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Before the U.S. Senate Committee on Banking, Housing and Urban Affairs

Housing Finance Reform: Essentials of a Functioning Housing Finance System for Consumers

October 29, 2013

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

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

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

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

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

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

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

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

One of the key reasons that Fannie Mae and Freddie Mac ended up in conservatorship is because their incentives were skewed toward short-term gains. Shareholders looked to steady or increasing quarterly earnings reports. Therefore, in the face of declining market share because of growing numbers of private-label securities packaging subprime and Alt-A loans, Fannie Mae and Freddie Mac management decided to weaken credit standards to compete for the Alt-A business. This decision proved disastrous. While these Alt-A loans were roughly 10 percent of Fannie Mae's outstanding loans in 2008, they were responsible for 50 percent of its credit losses.[1]

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[1] *See* Federal National Mortgage Association, SEC Form 10-Q, June 30, 2008, at 6; Federal Home Loan Mortgage Corporation, SEC Form 10-Q, June 30, 2008, at 71.

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

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

Smaller Lenders Should Continue to Have Direct Access to the Secondary Markets Through a Cash Window: Housing finance reform should ensure that smaller and regional lenders – which often provide credit in rural and underserved communities that are overlooked by larger lenders – remain competitive in the secondary mortgage market. The current system provides smaller lenders with direct access to sell their loans to Fannie Mae and Freddie Mac, and a reformed system should retain this approach. The GSEs provide a "cash window" that gives smaller lenders an upfront cash payment – instead of a small interest in a security – in exchange for whole loans. This cash window access allows smaller lenders to avoid going through an aggregator, who could be a larger competitor. It also provides smaller lenders with the option of retaining servicing rights or selling those rights.

[2] Patricia Mosser, Joseph Tracy, and Joshua Wright, *The Capital Structure and Governance of a Mortgage Securitization Utility*, Federal Reserve Bank of New York Staff Report no. 644, at 18, 32-38 (October 2013).

Keeping servicing rights helps these lenders hold onto their best customers, rather than passing on customer contact information to larger competitors serving as aggregators.

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

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

Secondary Market Entities Should Be Required to Serve a National Market: A reformed housing finance system should continue to fulfill a national role where it serves all markets at all times, including rural and underserved areas. One of the relatively unnoticed success stories of the current housing finance system is the creation of a stable national housing market that can weather regional or even national economic cycles. Although we believe they could have done more to prevent overly constrained credit in recent years, the fact is that Fannie Mae and Freddie Mac have kept the housing market going during the worst economic crisis since the Great Depression.

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

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

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

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

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

Portfolio Capacity and Government Backing in Times of Economic Stress Are Needed for Successful Loan Modifications: One part of housing finance reform that seems at risk of being overlooked is the infrastructure needed to facilitate successful loan modifications. In order to prevent unnecessary and costly foreclosures that would put government reinsurance at risk, housing finance reform should preserve the ability of Fannie Mae and Freddie Mac to modify distressed loans. This involves a portfolio capacity to hold distressed-then-modified loans and a government liquidity backstop to support this portfolio in times of economic stress when modifications are most needed.[3] In addition, we support servicing standards that require a standardized and publicly available net-present-value test for modifications.

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

II. Housing Finance Reform Should Allow the Use of Compensating Factors in Underwriting.

GSE reform legislation should not prohibit lenders from using compensating factors to make more informed decisions about credit risk. In the wake of the financial crisis and while under conservatorship, the GSEs have become overly conservative – only the most pristine borrowers can get a conventional mortgage. The average borrower denied a GSE loan had a FICO score of 734 and was willing to put 19% down.[5] Purchase originations are at their

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

[4] *OCC Mortgage Metrics Report, Disclosure of National Bank and Federal Savings Association Mortgage Loan Data, Second Quarter 2013*, at 35 (September 2013). .

[5] *See* Kenneth Harney, *Mortgage lenders set higher standards for the average borrower,* The Washington Post (September 28, 2012).

lowest levels since the early 1990s.[6] There is a risk of enshrining or exacerbating this narrow market as part of housing finance reform, which would result in pushing young and lower-wealth borrowers into a separate and more expensive system.

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

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

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

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

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

[6] *See* Governor Elizabeth A. Duke, *Comments on Housing and Mortgage Markets At the Mortgage Bankers Association*, at 2 (March 8, 2013). .

historical levels underscores the contraction in credit supply. From late 2009 to late 2011, the fraction of individuals under 40 years of age getting a mortgage for the first time was about half of what it was in the early 2000s."[7]

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

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

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

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[7] See Governor Elizabeth A. Duke, Comments on Housing and Mortgage Markets At the Mortgage Bankers Association at 2 (March 8, 2013).

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

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

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

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

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

Conclusion

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

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[10] *See* Laurie Goodman and Taz George, *Fannie Mae reduces its max LTV to 95: Does the data support the move?*, The Urban Institute, MetroTrends Blog (September 24, 2013).

[11] S*ee* Allison Freeman and Janneke Ratcliffe, *Setting the Record Straight on Affordable Homeownership* at 4-8 (May 2012); *see also* Christopher Herbert, Daniel McCue, and Rocio Sanchez-Moyano, *Is Homeownership Still an Effective Means of Building Wealth for Low-income and Minority Households? (Was it Ever?)*, Joint Center for Housing Studies, Harvard University, at 48 (September 2013) (Overall, owning a home is consistently found to be associated with increases of roughly $9,000-$10,000 in net wealth for each year a home is owned.").

A Framework for Housing Finance Reform:

Fixing What Went Wrong and Building on What Works

Center for Responsible Lending Working Paper
Eric Stein and Carrie Johnson
Updated October 28, 2013

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

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

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

The Center for Responsible Lending (CRL) is a non-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, one of the nation's largest non-profit community development financial institutions. Self-Help has provided $6 billion in financing to 70,000 homebuyers, small businesses, and non-profits and serves more than 80,000 mostly low-income families through 30 retail credit union branches in North Carolina, California and Chicago.

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

1. **Adopt a Mutual Ownership Model Instead of Stock Ownership:** Require issuer-guarantor entities to have a mutual ownership structure instead of stock ownership. This structural change would align incentives for long-term stability instead of being tilted toward stockholder interests, market share and quarterly earnings reports.

2. **Put Private Capital in a First Loss Position and at Increased Levels:** Put private capital in a first loss position and subject it to strong capital standards.

3. **Provide an Explicit – and Paid-For – Government Guarantee:** Provide an explicit government guarantee that is paid for upfront and actuarially determined.

4. **Put in Place a Strong Regulator:** Create a strong federal regulator of issuer-guarantor entities empowered with authorities comparable to safety and soundness regulators of depository institutions.

5. **Prevent Issuer-Guarantor Entities from Holding Investment Portfolios:** Prevent issuer-guarantor entities from holding arbitrage portfolios of individual mortgages and mortgage-backed securities, while still permitting a limited purpose portfolio with government backstop to support aggregating loans of small lenders and to prevent foreclosures through loan modifications.

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

1. **Equal Treatment for Smaller Lenders:** Smaller lenders should have equal access to the secondary markets, as they currently do through the GSE "cash window," and should not be forced to access the capital markets through their larger competitors. Secondary market entities should not be split into separate issuer-companies and bond guarantor-companies, because so doing would jeopardize this smaller lender access.

2. **Serve All Markets at All Times:** The housing finance system must both serve a national housing market, including rural areas, and must ensure that creditworthy borrowers are able to access the mainstream system. The system should not be weakened by allowing secondary market entities to fragment into regionalized pieces without a national mandate. Also, legislation should not hardwire down payment mandates and, instead, should let the new system address risk through traditional underwriting standards, including compensating factors.

3. **Preserve and Maintain the TBA Market for 30-Year Fixed Rate Mortgages:** The current system is built around the to-be-announced (TBA) market for 30-year fixed-rate mortgages. This system provides broad access to credit for borrowers and widespread liquidity for investors, and the infrastructure supporting the TBA market must be maintained. Government reinsurance should also not be available to the senior tranches of structured securities, which are incompatible with the TBA market. These securities fail to provide benefits comparable to the TBA system and introduce excessive risks to the government guarantee.

4. **Promote Cost-Effective Loss Mitigation:** Servicers will not facilitate loan modifications – even when it is more profitable than foreclosure – if they are forced to hold modified loans on to their books. To facilitate loan modifications, as happens currently with Fannie Mae and Freddie Mac, GSE reform should retain a targeted and very limited portfolio capacity through a backup government line of credit.

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

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

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[1] *See* eMBS and Urban Institute's Housing Finance Policy Center (2013).
[2] *See* Inside Mortgage Finance and Urban Institute's Housing Finance Policy Center (2013).

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

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

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

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

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

1. **Adopt a Mutual Ownership Model Instead of Stock Ownership:** Require issuer-guarantor entities to have a mutual ownership structure instead of stock ownership. This structural change would align incentives for long-term stability instead of being tilted toward stockholder interests, market share and quarterly earnings reports.

2. **Put Private Capital in a First Loss Position and at Increased Levels:** Put private capital in a first loss position and subject it to strong capital standards.

3. **Provide an Explicit – and Paid-For – Government Guarantee:** Provide an explicit government guarantee that is paid for upfront and actuarially determined.

4. **Put in Place a Strong Regulator:** Create a strong federal regulator of issuer-guarantor entities empowered with authorities comparable to safety and soundness regulators of depository institutions.

5. **Prevent Issuer-Guarantor Entities from Holding Investment Portfolios:** Prevent issuer-guarantor entities from holding arbitrage portfolios of individual mortgages and mortgage-backed securities, while still permitting a limited purpose portfolio with government backstop to support aggregating loans of small lenders and to prevent foreclosures through loan modifications.

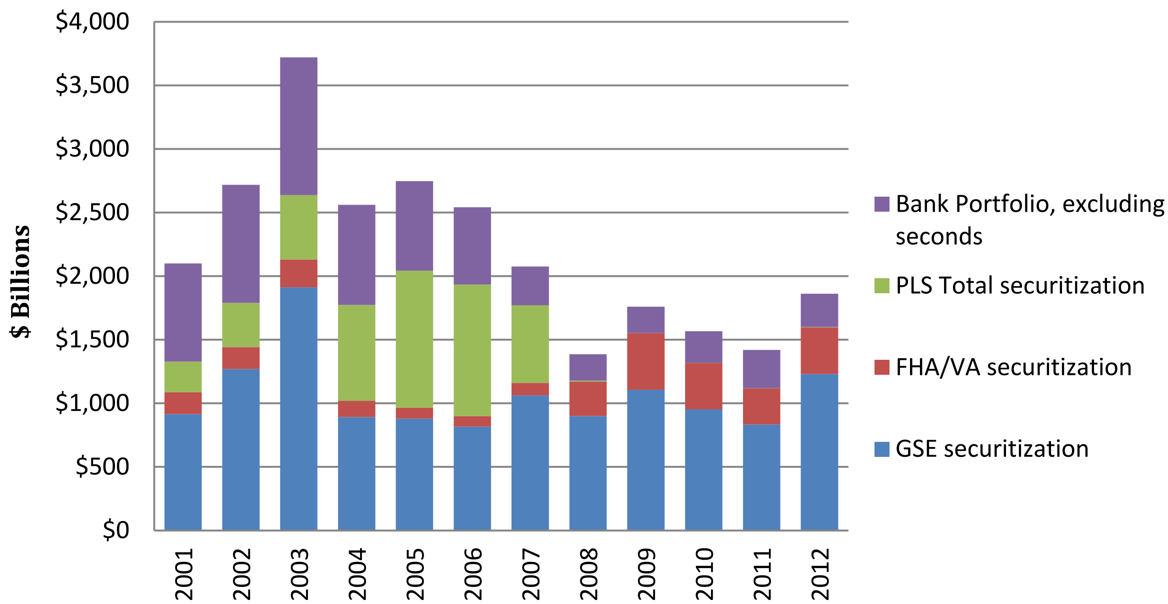
1. Adopt a Mutual Ownership Model Instead of Stock Ownership.

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

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

Prior to entering conservatorship in 2008, both Fannie Mae and Freddie Mac had implicit government backing combined with private shareholders seeking market share to drive high quarterly gains and returns on equity. In the years leading up to the crisis, GSE market share and profits were put at risk in the face of growing private-label securitizations competition. As the subprime and Alt-A markets grew in size from 2001 through 2006, the percentage of loans eligible for purchase by Fannie Mae and Freddie Mac under their traditional underwriting standards – also called conforming loans – decreased significantly. From 2003 to 2006, the GSE and government share of the MBS market (Fannie Mae, Freddie Mac and Ginnie Mae) fell from 78 percent to 44 percent while the private label securities share rose from 22 percent to 56 percent. [3] It is no coincidence that this 34 percent swing in favor of private label securities occurred during the worst period of lending in American history since the Great Depression. [4]

Figure 1: First Lien Origination Volume



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

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

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

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

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

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

B. A Mutual Ownership Model.

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

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[5] *See* Federal National Mortgage Association, United States Securities and Exchange Commission Form 10-Q, for the quarterly period ended June 30, 2008, at 6 (available at http://www.fanniemae.com/ir/pdf/earnings/2008/q22008.pdf);
Federal Home Loan Mortgage Corporation, United States Securities and Exchange Commission Form 10-Q, for the quarterly period ended June 30, 2008, at 71 (available at http://www.freddiemac.com/investors/).

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

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

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

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

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

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

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

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

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

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

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

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

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

B. Putting Private Capital in a First Loss Position.

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

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

[12] Housing and Economic Recovery Act of 2008, Public Law 110-2889, Section 1110 (July 30, 2008).

[13] *See* 12 U.S.C. § 4611.

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

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

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

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

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

could also be established.

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

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

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

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

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

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[15] Section II(3) address the problems in allowing structured securities to access government reinsurance.
[16] *See* Written Testimony of Mark Zandi, Chief Economist and Co-Founder Moody's Analytics, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Hearing: Essential Elements of Housing Finance Reform, at 2 and FN 15 (September 12, 2013) (available at http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=e11b481b-1c9f-49f8-acd5-b062387038a7).

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

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

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

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[17] *See* Mark Zandi and Cristian deRitis, *The Road To Reform*, at 1 (September 2013).

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

[19] *See* Federal Home Loan Bank Capital, Mortgage Market Note 09-3, Federal Housing Finance Agency, at 2 (July 16, 2009) (available at http://www.fhfa.gov/webfiles/14595/MMN093FHLBcapital71609.pdf).

[20] *See* Federal Home Loan Banks Office of Finance, Credit Ratings at http://www.fhlb-of.com/ofweb_userWeb/pageBuilder/credit-ratings-31 (last accessed on October 9, 2013).

recover from the recent housing crash.[21]

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

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

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

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

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

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

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

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

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

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

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

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

4. Put in Place a Strong Regulator.

Another key problem with Fannie Mae and Freddie Mac was the lack of a strong and independent regulator to oversee these entities. The Office for Federal Housing Enterprise Oversight was created under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 for the purpose of overseeing the GSEs. Although OFHEO was able to collect assessments from the GSEs, the law subjected OFHEO to the appropriations process in order to spend these funds on its operations. This left OFHEO with substantially less independence than the safety and soundness regulators of depository institutions, which do not require acts of Congress to fund their operations. OFHEO's resources and ability to effectively regulate Fannie Mae and Freddie Mac were compromised by the GSEs' political strength.[27]

These weaknesses were addressed in reform legislation in 2008, and this progress should not be jeopardized. In 2008, Congress passed HERA, which disbanded OFHEO and created a new regulator, the Federal Housing Finance Agency. Fannie Mae and Freddie Mac were then put into conservatorship in September 2008 by FHFA, and this regulator has been overseeing the GSEs'

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

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

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

operations in the years since. FHFA has appropriate authority to oversee the safety and soundness of Fannie Mae and Freddie Mac, adjust their capital levels as needed, as well as collect assessments that are not subject to appropriations.

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

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

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

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

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

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[28] S. 1217, Section 1214(d).

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

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

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

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

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

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

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

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

Third, reform should preserve the TBA market for 30-year fixed-rate mortgages, which strongly benefits borrowers, lenders and the economy. To this end, reform should not provide government reinsurance for the senior tranches of structured securities. Among other reasons, such a guarantee is unnecessary and makes the regulator's job too difficult to police every structured deal in the nation. Finally, reform should promote cost-effective loss mitigation by providing a government liquidity backstop for modified loans, as the GSEs have now, as well as for the entities' cash window to aggregate loan purchases by smaller lenders.

1. Providing Equal Treatment for Smaller Lenders.

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

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

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

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

[32] *See* Independent Community Bankers of America, *Housing Finance Reform: A Community Banking Perspective* (September 2013).

There are two aspects of the current system that make competitive pricing through a direct cash window access possible. First, because Fannie Mae and Freddie Mac perform both issuer and bond guarantor functions, they have certainty when deciding to purchase individual loans that these loans are acceptable for yet-to-be issued securities. This certainty facilitates the cash window, because issuers might be reluctant to put cash on the table when the bond guarantor commitment is unclear or needs to be coordinated. Second, smaller lenders are not required to go through their larger competitors in order to access this secondary market. While future secondary market entities should have mutual ownership, the current system does <u>not</u> have the problem of enshrining larger lenders as gatekeepers to the secondary market.

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

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

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

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

[34] *See* Ginnie Mae, Approved Single-Family Issuers (available at http://www.ginniemae.gov/doing_business_with_ginniemae/issuer_resources/approved_issuers_document_custodians/Pages/single_family.aspx).

One key difference between the Ginnie Mae system and the one contemplated in S. 1217 is that Ginnie Mae-approved issuers have certainty that the loans they aggregate have a credit guarantee, and there is no separate process required to gain guarantee status besides being FHA, VA or USDA approved. As described above, the same might not be the case under S. 1217.

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

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

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

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

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

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

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

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

2. Serve All Markets at All Times.

A reformed housing finance system must continue to fulfill a national role where it serves all markets at all times. This section addresses two prongs of this requirement. First, from the lender perspective, the housing finance system must support lenders operating in all parts of

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

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

the country, including rural areas. Second, from the borrower perspective, the system should permit traditional underwriting through compensating factors to provide creditworthy borrowers who can afford a mortgage access to a mainstream mortgage and avoid pushing certain communities into higher cost products.

A. Serving All Eligible Lenders in a National Market.

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

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

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

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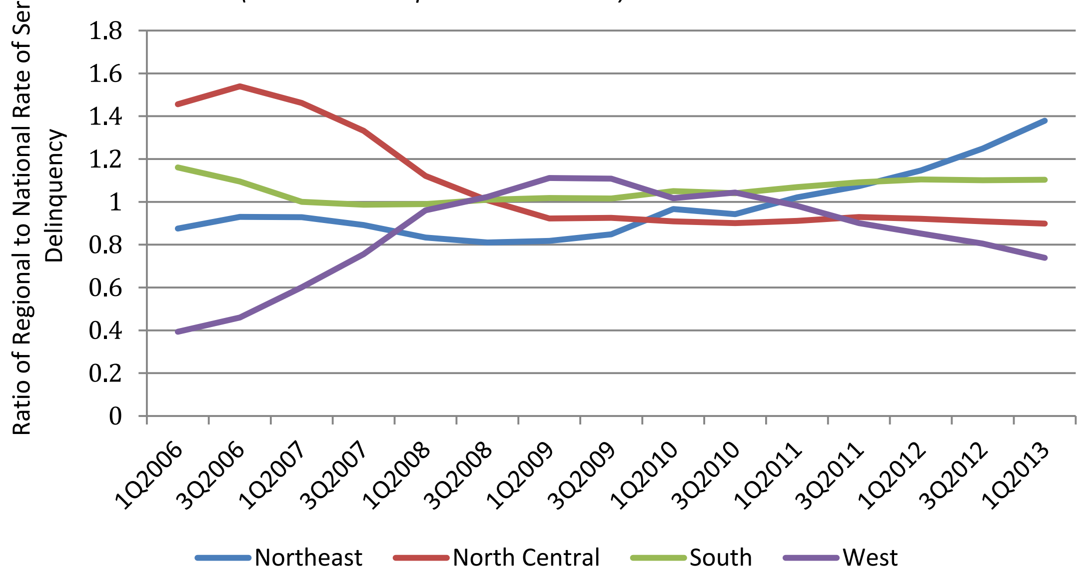
[37] 12 U.S.C. § 1716(4).

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

Figure 2: Regional versus National Delinquencies

(National delinquencies as base 1)



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

B. Permit Use of Compensating Factors in Underwriting.

Just as a reformed system should not leave lenders serving certain states or neighborhoods behind, the future system must not become overly narrow in terms of the borrowers it serves. We believe that GSE reform legislation should not prohibit lenders from using compensating factors to make more informed decisions about credit risk. Any good underwriter knows that some borrowers who can only put 3 percent down are a lower credit risk than others who can put 20 percent down, but legislation is unable to make this kind of determination across the board.

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

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

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

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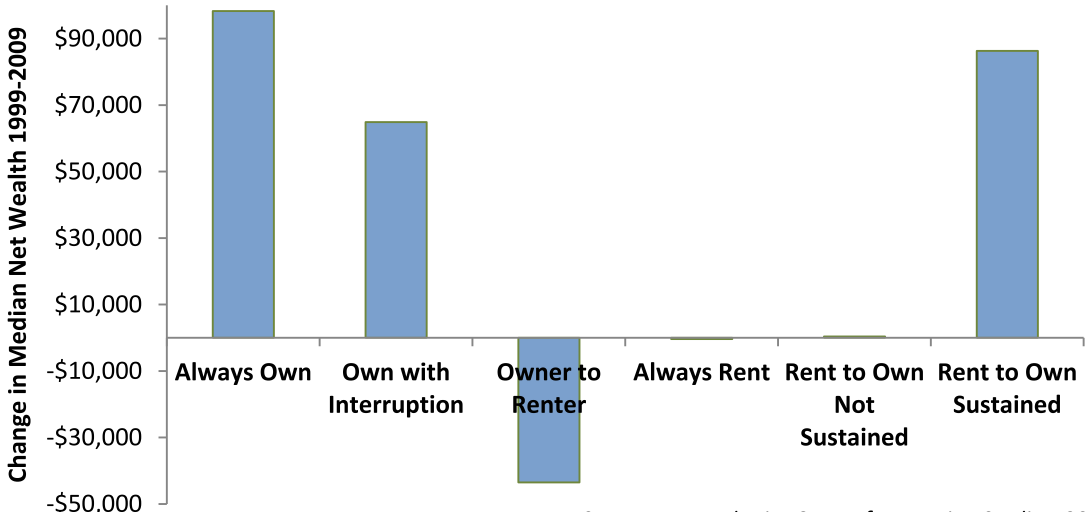
[38] *See* Kenneth Harney, *Mortgage lenders set higher standards for the average borrower*, The Washington Post (September 28, 2012).

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

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

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

Figure 3: Homeownership Provides Greatest Opportunity to Grow Household Wealth



Source: Harvard Joint Center for Housing Studies, 2013

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

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essentially fell back to their initial wealth levels. At least in terms of household wealth, failed attempts at owning do not appear to leave the typical household worse off than when they started.") (available at http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/hbtl-06_0.pdf).

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

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

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

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

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

[42] *See e.g.*, Thomas Shapiro, Tatjana Meschede, and Sam Osoro, *The Roots of the Widening Racial Wealth Gap: Explaining the Black-White Economic Divide*, Institute on Assets and Social Policy (February 2013) (available at http://iasp.brandeis.edu/pdfs/Author/shapiro-thomas-m/racialwealthgapbrief.pdf).
[43] *See The State of the Nation's Housing*, Joint Center for Housing Studies, at 3 (2013) (available at http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/son2013.pdf).
[44] *See Setting the Record Straight on Homeownership*, UNC Center for Community Capital, Research Brief (2012).

was in the early 2000s."[45]

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

Not only is there a huge cost to putting these restrictions into law, but there is also a limited benefit in terms of reducing default rates. When looking at loans that already meet the product requirements for a Qualified Mortgage, a UNC Center for Community Capital and CRL study shows that these requirements cut the overall default rate by almost half compared with loans that did not.[47] Layering on a down payment requirement on top of these protections produces a marginal benefit.[48] This makes sense, because risky product features and poor lending practices

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

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

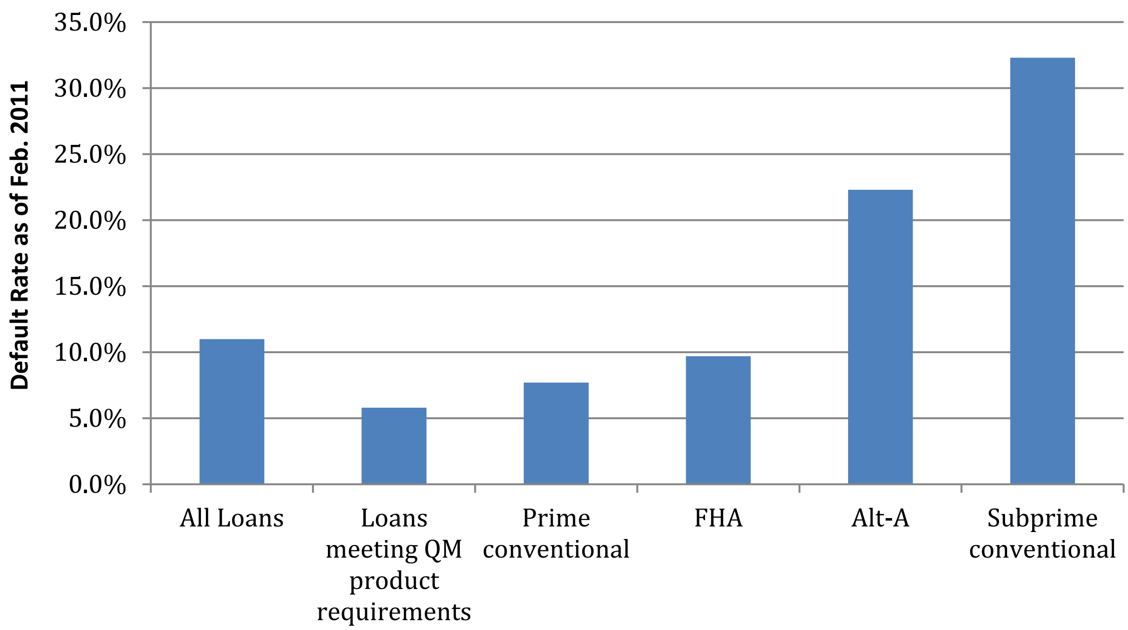
[47] Roberto G. Quercia, Lei Ding, Carolina Reid, *Balancing Risk and Access: Underwriting Standards for Qualified Residential Mortgages*, Center for Responsible Lending and UNC Center for Community Capital (Revised March 5, 2012) (stating that "[l]oans consistent with the QM product features—which include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

[48] *Id*., at 18.

caused the crisis by pushing borrowers into default, and the Dodd-Frank Act reforms address these abuses. The Qualified Mortgage and Ability to Repay reforms restrict risky features such as high fees, interest-only payments, prepayment penalties, yield-spread premiums paid to mortgage brokers, lack of escrows for taxes and insurance for higher priced mortgage loans, teaser rates that spiked to unaffordable levels even with constant interest rates, and outlawing no-doc loans. These reforms address the unaffordable and abusive loan products that caused the crisis.[49]

Figure 5: Default Rates for QM-Like Loans Are Substantially Lower

(2000-2008 Originations, All Loans)



Source: UNC Center for Community Capital and CRL, 2012

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

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

[50] *See Setting the Record Straight on Homeownership*, UNC Center for Community Capital, Research Brief (2012).

> The default rate for 95 to 97 percent LTV mortgages is only slightly higher than for 90 to 95 LTV mortgages, and the default rate for high FICO loans with 95 to 97 LTV ratios is *lower* than the default rate for low FICO loans with 90 to 95 percent LTV ratios. . . . For mortgages with an LTV ratio above 80 percent, credit scores are a better predictor of default rates than LTV ratios.[51]

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

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

Market Access Fund, Housing Trust Fund and Capital Magnet Fund: In addition to ensuring that a reformed housing finance system broadly serves the market, we support the creation and funding of a multi-purpose fund that builds on Title IV of S. 1217 so that then new housing finance system can further serve a range of housing needs. In particular, we support assessing all mortgage backed securities (not just guaranteed securities) a 10 basis point annual user fee

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

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

[53] *See* Allison Freeman and Janneke Ratcliffe, *Setting the Record Straight on Affordable Homeownership* at 4-8 (May 2012.

(i.e., a "strip") that would be used to support a Market Access Fund and the two funds created under HERA – the Housing Trust Fund and the Capital Magnet Fund. These funds, each of which uses a different mechanism to serve very different housing purposes, would be administered, respectively, by a separate office within the federal guarantee agency, HUD and the Treasury's CDFI Fund. We suggest that percentage allocations to the three funds provided in Title IV be reconsidered to assure that the allocations more closely reflect the needs that each fund addresses.

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

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

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

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

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

large numbers of individual securities would overwhelm the regulator, and essentially turn it into a very large ratings agency. As a result of these comparative disadvantages, structured securities should not be able to access a government guarantee for senior tranche investors.

Figure 6: Bond Guarantor Model vs Structured Securities Model

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

A. Structured Securities are Incompatible with the Forward Market.

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

Because of this system, lenders are able to offer borrowers a rate lock, which is a commitment to fund a loan at a specific interest rate for a specified number of days – such as a 4.5 percent rate commitment for 60 days. This allows the potential homebuyer to decide on a price range based on the locked-in interest rate, which facilitates negotiations among buyers and sellers. At the same time, the forward market gives the lender an ability to commit to sell the rate-locked loan on the secondary market before it has been originated. This benefits the lender, because it hedges the risk that interest rates will rise before closing the loan. Furthermore, this hedging happens in a simple manner available to less sophisticated lenders lacking complicated derivatives operations.

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

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

The Bond Guarantor Model: The TBA market is the backbone of a highly liquid capital market for mortgage-backed securities. The key to this liquidity is having standardized pass-through securities and a streamlined investment process.[55] All pass-through securities provide a credit

[55] For a discussion of the TBA market and factors contributing to homogeneity among securities, *see* James Vickery and Joshua Wright, *TBA Trading and Liquidity in the Agency MBS Market*, Federal Reserve Bank of New York Economic Policy Review (May 2013) (available at http://www.newyorkfed.org/research/epr/2013/1212vick.pdf); *see also* Written Statement of Thomas Hamilton, Managing Director, Barclays' Capital, Before the U.S. Senate Committee on Banking, Housing,

guarantee to investors, pro-rata payments to investors, and only include mortgages meeting common underwriting standards. In addition, the system uses a standard set of upfront disclosures for investors.[56] When taken together, this standardization makes securities highly fungible and, therefore, liquid.

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

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

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

Second, there are a limited number of investors willing to take credit risk by investing in the subordinate tranches of a security. Almost all MBS investors are rate investors such as foreign investors or pension funds and not credit risk takers. In fact, during the subprime boom, the lack of subordinate investors led firms to repackage the subordinate tranches from multiple securities into new pools, known as collateralized debt obligations (CDOs). These new pools were then sliced again into new senior and subordinate tranches, with senior CDO tranches getting pristine credit ratings when they were actually backed by risky tranches backing risky

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and Urban Affairs, Subcommittee on Securities, Insurance, and Investment, Hearing: Examining the Housing Finance System: The To-Be-Announced Market (August 3, 2011).

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

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

loans.[58] Only by transforming B grade investments into AAA rated securities through the CDO process were firms able to attract a larger number of investors for these subordinate pieces. Finding investors for AAA paper did not present a problem. Providing a government guarantee on the senior tranches of structured securities would not help obtain subordinate investors, because these investors would still need to take on credit risk, and is, therefore, unnecessary.

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

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

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

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

Structured Securities Model: It's true that a 30-year fixed-rate product could exist in a system without the TBA market (or even without a credit guarantee), but it would exist at much lower levels and at much higher rates than it does today. Even with a guarantee on the senior tranches, the investors committing to a subordinate piece of a security would be taking on credit risk for 30 years in addition to interest rate risk. This would result in a larger number of

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

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

adjustable-rate mortgages or shorter-term mortgages (or both) to minimize the risk of these losses. The end result would be securities filled with pristine mortgages (as is currently the case in today's private-label jumbo market[60]) that present little risk, but also do little to provide broader access to credit. Given this reality, it would be hard to justify opening up the government guarantee to structured securities.

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

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

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

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

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

Bond Guarantor Model: The ongoing $6.3 trillion investment in Fannie Mae and Freddie Mac

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

[61] *Id.*, at 15.

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

Structured Securities Model: The structured securities model is inherently pro-cyclical, since the capital markets fund the risk capital for each deal. In times of economic stress or in a down housing market, investors will be unlikely to take this credit risk. Without investors for the subordinate tranches of these securities, the deals cannot be completed and the market would collapse (regardless of whether the senior tranches have a government guarantee). In fact, this is exactly what has happened in recent years with the exception of a $39 billion of private-label securities for mostly pristine jumbo loans. The government guarantee should not be available for securities where capital will become scarce just when it is most needed.

F. Structured Securities Would Frustrate Regulatory Oversight.

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

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

4. Promote Cost-Effective Loss Mitigation.

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

The government has recognized these priorities repeatedly in our history. Fannie Mae and Freddie Mac have such a portfolio now, and the federal government created one through the Home Owner Loan Corporation after the Great Depression to restructure a million three- and five-year bullet loans into more affordable long-term, fixed-rate and amortizing loans.[62]

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

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

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

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

could be, even with partial claim authority.[63] This affordability limitation significantly increases re-default rates.

GSE Modifications: GSE borrowers are able to obtain more affordable modifications because *the GSEs* purchase the non-performing loans out themselves, repay the investor in full as promised, and then hold the non-performing loan on their portfolios. Under conservatorship, the GSEs are able to use a limited portfolio capacity backed by government-guaranteed debt for this targeted purpose. S. 1217 appropriately grandfathers this loss mitigation portfolio, which totals approximately $220 billion just for Fannie Mae.[64] Under the GSE model, the servicer does not have the same liquidity and capital pressure to either re-securitize or foreclose, resulting in the appropriate incentives to modify the loan. As a result, under HAMP, GSE modifications are able to go to a 2 percent interest rate and a new 40 year term, making them much more affordable to borrowers while still being net present value positive for taxpayers.

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

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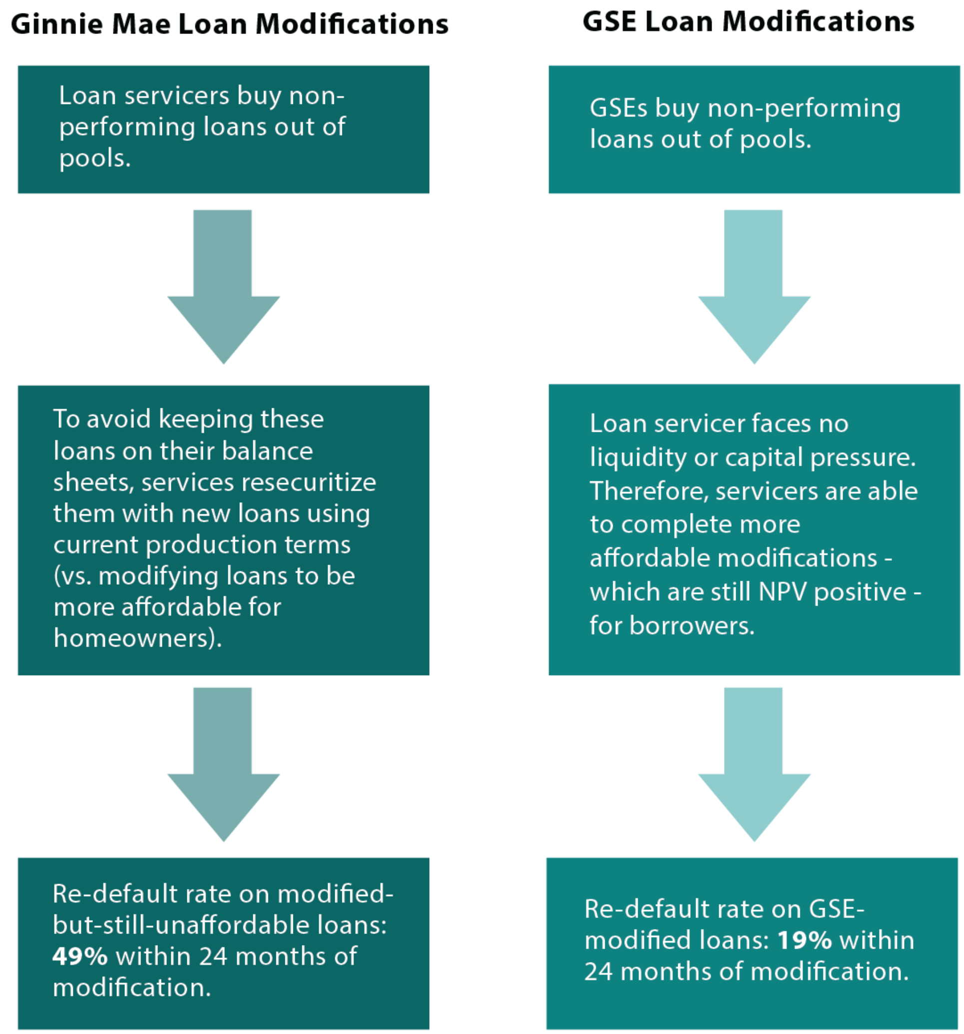
[63] *See* Trial Payment Plan for Loan Modifications and Partial Claims under the Federal Housing Administration's Loss Mitigation Program (ML 2011-28).

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

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

[66] Wells Fargo Home Mortgage, *FHA Loss Mitigation and Ginnie Mae Restructuring*, (August 2013).

Figure 7: Ginnie Mae vs. GSE Loan Modifications



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

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

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

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

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

Conclusion.

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

To summarize, the fixes to the five fundamental flaws that led the GSEs into conservatorship are to require issuer-guarantor entities to have mutual ownership – rather than stock ownership –

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

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

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

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