of questions by April 15, 2010 for public comment and will seek responses from a wide variety of constituents, market participants, academic experts, and consumer and community organizations. These questions will ask participants to provide comment on their recommendations for, and comments on (i) the priorities for government housing policy, (ii) the role of government in the housing finance system, (iii) characteristics of mortgage products available to consumers, (iv) the best practices to ensure consumer protection, and (v) the most effective design of the housing finance system.

The Administration will seek to work closely with the Congress, on a bipartisan basis, prior to finalizing a comprehensive reform plan.

Given the importance of the long term stability of the housing market and the critical role the GSEs continue to play in the current financial circumstances, this approach to GSE reform, built upon significant input from various stakeholders, should form the basis for a strong bi-partisan solution, introduced, enacted and executed at a time of greater market stability.

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TESTIMONY OF

VINCE MALTA

NATIONAL ASSOCIATION OF REALTORS®
2010 VICE PRESIDENT AND LIAISON TO GOVERNMENT AFFAIRS

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

ENTITLED

"HOUSING FINANCE AND THE PATH TO REFORM: PART I – GOVERNMENT AND STAKEHOLDER PERSPECTIVES"

MARCH 23, 2010

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EQUAL HOUSING OPPORTUNITY

INTRODUCTION

Chairman Frank, Ranking Member Bachus, and members of the committee, thank you for inviting me to testify today and to offer the REALTOR® perspective on housing finance.

I am Vince Malta the 2010 Vice President and Liaison to Government Affairs for the NATIONAL ASSOCIATION OF REALTORS® (NAR). I am a third-generation REALTOR® and the CEO and founder of Malta & Co., Inc. I have been in the real estate business for over 25 years and served the industry in countless roles. Most recently, I chaired the National Association of REALTORS® Presidential Advisory Group (PAG) on Government-Sponsored Enterprises (GSEs).

I am here to testify on behalf of more than 1.2 million REALTORS® who are involved in residential and commercial real estate as brokers, sales people, property managers, appraisers, counselors, and others engaged in all aspects of the real estate industry. Members belong to one or more of some 1,400 local associations/boards and 54 state and territory associations of REALTORS®.

We thank the House Financial Services Committee for holding this very important hearing on an issue that is paramount to the future viability of the U.S. housing market and our overall economy.

REALTORS® PERSPECTIVE

REALTORS® recognize that our current housing finance structure, with 1) loans backed by the Federal Housing Administration (FHA) comprising up to 30% of the market, 2) the Government-Sponsored Enterprises (GSEs) in conservatorship and controlling nearly 70% of the market, and 3) little-to-no private capital in the marketplace, is both unwanted and unsustainable.

Also, REALTORS® recognize the fragility of the housing market and the overall economy, where any misstep in the implementation of a new housing finance system will likely cause the derailment of our current tenuous recovery, leaving us either back where we started or in a worse predicament. Therefore, until the housing market and overall economy stabilize, and economic and industry experts have an opportunity to fully determine and understand the impact of any proposed new housing finance model, REALTORS® respectfully recommend that we—the industry and government—move forward deliberately, but cautiously, in designing a new housing finance model.

In the balance hang many potential homebuyers who currently have the desire and ability to purchase a home. Any artificial disruption to the housing recovery would injure these aspiring new homeowners (specifically, those taking advantage of the soon to expire home purchase tax credit), as well as existing homeowners, as home values / prices, which have begun to stabilize in most markets, start falling again.

RESTRUCTURING THE SECONDARY MORTGAGE MARKET

As our members began exploring the question of "how to improve the U.S. housing finance sector", there were a couple of significant issues for which they sought a solution. First, and foremost, REALTORS® wanted to ensure that in all markets there is always mortgage capital available for the creditworthy housing consumer. Second, and as important, REALTORS® wanted to ensure that taxpayer dollars were optimally protected. These were the driving forces behind the initial nine principles (see Appendix A) that NAR drafted in late 2008, and they are the drivers behind the recommendation that we put forward today.

Presidential Advisory Group Background

In late 2008, the National Association of REALTORS® formed a Presidential Advisory Group (PAG) to specifically focus on the restructuring of Fannie Mae and Freddie Mac when they come out of conservatorship. The PAG's immediate task was to suggest to restructure Fannie Mae and Freddie Mac (Government-Sponsored Enterprises) in a manner that supports the Nation's historical housing policy of ensuring the continual flow of capital into the housing and mortgage markets in all economic conditions, and that removes the current private profit and public loss structure.

Initially, the PAG, which is comprised of NAR member volunteers, developed nine principles that they believe need to be met in order to ensure a robust financing environment for both residential and multi-family housing. NAR shared these principles with Congress and industry partners on several occasions; however, that was just the beginning.

The PAG then initiated a request for white papers from academics and other secondary mortgage market experts to provide their ideas for a restructure of the GSEs based on NAR's initial secondary mortgage market principles. NAR received a number of papers, and in mid November 2009, the PAG convened a meeting of selected academics, whose ideas ran the gamut from Federalization to Privatization.[1]

Upon completion of the PAG's review of the white papers, the members agreed that a hybrid of a few of the proposals best addressed their principles, and their desire for a safe and sound secondary mortgage market.

[1] Among the outside experts NAR consulted were Mercy Jimenez (Principal, Covered Bond Investor), Alex Pollack (Resident Fellow, American Enterprise Institute);Tom Stanton (Fellow of the Center for the Study of American Government, Johns Hopkins University); Susan Wachter (Professor of Real Estate, Finance and City and Regional Planning, The Wharton School, University of Pennsylvania); and Susan Woodward (Founder and Chairman, Sand Hill Econometrics).

KEY ELEMENTS OF NAR's RECOMMENDATION

NAR believes that any organization with a private profit and public loss structure, as the GSEs were structured before conservatorship, is flawed and problematic. In order to ensure that the conflict between the new entities' mission and shareholder needs is eliminated, and given the need for some level of government backing to ensure a steady flow of mortgage funding, NAR proposes a structure that is not driven by the shareholders' need to maximize profits.

NAR believes a "government-chartered" structure is the best model for the new entities because this structure type establishes a separate legal identity from the federal government, while serving a public purpose (e.g. the Export-Import Bank of the United States). Unlike a federal agency, government-chartered organizations are established to be politically independent and often are self-sustaining—not requiring appropriations from Congress. The ability of the entities to focus on their mission (provide liquidity to the housing market), without the need to chase risky opportunities in order to maximize profit, meets the criteria of our members.

Moreover, a government-chartered authority should remove any ambiguity regarding the government's backing of this secondary market entity. REALTORS® believe that government backing of a new entity is required in order to instill confidence in potential investors of the entity's mortgage-backed securities (MBS). Without the confidence of these investors, the ability of the entity to raise capital for the purpose of providing liquidity to the secondary mortgage market will be limited.

However, REALTORS® also believe that the entity should not be operated as if the government / taxpayers are in the first lien position. The entity should be self-sufficient (need no appropriations), price risk effectively to cover potential losses, and utilize any profits to establish capital reserves to alleviate losses that occur in economic down turns.

Lastly, our members believe that the conversion of the existing government-sponsored enterprises (Fannie Mae and Freddie Mac) into government-chartered authorities will pose the least amount of market disruption, and ensure a continual flow of capital to the secondary market during the transition period. Because of their existing capabilities and infrastructure, the current GSEs are best positioned to become government-chartered authorities. With this in mind, our members also suggest that the new authorities import the best components from the current GSEs (e.g. their ability to create MBS, their automated underwriting systems, etc.).

Why not Full Privatization or Nationalization?

Privatization

NAR considered a number of different models for the future structure of the GSEs. The first models that our members considered were the obvious, either fully private or fully federal. Our members thought that neither would effectively solve for the two issues that they

deemed necessary to address the challenge of restructuring the secondary mortgage market entities.

REALTORS® believe that full privatization is not an effective option for the secondary market because a private firms' business strategy will inevitably focus on optimizing its revenue / profit generation. This model would foster mortgage products that are more aligned with the business' goals (e.g. based upon significant financial risk-taking) than in the best interest of the nation's housing policy or the consumer. This situation would lead to the rescinding of long-term, fixed rate mortgage products (e.g. 30-year fixed-rate mortgage products), and an increase in the costs of these products to consumers, or both.

According to research presented to NAR by economist Susan Woodward, there is no evidence that a long-term fixed-rate residential mortgage loan would ever arise spontaneously without government urging. Ms. Woodward points out that a few other developed countries have encouraged the use of amortizing long-term loans, but in all instances (save for Denmark), the loans have adjustable rates and recast every 5 years. She goes onto indicate that the United States is unique in supporting 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. Lastly, she notes that in early 2000, when Former Federal Reserve Chairman, Alan Greenspan, hinted at its abandonment, the public outcry was such that he eagerly abandoned that position.

Second, the issue of the size of the US residential mortgage market arises. Currently, the US residential mortgage market stands at $12 trillion, with the GSEs owning or guaranteeing $5 trillion of mortgage debt outstanding and providing capital that supports roughly 70% of new mortgage originations. REALTORS® believe that it is extremely unlikely that enough pure private capital – without government backing - could be attracted to replace existing mortgage funding, or assume the GSEs market share, and make mortgage lending available in all types of markets.

Finally, our members fear that in times of economic upheaval, a fully private secondary mortgage market will cease to exist as has, to a great extent, occurred in the jumbo mortgage, the commercial mortgage, and the manufactured housing mortgage markets. When the economy turns down, private capital rightfully flees the marketplace. Should that happen in the residential mortgage market, 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.

Nationalization

In contrast to privatization, full nationalization places the government / taxpayer in the first lien position should the housing market turn down and these institutions run into financial trouble. A top priority of our members is to remove, as much as possible, any ability to have the taxpayer fully on the hook to protect these entities. Converting the GSEs to federal agencies, or merging them with the FHA and Ginnie Mae, conflicts with this goal of our members.

Moreover, nationalization would yield a number of undesirable consequences. First, establishing one public secondary mortgage market entity – Ginnie Mae – would remove competition in the secondary mortgage market, and remove any incentive for innovation. Though our members favor more vigorous regulation of the products the new entities will purchase, they also recognize that innovation is required along the mortgage origination supply chain in order to foster a more efficient and less costly product for consumers.

In addition, a single organization that dominates the secondary mortgage market (e.g. operating in the conventional-conforming space and the FHA space) may lose its ability to adequately focus on the past missions of the prior organizations. For example, an organization that combines FHA and Ginnie Mae with the GSEs could lose focus on either the low- and moderate-income housing mission or ensuring that the middle market has access to affordable mortgage capital. Though today, FHA and the GSEs are serving similar clientele, our members assume that as the economy recovers, these organizations will return to their traditional consumer base.

Protecting Excess Revenue

REALTORS® believe that it is prudent to have the new entities invest all excess capital earned in strong markets into a capital reserve fund so that they can pursue countercyclical activities in weaker markets, as well as store capital to prevent the need for taxpayer funds during economic downturns. Again, a primary goal of our members is to ensure that the government and taxpayers are not immediately on the hook even if a serious downturn occurs.

Also, in the current economic environment, as banks and other financial institutions are being encouraged to hold more capital against well performing assets, the new entities should set the industry standard for safe and sound operations.

Utilization of Retained Portfolio

NAR believes that the entities should maintain a portfolio for the purpose of funding their daily operations, to use in a countercyclical fashion when the market turns down and private capital inevitably leaves the market place, and to test innovative products and house mortgages on products that are not easily securitized (e.g. multi-family housing loans and rural mortgages). The use of the portfolio will ensure that there is a continual flow of capital into the secondary mortgage market during downturns thus preventing a collapse of the housing market, as well as provide much needed capital to those portions of the housing market that don't traditionally have access to large amounts of private capital.

Our members do not recommend a specific size of the portfolio; however, they do believe that the portfolio should only be large enough to support the authorities' business needs, the products that lack private market capital, and when necessary because of insufficient private investment, and only to the extent needed, ensure a stable supply of capital consistent with

market conditions. REALTORS® insist that the portfolio size should not be driven by for-profit motives.

Covered Bonds as an Additional Liquidity Tool

REALTORS® believe that all options should be utilized to encourage liquidity in the housing market. One tool that has captured the attention of NAR's members is covered bonds. Though an underutilized tool in our current secondary mortgage market arsenal, covered bonds are a product that should be further explored because of the added security these financial vehicles offer to potential investors. REALTORS® do not believe that this tool can be dominant in our secondary market, but its use should be expanded.

As the GSEs are restructured, NAR members feel that whatever model is selected should allow the organizations to pilot the use of covered bonds (e.g. to help improve liquidity for multifamily housing) in order to foster a better understanding of the tool, and then encourage its use in the nation's residential secondary mortgage market.

NAR'S RECOMMENDATION

In order to ensure that the flow of capital continues to enter the mortgage market regardless of the state of the housing or mortgage markets or overall economy, Fannie Mae and Freddie Mac should be converted into government-chartered, non-shareholder owned authorities that are subject to tighter regulations on product, profitability, and minimal retained portfolio practices in a way that ensures the protection of taxpayer monies.

The New Entities Impact on Private Capital Participation in the Secondary Market

Our members expect that the new government-chartered non-shareholder owned authorities will ensure that there is liquidity in the market place for those standard mortgage products (e.g. long-term fixed rate mortgages and traditional adjustable rate mortgages with reasonable annual and lifetime caps) that are the foundation of our housing finance market. Our members realize that initially the authorities may curtail some private participation in this portion of the market; however, over time, the private market participants, as in the past, will offer innovations driven by consumer need and demand. Also, with the new entities offering standard products, private capital will be free to return, compete, and exploit opportunities in addition to the products offered by the new authorities.

REALTORS® believe that this is likely to occur because under the recent GSE model, even as Fannie Mae and Freddie Mac enjoyed very low costs of funds compared to their competitors / customers, beginning in the early 2000s the competitors' share of the secondary market grew at significant rate until the collapse of the marketplace. It is only now, with a collapsed marketplace and private capital sitting on the sidelines, that the GSEs market share has increased significantly. Our members fully anticipate that with the full recovery of the market, and the conversion of the GSEs into these new entities, and a return of private capital into the secondary market, we will see the appropriate balance of

government, government-hybrid, and private capital activity in the secondary mortgage market.

CONCLUSION

The National Association of REALTORS® supports a secondary mortgage market model that includes some level of government participation, but that protects the taxpayer while ensuring that all creditworthy consumers have reasonable access to mortgage capital so that they too may attain the American Dream – homeownership. Our members recognize that this is but the first of many conversations regarding how we mend, and improve, a housing finance system that had served us well for many years. We believe that the NAR recommendations, along with some key elements that we mentioned today, will help Congress and our industry partners design a secondary mortgage model that will be in all of our nation's best interest today, and in the future.

I thank you for this opportunity to present our thoughts on reforming our housing finance system, and as always, the National Association of REALTORS® is at the call of Congress, and our industry partners, to help continue the housing and national economic recovery.

Appendix A

National Association of REALTORS® Recommendations For Reforming the GSEs

National Association of REALTORS® Government Affairs Division
500 New Jersey Avenue, NW, Washington DC, 20001

The Issue:

How to restructure Fannie Mae and Freddie Mac (Government-Sponsored Enterprises) in a manner that supports the Nation's historical housing policy of ensuring the continual flow of capital into the housing and mortgage markets in all economic conditions, and removes the current private profit and public loss structure.

NAR's Recommendation:

Convert Fannie Mae and Freddie Mac into **government-chartered, non-shareholder owned authorities** that are subject to tighter regulations on product, revenue generation and usage, and retained portfolio practices in a way that ensures they can accomplish their mission and protect the taxpayer.

NAR's Rationale:

Government-chartered entities are organizations that have a separate legal identity from the federal government but serve a public purpose (e.g. the Tennessee Valley Administration and the Export-Import Bank). Unlike a federal agency, the organizations enjoy considerable political independence and often are self-sustaining – not requiring appropriations from Congress. The conversion of the government-sponsored enterprises into government-chartered authorities will ensure that the flow of capital continues to enter the mortgage market regardless of the state of the housing or mortgage markets or overall economy and minimize the incentive for the authorities to take undue risk.

NAR believes that any organization with a private profit and public loss structure, as the GSEs are presently structured, is inherently flawed and problematic. In order to ensure that the conflict between the new entities public purpose (mission) and shareholder demands is eliminated, NAR proposes that the organizations not offer equity to the public.

Appendix A

Key Elements of a proposed restructure that NAR believes are required to ensure the continual flow of capital into the housing and mortgage markets:

MISSION

The authorities' mission is to ensure a strong, robust financing environment for homeownership and rental housing, including access to mortgage financing for underserved segments of the population that have the financial resources to sustain homeownership.

BUSINESS PRACTICES

The government must clearly, and explicitly, guarantee the business of the restructured entities. Taxpayer risk would be mitigated through the use of mortgage insurance on loan products with a loan to value ratio of 80 percent or higher and MBS guarantee fees paid to the government. Only if these pools prove to be insufficient in some future economic crisis would the federal taxpayer be called upon to make good on the federal guarantee of the MBSs.

Sound and sensible underwriting standards must be established for loans purchased and securitized in MBSs, loans purchased for portfolio, and MBS purchases.

The authorities will retain and reinvest all excess revenue to accumulate capital in strong markets, to pursue a countercyclical policy in weaker markets, and to support the secondary market, provide for innovation, remain mission focused, and maintain their capacity.

The primary purpose of the authorities' portfolios will be to support their operations in both the single family and the multi-family housing markets. The portfolios should only be large enough to support their business needs and when necessary because of insufficient private investment in the mortgage market, and only to the extent needed, ensure a stable supply of capital consistent with market conditions.

In order to increase the use of covered bonds, particularly in the commercial real estate arena, the organizations should pilot their use in multifamily housing lending and explore their use as an additional way to provide more mortgage capital for residential housing. Also, initially a government guarantee, such as by the FDIC, should be considered to enhance the covered bond option to entice private market participation.

The authorities should price loan products based on risk. Housing affordability goals will assure that the entities serve a full range of borrowers directly by the GSEs or indirectly by programs assisted by the GSEs.

Appendix A

The organization must set standards for their MBSs that establish transparency and verifiability for loans within the MBSs that are purchased or securitized by the government-chartered authorities.

The entities should only purchase and guarantee transparent and verifiable mortgage loans, and should only purchase derivatives as a limited option in order to manage risk, not to generate profit.

At least two entities are required to provide for competition in the secondary market and avoid the risk a single entity would lose incentive to innovate and to be efficient.

GOVERNANCE

Political independence of the entities is mandatory for successful operation (e.g. the CEOs will have fixed terms so they cannot be fired without cause, and the authorities will be self funded – no ongoing appropriations).

The governance structure should provide for a Chief Executive Officer to oversee daily operations, a Board of Directors with practical expertise to ensure effective and efficient operation, and an advisory board comprised of industry participants and consumer representatives to provide the organization, and its management, with real-time, front-line information regarding the authorities' effectiveness and advice on their operation.

The entities will be permanent (not expire).

OVERSIGHT

There must be strong oversight of the entities (for example, by the Federal Housing Finance Agency – FHFA or a successor agency), that includes the providing of timely reports to allow for continual evaluation of their performance.

ASSOCIATED FINANCIAL REGULATORY REFORM

Reform of the credit rating agency sector is required, to address the inherent conflict of interest in the current system.

Appendix B

GOVERNMENT SPONSORED ENTERPRISES
NAR PRESIDENTIAL ADVISORY GROUP

NAR PRINCIPLES:
ENSURING A STRONG, ROBUST FINANCING ENVIRONMENT FOR HOMEOWNERSHIP AND MULTIFAMILY HOUSING
NOVEMBER 2009

In light of disruptions in the credit markets and the conservatorship of Fannie Mae and Freddie Mac, NAR has developed principles for the consideration of the 111th Congress and the Obama Administration. NAR believes that these principles require a continuing role for the federal government in the mortgage market. The new secondary mortgage market model must:

1. Ensure an active secondary mortgage market by facilitating the flow of capital into the mortgage market for all types of housing, in all market conditions.

2. Seek to ensure affordable mortgage rates for qualified borrowers.

3. Establish: (a) reasonable housing affordability goals so all qualified borrowers,[2] including low- and moderate-income households, have an opportunity to realize the dream of homeownership; and (b) reasonable multifamily rental housing affordability goals to increase the availability of financing for rental housing. Housing affordability goals should not provide incentives for the institution that are inconsistent with sustainable homeownership or rental housing.

4. Require the institution to pass on the advantage of its lower borrowing costs (and other costs of raising capital) by making mortgages with lower rates and fees available to qualified borrowers.

5. Ensure mortgage availability throughout the nation.

6. Require sound underwriting standards, consistent with NAR's Responsible Lending Principles adopted in May 2005 (see attached).

7. Require the highest standards of transparency and soundness with respect to disclosure and structuring of mortgage related securities.

8. Ensure there is sufficient capital to support mortgage lending for all types of housing, in all market conditions.

9. Provide for rigorous oversight.

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[2] NAR's Responsible Lending Policy supports requiring all mortgage originators to verify the borrower's ability to repay the loan based on all its terms, including taxes and insurance, without having to refinance or sell the home (with limited exceptions for borrowers with significant assets).

Appendix C

NATIONAL ASSOCIATION OF REALTORS® RESPONSIBLE LENDING POLICY ADOPTED MAY 2005

Why Do REALTORS® Seek to Prevent Abusive Lending?

REALTORS® have a strong stake in preventing abusive lending because:

- Abusive lending erodes confidence in the Nation's housing system.
- In a credit-driven economy, the legislative and regulatory response to lending abuses can go too far and inadvertently limit the availability of reasonable credit for prime as well as subprime borrowers.
- Citizens of communities, including REALTORS®, are harmed whenever abusive lending strips equity from homeowners, especially when the irresponsible lenders concentrate their activities on certain neighborhoods and create a downward cycle of economic deterioration.

Responsible Lending Principles

NAR supports the general principle that all mortgage originators should act in "good faith and with fair dealings" in a transaction and treat all parties honestly. NAR's Code of Ethics already imposes a similar requirement on REALTORS®, who are required to treat everyone in the transaction honestly. NAR encourages policy makers to use such a standard of care as a guiding principle when drafting anti-predatory lending legislation and regulations rather than using the phrase to create a new federal duty that would be too general and, therefore, too difficult to enforce.

1. Affordability. NAR supports strong underwriting standards that require all mortgage originators to verify the borrower's ability to repay the loan based on all its terms, including taxes and insurance, without having to refinance or sell the home.[3] Lenders should consider all relevant facts, including the borrower's income, credit history, future income potential, and other life circumstances. Lenders should not makes loans to borrowers that make loss of the home through sale or foreclosure likely if the borrower is unable to refinance the mortgage or sell.

- Underwriting Subprime Loans with "Teaser Rates." Some loans are structured with a significant jump in monthly payments often resulting in "payment shock" for the borrower. While these mortgages may be a reasonable choice for borrowers who can afford them, a majority of subprime borrowers do not understand the unique terms and conditions of these risky mortgage products that can result in a significant "payment shock." Therefore, lenders (including mortgage brokers) should exercise more caution when underwriting such loans to subprime borrowers to make sure the borrower is able to afford the mortgage. Examples of these risky mortgage products include loans with a short-term interest "teaser" rate for the first

[3] The limited exceptions to this general principle would include prime borrowers with sufficient verifiable assets to handle a balloon mortgage or a significant jump in mortgage payment.

two or three years (known as 2/28s and 3/27s), loans with an initial interest-only period, and mortgages that negatively amortize.[4]

NAR will carefully monitor the debate on underwriting standards for subprime loans and will support policies consistent with the goal of assuring that borrowers who have demonstrated the financial capacity to meet their mortgage obligations, taking into account all relevant circumstances, continue to have access to mortgage loans made by responsible lenders.

- Reasonable Debt-to-Income Ratio. NAR supports requiring lenders to make subprime loans that have a reasonable debt-to-income ratio. Borrowers should have enough residual income after making their monthly mortgage payment, including taxes and insurance, to meet their needs for food, utilities, clothing, transportation, work-related expenses, and other essentials. Requiring underwriting at a fully amortizing, fully indexed rate is meaningless if the lender uses such high debt-to-income ratios that the family doesn't have enough income remaining to pay for other necessities.

- Escrow/Reserve for Payment of Taxes and Insurance. Lenders that make subprime mortgage loans should generally require that the monthly payment include an amount to be held by the mortgage servicer in an escrow/reserve/impound account for the payment of the borrower's periodic payments, such as taxes, insurance, and homeowner association/condominium fees. Similar to the exception for prime loans in some jurisdictions, borrowers that make at least a 20 percent downpayment should have the option to budget for these payments independently.

2. Limit Stated Income/Stated Assets Underwriting. Because mortgages underwritten based on "stated income" and/or "stated assets" (also known as "no income verification" or "no doc" loans) typically have higher rates, lenders making subprime loans should, as a general rule, underwrite loans based on verified income and assets.

3. Flexibility for Life Circumstances. NAR believes that a standard for determining a borrower's ability to repay must be flexible to accommodate borrowers with unique circumstances, such as:

- ✓ Borrowers who have demonstrated the ability to make monthly payments, over a long term, that are higher than underwriting standards would otherwise allow. Lenders should consider, for example, the borrower's history of making rent and student loan payments.
- ✓ Borrowers with high assets but low income who, for cash management or other financial planning reasons, elect a mortgage with a monthly payment that their current income is not sufficient to cover.
- ✓ Borrowers who anticipate a jump in income or assets due to life events such as graduation, completion of professional training, completion of payment obligations for student or car loans, another member of the household entering the work force when young children start school, or an inheritance.

4. Anti-Mortgage Flipping Policy. NAR supports an anti-mortgage-flipping rule requiring mortgage originators making or arranging for a loan that refinances an existing residential mortgage to verify that the new loan provides a significant benefit to the borrower (one test often proposed is

[4] Negative amortization ordinarily results if the mortgage permits a borrower to pay less than the interest on the mortgage for a limited time, in which case the difference is added to the total amount of the loan the borrower must repay.

the loan must provide a "reasonable net tangible benefit" to the borrower). The lender should consider the circumstances of the borrower, as discussed above, all terms of the new loan including taxes and insurance, the fees and other costs of refinance, prepayment penalties, and the new interest rate compared to that of the refinanced loan.

5. Bar Prepayment Penalties. NAR opposes prepayment penalties for all mortgages. Prepayment penalties often work to trap borrowers in loans they cannot afford by making it too expensive to refinance. If complete prohibition of prepayment penalties is not feasible, NAR supports permitting prepayment penalties for the shortest time and the lowest amount possible. For example, a borrower in a 2/28 mortgage should be able to refinance by the end of the initial two-year "teaser" rate period without having to pay a prepayment penalty.

6. Improvements for Assessing Creditworthiness. Borrowers with little or no credit history, as traditionally measured, usually have lower credit scores and must pay more every month for their mortgage than those with higher scores. NAR supports ongoing efforts to take into account consumer payment history not typically considered, such as rent, utility, telephone, and other regular payments and urges HUD, the regulators, the GSEs, and lenders to work to strengthen these efforts. Use of alternative credit approaches will be especially beneficial for low- and moderate-income first-time homebuyers and borrowers with problematic loans that need to refinance their mortgage to avoid foreclosure.

Another public policy issue associated with credit histories is the failure of furnishers to report good payment histories to the consumer reporting agencies. NAR has heard reports that many problematic subprime lenders purposefully withhold information on timely mortgage payments from the credit bureaus in order to prevent their customer from refinancing with another lender. The result is obvious—the borrowers with no positive payment histories for their subprime loan keep treading the waters of high-interest rates and expensive credit products. NAR supports requiring all institutional mortgage lenders, or the mortgage servicers acting on their behalf, to report payment history of all borrowers to at least the three national credit bureaus on a monthly basis.

7. Mortgage Choice for Borrowers. NAR supports requiring mortgage originators to offer borrowers one or more mortgages with interest rates and other fees that appropriately reflect the borrower's credit risk. It remains the responsibility of borrowers to decide which is the best mortgage for their needs and circumstances, but they may only do so if they understand all the facts so they can make an informed decision. The following are suggested principles for consideration of Congress and the regulators:

- For originators who offer nontraditional mortgage products, the originator should:
    - offer all borrowers a choice of several significantly different mortgage options;
    - include at least one traditional loan product as one of the options for the borrower to consider, if the borrower qualifies for such a product offered by the originator; and
    - before application acceptance, disclose information about the maximum potential payment over the life of the loan and the date the initial payment will increase to a fully amortizing, fully indexed payment amount.

- For subprime borrowers, originators that offer FHA-insured mortgages or VA home loan guaranty mortgages should consider whether these types of mortgages should be offered as an appropriate option.

- If the originator does not offer mortgages with rates and fees appropriate for the borrower's credit risk, the originator should inform the borrower a lower interest rate may be available from another originator or that the borrower may wish to seek housing counseling, to allow the borrower an opportunity to shop elsewhere or receive counseling before proceeding. For example, a prime borrower that applies for a loan to a lender that only makes subprime loans should be advised that other options may be available.

- For loans originated by a mortgage broker, the broker should offer mortgage options that are among the lowest-cost products appropriate for the borrower.

8. Enforcement/Remedies. NAR supports enactment of strong remedies and penalties for abusive acts by mortgage originators. Among the options for consideration are:

- Criminal penalties similar to those under RESPA.

- Civil penalties similar to those under RESPA.

- Assignee liability that balances the need to protect innocent borrowers with problematic loans against the risk that increasing the liability of innocent holders of mortgages in the secondary market could reduce the availability of mortgage credit.

- Prohibition of mandatory arbitration clauses that bar victims' access to court.

9. Strengthen Appraiser Independence. NAR believes that the independence of appraisers should be strengthened to ensure that appraisals are based on sound and fair appraisal principles and are accurate. There are reports that appraisers have been pressured to meet targeted values or risk losing business. Appraisal pressure undermines the integrity of the mortgage lending process if the result is a mortgage loan made based on an inaccurate property valuation. NAR recommends the following measures to strengthen the appraisal process:

- Require lenders to inform each borrower of the method used to value the property in connection with the mortgage application, and give the borrower the right to receive a copy of each appraisal at no additional cost.

- Establish enhanced penalties against those who improperly influence the appraisal process. Those with an interest in the outcome of an appraisal should only request the appraiser to (1) consider additional information about the property; (2) provide further detail, substantiation, or explanation for the appraisal; and (3) correct errors.

- Provide federal assistance to states to strengthen regulatory and enforcement activities related to appraisals.

- Support enhanced education and qualifications for appraisers.

Testimony of

Vincent F. O'Donnell

Vice President for Affordable Housing Preservation

Local Initiatives Support Corporation

Housing Finance – What Should the New System Be Able to Do?

Government and Stakeholder Perspectives

House Committee on Financial Services

U.S. House of Representatives

March 23, 2010

Statement of Vincent F. O'Donnell

Introduction and Overview

Good morning, Chairman Frank, Ranking Member Bachus, and distinguished members of the Committee. Thank you for the opportunity to testify regarding the functions and needs of the nation's housing finance system.

My name is Vincent O'Donnell. I serve as Vice President for Affordable Housing Preservation at the Local Initiatives Support Corporation (LISC), a national nonprofit intermediary dedicated to helping community residents transform distressed urban and rural neighborhoods into healthy and sustainable communities of choice and opportunity. In that position, I lead LISC's national efforts to support nonprofit rental housing preservation transactions; to build the capacity of nonprofit community development corporations (CDCs), residents, and state and local government; and to coordinate a variety of housing preservation policy activities, including helping to facilitate the National Preservation Working Group, a broad coalition of nonprofit, tenant and governmental preservation stakeholders. I speak today from the perspective of LISC as a whole, although I will address several issues specific to rental housing preservation within that scope.

Since 1980 LISC has worked in numerous partnerships involving banks and thrifts, CDCs, and government at all levels to revitalize urban and rural communities. LISC currently invests $600 million to $1 billion or more each year in these partnerships. Over time we have invested $9.6 billion, generating over $29 billion of development activity, including 253,000 affordable homes and 38 million feet of retail and community space. Most of this money has come from the private sector, including banks, Government-Sponsored Entities (GSEs) and insurance companies, mostly in the form of loans and investments.

Our work covers a comprehensive range of integrated activities that contribute to sustainable communities, including housing, economic development, building family wealth and incomes, education, and healthy lifestyles and environments. Our first name is Local, and we operate through 29 local offices and a national rural development program.

We have seen at close hand how the best and worst elements of the housing finance system affect low-income metropolitan and rural communities and their residents.

We have seen effective public private partnerships that have financed the production and preservation of about two million affordable rental homes in the last two decades. We also saw partnerships grow sustainable home ownership in the 1990s, fed by 30-year fixed-rate mortgages, prudent underwriting, and innovation. This work has improved life for millions of families and helped to revive urban and rural communities previously written off as beyond redemption. It also shows that private interests can serve public interests safely and profitably. Private participation leverages public resources and helps deploy them efficiently, effectively, and with a very high rate of success. These partnerships are neither spontaneous or lucky. They are the result of careful public policies that blended responsibility, opportunity, prudence, capacity, and accountability.

That said, we have also seen predatory lending ravage families and neighborhoods, fueled by flawed capital markets, mortgage products and underwriting and driven by players at multiple levels seeking a quick profit with no skin in the game and no effective regulation. We have also seen public policies that over-sell the genuine virtues of home ownership and ignore, neglect, or even denigrate the rental housing where one-third of American households live.

An important lesson is that the long-term interests of consumers and lenders, and of communities and the financial system, are and must fundamentally align rather than conflict. A loan that does not work for consumers and communities ultimately will not work for lenders and investors, or for the financial system and the economy. At the same time, failure to include all communities and their residents within the financial mainstream, consistent with safety and soundness – in short, a return to red-lining or the margins of our system – will only undermine opportunity and prosperity. In some cases, short-term expediencies have unfortunately overtaken long-term prudence. But this debate must not set up false dichotomies between insufficient and excessive lending. We and many others have worked collaboratively on a solid, common-sense middle ground.

In applying the lessons of the past to the challenges of today and tomorrow, we recommend two guiding principles:

(1) the housing finance system should be integrated in several dimensions, and

(2) private institutions that receive public benefits should also help to address public objectives.

We will develop these principles further below, but first it may be useful to set the context for our perspective.

Roles of CDFIs and Intermediaries

One of LISC's roles is that of a Community Development Financial Institution (CDFI). In that capacity, we make short- and intermediate-term loans and equity investments to benefit low-income people and communities. We do not, however, generally make long-term loans, but instead are interdependent with the institutional systems for housing finance. We also wish to stress that our interests extend beyond the specific activities we undertake. Because we work in economically distressed areas, the availability of mortgage financing in these areas sets the context of either vitality or disinvestment in which we operate. What we can do, how big a difference it can make, and its long-term success, all depend on this broader context.

We typically work with our community partners at the front end to identify unmet needs and then we invest in the solutions. The transactions themselves may involve production or preservation, and include both homeownership and rental housing. This support extends from an initial broad planning effort, through funding of predevelopment, to acquisition and construction financing for specific transactions, and often permanent equity investments in rental housing generating Low Income Housing Tax Credits.

In doing so, we both affect the housing finance market and depend on it. CDFIs such as LISC identify projects that often will not be done through market forces alone. In our work, we have found affordable housing finance is safe and profitable, but perhaps not the most profitable or easiest transactions available to the private market. One of our jobs is to make this socially beneficial enterprise attractive to institutional lenders and investors, often by intervening early in the process when risks are the greatest; by structuring complex financing including public programs; and by undertaking projects too small to attract private interest, especially at early stages. In that sense, we foster sound financing opportunities for the housing finance sector.

At the same time, our work requires the availability of permanent mortgage financing on reasonable and reliable terms. Basically, short-term sources of financing such as CDFIs will be reluctant to invest whenever permanent or construction financing is unavailable, unpredictable, too costly, or otherwise unworkable.

Historically, we have an excellent record of shepherding our scarce capital resources while supporting difficult, but socially valuable, transactions. However, in the last two years, changes in the housing finance environment, combined with long-standing structural issues with federal subsidies, have made our work dramatically more difficult. The result is that we are no longer able to invest as confidently in the very housing whose creation and preservation has become even more urgent.

One example of how this uncertainty affects the availability of debt and equity capital is Section 8 appropriations risk. Since 1997, when the Multifamily Assisted Housing Reform and Affordability Act of 1997 (MAHRA) was enacted, long-term fully-funded rental assistance contracts have been gradually converting to a status in which the available funds are annually appropriated. Over a period of more than a decade, in large part due to reliable and disciplined federal funding, capital markets have adjusted to this reality, requiring manageable discounts for the appropriations risk.

More recently, however, a combination of under-funding of project-based Section 8 contracts and more conservative investment standards has undermined this public-private bargain. The result is increased difficulty in obtaining permanent financing for properties that once were considered to be relatively good risks. Lower debt leverage and duplicative reserve requirements, for example, undermine the feasibility of valuable efforts to extend useful life of existing affordable housing. We are grateful that Congress has acted promptly and unequivocally to restore annual project-based Section 8 funding levels. While we are still working through the damage done by a breach of confidence at a particularly vulnerable time, I want to note some important and helpful government responses.

HUD Secretary Shaun Donovan has recognized the importance of aligning subsidy programs and financing sources in several ways. HUD has announced a Transforming Rental Assistance initiative, whose principles include streamlining and simplification, reliability of rental assistance, and market discipline. One of the initiative's major purposes is to increase transparency and the ability to leverage private capital. In addition, HUD has taken a number of concrete administrative steps to align FHA programs with the Low Income Housing Tax Credit and with the process of renewing Section 8 contracts and preserving assisted multifamily housing.

I also want to commend H.R. 4868, the Housing Preservation and Tenant Protection Act of 2010, which was filed last week by Chairman Frank and co-sponsored by many members of this committee. We are hopeful that a number of provisions in this bill, and in the Section Eight Voucher Reform Act, will improve the climate for permanent financing of affordable housing preservation transactions, on both the debt and the equity side.

Finally, we are enthusiastic about the new Capital Magnet Fund, through which the Treasury Department's CDFI Fund will position CDFIs and nonprofit housing developers to leverage private financing effectively.

An Integrated Housing Finance System

While the GSEs have been central to housing finance, we believe Congress should consider their future in the context of the broader housing finance system. We believe that system fragmentation has increased risk, created unlevel playing fields, reduced access to responsible credit, and thwarted efficiency. We do not presume that the GSEs, in their current form, are essential to a well-integrated housing finance system, provided that: (1) the system assumes the functions and capabilities that GSEs have developed; and (2) transitional challenges are addressed. However, before deciding on any structural issues, it will be important to be clear about the characteristics of the future system and then to consider what structures are most likely to meet these needs.

- Primary and secondary markets. It may seem obvious to coordinate the primary market where mortgages are originated on Main Street with the secondary market where mortgages are bought and traded on Wall Street. However, coordination has been incomplete in the past and could be either better or worse in a future system. A secondary market that accepted and even encouraged irresponsible subprime and nominal prime lending to homeowners, but would not support home rehabilitation or small rental properties, has not well served people, communities, the financial system, or the economy. Congress took a good step in 2008 when it aligned the GSEs' affordable housing goals more closely with banks' lending targets.

- System-wide regulation. While we support Congressional and Administration efforts to regulate the primary mortgage markets, it is equally important to regulate secondary markets as well. In housing finance, we have seen bad mortgage practice start in the unregulated segment and then migrate throughout the system, supplanting some safer practice and inflating housing price bubbles. The secondary markets are powerful drivers of the primary market. We have sometimes seen complex financial engineering in the credit markets mask and amplify risks instead of mitigate them, and then make fixing the resulting problems virtually impossible. The subprime mortgage crisis and the related difficulties of untangling several layers of mortgage-backed securities or modifying the mortgages are a painful example. Accordingly, we strongly urge regulation of all secondary mortgage market sponsors.

- Both homeownership and rental housing. While homeownership will understandably consume most of the debate, it is important to address the rental housing where about one-third of all American households live. The GSEs have

played an increasingly important role in financing large-scale multifamily rental housing.

- However, the GSEs and unregulated secondary markets have poorly served the smaller rental buildings – including single family homes – where many renters live.

- Affordable rental housing has distinctly different risks compared to homeownership, in that it is often necessary to combine a variety of rental assistance subsidies with multiple sources of capital subsidy. Affordable housing preservation transactions, despite being generally immune to some development problems, such as zoning barriers, are especially challenging in this regard.

- Moreover, we have seen disturbing practices in multifamily housing finance, where some properties received mortgages much larger than rents can carry. This excessive leverage was based on unrealistic projections of rent increases that the market could not sustain, even if current tenants were displaced. Many of these mortgages are defaulting, and many have short terms that require impossible refinancing. For many of these properties, the market will not safely accomplish deleveraging. Recent experience indicates that, absent some intervention, owners will cut operations and maintenance expenditures in order to make interest payments, buildings will be capital starved, and mortgages may be sold at excessive prices. This phenomenon results in harm to buildings, neighborhoods and tenants. To the extent that banks are the lenders, these mortgages contribute to the commercial real estate mortgage problem that threatens many smaller and mid-sized banks, revealing the limits of prudential bank regulation. Moreover, consumer protection laws generally do not cover rental housing finance.

- Both market-rate and affordable housing. Some observers have suggested that the capital markets should address market-rate housing and that government programs, like the Federal Housing Administration or appropriated funds, should take full responsibility for affordable housing. We strongly support a vital FHA as well as federal appropriations, but assert just as strongly that low-income people need full and equitable access to mainstream capital markets. The FHA, historically, has not proven to be especially nimble or innovative, and its multifamily programs are often unresponsive to the needs of low-income communities, especially for smaller and mid-sized buildings. Serving affordable housing needs also requires:

  - coordination with public development subsidies, including LIHTCs;

  - support for and coordination with the CDFIs that have become integral to the development process; and

  - as noted earlier, the ability to accommodate federal rental assistance.

- Both debt and equity. While most of the debate will appropriately focus on mortgage financing, it will be important to consider the requirements and sources

of equity as well. On the rental housing side, the GSEs provided about 40% of the LIHTC equity market, which has struggled since the GSEs withdrew from the market over two years ago. In financing affordable rental housing, LIHTC equity is often the largest source of permanent financing, and market-rate mortgage financing plays a lesser role. It will be appropriate for secondary market institutions to participate as LIHTC investors or as guarantors of investments, in addition to sources of debt capital. On the home ownership side, most first-time homebuyers cannot afford a 20 percent down payment plus closing costs. The GSEs, along with FHA, have played essential roles by offering prudent low-cash home purchase mortgage products. These products, perhaps combined with additional savings incentives like Individual Development Accounts, must remain a viable part of the housing finance system.

Meeting Public Policy Objectives

We believe it is both necessary and appropriate to expect private institutions that receive public benefits to address meet public policy objectives. The first of these public benefits is regulatory oversight, which we believe will greatly improve access to credit markets as well as reduce the cost of capital. In today's financial climate, two years after the collapse of Bear Stearns, there is still very little purely private mortgage capital available on a long-term basis. The great majority of long-term mortgage financing comes through the GSEs and FHA. The Federal Reserve has been supporting the GSE channel by purchasing mortgage backed securities, and is only now preparing to attempt to ease out of that role. The capital markets may not return to past vitality for several years, and even then may not be able to do what they used to do.

In addition to regulatory oversight, private institutions have benefited from FHA mortgage insurance, GNMA securities guarantees, and the GSEs' credit enhancements. While the federal role in mortgage markets may change, similar support should help justify private obligations to address the following public policy objectives.

- Liquidity in all economic conditions. The current financial and economic climate reinforces the core importance of providing liquidity in all economic conditions.

- Long-term, fixed-rate mortgages for both homeowners and rental housing remains important. The benefits for homeowners are well established. For rental housing, long-term fixed-rate financing allows a predictable payment stream – especially important to affordable housing and in stable and declining markets, where rents cannot be presumed to grow faster than operating expenses. It also reduces the likelihood of forced refinancing in difficult times, a problem we see now in both rental and owner-occupied housing. Many observers believe that federal credit enhancements on mortgage-backed securities will be necessary to providing long-term, fixed-rate mortgage products.

- Capital access for all communities, including economically distressed, low-income, rural, and minority communities, on a fair, equitable and sustainable basis will be essential to the economic and social viability of these communities. In particular, private institutions should partner with CDFIs to help deliver financing products and support housing production and preservation and other community development activities. For rental housing, we would also suggest that LIHTC equity investments be considered as a valuable form of financing, albeit in the form of an investment.

- A small millage fee to support the Housing Trust Fund and the Capital Magnet Fund. Congress already approved this policy approach with respect to Fannie Mae and Freddie Mac as part of the Housing and Economic Recovery Act of 2008. The principle should be affirmed and applied more broadly to secondary market institutions. Broadening the base would allow a lower millage rate to generate a given level of funding, and keep the playing field level for all institutions.

Conclusion

Chairman Frank and members of the committee, the decisions you make in reforming the housing finance system will have far-reaching consequences for all Americans and all communities, but for none more than low- and moderate-income families and communities. It would be a tragedy, and a travesty, if the same people and places that had worked so hard to improve their futures only to suffer irresponsible lending and the ensuing foreclosures and unemployment, were now locked out of the financial mainstream. That would hurt not just them, but all of us.

Anthony B. Sanders[1]
Oral Testimony
House Financial Services Committee
March 23, 2010
Hearing on "Housing Finance-What Should the New System Be Able to Do?
Part I-Government and Stakeholder Perspectives"

[1] Anthony B. Sanders, Ph.D. is Professor of Finance at the School of Management at George Mason University where he holds the title of Distinguished Professor of Real Estate Finance. He has previously taught at the University of Chicago (Graduate School of Business) and The Ohio State University. He previously served as Director and Head of Asset-backed and Mortgage-backed Securities Research at Deutsche Bank in New York City. His research and teaching focuses on real estate finance (both commercial and residential). He has published articles in Journal of Finance, Journal of Financial and Quantitative Analysis, Journal of Business, Journal of Financial Services Research, Journal of Housing Economics and other journals. Professor Sanders has testified in the U.S. Senate and U.S. House of Representatives on the U.S. real estate asset and debt markets.

Anthony B. Sanders

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House Financial Services Committee
March 23, 2010
Hearing on "Housing Finance-What Should the New System Be Able to Do?
Part I-Government and Stakeholder Perspectives"

Mr. Chairman, Ranking Member Bachus and members of the Committee:
The Federal debt stands at $8 trillion. But the Fannie Mae, Freddie Mac and Federal Home Loan Bank debt stands at $8 trillion as well. This combined debt load for the U.S. is $16 trillion and represents 110% of our gross domestic product (see Figures 1 and 2). This "Grecian Formula" of debt issuance to fund housing goals is not sustainable. We simply have too much leverage in the housing finance system.

To make matters worse, the Federal government controls 95% of residential mortgages made with FHA insurance or Fannie Mae and Freddie Mac loan purchases. Stated differently, our financial institutions will not originate residential mortgages unless the Federal government insures or purchases them.

We need to take immediate action to get the financial institutions and the investment community back in the game and wind down the Federal government's involvement. We have affordable housing missions at HUD, at Fannie and Freddie through affordable housing goals, at financial institutions through the Community Reinvestment Act, and numerous other Federal, State and Local programs. Given the massive supply of vacant housing on the market, the shadow inventory of foreclosed houses at financial institutions and the multifamily vacancy rates, perhaps it is high time that we consolidate the affordable housing missions under one tent.

Historically, the nation's affordable housing mission has been under HUD. Hence, I would recommend that any Federal affordable housing mission be housed there. But the FHA, our low-to-moderate income mortgage insurance entity, is woefully antiquated in terms of technology and is in desperate need of modernization. Thus my first recommendation is a dramatic overhaul and modernization of the FHA.

My second recommendation is to slim down Fannie and Freddie's role in the housing market. We can begin by 1) removing their affordability housing mission, 2) unwinding the retained portfolios at an accelerated pace and 3) toughening the regulatory oversight of Fannie and Freddie by moving it to a stronger FHFA.

My third recommendation is to pass legislation governing a covered bond market (similar to the market that exists in Denmark) and begin with the jumbo mortgage market. Covered bonds potentially provide an excellent vehicle to fund the residential and commercial mortgage markets going forward.
My fifth recommendation is to repair the securitization model that is already in existence. This can be done by requiring lenders to retain a first loss piece on their balance sheet.

My fourth recommendation is to repair the securitization model that is already in existence. Having lenders retain "skin in the game" of at least 5% of the loans originated and sold is a good start. Our recent downturned in housing teaches us that 5% would be grossly insufficient to cover future downturns in housing prices. One the other hand, a private securitization market should be a "buyer-beware" market, so "skin in the game" would then be pointless.

Lastly, we have to return to a 10-20% or more down payment standard for mortgage lending (and 10% in the FHA programs). The housing price bubble of the last decade was fueled mostly by low interest rates combined with low down payment mortgages (and "exotic" mortgages such as pay option ARMs). The much maligned subprime market was a convenient scapegoat for the crisis. Had lenders and the GSEs adhered to a 10-20% down payment standard, there would not have been a bubble in the first place. And the subprime borrowers would not have defaulted in such numbers had the bubble not burst.

Mr. Chairman, thank you letting me share my comments and suggestions with you and the committee.

Thank you.

Appendix: Full Report of Anthony B. Sanders
Also available at http://mason.gmu.edu/~asander7/

The Federal debt stands at $8 trillion. But the Fannie Mae, Freddie Mac and Federal Home Loan Bank debt stands at $8 trillion as well. This combined debt load for the U.S. is $16 trillion and represents 110% of our gross domestic product (see Figures 1 and 2). This "Grecian Formula" of debt issuance to fund housing goals is not sustainable.

How We Got Here

Our total Federal debt as of the end of 2009 is presented in Figure 1. This figure includes both on-balance sheet Federal debt at $8 trillion and "off-balance sheet" Federal debt in the form of Fannie Mae, Freddie Mac and Federal Home Loan Bank debt of an additional $8 trillion.

In Figure 1 I plot the Federal debt since 1990 and the GSE and Agency debt. The big turning was the third quarter of 1999 when GSE and Agency debt passed the Federal debt in terms of size. From 1999 to the end of the Clinton Administration, GSE and Agency debt grew 57%. GSE and Agency debt grew dramatically until mid-2003 and then began growing their debt again in 2007. In fact, until the dramatic spike in Federal debt in 2008, the Federal debt grew 36% over a nine year period from 1999-2007. GSE and Agency debt grew a staggering 114%.

Before 1999, house prices in the U.S. were relatively flat although the GSE/Agency debt was growing (although slowly compare to growth rates in 1999-2003). As you can see in Figure 3, the Case-Shiller Index of 10 cities began to grow dramatically and in closely in line with GSE/Agency debt expansion. While GSE/Agency debt was relatively flat from 3rd quarter 2003 to 3rd quarter 2005 (a two-year hiatus), the debt issuance began to heat up again in 3rd quarter 2005. The lull in the GSE/Agency debt issuance reflects the rise in the private label securitization market during 2003-2005 where the GSEs lost market share to the jumbo, subprime, ALT-A and related mortgage markets. However, the GSEs began to enter the game again and actually provided liquidity to the subprime and ALT-A markets by either purchasing ALT-A loans or investing in subprime ABS. By the end of 2007, housing prices began falling off a cliff and the GSE/Agency debt began to really accelerate again. Hence, we are up to $8 trillion in GSE/Agency debt at the end of 2009.

In addition to the staggering debt load and leverage in the residential mortgage market, Fannie Mae and Freddie Mac are chartered by Congress with a mission to provide liquidity, stability and affordability to the U.S. housing and mortgage markets. As can be seen in Figure 4, having housing prices rise over 200% in just over 10 years is hardly in line with providing affordable housing. They did, however, provide benefits to those who purchased a house at the beginning of the housing run-up. Unfortunately, millions of households are suffering from the bubble burst in terms of lost asset value and foreclosure. Was letting the bubble grow worth the pain that it caused?

Government Dominance of the Residential Mortgage Market

To make matters worse, the Federal government controls 95% of residential mortgages made with FHA insurance or Fannie Mae and Freddie Mac loan purchases. It is downright dangerous to have so much leverage and credit risk concentrated in Fannie, Freddie and the FHA. This also means that our financial institutions will not originate residential mortgages unless the Federal government insures or purchases them.

We need to take immediate action to get the financial institutions and the investment community back in the game and wind down the Federal government's involvement. We have affordable housing missions at HUD, at Fannie and Freddie through affordable housing goals, at financial institutions through the Community Reinvestment Act, and numerous other Federal, State and Local programs. Given the massive supply of vacant housing on the market, the shadow inventory of foreclosed houses at financial institutions and the multifamily vacancy rates, perhaps it is high time that we consolidate the affordable housing missions under one tent.

Recommendation 1: Modernize the FHA

Historically, the nation's affordable housing mission has been under HUD. Hence, I would recommend that any Federal affordable housing mission be housed there. But the FHA, our low-to-moderate income mortgage insurance entity, is woefully antiquated in terms of technology and is in desperate need of modernization. Thus my first recommendation is a dramatic overhaul and modernization of the FHA.

The FHA has an aging Information Technology infrastructure that struggles to keep up with the volumes of transactions that are being managed today. Their antiquated IT infrastructure makes it difficult to properly mitigate risks. Of course, the FHA is woefully understaffed in certain areas and the federal hiring process really hinders their ability to attract better talent.

The FHA is reliant on Congress for virtually any proposed rule or legislative change. Practically everything the FHA does requires a proposed rule or legislative change. For example, it takes a minimum of 5 months to modify any rule or change in policy. This means that if the FHA observes high default rates in a certain area (such as down payment buy downs from 3.5% to 0%), it takes them a minimum to 5 months to change that policy (and that assumes that HUD and Congress agree to it). The FHA averaged somewhere in the neighborhood of 1.6 million loans last fiscal year, or about 133,000 per month. If 10 to 20% of these loans were the risky product that the FHA would like to stop, that exposes the FHA to potential losses of $2 to $4 billion in losses.

Seller funded down payment assistance loans are a perfect example of problems facing the FHA. This product was authorized in the National Housing Act which makes it legislatively authorized. You would think the FHA would have the discretion to kill the product when they realized these loans were 3 to 4 times more likely to default. In fact, despite being a small percentage of their book of business, these loans were responsible for approximately 35% of their losses.

Recommendation 2: Slim Down Fannie Mae and Freddie Mac

My second recommendation is to slim down Fannie and Freddie's role in the housing market. This can be done by 1) removing the affordability housing mission, 2) reduce their conforming loan cap and also introduce a floor so as to not compete with the FHA program, 3) unwind the retained portfolios at an accelerated pace until the retained portfolios are near zero, 4) toughen the regulatory oversight of Fannie and Freddie by moving it to a stronger FHFA, 5) abandon their private/public structure moving them toward private companies without a Federal Government debt guarantee. Lastly, restrict their loan purchases to their previous core 10-20% down payment, 30 year fixed-rate mortgages and plain, vanilla ARMs. In addition,

1) Given that aggregate taxpayers are on the hook for the 65% of the population that own homes, of which approximately 70% were GSE loans, it is not really clear why the renters should be subsidizing the owners. If Fannie/Freddie were privatized, rates go up by something like 100 basis points, but taxpayers would no longer short the put (bear the risk).

2) Risk sharing program, where the originating entity retains equity risk on the loan, (first loss such as 5-10% of loan amount), and the government insurance provides mezzanine or catastrophic risk at the asset level and counterparty risk at all levels. That is, the lender has a first loss on the loan, the loan gets government wrap, and the buyer of MBS only faces the government.

3) A program more similar to the government control of airwaves could be used for the guaranty. Government would auction off the right to insure 'x' billion loans for 'x' years. This would consolidate lending to larger parties and monetize the insurance fee as current income for the government. The loan originator, subject to stringent approved underwriting, delivers product with a pre-wrap certificate. This underwriting process would be similar to FHA loans today (after modernization, of course).

4) Regarding the retained portfolio, I would take their portfolio and divide into three tranches: the lower quality loans, the loans that are outside of a narrow definition of conforming loans (for example, second homes or higher-priced homes), and what a narrow mandate might support (traditional, high quality, first lien loans). Securitize the low quality and nontraditional loans. Establish a narrow mandate, recapitalize them and remove all subsidies and future guarantees. As part of the recapitalization, impose a narrow mandate until they repay the Treasury.

Recommendation 3: Introduce Covered Bonds as an Alternative

My fourth recommendation is to pass legislation governing a covered bond market (similar to the market that exists in Denmark) and begin with the jumbo mortgage market. Covered bonds potentially provide an excellent vehicle fund the residential and commercial mortgage markets. Specifically, covered bonds solve some of the problems found in the securitization model, such as keeping loans with the lender so that they are easier to modify in case of further economic downturns. Covered bonds would allow financial institutions to get back in the lending game since new loans could be kept on balance sheet, but bonds issued against those assets. As long as the assets (loans) are high quality and have transparency, the covered bond market should provide a viable competitor to Fannie/Freddie. I would also recommend a covered bond model that includes less than prime loans with 20% down payment or more. Neither of these covered bond programs should carry a guarantee.

Recommendation 4: Repair the Securitization Model

My fifth recommendation is to repair the securitization model that is already in existence. Having lenders retain "skin in the game" of at least 5% of the loans originated and sold is a good start. Our recent downturned in housing teaches us that 5% would be grossly insufficient to cover future downturns in housing prices. One the other hand, a private securitization market should be a buy beware market, so "skin in the game" would then be pointless. Concerning subprime securitization, I support the private sector in originating and selling/securitizing loans to subprime borrowers. On the other hand, I am concerned about the temptation to open the low down payment, exotic mortgage fountain again. Having borrowers have skin in the game (say 10%-20% for subprime and 10% for lower risk borrowers/mortgage type) may be an appropriate fix.

Recommendation 5: Return to 10-20% Down payment standards

Lastly, we have to return to a 10-20% or more down payment standard for mortgage lending (and 10% in the FHA programs). The housing price bubble of the last decade was fueled mostly by low interest rates combined with low down payment mortgages (and "exotic" mortgages such as pay option ARMs). The much maligned subprime market was a convenient scapegoat for the crisis. Had lenders and the GSEs adhered to a 10-20% down payment standard, there would not have been a bubble in the first place. And the subprime borrowers would not have defaulted in such numbers had the bubble not burst.

Figure 1

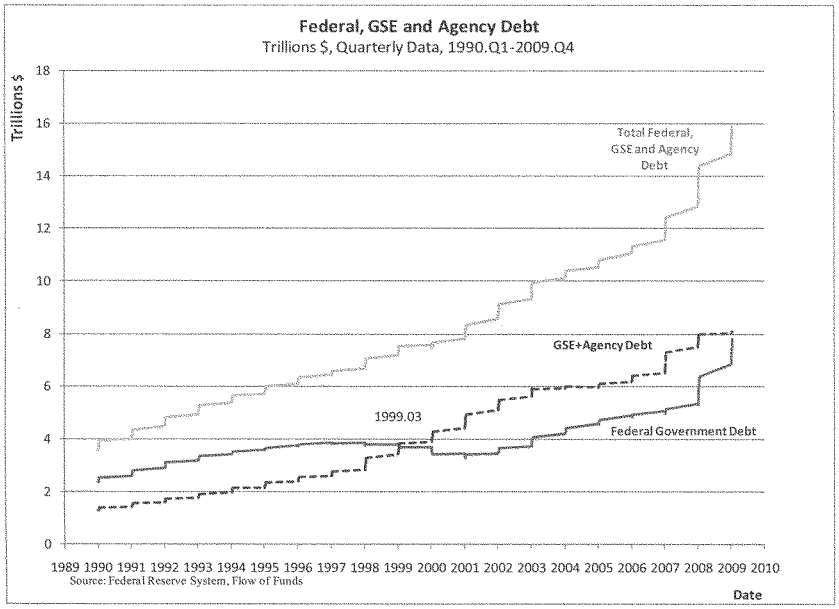

Federal, GSE and Agency Debt
Trillions $, Quarterly Data, 1990.Q1-2009.Q4
Trillions $
18
16
14
12
10
8
6
4
2
0
Total Federal, GSE and Agency Debt
GSE+Agency Debt
1999.03
Federal Government Debt
1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010
Source: Federal Reserve System, Flow of Funds
Date

Figure 2

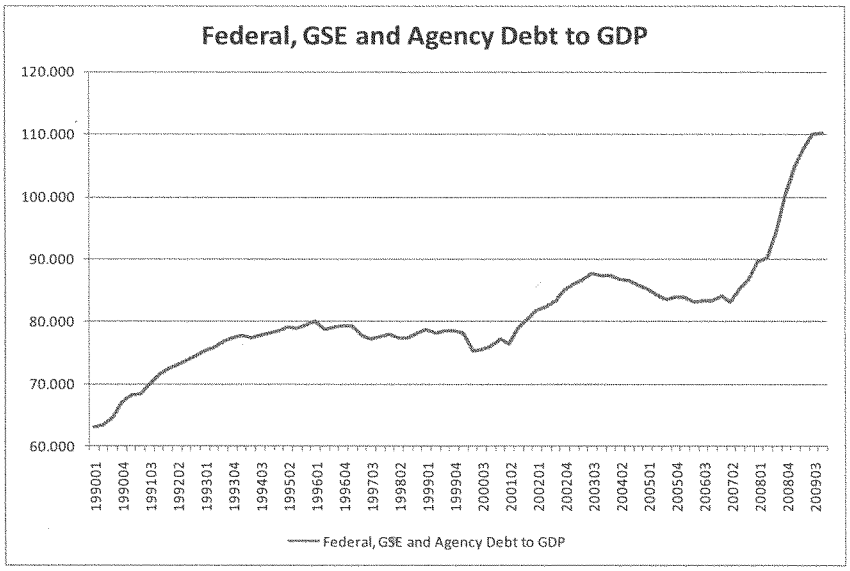

Federal, GSE and Agency Debt to GDP
120.000
110.000
100.000
90.000
80.000
70.000
60.000
199001
199004
199103
199202
199301
199304
199403
199502
199601
199604
199703
199802
199901
199904
200003
200102
200201
200204
200303
200402
200501
200504
200603
200702
200801
200804
200903
Federal, GSE and Agency Debt to GDP

Figure 3

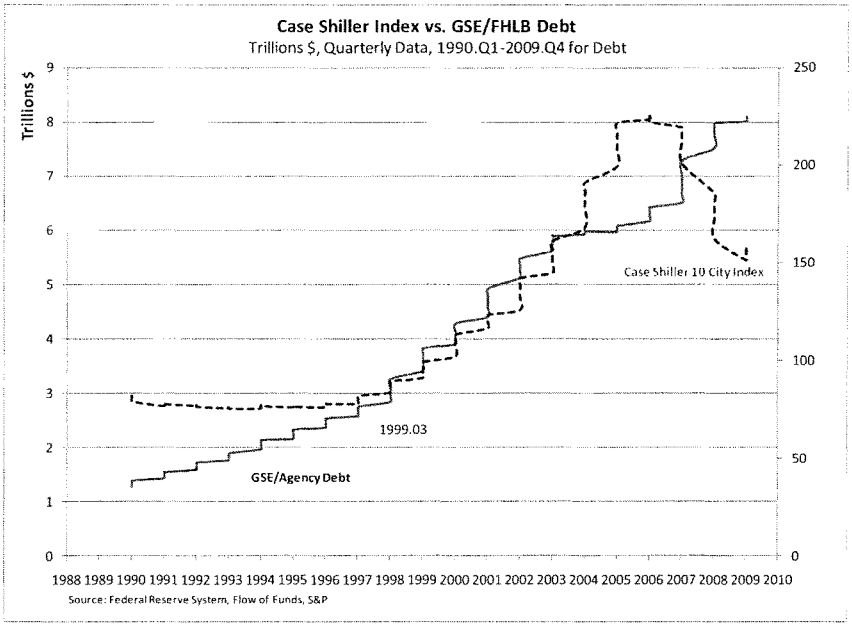
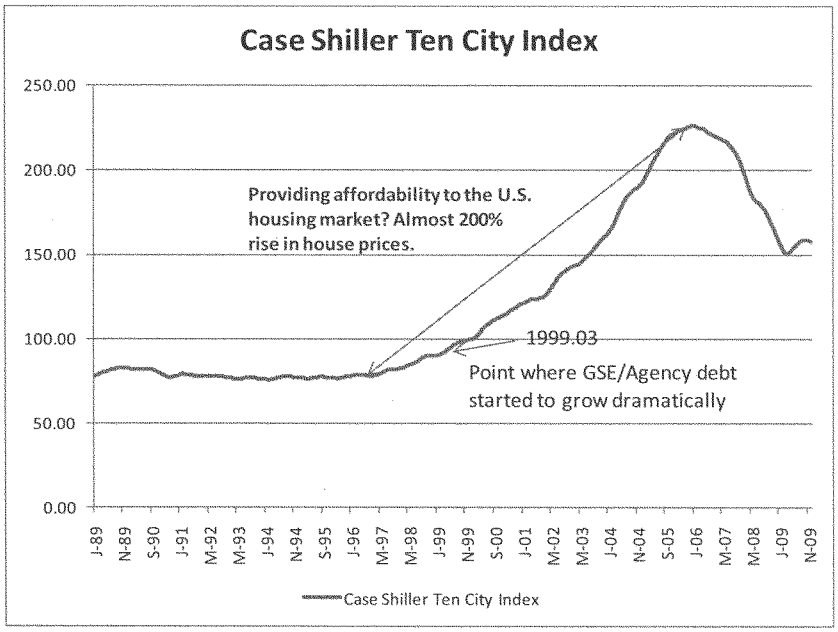

Case Shiller Index vs. GSE/FHLB Debt
Trillions $, Quarterly Data, 1990.Q1-2009.Q4 for Debt
Trillions $
9
8
7
6
5
4
3
2
1
0
250
200
150
100
50
0
Case Shiller 10 City Index
1999.03
GSE/Agency Debt
1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010
Source: Federal Reserve System, Flow of Funds, S&P

Figure 4


Case Shiller Ten City Index
250.00
200.00
150.00
100.00
50.00
0.00
Providing affordability to the U.S. housing market? Almost 200% rise in house prices.
1999.03
Point where GSE/Agency debt started to grow dramatically
J-89
N-89
S-90
J-91
M-92
M-93
J-94
N-94
S-95
J-96
M-97
M-98
J-99
N-99
S-00
J-01
M-02
M-03
J-04
N-04
S-05
J-06
M-07
M-08
J-09
N-09
Case Shiller Ten City Index

Center for American Progress Action Fund

Statement of Sarah Rosen Wartell
Executive Vice President
Center for American Progress Action Fund

before

The Committee on Financial Services
United States House of Representatives

Hearing on

Housing Finance –
What Should the New System Be Able to Do?

March 23, 2010

Introduction

I am honored to have the opportunity to share some thoughts on the future of the housing finance system. I applaud the Chairman and Committee for beginning this conversation. The financial crisis has demonstrated just how central housing finance is to both our economy and to the lives of American families. The crisis forces us to step back and consider anew first principles -- what are the goals of federal housing policy -- and what system of housing finance will best accomplish these goals.

The testimony I submit today first describes the traditional goals of the system and argues they remain the right objectives. The missteps that led to the recent crisis represent, not the failure of this vision, but a failure to keep these objectives paramount. History suggests that the private market alone will not achieve these objectives.

It then looks backwards, before it looks forward. An assessment of the past is an important first step in designing the system of the future, as we must make sure we have learned the right lessons from the crisis about how to achieve the system's goals. So this testimony lays out in some detail, first, an assessment of the origins of the crisis, a tale of failure by regulators to put the brakes on an unregulated system that was demanding the indiscriminate production of unsustainable mortgages, and, second, a pointed rebuttal to some common assertions about the origins of the crisis that the evidence shows are unfounded.

Lastly, the testimony offers a caution to those who would act too precipitously or critique the Administration for its deliberate step-by-step management of housing markets through the crisis.

About the Mortgage Finance Working Group (MFWG)

This testimony benefits from 18 months of conversations with the Mortgage Finance Working Group, sponsored by the Center for American Progress, with the generous support of the Ford Foundation and Living Cities. CAP first assembled the MFWG members in 2008 in response to the housing crisis. These affordable housing finance experts each sought to strengthen their understanding of the causes of the crisis and possible options for public policy responses through discussion and shared learning. Immediately after the conservatorship of the housing GSEs, the group began exploring the options for the future of the U.S. mortgage markets. The members of the working group include academics, former government officials, representatives of housing nonprofit groups, private lenders and developers of affordable housing, and others. I am grateful for all I have learned from these colleagues and the ideas we have formed together, but of course I speak only for myself in the views expressed here. I offer my special thanks to CAP's Associate Director for Financial Markets Policy for his assistance in preparing this testimony.

The working group has produced to date two pieces:

- A Responsible Market for Housing Finance: Draft White Paper on the Future of the U.S. Secondary Market for Residential Mortgages, prepared by the Mortgage Finance Working Group, sponsored by the Center for American Progress, December 2009, available at: http://www.americanprogress.org/issues/2009/12/housing_finance.html

- Principles to Guide Development and Regulation of a Renewed Mortgage Finance System, February 2009, available at: http://www.americanprogress.org/issues/2009/03/pdf/mortgage_finance_principles.pdf

Summary

1. **The goals of the housing finance system should include liquidity, stability, and affordability.** These objectives served us well for almost three quarters of a century. The missteps that led to the recent crisis represent, not the failure of this vision, but a failure to keep these objectives paramount. Key features of a system to achieve these goals include: transparency, standardization, risk management, regulatory oversight, affordable and sustainable homeownership, long-term fixed rate pre-payable mortgages, and access to credit for underserved communities. The system also must support a balanced housing policy that focuses on affordable rental housing, as well as sustainable homeownership, with a goal of having affordable options that are appropriate to the different circumstances of different individuals and families. History strongly suggests that the private market alone will not achieve these objectives.

2. **The housing and economic crises were the result of the rapid and unchecked growth of a "shadow banking system" of unregulated and irrationally-priced private label mortgage-backed securities (PLS).** As investor demand for PLS grew, issuers in turn demanded more subprime loans than good lending practices would yield, driving down standards and distorting efficient markets for consumers, originators, issuers, and investors. The system of the future must learn the lesson from this experience. We must not reproduce a bifurcated system in which unregulated capital in one part of the market drove a "race to the bottom" in underwriting and highly leveraged risk. In the future, all mortgage backed securities (MBS), whether or not backed by the government, must be subject to regulation. This is a key distinguishing feature of the draft proposal on which CAP's Mortgage Finance Working Group is working – it subjects the private markets for mortgage backed securities to regulation comparable (albeit not identical) to that applied to any portion of the market benefiting from public support.

3. The Housing Government-Sponsored Enterprises, Fannie Mae and Freddie Mac, made poor decisions with extremely costly consequences for taxpayers. They came to the party late, drawn into the subprime market in an attempt to regain lost market share and chase what seemed to be high rates of returns. As others left, they stayed and inexplicably "doubled down" as credit quality collapsed. Their regulators also made significant errors in how they exercised their oversight authority, most egregiously in giving them goals credit for subprime purchases without regard to whether the loans were sustainable. **While both GSE decisions and failures of GSE regulatory oversight contributed to making problems worse, neither was the primary cause of either the flood of poorly underwritten subprime mortgage nor the larger global financial meltdown** – a distinction that belongs to the failure of regulators to control the PLS market.

4. **Neither was the crisis the result of lending to low- and moderate-income borrowers and minority homebuyers. Nor was it the result policies like the Community Reinvestment Act and the GSE affordable housing goals that encouraged certain institutions to provide those credit-worthy borrowers with access to credit.** Misaligned incentives drove poor lending practices – not public policy goals.

5. While much of the lending to low- and moderate-income borrowers during subprime frenzy was, on net, more detriment than benefit to these families, in fact, **we know how to do affordable homeownership right.** In the years bad money chased out good, a range of policies and programs effectively offered sustainable, affordable homeownership. Close analysis by academics shows that borrowers benefitting from these sound lending practices were much more likely to sustain homeownership than comparable borrowers in subprime loans, even as economic conditions worsened. The secondary market system of the future should support rather than hinder the development of sound and sustainable affordable lending practices.

   What's more, **we have a responsibility to ensure that the system of the future helps to repair the damage done to communities stripped of equity by subprime lending and the foreclosure epidemic.** Rebuilding these communities will be impossible without access to capital in the form of fair and sustainable loans. It would be obscene if we first failed to prevent harmful subprime lending and then denied the communities hardest hit the credit needed to recover.

6. **Managing the housing markets through the transition.** We need a new system with new institutions to arise from the ashes, once some kind of normalcy has returned. The current situation, in which the federal government, through the GSEs or FHA insured loans in Ginnie Mae guarantied MBS, backstops almost 90 percent of the market for home mortgages, is not desirable or

sustainable. No one seeks to preserve the government's greatly expanded role longer than necessary. We need to gradually reduce the federal role to one focused on serving the historical objectives of liquidity, stability, and affordability and concentrate a federal backstop on a smaller portion of the market that best serves public purposes.

However, even simple pronouncements by policymakers about what the future might bring could move markets and could unleash further deterioration of home values, threaten the fragile economic recovery, and make domestic and overseas investors wary of so-called "agency securities," which represent trillions of dollars of investment in the U.S. economy. What is more, the extent of taxpayer exposure to loss from its existing backstop obligations through the GSEs and FHA, which are keeping credit flowing to the housing market today, would be increased by turmoil in the housing markets. Similarly, taxpayer losses can be mitigated by careful housing market management.

As this committee knows well, policymakers have a heavy responsibility to move ahead carefully when considering housing finance reform. There is great value in having a robust public conversation *outside the government* to inform policymakers before proposals are made and action is taken. That is why this series of preliminary hearings is so important to begin the debate.

1. Goals of the Housing Finance System

Since the Great Depression, U.S. housing finance policy has rested on three enduring objectives:

a. **Liquidity:** The system should provide sufficient credit liquidity to meet demand across all market segments and cycles. **Transparency** and **standardization** have proven necessary to ensure consistent, broad, and deep secondary markets necessary for liquidity.

b. **Stability:** The system should work to reduce swings in value and the resulting effects on the local, national, and global economy. But intermediation between the needs of short-term investors and long-term borrowers is vulnerable to bubble-bust cycles and systemic losses, so appropriate **risk management** and **regulatory oversight** are necessary to reduce, to the extent possible, these wealth destroying cycles.

c. **Affordability:** The system should work to promote **affordable and sustainable homeownership**, broad availability of long-term, pre-payable, fixed rate loans, finance for affordable multifamily housing, and access to credit for underserved communities.

While some have criticized these principles—and more generally the involvement of government in the housing finance markets—they have served this country well through many generations, and should continue to be the basis for U.S. housing finance policy going forward. As detailed later in this testimony, the problems that drove the recent housing crisis stemmed from policy makers and regulators who, enamored with the elegance of free market theory, allowed a relatively unregulated private securitization market to run amok, creating a massive credit bubble driven by unsustainable (and some even fraudulent) lending. Far from the historical goals of housing policy, it was the divergence from these principles that led our economy astray. These same underlying objectives can guide us again as we build a new and improved system of housing finance.

Liquidity

The U.S. residential housing market is the largest single credit market in the world, with nearly $12 trillion in total outstanding debt.[1] To meet the mortgage needs of Americans, a tremendous amount of credit liquidity is required. And to ensure that U.S. housing markets are relatively stable, this credit liquidity must be relatively constant over time, including during economic and financial downturns.

To meet the enormous financing needs of U.S, residential housing, intermediation between the needs of investors, who are typically seeking safe, short-term, liquid assets, and the needs of borrowers, who are typically seeking risky, long-term, illiquid loans, is required. To put it simply, investors are unlikely to commit capital to borrowers for periods as long as 30 years at a fixed rate of return for even a small fraction the market at reasonable rates of return. Securitization is the primary mechanism for such intermediation, whether by the GSEs, by lenders issuing MBS with a Ginnie Mae wrap (government guarantee), or through private securitization channels. (The Federal Home Loan Banks serve a somewhat similar function, but their role is beyond the scope of this testimony.)

The alternative is a financial system that predominantly provides short-term, non-amortizing home loans, such as the ARMs that proliferated during the past decade or the short-term bullet loans that dominated during the pre-New Deal era. We have learned the dangers to family and community stability from short-term adjustable or ballooning debt. Predictable and stable housing debt has largely been a successful way for American families to acquire equity that has helped to finance the educations, small business start ups, and retirements of millions. Any proposed mortgage finance system must also be judged by whether it results in the availability of long-term fixed rate credit.

[1] As of the end of Q3 2009, single-family mortgage debt outstanding was at $10.85 trillion, and multifamily mortgage debt outstanding was at $912 billion, according to the Federal Reserve. *See* http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm.

Unfortunately, the process of financial intermediation is inherently pro-cyclical. During good times, financial intermediaries tend to lend too freely, taking on bad credit risks. During downturns, these same financial intermediaries face impaired balance sheets and generally become more risk-averse, so they tend to constrain credit too much. In the absence of some source of countercyclical liquidity, this dynamic can severely exacerbate economic downturns, as a lack of credit suffocates an already weakened economy. The Great Depression was an example of the extreme economic deterioration that can occur when a lack of countercyclical credit is paired with an economic decline. The ability of the federal government to provide countercyclical liquidity in the most recent crisis helped to keep our economy from repeating the Depression-era experience. Retaining the ability to provide counter cyclical liquidity should be a strong consideration of policy makers as they consider how to rebuild the U.S. housing finance system.

Liquidity exists only so long as there are investors who want to invest. Deeper markets result when investors have confidence, there is transparency, and standardized investment vehicles. The larger the market for securities and the more homogenized the products, the greater the liquidity the market will provide.

Stability

Both the investors who financed the U.S. mortgage market and the borrowers obtaining credit all suffered from the housing bubble and its rapid deflation. A major goal of policy should be to avoid these cycles, which have historically plagued other kinds of housing finance systems, and the large social costs they impose. Stability should continue to be a key objective.

Systemic stability is threatened by poor risk assessment and bad underwriting practices, which can be created or exacerbated by misaligned incentives. A lack of standardization and transparency also increase the likelihood of mispricing risk, as investors have less ability to independently assess risk, thus reducing market discipline.

In short, a key goal for any mortgage finance system must be to encourage the best possible risk management which requires discipline in both loan origination and intermediation. This means that pro-cyclical tendencies must be monitored and mitigated and risk must be appropriately understood and priced at all levels of the lending channel. Special attention must be paid to any systemic risks to the taxpayer and larger economy.

Affordability

There is a strong social interest in providing broad access to affordable mortgage credit on fair, nondiscriminatory, and sustainable terms. Homeownership has been historically one of the primary ways most Americans accumulate wealth, allowing them to save for education, retirement, and small business formation, and climb the

socioeconomic ladder. A system that does not provide access to credit to credit-worthy low- and moderate-income borrowers is therefore inconsistent with our traditions and values.

All borrowers benefit to the extent that a secondary market system of housing finance system more efficiently allocates credit to borrowers. And a higher homeownership rate, if stemming from more homebuyers for whom homeownership is appropriate, yields community benefits and social cohesion as well. But government intervention and assumption of risk cannot be justified merely to lower the cost of homeownership for middle and upper income borrowers.

Access to Credit for Communities Devastated by the Foreclosure Crisis

In the wake of the foreclosure crisis, lenders will be tempted to limit credit availability to only the strongest borrowers. But as housing markets normalize, we must not go back to the old days where entire communities were shut out from access to the best financing. Homeowners at the higher end of the socioeconomic ladder already enjoy significant governmental subsidies.[2] And there is ample evidence that many households that may not fit the perfect mortgage model for private lenders—"20 percent down, established credit, 31 percent debt-to-income ratio"—can become successful, long-term homeowners, when well underwritten and given access to affordable, fixed-rate financing.

Policy makers and regulators opened a Pandora's box of unregulated predatory and unsustainable lending that had devastating consequences for low- and moderate-income communities, particularly minority communities. While some too eagerly joined the speculative furor, millions of Americans thought they were playing by the rules—work hard, buy a home, pay your mortgage—only to find that the game had been rigged against them. It would be simply obscene if, as a result of the crisis, these foreclosure-impacted communities are now deprived of the credit they need to rebuild and restore home values for everyone. The housing finance system of the future must continue to ensure there is fair, nondiscriminatory, access to sustainable lending products for credit-worthy borrowers.

Rental Housing Finance

The housing finance system also must provide capital to support affordable rental housing. In recent years, our implicit national housing policy disproportionately emphasized homeownership. When homeownership is done right, it can be an

[2] Of the more than $400 billion a year in tax expenditure that supports homeownership, retirement savings, and investment, 90 percent goes to families in the top 20 percent of the income distribution, while less than 3 percent goes to families in the bottom 60 percent. See Lillian Woo and David Buchholz, "Subsidies for Assets: A New Look at the Federal Budget," CFED, Washington, DC, February 2007, available at http://www.communitywealth.com/_pdfs/articles-publications/individuals/paper-woo-bucholz07.pdf.

important tool for economic mobility and opportunity for families, as well as providing social, psychological, and societal benefits. But for some, homeownership will never be appropriate and for others, it will only be appropriate at certain times in their lives.

Affordable rental housing is particularly important given the fallout from the foreclosure crisis. As households transition out of homeownership, many with badly damaged credit, the demand for quality rental housing will grow. Demographic trends also suggest rising demand and a continued gap between incomes and the rents those incomes can support. The housing finance system must support the production and preservation of housing stock to meet the full spectrum of housing needs in America.

In recent years, the housing GSEs were a dominant source of both equity and debt for the production and preservation of the multifamily units that house most renters. With unemployment so high and incomes constrained, financiers of rental housing are now facing rising defaults akin to the earlier wave of troubled single family loans. The multifamily finance market will go through a major restructuring. We tend to think about the housing finance system predominantly in terms of homeownership. But a balanced housing policy would give explicit consideration to the design of a system that works for the finance of rental housing as well.

2. The "Shadow Banking System" of PLS

Design of the system of the future must be informed by rigorous analysis of what worked and what did not work in the housing system in recent years. It is thus worthwhile repeating the history of the crisis for the lessons it offers for the design of the future system.

Until recently, there were effectively four home mortgage lending channels in the United States:

- loans held in portfolio by depository institutions,
- loans originated with government insurance (FHA and VA) and sold to investors in MBS with a Ginnie Mae guaranty,
- loans originated for sale to the GSEs, which then sold them to investors in the form of MBS (or held them in portfolio), and
- loans originated for sale to investors in the form of private label MBS (PLS).

Private securitization arose in the 1980s and became a popular way to access secondary market finance for non-conforming (not eligible for GSE-securitization) mortgages, subprime, and other niche products. This channel grew as a share of mortgage originations dramatically from 2002 to 2007. This discussion describes the business practices that we saw in that period.

Like other lending channels, private securitization of mortgages intermediated between the needs of investors seeking safe and liquid investments and borrowers seeking riskier and illiquid loans. It used an "originate to distribute" model, in which lenders (banks and non-banks) originated mortgages with the intention of reselling them to issuers of MBS. These issuers, which were typically organized as conduits (with no other assets or liabilities other than those related to the securitization of loans), pooled the mortgages, and issued bonds based on the cash flows (principal + interest). In theory, this model distributed risk to the investors best able to bear it. In practice, however, it increased the distance between lender and borrower, made the investment more complex and opaque and risk harder to assess, and created perverse incentives for all the intermediaries paid for their role in the process without regard to the performance of the loan or investment over time.

Key to the development of private securitization as a mainstream lending channel was its ability to produce investment-grade securities, which were greatly in demand. Institutional investors (such as pension funds, mutual funds, and money market funds) and central banks and sovereign wealth funds (from export-heavy countries such as China and the OPEC nations with large trade surpluses) had growing assets, creating an enormous demand for dollar-denominated investment-grade bonds, both for direct investment and for use as collateral in a variety of transactions, including commercial paper, the repo market, and credit default swaps.

Private securitization was able to create investment-grade paper out of subprime mortgages through two main mechanisms: (1) a structure of tranches that theoretically left the senior bond holders heavily overcollateralized against credit losses and (2) third party insurance arrangements. In the first, securities were issued with different levels of seniority, with a "cascading" stream of payment as obligations to the more senior tranches were satisfied. The most senior tranches were typically investment grade (Aaa or Aa) rated and were the first to get paid. Only when they were paid in full, would the lower tranches get paid. Consequently, the lower tranches were higher risk and received higher coupons – rates of return. The core idea was that, with several tranches that would cumulatively absorb a high level of losses (typically between 20-50%), this structure could create a seemingly high quality, safe investment security (the senior tranche) out of a pool of relatively risky loans.

Private securitization also relied heavily upon the use of third-party credit guarantees, including mono-line insurance and credit default swaps (CDS), to achieve investment-grade ratings for its bonds. When the senior tranche of a PLS issue did not have sufficient overcollateralization against loss to justify an investment-grade rating, the securitization's sponsor would often purchase third-party insurance or CDS—effectively a promise to pay the investor in the event that their bond was hit by credit losses. Because the insurers (such as Ambac) or CDS

issuers (such as AIG) were typically AAA-rated credit risks, their promise to repay in the event of a default translated into a AAA rating for the bond they were guaranteeing.

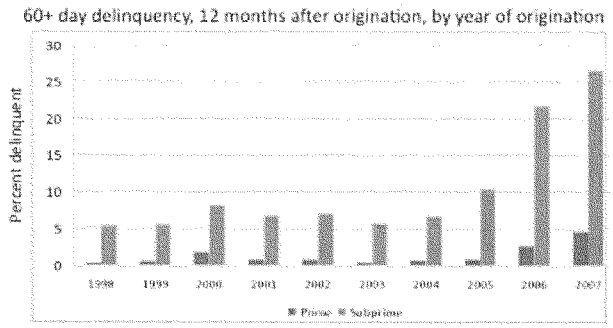
Of course, the entire process relied on the assumption that the rating agencies could accurately assess risk to the investor. But increasingly, they became more focused on the structure of the transaction than on the quality of the underlying loan assets. Little attention was given to the changing characteristics of the mortgages upon which these securities rested: the credit-worthiness of the borrower and the risk that the collateral (the home) might decline in value. Past performance of similarly transactions gave rating agencies and investors a false sense of confidence, while the asset quality of the underlying mortgages fell dramatically as demand for mortgages to feed the PLS market grew.

Subprime loans quickly saturated the market, with fewer and fewer borrowers available who had comparable risk characteristics to prior-era subprime borrowers. As demand for PLS offering high yields mounted, the PLS markets adapted by broadening the criteria for loans eligible securitization, while the rating agencies continued to give the senior tranches investment grade ratings.

An analogy is helpful. Imagine that there was suddenly great demand for hamburgers in the U.S., as health experts began to extol their benefits. But the beef industry would face a shortage of beef satisfying USDA criteria for Grade A meat to sell for human consumption. To satisfy restaurant and grocery demand, the beef industry might try to convince the USDA that older, less healthy cows should receive the Grade A designation. If USDA inspectors were dependant for their income on those whose meat they graded, they might feel pressure to change the criteria. And it there was no need to publish to the public the grading standards and submit for public comment changes, it might be some time before we realized that what went into hamburgers had changed. This is basically what happened with the PLS markets. Investors were eating horse meat.

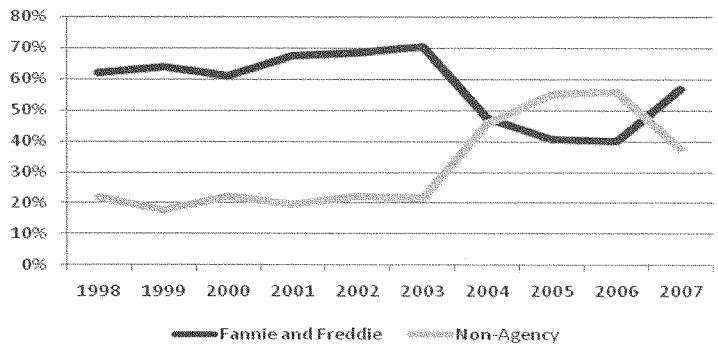
PLS markets accepted a broad array of new loan types, which were untested but high yield and high risk, and ignored serious problems with underwriting, accepting a high level of "no doc" or "low doc" loans. As Figure 1 demonstrates below, subprime credit quality dropped precipitously, with early delinquencies rising from just above 5 percent in 2003 to over 25 percent in 2007.

Figure 1
Credit Quality of Subprime Loans Deteriorated Dramatically



These problems might have been checked by a different model in which major actors had an incentive tied to long-term performance, not simply volume of origination and issuance. In the "originate to distribute" model, the primary market drivers had no "skin in the game." The credit risk of PLS was grossly understated and the PLS risk was seriously underpriced. With portfolio managers instructed to invest only in investment grade securities and PLS investments offering higher returns, PLS saw a huge surge in market share during the credit boom. As a result, more and more exotic and poorly underwritten mortgages originated for the PLS pipeline were pitched to consumers who might have chosen "plain vanilla" mortgages in another time. GSE market share dropped to less than 30 percent in 2006, down from over 50 percent in the 1990s, as illustrated in Figure 2 below.

Figure 2
Share of Mortgage-Backed Securities Issued



Source: Inside Mortgage Finance

Another consequence of the tremendous demand for PLS and the subprime mortgages that fed them was pressure on the GSEs to maintain their collapsing market share. Origination channels that had typically delivered a large volume of loans to the GSEs, most famously Countrywide but many others as well, suddenly had greater leverage. They were able to get the GSEs to provide better pricing and lower credit standards, as they faced losing yet more business if they did not. The GSEs also began to buy the triple-A rated tranches of PLS for their own portfolio and convinced their regulators to credit these purchases toward affordable housing goals, inexplicably crediting goals-eligible loans without discerning whether they were sustainable. In 2007, as many investors became wary of these products, the GSEs stayed in the market for PLS longer than most, thus consuming a larger share of the shrinking pie.

As the performance of PLS backed by subprime loans began to deteriorate in 2007, financial institutions began to weigh their exposure to these instruments. Increasingly, investors in PLS (and the associated paper that utilized PLS as collateral, such as commercial paper and repo agreements) panicked. Investment banks and other institutions with large exposures were no longer trusted as counterparties and literally faced a "run on the bank" by the fall of 2008, bringing the financial system to the verge of collapse.

The system of the future must learn the lesson from this experience. We must not reproduce a bifurcated system in which unregulated capital in one part of the market drove a "race to the bottom" in underwriting and highly leveraged risk. In

the future, all mortgage backed securities (MBS), whether or not backed by the government, must be subject to regulation. This is a key distinguishing feature of the draft proposal on which CAP's Mortgage Finance Working Group is working – it subjects the private markets for mortgage backed securities to regulation comparable (albeit not identical) to that applied to any portion of the market benefiting from public support.

3. The Role of the GSEs: Late to the Party

Some argue that the GSEs were the "but-for" cause of the housing crisis. A close review of historical record shows that they made problems worse and regulators failed to step in when they might have, but their practices were not the origin of the crisis.

GSE-guaranteed MBS are based upon the cash flows from "conforming mortgages." Investors in GSE MBS rely upon a guarantee from Fannie Mae or Freddie Mac of timely payment of principal and interest that protects the investor against credit losses, although the investor retains the interest rate risk represented by early prepayments. Their charters effectively require that borrowers obtain private mortgage insurance when the loan amount is more than 80 percent of the collateral value. Until recent years, the GSEs purchased and issued MBS based primarily on "prime" mortgages, with generally sound underwriting.

The GSEs also began in the late 1990s to issue greater amounts of debt and use the borrowed funds, not to securitize loans, but to hold whole mortgages in their retained portfolio, taking advantage of their lower cost of capital. The portfolio was especially helpful for investing in innovative and unusual loan products and to support the affordable multifamily rental market, where securitization was less common until recently. But it also became an opportunity to buy and hold PLS for the GSEs' own account.

The relevant history of the GSEs in can be considered in four periods.

> Pre-2002: GSEs dominated the mortgage markets. Default rates were generally low, housing appreciation was relatively predictable, and generally pegged to inflation, rents, and other factors (such as measured by Case-Shiller or other indices).
>
> 2002-2005: PLS experienced enormous growth, taking large market share from the GSEs. New forms of loan products, such as 2/28 interest-only ARMs, financed through PLS which were underpriced for the risk, resulted in a home lending boom, with rapid home price appreciation and high levels of home refinancing.

2005-2008: GSEs respond to PLS competition by successfully lobbying their regulator to allow them to purchase Alt-A and some subprime mortgages for securitization, as well as Aaa-rated PLS and lower quality whole loans for their portfolio.

Fall 2008 to the present: Following the failures of Lehman and AIG, and with housing-related losses soaring, the GSEs are placed into conservatorship by the federal government. PLS evaporate as a source of capital for housing finance and the GSEs become an essential source of countercyclical mortgage credit lending. They also help the Bush and then Obama Administration's to implement efforts to keep the housing markets from collapsing (such as the loan modification and refinance programs).

The GSEs biggest problems arose because they wanted to respond to the competitive threat of the PLS issuers, who were providing investment-grade PLS securities that were more attractive to investors, and subprime exotic mortgage products, that were coming to dominate the home lending market. Regulators failed to detect that the PLS market had disregarded and underpriced risk, and catastrophic consequences awaited all who followed the PLS issuers into the deep end. The GSEs' purchases of Alt-a and subprime loans and PLS for their own portfolio certainly helped to sustain investor demand for these loans longer than if they had been precluded from their purchase. But it was competition from this underpriced market that undermined the GSE business model and drove them to take greater and greater risks.

The GSEs, like depository banks and unlike PLS, were a under prudential risk regulation regime. Bank and GSE regulators in the middle of the decade failed to intervene as the systemic risk from the PLS market infected our entire financial system. The lesson to be learned here is that competition from an unregulated channel can distort incentives in even regulated channels and the very opposite of an efficient market results.

The GSEs are now experiencing losses originating from two different sources: their traditional MBS guarantee business and the purchase of PLS and alt-A loans for their portfolio.

First, as a mono-line business exclusively invested in housing assets, the companies experienced and continue to experience significant losses from their core business of guaranteeing MBS issued on pools of conventional conforming mortgages. The housing bubble first inflated house prices and then values fell as much as 30 percent nationwide. The stress tests that regulators applied to their book of business tested their capacity to survive two regional recessions, but nothing like the severe house price depreciation of the past three years. Regulators failed to check the PLS-driven bubble. The GSEs' regulators failed also to judge how rapid house price appreciation exposed the GSEs to great risk of loss and allowed them to chase market share with declining credit standards on the guarantee business, especially

as they moved into buying so called "Alt-a" (typically low documentation) loans for their MBS business and to hold in portfolio.

GSE-conforming loans, however, which have historically performed well, have seen default rates that are a fraction of default rates for loans originated for the PLS market, even in this unprecedented housing downturn. As of Q2 2009, PLS made up 13 percent of all single-family first mortgages, but accounted for 35 percent of serious delinquencies. GSEs, on the other hand, held 57 percent of all such mortgages but accounted for only 26 percent of seriously delinquent mortgages.[3]

The GSEs also have experienced losses for their portfolio, funded by issuing debt and using the proceeds to finance direct investments that they hold in portfolio rather than use to back MBS. These losses were largely accumulated from investing in the Aaa-rated traunches of PLS and subprime and Alt-a loans.

In sum, the GSEs made poor decisions with extremely costly consequences for taxpayers. They came to the party late, drawn into the market in an attempt to regain lost market share and chase return. As others left, they stayed and inexplicably "doubled down" as credit quality collapsed. Their regulators also made significant errors in how they exercised their oversight authority, most egregiously in giving them goals credit for subprime purchases without regard to whether the loans were sustainable. While both GSE decisions and failures of GSE regulatory oversight contributed to making problems worse, neither was the primary cause of either the flood of poorly underwritten subprime mortgage nor the larger global financial meltdown. That distinction that belongs to the failure of regulators to control the PLS market.

4. Low-Mod Lending Didn't Cause the Crisis

Some also claim that the Community Reinvestment Act (CRA) or the affordable housing goals of the GSEs were the driving cause of the mortgage crisis, broadly claiming that government intervention overcame the markets' ability to reach an efficient outcome in pricing risk. This narrative does little to explain how Bear Stearns or AIG became exposed to subprime mortgage risk or how Goldman Sachs and Morgan Stanley developed multi-trillion dollar repo markets based on the use of Aaa-rated subprime mortgage securities as collateral. It also is based in a misunderstanding of the scope and impact of CRA and the housing goals.

CRA was enacted in 1977 in response to widespread reports of redlining and other forms of discrimination. It requires covered banks to provide broad access to credit on non-discriminatory terms in any communities in which it operates consistent with safety and soundness.[4] It also *only applies to chartered banks and thrifts.* The private securitization pipeline largely bypassed these regulated institutions, using a

[3] http://www.freddiemac.com/corporate/company_profile/pdf/fm_housing_crisis.pdf.
[4] *See* http://www.occ.treas.gov/crainfo.htm.

network of non-bank lenders, such as Ameriquest and New Century, to originate loans. At the height of the subprime boom in 2006, only one of the top 25 lenders was directly subject to CRA.[5] What's more, CRA does not reach the bank holding company level. So the fact that Countrywide owned a bank does not mean that Countrywide Financial Corporation as a whole was subject to CRA, but only the small bank that it operated. Finally, CRA obligations only extend to communities in which a bank has a branch office. As a result, only a tiny fraction of loans could be reasonably attributed to the CRA. Indeed, CRA assessment-area lending accounted for only 9% percent of higher-priced loans to borrowers and neighborhoods potentially eligible for CRA credit.[6]

In assessing the claim that CRA drove subprime lending, Former Comptroller of the Currency Gene Ludwig and co-authors reach this conclusion: "[I]t is apparent that the increase in subprime defaults did not result from the CRA inducing banks to reduce underwriting standards or undervalue risk. Rather, investors' desire for higher investment yields and Wall Street's response pulled the non-CRA, unregulated mortgage market in that direction."[7]

Loans originated for CRA purposes actually performed quite well, both before, during, and after the subprime bubble. As San Francisco Federal Reserve Bank President Janet Yellen has stated: "There has been a tendency to conflate the current problems in the subprime market with CRA-motivated lending, or with lending to low-income families in general. I believe it is very important to make a distinction between the two. Most of the loans made by depository institutions examined under the CRA have not been higher-priced loans, and studies have shown that the CRA has increased the volume of responsible lending to low- and moderate-income households."[8]

Yellen's comments were supported by research from the Federal Reserve Bank of San Francisco, which found that, controlling for borrower and loan characteristics of more than 200,000 purchase money mortgages originated in California from 2004 to 2006 in low- and moderate- income census tracts, loans originated by CRA-

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[5] http://www.mcclatchydc.com/2008/10/12/53802/private-sector-loans-not-fannie.html.

[6] Kevin Park. "Subprime Lending and the Community Reinvestment Act." Joint Center for Housing Studies, N08-2.

[7] Eugene Ludwig, James Kamihachi, and Laura Toh "The Community Reinvestment Act: Past Successes and Future Opportunities," Federal Reserve Board of San Francisco at: http://www.frbsf.org/publications/community/cra/cra_past_successes_future_opportunities.pdf.

[8] Opening Remarks to the 2008 National Interagency Community Reinvestment Conference, March 31, 2008, http://www.frbsf.org/news/speeches/2008/0331.html, citing that "According to the 2006 HMDA data, 19 percent of the conventional first lien mortgage loans originated by depository institutions were higher-priced, compared to 23 percent by bank subsidiaries, 38 percent by other bank affiliates, and more than 40 percent by independent mortgage companies. " Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, "The 2006 HMDA Data," *Federal Reserve Bulletin,* Volume 94 (2007), p. A89. See also, The 25th Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System (Joint Center for Housing Studies, Harvard University, Cambridge, MA, March 2002).

regulated institutions had significantly lower likelihood of foreclosure than those originated by non-CRA regulated independent mortgage companies.[9]

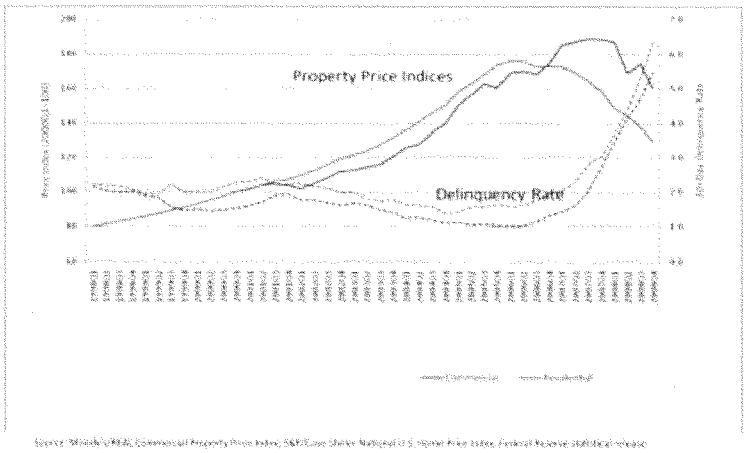
With respect to the claim that it was the affordable housing goals of the GSEs that caused the crisis, the basic argument appears to be that these goals forced the GSEs into buying up subprime securities, which singlehandedly drove the market for subprime loans. While there is no doubt that the GSEs added to the total demand for such loans, this line of criticism overlooks the ample demand for such securities from the rest of the market. It also assumes that the affordable housing goals were the driving cause of the GSEs' ill-conceived foray into Aaa-rated subprime, rather than the relatively high rates of return these securities were offering over similarly rated instruments and the GSEs' struggle to maintain market share.

There are some other important points to consider in assessing whether CRA and the affordable housing goals drove the crisis. First is the question of timing. CRA was enacted in 1977, and the GSE affordable housing goals were implemented in 1993. Why was it only in the mid-2000s that these initiatives would have caused major problems?

Furthermore, if these government mandates related to residential mortgage lending were the cause of the financial crisis, why did we see the exact same credit expansion and collapse pattern in commercial real estate, which did not have any parallel requirements to the affordable housing goals or CRA? As the chart below indicates, commercial real estate followed almost an identical bubble-bust cycle as that of residential real estate. Similar cycles can be seen in other credit markets in which private securitization played a major role. (See following page.)

[9] Laderman, Elizabeth and Carolina Ried. 2008. Lending in Low- and Moderate-Income Neighborhoods in California: The Performance of CRA Lending During the Subprime Meltdown. Working Paper, Federal Reserve Board of San Francisco.

Commercial vs. Residential Real Estate



5. Affordable Homeownership Done Right

While much of the lending to low- and moderate-income borrowers during subprime frenzy was, on net, more detriment than benefit to these families, in fact, we know how to do affordable homeownership right. It would be unfortunate if, as a result of the crisis, we would now shy away from lending to those underserved borrowers for whom sustainable homeownership is possible with appropriate lending products and practices.

In the years before the capital markets fueled a subprime deluge and bad money chased out good, a range of policies and programs effectively created sustainable, affordable homeownership. Close analysis by academics at the Center for Community Capital at the University of North Carolina, the Urban Institute, the Federal Reserve Bank of San Francisco, and elsewhere shows that borrowers from private and non-profit lenders using sound lending practices were much more likely to sustain homeownership than comparable borrowers in subprime loans, even as economic conditions worsened. Proven on the ground, these programs point a way forward that provides access to affordable homeownership for those who are ready for it. The secondary market system of the future should support rather than hinder the development of sound and sustainable lending practices informed by the record of affordable lending that worked.

The deluge of PLS-driven lending that targeted low- and moderate-income borrowers—particularly in minority communities—during the past decade was not actually affordable home lending. As discussed above, a robust PLS market created a strong demand for high-yield mortgage products. This was manifested in the form of strong financial incentives across the PLS "originate-to-distribute" pipeline to originate and securitize more high-cost, high-risk mortgages, such as interest-only or negative amortization adjustable-rate mortgages. The PLS market's strong demand for high-yield mortgage products also resulted in a blind eye being turned to underwriting standards, creating the conditions for rampant fraud. Simply put, the incentives of the PLS pipeline were not to promote affordable or sustainable mortgages, but rather to promote higher-cost, higher-risk mortgages.

Thus, while a flood of cheap PLS financing poured into low and moderate income communities, this financing did not translate into affordable or sustainable mortgages. And it has been shown to have a negative impact on homeownership rates. We now have 2.6 million fewer homeowners than we did before the rise of subprime lending, a number that is almost certain to increase as the fallout from the foreclosure crisis continues. Because so much of the predatory lending targeted minority communities, the impacts among minority homeownership rates are just as profound. Among African Americans, the homeownership rate has dropped from 49% in 2004 to 46% at the end of 2009, a level not seen since 1999.

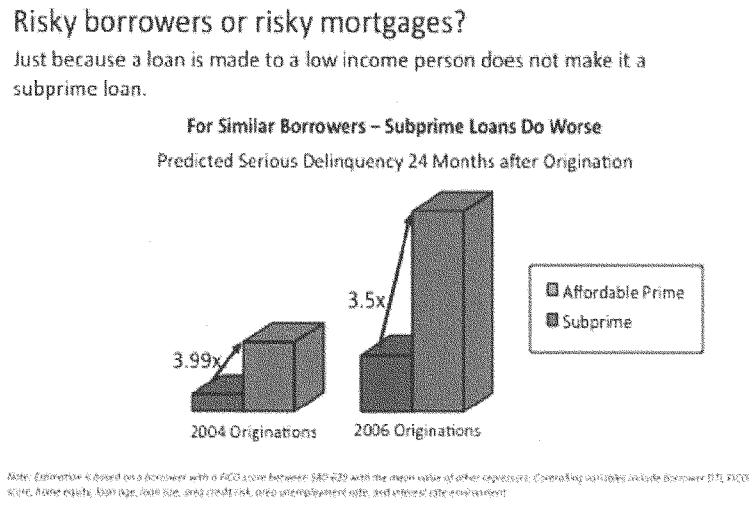
Lost amid the debate over how to prevent another subprime lending crisis, is the fact that subprime lending actually crowded out well-designed affordable homeownership programs that were actually working quite well. A 2009 examination of the foreclosure experiences of city-based affordable homeownership programs in 5 cities (Boston, Chicago, Los Angeles, New York and San Francisco), found that, out of nearly 9,000 low-income families helped to purchase homes, the overall default rate was below 1%.[10] More recently, in New York City, the housing agency reported only 13 foreclosures out of more than 20,000 subsidized homes sold to low-income buyers since 2004.[11]

Rigorous research has confirmed that these are not just isolated successes. Researchers at the UNC Center for Community Capital compared the performance of loans from a large, national portfolio of affordable and community reinvestment act mortgages to that of loans made by the subprime market. When matching borrowers with similar profiles (for example, comparable borrower risk factors, down payment, and market conditions) the borrowers who obtained subprime loans were three to five times as likely to default as their counterparts who had received the prime, affordable mortgages instead. In this study, adjustable rate

[10] Sustaining Homeownership: The Experience of City-Based Affordable Homeownership Programs, Carolina Reid. (

[11] http://www.nytimes.com/2010/03/07/nyregion/07foreclose.html?pagewanted=1

mortgage, prepayment penalty and broker originations were features associated with increased risk of default, and layering of these features generally magnified default
risk.



Perhaps more importantly, we have identified certain key features that enhance the likelihood of sustainable homeownership. While it is true that high down payments, higher wealth, and lower debt-to-income ratios are associated with lower default risk, these are by no means the only relevant factors for homeownership. Loans to LMI borrowers who lack high wealth or income are still highly sustainable when they are accompanied by flexible underwriting guidelines, combined with risk mitigation strategies, education and counseling, enhanced servicing, and default prevention strategies.[12] Fixed rates, fully amortizing loan terms, full documentation of income and demonstrated ability to pay are among the other important feature of affordable mortgages that work.

[12] Quercia, Roberto G. Assessing the Performance of Affordable Loans: Implications for Research and Policy. Journal of Planning Literature, Vol. 14, No.1 (August 1999). Sage Publications.

The experience of Self Help, based in North Carolina, illustrates these points. Since the early 1990s, Self-Help has made more than 4,000 direct loans totaling over $318 million.[13] It also created a Secondary Mortgage Market program which has financed over 40,000 home purchase loans to low-income and minority borrowers in 48 states totaling more than $4 billion and made by nearly 40 lenders mostly between 1999 and 2005. These loans were made to low and moderate income borrowers (average income of $32,600), and featured minimal cash to close and high loan-to-value ratios, with more than half having an LTV of 97% or higher. By offering some of the loan features described above, these loans had performed quite well, with a delinquency rate well below that of subprime ARMs, subprime fixed, and even prime ARMs.[14]

Another approach that has worked to address the wealth barrier facing lower income and minority families is shared equity. In brief, the shared equity approach bridges the gap between an affordably sized first mortgage loan not exceeding 80% of purchase price, and the borrower's limited savings. Public or non-profit supplied funding provides down payment assistance. This down payment assistance, however, is treated as an investment that creates in effect a partnership between the individual homebuyer and the public/non-profit support. Shared equity fairly returns to the public/non-profit its share of the investment through the creation of a long term affordable asset, while returning to the homeowner a reasonable increase in personal wealth. Approaches such as the community land trust and deed restricted resales embody these policies.[15] One recent study found that the foreclosure rate among community land trust homeowners was less than 0.2 percent—one-sixth of the national average and an even smaller fraction of the average among the lower-income homeowners that these groups serve.[16]

Savings programs targeted to lower-income people, such as Individual Development Accounts, also appear to create more stable homeownership. For example, a soon to be released study sponsored by the Corporation for Enterprise Development (CFED) examined the incidence of foreclosure among a sample of 831 IDA participants who purchased homes between 2001 and early 2008. Roughly 68% of IDA buyers were minority households, and roughly 75% were headed by women. But only 3% of the IDA borrowers entered foreclosure between 2001 and April, 2009. This is contrasted to an overall foreclosure rate in the same communities for all loans originated over the same time period of 6.3%, and a nearly 9% foreclosure rate for

[13] www.self-help.org, Accessed 3/22/2010

[14] Quercia, Roberto, Janneke Ratcliffe and Michael Stegman; The CRA: Outstanding and Needs to Improve. In Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act. pp.47-58. Federal Reserve Banks of Boston and San Francisco. February 2009.,

[15] David Abromowitz and Rick Jacobus, A Path to Homeownership: Building a More Sustainable Strategy for Expanding Homeownership, Center for American Progress (2010), *available at* http://www.americanprogress.org/issues/2010/02/shared_equity.html.

[16] National Community Land Trust Network, 2008 Foreclosure Study. Online at:http://www.cltnetwork.org/doc_library/National%20CLT%20Survey%20News%20Release%20FINAL%20V2.pdf.

low-income individuals who purchased similarly priced homes over the same time period.[17]

6. Managing the Housing Market through the Transition

The Administration deserves credit for its deliberate step-by-step management of housing markets through the crisis. If overseas investors had lost confidence in the mortgage-backed securities that finance most home mortgages (especially as bank capital was squeezed), credit for home loans would have become virtually impossible to obtain. Home values and consumer confidence could have fallen far further if credit availability had not been maintained. I do not minimize pain felt by the millions of Americans who have lost or face losing their home or have seen their home equity erode. We have been critical of the Administration for not taking some additional steps to do more to stem foreclosures. Still, they faced the risk of significantly worse than we have experienced. If they had not been as successful at keeping credit flowing, the consequences for the consumer would have been extreme.

The current situation, in which the federal government, through FHA-Ginnie Mae or the GSEs, backstops almost 90 percent of the market for home mortgages, is not desirable or sustainable. No one seeks to preserve the government's expanded role one moment longer than necessary. But there could yet be severe consequences from acting too precipitously to disrupt the unfortunate status quo. Policymakers must move carefully and avoid destabilizing action that could unleash further deterioration of home values, threaten the fragile economic recovery, and make domestic and overseas investors wary of so-called "agency securities," which represent trillions of dollars of investment in the U.S. economy. We have learned that the larger global economy is deeply entangled with the U.S. housing market. It would be irresponsible for policymakers to make dramatic pronouncements about what the future may bring without carefully considering the ways such pronouncements could affect domestic and international market responses and the consequences of those responses to the assets, expenses, and economic opportunities of American families.

How policymakers manage the transition from the status quo to the future will determine the ultimate taxpayer cost. The taxpayers will take significant losses from their exposure on the GSEs and are at risk as well through FHA if housing markets decline significantly further. The extent of those losses may be reduced by prudent management of housing markets by policymakers and they could be greatly exacerbated by additional home value deterioration or new threats to our very

[17] This data comes from a study by CFED, to be released at the Center for American Progress on April 1, 2010.

fragile economy. The wrong steps that too quickly constrain access to credit could result in far greater taxpayer losses from our existing exposure to the housing market.

As this committee knows well, simple statements by policymakers about their views on policy direction can move markets. As a result, there is great value in having a robust public conversation *outside the government* to inform policymakers before proposals are made and action is taken. That is why this series of preliminary hearings is so important to begin the debate.

Speaking only for myself, I do not purport to know yet the right answer to all of the complex questions that must be resolved by policymakers. This is one of the most difficult and complex set of financial problems this nation has faced. As we learned over the last few years, the consequences are great if we get it wrong.

Circumstances demand a robust but deliberate development of options and analysis of their consequences. We need to engage and learn from academics, think tank denizens, builders, lenders, investors and other market participants, community advocates, state and local government representatives, and consumer representatives, and many others before good policy choices can be confidently made.

Sarah Rosen Wartell
Executive Vice President, Center for American Progress and Center for American Progress Action Fund

Sarah Rosen Wartell is Executive Vice President of both the Center for American Progress (CAP) and the Center for American Progress Action Fund (CAP Action) and leads the American Progress policy program on housing finance. In recent years, she also has guided the Center's economic policy team, editing in 2007 its multi-part economic strategy for the nation entitled "Progressive Growth."

Ms. Wartell helped to found CAP and CAP Action in 2003. She co-authored the original business plan and oversaw the management of the organizations through rapid growth. Recently, with the hiring of a COO, she has turned her attention to directing the Center's overall policy program, while continuing her own work in economic policy and housing.

Ms. Wartell served as Deputy Assistant to the President for Economic Policy and Deputy Director of the National Economic Council in the Clinton administration, where she advised the President, led interagency policy development, and negotiated with Congress on banking, housing and community development, consumer protection, pensions, bankruptcy, e-commerce, legal reform, and a host of other issues. She also oversaw the development of President Clinton's New Markets and Consumer Protection and Financial Privacy initiatives.

From 1993-1998, she held various titles including Deputy Assistant Secretary at the Federal Housing Administration in the Department of Housing and Urban Development, where she focused on FHA reform, single family finance, risk-sharing, credit reform, consumer protection under RESPA and manufactured housing standards, and other housing finance policy issues.

She also served as a consultant to the Millennial Housing Commission and the William J. Clinton Presidential Foundation. Earlier, she practiced law with the Washington, D.C. firm of Arnold & Porter.

She is a member of the Board of CFED (Corporation for Enterprise Development), an innovative non-profit working at federal, state and local levels to expand economic opportunity for low and moderate income Americans through asset-building strategies.

She is a graduate of the Yale Law School and Princeton University.

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B. Dan Berger
Executive Vice President
Government Affairs

March 22, 2010

The Honorable Barney Frank
Chairman
United States House of Representatives
Washington, DC 20515

The Honorable Spencer Bachus
Ranking Member
United States House of Representatives
Washington, DC 20515

Dear Chairman Frank and Ranking Member Bachus:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only national trade association exclusively representing the interests of our nation's federal credit unions, I am writing in conjunction with tomorrow's hearing entitled "Housing Finance-What Should the New System Be Able to Do?: Part I-Government and Stakeholder Perspectives".

Government Sponsored Enterprises like Fannie Mae and Freddie Mac allow credit unions to obtain the necessary liquidity to create new mortgages for their member-owners by utilizing the secondary market. Despite their conservatorship, Fannie Mae and Freddie Mac have remained an important tool for credit unions to help them free up funds to make more loans. GSEs have served as a valuable resource and partner in credit union efforts to promote homeownership to their members, particularly low- and moderate-income members, in the current economic environment.

We realize that Fannie Mae and Freddie Mac will likely transition out of their current conservatorship into a new model. As Congress considers ways of reforming the current GSE system, we believe it is important that safeguards are in place to make for a smooth transition, and that the important roles that Fannie Mae and Freddie Mac play for credit unions and the secondary market not be compromised. As credit unions can only raise capital from their membership, having additional sources of liquidity is of key concern to our members. We look forward to working with the Committee on this issue and the future of the GSEs as it moves forward.

Thank you for the opportunity to share NAFCU's views on the matter of GSE reform. If you have any questions or if we can be of further assistance to you or your colleagues on this issue, please do not hesitate to contact myself or NAFCU's Director of Legislative Affairs, Brad Thaler, at (703) 522-4770.

Sincerely,

B. Dan Berger
Executive Vice President of Government Affairs

cc: Members of the House Committee on Financial Services

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TO: **House Committee on Financial Services**
c/o Terrie Allison

FR: **Vincent F. O'Donnell, Vice President, Preservation Initiative**

DATE: **April 30, 2010**

RE: **Follow-up to March 23, 2010 Hearing on Housing Finance**

Following up on the transcript of the March 23, 2010 hearing, you requested a response to several questions from Representative Maloney. My reply follows. Thanks again for the opportunity to provide additional input to this important matter.

1. How do you envision the GSEs balancing their mission of increasing the number of affordable housing units with their goal of profitability?

According to the GSEs' charters, the Enterprises are obligated to undertake activities supporting the secondary market for lending activity that serves low- and moderate income households -- both homeowners and renters. While it is very important for the GSEs to maintain their profitability in order to continue to attract private capital into the mortgage market, it is also true that the charters provide that activities undertaken in service to low- and moderate-income households need not achieve the same level of profitability as their other business. Specifically, the charters permit "a reasonable economic return that may be less than the return earned on other activities." At the same time, it is important for all the GSEs' activities, whether or not they are designed to serve the needs of low- and moderate-income households, to maintain appropriate standards that do not in any way harm the overall market or the market serving lower-income populations.

2. It appears that in the case of Stuyvesant Town, which is in my district, profitability clearly won out.

Yes

3. What can Congress do to ensure that we do not have a repeat of the Stuyvesant Town situation, where the GSEs were investing in deals that meant that many tenants were going to have to be forced out in order for the owners to service their debt?

Congress has several tools available to regulate the GSEs to prevent activities that damage the mortgage market, and to protect tenants such as those living in Stuyvesant Town.

One route is through the GSEs' Affordable Housing Goals requirements. The Housing Goals regulations contain provisions that allow the regulator to deny goals credit to certain types of mortgages as determined by the FHFA. However, denying Housing Goals credit is not necessarily a strong deterrent when a sufficient profit motive is present. Also, it is important to note that certain areas of GSE business take place outside of the realm of the Housing Goals (which cover only conventional mortgage purchases), so any disincentive that is based in the housing goals will not apply to all GSE activities.

Under the recent proposal from the FHFA, for example, FHFA proposed excluding purchases of private label securities from consideration for the Housing Goals entirely. This exclusion makes sense because we believe the GSEs should be judged primarily on their core lines of business rather than on purely financial investments they make. However, it does have the side effect of excluding that activity from scrutiny under the responsible lending elements of the Housing Goals.

One option to address this issue would be to adjust the rules to penalize the GSEs' Housing Goals performance by requiring negative goals credit for any activity that is determined to violate good lending practices or investment in instruments based on inappropriate lending practices, whether or not it is in a business line governed by the Housing Goals. This would help ensure that good lending practices are adhered to or supported in all areas of the GSEs' business. That said, it is still only a limited disincentive. If a GSE is motivated to undertake a particular transaction that would have a negative impact on the goals, it would still be able to "make up" the loss of goals credit through additional purchases of mortgages that do meet the goals requirements.

The Duty to Serve provisions may be a more appropriate tool to capture the full picture of the GSEs' activities, including lines of business that are excluded from the Housing Goals. Because the Duty to Serve is a qualitative assessment of GSE business activity it is more than just a "numbers game" that can be manipulated as described above. The FHFA should have the flexibility to provide a failing or reduced grade on any portion of an Enterprise's annual evaluation if there are violations of responsible lending practices, or investments in instruments based on irresponsible lending, that have a negative impact on the market or individual tenants and communities.

Finally, Congress has the ability to make changes to the GSE Charter Act, which specifies what activities the GSEs may engage in, including prohibiting any activities that violate responsible lending practices.

U.S. House of Representatives

House Financial Services Committee

"Housing Finance—What Should the New System Be Able to Do: Part 1 – Government and Stakeholders Perspectives"

Questions for the Record

Treasury Secretary Timothy F. Geithner

March 23, 2010

Questions from Representative Ed Royce (R-CA)

1. The GAO reports that in 2008 there were more than $290 billion in unpaid federal income taxes. It appears that the outstanding amount of unpaid taxes increases every year. What is that amount today? What is your plan to collect these taxes? Do you believe the IRS is effective in collecting delinquent taxes owed?

The $290 billion figure you reference is an estimate of the size of the net tax gap for Tax Year 2001. The net tax gap is the amount of taxes that should be paid, but are not paid, even after taking account of IRS enforcement efforts. More recent estimates are not yet available, but the Treasury and IRS have initiated efforts to update the estimate of the tax gap on an ongoing basis.

IRS has undertaken a series of improvements in tax enforcement and is constantly working to reduce the tax gap. Indeed, IRS enforcement revenue (resulting from IRS efforts to address non-compliance) rose from $34 billion in FY2002 to $59 billion in FY 2007 before dropping somewhat to $49 billion in FY2009.

Research shows that the presence of third party information reporting to the IRS significantly increases compliance. The IRS is in the process of implementing important new information reporting rules (merchant payment card and securities basis reporting) that will address targeted areas of non-compliance.

The IRS continues to build on its multi-year international compliance strategy, which builds upon recent successful initiatives to bring those with assets hidden offshore back into the U.S. tax system. These efforts consist of a significant investment in resources with the expertise necessary to examine more complex enterprise structures and transactions, as well as implementation of the Foreign Account Tax Compliance Act (FATCA).

The IRS is developing new regulations on tax return preparers, with the twin goals of increasing taxpayer compliance and ensuring uniform and high ethical standards of conduct for tax preparers. The regulatory proposal includes a registration system, competency examinations, continuing professional education, and imposing stronger ethical standards on all return preparers. Proposed regulations for the first step of registration have been issued and the IRS is receiving comments. These rules will be finalized shortly with the intent of having a registration system in place beginning in September 2010 for the 2011 filing season.

2. Non-tax debts that are owed to the federal government are collected by the Treasury Department pursuant to the Debt Collection Improvement Act. Of the approximately $5 billion owed, what percentage of that will be recovered? Why isn't the average recovery of these debts more than 5 or 6 percent?

Recovery by Treasury of nontax debts owed to the federal government is affected by factors defining the status of a debt and/or a debtor that can prevent referral to and active collection by Treasury. Among those factors are:

- The debtor is in bankruptcy;
- The debt is owed by a foreign sovereign;
- The debt has been granted an exemption from referral to Treasury; and
- The status of the debt at the creditor agency. This includes debts subject to forbearance, foreclosure, a formal appeals process, internal offset, wage garnishment, and collection by a private collection agency.

Over the past seven fiscal years, Treasury's average recovery rate on non-tax delinquent debts has been 8.2%.

The recovery rates on delinquent nontax debt owed to federal agencies differ from debt type to debt type. Delinquent debt referred to Treasury's Financial Management Service (FMS) includes debts from direct and insured loans, including disaster loans, housing loans, and student loans. Because government loans are often made available to segments of the population that are not often served by the private industry, the default rate on government loans is often higher than the default rate on private loans. Delinquent debt referred to FMS also includes administrative debt, including debt arising from fees, fines, grants, overpayments, and penalties. The creation of administrative debt is generally not based on creditworthiness, which affects collection rates. In addition, debts referred to FMS are often at least more than 180 days delinquent, and can be delinquent for more than 10 years. The older the debt, the more difficult it is to recover, as people change addresses, move to a different city or state, and change or lose jobs.

3. Are you planning to have the Treasury Department expand its scope of operations to include collection activities for overdue child support payments, delinquent state taxes, and defaulted student loans? This work is done today by state government workers and professional private sector contractors. What are the reasons behind this move? Do you believe that the government can do this work more effectively and at lower cost than state government employees and private sector employees?

The Treasury Department's Treasury Offset Program (TOP) offsets federal payments to collect overdue child support obligations, delinquent debts owed to a state, and/or federal nontax debts, including defaulted student loans. TOP is unique to Treasury in that its databases provide ability to efficiently and accurately match existing debts to pending payments that other entities do not possess.

Treasury's Cross-Servicing program employs many collection tools. Among them is the use of private collection agencies (PCAs). As expressly contemplated by the Debt Collection Improvement Act of 1996, FMS has contracted with five (5) PCAs in order to utilize their experience and expertise in the field.

In addition, the President's FY 2011 Budget contains five Treasury debt collection legislative proposals. These proposals would, over ten years, collect an estimated $2.0 billion in federal tax debt, $1.1 billion in delinquent child support, and $1.2 billion in delinquent state taxes.

- Authorize post-levy due process for levies under the Federal Payment Levy Program. *Estimated revenue: $1.156 billion over 10 years*

- Allow IRS to levy 100% of all vendor payments, including payments for the purchase and lease of real estate, to collect delinquent taxes. *Estimated revenue: $845 million over 10 years*

- Allow the offset of SSA, RRB and Black Lung benefits to collect delinquent child support payments. *Estimated revenue: No federal budgetary impact; $1.1 billion over 10 years for child support.*

- Allow offset of federal income tax refunds to collect delinquent state income taxes for debtors who currently reside in other states. *Estimated revenue: No federal budgetary impact; $1.2 billion over 10 years for state taxes.*

- Allow FMS to deduct its fee from amounts collected from tax levies rather than have fees paid out of IRS's appropriation. *No revenue impact.*

4. Are you aware that the federal government is exempt from the Fair Debt Collection Practices Act, the Fair Credit Reporting Act, and from every state-level consumer protection law and regulation? In the event that Treasury were to take over these responsibilities, are you concerned that those exemptions remove many legal protection from those individuals that the Treasury Department would target for collection of non-federal debts?

While the provisions of the Fair Debt Collection Practices Act and various state debt collection laws do not apply to federal agencies, many provisions of the Fair Credit Reporting Act do apply. Furthermore, the private collection agencies used by Treasury's FMS are required to comply with all such laws. Moreover, the Debt Collection Improvement Act of 1996 provides many, and often greater, protections to debtors.