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ESSENTIAL ELEMENTS OF HOUSING FINANCE REFORM

HEARING

BEFORE THE

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

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

ON

DISCUSSING THE ESSENTIAL ELEMENTS THAT MUST BE A PART OF HOUSING FINANCE REFORM LEGISLATION AND ENSURING THAT REFORM OF THE HOUSING FINANCE SYSTEM IMPROVES THE CURRENT SYSTEM WITHOUT CREATING MARKET DISRUPTIONS THAT THREATEN OUR HOUSING RECOVERY OR INCREASE COSTS FOR BORROWERS

SEPTEMBER 12, 2013

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ESSENTIAL ELEMENTS OF HOUSING FINANCE REFORM

THURSDAY, SEPTEMBER 12, 2013

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

The Committee met at 10:17 a.m. in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I call this hearing to order.

I would like to thank the witnesses for joining us today as the Committee sets out on a path that I hope will lead to comprehensive housing finance reform. Our witnesses are here to help educate us regarding what essential elements must be a part of housing finance reform legislation in order for it to be credible and successful. We must ensure that reform of the housing finance system improves our current system and does not create market disruptions that threaten our housing recovery or unnecessarily increase costs for borrowers.

During our first housing finance reform hearing this Congress, Ranking Member Crapo and I explored whether a bipartisan solution to reform the housing market was possible. At that time, there was no agreement regarding the role of the Federal Government let alone what a new structure could look like. I would like to thank Senators Corker and Warner and the cosponsors of the bill for showing that there is bipartisan support for a Government guarantee in a new housing system and willingness to move legislation forward.

Recognizing that there are many details that need to be explored and discussed by the full Committee and that many Committee Members have input of their own that they would like to include, we plan to hold hearings this fall to explore the finer points of proposed changes. This will give the entire Committee the opportunity to explore the various modifications and wholesale changes that we will consider. Ranking Member Crapo and I are undertaking this in-depth process with the goal of reaching agreement by the end of the year.

To give a sense of what a massive undertaking this process is, our housing finance market is the second largest and most liquid financial market in the world. So the consequence of getting any major reform wrong cannot be overstated. To that end, it is essential that we fully understand the mechanics of how a new system

would function, and how we should smoothly transition from the current system to a new one. Any new housing finance system and the transition to it could dramatically change the way that families qualify and affect who can afford to buy a home.

I have asked the experts testifying today to help us analyze proposed changes to the system and to help us understand which essential pieces of the current system should be preserved. Better understanding the interaction between the pieces that we would like to preserve—like widely available, 30-year, fixed-rate mortgages—and the changes we would like to make is critical in order to achieve meaningful improvements to the current system.

With that, I will turn to Ranking Member Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you, Mr. Chairman. There seems to be more traction toward moving forward with housing reform than there has been at any point during the 5-year conservatorships of Fannie Mae and Freddie Mac. Mr. Chairman, thank you for making this a top priority of the Committee during this Congress.

In March of this year, this subject became one of our first hearings, and now I look forward to working toward a solution with you and all of the Senators of this Committee.

Many other people deserve credit for getting the ball moving and getting it going forward well on this important topic. Senators Corker and Warner and all of the cosponsors of their bill have worked collaboratively in developing a proposal that will help shape our debate as we move forward, and I thank them and their staffs for their hard work.

Senator Reed also has put a tremendous amount of work into helping us get toward the right answers and the right legislative language, and there are many other Senators on this Committee who may not have introduced legislation but who have put a tremendous amount of thought and effort into the issue behind the scenes advocating for a resolution.

Chairman Hensarling likewise deserves a lot of credit and our thanks for his work in moving a proposal out of the House Financial Services Committee. In fact, given the President's recent comments, it appears we now are experiencing the first moment since the crisis that the White House, the Senate, and the House are all moving forward or advocating for reform.

Given this circumstance, we must use this opportunity to concentrate on building consensus around ending the conservatorships while building a stable secondary market that brings back private capital and avoids repeating the mistakes of the past.

As I noted, a tremendous amount of work on this topic has already been done by many of the Committee's Senators, and we must not lose this momentum.

As such, the Banking Committee intends to hold a series of hearings to gain insight from experts, regulators, and stakeholders to ensure that the Committee moves forward in an educated fashion. These hearings will provide a more in-depth analysis of some of the necessary components of reform with a goal of marking up a bipartisan bill by the end of the year.

There will be costs and tradeoffs associated with every decision that we make. As we evaluate those tradeoffs, I am pleased to have before us a panel that represents decades of real experience and study of our mortgage markets. I look forward to hearing from the witnesses, gaining their input and analysis about what are the essential elements of any reform. It will also be helpful to hear what questions we need to be asking to arrive at the best solutions.

Despite the tough decisions that lie ahead, our task is vital. For more than 5 years, our housing finance system has remained in limbo, unable to innovate or even function outside of a massive Government intervention. In those 5 years, we have seen other financial markets recover while watching the housing market remain stagnant. During those same 5 years, we watched the bill to the American taxpayers rise to nearly $200 billion while simultaneously creating numerous legal questions that our courts may be sorting out for years to come. This cannot be allowed to continue.

Chairman Johnson and I were able to work together with the other Senators on the Banking Committee to pass the Federal Housing Administration Solvency Act of 2013 out of Committee with a large, bipartisan vote. As a Committee, we must re-create that consensus while turning our full attention to reforming the Government-sponsored entities and our broader housing finance market.

Hopefully our past work and the further collaborating of our Senators has engendered a level of trust and good will that can lead this Committee to a strong product with an equally strong level of support.

Mr. Chairman, again I thank you, and I look forward to working with you and all Members of the Committee as we move forward.

Chairman JOHNSON. Thank you, Senator Crapo.

Are there any other Members who would like to give a brief opening statement? Senator Tester.

STATEMENT OF SENATOR JON TESTER

Senator TESTER. I would, and I apologize to Senator Corker right now because I know he hates these things, but I am not going to be here for the questions, so I have got to say this.

First of all, I want to thank the Chairman and Ranking Member for their opening statements. We have got an opportunity here to do something good. I was sent to Washington, D.C., to try to fix what is wrong with Washington, D.C. We can make excuses up. We can talk about how we are too busy to do this. We can talk about Syria. We can talk about the debt limit. We can talk about all that stuff. But the bottom line is we can multi-task, we must multi-task. And if we let this opportunity escape us by not working together and pushing it forward—the same way we did with the FHA Solvency Act, I might add—then we are not doing our constituencies the services that they expect of us.

So I look forward to working with everybody on this Committee to get the Warner-Corker bill across the finish line. Thank you.

Chairman JOHNSON. Is there anyone else?

[No response.]

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

Before we begin, I would like to introduce our witnesses who are here with us today.

Our first witness is Ms. Julia Gordon, who is the director of housing finance and policy at the Center for American Progress.

Mr. Jerome Lienhard is the CEO of SunTrust Mortgage.

Mr. Richard Johns is the executive director of the Structured Finance Industry Group.

And, finally, we have Dr. Mark Zandi, chief economist at Moody's Analytics.

We welcome all of you here today and thank you for your time.

Ms. Gordon, you may proceed.

STATEMENT OF JULIA GORDON, DIRECTOR OF HOUSING FINANCE AND POLICY, CENTER FOR AMERICAN PROGRESS

Ms. GORDON. Good morning, Chairman Johnson, Ranking Member Crapo, and Members of the Committee. Thank you so much for inviting me to testify today. I am Julia Gordon, director of housing finance and policy at the Center for American Progress and convener of the Mortgage Finance Working Group, which released a comprehensive reform plan back in January of 2011 and has been meeting weekly since then to study the future of housing finance.

We stand at a critical inflection point for our Nation's housing finance system. While housing prices have begun to recover in many parts of the country, the fundamentals are not yet strong. The mortgage market today is significantly smaller than it was in the early 2000s. Two-thirds of originations are refinancings rather than home purchases. And much recent price appreciation can be attributed to cash investors.

In the meantime, the demographics that represent the future of home ownership, such as first-time home buyers, millennials, and people of color, have largely been shut out of the conventional mortgage market.

Production of apartment units is falling behind demand, and rents have risen significantly, with more than a quarter of all renters spending more than half of their income on housing. In our view, the status quo no longer serves the American public's best interests, and it is time to reform the system.

We are pleased to see a broad consensus emerging on the general outlines of housing finance reform that we must have a Government backstop behind private capital, that the long-term fixed-rate mortgage is a crucial product for families interested in home ownership, that the system must include not just single-family but also multi-family finance, and that the system provide access to all creditworthy borrowers and lenders of all sizes.

I commend Senators Corker and Warner for pushing this debate forward. By recognizing this consensus and developing a strong bipartisan framework for reform, they have done a true public service.

However, we still have a great deal of work ahead of us to adjust and fill in this framework so that it will work well for all bor-

rowers, all lenders, and all investors throughout all economic cycles.

First and foremost, a new housing finance system must place the Nation's housing needs at the center of the system. The structures and processes of the secondary market are not ends in and of themselves. Providing broad access to affordable, sustainable credit will provide the greatest benefit in the long run not only to families but also to lenders and investors while protecting taxpayers from future bailouts.

The system must provide a level playing field for all creditworthy borrowers in all geographic areas for all housing types and for lenders of all sizes. Additionally, it needs the capacity to help more families obtain mortgages in the conventional market through credit supports and safe innovation rather than relegating large swaths of borrowers to FHA unnecessarily, where mortgages are more expensive and where the Government will continue to provide a 100-percent guarantee. And to serve those families not yet ready for or interested in home ownership, the system should provide financing to preserve existing privately owned affordable housing stock and support the construction of new affordable units.

To create a deep liquid market and support widespread availability of a long-term fixed-rate mortgage product, we need both a Government guarantee and a healthy TBA market. We agree that there is no reason for the Government to guarantee 100 percent of the risk, and in our 2011 proposal we suggested that chartered bond guarantors stand in the first loss position, which is one of the options presented in the Corker-Warner bill.

However, we have significant concerns about the other option presented in that bill, which is having issuers lay off the risk directly through the private capital markets. We are concerned that structured transactions alone cannot effectively maintain the TBA market, provide broad access to sustainable credit, protect the taxpayer, and maintain access to credit throughout economic cycles. We expect, though, that bond guarantors will access the capital markets to lay off risk, perhaps along the lines of the Freddie STACR deal.

It perhaps goes without saying, but any new system also must support effective and fair mortgage servicing practices as well as appropriate systems to provide clarity regarding property title.

Finally, we need strong regulatory tools to ensure safety and soundness throughout the system, including examination, supervision, and enforcement authority for entities accessing the Government guarantee.

Thank you again for inviting me to testify today, and I look forward to continued discussion on these important matters as the Senate moves forward on housing finance reform legislation.

Chairman JOHNSON. Thank you.

Mr. Lienhard, you may proceed.

STATEMENT OF JEROME T. LIENHARD, II, PRESIDENT AND CHIEF EXECUTIVE OFFICER, SUNTRUST MORTGAGE, INC.

Mr. LIENHARD. Good morning, Chairman Johnson, Ranking Member Crapo, and Members of the Banking Committee. I am Jerome Lienhard, president and CEO of SunTrust Mortgage, which

is a subsidiary of SunTrust Banks. Thank you for allowing me to participate in the consideration of this important subject.

I am appearing today in my capacity at SunTrust Mortgage, and this testimony was prepared after consultation with the Regional Bank Group, an informal coalition of mid-sized lending institutions located throughout the United States. All views expressed today, however, are my own.

SunTrust is headquartered in Atlanta and operates mainly in the southeastern United States. SunTrust Mortgage is based in Richmond, Virginia, and employs about 4,300 teammates. Last year, we originated over $32 billion in mortgage loans which helped more than 120,000 of our clients purchase a home or lower their monthly payment through refinancing.

Today I would like to make two important points from the perspective of a regional bank:

First, while there is a need to reform the housing finance system, it is critical to retain the basic "plumbing" of the system that draws in enormous sums of investment capital and provides borrowers with interest rate certainty. These features can be retained in a mortgage market that serves both the interests of borrowers and taxpayers alike.

Second, reform must bring more private capital into the mortgage market in a principal loss position without reducing the global demand for mortgage-backed securities and while protecting competitive access for small and medium-sized institutions that serve millions of homeowners.

I will spend a few minutes elaborating on each of these points.

Out of thousands of mortgage loans that we make each year, on average we hold only one in six on our balance sheet. So while we own approximately $30 billion worth of mortgage loans, we actually originated and service more than $140 billion in mortgages involving more than 800,000 households. This is possible for us only due to the existence of the secondary mortgage market.

To provide our clients with basic information regarding how much they can afford to pay for a house, we must be able to tell them the interest rate and the monthly cost of the loan. You cannot really buy a house if you do not know what your mortgage payment will be.

We do this by referencing a daily pricing sheet that provides the interest rate and loan terms that we can offer on a guaranteed basis. These prices are set from the price of mortgage-backed securities trading in the "To Be Announced" or TBA market. The TBA security price assumes delivery of conforming mortgages into a Freddie Mac or Fannie Mae mortgage-backed security on a forward basis. This forward-pricing mechanism of the secondary market allows us to lock in the interest rates for our clients for up to 90 days.

But without that certainty, primary market lenders would be unwilling and, frankly, unable to provide forward price certainty to their customers.

Through the combination of mortgage standardization and the function of the MBS market, the existing system provides a tangible benefit to borrowers. And these benefits are available for anyone who transact with originators of any size: local banks, Main

Street banks such as SunTrust, as well as the largest mortgage originators.

While there is a need to address taxpayer risk by making structural changes to the housing finance system, these are key features, elements, and processes essential to maintaining a secondary market.

Regarding the critical issue of the structure of the credit guarantee, our markets perform so well in large part because credit risk associated with mortgage default is assumed by the GSEs. Investors from around the world allocate trillions of dollars of capital to our markets because it only involves interest rate risk to them.

Now, the problem, of course, is that providing credit protection puts taxpayers at risk. Using private sources of capital to cover credit exposure can help alleviate taxpayer risk.

We must also consider that if a variety of credit risk devices emerge in place of the relatively simple credit guarantee we have today, it could make mortgage-backed securities difficult for investors to value, fracturing the investor base, reducing liquidity, and increasing costs. If that market shrinks dramatically, so does lending to homeowners.

To the extent that private capital is intended to stand before any taxpayer-backed guarantees, the entities and instruments must be subject to regulatory oversight. If regulators cannot understand nor keep track of the various risk-sharing mechanisms, there is a danger that they will not perform as needed under crisis conditions.

And, finally, any new source of private sector credit protection should be available for all primary market lenders, including large, small, and Main Street institutions. Measures that create advantages for the very largest issuers of mortgage-backed securities or make the cost of market access more expensive for some and not others will reduce competition and must be avoided.

Let me conclude by thanking the Committee again for the time, attention, and consideration. I look forward to answering any of your questions.

Chairman JOHNSON. Thank you.

Mr. Johns, you may proceed.

STATEMENT OF RICHARD JOHNS, EXECUTIVE DIRECTOR, STRUCTURED FINANCE INDUSTRY GROUP

Mr. JOHNS. Chairman Johnson, Ranking Member Crapo, and Members of the Committee on Banking, my name is Richard Johns. I am the executive director of the Structured Finance Industry Group, or SFIG, a trade industry group that includes over 160 corporate members from all sectors of the securitization industry. On behalf of myself and SFIG's members, I thank you for this opportunity to address the Committee regarding proposed housing finance reforms, including the role to be played by the Government in the housing finance system and the importance of returning private capital to the residential mortgage market.

SFIG is generally supportive of the framework contained Senate bill 1217 and believes the reform process, particularly in relation to the securitization markets, must proceed in a measured and deliberate way. We appreciate the Committee's methodical approach in considering such reforms.

A central focus of any reform effort must be the preservation of the To Be Announced or TBA market, which is the third most liquid securities market in the world and handles over 90 percent of the Government-guaranteed MBS trading volume. The reason behind this deep liquidity of the TBA market is in its homogenous nature driven by standardization of loan pools and underwriting criteria, market standards and history, and the elimination of credit risk via the Government guarantee.

This deep liquidity not only drives down costs allowing a cheaper interest rate to be charged to the consumer, but it also enables the mortgage originator to hedge its risk, which in turn can be passed through to the consumer in the form of a rate lock to give them certainty of interest rate. Any reform process needs to be considerate of the credit risk to the homogeneity of the TBA market. For this reason, we suggest that there are three sequential stages that any reform effort should follow in order to preserve the TBA market.

First, the conversion into a common TBA should be adopted, making Freddie and Fannie MBS fungible and, therefore, deliverable into a single TBA market.

Second, any legislation should provide for the creation of a single agency security. This would facilitate the conversion and continued liquidity of legacy securities and promote a deep and liquid new-issue MBS market.

And then, third, a common securitization platform should be established to oversee and maintain the standardization of the market for Government-guaranteed MBS.

SFIG believes that retaining a Government guarantee against catastrophic loss for MBS is crucial to preserving the health of the TBA market.

Historically, rates investors have been attracted to the Government-guaranteed MBS in which the Government bears the bulk of the credit risk, and they have contributed trillions of dollars to the agency market because of those guarantees. Limiting the Government's involvement in the market by changing or ending the current infrastructure must account for the crucial contribution that rates investors make to the agency market and their historical aversion to credit risk.

We also believe that private investors have a role to play in ensuring against the credit risks posed by residential mortgages. To that end, SFIG generally supports having private capital take on credit risk in the first loss position with the explicit Government guarantee covering catastrophic risk.

SFIG continues to analyze the amount of risk that a private investor should assume, and we will provide the Committee with our ideas at a later date. However, whatever the final private enhancement is, it should be based on underwriting-related factors such as historical loss data, the likely loan times, and general housing and economic indicators.

Turning next to the mechanics of transitioning to a new structure, this process must be transparent, appropriate to market conditions, and handled with great care to minimize the disruptions to the flow of credit to consumers and, in particular, to ensure the continued health of the TBA market.

We believe steps must be taken to preserve the market for legacy securities while allowing sufficient time for eligible loans under the reformed system to be generated and take hold in the TBA market. SFIG believes that the best way to facilitate this transition is to create a single agency security to which the legacy securities would be converted. We also believe that the current and new infrastructure should operate in tandem for some period of time until the new framework has demonstrated that it will facilitate the continued functioning of the TBA market.

Finally, there are a number of initiatives underway around the country in which governments plan to exercise their eminent domain power to seize underperforming mortgage loans. Such use of eminent domain will undermine congressional efforts to encourage private capital in the market, and we encourage the Committee to include a provision limiting it in any reform legislation.

In conclusion, while we recognize the need to correct the errors of the past, we urge the Committee not to lose sight of the ways in which the agency market, and particularly the TBA market, has and continues to work well, enabling many Americans to enjoy the benefits of home ownership. We look forward to working with the Committee as it considers these vitally important issues. Thank you again for the opportunity to share SFIG's views.

Chairman JOHNSON. Thank you.

Dr. Zandi, you may proceed.

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

Mr. ZANDI. Thank you, Mr. Chairman, Mr. Vice Chairman, and the rest of the Committee, for the opportunity to be here today.

For the purposes of the meeting, the Committee hearing, you should know that I am on the board of MGIC. That is the largest mortgage insurer in the country. That is important for you to know. I am also on the board of the Reinvestment Fund. That is one of the Nation's largest CDFIs. And I am also, obviously, an employee of the Moody's Corporation. So those are very important things. These are my opinions, not those of Moody's or anyone else.

There are many essential elements to a good, well-functioning housing finance system. I go through many of them in my written testimony. I want to focus in my current remarks on one essential element, and that is the capital requirements of the new system. So I am going to talk a little bit about the amount of capital that is appropriate, the sources of that capital, and the cost of that capital.

I should say up front that I am taking as given that we are in a world of a hybrid system; that is, private first loss capital with a catastrophic Government guarantee. So in almost all circumstances, private investors will shoulder the burden of the losses. In very rare circumstances, catastrophes, the Government would step in and backstop the system. The guarantee would be explicit. It would be paid for by lenders and borrowers and not taxpayers. And the hybrid system is in the spirit of Corker-Warner. It is also what the President has recently come out in support of.

In terms of the amount of capital, in my view the appropriate amount of capital—a good benchmark for the appropriate amount

of capital is the Great Recession. In the recession, Fannie, Freddie, the private MIs lost or will lose ultimately about 4 percent. That is the loss rate, all in. To be conservative, I think it would be appropriate to capitalize the system at 5 percent. I think that would cover all significant circumstances.

That would be particularly conservative in the sense that the mortgages that get the Government guarantee in the future system under all proposals would be QM and, therefore, the loans that got Fannie and Freddie into real trouble, the Alt-A loans, would not be guaranteed in the future system. So I think 5 percent would be appropriate.

In terms of the sources of capital, they should be varied. We need capital—we need lots of capital. This is going to take a lot of capital, and it should come from everywhere. So we need capital coming from mortgage bond guarantors, MI companies, and the capital markets. Very important. When you have varied sources of capital, that creates stability in the system. That would be particularly, I think, the key feature of capital coming from mortgage bond guarantors. And it will be cheaper if you have it from varied sources of capital, and the capital markets are very, very important to that. And I think in the Corker-Warner legislation, one of the key features of that legislation that I find attractive is that it promotes varied sources of capital. We need that. It is very important to the future of the housing finance system.

In terms of the cost of the capital, you know, it is not free. If we are going to have a higher capitalization rate, mortgage rates are going to be higher. The question is how much higher. Well, it depends on lots of moving parts, and it may have to make a lot of assumptions. But my sense is under reasons assumptions that to go from the current system to a system that is capitalized at 5 percent probably would add another 40 basis points to mortgage rates, roughly speaking—excuse me, 40 basis points in G-fees, and that would be passed through largely in higher mortgage rates.

Just for context, every 10 basis points is about $15 on a monthly mortgage payment, so you do the arithmetic, going to the new system under my assumptions would add about $60 to the average monthly mortgage payment.

One other thing to note is that the cost will vary considerably depending on how the system is designed, and it will vary depending on the credit risk of the borrower, and it will vary according to where you are in the business cycle. The numbers I just articulated are for the typical borrower through the business cycle.

Let me end by saying—this is very important—the current system is dysfunctional. We have to change it. It is not good for taxpayers. It is not good for home buyers. I think it is laudable that you are taking this up in a very serious way.

Thank you.

Chairman JOHNSON. Thank you very much for your testimony.

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

Ms. Gordon, I am very concerned about the mortgage access in rural areas. What is needed in a new system to ensure that borrowers with similar qualifications have equal access to mortgages no matter where they live? How would you design requirements to

ensure that borrowers and lenders in States like mine are not left out?

Ms. GORDON. Thank you for that question. It is a very important question, both for rural borrowers in States like yours and for any borrower who lives in either a rural area or who may be in an urban area or some area that is not as well and easily served by primary lenders.

So what is important to remember is that while the interface for most borrowers with the system is through their primary lender, lenders will make those loans that the secondary market encourages them to make through policies. And we have had—in the system that, you know, we are hoping to reform, there have been mechanisms through Fannie and Freddie that do require lenders to be mindful that they are equally serving all creditworthy borrowers, you know, regardless of where they live or whether, you know, their file is a little bit harder to go through all the papers for than somebody else's.

And we are very concerned that if we do not build in mechanisms to address that, lenders will be able to, you know, what you might think of as cream the market, just basically do the low-hanging fruit, do the easy mortgages, do the mortgages with higher balances within whatever the loan limits are of the system, and that people will be disadvantaged, particularly in States like yours.

And so we think it is critical to establish in this bill some kind of responsibility for the secondary market to oversee making sure that all of these parts of the market are being adequately served, which means, you know, doing some kind of examination of the market, some kind of examination of where the demand and need is, and then looking at whatever entities ultimately are accessing the Government guarantee and providing the wrap, making sure that they are covering all of these different populations equally.

Chairman JOHNSON. Mr. Lienhard, will qualified borrowers and lenders of all sizes have fair access to the secondary market if private capital is require to play a larger role in front of a Government guarantee? Will this work with the TBA market? And how does the TBA market impact borrowers and lenders?

Mr. LIENHARD. Thank you for the question, Senator. I think that the beauty of the TBA market or actually the beauty of the construct that we have now and what I think needs to be preserved, as I mentioned in my testimony, is this separation of credit risk from interest rate risk. And so presumably the interest rate risk investors do not differentiate between the creditworthiness of the borrower. That is disintermediated ahead of the TBA market by the credit guarantee function. So as I understand your question—and I would be happy to have you help make me more clear in that understanding—I think the answer to your question is properly structured, yes. But I think that the critical nature of that structure does not necessarily reside in the TBA market but, rather, in the guarantee aspect of whatever reform we do. I do not know if that is a comprehensive answer.

Chairman JOHNSON. Mr. Johns, do you believe private investors are willing to stand in the first loss position before our Government guarantee both in good times and bad? What will investors need

to accept credit risk of a first loss position? And does that work with the TBA market?

Mr. JOHNS. I think the short answer is that investors are prepared to step into that role, as we have seen on the Freddie transaction. There was a sizable demand for the credit-linked note product, and I think there were 50 investors or over 50 investors, and the investors were scaled back fairly significantly, and I think all reads from the market are that there will be support for, you know, being able to facilitate those transactions again.

In addition, obviously, you have to look at the sort of broad swath of options out there such as the mortgage insurers and the bond insurers, you know, together with the capital markets, looking for the way to raise the private capital.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman.

I hope this question I want to get into here will evoke responses from all of you on the panel. I am going to start out with Dr. Zandi and Mr. Johns and then move to Mr. Lienhard and Ms. Gordon.

The issue is the forms and sources of private capital that we need to bring into the market. I think there is pretty clearly an emerging consensus that whatever the shape of the future housing finance system we create is, it must be designed to attract more private capital and decrease the Government role from what we currently have.

That being said, I think that I see in the testimony of the witnesses a little variation in terms of how we should approach that. Mr. Johns and Dr. Zandi, in your testimonies you both have advocated for the allowance of various forms of private capital to come into the system to meet market needs. So to start with you, what are the benefits that you see to sourcing private capital from many sources? And maybe you could also kind of define what you see those sources being broadly?

Mr. ZANDI. Well, there are two broad sources. The first is what I would call an insurance source—bond guarantors, private mortgage insurers, insurance entities. And the second I would label as capital market sources. Both are critical to a well-functioning system.

The insurance capital is more stable through thick and thin because of the way it is structured and set up, and one of the goals of any future housing finance system is that it obviously has to be stable. We need the flow of mortgage credit through good times and bad times.

The strength of the capital markets source of capital is that it can bring down the costs, and most of you get price discovery. You get a clearer sense of what the cost of risk is, because capital markets are pretty good at doing that. And so by bringing in capital market sources, you will lower the cost to mortgage borrowers through lower mortgage rates. So both are very important.

Now, how you structure that and how you align those two sources of capital up is a very difficult but critical question, and that is very, very important, but both sources are needed.

Senator CRAPO. Well, thank you, and we probably need to get into that in some depth, but I do need to move along. So, Mr. Johns, do you want to add anything to that perspective?

Mr. JOHNS. I think that I would go along with what Dr. Zandi said, that we would support their—I think, you know, maybe a couple of points. It is all—well, it is not all about—a lot of our focus needs to be on making sure that the TBA market continues to function when you look at the private capital alternatives. And, you know, insurance is not something that necessarily can directly impact the pool of loans within the MBS, and, therefore, I think that is something that has some potential.

The credit-linked note structure that Freddie did was a synthetic transaction, and, therefore, the actual loans that it referenced, you know, were not specifically sort of cash-flow impacted in the structure of the transaction, leaving the TBA market largely unaffected as a consequence.

There are other structures, senior subordination, you know, structures where you might say—you know, have a sort of deep subordination piece of the transaction and then have a AAA or a senior rated piece that is delivered into the TBA market. That is a different structure that we would have to look at and evaluate exactly how we would get that to work with the TBA market that is currently based on a pass-through mechanism.

Senator CRAPO. All right. Thank you.

And, Mr. Lienhard, I may have to get to you next time, the next round, because I am running out of time and I wanted to get to Ms. Gordon, because if I understand it correctly, you believe we should rely solely on bond guarantors. Is that correct?

Ms. GORDON. That is what I believe, and it is really for two reasons. One is, as everybody has been discussing, the importance of the TBA market and the belief that even—you know, we have already heard that a senior substructure would pose some problems for TBA. But even if you have some other kind of reference pool type structure, the fact is that these sort of one-off deals do not lend themselves as well to the kind of homogeneity that you need for an effective TBA market. They do not do as good a job at allocating risks across years, regions, lenders, and the like, but especially across years that you have an insurance format.

And also, just to Dr. Zandi's point regarding price discovery, we do have to—the private capital market's track record on pricing mortgage risk is checkered, as is everybody's, and so that is an area where you do introduce some uncertainty. And, again, even if in any individual structured transaction that actual transaction is funded, if you do not know how the investor institutions are carrying that on their books and evaluating it, you do not know if you are just exporting risk out of that particular mortgage-backed security into the larger financial system.

Senator CRAPO. Well, thank you. My time has run out, but we will get back to this.

Chairman JOHNSON. Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman. I want to commend Senator Corker and Senator Warner for moving so thoughtfully on this issue. I think, again, I thank the witnesses, but also the Chairman and the Ranking Member because, as we move here, I think we appreciate with each step how complex, interrelated, and how thoughtful we have to be about these judgments. We are transforming a huge, huge part of our economy, and

I am glad we started, and I think Senator Corker and Senator Warner deserve a great deal of credit. Thank you, gentlemen, very much, and I thank the Chairman and the Ranking Member.

Mr. Zandi, just this very simple-minded question in a very complex field, but you talk about capital, but one of the—sort of looking back, there was a lot of mysterious capital in the banking field several years ago, *i.e.,* people created entities, borrowed, leveraged themselves up to their—you know, wherever they could, and then it used that capital to go in and to invest in different products.

I know there is an ongoing FHFA pilot program, $30 billion in credit risk, *et cetera.* In general, and in terms of the pilot, is that an issue we have to deal with? And how might we deal with it in terms of avoiding being overleveraged?

Mr. ZANDI. Well, that is a good question. One of the concerns about capital markets as a source of capital is, in fact, leverage in the entire system. This is what Ms. Gordon was referring to. And it needs to be considered in the context of the broader financial system and any future housing finance system that we establish. So that is a potential risk created by drawing capital from the capital markets.

I do not think we are anywhere close to that yet. We are in early stages here, and what Freddie and Fannie are doing is quite small in the context of all the things that are going on, and quite appropriate, in my view, because we need to experiment. We need to see what works, what does not work, what the risks really are, and how to manage those risks.

So what they are doing is entirely appropriate, but you are right when we are thinking about the future of the housing finance system and the capital structure and where the capital is coming from, this is one of the risks that we need to really think about because there is a potential systemic problem.

Senator REED. And that just touches on what I think everyone has reflected, that there has to be a regulatory authority here that is looking at where the capital is coming from, that is looking at: Are these products accessible, available to everyone? Do they include multi-family housing as well as single-family housing? And that is something I think we would all recognize.

Mr. ZANDI. Yes, I think I am taking as given that we are going to have a catastrophic Government guarantee. I cannot see any system that does not work without that, and that requires regulation.

Senator REED. And that guarantor would be effectively a regulator as well as a guarantor.

Mr. ZANDI. Exactly, yes.

Senator REED. Mr. Johns, you talked about the TBA market is very critical, and there are multiple proposals, but one proposal seems to separate it into sort of two categories: first, a guaranteed piece up front, and then an unguaranteed piece, which would be sort of—or senior/junior, however you want to describe it. The issue might be, How do you price the second piece? It is pretty easy with a guaranteed—or easier to price a guaranteed issuance. I think that is a fair assumption. Is that a problem with this, having this set of bifurcated approach to TBA markets?

Mr. JOHNS. I do not know whether it is a problem necessarily. It is certainly something I am happy to take away to our members and talk about.

What I might highlight there is that with that proposal you are creating a bifurcation of the old market versus the new market, and consequently, you will have a very shallow new market when you move forward with that structure, which creates its own liquidity issues in and of itself.

Senator REED. So the question then—one of the first questions not only in terms of pricing is liquidity. Would actually anyone come into that market given the narrow—the ability—the lack of liquidity. Is that a fair——

Mr. JOHNS. I think so. I mean, look at liquidity as almost synonymous with cost. If you have shallow liquidity, the cost goes up. If you have deep liquidity, the cost goes down.

Senator REED. Again, I think this is extremely helpful, and as we go forward, I think we will learn more and I think very productively raise more questions than initially we will have answers, and that will allow us to come to a better answer at the end of the day. But thank you all for your excellent testimony.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Mr. Chairman and Ranking Member, thanks for having the hearing, and I do think we are at a point in time, after really 5 years—I remember how controversial the whole Freddie/Fannie issue was during the time we tried to do financial regulation. I think we are at a point where we are ready to take that on, and I thank you for having these outstanding witnesses.

To the witnesses, you know, 10 Members of this Committee, 5 on each side, have gotten behind the bill called S. 1217, and numbers of other folks on the Committee I know are working on this issue and have really spent a lot of time on it. And I commend everybody for the time they spent on this issue.

But starting with you, Dr. Zandi, is Senate bill 1217, with 10 Members of this Committee on it and probably others being added, a good starting point?

Mr. ZANDI. Absolutely. I think it is an excellent starting point. I think it shows a lot of hard work and a lot of good ideas and thoughts. And I do not know why you would want to start from scratch. I would start with that legislation. It is an excellent place to get going.

Senator CORKER. Mr. Johns?

Mr. JOHNS. I would agree. I think, you know, as I testified, we do believe that there is a phased implementation that we can work with on this, but the framework in and of itself and the end game is something that in general the industry is supportive of.

Senator CORKER. Mr. Lienhard?

Mr. LIENHARD. I believe a multi-trillion-dollar industry being run in conservatorship is long term an untenable situation. I think this bill definitely highlights all of the issues in moving forward, so, yes, I think it is a very good start.

Senator CORKER. Ms. Gordon?

Ms. GORDON. Absolutely I agree. I am just so glad that someone has started because I agree with Mr. Lienhard that we cannot continue in the conservatorship mode.

There does remain, as I mentioned, work to be done. I think we have done a lot of work on the sort of asset class side of things. We still need to do a lot of work on the access for borrowers side to get the bill to a place where we will, you know, feel like it can pick up and do better than the last system.

Senator CORKER. I appreciate that, and I would hope everybody would continue to make what has been worked on for a year even better, and I thank you for that comment.

One of the things I think that the 10 Senators who all made major contributions to this piece of legislation, all of which are on this Committee, tried to do was to create something that is more dynamic. I think all of us know we have this duopoly right now. I know that even though it has some strengths, there are a lot of weaknesses in that regard. And just again to go in the same order, have we done something with the construct? Again, we all know that, you know, there are tweaks that people would like to make, but have the 10 Senators on this Committee that have worked on this created something that is more dynamic in structure than the system we now have?

Mr. ZANDI. Yes, and I think that goes to the fact that in the legislation, you worked very hard to promote varied sources of capital. It is not just coming from one place. Let a thousand flowers bloom. Let us see what works here, what does not work. At some points in time, some sources of capital are going to work better than other sources of capital. And I think that makes the system dynamic, as you say, certainly more innovative because there is going to be more competition in the system as a result of that; lower costs because you are going to have capital coming in from different places; and, ultimately more resilient, as well.

So, I think that is the strength of the legislation, that you are allowing the system to be, as you call it, more dynamic, yes.

Senator CORKER. Thank you.

Mr. JOHNS. I would agree again with what Dr. Zandi says. I think as well the developments of a common securitization platform that allows you to have more dynamicism, and the various forms of capital that could be—you know, private capital that can be considered for the proposed enhancement I think as well leaves you with a dynamic element. Of course, that could, you know, settle hopefully as we feel our way as to what the most viable structure is.

Senator CORKER. OK.

Mr. LIENHARD. I am assuming we have the same definition of dynamic, yes, but one of the things I am concerned about—and it is not entirely clear to me that the bill yet addresses this—is the relative potential—the potential to disadvantage a regional originator versus a national originator, an unintended consequence of that simply because of the regional concentration or various exposures that exist in certain States, and so that would be something I would really be concerned about. So dynamic, yes, but I am not sure that is clear.

Senator CORKER. Well, and I am glad you made that comment. You know, I have spent a lot of time with your CEO and your former CEO, and, you know, regionals are kind of no-man's-land. You know, some people like that, some people do not. I think you all like it. But I do think that we have done a lot here to focus on, you know, where the—making sure the larger institutions do not have an advantage and making sure that the smaller institutions, as I think the Chairman alluded to when he began, had a lot of access. But I agree that we need to do some work to ensure that the regionals that in some ways are no-man's-land end up in a good place, and I appreciate you bringing that up. And I am not going to go to you, Ms. Gordon, because I am—I know I am out of time. I do want to say just if I could make one point, thank you, though for being here and thanks for your organization's contributions to helping us all with this bill.

There has been some discussion about capital and the increased cost—of the 10 percent capital, I might add, Dr. Zandi. But I am just, of course, getting with you.

The fact is, you know, there are numbers of things that actually lower the cost, and when you look at the increased competition, the fact that you have issuers who are going to be competing with technology, you have got a single security platform instead of a dual platform like we have now, you have the full faith and credit, you have got uniform PSA, you have got a clear definition of reps and warrants, and, candidly, you move beyond the legal limbo that we are in.

So I know that there are some costs of capital, but when you create the kind of dynamic and clear clarity that we would be doing with this bill, you also have some things that would lower costs. Would that be a fair statement to make?

Mr. ZANDI. Absolutely. And I did not comment on the 10 percent capital. In my view, 5 percent is appropriate. But getting to 10 percent, I think it can be organized in a way that it is not too costly. And you are absolutely right, there are things in the legislation—which should be, by the way, in every legislation—that will lower costs relative to where we are today, absolutely.

Senator CORKER. I thank all of your for your testimony and your contribution and Mr. Chairman and Ranking Member for having this hearing.

Chairman JOHNSON. Senator Menendez.

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

As the Committee considers its priority for housing finance reform, I think there are several objectives, but one that I would like to hear from you on that I think is very important and that I consider the bedrock of our current system is the 30-year, fixed-rate mortgage, which has made home ownership more accessible and affordable for generations of Americans, and most assessments of the market have concluded that, without some form of public sector guarantee or backstop, the vast majority of home buyers would lose access to that type of product.

So, number one, for the panel, do you all agree with this assessment? And, second, can you discuss what would be the impact to home buyers and even homeowners who, as they try to sell, would

find themselves with a marketplace quite different in terms of who the buyer would be of losing a 30-year, fixed-rate mortgage?

Ms. GORDON. I am happy to take a start. Yes, we absolutely agree with you that the 30-year, fixed-rate mortgage has been a tremendous product for families. It is sustainable. It helps make home ownership affordable. And we think protecting it should be one of the key goals of the work we are doing here now.

We believe you really need two things to protect that product: one is the Government backstop guarantee, and the other is the TBA market, which needs to be sufficiently liquid that institutional investors can move in and out as they are required to do so that they continue to have interest in participating in this system. And so that is—you know, as we go forward—assuming that we have now somewhat crossed the Rubicon of having the guarantee and these discussions, really digging down and making sure that we are really protecting that TBA market and that we fully understand the impact of these different structures on that is really important. You know, as Mr. Johns said, if we start to fragment that or make TBA shallower, it will not work as well.

Mr. JOHNS. I would just follow on from Ms. Gordon there. I think Ms. Gordon highlighted the need for the TBA and the Government guarantee. I think the two are effectively the same. If you are going to have the TBA remain liquid, you know, then the guarantee is required. And if the guarantee is there, the TBA market should be there providing we are cautious not to fragment that market, which will enable the maintaining of the 30-year fixed.

Senator MENENDEZ. Well, I hope we have crossed the Rubicon. I am never sure we have crossed the Rubicon until we cross it. But I hope that that is there. I think this is one of the essential elements, and I think those who have been working on this issue—I have shared my thoughts on it—I think they believe so, too.

Another thing that I am concerned about is a multitude of housing finance reform plans that many of you have either authored and/or helped contribute to. I think most of those plans acknowledge the need to keep in place some form of that Government guarantee or backstop, and in doing so, the attention naturally turns to policies as it relates to protecting taxpayers from losses, which is an important interest.

One example that is given in that regard is setting minimum underwriting standards for a mortgage to qualify for a guarantee. And as part of those standards, some proposals have suggested requiring a high minimum downpayment for a borrower to qualify.

Now, certainly no- and low-downpayment mortgages were a major problem during the financial crisis, and a downpayment certainly can affect the size of the riskiness of a loan. But my concern is that if we go too far in the other direction and set the bar too high, we will end up shutting out the market of creditworthy individuals and families who will have other compensating factors and are in a high-risk default at all. I know that in my own case, the first home that I bought, if some of the standards that are being suggested were the case, I would never have achieved that. And I was a responsible borrower and have been a responsible borrower ever since.

So my concern is a requirement that is too high can seriously undermine the goal of helping Americans afford home ownership. There is one prominent analysis that estimates that it would take an average family 14 years to save for a 5-percent downpayment and 22 years to save for a 10-percent downpayment.

So my question—maybe, Ms. Gordon, I think you have done a lot of work in this regard, but I am happy to hear from others—can you elaborate on the importance of getting the calibration right on the policies like downpayment requirements in order to properly balance the goals of protecting taxpayers but also meeting the goals that we have of making sure that we can give responsible borrowers the opportunity to have the ability to own their home?

Ms. GORDON. Thank you so much for asking that question. This is a matter of utmost concern to us when we think about accessibility of the system to the average homeowner.

First, let me just say that while we saw a problem during the crisis with loans that had low downpayments, it was not the low downpayment characteristic that caused these loans to be risky. These loans tended to be heavily risk layered; you know, maybe it was a negative amortization loan that had a low downpayment and had little or no underwriting that was taking place. And that caused loans that were low downpayment to be risky or to fail. There is quite a great deal of evidence that well-underwritten and safe fixed-rate mortgages that were made with low downpayments performed quite well throughout the crisis. And so, you know, I think we cannot just isolate that one factor and say this factor in and of itself is a big problem.

That said, you know, different lenders will have different views as to downpayment, which I think is appropriate. What I do not think we should do is enshrine a particular number in legislation. I think that would be a mistake regardless of which number we pick.

Senator MENENDEZ. Thank you.

Chairman JOHNSON. Senator Johanns.

Senator JOHANNS. Let me also add my voice to those who are saying thanks to Senator Warner and Senator Corker. And to the Ranking Member and to the Chair, thank you so much for taking this issue on.

Ms. Gordon, I could not agree with you more. Thank goodness somebody after 5 years has grabbed hold of this, because the one thing that seems clear from everybody's testimony is the current system is not where we want to be. We need to head in a different direction.

Dr. Zandi, you are probably feeling picked on because I am going to start with you also at the start here.

Mr. ZANDI. Well, you know, all my life I have been at the end of the list.

[Laughter.]

Senator JOHANNS. That is right.

Mr. ZANDI. Bring it on. It feels good.

Senator JOHANNS. It feels good to be in the A category, I guess.

Mr. ZANDI. In the A category, yes.

Senator JOHANNS. I was following your testimony about capitalization, and I think there are a lot of central pieces to this legisla-

tion, S. 1217, but I think that has got—we have got to get that right, or this thing just does not work.

You expressed an opinion that 5 percent is a good benchmark. I do not disagree with that. I think there is some safety built into that. You talked about varied sources of capital, and you have expanded on that.

You then talked about G-fees and the impact on the monthly payment. I want you for the record, just so we are clear on this, to please explain how G-fees and other sources of capital are going to get us to this varied capital system, if you will. Do you follow my question?

Mr. ZANDI. I am not sure I do.

Senator JOHANNS. Yes. What I am trying to figure out is: How would you describe G-fees relating to what we are trying to accomplish here? That is really what I am getting to.

Mr. ZANDI. G-fee is a guarantee fee. It is the cost to mortgage borrowers through the mortgage interest rate for paying for the potential losses that will occur from the lending. So, you know, you make loans. Some loans are going to go bad. That is going to create losses. And you need to charge a fee to compensate for those losses, and that is what the guarantee fee is.

Now, if you want to be prepared for a little bit of loss, then you would only need a lower G-fee. If you want to be prepared for bigger losses, which I think we are talking about here—and we need to be prepared for bigger losses given what we went through—it is going to result in a higher G-fee or a higher mortgage rate.

Senator JOHANNS. And to get to——

Mr. ZANDI. Does that make sense?

Senator JOHANNS. It does.

Mr. ZANDI. OK.

Senator JOHANNS. To get to the 5 percent that you think we should be focused on, you are saying that the net effect of this to the borrower is going to be roughly $60 a month.

Mr. ZANDI. Yes. That is obviously a lot of moving parts, a lot of assumptions. I am making assumptions about the future finance system, how we are going to organize ourselves. But my sense of it is that is a good ballpark figure. To get from where we are today, literally today, to that 5 percent world that we all feel really comfortable about and everything looks proper, I think it is going to be $60 a month, roughly.

Senator JOHANNS. OK. Now let me shift focus a little, and others can jump into this. In my State, like so many other States, I am worried about the small lender, the community bank out there that is not looking to be regional, but they want to serve their clientele. They want to create a relationship and continue that relationship.

We have tried with S. 1217 to make sure that their interests are protected. I would like your opinion as to whether you think S. 1217 gets us there.

Mr. ZANDI. Would you like my opinion?

Senator JOHANNS. Yes. Start, and we can go right on down.

Mr. ZANDI. I do. I think it is clear that the legislation is very sensitive to this issue. There are two key elements of the legislation that address this. One is in the common securitization platform there will be multi-lender securities. So what that means is that

small lenders—community banks—can sell into a security, and that security will get the Government guarantee. So they have access to the Government guarantee. So that is very important and I think critical to any system, because that is important for rural areas and more niche markets.

The second aspect of this is in the legislation itself there is a carveout for a bond guarantor that would service, explicitly service small lenders. So it is in the legislation. It is there to help protect against some of the concerns that you might have.

So I think there are things we can think about and we can tweak this and make this probably work a little bit better. But I think those two things go a long way to addressing that concern.

Senator JOHANNS. I am just going to have to ask the rest of the panel if they see something different, because I am out of time. Mr. Johns?

Mr. JOHNS. I would not say I see anything different. I would maybe sort of add to that that when you are looking at some of the constructs of, for instance, the credit-linked note product, you also want to be amenable—or we should as an industry be looking at potential structures that allow multi-issuers to that extent, which also, I think, ties in with one of the points that Mr. Lienhard made earlier.

Senator JOHANNS. Go ahead.

Mr. LIENHARD. As I look at the legislation, I do think that it has addressed the needs of small lenders well, and I think about the regionals as being the ones sort of disadvantaged.

Senator JOHANNS. OK.

Mr. LIENHARD. I will answer in the negative.

Senator JOHANNS. Ms. Gordon, any thoughts on that?

Ms. GORDON. I am glad the legislation does have some specific structures that will help in this regard. You know, I think some other things that—there are some ways to prevent market concentration that are not in here, such as preventing an originator from also being a bond guarantor, that I think we should think about for this legislation.

Senator JOHANNS. OK. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman.

I want to again actually start with Mr. Zandi. I think you appropriately pointed out that any reform may add some costs. But wouldn't you agree that at this point in conservatorship that we have an artificially low, nonsustainable pricing system in that we have no private capital, we have a direct Government guarantee, Fannie and Freddie have—so that regardless of what reform would look like, there is going to be some bump-up in mortgage rates just because the system now has, in effect, no capital at risk?

Mr. ZANDI. Yes, I think that is clear. I mean, I think the question is ultimately who pays. Is it the taxpayer who is going to pay for the mortgage, or is it going to be the lender and the borrower who pays for the mortgage, the full, all-in cost going through thick and thin economies? And right now it is on the taxpayer.

Senator WARNER. Right now it is 100 percent on the taxpayers, no private capital at risk.

Mr. ZANDI. And I think that is not appropriate.

Senator WARNER. We, in effect, have while potentially artificially low mortgage rates at this point, we clearly have all taxpayer exposure.

Mr. ZANDI. It is all taxpayer exposure, and it is inappropriate. And, actually, given the rise in G-fees since the GSEs have been in conservatorship, this has become less of an issue, but it is certainly still an issue.

Senator WARNER. And would there be any disagreement on the panel in terms of the current status?

Mr. Lienhard, let me acknowledge—one, thank you for coming up from Richmond. And, two, I agree with some of my colleagues that while we have, I believe, tried to make a very good-faith effort to make sure that the community-based banks, the credit unions and others, get access through a mutual or other entity so that they get that kind of fair pricing and nondisadvantage, that the regionals are kind of in between here. How will we get you into a market where there is—you get the same kind of pricing protection, but you get the kind of geographic diversity and others that you need? You know, at least as one of the group of 10 who have been involved in this, I am open for business on how we sort that through in a better way. I am not sure if you want to make any direct comment right now, but I look forward to——

Mr. LIENHARD. I mean, the only comment I would make is thank you for acknowledging that, Senator, and I think it is important to point out the fact that I believe our customers or our clients are advantaged by our ability to compete not only with small lenders but also the large lenders. And to the extent that the regionals are just by construct disadvantaged, that reduces the competition. So I appreciate both your and Senator Corker's acknowledgment of this and would really look forward to working with your staff on ways to resolve——

Senator WARNER. And let me also acknowledge, I think servicing improvements need to be made and there are multi-family improvements.

Ms. Gordon, I want to thank you again publicly for all the ideas and input you have had. I also want to make a bit of an editorial comment here in that, you know, kind of looking back at the old system, where we had a profit—you know, this profit-making enterprise that, as times were good, would make profits but when times were bad, the public bore the risk. It seemed like we had almost too many functions in Fannie and Freddie. We had a profit-making venture. We had this Government backstop entity. And we also had, you know, very important, again, goals that you have articulated quite well, you know, market access goals.

I would argue that the way S. 1217 has tried to separate out those goals—and I know you have got ideas on tweaks, but actually make sense. And would you acknowledge at least—as a matter of fact, in the old system, unfortunately, these entities got criticism from both ends of the political spectrum. They got from those who were perhaps on the progressive end saying you are not doing enough, and you got interests from more the market-based section saying you are disrupting your market function by doing too much.

Would you acknowledge that many of the very appropriate public housing goals that we would sometimes legislate with housing

trust funds and others, worthy goals, but were oftentimes never funded?

Ms. GORDON. Well, we have certainly had a problem in the past with not achieving, you know, exactly what we wanted to achieve. The National Housing Trust Fund and the Capital Magnet Fund are not being funded now even though the enterprises are awash in proceeds. And so I am not even sure why they are not being funded at this point.

I think that in looking at the bill, which, you know, we are very glad to see, though we do, of course, want some tweaks, that there is the provision to collect a fund that will be used to support those borrowers or communities that need something of a leg up to participate in the conventional market.

I do think, just to refer back to my answer to Chairman Johnson earlier, that the bill probably needs to do more to ensure that existing creditworthy borrowers are served, regardless of where they are or whether they are self-employed or whether they live in a rural area. I think we need to advance more on that.

But I think we should be aware, you know, in a policy sense that Fannie and Freddie did have a very clear public purpose. It did have affordable housing goals. And while there are those who think, I think incorrectly, that the goals caused the crisis, whereas there are others, as you noted, on the progressive side who feel like the goals never did enough, the fact is if we are dismantling that system, it is absolutely critical to have a strong sense of public purpose at the center of this new system in a way that is sustainable and appropriate.

Senator WARNER. And my time is up. I would simply say—and I know there are others who disagree with part of this, but at least if we are going to have these goals and part of the nontax pricing function of this Government backstop would give this auditable, identifiable funding entity that you could—we could measure in a way that we were never able to measure when it was commingled in the old system. And, again, we may agree whether this is appropriate or not, but I actually think there is a lot more transparency and a lot better ability to audit than we had in the past. And I thank again the Chair and the Ranking Member for the hearing and their willingness to work on this.

Chairman JOHNSON. Senator Toomey.

Senator TOOMEY. Thank you very much, Mr. Chairman. I want to follow up in the direction that Senator Warner was going. But first a quick question. I hope there is unanimity about this. That is, with respect to this idea that some municipalities have floated that they will, under the justification that they give citing eminent domain, they are threatening to confiscate certain private-label mortgages from investors.

So putting aside what strikes me as an egregious affront to the Constitution, the rule of law, and private contracts, does everybody agree that, to the extent that this were actually to take place, it would certainly discourage private capital from going into the residential mortgage market? Does everybody agree with that? And that that has, of course, the consequence of making mortgages either less available or more expensive or both?

Mr. JOHNS. I would actually go a little further and say not just it will discourage, it is discouraging, the mere threat——

Senator TOOMEY. The mere threat is already having that effect.

Mr. JOHNS. Absolutely.

Senator TOOMEY. Does anybody dissent from that?

Ms. GORDON. I mean, I am not sure I will dissent that the threat is having an effect, but I will say that, first of all, I think this is a local matter; and, second, there have been numerous efforts for municipalities to be able to address the problem that they face. And until they have a way to address that problem, it is not surprising that a number of different avenues are being pursued.

Senator TOOMEY. OK. Thanks.

Let me go on to the heart of this, another matter, which is I am little concerned that it sounds as though it is almost given as a certainty that there must be a Government guarantee in this market. And I would remind everybody, for what it is worth, the House Banking Committee has passed out of Committee a GSE reform bill that has no Government guarantee. So this is not terribly unusual. I would also point out we have huge segments of our capital markets that have never had a Government guarantee. Nobody contemplates a Government guarantee, I trust, for commercial paper markets and corporate bond markets and other sorts of markets where the private sector provides massive liquidity on a routine basis.

I also want to stress there are very substantial risks, I think, that attend to a Government guarantee. The obvious is it puts taxpayers at risk. And I think we should not overlook that risk that taxpayers bear.

I think it tends to divert capital that would otherwise go to other places, but if the Government is weighing in with a guarantee, it creates incentives to send money in certain places. It probably encourages excessive risk taking.

And the last and the biggest risk, I think we have heard allusions to it around this table today, which is the inevitable politicization of the process. If you have a Government guarantee, it is necessarily a political process to define the terms under which one has access to that guarantee. And in the process of setting those rules, what we hear—and, in fact, the Senator from New Jersey brought it up as his very next question—the concern that maybe not enough people will have that access. All the politics always drives toward ever expanding the universe of people who will have access to this, and I do believe that this political mandate to expand mortgage lending to people, including some who were not able to pay back those mortgages, was absolutely at the heart of the financial crisis that we just went through. And it seems to me maintaining a Government guarantee preserves—continues that risk. And it can be lessened somewhat. I am sure there are ways to do that. But I do not see how it ever goes away.

Now, it seems to me the arguments I hear and justification for the Government guarantee usually seem to be variations on three arguments: one, we need it to maintain the 30-year, fixed-rate mortgage; number two, it helps keep mortgage rates lower than they would otherwise be; and, number three, it is the assurance

that we will always have a liquid market, even in the worst of circumstances that might otherwise dry up the private capital.

I think we should spend some time really evaluating these presumed advantages. I do not think we have challenged them as thoroughly as we might.

A quick question. Mr. Zandi, I think you were asked the question in a House hearing, a Banking hearing, I assume, about whether or not you thought there would be a 30-year, fixed-rate mortgage product in the absence of a Government guarantee. And if my information is correct, the answer was that we probably would have such, and we do, after all, have private-label securities, including 30-year, fixed-rate private-label mortgages that have no Government guarantee. So the product does exist in the absence of a Government guarantee. Isn't that true?

Mr. ZANDI. It does. It would be a marginal product compared to where it is today. Europe, the rest of the world, would be a good case study for what the 30-year, fixed-rate would look like without a Government guarantee. And if you look at those markets, the share of the market that has a 30-year, fixed-rate, fully prepayable mortgage is small, 10, 15 percent of the market.

Senator TOOMEY. But there could be other differences that might explain part of that as well.

Mr. ZANDI. Could, yes, absolutely.

Senator TOOMEY. And so it is not clear that that is the whole thing. And we have had private-label mortgages and jumbo mortgages that are 30-year and fixed and they have no Government guarantee.

Mr. ZANDI. Yes, but I think it is reasonable—a prudent planner would expect, without any Government guarantee—take the House financial services bill, the PATH bill. If that were law, taken as is, the share of the mortgage market that would be a 30-year, fixed-rate, fully prepayable mortgage would be much, much smaller than it is today.

Senator TOOMEY. Or it might be maintained but at a higher rate.

Mr. ZANDI. Well, it would be at a higher rate, so then it would be unaffordable and therefore the share would be——

Senator TOOMEY. Well, it is an open question as to how much of the difference in rate gets capitalized in land values and——

Mr. ZANDI. Absolutely. And, by the way, all your concerns I sympathize with. Those are very legitimate concerns and need to be explored. I totally agree with that, that you are absolutely right, those are things we need to worry about. That is why a high rate of capitalization in a hybrid system is critical because it addresses some of those concerns. It does not mitigate them, but it addresses them.

Senator TOOMEY. I see I have run out of time, but I do hope we will drill down a little bit more on some of these issues. And, Mr. Chairman, I appreciate the indulgence.

Chairman JOHNSON. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman. I am very pleased that the Committee is going to focus on housing finance reform this fall. I think it is very important. But as always, the devil is in the details, so I just wanted to ask a couple of questions.

I want to go back to the question about underwriting criteria. As you know, there are lots of factors that go into that: income level, total assets, credit history, savings, outstanding debt obligations, downpayment amount, just to name some of them. And a borrower can do poorly on some of those but still do well on others and be a good candidate for a mortgage.

Community bankers tell me that this very flexible, holistic approach is very important to them in placing mortgages and making their lending decisions based on individual circumstances and market conditions.

So I understand why the Government would want to make its guarantee—make sure that its guarantee is available for mortgages that are likely to be repaid. But the question is how to make sure that the Government is insuring decent mortgages. So I want to ask a structural question as we are thinking about this statute.

Should the statute set a specific condition that must be met, like a certain downpayment amount or a certain credit score or a certain income level, and then hold hard and fast to that no matter what as a matter of statutory law? Or is it better to let the mortgage market adapt based on market conditions and based on new information about what combination of underwriting criteria best predict repayment? Ms. Gordon, maybe I could start with you on that.

Ms. GORDON. Sure. Thanks so much for this question, because I believe the answer is we absolutely should not set underwriting criteria in legislation in the context of the housing finance system.

What we do have now that we did not have before is through the Dodd-Frank Act there are quite specific rules now governing the underwriting of mortgages, and those rules have been the subject of much discussion, much work by the Consumer Financial Protection Bureau, and, you know, quite a lot of interested parties have been involved in that process. And while not all of us agree with every part of the way the rules came out, those rules are there now, and they are underpinning that aspect of consumer protection. And so I think it would be difficult if we, as I said, enshrined things in legislation.

Senator WARREN. OK. And let me just ask that same question of Mr. Lienhard. You do this for a living.

Mr. LIENHARD. Yes, I think that one of the pitfalls I see with hard-coding underwriting standards into legislation is that underwriting expertise and criteria can change over time, and so presumably we get better and better at understanding the characteristics of borrowers and the collateral in terms of sort of what a downpayment or what debt-to-income ratios or any other criteria that might emerge years from now. So I think that is sort of problematic, because when it is in legislation, then it is hard to sort of innovate and advance.

I also think that the capital standards for the private capital should be able to create very legitimate risk to the guarantees, and that will force, in my view, to borrow Senator Corker's word, a dynamic underwriting enforcement or mechanism that I think you are looking for through the guarantee, the private guarantee function. So I would be very opposed to hard-coding underwriting standards.

Senator WARREN. Good. Thank you.

I am going to assume that I am going to get a similar answer, because I want to try to hit a second question. So if I am not, you should flag me. OK?

Mr. ZANDI. Well, I think the loans that are guaranteed by the Government in the system should be QM.

Senator WARREN. All right. Got it.

Mr. ZANDI. And that should be hard-coded.

Senator WARREN. Got it. But it is QM.

Mr. ZANDI. QM.

Senator WARREN. Rather than coding in a specific quality.

Mr. ZANDI. Right. Should be QM, though, because that gets rid of a lot of the egregious loan products that are at the heart of problems we had.

Senator WARREN. Right. So I want to ask a different question then as well, and that is, there are—because there are limitations on the scope of the Government guarantee, there will be mortgage-backed securities that are not guaranteed. That is our private-label market. We might make an estimate, just to get us started, that that might be something like half the market, $5 trillion. We do not know. I realize it will depend on other factors and likely go up and down.

But here is my concern. My worry is that we will have a guaranteed market and we will have a private-label market, but that the private-label market will create the same kind of problem that we ended up in in 2008. There is no explicit guarantee of the private-label market, but if it is so big and so important that the players in the market begin to believe that there is an implicit Government guarantee, that that in turn will create the problems of moral hazard, of excessive risk taking, the problems with Fannie and Freddie that got us here in the first place, and all the problems of they scoop up the profits in good times and then leave the taxpayer with the bill in bad times.

So I am worried about the question of whether or not we need some Government regulation of the nonguaranteed market to ensure that this kind of aggregation of risk does not occur. Dr. Zandi?

Mr. ZANDI. I think it is appropriate for you to be concerned about this, and let me make a broad statement and then a more specific one.

Broadly, it is very important to consider housing finance reform in the context of the entire mortgage finance system. You know, right now we have just been focused on the part that would get the Government guarantee, but we have to think about it in the context of bank lending in terms of the private-label securities market and what may come from other sources. So we have to think about this—and the FHA, by the way. So we have to think about this holistically, and that is one very good thing about the PATH Act. It did try to think about it holistically. So that is key. So that is a broad statement, and so you are exactly right that we should be focused on this.

More specifically, I do think that there should be some levers to address this risk. I do think we have QRM. QRM feels like it is going to be set to QM. But I would argue that QRM and QM are not coming down from the Mount, right? These are things that we

can adjust and set in the future if things seem to be going awry, because now regulators are looking at the system in a—looking at it in terms of systemic risk, that this is now a lever we have, the regulators have a lever to change it if we need to.

The other thing I would say is that the regulator that we are talking about here in the context of housing finance reform should have broader authority as well to look at the entire system and make some changes, if need be. I am just making this as an example. You know, I think it might be appropriate that we have a rep and warranty system that is consistent across all lending so that, you know, we do not get that bifurcation in the mortgage finance system. And if you do that, then you can control for this risk right at the root, you know, in the origination process.

Now, we have to think this through, and I am thinking out loud for you, but—and there may be things I am not thinking about, but I think that is the kind of way I would approach this, yes.

Senator WARREN. Good. Thank you very much, and thank you for your indulgence, Mr. Chairman. I hope we can pursue this later. Thank you.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you. Good to see you, Mark.

I started wrestling with the GSE reform, as you know, and others probably, about 10 years ago. I had an economist that was advising the Banking Committee at the time I was Chairman of the Committee, and she came to me and told me then could she have 30 minutes of my time. I said, "Absolutely." And she explained to me then how thinly capitalized Freddie and Fannie were and how concerned she was and we should be with the implicit guarantee. And also some of the underwriting standards had eroded, so to speak.

We tried then to reform Freddie and Fannie. We were not trying to put them out of business. We were trying to build their capital up and so forth and change some things, to no avail. Of course, we are where we are today, and that is why we are having this hearing.

I am concerned about the housing market. Right now Fannie and Freddie are about the only game in town. But we still—they are sitting in our lap. They are doing a lot better, I think, under the leadership of Mr. DeMarco. They are buying better mortgages. Is that fair, Dr. Zandi?

Mr. ZANDI. Yes, that is fair.

Senator SHELBY. All of that?

Mr. ZANDI. Yes.

Senator SHELBY. But still if we are going to reform the GSEs, how do we, if we do, limit or can you limit the implicit guarantee? See, a lot of us would like to create the private sector period, if we could. Is that possible? I do not know it is probable. And a lot of people do not want to have capital. Fannie and Freddie, as I just said, had some of the thinnest capital of any financial institution in the world left standing.

Mr. ZANDI. Right.

Senator SHELBY. Capital itself will not solve everything, but it is a cushion, a big one. Some people argue—and I have not analyzed everything in this proposal by Senators Warner and Corker, but we

are doing it. Will this legislation—I will start with you, Dr. Zandi. Would this legislation change dynamically how the GSEs operate? Or will it be akin to what we had before?

Mr. ZANDI. It will change it wholesale, Senator. You know, I think just to give you context, Fannie and Freddie before the crisis had 50 basis points of capital, 0.5 percentage points, and that is being charitable.

Senator SHELBY. You could see through it, couldn't you?

Mr. ZANDI. The quality of the capital was highly questionable.

Senator SHELBY. Sure.

Mr. ZANDI. We are talking about in the Corker-Warner bill as written now 10 percent capital, and I am arguing, you know——

Senator SHELBY. I know.

Mr. ZANDI. Yes. So and then there are many, many other changes in the legislation. So we are talking—and it is an explicit guarantee. It is not implicit. You know, it is right there in our face, and we are saying it is explicit, and we are charging for it, and we have all the appropriate mechanisms for ensuring that taxpayers get their money back.

Senator SHELBY. But won't you have to tie capital, which is a cushion—is 5 percent maybe not enough? You can argue that. Or 10 percent or 8 percent. But adequate capital, good capital, with underwriting standards and so forth. You know, we have—we all have preached and pushed for people to have a chance to own a home here. But, gosh, we found out that everybody cannot or would not want to own a home or would ever make the payments and so forth, which is sad in a way. But some people do not want to buy. Our home ownership has gone down some. But isn't the key to any mortgage underwriting the underwriting itself, the credit, the downpayment, what they got in the game, and the capital of the institution, all this tied together?

Mr. ZANDI. Sure, absolutely. You can have all the capital in the world, but if you are making——

Senator SHELBY. Bad loans.

Mr. ZANDI. It is not going to matter, right? It is going to wipe out the capital. So we have to make sure it is not garbage in. We have to make sure that it is high-quality mortgages that are getting the explicit Government backstop, yes.

Senator SHELBY. What is your—and I will give, with the help of the Chairman maybe, others a chance to answer. You said you believe this is a step in the right direction, you know, this proposed legislation. You have got to have some concerns there. How can we improve this legislation?

Mr. ZANDI. I do have concerns.

Senator SHELBY. OK.

Mr. ZANDI. Some of it just resolves around the specific numbers. But in terms of structure, I would just mention one thing, and that is, I think it is very important that the institutions that are providing the capital cannot also be making the loans, that we need a clear break between these functions. Because if you allow them to combine, then you can get a vertically integrate market. What I mean is big institutions that feel like Fannie Mae and Freddie Mac that are too big to fail. So we need to separate those two

things, those two functions, and that has to be clear in the future housing finance system.

Senator SHELBY. Heretofore they have been buying the loans, haven't they?

Mr. ZANDI. Yes. Now, in the current structure, Fannie and Freddie do not originate loans. We need to preserve that aspect of the current system.

Senator SHELBY. OK. Mr. Johns, do you have some observations on this?

Mr. JOHNS. Yes, I think the capital does have to be tied to the underwriting standards. I think we would encourage, you know, if there is going to be a hard-coded number in the legislation, you know, in addition to that you want to have some regulatory flexibility that would allow you to take account of those differences in, you know, not just underwriting standards but any other criteria that should drive the loss number higher.

Senator SHELBY. Mr. Lienhard?

Mr. LIENHARD. I think my concern hinges around the execution. So while we need to move forward in terms of reform and the current system is untenable, it is very simple for an originator and the nature of the guarantee is very straightforward. There is no way we will replace that, but we will have multiple options, and those options involve in my mind, as I think about implementation, execution risk on the part of issuers.

Senator SHELBY. Give us a couple of examples.

Mr. LIENHARD. If you choose the wrong structure, if you choose the wrong guarantee and how that attaches to the TBA market and how—you know, we simply cannot——

Senator SHELBY. Should that be done by the regulator, the structure, or should we tie it to legislation and put it in a straitjacket?

Mr. LIENHARD. I think that the regulator is intimately involved in regulating those structures. That is actually really important. But the legislation should set the tone, and I think it is important for the Committee to recognize that, you know, it is not that easy for originators to just simply switch to a new structure or a new provider if, in fact, it is turning out that that mechanism is not working well. So I think the choice, the multiple choice and this idea of competition is a really good one, but the execution associated with sort of switching choices is challenging from an implementation perspective.

Senator SHELBY. Let me—well, you answer first, Ms. Gordon, and then I have got one follow-up.

Ms. GORDON. Just a couple of comments on things that have come up throughout your remarks. I do think it is important to note that the erosion of underwriting standards was, in fact, initiated and led by what was happening in the private securitization market. It was not until toward the end of that period that Fannie and Freddie, because of their conflicted responsibility—well, because they were chasing profit and market share, they at that point abandoned what had been very sound underwriting standards that had kept the market safe for many years, and that was their big mistake, along with the gross undercapitalization that you have talked about.

I do think now that we have instituted underwriting standards through QM and risk retention standards through QRM that it is easier to link up this new system to those standards, which will help on the underwriting side, and we have already talked about the capitalization side.

Senator SHELBY. Let me ask my last question here. We have had testimony before this Committee before on a number of occasions that in the multi-family area, conventional FHA, but conventional, too, that there are very few foreclosures. Very few. And I know that is—we are not talking about apples and oranges. We are talking about big apples and smaller apples here, I think. And I know that their underwriting is very important in multi-family for the most part, especially conventional. You have got to have some skin in the game. But is the lack of skin in the game—in other words, lack of downpayment underwriting—that causes some of our problem? Dr. Zandi? As opposed to multi-family.

Mr. ZANDI. Yes, I mean, I think in the single-family system, pre-crisis, currently, there is not enough skin in the game. We do not have enough capital, private capital. We do not require the folks that are receiving the mortgages and benefiting from issuing the mortgages to fully participate in the risk. So that is what we need to fix, and if we get that right, I think we will have a much sounder system with lower default rates and, you know, address some of the concerns that Senator Toomey has with regard to moral hazard.

Senator SHELBY. Mr. Johns, do you have anything?

Mr. JOHNS. Are you talking about skin in the game from the——

Senator SHELBY. Downpayment.

Mr. JOHNS. From the consumer perspective.

Senator SHELBY. Equity. In other words, if I—I remember anecdotally, I remember when I was very young—and that was a long time ago, but my wife and I bought our first house, built our first house, which we still live in. We want to pay as much down as we could to make the payments lower and also to pay it off as soon as we could, because we came from parents who came out of the Depression. They did not want debt. You understand that well. Now a lot of people do not want to pay anything down, even if they could. So I am speaking of skin the game.

Mr. JOHNS. OK. So I think on that side I would support what Dr. Zandi is saying. It is an interesting sort of dichotomy because obviously you will have—we have many members within the Structured Finance Industry Group. You range from the issuers to servicers and the originators, and you have investors at one side. Clearly there is a balance of play there from a market perspective as to, you know, the more skin in the game that a homeowner has, then, you know, clearly there is less likelihood of default. At the same time, if you add that requirement to can you access the market, then it may reduce the amount of originations that you have that you can clear away and get low-cost funding for.

So, you know, as an organization, it is something that we are very aware of. You know, if we look at the risk retention rules that have sort of recently come out, clearly it is an issue that will be debated over the next couple of months until, I think—at least until the common letters are submitted on October 30, and I would

be happy to come back and give you a full read on where the industry as a whole sits on that.

Chairman JOHNSON. Could the Senator think about wrapping up?

Senator SHELBY. I will conclude. You have been very generous with my time and yours, too. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Heitkamp?

Senator HEITKAMP. We all know how you feel, waiting to be last. We are in a spot where we have choices, and if we get bogged down on political ideology, we will make the choice to do nothing. Because I have been around here long enough now in my short time period to know that when we get into philosophical debates, we do not do reform. We do not do the things that we need to do to give certainty to the market, to give certainty to the American people, and to respond to their concerns.

So I am going to ask one very broad question, which is three choices: Do nothing, which seems to be the kind of choice of default in Washington, D.C., as we bog down in philosophical debates. We have got the PATH Act, which shows that this is going to be market driven. Very little information—and maybe I am just not looking in the right places, but very little information about the consequences on the American middle class and home ownership and new families as a result of the lack of expression of explicit Federal guarantee and the availability of the 30-year, fixed-rate mortgage into the future. And we have got a hybrid. We have got an opportunity to do real reform, and I know that there are so many of you on this panel who have participated in that discussion. Great work. I have read a lot of the work that has come out of your organization and I really appreciate it. For somebody who brings maybe a new perspective to this issue, it has been extraordinarily helpful. And so those are our three choices. Obviously the bill that we are considering today is the hybrid. It is that choice.

I want to ask you, Doctor, where can we better inform the American public about the actual consequences to our middle class and to our citizens on the consequences of those three choices? Where do we go for that information? Because I know you have been asked here kind of pick a choice or do a critique, and that was going to be my question, which is do a critique between the PATH Act and what we have in front of us in terms of affordability and availability of home ownership. But I want to know who is going to do that work so that we can better inform the public.

Mr. ZANDI. Well, I think the thing that would resonate with people is, you know, how much is this going to cost me? You know, what does it mean for my monthly mortgage payment? And——

Senator HEITKAMP. If I can just interrupt, it may also be, Can I get a mortgage?

Mr. ZANDI. That as well, sure, absolutely. But I think if we can come up with that number under different pieces of legislation, that would be quite informative. You know, I have taken a crack at that. I have done that for the PATH Act. I have done that for Corker-Warner, under different capitalization assumptions. And, of course, there are a lot of moving parts. But we have done that work. We can make it better and refine it as the legislation improves, but——

Senator HEITKAMP. And can you give some insight on your conclusions as a result of that work?

Mr. ZANDI. Yes. So if we go from the current system to where I think the system should be, 5 percent capitalization, that would add roughly $60 to the monthly mortgage payment.

If we go to a 10 percent capitalization—so this is what is in Corker-Warner right now—that would probably add another $60 to the monthly mortgage payment. So it would be $120 from where we are today. And, again, a lot of moving parts and a lot of assumptions.

If we go to the PATH Act, then—and I am going to do this calculation for you precisely, but I am just going to give you a sense of the ballpark estimate. I do not want to be on the record saying a specific number and be wrong, but it is probably double that. You know, it is probably $240 a month from where we are today. So it is a significant increase in the cost.

And, obviously, those are big numbers, right? I mean, just add it up. And that means that for the average typical home buyer, it is going to be a lot harder to get a mortgage. And then for the people—and those numbers I just gave you, that is for the typical borrower. That is for the person that is right down in the middle of the distribution of borrowers in a normal economic environment. If you go to the person—take QM and go to the end of the box, you know, the guy that is just marginal, still qualifies but is marginal, in a bad economy, in a recession, let us say, then the cost is going to be higher than that, measurably higher than that.

So these decisions you are making really mean a lot for Americans. I mean, 65 percent of Americans own a home. You are going to affect them.

Senator HEITKAMP. And I see I am out of time, but I just want to reiterate the point that for so many Americans, their home has not just been a house. It has also been their investment, banking on the availability. And as we look at a reduction in the number of companies, in fact, an elimination in the number of people—entities in the private sector who are willing to do a defined benefit plan anymore, we are all now saving for our future. I worry greatly how all of this will affect retirements into the future, how all of this will affect our ability to supplement our older income. And so this is enormously important, not just to the American economy, but it is enormously important to Americans that we get this right. And I think, you know, we have this Committee, at least the 10 of us who have sponsored this legislation, take a look at this and say if we do nothing, this place will not result in reform. And that may be the worst outcome for the people who most disagree with this provision.

And so I just want to—you all have had an enormous opportunity, I think, here to provide input. I hope that you will continue that, and I thank you for the work that you have done on behalf of the American people and on behalf of the American economy. It has been extraordinary, and I have really enjoyed listening.

Chairman JOHNSON. Thank you again to all of our witnesses for being here today. Your testimony will help guide our hearings going forward. I look forward to continuing this discussion and

working with Senator Crapo and all of my colleagues on the Committee to achieve an agreement on housing finance reform.

This hearing is adjourned.

[Whereupon, at 12:07 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

Center for American Progress

Statement of Julia Gordon
Center for American Progress

Before the Senate Committee on Banking, Housing and Urban Affairs
"Essential Elements of Housing Finance Reform"

September 12, 2013

Good morning Chairman Johnson, Ranking Member Crapo, and members of the committee. I am Julia Gordon, the director of housing finance and policy at the Center for American Progress. As part of my work, I convene the Mortgage Finance Working Group, a group of housing experts that have been meeting for more than four years to discuss the future of housing finance. The working group originally released its comprehensive "Plan for a Responsible Market for Housing Finance" back in January of 2011.[3] Since then, we have continued to offer comment on a variety of related developments. I greatly appreciate the opportunity to testify today about the essential elements of housing finance reform.

Housing finance mechanisms have evolved over time and in response to crises, from the creation of the Federal Home Loan Bank System and federal deposit guarantees to the more recent bailouts of private institutions and the conservatorship of the Government Sponsored Enterprises. Now, we have the opportunity to put in place a system that will serve the next generations even better than the systems that have preceded it.

In seeking reform of the housing finance system, Congress has important decisions to make. A new system could provide credit to a broad and diverse population, offer safe investment opportunities to a wide range of investors, and result in a larger, more stable housing market. Alternatively, it could create an environment in which credit and housing choices are more costly, more limited, and less sustainable, especially for minority and low- and moderate-income households, and where there are fewer opportunities for investors who do not seek credit risk.

These choices will determine not only the sustainability of a robust housing market, but also future economic opportunities for millions of families. Homeownership and the housing finance system play a unique role in ensuring strong families, strengthening neighborhoods, and boosting the overall economy. For this reason, it is critical to redesign the system to account for shifting demographics and changing consumer profiles, including the rapid growth of communities of color, ever-increasing student debt burdens, rising demand among rural Americans, and increased economic insecurity among all but the wealthiest families.

Why Congress Should Act Now

America's housing finance system needs reform now.

While housing prices have begun to recover in many (although not all) parts of the country, our national mortgage market today is significantly smaller than it was in the early 2000s.[2] The homeownership rate has dropped from close to 70 percent to 65 percent,[3] and while the housing market has improved from the crisis, the fundamentals are not yet there for a robust, accessible and sustainable market to develop.

To start, approximately two-thirds of mortgage originations in the second quarter of 2013 were for refinancing, not home purchases.[4] Many purchasers are now investors rather than owner occupants, and a large percentage of these investors purchase with cash rather than a mortgage (estimates suggest that nearly 40 percent of homes purchased in May 2013 were purchased with cash, meaning they were likely purchased by investors[5]). This investor presence may support housing prices and perhaps even inflate them,[6] but will not necessarily stabilize neighborhoods or pave the way for homeownership in the future.

In the meantime, first-time homebuyers, young homebuyers and homebuyers of color – the future of homeownership in the United States[7] – have largely been shut out of the conventional mortgage market. The Federal Housing Administration backed financing for 46 percent of first-time buyers in 2012 and about half of home purchases obtained by homebuyers of color in 2011.[8] Homeownership rates for young people (ages 25-34) are among the lowest in decades.[9] This decline in homeownership has led to an increase in renters.

Meanwhile, production of multifamily apartment buildings is falling behind demand.[10] As supply and demand shift, rents have risen significantly – five percent in 2012 alone.[11] This is only putting more pressure on the nation's renters, more than half of whom are "rent impoverished," or spending more than thirty percent of their income on housing.[12] These figures do not suggest well-functioning single and multi-family housing finance markets.

So where do we go from here?

We cannot go back to the status quo ante. It's true that for many decades, the government-sponsored enterprises, or GSEs (Fannie Mae and Freddie Mac), offered our nation's financial institutions a robust and reliable secondary market for mortgages, providing liquidity and stability for the housing market. Yet due to the so-called implicit guarantee -- which the GSEs routinely insisted did not exist -- these companies enjoyed all the benefits of a federal guarantee without any of the costs. Their funding costs were cheaper, giving their portfolio an advantage, their equity costs were lower because the guarantee substituted for a risk premium, and their regulator – already weaker due to structural differences from other financial regulators -- permitted gross undercapitalization.

Nor can we continue with the system we have right now. Last week marked five years since Fannie Mae and Freddie Mac went into conservatorship, an astonishing length of time that was never contemplated by the architects of the conservatorship. In the absence of direction from Congress, the Federal Housing Finance Agency is winding down the GSE presence in the market and limiting or eliminating the ways in which the GSEs serve a public purpose. While we agree with some of their actions, such as the initiative to establish a common securitization platform, and disagree with others, this single agency, whose deliberations largely take place behind closed doors, and whose officials are not elected, appointed, or confirmed, has vast control over decisions at the GSEs—decisions that impact American families broadly, whether they currently own their home, hope to become homeowners someday, or are seeking affordable rental options.

It is hard to see how the current system satisfies anyone, either those seeking smaller government (since

the system is now effectively nationalized) or those who believe the GSEs should fulfill their public missions by enabling broad based and affordable access to credit, adopting best practices in loss mitigation, and capitalizing the Housing Trust Fund and Capital Magnet Fund.

Our vision of a well-functioning and responsible housing finance system that protects taxpayers is grounded in five core principles: liquidity, stability, transparency, access and affordability, and consumer protection.

- **Liquidity:** The system needs to provide a reliable supply of capital to ensure access to mortgage credit for both rental and homeownership options, every day and in every community, during all kinds of different economic conditions, and for large and small lenders alike.

- **Stability:** Private mortgage lending is inherently procyclical. Stability for the market requires sources of countercyclical liquidity during economic downturns or in the wake of other exogenous shocks causing private capital withdrawal. Stability also requires sustainable products and capital requirements that are applied equally across all mortgage financing channels for the long cycle of mortgage risk.

- **Transparency:** Underwriting and documentation standards must be clear and consistent across the board so consumers, investors, and regulators can accurately assess and price risk and regulators can hold institutions accountable for maintaining an appropriate level of capital. Secondary market transparency and standardization lower costs and increase availability of credit.

- **Access and Affordability:** It is critical for any housing finance system to ensure a level playing field for all creditworthy borrowers, rather than to allow lenders to "cream" the market, leaving perfectly creditworthy lower wealth, lower income or minority segments underserved. Additionally, the system should enhance access and affordability for underserved market segments. With appropriate incentives and tools, attaining these goals can benefit the market as a whole.

- **Consumer Protection:** As the current crisis has demonstrated, consumer protection is inextricably linked with financial institution safety and soundness. Along with regulators such as the Consumer Financial Protection Bureau, any structure supporting the nation's housing market must share a commitment to ensuring that the system supports rather than undermines the financial health of the consumer.

Today, we see a broad consensus emerging on the general outlines of housing finance reform in a way that has a potential to embody these principles. While the details differ, S. 1217, the work of the Bipartisan Policy Center, and numerous other proposals support our view that homeownership is a desirable option when viable, and that those who do not buy a home ought to have access to affordable, quality rental housing.[13]

Additionally, these proposals agree that a government role is critical to maintain access to long-term, sustainable mortgage products; that there is a critical need for a reformed multi-family finance system to meet the demand for affordable rental; and that the system must provide access to safe and affordable mortgages for all creditworthy borrowers, including those of low and moderate income.

Some policymakers still question the need for any government role in the housing market. This position

is embodied in the PATH Act legislation proposed by Chairman Hensarling of the House Financial Services Committee. It is becoming increasingly clear, however, that most stakeholders do not support such a radical restructuring of the market.

Thus, now is the ideal time to consider in some detail the essential elements of a reformed housing finance system in the context of broader, long-term considerations and priorities.

Ten Essential Elements of a Strong Housing Finance System

1. ***First and foremost, a new housing finance system must place the nation's housing needs at the center of the system.***

The structures and processes of the secondary market are not ends in and of themselves. Rather, they are a means to provide housing to our nation's families. Placing the goal of access to affordable, sustainable credit at the center of the new system's mission will provide the greatest benefit in the long run not only to families but also to lenders and investors while protecting taxpayers from future bailouts.

While most people think of mortgage lenders as the point of intersection with the public, the less transparent but very large secondary mortgage plays a critical role in ensuring access and affordability within the housing finance system. Lenders prefer to make the types of mortgage loans that the secondary market will buy. For this reason, one of the most effective ways to ensure a broad, accessible and affordable primary mortgage market is by creating a secondary market that promotes those principles.

Using a range of possible tools, the secondary market can encourage lenders to provide all Americans access to safe, affordable mortgages, including traditionally underserved populations such as Hispanics, African-Americans, rural residents, low- and moderate-income families, Asians, and Echo Boomers; collectively, these are the future of the mortgage market. It can also help to increase access and affordability by supporting standardization and lowered costs and by adopting responsible, targeted product innovations that can be made widely available throughout the mortgage market.

Any legislation overhauling the nation's housing finance system should include a purpose statement that makes clear the goal of the system is to provide liquidity, stability, transparency, and access to affordable credit for qualified borrowers across all geographies, housing types, populations, and mortgage balances within specified limits, including providing credit to traditionally hard-to-serve or underserved markets and supporting mortgages that further the purposes of the Community Reinvestment Act and other regulatory or statutory requirements for which primary market originating lenders are responsible.

Moreover, the entity that administers the government guarantee -- in S.1217, this entity is called the Federal Mortgage Insurance Corporation, or FMIC, which I will use as a shorthand for this entity throughout my testimony -- should prominently include in its structure an office or offices dedicated to ensuring broad access to credit. Through such offices, the FMIC should annually examine the characteristics of all securities it insures to be sure that the market is effectively serving qualified borrowers and renters from all backgrounds, geographies, income levels and housing types. In short, a person should quickly be able to ascertain the centrality of these principles to the entity's mission simply by viewing the entity's organizational chart, and the FMIC should have the organizational capacity to implement these principles. To the extent that the FMIC is governed by a board of directors, the directors must reflect experience and expertise in housing policy and community investment as well as

securitization and capital markets.

In the remaining items in this list, we discuss additional ways to advance and support this core public purpose.

2. ***The system should enable a deep, liquid market that will attract capital and keep credit affordable through providing a government guaranty and preserving the TBA market and the long-term, fixed rate mortgage.***

If we want to provide broad access to affordable, sustainable credit as well as provide attractive investment opportunities for a range of investors, any new housing finance system must incorporate three components of today's system: a guaranty for investors in mortgage-backed securities, a robust TBA market, and the widespread availability of long-term, fixed-rate mortgages. These three items are very interdependent, but we will look at each separately:

The government guaranty: The guaranty on government-backed securities provides a broad class of so-called "rate investors" the confidence to invest in the U.S. housing finance system at efficient, fixed rates.

Some have asserted that the significant development of the financial sector since the 1930s means that a purely private mortgage system could effectively serve the mortgage needs of Americans today. They point to the nascent recovery in the so-called jumbo mortgage markets, an area that lacks any government support because these mortgages are for the high end of the housing market, as evidence supporting the idea that the purely private markets can capably serve the mortgage markets.[14]

However, the fact that the purely private markets may be able to meet the mortgage needs of a small, wealthy slice of homebuyers does not mean that they will be able to meet the mortgage needs of all Americans. This argument ignores the limited investor appetite for long-term debt investments—the type of investments that fund home mortgages—in the absence of a government backstop. While investor demand for long-term sovereign debt is enormous, totaling many trillions of dollars for U.S. Treasuries alone, the demand for privately issued long-term mortgage obligations that don't carry a government backstop is small in comparison.[15] What's more, the jumbo market is enabled by the existence of the conventional market, as lenders need to compete with a product that wealthier borrowers could access with a larger down payment or if they bought a less expensive house. The conventional market also provides transparent pricing information and benchmark prices and rates upon which the jumbo market relies for its own pricing and rate-setting.

We agree with the drafters of S. 1217 and the Bipartisan Policy Commission that a 100 percent government guaranty is not necessary to achieve the benefits of a government-backed system. Our plan also recommends that private capital take a first-loss position on the guaranteed securities. However, as we discuss later in this testimony, we think that how that first-loss position is structured has very significant implications for the workability of the new system.

The TBA Market: The TBA ("to-be-announced") market -- which really can be used to describe an overall market or a type of trade or delivery -- today provides for the forward sale of mortgage-backed securities (MBS) guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae before the securities have actually been manufactured (i.e., before the mortgages that will back those securities have been identified). The TBA market is an important part of today's mortgage finance system, and proposals to reform the system must take into account how they would affect the TBA market's operation.

The TBA market is important to consumers for several reasons. First and foremost, in combination with the government guarantee, the existence of a deep and liquid market where MBS are easily traded is another essential precondition of the long-term, fixed-rate mortgage. Second, forward commitments facilitate rate locks, thereby providing consumers with certainty going into their home purchase, protecting them from a possible increase in rates during the time required to finalize the purchase of the house and to close on the loan. Third, because the TBA market is so liquid, it attracts a great deal of both domestic and foreign investment, which results in mortgages that are more affordable to everyone.

The TBA market is also critically important to investors. It provides a safe investment for rate investors, who can enter and exit the market at will, and it provides a high degree of price transparency. These characteristics are critical for a variety of different types of investors, including foreign central banks, fixed-income investors, and regulated financial institutions who are subject to restrictions based in charter, statute or regulation. In addition, the TBA market enables the pricing and hedging of many non-TBA eligible mortgage products, including jumbo mortgages.[16]

Unfortunately, the structured transaction solutions envisioned by S. 1217 and some other proposals would not be compatible with a deep and liquid TBA market. In a senior/subordinate deal, the subordinate piece would certainly not be eligible, and it is not clear that investors would consider senior tranches to be sufficiently homogeneous. What's more, even for a credit-linked-note transaction or other structured deal without a separate subordinate piece, any variations in the underlying documents from one deal to the next would lessen the level of homogeneity that's required for a market where new MBS are traded alongside more seasoned securities.

It is also worth noting that significant cutbacks in loan limits will result in a smaller overall market, which will reduce liquidity and raise prices. However, generally speaking, we believe that reducing loan limits is a better way to bring in private capital than over-charging for the guaranty fee.

The long-term, fixed rate mortgage: The explicit government guaranty together with the TBA market enable the widespread availability of the long-term, self-amortizing, fixed-rate mortgage, which maximizes affordability and economic security for the majority of American homeowners. While adjustable rate mortgages may be right for some borrowers under specific circumstances, they expose borrowers to interest rate risk, and shorter-duration products with balloon payments that are designed to be refinanced every two to seven years expose borrowers not only to ordinary interest-rate risk, but also to the risks that they may not be able to refinance when they need to due to other adverse changes in market conditions. While mortgage rates have been low for a long time, they are turning upward, and that can do a lot of damage quickly to borrowers who are not prepared.

Research conducted at the UNC Center for Community Capital confirms the important role that safe and sustainable products play in making homeownership work better for more households. A longitudinal study of nearly 50,000 families, with a median income of around $35,000 who purchased homes in the decade leading up the bubble and bust, has found relatively low default rates, despite the fact that most of these borrowers put down less than 5% on their home purchase and about half had credit scores below 680. Although these borrowers would be very unlikely to get approved for a mortgage in today's tight market, they turned out to be good credit risks even through a major recession, and they even managed to build some equity at the median. These loans were prime-priced, fully underwritten loans, extended by banks around the country and sold to Fannie Mae.[17] A comparison with similar borrowers receiving adjustable-rate and other non-traditional loan features

via the purely private market, who defaulted at rates three to five times as high, highlights the important role that good products play in reducing credit risk.[18]

Providing borrowers with that kind of stability also has benefits for the economy as a whole. Prior to the introduction of the major housing and finance reforms of the 1930s, the United States had a mortgage system that closely resembled the purely private system conservatives are arguing for today. Mortgages were typically for a term of 5 years and depended on regular refinancing.[19] That system failed spectacularly when the Great Depression hit and half of all homeowners defaulted on their mortgage (although foreclosure rates remained lower than today due to the government's creation of the Home Owners' Loan Corporation).[20] In the 2008 crisis, the mortgages that brought down the system were not long-term fixed rate products, but were hybrid adjustable rate mortgages, interest-only, or option ARMs with negative amortization.

3. ***The system should protect taxpayers from having to bail out any part of the mortgage or financial system, which is best accomplished through a bond guarantor structure.***

Our proposal, along with S. 1217 and the Bipartisan Policy Commission, all contemplate protecting taxpayers by making the government guaranty more remote behind private capital in first-loss position and by adequately pricing and reserving for the government guaranty. In all these scenarios, the first layers of risk would be absorbed by owners' equity and, on lower-down-payment loans, by traditional private mortgage insurance. Similarly, all the scenarios contemplate a government insurance entity such as the FMIC that will step in as a catastrophic reinsurer.

Where the plans differ is how to structure putting private capital in a credit-risk-taking, first-loss position. Some, like ours, call for specialized mono-line institutions or bond guarantors, as they are called in S. 1217. Other plans envision issuers that lay off the credit risk through structured transactions. S. 1217 offers a plan through which issuers could toggle between bond guarantors and a purely private capital markets transaction.

In our view, the institutional solution of well capitalized, bond guarantors chartered or licensed by the FMIC has significant advantages and ultimately, is the only structure that meets all the other requirements we believe are necessary. First, such a system is far more likely to be regulated and managed effectively for safety and soundness. There will be far fewer bond guarantors than issuers, and especially if these guarantors are chartered entities, the regulator will be able to closely monitor their operations and recognize risks early on. On the other hand, the FMIC would need extraordinary regulatory capacity or ironclad coordination with banking regulators to evaluate the safety and stability of the many institutions involved in the structured transactions.

Second, bond guarantors are much more efficient at pooling and spreading risks, which is the core function of insurance. Structured transactions, to the extent that they cover a single or limited number of pools, cannot allocate risks and reserves across years, regions, lenders, and so on.

Third, as we have seen in recent private label securitizations, investors in structured transactions have proven unwilling to assume risk on anything but the most pristine mortgages. If investors are assuming the first-loss risk, their high level of scrutiny will result in higher prices for non-traditional but still creditworthy borrowers, as the investors will demand a premium for taking risk that is not well-understood or serving borrowers who are perceived as more risky.

Fourth, as we noted earlier, individual deals are much less likely to be able to support a robust TBA

market.

Fifth, although the appeal of a structured transaction is that the money is already there to cover losses, it is much harder to ascertain how the investor institutions are accounting for these assets on their own books. As a result, these structures could export risk from within the four corners of the security out into the larger financial sector, which puts the taxpayer at risk once again.

Finally, bond guarantors can provide more protection to the taxpayer at less cost. For example, if losses occur in a senior/sub arrangement or in a credit-linked-note transaction, there is a stop-loss on that deal at the ten percent mark, at which point the government guaranty will attach. With bond guarantors, however, the guarantor can spread risk among pools, so if one pool loses 11 percent and another loses only 1 percent, there is no need to access the guaranty. Furthermore, the bond guarantor would have to exhaust not only its reserves but also its corporate resources before tapping the reinsurance fund. These institutions will have established business lines and a strong incentive to stay in business through the ups and downs of the business cycle. (To be clear, we do not intend to prohibit using structured transactions anywhere in the system. Bond guarantors can choose to lay off risk however they choose, including in capital markets.)

We do not believe the S. 1217 approach of offering both executions will work. First, as currently drafted, the bill tilts the playing field toward the pure capital markets approach, since that execution has little by way of regulatory requirements and can more easily meet the capital thresholds through leverage. Moreover, allowing investors to toggle back and forth between executions will likely fragment the market sufficiently to undermine TBA.

4. The system should operate effectively throughout all economic and business cycles.

The more central a role is played by private capital, the more instability is introduced. Private capital is inherently pro-cyclical, meaning that it tends to be plentiful and cheap during good times and scarce and expensive during downturns, thus inflating bubbles and deepening downturns, a lesson that we learned very painfully during the recent financial crisis. If Fannie, Freddie, and FHA had not been readily available to provide countercyclical capacity, the housing market decline would have been far more severe and the resulting economic damage would likely have been a full-blown depression rather than a recession.[21]

While this is a challenging problem, we suggest that there are two keys to solving it. The first is to build in countercyclical capability in an intentional and effective way. The mechanism envisioned in S. 1217 to change the attachment point of the government guaranty in an economic downturn requires the written agreement of two agencies together (FMIC plus HUD), would be limited to six months, and could not occur more than once in a three year period. Recent experience has shown that requiring multi-agency agreement can be very contentious and time consuming. But more concerning, recessions or downturns can last more than 6 months and happen more than once in a three year period. For this reason, rather than risking getting this critical function "wrong" in the statute, it might make more sense to permit the government entity to set the terms of the attachment point through regulation, considering how best to move quickly in times of economic stress when private capital flees. This flexibility will be easier using a system based on bond guarantors rather than structured transactions, because institutions may tighten, but Wall Street transactions may dry up entirely.

The second key to countercyclical capacity is to recognize that what is done in good times is just as important as what is done in times of stress. Adequate reserving and building up of capital is critical

and can best be achieved using institutional risk taking solutions (rather than structured transactions). Regulatory discipline around pricing and risk management also needs to be imposed on the private market, and should be the charge of a strong regulator.

5. ***The system should ensure that all creditworthy borrowers have access to the mainstream housing finance system regardless of demographic characteristics, geographic location, or housing type.***

For a variety of reasons, the mortgage market often serves those borrowers perceived to be the "easiest," most lucrative, or least risky borrowers at the expense of borrowers who are equally able to sustain homeownership but require more customization and consideration due to factors such as self-employment, nontraditional credit histories, the purchase of smaller homes, or living in certain rural or urban neighborhoods.

We see this phenomenon quite vividly today. Lenders are now requiring higher credit scores, larger down-payments, lower debt-to-income ratios, and essentially refusing to lend in certain geographies, regardless of a potential homeowner's creditworthiness. Symptomatic of this trend, between 2007 and 2012 originations of prime home purchase mortgages fell 30 percent for borrowers with credit scores above 780 but fell 90 percent for borrowers with credit scores between 620 and 680.[22] As a result, the market is largely serving the most pristine borrowers, those seeking higher balance loans, and those in well-served locations. In other words, they are "creaming" the market.

Because the secondary market can play a crucial role in determining the behavior of the primary lending market, we believe any new system should build in a requirement that lenders provide a level playing field for all primary market loans meeting the standards for the guarantee, rather than serving only a limited segment of the business, such as higher-income portions of that market.

This obligation would have four parts:

- Bond guarantors as a whole would be expected to mirror the primary market (roughly) in terms of the amount and the geography of single-family low- and moderate-income loans (other than those with direct government insurance) that are securitized and are eligible for the guaranty.

- Bond guarantors (or issuers) for multifamily loans would be expected to demonstrate that at least 60 percent of the units supported by securitized multifamily loans during the preceding year were offered at rents affordable to families at 80 percent of the relevant area median income, measured at the time of the securitization.

- Bond guarantors (or issuers) would be required to provide loan-level data on securitizations to the government (which will be required to make these data public) that are more robust than those of the Public Use Database currently produced by the Federal Housing Finance Administration.

- All entities would participate in a yearly planning, reporting, and evaluation process covering their plans for and performance against both the single-family and multifamily performance standards and government-identified areas of special concern, such as rural housing, small rental properties, and shortages created by special market conditions such as natural disasters. Substantial underperformance could lead to fines and possible loss of the ability to access the guaranty.

This mechanism can proactively support the flow of fair and affordable credit by identifying market

gaps, elevating promising products, and halting predatory or discriminatory activity. As is the case in our current housing-finance structure, there must be a market regulator responsible for monitoring the use of the taxpayer guarantee, ensuring that the public benefit is not abused or unfairly rationed. Because it will have a comprehensive view of the national housing landscape, the secondary market regulator will be in the best position to ensure that the benefits of a taxpayer-funded guarantee are available to all qualified borrowers, regardless of the ultimate structure of the system.

6. ***The system should include provisions to help enable more borrowers to access the mainstream housing finance system.***

For generations, affordable homeownership has provided a primary means for families to climb the economic ladder and achieve financial stability. Homeownership results in a host of positive externalities both for families and for their neighborhoods, ranging from better health and education outcomes to safer streets and more small-business development. [23]

While mechanisms to level the playing field for creditworthy borrowers can help, they will not fill all the gaps left by a national history of discrimination and wealth disparities. These gaps are especially important to fill in the aftermath of the housing crisis, where many communities saw equity stripped by subprime lending or were hit very heavily by the recession and unemployment. These neighborhoods, who are most in need of capital to rebuild, will likely be the last to get it from a private market left to its own devices. The Community Reinvestment Act is too limited in scope to be expected to generate the level of support required solely through banks' balance sheet lending.

However, many prospective homeowners and owners of rental homes who are not easily served by private markets demanding competitive rates of return can be well served with limited amounts of credit enhancement. These borrowers inhabit a "grey zone" between private credit and fully insured credit through agencies like the FHA, VA and USDA's Rural Housing Services (RHS). During their most effective years, the GSEs generated some of this innovation through their own risk capital by relying on standard, fully documented loans; their large market shares; and broadly priced credit products, using limited pilots or trusted partners. Banks subject to the Community Reinvestment Act also do some of this on a limited scale, both internally and through support of mission-oriented intermediaries such as Community Development Financial Institutions (CDFIs).

To ensure that the new system has the capacity to serve these categories of borrowers, we propose establishment of a Market Access Fund, which would have three broad functions:

- Provide support for research, development and pilot testing of innovations in products, underwriting and servicing geared to expanding the market for sustainable homeownership and for unsubsidized affordable rental.

- Provide limited credit support for products that expand sustainable homeownership and affordable rental but that cannot be piloted at sufficient scale to determine whether they can be sustained by the private market, or, alternatively, are best served by FHA, VA and/or USDA or by state housing finance agencies.

- Provide incentive grants to encourage development of self-sustaining support services, such as housing counseling, that have proven effective in expanding safe and affordable homeownership, but that so far have not developed a sustainable business model that combines lender support, client fees and limited government and philanthropic subsidy.

We propose that the Market Access Fund be funded through a 10 basis point assessment on all securitized mortgages, whether or not an issue receives a federal catastrophic guarantee.[24] The fee would be structured as a "strip" from the mortgage coupon, in the same way that servicing fees are charged, and would continue for the life of the mortgage. It could be easily collected by the SEC on behalf of the Fund, or, if proposals for a single mortgage backed securities platform are implemented, by the platform. Estimates suggest this fee would result in approximately $5 billion in revenues by the fifth year of generation.

This fee would be split among the Market Access Fund, the National Housing Trust Fund, and the Capital Magnet Fund (the latter two funds were established by HERA but the FHFA has declined to fund them citing conservatorship as a reason, an action now being challenged in court[25]). The National Housing Trust Fund allows the states to expand the supply of rental housing for those with the greatest housing needs, and the Capital Magnet Fund enables CDFIs and nonprofit housing developers to attract private capital and take affordable housing and community development activities to greater scale and impact.

By creating and using the Market Access Fund in this manner, all participants in the mortgage market will be contributing to the stability of that market and of the economy. That will be a marked contrast to the pre-crash system in which the so-called private market was able to use the credibility and stability of the US capital markets to simultaneously abuse lower wealth borrowers and communities and make huge profits.

Other proposals call for all low- and moderate-income lending to be served through the FHA. This approach ignores the fact that much of this segment can be well and safely served by the core conforming conventional market, and that the primary market's conventional lending to such segments, through CRA and otherwise, depends on a reliable secondary market outlet. Instead, it would institutionalize a dual mortgage market, with less choice and higher costs for borrowers who would most benefit from access to the prime conventional market, and it would unnecessarily and inefficiently drive credit risk onto the government's balance sheet.

We argue that access and affordability objectives can be achieved whether the GSEs are replaced by numerous private credit-risk takers, a public utility, or a nationalized secondary market. That said, the more centralized the credit-risk-taking entity (s), and the more authority it has, the easier it is to align the delivery of the guaranty with broader housing policy objectives.

7. ***The system should provide financing to preserve the existing privately-owned affordable housing stock and support the construction of new affordable units.***[26]

Approximately one-third of Americans live in rental housing.[27] Rental homes provide a starting place for new households, mobility for people who move with their work, convenience to transit, a transition for older adults who no longer need a large home, and affordable shelter for many Americans of low and moderate income. Rental housing is in urban, suburban, and rural communities. As we restructure the mortgage finance system, we must ensure that it directs capital to rental housing, particularly housing that is affordable to low- and moderate-income households.

The cost of rental housing is an increasing burden, particularly for people with the least income. HUD recently reported that the number of low-income renter households with worst case needs increased to 8.48 million in 2011, up from a previous high of 7.10 million in 2009.[28] Looking specifically at working households, the Center for Housing Policy found that more than one in four renter households spent

more than half of their income on housing.[29] In most places, rents are rising faster than income.[30]

Rental housing needs access to capital to serve the many people who rely on it. Construction of new rental properties only occurs if there is permanent mortgage capital available to finance it once construction is complete. In addition, properties large and small need periodic renovations, typically every five to seven years. To preserve older affordable rental housing, developers often need financing to acquire as well as renovate the properties. The secondary mortgage market provides a critical source of capital to finance all of this construction, acquisition, renovation, and refinancing.

The primary means that the federal government uses to ensure that capital flows to rental housing are FHA and the GSEs, each of which has a division devoted to multifamily housing.[31] During the 2008 financial crisis, when private capital retreated nationwide, FHA and the GSEs were virtually the only sources of capital for financing rental housing.[32] Even as private capital has gradually returned to multifamily, it has mostly focused on A-class properties in the strongest urban and suburban markets, leaving government channels to finance older, less-expensive properties and those in secondary and tertiary markets. As private capital gradually broadens its risk exposure, the recent crisis is a reminder that only a government-supported channel provides the countercyclical capacity to ensure steady access to capital for rental housing.

But even under normal conditions, private sources of multifamily rental financing often cannot provide enough credit in rural areas and smaller cities or produce the long-term, fixed-rate mortgages that attract diverse investors and to produce affordable properties.[33] The GSEs have long played a role in making sure these gaps in the multifamily market are filled.

Performance of the GSE multifamily divisions, in particular, has been strong throughout the financial crisis. Default rates for Fannie Mae and Freddie Mac multifamily loans have remained well below 1% throughout and since the financial crisis—a fraction of the multifamily default rate seen by commercial banks and private-label MBS.[34] Disciplined underwriting, a strong network of originators, and active asset management kept both GSE's multifamily divisions profitable—far different from single-family.[35] That provides a strong track record on which to build as we consider options for housing finance reform for multifamily.

Ensuring adequate financing for affordable housing preservation and construction requires a carefully deployed and targeted government guarantee to encourage private capital to bear risk ahead of the government for affordable multifamily finance. It is essential that multifamily rental finance needs get explicit attention in housing finance reform so that the eventual new system preserves the strengths that have lasted through the financial crisis to finance affordable rental housing.

As we recommend in the single-family area, we believe the way forward should be for bond guarantors (most likely specializing in multi-family) to take predominant risk ahead of the government guaranty for permanent financing. These entities would be required, on an annual basis, to demonstrate that 60 percent of the units financed by securities it guarantees are affordable to a family making 80 percent of median income. Moreover, as in single family, the entities would pay the fee that will help support the National Housing Trust Fund and the Capital Magnet Fund – existing funds that, if properly capitalized, would help breach the housing affordability gap.

8. ***The system should support effective and fair mortgage servicing practices as well as appropriate systems to support clarity of property title.***

One of the most "broken" parts of the housing finance system is mortgage servicing. In the aftermath of the housing and financial crisis, the perverse financial incentives embedded in the current system of servicer compensation as well as confusing pooling and servicing agreements resulted in servicers severely compounding the damage rather than ameliorating it.

The single largest driver of the foreclosure crisis was servicers that routinely foreclosed on homes when foreclosure was not only unnecessary, but neither in the best interest of the investor or the homeowner. This occurred in large part because the way servicers are compensated gives them an incentive to pursue foreclosures over modifications. Once a loan is in default, servicers must choose to foreclose or modify. A foreclosure guarantees the loss of future income, but a modification will also likely reduce future income, cost more in the present in staffing, and delay recovery of expenses. Moreover, the foreclosure process itself generates significant income for servicers.[36]

Yet, for servicers, the true sweet spot lies in stretching out a delinquency without either a modification or a foreclosure. Income from increased default fees and payments to affiliated entities can outweigh the expense of financing advances for a long time. This nether-world status also boosts the monthly servicing fee and slows down servicers' largest non-cash expense, the amortization of mortgage servicing rights, since homeowners who are in default are unlikely to prepay via refinancing.[37] Finally, foreclosure or modification, not delinquency by itself, usually triggers loss recognition in the pool. Waiting to foreclose or modify postpones the day of reckoning for a servicer. But delay can cost a homeowner the opportunity to obtain a modification.

Servicers also have routinely overcharged homeowners and investors for routine activities such as insurance and default servicing fees. For example, overcharging for lender-placed insurance (also called force-placed insurance), as well as placing that insurance when not necessary, often pushed borrowers who were otherwise making their monthly payments into default and foreclosure. There is ample evidence that servicers have received kickbacks from insurers, made force-placed insurance a profit center through "commissions" to servicer affiliates, and entered into captive reinsurance schemes with servicer affiliates.[38]

Going forward, congressional legislation concerning the securitization system should build in standardization, accountability, and transparency concerning servicer compensation and contractual obligations. For example, servicers should be prohibited from having any financial interest in force-placing insurance other than the coverage provided by the insurance, and Congress can address the non-competitive market structure for third-party products generally – including title insurance, private mortgage insurance and force-placed insurance – by requiring mortgage securitization platforms to enable investors to directly purchase these products instead of reimbursing inflated charges made by servicers and loan originators. Contracts must spell out the core principle that servicers should act in the best financial interest of both investors and borrowers, keeping homeowners in their homes rather than foreclosing when doing so would return the greatest value to investors. Failure to fulfill this obligation should result in financial consequences that incentivize compliance. (While the Consumer Financial Protection Bureau has established loss mitigation standards for servicers that offer loss mitigation, it did not mandate offering loss mitigation, leaving this issue up to Congress.)

Additionally, once an initial request for loss mitigation has been made by the homeowner, the servicing agreements should require servicers to refrain from initiating a foreclosure or, where a foreclosure has been initiated, from taking any additional steps to pursue that foreclosure, until completion of the review

of any loss mitigation application, including written notice to the homeowner documenting any denial and the completion of any appeal process. The practice of pursuing loss mitigation and foreclosure simultaneously (also known as "dual tracking") has been one of biggest drivers of unnecessary foreclosures.

One structural suggestion for improving servicing practices is to provide bond guarantors with the ability to buy defaulted loans out of pools and hold them in portfolio to have more flexibility in modifying those loans. Ginnie Mae does not have a portfolio now, which requires servicers themselves to purchase loans having payment difficulties out of the pass-through securities and them attempt to re-securitize them. As a result, servicers can only modify the loans to current interest rates and 30-year terms (in other words, very shallow modifications) to fit into new Ginnie Mae pools. Fannie and Freddie, on the other hand, have been able to offer modifications that are both more affordable and sustainable because they can buy loans out of pools and hold them in portfolio, where it is easier to reduce interest rates and/or extend loan terms.

Another set of abusive servicer practices related to their failure to use the traditional systems of tracking property title, resulting in massive confusion and lack of ability to prove ownership or the right to foreclose. Various legislative proposals suggest creating one privately operated national system rather than multiple, publicly operated state systems. There are several problems, however, with such proposals.

First, clarity of real property title is a public good and should be provided by the government, rather than by private parties, as is already done by the federal government for patents, trademarks, copyrights, broadcast spectrum, airplanes, and nautical vessels, among other types of property.

Second, the existing proposals would separate land and mortgage records, which are currently maintained in unified local databases. While the aim in doing so is to improve on MERS, a troubled privately-operated mortgage registry, MERS operates as a superstructure addition to local land records, rather than as a completely separate database. When a lien is registered with MERS, MERS is listed as the lienholder in the local land records, with the actual mortgage rights tracked in MERS' electronic database, so someone investigating property title will see in the local land records that there is a lien. With a separate national system, local land records would cease to provide definitive sources of clear title, but would also continue to exist and be relevant for determining title. The result would undermine the very goal of a national system, as it would only add a title system, rather than consolidate existing ones.

Third, none of the proposals has considered the interaction between voluntary mortgage liens recorded in a national database and various types of involuntary liens (such as tax liens, construction liens, and judgment liens) recorded in local land records. Similarly, the national system would not be mandatory for all consensual mortgage liens, but only for those using a new federal securitization platform or insured by a new government-sponsored entity. This means that the national database would be incomplete even as to voluntary mortgages.

A fourth problem is that in about half of all states, a mortgage is considered actual ownership of the land with the borrower having a repurchase option, rather than as a lien, so mortgage recordation and transfer law in these states is subject to various legal requirements relating to the transfer of real property. The interaction of a national system with these local real property laws has not been considered and could potentially create more confusion than a national database resolves.

Finally, it is not clear whether there is constitutional authority for the federal government to interfere with real estate recordation, which is traditionally a local right.

A simpler solution to lack of consistency of mortgage title procedures among the states would be to recreate a federally-owned and operated MERS-type system that would sit as a superstructure on local land records. Such a system could easily interface with existing land records, local real property law, and lien priority rules. Further, with any federal-MERS system, it would be simple to correct the major failings of the MERS system: failure to properly and timely register transfers could have definite legal effects, thereby ensuring the accuracy of the database; foreclosures could be required to be undertaken in the name of the real party in interest; and transfers within the database could only be made by properly registered and vetted agents of lenders, rather than by MERS' poorly-supervised and much-criticized system of 20,000 "signing agents," none of whom actually work for MERS.

9. The system should provide access and a level playing field for both large and small lenders.

A diverse lending market is crucial for ensuring broad access to credit for all borrowers and communities, including rural communities, communities of color, and communities that have been hard-hit by the recession. A secondary market that enables lenders of all sizes in all communities to offer mortgages on equal and well understood terms is one of the major beneficial functions of Fannie Mae and Freddie Mac that, going forward, the reformed system must retain and even improve on.

In revamping the current housing finance system, we risk building a system that favors large, well-capitalized banks (and their affiliates) and leaves small originators at the mercy of their larger competitors as to whether and under what terms they can access the government-guaranteed market. Some proposals, including S. 1217 and the Bipartisan Policy Commission proposal, would explicitly allow banks and originators to perform the predominant credit risk-taking function. In a marketplace already characterized by extreme concentration of origination and servicing in entities that have both explicit government guarantees (on deposits) and implicit guarantee ("too big to fail"), this structure would only extend the large banks' market power and encourage the accumulation of risk with an implicit government guaranty. In effect it would be recreating Fannie and Freddie, except under the control of the largest originators. While proponents point to the Ginnie Mae model where originators are also issuers, they ignore the fact that the credit risk-taking function is not provided through Ginnie Mae or the issuers, but through FHA on a per-loan basis, universally available on equal terms. In the case where issuers themselves are determining the risk parameters and pricing for the predominant credit risk, such a transparent and level playing field will be hard to achieve.

In our view, originating lenders should not also be able to own the bond guarantors or other entities that perform the predominant credit risk-taking function, except as part of a broad-based mutually owned entity designed to ensure access at equitable prices to smaller lenders such as community banks, credit unions and community development finance institutions. It might also be appropriate for a government entity, such as a housing finance agency or agencies, to become a guarantor. While S. 1217's proposal of a cooperatively-owned entity is a useful idea, in the context of the rest of the bill, it is not clear that it would provide comparable access on equal terms.

10. The system should include strong regulatory tools to supervise, monitor and ensure the appropriate operation of entities that provide access to the government guarantee.

Regulatory supervision for system safety and soundness will be a crucial part of a well-functioning housing finance system. Lax regulation and captured regulators in many ways led to the crisis we

recently experienced, both in the housing finance system and the financial system as a whole. As former FHFA director James Lockhart recently noted, "An ounce of prevention is worth a pound of cure."[39]

For any new system, it is critical that the government have access to the full range of regulatory tools to supervise bond guarantors, issuers, and other counterparties. There needs to be a regulator with authority to examine and even take injunctive type action, similar to the FDIC's Prompt Corrective Action, or PCA, which can and should be done in coordination with the FMIC if the FMIC is not the primary regulator. Furthermore, any entity providing insurance of any type, whether it's loan or pool level, must be licensed as an insurer either by a state (potentially subject to standards set at the federal level) or by the federal government.

We believe that effective oversight may be difficult to achieve in a system where issuers engage in diverse structured transactions. Initial "approval" of an issuer does not equal oversight, and in fact, may be counterproductive in that it may give a green light to subsequent actions that are unmonitored by the regulator. It will be much more effective to provide the FMIC with adequate tools, including the power to charter or license bond guarantors, and other counterparties have their own regulators with whom the FMIC can coordinate.

Conclusion

From the 1930s through the end of the last century, the United States enjoyed a vibrant, stable, housing market that evolved to provide liquidity for mortgages in all parts of the country through every business cycle. The system was not perfect, but it taught us valuable lessons as we look to rebuild. By applying those lessons, we have the opportunity to build a mortgage market that is fair, accessible, affordable, and fiscally sound -- in short, one that works better for more households and communities than ever before.

Thank you again for inviting me to testify today. I look forward to continuing discussion on these important matters as the Senate moves forward on housing finance reform legislation.

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PREPARED STATEMENT OF JEROME T. LIENHARD, II

PRESIDENT AND CHIEF EXECUTIVE OFFICER, SUNTRUST MORTGAGE, INC.

SEPTEMBER 12, 2013

Good morning Chairman Johnson, Ranking Member Crapo and Members of the Banking Committee. I'm Jerome Lienhard, president and CEO of SunTrust Mortgage, a subsidiary of SunTrust Banks. Housing finance reform is a critical matter with wide-ranging implications. Thank you for allowing me to participate in the consideration of this important subject.

I am appearing today in my capacity at SunTrust Mortgage and this testimony was prepared after consultation with the Regional Bank Group, an informal coalition of mid-sized lending institutions located throughout the United States. All views expressed today, however, are my own.

SunTrust is headquartered in Atlanta and operates mainly in the Southeastern United States. We are committed to *Lighting the Way to Financial Well-Being* by listening to client needs and offering a broad range of banking, borrowing, and investment services for individuals and small to-mid-sized businesses.

SunTrust Mortgage, the organization that I lead, is based in Richmond, Virginia and employs about 4,300 teammates. Last year, we originated over $32 billion in mortgage loans which helped more than 120,000 clients purchase a home or lower their monthly payment through refinancing.

The Regional Bank Group consists of 18 financial institutions that share a business model and a set of values dedicated to providing banking products and services to America's families and businesses. We take in deposits and redeploy them by making loans in our communities. Our clients are people and businesses with real needs such as checking accounts, loans and payment services.

Today I'd like to make two important points from the perspective of a regional bank:

- First, while there is a need to reform the housing finance system, it is critical to retain the basic "plumbing" of the system that draws in enormous sums of investment capital and provides borrowers with rate certainty. These features can be retained in a mortgage market that serves the interests of borrowers and taxpayers alike.
- Second, reform must bring more private capital into the mortgage market in a principal loss position without reducing the global demand for mortgage-backed securities and while providing competitive access for small and medium-sized institutions that serve millions of homeowners.

I will spend a few minutes elaborating on each of these points.

Out of thousands of mortgage loans that we make every year, on average, we hold only one in six on our balance sheet. So while we own $30 billion worth of mortgage loans, we actually originated and service more than $140 billion in mortgages involving more than 800,000 households. This is possible for us, and other regional banks, due to the existence of the secondary mortgage market.

This vast majority of the mortgages we originate for sale in the secondary market are either "conforming" loans, meaning they comply with the guidelines set by Fannie Mae and Freddie Mac; FHA loans, which comply with the insurance terms established by the Federal Housing Administration in HUD; or VA loans eligible for the Veterans Administration's guaranty program.

The process by which we price and close the loan and package it for the secondary market are important to a well-informed discussion relating to housing finance reform.

Our clients come to SunTrust Mortgage through our branches, on-line or through our network of loan officers and institutional mortgage partners. We listen closely, assess needs, and thoroughly explain the full range of products that we have available to our clients.

To provide the client with basic information regarding how much they can afford to pay for a house, we must be able to tell them the interest rate and the monthly cost of the loan. You can't buy a house if you don't know what your mortgage payment will be.

We do this by referencing a daily pricing sheet that provides the interest rate and loan terms that can be offered on a guaranteed basis. These prices are set from the price of MBS trading in the "To Be Announced" (TBA) market. TBA security prices assume delivery of conforming mortgages into a Freddie Mac or Fannie Mae mortgage-backed security on a forward basis. The forward-pricing mechanism of the secondary market allows us to lock in the interest rate for clients for up to 90 days.

Once we lock an interest rate, we proceed through the mortgage lending process. Acting as an agent for Fannie Mae and Freddie Mac, we make sure the client's mortgage is properly qualified, underwritten, documented, settled and delivered using GSE guidelines and requirements. This requires expertise and very detailed execution.

But it all starts with the certainty we have regarding how we are funding the mortgage. Without that certainty, primary market lenders would be unwilling and unable to provide forward price certainty to borrowers. The MBS market solves the "chicken or egg" problem of funding risk by allowing lenders to set mortgage loan delivery terms up front, while allowing execution and delivery to follow.

Through the combination of mortgage standardization and the function of the MBS market, the existing system provides a tangible benefit to borrowers. And these benefits are available for borrowers who transact with originators of any size: local banks, Main Street banks such as SunTrust, as well as the largest mortgage originators.

While there is a need to address taxpayer risk by making structural changes to the housing finance system, the securitization platform, the standard-setting on lending and documentation and the servicing requirements are absolutely essential to maintaining a secondary market. This infrastructure is so foundational that we must emerge from housing finance reform with these key functions intact.

Let me conclude with a few remarks on the critical issue of the structure of the credit guarantee. Our markets perform so well in large part because credit risk associated with mortgage default is assumed by the GSEs. Investors from around the world allocate trillions of dollars of capital to our market because it only involves interest rate risk.

The problem, of course, is that providing credit protection puts taxpayers at risk. Using private sources of capital to cover credit exposure can help alleviate taxpayer risk.

However, if changes are made to the credit guarantee function, it must work well for investors. It must also operate transparently and with scale. The U.S. mortgage market involves trillions of dollars. This quantity of private capital required to backstop the market is very significant. If that market shrinks dramatically, so does lending to borrowers.

We must also consider that if a variety of credit risk devices emerge in place of the relatively simple credit guarantee we have today, it could make mortgage-backed securities difficult for investors to value, fracturing the investor base, reducing liquidity and increasing costs.

To the extent that private capital is intended to stand before any taxpayer-backed guarantees, the entities and instruments must be subject to regulatory oversight. If regulators cannot understand nor keep track of the various risk sharing mechanisms, there is a danger that they will not perform as needed under crises conditions.

Finally, any new source of private sector credit protection should be available for all primary market lenders—including large, small and Main Street institutions. If certain entities cannot obtain competitive access to credit protection in the secondary market, they will have a great difficulty competing in the primary market. Measures that create advantages for the very largest issuers of MBS, or make the cost of market access more expensive for some and not others, will reduce competition and must be avoided. Additionally, any new framework should maximize the secondary market liquidity in the new MBS to ensure that regulated financial institutions are able to participate as investors, use the securities as liquid assets, and pledge them as collateral.

Let me conclude by thanking the Committee again for its time, attention and consideration. We stand ready to provide you with any assistance or advice you may need as your important work continues. I look forward to answering any of your questions.

PREPARED STATEMENT OF RICHARD JOHNS

EXECUTIVE DIRECTOR, STRUCTURED FINANCE INDUSTRY GROUP ("SFIG")

SEPTEMBER 12, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee on Banking, Housing and Urban Affairs:

My name is Richard Johns. I am the Executive Director of the Structured Finance Industry Group, Inc. ("SFIG"), a trade industry education and advocacy group established in March 2013 that presently is comprised of over 160 corporate members

from all sectors of the structured finance and securitization market, including investors, issuers, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers, and trustees. A key element of SFIG's mission is to educate and advocate on behalf of the structured finance and securitization industry with respect to policy, legal, regulatory and other matters affecting or potentially affecting the structured finance, securitization and related capital markets. It is with that mission in mind that I thank you for this opportunity to address the Committee regarding proposed housing finance reforms, including the role to be played by the Government in the housing finance system and the importance of returning private capital to the mortgage market.

As this Committee continues its examination of potential reforms to our system of housing finance, SFIG welcomes the opportunity to provide commentary and analysis, particularly as it relates to the impact of various reform options on the securitization markets. Before I proceed, I want to acknowledge the effort of all those who are working to make reasonable but necessary reforms to the housing finance system. SFIG believes that the reform process must proceed in a measured and deliberate way, and we appreciate the Committee's methodical approach in considering reforms that are so inherently critical to the U.S. housing market and the economy as a whole. As an organizing principle for this process, we suggest that there are three sequential stages that any reform effort should follow in order to preserve the TBA ("To Be Announced") Market. First, a conversion into a common TBA should be adopted, making Fannie and Freddie MBS fungible and therefore deliverable into a single TBA Market, eliminating current pricing and liquidity inefficiencies in the Agency Market.[1] Second, any reform legislation should provide for the creation of a single agency security that not only would facilitate the conversion and continued liquidity of legacy securities but also would promote a deep and liquid new-issue MBS market. Third, a common securitization platform should be established for the purpose of overseeing and maintaining the standardization of the market for Government-guaranteed MBS. With that organizing principle in mind, SFIG believes that there are a number of issues that must be addressed in any reform process, specifically:

- An integral part of any reform will be to ensure the continued liquidity of the TBA Market, which is the most efficient and cheapest mechanism to enable a mortgage consumer to "lock in" the interest rate at the time when a mortgage loan is approved and thereby minimize the cost of borrowing. The TBA Market also creates efficiencies and cost savings for lenders that are passed on to borrowers in the form of lower rates. Currently, the TBA Market is reliant in part on the existence of Government-guaranteed MBS, making it imperative that any reform legislation include provisions that preserve some form of a Government guarantee.
- The best approach to risk sharing in a reformed housing finance system would be for private capital to assume the first risk of loss, the proper amount of which should be flexibly assessed in light of market factors, while retaining an explicit Government backstop against catastrophic loss. The retention of the catastrophic Government guarantee is critical to ensuring the continued participation of institutional "rate investors," which provide a majority of the capital currently invested in the Agency Market.
- The transition from the status quo to a new housing finance structure must be transparent, appropriate to market conditions, and handled with great care to minimize any disruptions to the flow of credit to consumers, and in particular to ensure the continued functioning of a healthy TBA Market. Of utmost concern is that steps must be taken to allow the fulfillment of existing commitments (including contracts for future delivery) and preserve the market for legacy securities (*i.e.,* outstanding Government-guaranteed MBS), while allowing sufficient time for eligible loans under the reformed system to be generated and take hold in the TBA Market. SFIG believes that the best way to facilitate this transition would be to create a single agency security to which legacy securities would be converted and which Fannie and Freddie could begin issuing even before a single securitization platform is fully functional. This would allow for cost savings as well as greater liquidity in the TBA Market. Failure to take such steps not only would discourage investors from participating in both the leftover

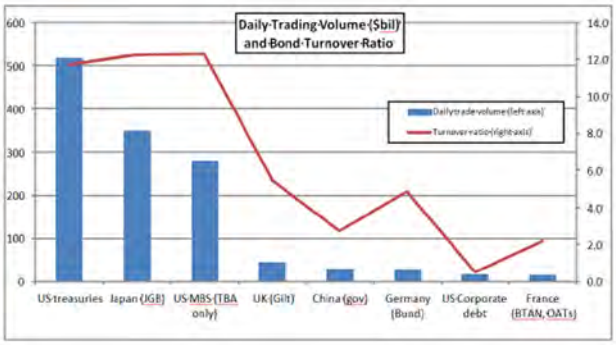
[1] In order for a common TBA to be implemented successfully, a number of issues need to be considered and addressed, and SFIG believes originators, financial intermediaries and investors must play a major role in that process.

and post-reform TBA Market, but it also would create substantial mortgage funding issues.

- Any new infrastructure for the housing finance system must provide for or facilitate the standardization of MBS instruments that receive an ultimate Government guarantee in order to ensure the continued functioning of the TBA Market. Standardization is critical to maintaining the fungibility and liquidity of the Government-guaranteed MBS that drive the TBA Market.
- Any reform legislation should leave to regulators, working with market participants, the determination of the specific types of representations, warranties, enforcement provisions and recourse to be used in the new housing finance system.
- With respect to affordable housing, Congress should explicitly promote that goal through a stand-alone program not linked in any way to the operation of the secondary mortgage market, and should fund that program through separate legislative mechanisms.
- Conversely, Congress should reduce the upper loan limits for Government-guaranteed loans to ensure that the benefits of low-cost mortgage loans are directed at the segment of the population most in need of those loans.

REFORMS MUST PRESERVE THE SMOOTH FUNCTIONING OF THE TBA MARKET.

As shown in the chart below, the TBA Market is the third most liquid securities market in the world.[2]



Moreover, more than 90 percent of Government-guaranteed MBS trading volume occurs in the TBA Market. Accordingly, any reforms must be complemented by steps to ensure the TBA Market's continuing efficiency and liquidity.

The TBA Market creates efficiencies and cost savings for lenders that are passed on to borrowers in the form of lower rates. It also is the most efficient and cheapest mechanism to enable a consumer to "lock in" the interest rate at the time when the loan is approved, rather than take the risk that interest rates will rise between approval of the loan and the closing of the loan, which would increase the cost of the mortgage loan to the consumer and possibly make it unaffordable. The TBA Market does this through a system of forward trades of mortgage loan pools for guaranteed MBS that facilitates the shifting of interest rate risk into the capital markets. Thus, originators can offer consumers this ability to "lock in" mortgage rates by hedging the risk that interest rates will rise between application and closing. In this way, the TBA Market allows for stability between the time of loan origination and loan closing, ensuring that the terms of a mortgage loan do not fluctuate due to macroeconomic changes and reducing costs to consumers.

The distinguishing trait of trades in the TBA Market is their homogeneity (*i.e.,* standardized underwriting criteria and loan features, the Government guarantee, the geographic diversification incorporated into the pooling process, the limited number of issuers, the simple structure of "pass-through" security features, and the

[2] Sources: Securities Industry and Financial Markets Association; UK Debt Management Office; FRG Finance Agency; Japan Securities Dealers Association; *AsianBondsOnline.com;* Agence France Tresor Monthly Bulletin.

restriction of the range of interest rates on loans deliverable into a single security). The parties to the trades agree only on certain criteria of the securities to be delivered: issuer, maturity, coupon, price, par amount, and settlement date. The actual securities to be delivered at trade settlement are not specified on the date the transaction is executed. Rather, just before the settlement date, the seller notifies the buyer of the specific securities that will satisfy the TBA agreement.

Because TBA buyers are indifferent as to the specific securities delivered, originators are able to easily and inexpensively cover their hedges should they originate less collateral than expected in any given period, significantly reducing the cost to hedge and rate lock. Moreover, since the TBA Market simplifies the analytical and risk management challenges for participants, a broader group of investors participates in the TBA Market than would otherwise participate if investment decisions were more complex. The additional investors-specifically foreign central banks, mutual funds and hedge funds-inject more capital into the market for financing mortgages and ultimately reduce the cost of capital to consumers.

Homogeneity is what makes the TBA Market possible, specifically, the fungibility of the conforming loan product (through standardized underwriting criteria and loan features) and a Government guarantee, which equalizes credit risk. Additionally, due to the specific exemption from SEC shelf registration requirements applicable to Government-guaranteed securities, specific collateral need not be identified, thus allowing forward selling. It is not possible to replicate the TBA Market without these factors. Any reform which does not accommodate, or suitably replace, the existing TBA Market will undoubtedly impact mortgage originators and consumers both severely and negatively by reducing price transparency, liquidity, and the originators' options to rate lock and thus satisfy consumer needs.

In short, the TBA Market removes uncertainty from the mortgage origination business and keeps mortgage rates low for potential borrowers. As noted in a report published by the Federal Reserve Bank of New York, "the TBA market serves a valuable role in the mortgage finance system," and "evaluations of proposed reforms to U.S. housing finance should take into account potential effects of those reforms on the operation of the TBA market and its liquidity." *TBA Trading and Liquidity in the Agency MBS Market,* James Vickery and Joshua Wright, FRBNY Economic Policy Review, May 2013.

One factor that any reform must account for is that the TBA Market is reliant in part on the existence of MBS that are guaranteed by the Government. For that reason, the TBA Market is extremely sensitive to any changes to the role that the Government will have in the housing finance system going forward. Indeed, the TBA Market could not be recreated without the features discussed above that are unique to Government-guaranteed MBS. Accordingly, SFIG believes that the maintenance of a partial, second-loss Government backstop against catastrophic loss for MBS is crucial to preserving the health of the TBA Market and continuing to promote stability and affordable interest rates for consumers in different market cycles.

THE HOUSING FINANCE SYSTEM WORKS BEST WHEN THERE IS RISK-SHARING AMONG PARTICIPANTS.

Mortgage securitization is by nature a process by which the risks associated with residential mortgage lending are spread among various investors with differing appetites for risk. Attracting private capital to undertake these risks is of critical importance to the consumer and the economy as a whole. The Government has always guaranteed a large percentage of residential mortgage securitization, but historically the market also included securitizations funded solely by private capital with no explicit Government guarantee. These two markets cater to two different types of investors distinguished by the type of risk that each is willing to undertake, specifically, "rate risk" and "credit risk." For this reason, any reforms that aim to limit the Government's involvement in the Agency Market by changing or ending the current infrastructure must account for the impact that such changes will have on the flow of private capital that historically has favored Government-guaranteed MBS.

As noted, there are two main risks associated with residential mortgage lending. The first, called market or rate risk, results from interest rate changes. After the interest rate on a residential mortgage loan is set (for example, the interest rate on a fixed-rate residential mortgage), that mortgage loan becomes less valuable over time if current residential mortgage rates rise, because the owner of that mortgage loan earns less in interest than it would if it owned a mortgage loan at the current (higher) market rate of interest. In addition, a consumer generally has the right to prepay his residential mortgage loan at any time (for example, if the consumer decides to sell the home), which may reduce the economic upside to the owner of the mortgage loan. Furthermore, refinancing of residential mortgages generally occurs

when interest rates fall. The specific market risks associated with owning residential mortgage loans are dependent on the precise terms and types of mortgage loans.

The second risk associated with mortgage lending is credit risk. Credit risk consists of two components: (1) default risk; and (2) loss severity risk. Default risk is the risk that the consumer fails to repay the loan. Loss severity risk is the risk that, after a consumer defaults, the lender will not recoup all of the principal lent and the expected interest on that principal.

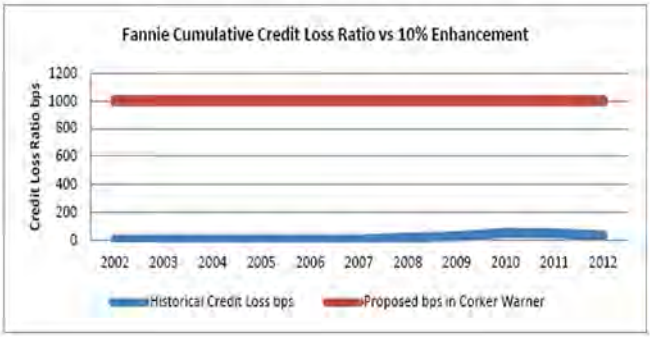
Private capital "rates investors" are willing to bear the rate risk and prepayment risk, but seek to avoid credit risk, because these investors operate under investment guidelines, capital requirements, and liquidity requirements that preclude them from purchasing private-label securities in any significant concentration. Examples of rates investors are foreign central banks, domestic banks and mutual funds. Historically, "rates investors" have been attracted to Government-guaranteed MBS—in which the Government bears the bulk of the credit risk—and they have contributed trillions of dollars to the Agency Market because of those guarantees. By contrast, "credit investors" such as insurance companies and investment funds have fewer constraints on taking credit risk, and may in fact actively seek it out in exchange for higher potential returns.

Limiting the Government's involvement in the market by changing or ending the current infrastructure must account for the critical contribution that rates investors make to the Agency Market and their historic aversion to credit risk, as well as the limited pool of private capital available to fund credit risk. Accordingly, SFIG believes that retention of a catastrophic-loss Government backstop is essential to maintaining and increasing the participation of rates investors in the Agency Market. Indeed, SFIG believes that the TBA Market and the rates market for MBS cannot function without such a guarantee.

However, we also acknowledge that private investors have a role to play in insuring against the credit risks posed by residential mortgages. To that end, SFIG generally supports the approach of having private capital take on credit risk, while also having a Government guarantee that is explicit and priced in a reasonable manner. Any risk-sharing structure should be carefully reviewed to ensure that the TBA Market is not disrupted. Furthermore, we believe that private capital should be placed in the first-loss position, with the private credit enhancement being calculated to cover reasonable risks presented by the market and the Government backstop covering catastrophic risk, *i.e.,* the Government guarantee will generally be called upon only when the operation of the secondary mortgage market as a whole is at risk.

SFIG supports a variety of mechanisms to bring private capital into the mortgage market, including corporate guarantees and capital markets transactions. Various forms of capital should be allowed to compete on a level playing field that balances sufficient risk retention at each step of the origination process to align incentives with the separation of functions and responsibility necessary to attract diverse capital sources.

As for the amount of risk that a private investor should be required to assume, SFIG believes that the 10 percent first risk of loss provided for in S. 1217 is too high, as shown in the chart below.[3]



[3] Source: Securities Industry and Financial Markets Association, *Housing Finance, September 2013,* at 10.

We suggest that, if the Committee is determined to include some minimum level of risk assumption in the legislation, the level be considered a "target" that the Committee establishes based on underwriting-related factors, such as historical loss data in the TBA market. Furthermore, the regulators should have the discretion to deviate from the target based upon their own assessment of qualitative risk factors.

The regulators will have to take a variety of complex factors into account to ensure that the private credit enhancement is rationally sized at a level that is commensurate with the qualitative attributes of risk-sharing structures. These factors include readily available historic information, the likely loan types, general housing/economic indicators, any applicable representations and warranties, and whether the various forms of insurance and guarantees—*e.g.,* the combination of homeowner's equity and mortgage insurance, Mortgage Insurance Fund coverage, and the Government catastrophic guarantee—may be duplicative and overlapping due to counterparty risk, thereby reducing the amount of risk that private investors should assume.

We believe that if the required private credit enhancement is too high and vastly exceeds the loss expectations of the associated assets, the redundant enhancement creates the potential for distortion. Originators must find a way to pay for the enhancement, and the available options may not be good for the consumer or housing market. For example, an originator may simply pass the cost of the redundant enhancement directly through to consumers via increased rates, thereby undermining one of the primary benefits that the Agency Market affords consumers, namely, lower cost loans. And even if such steps are taken, the possibility remains that there might not be sufficient private capital in the market to satisfy a private credit enhancement level that exceeds what is necessary to address the actual risk factors.

THE TRANSITION TO A NEW HOUSING FINANCE STRUCTURE SHOULD BE IMPLEMENTED GRADUALLY AND WITH GREAT CARE.

The transition from the status quo to a new housing finance structure must be handled with great care to minimize any disruptions to the flow of credit to consumers. The transition process should be carefully implemented, and to avoid severe market disruption should allow for: (1) a clear and transparent plan for transition; (2) a determination that market conditions are appropriate for the transition; (3) the fulfillment of existing commitments (including contracts for future delivery); (4) a determination that issues relating to legacy securities have been appropriately handled; (5) time to generate eligible loans; (6) testing or piloting the new structure in a real market environment; and (7) continuation of the TBA Market.

SFIG's primary transition-related concern centers on ensuring that whatever system is put in place, it performs and functions properly and continues to facilitate a robust TBA Market. It is imperative that steps be taken both to preserve the market for legacy securities (*i.e.,* outstanding Government-guaranteed MBS), while allowing sufficient time for eligible loans under the reformed system to be generated and take hold in the TBA Market. Otherwise, the post-reform TBA Market will stall as: (1) investors in legacy securities are left with orphaned securities that continue to lose value as they factor down and their market becomes smaller and smaller; and (2) the market for new agency securities takes time to ramp up.

SFIG believes that the surest method of facilitating a smooth transition is to allow for a conversion mechanism such that existing Government-guaranteed MBS are interchangeable with the new Government-guaranteed MBS. Fannie and Freddie could begin issuing a single mortgage-backed security even before the single securitization platform is fully functional. This would allow for cost savings as well as greater liquidity. Failure to take this step not only would discourage investors from participating in both the leftover and post-reform TBA Markets, but it also would create substantial mortgage funding issues as liquidity diminishes.

SFIG also believes that all market participants would benefit to the extent that the current and new infrastructures operate in tandem for some period of time, or, in the alternative, appropriate portions of the current infrastructure are utilized by the new infrastructure. In addition, a final wind down of Fannie and Freddie should happen only after the new framework has been sufficiently tested and we can all be confident that it will facilitate the continued functioning of the TBA Market.

We believe that these and other operational and delivery issues that will arise from the winding down of the existing framework and the ramping up of the new framework should be minimized by actively engaging directly with the relevant industry participants to determine the appropriate balance of regulatory discretion and legislative guidance regarding how the transition should proceed, as well as maintaining consistency (to the extent feasible) among the MBS issued across the platforms.

STANDARDIZATION IS ESSENTIAL TO THE FUNCTIONING OF THE REFORMED TBA MARKET.

Any new infrastructure for the trading of Government-guaranteed securities will necessarily include requirements for areas such as disclosure, documentation, data collection and overall standardization of Government-guaranteed MBS transactions. Indeed, standardization of documents (*e.g.,* standard Government loan forms), structuring and underwriting (*e.g.,* conforming loan limits, document verification, *etc.*) is critical to the TBA Market because it increases fungibility and liquidity of Government-guaranteed MBS. These requirements should be very transparent, take into consideration the needs of all parties to the transactions, and include investor protections. Important to this standardization of the market will be establishing common infrastructure in the form of a common securitization platform that will lower barriers to entry for new participants into the system and enable different entities to issue a single security without variation.

We would also caution that standards and practices that may or may not be appropriate for the new Government-guaranteed securities may not be appropriate for private-label securities given the wide variety of loan types, origination practices, servicing contracts, deal structures and the difference in negotiating power of transaction participants. The newly reemerging private-label RMBS market should not be expected to align completely with the rules and standards that are developed for the new Government-guaranteed securities. As noted above, the two markets cater to two different types of investors.

LEGISLATION SHOULD NOT SPECIFY THE TYPES OF REPRESENTATIONS AND WARRANTIES TO BE USED IN THE NEW HOUSING FINANCE SYSTEM.

We do not believe that language specifying the types of representations, warranties, enforcement provisions and recourse to be used in the new housing finance system should be prescribed in legislation. Rather, these are matters that should be left to the discretion of regulators. SFIG is actively focused on evaluating different representation, warranty, enforcement and recourse approaches that have arisen in the private-label RMBS market. We have also begun a dialog with regulators and agencies regarding this topic to explore how the Government might incorporate our analyses into its current efforts. Areas of particular interest include common securitization platform, secondary market viability of loans that do not meet Qualified Mortgage-Safe Harbor and Qualified Residential Mortgage standards, Regulation AB 2 proposals and due diligence, data, breach, repurchase and other disclosures.

AFFORDABLE HOME OWNERSHIP SHOULD BE PURSUED THROUGH A SEPARATE, EXPLICIT PROGRAM DEDICATED TO THAT GOAL.

SFIG agrees that all segments of American society should have the opportunity to become home owners and that the Government can and should play an important role in making that goal a reality. However, we do not agree with the current system, which has led to implicit subsidies in the form of purchases of subprime loans from noncreditworthy consumers. Instead, SFIG believes that Congress should explicitly promote affordable housing through a stand-alone program not linked in any way to the operation of the secondary mortgage market, and should fund that program through separate legislative mechanisms.

On the flip side of the equation, we also agree that the current upper limits for Government-guaranteed loans should be reduced, to ensure that the market is focused on the segment of consumers for whom the Government guarantee is most essential in obtaining reasonably priced residential mortgages.

CONCLUSION

The issues confronting the Committee as it considers reforms to the housing finance system are critical not only to the health of the nation's housing market, but to the growth of the nation's economy generally. While we recognize the need to correct the errors of the past, we urge the Committee not to lose sight of the ways in which the Agency Market has worked well, and continues to work well (such as through the TBA Market), to facilitate the ability of Americans to enjoy the benefits of home ownership. To that end, we encourage the Committee to strive to retain the mechanisms, such as the Government guarantee, that have succeeded in bringing vast amounts of private capital into the housing market, while it takes steps to more equitably and effectively distribute the risks related to residential mortgages.

We look forward to working with the Committee as it considers these vitally important issues. Thank you again for the opportunity to share SFIG's views.

Written Testimony of Mark Zandi
Chief Economist and Co-Founder Moody's Analytics

Before the Senate Banking Committee

"Essential Elements of Housing Finance Reform"

September 12, 2013

The nation's housing finance system is dysfunctional and should be reformed.[1] Since the government took over Fannie Mae and Freddie Mac during the financial collapse five years ago, effectively nationalizing the nation's housing finance system, nothing meaningful has changed. The government still makes nearly nine of every 10 U.S. mortgage loans.[2] This is bad for both taxpayers and homebuyers.

As policymakers decide how to reform the housing finance system, it is critical that the future system achieves the following goals:

- *Stability.* The future housing finance system must be resilient to crises. Financial market panics and the failure of private financial institutions should not impair the flow of mortgage loans. Households and investors must be confident that they can finance properties, and buy and sell securities under all economic conditions.
- *Liquidity.* The system must be sufficiently deep, standardized and transparent to attract a wide range of global investors and to operate efficiently. The system must be able to provide desirable mortgage products such as long-term, fixed-rate fully pre-payable loans to creditworthy borrowers under all market conditions.
- *Access and equity.* The system must allow all creditworthy borrowers a chance to obtain mortgage loans they can repay under normal life circumstances. Entities operating in the system must serve all qualified mortgage applicants without regard to race, color, national origin, religion, sex, familial status, or disability.
- *Affordability.* The system must provide support to expand access to affordable mortgage financing and for affordable rental housing, explicitly and on-budget.
- *Taxpayer protection.* The government's role in the housing system must be explicit and transparent, with significant private capital at risk ahead of taxpayers. Premiums to cover the government's risk should be on-budget, and subsidies to ensure the system meets other public purposes should be funded from dedicated fees.
- *Market-driven.* The current outsize government role in the system should recede as private capital returns. Private market participants with their own capital at risk should be primarily responsible for allocating resources between housing and other activities. The system should allow entry and innovation by new participants of all sizes and ensure that financial institutions in the new system are not too big to fail.

To achieve these goals, the future housing finance system should embody a number of essential elements:

- *Catastrophic government backstop.* The federal government must provide an explicit catastrophic backstop to the future housing finance system. Private investors should provide the first-loss capital supporting the system, but there should be a government backstop in case of a catastrophic financial crisis. That is, under almost all circumstances, private investors shoulder losses when mortgages default. But during rare, catastrophic situations such as the Great Recession, when mortgage losses wipe out private capital, the government should ensure that mortgage lending is uninterrupted. This is a hybrid housing finance system.

  A hybrid system will preserve the long-term fixed-rate mortgage as a mainstay of U.S. housing, and it will ensure that affordable mortgage loans are available to most middle-income Americans through good and bad times. Taxpayers backstop the system, but it should be designed so that mortgage borrowers bear the ultimate cost.

- *Substantial private capital.* 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.

- *Varied sources of private capital.* The future housing finance system should attract varied sources of private capital to bear risk ahead of the government and to protect taxpayers. At the level of individual mortgages, private capital sources should include homeowners' down payments and the capital of any private mortgage insurers attached to the loan. At the level of the mortgage-backed security, capital sources should include, but not be limited to, the capital of the mortgage guarantors, risk retention by mortgage issuers, and the capital put at risk by global investors who take on housing risk from mortgage guarantors. This risk transfer could take place in a variety of ways, including through nonguaranteed tranches of guaranteed MBS, credit-linked notes, and credit default swaps.

- *Strong regulator.* To ensure the integrity of the housing finance system, it should be overseen by a strong regulator, fashioned along the lines of the FDIC. The regulator will ensure that private participants in the system are well-capitalized and that the mortgages receiving the government backstop are of high quality. The regulator's role in the housing finance system would be similar to the FDIC's role in ensuring the integrity of the nation's banking system. It would manage an insurance fund, funded by mortgage borrowers, to pay for any future costs that the government bears backstopping the system.

- *Common securitization platform.* A government-run common mortgage securitization platform would leverage current efforts by the Federal Housing Finance Agency to develop a single securitization platform for Fannie and Freddie securities. The platform would be used for all non-Ginnie Mae government-guaranteed securities and, although not required, could be used for nonguaranteed securities. A common platform would result in greater standardization, benefit from significant economies of scale, and provide a more liquid market for MBS, to the benefit of both investors and homeowners. A common security platform would likewise make it easier to modify loans if needed during future housing downturns, and allow for a "to-be-announced" trading market that remains liquid and makes it easier for originators to offer rate-lock commitments. Loans that use the securitization platform should be covered by a uniform servicing standard, encouraging prudent underwriting and aligning investor and borrower interests.

- *Competitive and independent mortgage guarantor market.* Mortgage guarantors providing capital to the housing finance system should be independent from large institutions that originate mortgage loans. This is necessary to impede vertical integration in the system, which would restrict entry of new sources of private capital and stifle competition. This would also facilitate better risk management, as both originators and guarantors would assess the risk of the mortgage loans and securities they are originating and securitizing. A sufficient amount of private capital should be forthcoming to the new housing finance system despite this line between large mortgage originators and guarantors.

- *Equal access and affordability.* All creditworthy borrowers and small lenders should have equal access to the government backstop. With so many communities devastated by the foreclosure crisis and so many family balance sheets impaired by the economic dislocation of the last five years, private markets alone may prove reluctant to serve all those able to manage prudent mortgages made on sustainable terms. The future housing finance system should provide transparent on-budget mechanisms and funding to support access to affordable housing, for both owners and renters. Small mortgage lenders should also have unfettered access to the government backstop. Without that access, smaller urban, rural and niche markets served by these lenders may not have the same access to affordable mortgage loans.

- *Seamless Transition.* Housing finance reform will not succeed without a smooth transition from the current, largely nationalized, housing finance system to the future hybrid system. The transition must not hinder the housing and economic recoveries, and it must protect holders of legacy Fannie and Freddie mortgage and debt securities and ensure that taxpayers are finally made whole for the support they provided during the crisis.

> The transition must also resolve the fate of Fannie Mae and Freddie Mac. While few wish to return to the old system, which was dominated by these thinly capitalized, too-big-to-fail behemoths, the consensus stops there. A desirable approach would be for the government to put Fannie and Freddie into receivership, and to strip them of their key assets. They would then be re-chartered as new private mortgage guarantors, able to license back these assets from the government receiver. Their operations would not be disrupted, ensuring that the mortgage market functioned smoothly through the transition. But to level the competitive playing field, any other new guarantors could also license the same key assets from the receiver. This would facilitate easy entry into the guarantor market and thus competition.

Decisions made about the future of the mortgage finance system will affect U.S. homeowners and the broader economy for decades. Success will depend on striking the appropriate balance between the benefits of the private market and the backstop of the federal government. Finding the right balance will result in a stronger housing market, a more stable financial system, and a healthier economy.

Inaction also represents a policy decision, since leaving Fannie Mae and Freddie Mac in conservatorship means the effective nationalization of the U.S. housing finance system. Such a course would penalize American families looking to buy homes and leave taxpayers exposed to excessive housing risk. Housing finance reform is a vital priority for public policy.

Catastrophic government backstop

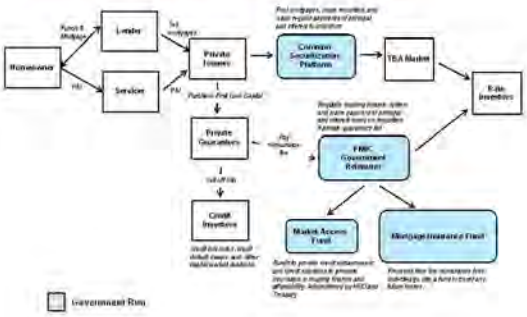
Much of the housing finance reform debate has focused on the system's end state—whether the housing finance system should be privatized, remain effectively nationalized as it is today, or be a hybrid with substantial private capital and a catastrophic government backstop.

While there are advantages and disadvantages to any housing finance system, a hybrid system is the most desirable option. In a hybrid system, private capital is responsible for losses related to mortgage defaults, but in times of financial crisis, when private capital is insufficient to absorb those losses, the government steps in. Mortgage borrowers who benefit from the government backstop pay a fee to compensate the government for potential losses.

To be eligible for the government's catastrophic guarantee, MBS must include only high-quality mortgage loans, and substantial private capital must be able to take losses before the guarantee kicks in.[3] To ensure that the private institutions and investors follow the rules, a government regulator—call it the Federal Mortgage Insurance Corp.—oversees the housing finance system (see Chart 1). The FMIC also maintains an insurance fund—the Mortgage Insurance Fund—to cover any losses the government may incur in a catastrophic situation. The FMIC charges a guarantee fee, or g-fee, to fund the MIF and oversee the housing finance system.[4] To obtain the government guarantee, mortgage-backed securities must also use a common, government-run securitization platform.[5]

Under most proposals for a hybrid system, between a third and half of all mortgage loans will be covered by this catastrophic government backstop.

Chart 1: Future Housing Finance System



As in the current system, mortgage originators, servicers and MBS issuers could be affiliated with each other. A new addition would be private MBS guarantors: monoline companies, backed neither explicitly nor implicitly by the government. These guarantors would be required to maintain capital and liquidity similar to major banks. They would purchase catastrophic insurance from the government, so that the government would repay MBS investors if the guarantors became insolvent. The guarantors themselves could fail, however.

A hybrid system would be resilient to financial and economic crises and would mitigate the impact if crises did occur. The system would preserve the vital "to-be-announced" or TBA market and the long-term, fixed-rate, fully pre-payable mortgage as a mainstay of U.S. housing. It would ensure that affordable mortgage loans are available to most middle-income Americans through good and bad times. Taxpayers would backstop the system, but it would be designed so that borrowers bear the ultimate cost. It would also be designed to allow small mortgage lenders easy access to the government guarantee and promote affordable single-family and rental housing, since qualifying multifamily mortgages could also be eligible for the government guarantee.[6] A hybrid housing finance system has the broadest political backing: Senators Bob Corker (R-TN) and Mark Warner (D-VA) recently introduced legislation to establish a hybrid system, and President Obama has expressed support.[7]

Substantial private capital

The future hybrid finance system's capital requirements will depend on a range of factors, including mortgage origination volume, the share of originations receiving the government guarantee, and the amount of private capital needed to stand in front of the guarantee. Based on the assumptions described below, the system will require $123 billion in new capital by 2020, and $175 billion over the long run (in today's dollars).

Origination volume

In 2016, the year the transition to the new housing finance system begins, single-family mortgage originations are expected to total nearly $1.2 trillion, a significant drop from recent years because of lower anticipated refinancing activity.[8] The average coupon on outstanding mortgages is currently close to 5%. With mortgage rates expected to average 6.5% by 2016, most homeowners with mortgages will have little reason to refinance.[9]

Partially offsetting the drop in refis will be stronger originations for home purchases. This will be fueled by rising home sales and prices and a greater demand for mortgages as investor demand wanes and first-time and trade-up buyers become more active.[10] Purchase volumes will be dampened somewhat by lower loan-to-value ratios; these are currently high because of the loss of equity during the housing crash and the high share of low down payment FHA lending. LTVs are expected to decline modestly through the end of the decade as homeowners' equity is rebuilt and FHA lending recedes.

Single-family mortgage originations are expected to rise approximately 3% per year between 2016 and 2020, reaching $1.4 trillion (see Chart 2). This is consistent with expected long-run house price growth, as the other factors affecting origination volumes will largely offset each other.

Chart 2: Mortgage Origination Outlook

Sources: MBA, Moody's Analytics

Multifamily mortgage originations are expected to total $170 billion in 2016. This would be a record, produced as the multifamily market benefits from a further modest decline in the homeownership rate. Foreclosures will remain elevated through 2016 as the last of the problem single-family loans made during the housing boom are resolved. Between 2016 and 2020, multifamily originations are expected to grow 4% per year to $200 billion. Strong demand during this period for apartments from an expanding cohort of people between ages 25 and 34—the principal source of apartment demand—is expected to support stronger growth in rents and multifamily property prices.

The share of single-family mortgage originations that qualify for a government guarantee will largely be determined by policymakers. A key policy lever affecting the share is the limit on conforming loans. Currently, Fannie and Freddie loans are capped at $625,000 in high-cost areas and $417,000 everywhere else. Assuming policymakers set the loan limit at $417,000 across the country, based on the distribution of loans currently backed by Fannie and Freddie, just less than 40% of originations would receive the guarantee. It is thus assumed that the share of single-family mortgage loans receiving the catastrophic government guarantee in the hybrid system will decline steadily, from approximately 65% now to 40% by 2020.

Guarantee share

The conforming loan limit will determine the guarantee share, because government-guaranteed loans will be favored by mortgage originators. Other alternatives, such as holding loans on originators' balance sheet or securitizing them in the private-label market will be more costly. Based on current pricing for Fannie Mae MBS, the marginal cost of funding for government-guaranteed securities in the hybrid system will be approximately 50 basis points.[11] This compares with well over 100 basis points for bank funding via senior unsecured debt and closer to 150 basis points for private-label MBS. The difference in marginal funding cost will be much greater in stressed economic periods. During the worst of the Great Recession, the marginal cost of bank funding was as high as 1,000 basis points. And of course, the private-label market shut down.

The share of multifamily mortgages with the government guarantee will also be determined by regulatory eligibility limits. These are assumed to remain close to Fannie's and Freddie's current 40% share of originations. The government guarantee is important to ensuring the flow of multifamily mortgage credit during difficult economic periods and to rental developments catering to lower-income households, as well as those in rural and smaller urban areas.

Private first-loss capital

The amount of private capital required to stand in front of the government's guarantee is also a matter of substantial debate, although there is general agreement that it should be greater than it was before the Great Recession. Prior to the downturn, Fannie and Freddie had enough capital to withstand a loss rate of only about 1%. This was clearly insufficient, as the institutions ended up in conservatorship, effectively nationalizing the housing finance system.

A good benchmark for the amount of private capital backing housing finance is the amount of losses suffered in the Great Recession. This was the proverbial hundred-year flood. Fannie, Freddie, and the private mortgage insurers will ultimately have a combined loss rate of between 4% and 5% resulting from the recession (see Table 1).[12] This would be a conservative capitalization rate, since in the future system, regulation would demand that guaranteed mortgages be of higher quality than those purchased by Fannie and Freddie before the recession.

Table 1: Residential Mortgage Loan Realized Losses
$ bil

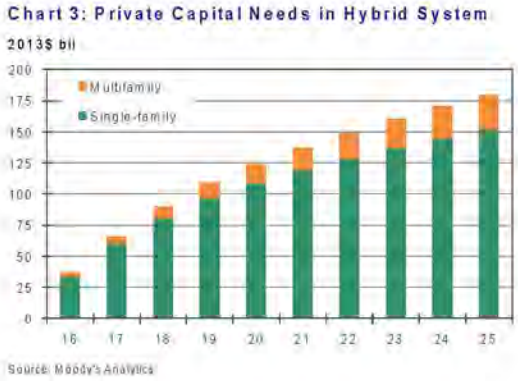
	2006	2007	2008	2009	2010	2011	2012	Total 2006-2012	Debt Outstanding Yr-end 2007	Losses as a % of Debt
Total	17.1	38.5	136.5	216.1	190.0	161.8	159.9	919.9	11207	8.2
Government-Backed	7.1	7.7	17.9	31.8	51.4	46.3	44.2	206.4		
Fannie Mae & Freddie Mac	0.8	1.8	10.3	21.3	37.3	31.4	26	128.9	4820	2.7
Fannie Mae	0.6	1.3	6.5	13.4	23.1	18.3	14.4	77.6		
Freddie Mac	0.2	0.5	3.8	7.9	14.2	13.1	11.6	51.3		
Federal Housing Administratior	6.3	5.9	7.6	10.5	14.1	14.9	18.2	77.5	449	17.3
Privately Backed	10.0	30.8	118.6	184.3	138.6	115.5	115.7	713.5		
Mortgage insurers	1.5	6.9	10.8	9.6	6.6	6	6	47.4		
Depository Institutions	2.7	7.3	35	54.9	48.2	35.3	33.3	216.7	3729	5.8
Private-Label Mortgage Securiti	5.8	16.6	72.8	119.8	83.8	74.2	76.4	449.4	2209	20.3
Subprime	5.6	15.5	55.9	71.6	39.0	34.7	35.5	257.8		
Alt-A	0.2	0.9	11.3	28.0	24.0	20.5	20.1	105.0		
Option ARMs	0.0	0.2	5.2	17.9	17.4	14.8	16.5	71.9		
Jumbo	0.0	0.0	0.4	2.3	3.4	4.1	4.3	14.6		
Note: Securitized HELOC	0.2	1.5	5.1	5.1	3.4	2.1	1.6	18.9		

Sources: Fannie Mae, Freddie Mac, HUD, FDIC, Federal Reserve Board, Moody's Analytics

Private capitalization of 5% would also be consistent with the amount of capital the nation's largest banks are required to hold under Basel III and the Dodd-Frank Act. To be well-capitalized, systemically important banks will likely need to maintain a 10% Tier 1 common equity ratio. With mortgages receiving a 50% average risk weighting, the guarantors in the hybrid system would need to hold 5% capital.

The level of private capitalization has a significant impact on mortgage rates: The higher the level required, the more guarantors in the future hybrid system will need to charge in guarantee fees. At a 1% capitalization rate, guarantors would need to charge 20 basis points, about what Fannie and Freddie charged before the recession.[13] At a 5% capitalization rate, the g-fee would be close to 70 basis points. For context, Fannie's current average g-fee is 57 basis points, consistent with an approximately 4% capitalization rate. Every 10-basis point increase in g-fees adds about $15 to the monthly cost of a typical mortgage.

Based on the origination outlook and the expected guarantor share, the amount of mortgage debt receiving a government guarantee will increase from approximately $800 billion in 2016 to $3.1 trillion in 2020.[14] With a 5% capital requirement, the amount of private capital needed in the future housing finance system would rise from approximately $37 billion in 2016 to $123 billion in 2020 (in today's dollars). Over the long run, after the guarantors' single-family and multifamily books of business have settled into their 40% shares, close to $175 billion in private first-loss capital (in today's dollars) will be needed to support the housing finance system (see Chart 3).



10% capital

In the proposed Corker-Warner hybrid housing finance system, the system is required to be capitalized to a much higher 10%. Capitalizing the housing finance system to withstand such a massive loss is not necessary—the odds of losses this large are extremely remote, and a 5% capitalization is more than adequate to weather future financial storms.[15] It also represents a misallocation of a significant amount of capital—about $250 billion in today's dollars in the long run—that could go to more productive uses in the economy.

Mortgage rates will also be higher. How much higher depends on many factors, the key ones being the source of additional private capital and the required rate of return. If it comes from a private mortgage bond insurer with a required return on equity of 15%—the amount private mortgage insurance companies currently require—the cost would increase by 70 basis points.

It would have less of an impact on mortgage rates if the extra capital came from capital markets. Since the likelihood of losses greater than 5% is so low, investors would likely be willing to invest in a security covering the additional 5% of required capital at a low interest rate, say 125 basis points over 10-year Treasury yields. For context, the average historical spread between yields on Fannie Mae securities and Treasuries is just over 100 basis points.[16] In a full-employment economy, 10-year Treasury yields should be near 4.75%, and thus investors would require a 6% yield to provide the 5% of additional capital.[17] The impact on mortgage rates would be 30 basis points (.06 * .05).

This rate impact is probably somewhat overstated given other elements of the Corker-Warner legislation that serve to reduce to mortgage rates from current levels. This includes the move to a single security, a uniform pooling and servicing agreement, increased competition among guarantors and issuers, and the varied sources of capital from equity and fixed income markets.

However, it is important to note that increasing the system's capitalization to 10% would have a meaningfully larger impact on mortgage rates for borrowers that are less creditworthy than average, although still eligible for a government guarantee, and during economic recessions. For example, the increased cost of moving from a 5% to a 10% capitalization to a borrower who is at the edge of eligibility during a typical post-World War II recession would be closer to 80 basis points. For context, every 50 basis point increase in mortgage rates, increase monthly mortgage payments for the average mortgage borrower would rise by $75, a 5% increase.

A significant benefit of such a high capitalization is that it would provide a fortress financial foundation for the housing finance system. It would all but eliminate taxpayers' exposure to risk, and should allay any concern about the government charging too little for its guarantee.[18] Under most circumstances the government's g-fee should be very small. Higher capitalization should also dispel any moral hazard concerns that private financial institutions would lower their underwriting standards and take on too much risk thinking that the government guarantee would bail them out.[19] It is hard to conceive that this would be a problem in the Corker-Warner housing finance system since private capital has so much skin in the game. If the government guarantee is needed, private investors would have suffered devastating losses.

Varied sources of capital

A substantial amount of private capital will thus be necessary to support the future housing finance system. Over time, some will come through the guarantors' retained earnings. This will not help in the early years, but under conservative assumptions, retained earnings could provide as much as one-third of the guarantors' capital requirements by 2020. By then the guarantors' earning power should be strong enough to make them roughly self-capitalizing. Yet this will not help produce the capital needed when the new system begins operating in 2016, or the roughly $85 billion in capital still needed in 2020 ($123 billion in total capital needs less $38 billion in estimated retained earnings).

The equity market is a potential source for early capital. Some financial institutions have held big initial public offerings in the recent past: AIG, Visa, and Bank of America each raised close to $20 billion in equity. The guarantors in the future housing finance system should have a return on equity similar to that of the money-center banks and life insurers, about 10%. This would be consistent with a valuation of 100% of tangible book value and a price-earnings multiple of 10. The guarantors' return on equity would be less than the 15% return on equity that private mortgage insurers have historically received, although this appears to have declined closer to 12% in the current low-interest rate environment. It is encouraging that many private mortgage insurers have been able to raise significant equity capital in recent months.

But it is hard to see the equity market producing the entire $85 billion in additional capital needed by the guarantors by 2020. Equity investors will be rightly nervous about the new system, and will question the guarantors' earnings prospects in a highly regulated

and mature market. The guarantors' earnings may also be relatively volatile, fluctuating with the housing and business cycles, and their market share will shift against the nonguaranteed part of the mortgage finance system. And of course there is the reputational risk associated with playing a pivotal role in the provision of mortgage credit.

Nonetheless, it is reasonable to expect the equity market to comfortably provide $50 billion in capital over a five-year period. In one plausible scenario, three guarantors would go public in 2016, the first year of the hybrid system, raising a total of $24 billion. Two additional IPOs in 2017 and 2018 would raise an additional $16 billion. The remaining $10 billion would be raised in subsequent equity offerings as the guarantors' capital needs increase. Five guarantors would thus be up and running by 2020.

Equity investors in the new guarantors would likely include those currently taking equity stakes in private mortgage insurers. Shareholders in the nation's largest PMI companies include mutual funds such as Fidelity and the Vanguard Group, pension funds such as TIAA-CREF, asset management firms such as Goldman Sachs Asset Management and State Street Global Advisors, hedge funds such as Paulson & Co. and Citadel, and diversified financial institutions such as BlackRock (see Table 2). A wide range of global reinsurers are also providing capital relief to the PMI companies and would likely be interested in taking stakes in the new guarantors.

Table 2: Private Mortgage Insurers' Top 10 Shareholders
Mar 31, 2013

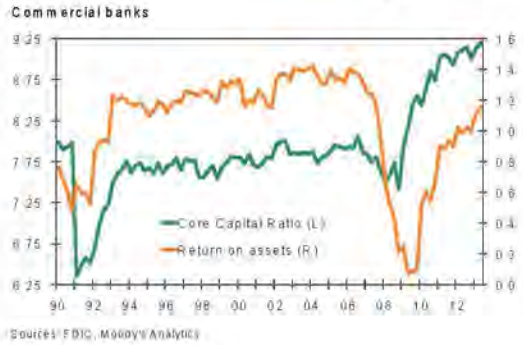
MGIC		Radian		Genworth	
Shareholder	%	Shareholder	%	Shareholder	%
Maverick Capital	6.98	Fidelity Management	9.33	Dodge & Cox	7.19
Paulson & Co.	5.03	Paulson & Co.	6.65	The Vanguard Group	6.02
The Vanguard Group	5.02	BlackRock Trust	5.25	Fidelity Management	5.62
BlackRock Trust	4.41	The Vanguard Group	5.16	BlackRock Trust	4.03
Blue Ridge Capital	4.41	Dimensional Fund	5.12	State Street Global Adv	3.94
Old Republic	4.01	Rima Senvest	5.05	Legg Mason Capital	2.78
Dimensional Fund	3.68	T. Rowe Price	4.12	Highfields Capital	2.67
SAB Capital	3.63	Morgan Stanley	2.05	Paulson & Co.	1.83
Fidelity Management	3.48	State Street Global Adv	1.76	ESL Investment	1.70
Perry Capital	2.65	Columbia Management	1.71	Gosha Trading	1.40

Sources: Companies, Moody's Analytics

Yet even if the guarantors can raise the amount of equity envisaged from public markets, a capital shortfall remains that grows from $13 billion in 2016 to $35 billion in 2020. This shortfall would be temporarily filled by the nation's large mortgage originators through a seller-financing arrangement. In the hybrid system assumed here, originators would not be permitted to own guarantors, but there would be an exception while the system is being established. In that period, originators would be required to temporarily take equity in the guarantors in partial payment for the government-guaranteed mortgages they sell. The equity received by the originators as payment would be valued at 100% of tangible book value.

The success of requiring large originators to temporarily hold equity in the guarantors hinges on several factors. Most importantly, the originators, which include the nation's largest banks, would need to have excess capital. Capital ratios in the banking system are at a record high and rising: According to the Federal Deposit Insurance Corp., the Tier 1 capital ratio for all banks is above 9% and climbing (see Chart 4). Banks are also making record profits, and although their recent profitability is temporarily supported by improving credit quality and the resulting release of loan-loss reserves, they should have plenty of excess capital given their long-term earnings power and more limited growth opportunities post-regulatory reform.

Chart 4: Banks Will Have Excess Capital



While bank originators may object to this arrangement, they also have a strong incentive to ensure that the guarantors in the new hybrid system are well-capitalized. Originators will prefer a well-functioning housing finance system, with a government backstop and a to-be-announced market, to alternatives that require them to hold many more mortgages on their balance sheets. However, since the banks' investments in the guarantors would have pedestrian returns, and since a 100% risk-weighting would be capital-intensive, bank originators would be expected to sell their stakes in the guarantors as soon as their capital is no longer needed. There would also be a reasonable divesture period, in case they are unexpectedly slow to sell their shares.

Critical to this arrangement's success is that even with their equity stakes, the large bank originators should have no control over the guarantors. Otherwise, small lenders would be appropriately nervous about their ability to compete. Large originators would receive nonvoting or B-shares as payment from the guarantors. This is similar to the arrangement Visa set up with its bank members when it designed its IPO. Once the B-shares were sold to non-originator investors, they would become voting A-shares.

Attracting varied sources of private capital into the housing finance system will take experimentation and innovation. It is thus encouraging that the Federal Housing Finance Agency has mandated Fannie and Freddie to begin that process. The goals are

modest but substantive, and they motivate Fannie and Freddie to experiment creatively. Although the pricing on these risk-sharing deals may not be economical, at least for now, what is learned from these efforts will be instrumental to ensuring there is enough private capital to support the future housing finance system.

Freddie recently issued Structured Agency Credit Risk, or STACR, securities, designed to offload the first-loss piece of certain guaranteed MBS into the private capital markets. The STACR's synthetic senior-subordinated floating-rate structure provides investors protection for prepayment and interest-rate risk.[20] Investor demand for the security was limited for a number of reasons—it was not rated and it has no risk-weighting—but it had a reasonably successful debut nonetheless. However, private investors will need more information to assess the relative value of STACR securities and alternative credit risk-sharing arrangements. This is necessary to scale up the effort and to better inform the debate on the future housing finance system.

Fannie also recently engaged in a risk-sharing transaction with NMI, a new private mortgage insurer. Offloading risk to the PMIs is worthy of experimentation, but this effort will also take time to scale up, since as much of the industry is still struggling to resolve its poor quality legacy books and uncertainty regarding future capital requirements.

Strong regulator

The future housing finance system should have a new, independent federal government overseer called the Federal Mortgage Insurance Corp.—a name chosen intentionally to mimic the Federal Deposit Insurance Corp. The current FHFA would be folded into the FMIC, but this new regulator would have considerably broader responsibilities, notably including oversight of MBS insurers and the securitization platform. The FMIC would determine which securities are eligible for the government guarantee, set standards for mortgages included in such securities, and determine capital, liquidity and other prudential requirements for MBS insurers. The regulator would ensure that appropriate private capital was at risk ahead of the government guarantee.

The FMIC would establish an insurance fund—the Mortgage Insurance Fund—similar to the FDIC's Deposit Insurance Fund to cover losses on guaranteed MBS. While the new system was being put in place, this MIF would be built up using a portion of the g-fees charged by Fannie Mae and Freddie Mac. Once established, the fund would be maintained with g-fees paid by MBS insurers. The FMIC would adjust g-fees to strengthen the fund if needed to cover future losses.

The FMIC would be instructed to set g-fees adequate to allow the fund to withstand a severe housing and economic downturn similar to that of the Great Recession. Regular stress-testing and other risk management techniques would be used to set the g-fees, whose level would depend on the amount and structure of the first-loss private capital available. The greater the amount of first-loss private capital and the higher its quality, the lower the necessary g-fees. Along the lines of the FDIC, the FMIC would be required to increase g-fees if the MIF, after expected claims, is projected to fall below a minimum level. The FMIC would set g-fees to keep the MIF solvent.

Finding the right level for the g-fee will be difficult, but as housing finance reform progresses the FMIC can use various techniques to better price the guarantee. For example, it is conceivable that in the future the government would not guarantee all MBS that qualify for its backstop, enabling the FMIC to use an auction mechanism to inform the price of government insurance.

In a future financial crisis, the Treasury secretary and the chairman of the Federal Reserve could decide, after consultation with the president, to give the FMIC authority to adjust the extent of risk-sharing between the federal government and MBS insurers (the attachment point) to ensure the liquidity of the MBS market and the availability of mortgage credit. Policymakers would thus have a mechanism to reduce the amount of private capital required ahead of the government guarantee, providing increased support for housing and the overall economy. This process mimics the systemic risk exception for the FDIC, and is meant to be used in similar circumstances. It would not be used for normal countercyclical macroeconomic adjustments, which would remain the responsibility of the Federal Reserve.

The FMIC would coordinate with bank regulators, the Securities and Exchange Commission, and the Consumer Financial Protection Bureau to reconcile the new housing finance system with emerging regulations governing the private mortgage securities market and mortgage-related activities of depository institutions and others.

Common securitization platform

All non-Ginnie Mae, government-guaranteed securities should use a common securitization platform. Although not required, nonguaranteed securities could use the same platform. The common securitization platform would produce a more liquid market, facilitate loan modifications in future downturns, and give issuers operating flexibility at a low cost. It would also allow for a robust TBA market.

The securitization facility would leverage current efforts by the FHFA to develop a single platform for Fannie Mae and Freddie Mac securities. For a fee, the securitization facility would provide a range of services, including mortgage loan note tracking, master servicing, data collection and validation to improve transparency and integrity, and bond administration.

Mortgage loans included in securities that use the common securitization facility (including all mortgages that benefit from the government guarantee plus some nonguaranteed loans) would be covered by a uniform pooling and servicing agreement and uniform servicing standards that encourage prudent underwriting and align investor and borrower interests. This would encourage the adoption of similar standards for other mortgages.

The common securitization platform would permit multiple originators to sell mortgages into single securities with access to the government guarantee. In return, the originators would receive pro rata shares of the security. Pooling requirements would be

largely the same as for typical single-originator securities, and they would be good for delivery into the TBA market. Originators could thus easily convert securities to cash before the securities were created, an especially important feature for smaller originators.

The common securitization platform would also promote development of a common government-guaranteed security, which would improve liquidity in the TBA market and result in lower mortgage rates. A common security would also lower entry barriers into the guarantor market, as no guarantor would have an advantage because of the liquidity of the securities they back.

This is a problem in the current housing finance system, as Freddie Mac securities are much less liquid than Fannie Mae securities. Fannie and Freddie split the MBS market 60-40, but on a typical day the trading volume of Fannie MBS is 10 times greater than that of Freddie MBS. To compensate, Freddie is forced to charge a lower g-fee than Fannie. In the second quarter of 2013, Fannie's average g-fee was 57 basis points, compared with Freddie's 51 basis points. There are some modest differences in the securities—Freddie pays investors more quickly than Fannie and its securities prepay a bit more quickly—but the key difference is their liquidity. This liquidity difference makes the mortgage market less efficient and less competitive, and leads to higher costs for mortgage borrowers and taxpayers.

A potential near-term fix to this problem would be to make Fannie and Freddie securities fungible, creating a common TBA security.[21] That would require a change to the good-delivery guidelines for TBA, to allow the delivery of either Fannie or Freddie securities into the same contract. The securities themselves would not change; their separate TBA markets would simply be merged. Both securities would still be separately identifiable and tradable, only the TBA trades would be merged. Not only would this interim step improve liquidity, it would demonstrate investor interest in a truly common security that would be an important feature of the future hybrid housing finance system.

Competitive and independent mortgage guarantor market

The future housing finance system should have five to 10 MBS guarantors. Five guarantors would ensure that the system is competitive and free from too-big-to-fail risk. Competition among guarantors would reduce interest rates on MBS and thus mortgage interest rates paid by homeowners. More than 10 guarantors could result in prohibitively high transaction costs. This is important for smaller MBS issuers grappling with the complexity of dealing with many guarantors and their different contracts, data exchange processes, and accounting and underwriting systems.

The MBS guarantor industry would exhibit significant economies of scale. Creating these scale economies is that a guarantor's risk declines as its portfolio increases in size and resembles the risk across all mortgage borrowers. Since the risks in mortgage lending are not independently distributed—the strong form of the law of large numbers does not hold—and significant losses can occur—the mortgage loss distribution is fat-tailed—capital and regulatory costs are high. This favors larger guarantors. Larger guarantors can

charge less for more marginal risks since they will have less of an impact on the risk of their entire larger portfolio. And informational asymmetries also advantage larger guarantors that are able to collect more and better data and information.

The scale economies could be reduced somewhat if the government guarantee is confined to QM loans, which seems likely. These loans are more homogenous and the risk premiums on a guarantor's portfolio may converge more quickly to the population loss rate. Informational asymmetries could also be less significant if there is greater data transparency in the new housing finance system.

The scale economies in the MBS guarantor industry are expected to peak with guarantors that have close to a 20% share of the market. There may be one or two guarantors that cater to the most homogenous part of the mortgage market with a larger share, and several smaller guarantors that are more niche insurance providers. A guarantor established to cater to small mortgage originators as envisaged in a number of hybrid systems might be an example of a niche guarantor. For context, the five largest life insurance companies account for one-third of that market, while the top five property and casualty insurers account for almost half. The private mortgage insurance market is more concentrated, particularly in the wake of the housing bust and the industry's consolidation, with the five largest PMI companies accounting for 85% of that market.

Mortgage guarantors should also be independent from large mortgage originators. This has a number of benefits in addition to reducing the size and market heft of players in the housing finance system. More private capital is likely to come into the system if big banks are unable to dominate it. Separating guarantors from originators would also ensure that more due diligence would be applied to the mortgage loans and securities being originated. Independent guarantors would be especially careful in their underwriting given how much skin in the game they would have.

Worries about regulatory overlap between the FMIC and banking regulators would also be addressed. Under any circumstance, the FMIC would need to coordinate with the Federal Reserve, SEC, OCC, CFPB and other agencies, but the regulatory burden would be significantly reduced if issuers, who can be heavily regulated depository institutions, are not permitted to own guarantors.

Equal access and affordability

The future housing finance system should promote access to affordable owner-occupied and rental housing. The long-term, fixed-rate, fully amortizing and fully pre-payable mortgage has served borrowers well at many income levels and appears to be desired by most U.S. homeowners. At the same time, the destruction of homeowners' equity in the Great Recession and changing demographics suggest there is value in responsible experimentation and flexibility in future housing finance arrangements.

This experimentation might prove challenging for the private housing finance system, in part because good ideas take time to prove, but once proven are easily replicated. Limited and potentially temporary forms of credit enhancement (for example, soft second

mortgages at below-market rates, or loss reserves for a pool of loans testing alternative underwriting strategies to determine ability to repay) can enable the unsubsidized market to serve many more families capable of becoming and remaining homeowners.

Innovation is also needed to maintain a supply of unsubsidized affordable rental housing in small properties, those with up to 50 units. Such housing accounts for the bulk of unsubsidized rental units and a high percentage of all affordable units, but often needs refinancing, renovation and repair, yet has little access to capital. After market contractions, private credit providers tend to leave behind good credit risks. The inability of creditworthy borrowers to access credit exacerbates income and wealth disparities and impairs economic development in many communities.

The statutory program definitions under which the FHA and VA operate make innovation extremely difficult. To address these concerns, the future system should establish a Market Access Fund to provide explicit credit enhancement and direct subsidies. With the former GSE housing goals abolished, affordable housing activities would be supported instead by the MAF through a transparent mechanism and with dedicated funding.

The MAF should be financed by an assessment on all MBS, both guaranteed and nonguaranteed. Charging the fee on both guaranteed and nonguaranteed MBS eliminates the fee as a source of market bias while providing a stable and consistent source of funding for the MAF. The fee could vary according to guarantors' success in achieving a national service mandate to operate in all parts of the country and promote access to affordable housing, consistent with safety and soundness requirements.

The Market Access Fund could consist of four subsidiary funds:

1. R&D Fund: Provide grants and loans for research (including market research), development and pilot testing of innovations in pre-purchase preparation, product, underwriting and servicing that expand the market for sustainable homeownership and for unsubsidized affordable rental housing.

2. Credit Support Fund: Provide limited credit enhancement and other credit support for products that increase sustainable homeownership and affordable rental by supporting the testing, beyond pilot projects, of products that if successful have the potential to be scaled up and eventually sustained by the private market.

3. Capital Magnet Fund: Provide funding for the Capital Magnet Fund, which enables CDFIs and nonprofit housing developers to attract private capital and take affordable housing and community development activities to greater scale and impact. This fund was authorized by Congress under the Housing and Economic Recovery Act of 2008, or HERA; the CMF was to have permanent, dedicated financing through a charge on Fannie Mae and Freddie Mac but has not been funded, other than one round of appropriated funding in fiscal 2010.

4. National Housing Trust Funds: Provide funding for the National Housing Trust Funds, which is a HUD-administered state block grant program designed primarily to increase and preserve the supply of rental housing for extremely low income families. The NHTF was authorized by HERA but has never received funding.

Seamless transition

The transition from the current, largely nationalized housing finance system to the future hybrid system must protect the economic recovery. Government support to the housing finance system cannot be withdrawn too quickly without undermining the housing recovery, which is vital to the broader economic recovery. Mortgage credit conditions are still very tight: Lenders remember the massive losses suffered during the housing crash and are uncertain about a number of regulatory issues. Prematurely withdrawing government support would exacerbate this problem.

Taxpayers should be made financially whole during the transition. The government's support to Fannie and Freddie should be repaid, along with the cost of backstopping the rest of the financial system when Fannie and Freddie failed, and the costs associated with setting up a new financial system. Taxpayers should also receive a return on their financial support commensurate with the risks they took.

Investors in legacy Fannie and Freddie MBS and debt securities should also be protected. The federal government now guarantees existing MBS and bond obligations of Fannie and Freddie through agreements between the Treasury Department and the two firms. This must continue through the transition period. Not doing so would undermine investors' faith in the U.S., raising borrowing costs and exacerbating the nation's fiscal problems. This is a legacy of the old system, and while the new system should avoid re-creating this obligation, we cannot retroactively change expectations without damaging the nation's credibility in global credit markets.

A critical question in the transition to a future housing finance system is what to do with Fannie Mae and Freddie Mac. For all that is wrong with the current system, Fannie and Freddie are doing an effective job buying conforming mortgages, bundling them into MBS with a government guarantee, and selling them to global investors. The mortgage market is not working as well as it should, but it is working. Whatever is done with Fannie and Freddie must not disrupt this flow of mortgage credit, for the sake of the housing and economic recoveries.

Arguably the most straightforward approach, with the least amount of near-term risk, would be to recapitalize and reprivatize Fannie and Freddie. Both are currently profitable, as a result of improving mortgage credit conditions and their higher guarantee fees. The two agencies' profits are flowing to the U.S. Treasury, rapidly repaying the $188 billion Fannie and Freddie received from taxpayers in order to stay in business. At last count they still owed $42 billion but were on track to repay the Treasury's investment by early 2014.

After that, their profits could be used to build the capital necessary for them to become private guarantors in the future finance system. Once appropriately capitalized, they would be reprivatized, with the government selling them to private investors to maximize the return to taxpayers.

There is a considerable downside to this approach, however: The future housing finance system could again be dominated by Fannie and Freddie or their successors. The system could encourage competition, for example, by establishing a new common securitization platform run as a government utility that produces a single government-backed security. The reincarnated Fannie and Freddie would also likely be classified systemically important financial institutions, or SIFIs, and thus face stiffer capital and liquidity requirements. This would raise their cost of capital vis-à-vis newer entrants, further supporting competition.

But the two giant firms would still have considerable advantages of size and scale, important legacy relationships, and entrenched software and systems. Most likely this approach would create a hybrid system dominated by a duopoly, firms with significant power over the mortgage and housing markets that would be much too big to fail. The arrangement would be uncomfortably similar to the dysfunctional system that prevailed prior to the Great Recession.

An alternative approach would be to simply put Fannie and Freddie into receivership and liquidate their assets. Guarantors in the hybrid system would be largely new entities, begun by those purchasing Fannie's and Freddie's assets. There is significant risk in this approach, as there would be no assurance that the new guarantors would be able to continue the institutions' activities, at least not in a timely way. The chance of a disruption in the flow of mortgage credit would be uncomfortably high.

A better approach would be for the government to put Fannie and Freddie into receivership, and to strip them of their key assets. They would then be rechartered as new private guarantors, able to license back these assets from the government receiver. Their operations would not be disrupted, ensuring that the mortgage market functioned smoothly through the transition. But to level the competitive playing field, any other new guarantors could also license the same key assets from the receiver. This would facilitate easy entry into the guarantor market and thus competition.

The current Senior Preferred Stock Purchase Agreement between the U.S. Treasury and Fannie and Freddie would need to be restructured to permit the redemption of the Treasury's senior preferred shares and the cancelation of its warrant in the firms. The restructured SPSPA would determine the appropriate compensation taxpayers require from Fannie and Freddie for their financial support. Taxpayers should be made financially whole, receiving repayment for the support they provided to Fannie and Freddie, the cost of backstopping the rest of the financial system when they failed, and the cost of setting up a new financial system. Taxpayers should also require a return on their financial support commensurate with the risks they took. Under reasonable assumptions, Fannie's and Freddie's future profits would not be sufficient to fully compensate taxpayers.

Fannie and Freddie would be put into receivership, and their operating assets and liabilities moved into limited life regulated entities, or LLREs, allowing them to maintain their operations independent of the resolution process.[22] This is similar to the procedure envisaged in Dodd-Frank for failing SIFIs. The assets of the LLREs would then be sold or licensed back to Fannie's and Freddie's successor firms, which would be chartered as independent guarantors, and to the new competitor guarantors.

Fannie's and Freddie's $4.5 trillion legacy guaranty book would not be included in the assets transferred from the government receiver to the LLREs. More private capital would be needed to support the legacy books than could be raised in a reasonable period, ensuring that the new housing finance system would never get going. The receiver would engage the new guarantors to manage the loans in the legacy books, providing a steady source of revenue.

The impact on the federal budget of resolving Fannie and Freddie should be modest, although that depends somewhat on whether budget accounting from the Office of Management and Budget or the Congressional Budget Office is used. OMB treats Fannie and Freddie as private companies independent of the government, thus the impact on the federal budget is simply the net cash payments they make to the Treasury. OMB projects that Fannie and Freddie will remit just over $50 billion to the Treasury over the next decade. CBO treats Fannie and Freddie as part of the federal government and uses fair-value accounting to calculate the cost of the net subsidy the government provides mortgage borrowers via the institutions. CBO projects that there will be a negative subsidy of about $10 billion over the next decade.

Conclusions

Since the government took over Fannie Mae and Freddie Mac during the financial collapse five years ago, effectively nationalizing the nation's housing finance system, nothing meaningful has changed. The government still makes nearly nine of every 10 U.S. mortgage loans. This is bad for both taxpayers and homebuyers.

Taxpayers are on the hook for potential losses on the hundreds of billions of dollars in mortgages that Fannie and Freddie insure each year. This is not necessary: Private investors are willing to take on much of this risk and, with some safeguards, are capable of doing it.

The longer Fannie and Freddie stay in government hands, the more lawmakers will be tempted to use them for purposes unrelated to housing. This has already happened. Last year's payroll tax holiday was partially paid for by raising the premiums Fannie and Freddie charge homebuyers for providing insurance.[23] Mortgage borrowers will be paying extra as a result over the next decade.

The housing market's revival has allowed Fannie and Freddie to again turn large profits, amounting to tens of billions of dollars each year. Policymakers may begin to rely on these profits to fund government spending, making it especially hard to let Fannie and Freddie go.

Policymakers may also eventually be tempted to make Fannie and Freddie lend to people who really cannot afford mortgages. This is partly how the two institutions got into financial trouble during the housing bubble—they took on more risk than they should have to meet their housing-affordability goals. Helping disadvantaged households become homeowners is laudable, but experience shows that politically driven help can be abused.

The bigger problem now is the limbo status of Fannie and Freddie, which fosters indecision at the two institutions and by their regulator, the FHFA. Lenders who do business with Fannie and Freddie are unsure of the rules, and are thus extra cautious, keeping credit overly tight for potential homebuyers. This is evident in the average credit scores of borrowers through Fannie and Freddie, which today are in the top third of all of credit scores.

Some in Congress recognize the current situation's dangers and have introduced legislation to reform the nation's housing finance system. Yet these legislative efforts lack a clear plan for getting from the current housing finance system to the future one. The transition cannot be bungled: The nation's economic recovery depends on housing, which in turn depends on the flow of mortgage credit. The $10 trillion U.S. mortgage market is also critically important to the entire global financial system.

Yet while the transition will be complicated and rife with risk, it is eminently doable, as the path presented in this paper illustrates.

The federal government has unwound much of its extraordinary intervention in the economy prompted by the Great Recession. Fiscal stimulus has been replaced by fiscal austerity. The Trouble Asset Relief Program bailout fund will soon be history. The Federal Reserve is planning to begin normalizing monetary policy. That leaves Fannie and Freddie and the nation's housing finance system as the largest piece of unfinished business. It is time to finish it.

Endnotes

1 This testimony draws heavily from the white paper "*A Pragmatic Plan for Housing Finance Reform,*" Ellen Seidman, Phil Swagel, Sarah Wartell, and Mark Zandi, Moody's Analytics, Milken Institute and Urban Institute white paper, July 19, 2013.

2 The three agencies are currently responsible for 85% of all purchase mortgage originations. The nation's banks originate the remaining 15%, which they hold on their balance sheets.

3 Loans eligible for a government guarantee would be qualified mortgages as currently defined by the Consumer Financial Protection Bureau.

4 If the MIF were depleted in a future crisis and the Treasury were required to provide financial support to the housing finance system, the FMIC would have the ability to raise guarantee fees on future mortgage borrowers to ensure that taxpayers are made whole.

5 The securitization facility would be used for all non-Ginnie Mae government-guaranteed securities and, although not required, could be used for nonguaranteed securities.

6 Market Access Fund and MBS insurer for small lenders.

7 For an assessment of the Corker-Warner legislation, see "*Evaluating Corker-Warner,*" Mark Zandi and Cris DeRitis, Moody's Analytics white paper, July 2013. The president's support for a hybrid system was expressed in a speech.

8 According to the Mortgage Bankers Association, during the five years between 2008 and 2012, single-family residential mortgage origination volumes averaged approximately $1.75 trillion per year, of which $1.2 trillion were refinancings. With equilibrium fixed mortgage rates of 6.5% well above the average coupon of approximately 5% on outstanding mortgage debt, future refinancing volume is expected to be closer to $300 billion per year.

9 This is based on the assumption that 10-year Treasury yields will be close to annualized potential nominal GDP growth in the long run. Potential nominal GDP growth is expected to run between 4.5% and 5%, equal to 2% inflation and real GDP growth of 2.5% to 3%. Thirty-year fixed mortgage rates are expected to be approximately 175 basis points over 10-year Treasury yields.

10 The majority of home sales to investors are for cash, while most sales to first-time homebuyers are financed with mortgages.

11 This represents the option-adjusted spread on Fannie Mae 30-year current coupon securities.

12 The losses through 2012 are less than 5%, but foreclosures are still high and thus more losses are coming.

13 These mortgage rate impacts are based on a guarantee fee calculator that determines through a net-present-value computation of cash flows the fee necessary to meet conditions for both solvency and return on equity. The calculator is available upon request.

14 This assumes that single-family mortgage debt runs off by 10% per year as a result of prepayments and normal amortization. Multifamily debt is assumed to run off by 2% per year.

15 The protection to taxpayers is 12.5%. This includes 10% in private capital and 2.5% in the mortgage insurance fund. In other words, losses on mortgage securities backed by the government would have to be greater than 12.5% before taxpayers would be called upon to support the system. To produce losses of this amount, a financial crisis would have to be almost three times as severe as the Great Recession.

16 This spread is necessary to compensate investors for the prepayment risk in a mortgage security that does not exist in a Treasury bond. It is possible the spread would be narrower in the housing finance system envisaged in Corker-Warner given that the government guarantee would be explicit. However, investors may demand a larger spread until it is clear how the reforms to the system are working out and liquidity is fully established.

17 The 10-year Treasury yield consistent with an economy operating at full-employment and growing at its potential is estimated to be 4.75%. This equals the sum of 2% inflation and 2.75% annual potential real GDP growth. Potential real GDP growth is equal to the sum of 1% labor force growth and 1.75% labor productivity growth.

18 Concern that the government's gfee would be inadequate to compensate taxpayers should also be allayed since the legislation requires the FMIC to increase its gfee if the MIF is expected to fall below its 2.5% minimum.

19 This concern is expressed well by Peter Wallison in a July 1, 2013 Wall Street Journal op-ed *"The Corker-Warner Housing Finance Reform Won't Work."* http://online.wsj.com/article/SB10001424127887323873904578569820608849816.html

20 It is a synthetic security, in that it references a pool of recently originated mortgages although it is not a credit- linked note. A CLN is a more intuitive structure, but since it is a derivative it would have to satisfy a range of other regulatory requirements. The STACR structure avoids these regulatory issues.

21 A thorough discussion of a proposal to create a fungible Fannie-Freddie security is provided in an MBA working paper "Ensuring Liquidity Through a Common, Fungible GSE Security." http://www.mbaa.org/files/Advocacy/2013SingleSecurityConcept-Transition1.pdf

22 The LLRE is established under the Housing and Economic Recovery Act of 2008. http://www.gpo.gov/fdsys/pkg/PLAW-110publ289/html/PLAW-110publ289.htm HERA gives the FHFA authority to transfer of Fannie's and Freddie's assets to a LLRE to facilitate their orderly liquidation.

23 Fannie and Freddie guarantee fees were increased by 10 basis points for 10 years to help pay for the payroll tax holiday. This will raise more than $20 billion for the federal government over the next decade.

RESPONSE TO WRITTEN QUESTION OF SENATOR CORKER FROM JULIA GORDON

Q.1. During the hearing the issue of capital markets execution, as opposed to bond guarantor "entity" execution, was discussed. Could you briefly discuss the advantages of allowing multiple sources of capital—from both the equity and fixed-income markets—take on credit risk? And to the extent you have concerns, if you have them, please make suggestions for how we might alleviate those concerns?

A.1. Thank you for your question and the opportunity to weigh in on this important issue. I do not believe any advantages theoretically provided by the opportunity for multiple executions outweighs the potential disadvantages of providing a Government wrap to individual structured transactions. As I highlighted in my testimony, I'm concerned about the capital markets execution for several reasons:

- A system based on bond guarantors or other "entities" is significantly easier to regulate for safety and soundness. Not only will there be fewer entities to monitor, but the insurance that bond guarantors will provide is more easily understood by a regulator than diverse and complex structured transactions.
- Bond guarantors are much more efficient at pooling and spreading risks, which is the core function of insurance. Structured transactions, to the extent that they cover a single or limited number of pools, cannot allocate risks and reserves across years, regions, lenders, and so on.
- As we have seen in recent private-label securitizations, investors in structured transactions have proven unwilling to assume risk on anything but the most pristine mortgages. If investors are assuming the first-loss risk, their high level of scrutiny will result in higher prices for nontraditional but still creditworthy borrowers, as the investors will demand a premium for taking risk that is not well-understood or serving borrowers who are perceived as more risky.
- Individual deals are much less likely to be able to support a robust TBA market, as they do not offer the same level of homogeneity in contract terms and the structures likely will require high levels of loan level disclosures. These higher levels of disclosure will reduce liquidity by fracturing the market into more individually priced securities that will not be suitable for the fungible TBA market. Even if a system can be found to permit the forward trading that characterizes the current TBA market, the lack of homogeneity over time/across different vintages of loans will reduce liquidity.
- Even if the structured transactions are "funded"—as in, the money to cover losses is advanced to the instrument's issuer—

it will be hard to ascertain how these assets are accounted for on the balance sheets of the involved parties. As a result, risk could simply be exported out of the four corners of the MBS into the larger financial sector. Recent and on-going experience with regulating derivatives and capital markets risk-sharing structures illustrates the difficulties in even understanding how risks are actually shared, let alone less in regulating them.

- Bond guarantors can provide more protection to the taxpayer at less cost. If credit losses exceed the level of capital allocated to a security—S. 1217 proposes capital of at least 10 percent—in a structured transaction, the Government will be responsible for the additional losses. Bond guarantors, in contrast, would be obligated to use their corporate resources before tapping the reinsurance fund. The regulator could also require higher capital for bond guarantors in light of changing economic circumstances—an approach supported by the recent experience of loan level mortgage insurers—but it is unclear how this could be done when individual securities are credit enhanced through bond structures that, once set in place, are not amenable to changes.

Please note that nothing that I have proposed would prevent bond guarantors from laying off credit risk in capital markets. As a result, capital market investors could still be taking on credit risk, and their capital would still be available to fund our housing finance system. While this practice may reintroduce some of the problems I noted above—notably, accounting and systemic risk issues—a system in which bond guarantors are primarily responsible for first-loss credit risk would be more stable and better suited to meet the housing needs of America's families.

However, if the bill ultimately includes both executions as options, they must compete on a level playing field. As currently drafted, the bill encourages the pure capital markets approach, since that execution has little by way of regulatory requirements and can more easily meet the capital thresholds through leverage. Instead, the bill should include significantly stronger regulatory mechanisms for both executions. Initial "approval" of an issuer or bond guarantor does not equal oversight, and in fact, may be counterproductive in that it may give a green light to subsequent actions that are unmonitored by the regulator. Additionally, if the bill does hard-code first-loss capital requirements, we believe the 10 percent number would be appropriate for structured transactions, while the appropriate level for bond guarantors could safely be in the 4–5 percent range.

RESPONSE TO WRITTEN QUESTION OF SENATOR CORKER FROM JEROME T. LIENHARD, II

Q.1. During the hearing the issue of capital markets execution, as opposed to bond guarantor "entity" execution, was discussed. Could you briefly discuss the advantages of allowing multiple sources of capital—from both the equity and fixed-income markets—take on credit risk? And to the extent you have concerns, if you have them,

please make suggestions for how we might alleviate those concerns?

A.1. The health and stability of the secondary market for mortgages depends upon availability of a range of sources of capital to invest in the first-loss credit risk, meaning risk that will be taken ahead of the risk exposure of the Government on its guarantee. Broadly available investment capital will promote competition not only among institutions, but also among the forms and structures of investment execution. This diversity in turn will create an incentive for market participants to find the most efficient forms of execution.

That said, we believe that allowing for a broad range of forms of investment and retention of credit risk is best done on the back-end of a guarantor model. That is, we believe that it would be better for legislators to create a system in which issuers of securities ultimately back-stopped by the Government would be required to use bond guarantors to lay off the top-loss risk on their mortgage pools, allowing these bond guarantors to then further off-load that risk into the capital markets.

We hold this view for three reasons.

- First, creating a model that allows issuers to go directly to the capital markets as part of the bond structuring process runs the risk of fracturing the types of securities offered in the market to such a degree that it would compromise the "TBA" (To-Be-Announced) mortgage securities market. The TBA market depends on a high degree of standardization and homogeneity in issued securities. It would be unlikely for such standardization to hold in a market in which the credit risk of pools of loans were assumed and distributed through complex structured transactions. Moreover, participants in such transactions would likely seek to apply their own credit risk preferences, leading to more targeted pools of loans, with different credit characteristics and differentiated pricing. Such variability in the preferences of first-loss creditors regarding the composition of mortgage pools would make it more difficult to maintain fungibility of the pools and, therefore, of the resulting securities. This would materially inhibit forward trading through the TBA market. This problem does not arise if the system depends instead on issuers working with bond guarantors, which would issue a more standardized form of top-loss guarantee. These guarantors could then lay off some of the risks that they assume from issuers to the capital markets on the back end. In this way, the bond guarantor function would work with the capital markets in a transaction similar to reinsurance that would enable homogeneity and fungibility (meaning, ready trading markets) for the base mortgage securities.
- Second, we are concerned that, in a time of financial stress, the sources of capital in a pure and direct capital-markets-dominated execution structure could withdraw from the market quickly and categorically, causing a crisis in liquidity. If capital were to flee the market, the Government's offer to provide a back-stop to pools of guaranteed loans would be ineffective to ensure ongoing liquidity, because there would not be market

participants willing to provide the first loss coverage on which the entire system would depend. Again, this would not be as significant a risk if there were a number of well-capitalized bond guarantors in place to take first loss credit risk.

- Third, we are concerned that regulatory oversight of the credit risk taken ahead of the Government backstop, which will be an essential function of regulatory supervision in any new system, would be prohibitively difficult if a significant share of first-loss risk were being structured, assumed and distributed through myriad and complex securitization structures and transactions. It would be far more straightforward to conduct regulatory oversight of the Government's risk exposure if first-loss positions were being assumed by counterparties to the Government structured as bond guarantor agencies, as such oversight would entail traditional capital adequacy and risk management supervisory functions similar to those conducted today through Federal and State banking and insurance regulatory bodies.

One final related point: We believe a bond guarantor structure could and should enable issuers to work directly with the top-loss bond guarantors to provide their own mortgage-pool level credit enhancement as part of the issuer-bond guarantor transaction. This would enable issuers to participate in optimizing the pricing of the bond guarantee, driving incentives for low-cost and high credit-quality practices.

For these reasons, we would recommend allowing for a rich variety of sources of capital taking on credit risk in the system, but in a position supporting bond guarantors. The bond guarantors would interface directly with issuers and be directly accountable to the Government supervisory process where the Government is in a position of reinsuring that risk. This would preserve the critical forward trading function of today's TBA market while allowing intermediation of a wide variety of capital sources.

RESPONSE TO WRITTEN QUESTION OF SENATOR CORKER FROM RICHARD JOHNS

Q.1. During the hearing the issue of capital markets execution, as opposed to bond guarantor "entity" execution, was discussed. Could you briefly discuss the advantages of allowing multiple sources of capital—from both the equity and fixed-income markets—take on credit risk? And to the extent you have concerns, if you have them, please make suggestions for how we might alleviate those concerns?

The TBA Market

A.1. For markets to assume credit risk, a structure or structures are needed to replace the depth and liquidity of the current TBA or "to be announced" market. The TBA market is a forward-trading market that trades on limited information. The securities are guaranteed by the Government-Sponsored Enterprises ("GSEs") and investors assume interest rate risk and prepayment risk. TBA investors do not assume credit risk; rather they assume only the risk that depending on the interest rate environment, they may receive

their principal sooner or later than anticipated (generally due to borrower prepayment on the loans) or that the market value of the securities may fluctuate.

As discussed in the testimony of our Executive Director, the TBA market is a crucial underpinning to the American mortgage market. Originators can hedge and fund their forward origination pipelines because they can "lock in" the rates and prices on the loans during the period between each trade and settlement date. The TBA market is a large, liquid market, where buyers and sellers are able to trade large blocks of securities in a short period of time. The liquidity of the TBA market creates efficiencies and cost savings for lenders that are passed on to borrowers in the form of lower rates and broad availability of mortgage products, and helps to maintain a national mortgage market. The TBA market is the benchmark for all mortgage markets—it is the reference by which other mortgage markets and products are priced. Investors in a TBA security presently have general guidelines that indicate to them the "four corners" of what is contained in a particular security, however at the time a trade is entered into the exact composition of the security is not revealed. As an example, an investor may have knowledge that their particular pool cannot have more than 10 percent of the balance of a pool consisting of high balance loans.

SFIG is of the view that various structures may be able to function side by side with the TBA Market; however, because the TBA market requires a guaranty to function effectively, a capital markets execution should not be seen as an alternative to a guarantor model, but rather as a supplement. A guarantor should be able to raise capital to support its business through the equity and debt markets as well as pair off some of its risk to meet its capital requirements through risk transfers, swaps, credit-linked notes, *etc.* Raising these various forms of capital and having a guarantor act as the channel through which this risk is moderated acts as a countercyclical measure because it reduces the reliance on contemporaneous capital raises to fund mortgages.

Recent GSE Risk Transfer Transactions

SFIG recognizes the importance of these transactions as a monumental first step in transferring credit risk to the private market. Several of our members were participants in these transactions and accordingly, we look forward to having the private market work (with SFIG's support) with the GSEs to further build upon the recent credit risk transfer pilot transactions. These transactions may prove to provide an effective mechanism to transfer certain credit risk as a follow-on to TBA transactions, but they are not intended to be a funding source for originations.

SFIG is of the view that while the transactions are an artful way to effectively de-risk the GSEs, due to certain structural features, they cannot be seen as a capital markets execution that can unilaterally replace traditional GSE functions. This is primarily because the recent transactions still rely on the GSEs as the ultimate taker of catastrophic and systemic risk. In regards to the greater system of secondary market mortgage funding, the GSEs still act as the initial funding entity and the initial risk taker, thereby facilitating

reliable pricing to the consumer and allowing for a functioning TBA market.

Alternative Structures

A. Senior/Subordinate

For banks and mortgage companies that fund originations via the private-label securitization market, (generally through a senior/subordinate RMBS transaction), the following prerequisites are necessary before the proceeds on the loan and the rate to the consumer can be determined:

- the level of subordination likely required for each rating tranche for each particular pool of loans; and
- the likely price at which each tranche of these securities will sell.

Gain or loss on these senior/subordinate structures is typically determined through the subordination level that is required coupled with the pricing that the securities attain when sold. While hedging and rate-locking are possible in this type of market, it is more expensive and less efficient than in the current TBA market. Therefore, a lender is more exposed to market risk and uncertainty in a senior/subordinate structure than in a TBA security in the current market.

The senior/subordinate structure also contains other inherent features that are irreconcilable with the TBA market. Specifically, in a senior/subordinate structure the purchaser of the subordinated securities (which bear the majority of the risk) requires much more information on each of the loans than is required or even possible for a TBA security. In fact, it is the lack of certain information that allows diverse borrowers, property types, and loan attributes, which ultimately comprise the housing finance market, to be converted into homogenous, credit-neutral assets through the TBA market. Further, because the TBA market is a forward market based on a hypothetical pool, loan-level data is simply not available at the time of a trade. Finally, because a TBA trade does not specify the collateral to be delivered, an investor who purchases (or even examines the loan-level data related to) a specific security would be barred from participation in the TBA market for that entire coupon. This would mean that investors in credit would not be able to hedge interest rate risk in the TBA market and would severely impact investor interest in either of these markets.

A senior/subordinate structure may be used by the GSEs when loans are purchased by the GSEs in whole loan form for cash. These loans can be subsequently pooled into a senior/subordinate structure.

SFIG generally believes that senior/subordinate structures should predominantly exist in the private-label securities market, which serves as a supplement, not a replacement, for the TBA market, and also acts as a check and balance on guarantee fee pricing. Senior/subordinate structures could also be incorporated into the new housing finance system on a limited basis *e.g.,* as described above with cash loans.

B. Credit-Linked Notes, Swaps, Derivatives, and a risk index

Credit-linked notes would most resemble the current GSE risk sharing transactions and would also be compatible with the TBA market as a follow-on transaction; however, they require a credit intermediary if they are to support a countercyclical market and a steady and reliable source of mortgage funding, as would all the aforementioned forms of risk-sharing. An index would be the most scalable and, if broad enough, would attract the deepest capital base and require the least amount of sophistication to invest; however, it would require a credit intermediary/guarantor as well. These risk-sharing and risk-transfer options, the GSE risk transfer transactions, along with the use of swaps and other derivatives, are all artful ways to fund a guarantor entity which could provide countercyclical capital and act as a risk intermediary to allow for steady and reliable pricing to originators and ultimately to the consumer.

Conclusion

It is SFIG's view, as indicated in our testimony, that some form of TBA market needs to exist to allow market participants to forward trade, which in turn allows borrowers to "lock in" interest rates well in advance of closing and facilitates a national mortgage market and the extension of mortgage credit in all credit cycles.

Any private capital resulting in credit risk transfer should be scalable, compatible with the TBA market, and sustainable in both bull and bear markets. In our discussion above, we highlight several structures, including the recent GSE transactions. These structures are an excellent way to introduce private capital and supplement a guarantor or centralized risk intermediary and thereby support a TBA market. These structures should not be seen as a replacement for the TBA market or as a replacement for the need of a risk intermediary to ensure a steady source of funding for mortgage credit in all market cycles. While we have belief that preserving the TBA market requires an institution to perform the role of guarantor, we do not believe that the Government-Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac need to be preserved in their current form to fulfill that role. We hope that you consider these views as you evaluate options to reform the housing finance system. We welcome the opportunity to discuss our views with you in person.