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On Banking, Housing, and Urban Affairs

Principles of Housing Finance Reform

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Introduction

Good morning Chairman Crapo, Ranking Member Brown, and Members of the Senate Banking Committee. Thank you for the opportunity to testify regarding our nation's housing finance system, an issue that profoundly affects American families and is also critical to the overall housing industry, which is nearly 20 percent of the United States economy. I am the President of the Center for Responsible Lending (CRL), a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, a community development lender headquartered in Durham, NC. Since 1980, Self-Help has provided over $7 billion in financing to 131,000 families, individuals and businesses under-served by traditional financial institutions. It helps drive economic development and strengthen communities by financing hundreds of homebuyers each year, as well as nonprofits, child care centers, community health facilities, public charter schools and residential and commercial real estate projects. Through its credit union network, Self-Help's two credit unions serve over 130,000 people in North Carolina, California, Chicago, Florida and Wisconsin and offers a full range of financial products and services. Learn more at www.self-help.org and www.self-helpfcu.org.

This important hearing provides an opportunity to offer ways that we can build on existing reforms within the secondary mortgage market, and repair parts that are broken without major disruption to the overall market. The goal must be to ensure that the full universe of credit worthy borrowers – regardless of where they live, including in rural areas, or who they are – have access to the credit they need to be able to secure a mortgage so that they can build their American dreams. The system must also continue to offer equal access for lenders of every size, taking special care to serve community banks and credit unions. Additional changes to the system must factor in existing progress made by the Housing and Economic Recovery Act of 2008 along with the new mortgage protections created by Dodd-Frank and the Consumer Financial Protection Bureau. Further, it is important to remember that radical changes to housing finance could provoke unanticipated harms — some suggested changes could create heightened systemic risks, adversely impact community lenders and make housing credit unnecessarily expensive and restricted. Our testimony today draws heavily from our October 2013 working paper, *A Framework for Housing Finance Reform*.[1]

I. The Important Role Played by the GSEs Pre- and Post- Great Recession

A. The GSEs Created a National Housing Market

In evaluating proposed changes to the housing finance system, it is important to start by reviewing the role that the GSEs and FHA have played- in the nation's housing market. Together they have made stable and affordable mortgage credit available across the country and throughout economic downturns. Today, they hold mortgages worth $6.17 trillion with Fannie Mae at 44.2 percent, Freddie Mac at 27.5

[1] Eric Stein and Carrie Johnson, A Framework for Housing Finance Reform: Fixing What Went Wrong and Building on What Works, Center for Responsible Lending, October 2013, *available at* http://www.responsiblelending.org/mortgage-lending/policy-legislation/regulators/2013-crl-working-paper-on-gse-reform-a-framework-for-housing-finance-reform-oct-15pdf.pdf.

percent, and Ginnie Mae at 28.3 percent.[2] The GSEs were created by Congress in the 1930s to provide stability to the capital markets and to increase the availability of mortgage credit throughout the United States following periods of severe economic volatility. The GSEs have a mandate to serve all credit markets at all times, which ensures broad credit availability in all regions of the nation. The charters of the GSEs state that they must "promote access to mortgage credit throughout the nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing."[3] By bundling and securitizing mortgages with an implied federal government guarantee, the GSEs have increased the flow of credit to all parts of the nation. We now have a national mortgage market, investor confidence, increased loan volume, and widespread use of the 30-year fixed rate mortgage. This in turn has resulted in more affordable loans for consumers.

B. Fannie Mae and Freddie Mac Followed the Market in a Race to the Bottom

The housing boom and the subsequent financial crash revealed defects in the structure and operation of the GSEs. In the years leading up to the 2008 crisis, financial incentives at Fannie Mae and Freddie Mac drove them to chase market share by loosening underwriting guidelines, particularly for Alt-A no doc loans. This increased risk-taking led to larger credit losses that ultimately pushed the GSEs into conservatorship.

Prior to entering conservatorship in 2008, both Fannie Mae and Freddie Mac were perceived to have implicit government backing, and subsequent events showed this to be the case. This guarantee was combined with private shareholders seeking market share to drive high quarterly gains and returns on equity. In the early 2000s, both GSE market share and profits were put at risk in the face of growing private-label securitizations competition. As the subprime and Alt-A markets grew in size from 2001 through 2006, the percentage of loans eligible for purchase by Fannie Mae and Freddie Mac under their traditional underwriting standards – also called conforming loans – decreased significantly. From 2003 to 2006, the GSE and government share of the MBS market (Fannie Mae, Freddie Mac and Ginnie Mae) fell from 78 percent to 44 percent while the private label securities share rose from 22 percent to 56 percent.[4] It is no coincidence that this 34 percent swing in favor of private label securities occurred during the worst period of lending in American history since the Great Depression, as Wall Street pushed riskier loans and riskier securities backed by these loans.[5]

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[2] Laurie Goodman et.al., Housing Finance at a Glance: A Monthly Chartbook, at 6-7 (May 2017), *available at* http://edit.urban.org/sites/default/files/publication/90451/may_chartbook.pdf.

[3] Fannie Mae's charter is in Title III of the National Housing Act, 12 U.S. Code § 1716 et. seq. Freddie Mac's charter is in 12 U.S.C. §1451 et. seq.

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

[5] See e.g., The Financial Crisis Inquiry Commission, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, at 105 (January 2011) (stating that "[s]imultaneously, underwriting standards for nonprime and prime mortgages weakened. Combined loan-to-value ratios—reflecting first, second, and even third mortgages—rose. Debt-to-income ratios climbed, as did loans made for non-owner-occupied properties. Fannie Mae and Freddie Mac's market share shrank from 57 percent of all mortgages purchased in 2003 to 42 percent in 2004, and down to 37 percent by 2006. Taking their place were private-label

In response to this declining market share and harm to quarterly earnings targets, both Fannie Mae and Freddie Mac eased their underwriting standards and begin guaranteeing Alt-A mortgages – generally loans that did not fully verify income and assets – that were previously outside of the GSE credit box. While these Alt-A loans constituted roughly 10 percent of Fannie Mae's outstanding loans in 2008, they were responsible for 50 percent of its credit losses.[6]

Additionally, the GSEs purchased securities bundled with subprime loans that had risky product features for their own portfolio in order to obtain higher financial rates of return.[7] This race to the bottom in order to shore up returns for shareholders proved disastrous. These loans soon resulted in high default rates and generated substantial losses that the entities lacked the capital to cover. Although the GSEs were not the instigators of this abusive lending, their follow-the-leader approach hurt borrowers and led Fannie and Freddie into conservatorship. The Financial Crisis Inquiry Commission determined that the housing crisis that led to the Great Recession was totally avoidable and primarily the result of lax regulation and excessive risk taking by Wall Street Firms.[8] While misaligned incentives and insufficient oversight led to risk and volatility at the GSEs themselves, the activity of the GSEs contributed to the resulting harm, but did not cause the crash.[9] Nonetheless, this experience exposed weaknesses in the GSEs' structure, capital, operations and oversight.

C. Following the Financial Crash, GSE and FHA Lending Saved the Market from Complete Shutdown

Private capital retreated during the housing crash. The countercyclical nature of the GSEs and FHA insured mortgage programs sustained the market. Private label lending peaked in 2006 with approximately 40 percent of all mortgage originations.[10] It began to decline in 2007 and virtually ceased by 2008.[11] With record levels of defaults and foreclosures occurring amid sharp declining prices nationwide, overall mortgage lending dropped precipitously.

securitizations—meaning those not issued and guaranteed by the GSEs.") (*available at* http://fcic-static.law.stanford.edu/cdn_media/fcicreports/fcic_final_report_full.pdf).

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

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

[8] The Financial Crisis Inquiry Commission, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, at 27 (January 2011), *available at* https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

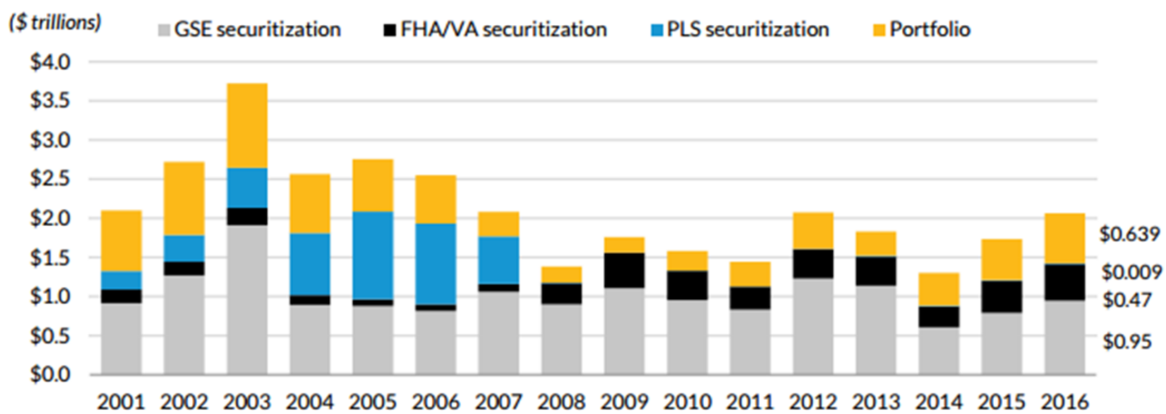
[9] Id.

[10] Laurie Goodman et.al., Housing Finance at a Glance: A Monthly Chartbook, at 8 (May 2017), *available at* http://edit.urban.org/sites/default/files/publication/90451/may_chartbook.pdf.

[11] Id.

Credit would not have been available for most mortgagees if not for government support during the financial crisis. Backed by government guarantees, the GSEs under Federal Housing Finance Administration conservatorship beginning in September 2008 and FHA continued to ensure that credit would be available. GSE lending jumped to over 65 percent of all mortgage originations in 2008.[12] FHA lending also stepped in and played a key role, increasing rapidly.[13] Since then, FHA purchase loans have dropped steadily and returned to more normal levels of the early 2000s.[14] Moody's estimated that FHA's contribution prevented a second collapse in the housing market, which could have sent the U.S. economy into a double-dip recession and caused the economy to shed another 3 million jobs and the unemployment rate to rise an additional 1.6 percent.[15]

Figure 1. First lien origination volume



Source: Inside Mortgage Finance and Urban Institute, last updated February 2017

Congress also acted quickly with a bipartisan response to the market crash with the Housing and Economic Recovery Act of 2008 (HERA).[16] HERA created the power for the GSEs to be taken into conservatorship in an effort to rein them in from their misaligned incentives. Simultaneously, HERA

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[12] Id.

[13] John Griffith, "The Federal Housing Administration Saved the Housing Market" (Washington: Center for American Progress, 2012), *available at* https://www.americanprogress. org/issues/housing/report/2012/10/11/40824/the-federalhousing-administration-saved-the-housing-market/. This report cites data estimates from Moody's Analytics in October 2010.

[14] US Department of Housing and Urban Development, Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2010, at 2 (November 2010), *available at* https://portal.hud.gov/hudportal/documents/huddoc?id=report_to_congress.pdf; See also, US Department of Housing and Urban Development, Federal Housing Administration Annual Report to Congress, The Financial Status Of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2016, at 8 (November 2016), *available at* https://portal.hud.gov/hudportal/documents/huddoc?id=2016fhaannualreport1.pdf.

[15] John Griffith, "The Federal Housing Administration Saved the Housing Market" (Washington: Center for American Progress, 2012), *available at* https://www.americanprogress. org/issues/housing/report/2012/10/11/40824/the-federalhousing-administration-saved-the-housing-market/. This report cites data estimates from Moody's Analytics in October 2010.

[16] 12 U.S.C. § 4501 et. seq.

created important reforms for the GSEs that allow for much needed regulatory oversight by providing a strong regulator, the Federal Housing Finance Agency (FHFA). These changes have greatly reduced the risk of future problems at the GSEs, and better aligned their incentives to their chartered missions. HERA's conservatorship was not intended to be indefinite, nor was it intended to be the catalyst for receivership of the GSEs. The GSEs have now paid far more into the Treasury Department than they received in assistance and they are operating in a much safer and sounder manner.[17]

II. Goals of Housing Finance Reform

As further housing finance reforms are considered, they must be evaluated by how well they serve the goals of the housing finance system: providing stable mortgage credit to all credit worthy borrowers; supporting the participation of all lenders, including community lenders; and protecting taxpayers.

A. Access to Mortgage Credit for all Credit Worthy Families Must be Supported Going Forward

Homeownership is the primary way that most middle-class families build wealth and achieve economic stability. Wide access to credit is critical for building family wealth, closing the racial wealth gap, and for the housing market overall.

Home equity accounts for much of American family wealth. For many low-to-moderate income (LMI) families and people of color in particular, a home represents the only asset that a family may ever own and the equity in their homes constitutes a larger share of personal wealth. Home equity accounts for only 30 percent of the net worth for wealthier households, but constitutes sixty-seven percent for middle-to- low income households.[18] Home equity accounts for 53 percent of African-American wealth as compared to 39 percent for whites.[19]

The Great Recession exacerbated inequality in wealth distributions. According to the Pew Research Center, in 2012 whites had 13 times the wealth of African-Americans and 10 times the wealth of non-white Hispanics.[20] Specifically, whites had a median wealth of $141,900 compared to $13,700 and $11,000 for non-Hispanic whites and African-Americans respectively.[21] Also, the St. Louis Federal Reserve reports that one in nine whites have less than $1,000 in wealth compared to one in four for Latinos and one in

[17] Congress of the United States Congressional Budget Office, The Effects of Increasing Fannie Mae's and Freddie Mac's Capital, at 5 (October 2016), *available at* https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/52089-gse-report.pdf.
[18] Brendan Greely, U.S. Homeowners Are Repeating Their Mistakes, Bloomberg, February 14, 2013, *available at* https://www.bloomberg.com/news/articles/2013-02-14/u-dot-s-dot-homeowners-are-repeating-their-mistakes.
[19] Thomas Shapiro, Tatjana Meschede, and Sam Osoro, The Roots of the Widening Racial Wealth Gap: Explaining the Black-White Economic Divide, Institute on Assets and Social Policy, (February 2013), p.3., *available at* http://iasp.brandeis.edu/pdfs/Author/shapiro-thomas-m/racialwealthgapbrief.pdf.
[20] Rakesh Kochhar and Richard Fry, Wealth inequality has widened along racial, ethnic lines since end of Great Recession, Pew Research Center, December 12, 2014, *available at* http://www.pewresearch.org/fact-tank/2014/12/12/racial-wealth-gaps-great-recession/.
[21] Id.

three for African-Americans.[22] Home equity plays a great role in determining a families' wealth and is the furthermost contributor to the racial wealth gap between whites and people of color.[23]

The different levels of wealth accumulation for whites and people of color are mostly correlated to each group's historic ability to become homeowners. In fact, FHA housing policies after World War II until the mid-1960s explicitly discriminated against people of color and limited their access to FHA mortgages, while promoting expanding homeownership's access for whites.[24] According to a report by Demos, if homeownership rates were the same for whites and people of color we would see a decrease in the racial wealth gap by 31 percent for African-Americans and 28 percent for Latinos.[25]

Despite historical inequities in access to mortgage credit, the future of the market depends on these often-excluded borrowers. Existing homeowners, especially older Americans, will need buyers when they want to sell and new families need access to affordable mortgage credit to buy their homes. The homebuyers of the future will be more racially and ethnically diverse than those of the past. Harvard's Joint Center for Housing Studies found that non-whites accounted for 60 percent of household growth from 1995-2015 and predicts that half of Millennial households by 2035 will be non-white.[26] As stated above, these borrowers have less wealth, which has translated into lower credit profiles and an inability to make large down payments on mortgage loans.[27]

A study of Self-Help's Community Advantage Program, however, shows that when provided an opportunity and safe mortgage loans these borrowers succeed.[28] In fact, the borrowers in the study who started with a net worth that was less than zero amassed a net worth of $38,000, compared with renters'

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[22] Ray Boshara and William Emmons, Stark Disparities in Wealth Are Key in Discussions on Race in the United States, Washington Post, December 30, 2014, *available at* https://www.washingtonpost.com/opinions/policies-that-can-bootstrap-the-poor-out-of-the-wealth-gap/2014/12/30/3bf972a6-8f87-11e4-a412-4b735edc7175_story.html?utm_term=.bfc010a14313.

[23] See Shapiro et al., The Roots of the Widening Racial Wealth Gap: Explaining the Black-White Economic Divide, Institute on Assets and Social Policy, (February 2013).

[24] For a more in depth review of how federal housing policies have discriminated against people of color, See Ta-Nehisi Coates, The Case for Reparations, The Atlantic, June 2014, *available at* http://www.theatlantic.com/features/archive/2014/05/the-case-for-reparations/361631/; See also, Bob Herbert, Against All Odds: The Fight for the Black Middle Class, Bob Herbert and Public Square Media, Inc (2016), *available at* http://www.pbs.org/wnet/chasing-the-dream/films/against-all-odds/.

[25] Tanvi Misra, Why America's Racial Wealth Gap is Really A Homeownership Gap, Demos, March 12, 2015, *available at* http://www.demos.org/news/why-americas-racial-wealth-gap-really-homeownership-gap.

[26] Joint Center for Housing Studies of Harvard University, State of the Nation's Housing 2017, June 2017, *available at* http://www.jchs.harvard.edu/research/state_nations_housing.

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

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

$266, even as housing values plunged.[29] The Community Advantage Program securitized mortgages for more than 50,000 families in 48 states.[30] Still, access to mortgage credit continues to be a challenge for far too many people. The Urban Institute found that from 2009 to 2014, there were 5.2 million mortgage loans missing from the market due to unnecessarily tight credit standards, including restrictions and measures put in place by the GSEs.[31]

<u>GSEs and Ginnie Mae Provide Access to Mortgage Credit in Underserved Communities</u>

Both the GSEs and Ginnie Mae continue to provide critical mortgage capital to underserved communities. The GSEs purchased over 2 million home purchase and refinance mortgage loans in 2015, including nearly a half a million loans to low- and moderate-income borrowers, nearly 400,000 loans to borrowers of color and over 300,000 loans to borrowers living in rural areas. At the same time, smaller financial institutions (those with assets less than $2 billion) relied on loans sold to the GSEs to meet the credit needs of nearly 200,000 borrowers seeking mortgage credit in rural communities. Loans backed by Ginnie Mae also continue to play a significant role in serving borrowers whose credit may warrant additional enhancement or who have limited resources for a down payment. Government-backed lending cannot and should not be sole source of mortgage lending in these communities.

To better understand the GSE market share among low- and moderate-income borrowers, borrowers of color, rural borrowers and among community banks and credit unions, CRL analyzed over six million home purchase and refinance mortgages for first-lien, owner-occupied, 1-4 family homes (including manufactured homes) reported under the Home Mortgage Disclosure Act in 2015 (referred to as purchase lending and refinance lending going forward). Of these loans, 34.2 percent were sold to Fannie Mae, Freddie Mac or Farmer Mac (collectively, the GSEs) and 16.2 percent were loans guaranteed through Ginnie Mae (see Figure 2).

Figure 2. 2015 purchase and refinance loans by purchaser

	All loans		Loans to LMI borrowers		Loans to borrowers of color	
	#	%	#	%	#	%
GSEs	2,065,978	34.2%	457,450	31.3%	374,133	30.0%
Ginnie Mae	976,119	16.2%	235,514	16.1%	262,773	21.1%
Not sold in 2015	1,245,698	20.6%	275,054	18.8%	225,453	18.1%
Other	1,752,868	29.0%	493,318	33.8%	382,781	30.7%
Total	6,040,663		1,461,336		1,245,140	

Source: CRL analysis of 2015 Home Mortgage Disclosure Act data, home purchase and refinance mortgages for first-lien, owner-occupied, 1-4 family homes, including manufactured homes. GSEs refers to all loans sold to Fannie Mae, Freddie Mac or Farmer Mac in 2015 calendar year. Other category includes loans acquired by an affiliate institution, commercial bank, savings bank, savings association, life insurance company, credit union, mortgage bank, finance company or private securitization.

[29] Allison Freeman and Roberto G. Quercia, Low- and Moderate-income Homeownership and Wealth Creation, UNC Center for Community Capital, at 2 (June 2014), *available at* http://ccc.sites.unc.edu/files/2014/08/6-20-14-Wealth-Creation-Policy-Brief.pdf.

[30] Id.

[31] Bing Bai, Lauri Goodman, and Jun Zhu, Tight credit standards prevented 5.2 million mortgages between 2009 and 2014, *available at* http://www.urban.org/urban-wire/tight-credit-standards-prevented-52-million-mortgages-between-2009-and-2014.

The GSEs and Ginnie Mae Provide Important Credit Access for Low- and Moderate-Income Borrowers and Borrowers of Color

In 2015, GSEs purchased 457,450 purchase and refinance loans made to low- and moderate-income borrowers making up 31.3 percent of purchase and refinance mortgage lending to LMI borrowers, or borrowers with incomes less than 80 percent of the area median income. Likewise, Ginnie Mae guaranteed 235,514 purchase and refinance loans to LMI borrowers making up 16.1 percent of all purchase and refinance lending to low- and moderate-income borrowers (Figure 2).

During the same year, the GSEs purchased 374,133 loans to borrowers of color, or 30.0 percent of all loans to these borrowers and Ginnie Mae guaranteed 262,773 FHA loans to borrowers of color—a 21.1 percent market share.

GSE Market Share Exceeds Ginnie Mae Market Share in Rural Communities

The GSEs also provide an important source of mortgage capital in rural communities, where they purchased nearly one out of every three new mortgages in 2015. In 2015, lenders made over one million purchase and refinance loans in rural areas.[32] The GSEs also purchased 76,661 purchase and refinance loans to LMI borrowers in rural areas and 20,504 loans to rural borrowers of color, a 26.2 percent and 21.9 percent market share, respectively (Figure 3).

In comparison, Ginnie Mae guaranteed 196,963 FHA loans in rural areas, including 52,876 loans (18.1 percent) to LMI borrowers and 24,234 loans (25.9 percent) to rural borrowers of color.

Figure 3. 2015 purchase and refinance loans by purchaser in rural areas

	All rural loans		Loans to rural LMI borrowers		Loans to rural borrowers of color	
	#	%	#	%	#	%
GSEs	320,525	30.0%	76,661	26.2%	20,504	21.9%
Ginnie Mae	196,963	18.4%	52,876	18.1%	24,234	25.9%
Not sold in 2015	271,145	25.3%	77,405	26.4%	22,872	24.4%
Other	281,233	26.3%	85,999	29.4%	25,982	27.8%
Total	1,069,866		292,941		93,592	

Source: CRL analysis of 2015 Home Mortgage Disclosure Act data

The GSEs also provide a critical source of mortgage capital for smaller lenders, those with assets of less than $2 billion in 2015. The GSEs purchased 177,028 purchase and refinance loans from smaller lenders lending in rural areas, or 25.1 percent of the market. Ginnie Mae guaranteed 139,792 purchase and refinance loans made by small lenders in rural areas that same year—a 19.8 percent market share (Figure 4).

[32] Census tracts, which were classified as either urban or rural areas based on the 2017 definition of *rural area* at 12 CFR 1282.1, and *available at* https://www.fhfa.gov/DataTools/Downloads/Pages/Duty-to-Serve-Data.aspx.

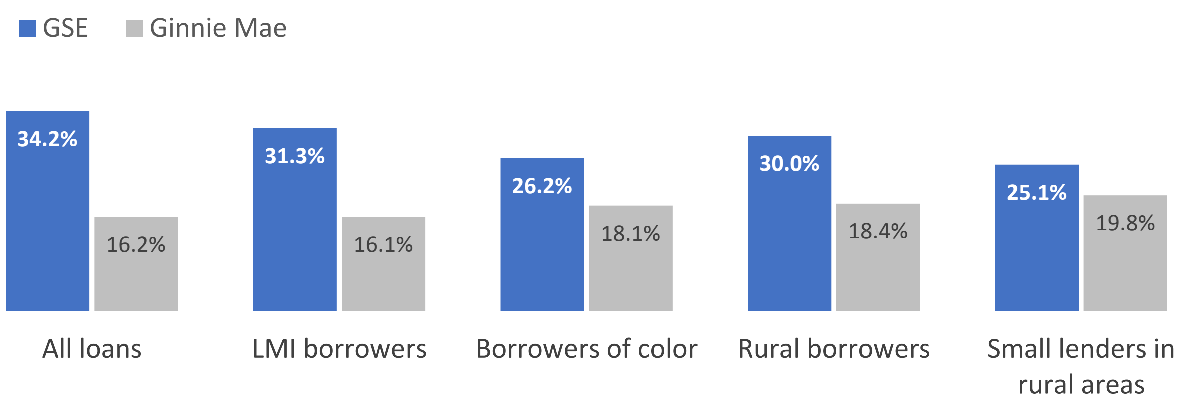
Figure 4. 2015 purchase and refinance loans originated by small lenders by purchaser in rural areas

	Purchase loans		Refinance loans		Total	
	#	%	#	%	#	%
GSEs	73,564	18.5%	103,464	33.4%	177,028	25.1%
Ginnie Mae	70,417	17.8%	69,375	22.4%	139,792	19.8%
Not sold in 2015	86,709	21.9%	71,089	22.9%	157,798	22.3%
Other	165,920	41.8%	66,122	21.3%	232,042	32.8%
Total	396,610		310,050		706,660	

Source: CRL analysis of 2015 Home Mortgage Disclosure Act data

In all, the GSE market share exceeds the market share of Ginnie Mae among low- and moderate-income borrowers, borrowers of color and rural borrowers. The GSEs also purchase one out of every four loans issued by smaller lenders in rural areas, exceeding the market share of loans guaranteed by Ginnie Mae and even exceeding the market share of loans that are originated but not sold to other institutions or the secondary market (Figure 5).[33]

Figure 5. Market share of GSEs and Ginnie Mae



Source: CRL analysis of 2015 Home Mortgage Disclosure Act data

In addition to support for home ownership, the GSEs also play a vital role in supporting affordable rental housing, which is essential for many working families. These programs have performed well, even through the financial crisis, and should be continued going forward.

[33] FHA operations have been hampered in recent years due to a variety of challenges including excessive uncertainty regarding lending liability, structural defects in its servicing process and outdated and under resourced technology and operations infrastructure. See, The Federal Housing Administration Can Do More With More, April 2017, *available at* https://www.brookings.edu/research/the-federal-housing-administration-can-do-more-with-more/.

B. Pricing Practices Should Expand Mortgage Access

The GSEs and FHA today have an affirmative duty to serve all markets which incentivizes them to set prices in a way that balances risk and access.[34] These participants in today's housing finance system are incentivized to pool risk and price credit risk on a pooled basis. Unfortunately, recent proposals for legislative housing finance reform share a common feature that undermines this pricing approach. Deep upfront credit risk transferred to private capital would incentivize actors to segment, rather than pool, credit risk and prices. Segmented pricing puts mortgage credit out of reach for too many credit worthy borrowers.

The total amount borrowers pay to cover credit risk is a function of modeled losses, capital standards and the required rate of return on capital.[35] Modeled losses are largely independent of system structures.[36] Capital requirements and required rates of return on capital are dependent on the structure of a future system, and function to increase or decrease the overall total amount to be held to guard against losses.

It is the policies of participants in the housing finance system that translate predicted credit losses into borrower prices and distribute prices for borrowers with different characteristics. Importantly, the degree to which costs are pooled or distributed is determined by the structure of the housing finance system. For example, FHA charges the same insurance premium to borrowers regardless of credit score,[37] whereas private mortgage insurers charge widely different fees to borrowers with different credit scores and/or levels of down payment (Figure 6).

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[34] CRL continues to work with FHFA to encourage changes which could further open up access to credit. For example, eliminating the loan level price adjustments (LLPAs) that were put in place after the crisis.

[35] For a more detailed discussion of the levers that affect pricing and the distribution of pricing for credit risk see Calhoun, M. and Wolff, S. Who Will Receive Home Loans, and How Much Will They Pay?, 2016, *available at* http://www.urban.org/policy-centers/housing-finance-policy-center/projects/housing-finance-reform-incubator/mike-calhoun-and-sarah-wolff-who-will-receive-home-loans-and-how-much-will-they-pay

[36] System structure could introduce new risks. For example, if a future system made it very difficult or costly for first-time homebuyers to purchase a home, then existing homeowners would have a difficult time selling their homes. This could depress housing prices or limit liquidity in the housing system overall, which could result in a downturn and create losses in the system above what would be predicted by current models.

[37] FHA premium rates available at https://portal.hud.gov/hudportal/documents/huddoc?id=17-07ml.pdf.

Figure 6. Private mortgage insurance pricing, 2017

	97-95.01% LTV 35% Coverage	95-90.01% LTV 30% Coverage	90-85.01% LTV 25% Coverage	85% LTV and under 12% Coverage
>=760	55	41	30	19
740-759	75	59	41	20
720-739	95	73	50	23
700-719	115	87	60	27
680-699	140	108	73	32
660-679	190	142	100	41
640-659	205	150	105	43
620-639	225	161	110	45

From online published rate sheets for Borrower Paid Mortgage Insurance from private mortgage insurers Genworth (https://mortgageinsurance.genworth.com/pdfs/Rates/11370775.Monthly_Natl.FIXED.0616.pdf) and Radian (http://www.radian.biz/sfc/servlet.shepherd/version/download/068C0000002osy9IAA)

Underwriting structures determine if borrowers are credit worthy, but pricing structures determine if a credit worthy borrower can afford a mortgage. Differential pricing creates an additional barrier to mortgage credit by increasing the price, sometimes significantly, for some borrowers relative to others. There is evidence of price acting as a barrier even in today's mortgage market. For example, although Fannie Mae's guidelines allow the GSE to purchase loans with credit scores down to 620 and loan-to-value (LTV) ratios of up to 97 percent, very few loans purchased by the GSE have these characteristics.[38] One reason is that risk-based pricing by both the GSEs and private mortgage insurers add significantly to the cost of loans for borrowers with lower scores and less wealth for a down payment. For example, the combination of loan-level price adjustments (LLPAs) and mortgage insurance (MI) premiums adds over 300 basis points to the cost of a mortgage for a borrower with a credit score of 620 and an LTV of 97 percent.[39]

The GSEs, though, currently set prices based on a more consolidated set of borrower characteristics than private actors like private mortgage insurers. They lay off credit risk largely through back-end credit risk transfer mechanisms which allows for pooling of loans and risk. Ultimately, these policies limit the degree to which loan pricing is highly segmented.[40]

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[38] See p. 6 of *2017 First Quarter Credit Supplement*, Fannie Mae, May 5, 201, *available at* http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2017/q12017_credit_summary.pdf

[39] 350/4+225=312.5 basis points. Fannie's Mae's LLPA for this combination of credit score and LTV is a one-time fee of 350 basis points (see page 2: https://www.fanniemae.com/content/pricing/llpa-matrix.pdf), we assumed a LLPA multiple of 4 to convert this upfront fee to an ongoing cost comparable to the MI premium. Borrower paid MI from Genworth for this combination of credit score and LTV is a continuing fee of 225 basis points (see: https://mortgageinsurance.genworth.com/pdfs/Rates/11370775.Monthly_Natl.FIXED.0616.pdf).

[40] Through the LLPAs the GSEs also have differential pricing, which limits their reach to underserved borrowers.

Comparing the GSE guarantee fee structure to the MI pricing structure reveals the private market's tendency to create finely defined bands. GSE guarantee fee pricing[41] breaks up credit scores into three bands: >=740, 700-739, and 620-699. From December 2013 to April 2016, MI companies broke up this same range into four bands: >=760, 720-759, 680-719, and 620-679. The most recent set of MI pricing, released in April 2016,[42] breaks this same range of credit scores into eight different bands: >=760, 740-759, 720-739, 700-719, 680-699, 660-679, 640-659, and 620-639.

Finely defined pricing frameworks produce more extreme pricing. Figure 7 below shows the change in basis points borrowers with a given credit score saw as a result of PMI pricing changes implemented in April 2016. Some borrowers, those with credit scores above 740, enjoyed a reduction in fees whereas others, almost all borrowers with scores below 680, experienced increases. The cells highlighted in dark green saw a decrease of more than 30 basis points. The cells highlighted in dark orange saw an increase of more than 30 basis points.

Figure 7. Change in MI pricing by credit score and LTV December 2013 to April 2016

	97-95.01% LTV 35% Coverage	95-90.01% LTV 30% Coverage	90-85.01% LTV 25% Coverage	85% LTV and under 12% Coverage
>=760	-50	-13	-9	-4
740-759	-35	-3	-3	-7
720-739	-15	11	6	-4
700-719	-16	-2	3	-6
680-699	9	19	16	-1
660-679	42	27	29	2
640-659	57	35	34	4
620-639	77	46	39	6

From online published rate sheets for Borrower Paid Mortgage Insurance from private mortgage insurers Genworth and Radian for December 2013 and April 2016.

Proposed housing finance systems that rely on deep, upfront private capital to cover credit risk do not provide a countervailing pressure to market incentives to finely and differentially price credit risk. Even in the current system, in which the GSEs have incentives for risk and price pooling, troubling pricing differences prevent credit worthy borrowers from getting mortgages. Unfortunately, the legislative proposals further erode incentives for pooling and are likely to result in even greater differential pricing. This will make it even harder and costlier for credit worthy borrowers of modest means to afford a mortgage.

C. Community Banks And Other Small Lenders Must Be Supported In Housing Finance Reform

Community banks, credit unions and other small lenders play a critical role in providing mortgages and other financial services on a local basis to American families, and they must be supported by the housing finance system. The current system has many provisions to do this, and these should be continued

[41] As described in *Fannie Mae and Freddie Mac Guarantee Fees: Request for Input*, FHFA, 2015*, available at* https://www.fhfa.gov/policyprogramsresearch/policy/documents/gfeerfi060514f.pdf
[42] Shown in Figure 6.

and expanded. Some proposals for changes in housing finance, though, would strongly tilt the system against these institutions.

Community banks, credit unions, and other small financial institutions deliver mortgages to their customers, along with other essential financial services, in the communities where they are located. As has been noted by many, these institutions have a different business model than larger institutions, often serving local markets and having close relationships with their customers. In rural areas, these institutions play a particularly important role. In many rural communities, community banks and credit unions are the only financial institutions providing retail branches and services in the community. These institutions also focus on traditional banking services and do not engage in many of the complex lines of business that larger institutions do, such as securities issuance, credit default swaps, or proprietary trading.[43] Disruptions to the traditional banking services, such as mortgages, cannot be offset with other products and lines of service. As a result, stress on community banks and their mortgage lending would be felt elsewhere. For example, community banks provide almost half of small business lending, and that is dependent on the overall sustainability of the institutions.

The GSEs provide a number of features that are essential for community banks. First is the GSEs' cash window, which provides lenders the option of selling individual loans. This means that smaller institutions do not have to trade their loans for securities or sell their loans to other large banks. Although many larger lenders trade their loans for GSE securities, this is difficult for small lenders. The securities carry the interest rate risk of the underlying loans and, as a result, can change substantially in value if market interest rates change. An increase in market interest rates would significantly reduce the value of the securities and create a loss for the bank holding the security. Larger institutions can purchase interest rate swaps to hedge this risk, but this is much harder for small lenders to do.

Another advantage of the current cash window is that the GSEs purchase these loans without requiring the transfer of the servicing of the loans to a third party. This enables the community banks and credit unions to continue the relationship with the customer during the life of the loan rather than having the loan serviced by a third party or even a competitor. Private loan purchasers and aggregators often require the seller to transfer the loan servicing to the purchaser. Keeping loan servicing in the hands of the community based financial institutions usually results in better consumer outcomes in terms of customer service and loan performance

The current cash window also provides comparable pricing to trading for securities. This is critical, as options such as the cash window are viable only if the pricing is at a level that permits community banks to be competitive in the mortgage market. Overall, the mortgage market favors larger lenders and larger transactions, particularly for securities. Sales of large pools of loans are more attractive to buyers of the loans and buyers of the securities backed by the loans. Absent safeguards, large lenders can leverage the government support to use these structural advantages to squeeze community banks and other small lenders out of the market. These important features of the cash window option, which are not available for FHA loans, are a reason that the FHA program, while vitally important, is not a substitute for community banks having access to conventional lending for their full spectrum of customers.

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[43] These distinctions have been recognized by the CFPB, which created a number of special provisions for these lenders in the mortgage regulations, exempting smaller lenders from many requirements and providing additional flexibility for underwriting and servicing of loans.

Given the importance of these provisions in the current housing finance system, they should be continued and expanded. However, some of the proposals for housing reform have provisions that would tilt the government supported mortgage market heavily against community banks. While most options preserve some form of a cash window, they do not have the supporting protections that make it workable. Most important is pricing parity with the securities option. If securities trade at a better price, it greatly diminishes the value of the cash window. This is true even if there is a provision that prohibits volume pricing or discounts. If all cash transactions are disfavored to securities, the lack of discounts in either market are of little consolation to community banks who are disproportionately dependent on the cash window transactions. To provide this pricing parity, the guarantor/issuer must have the ability to pool costs across the market. This makes it essential that guarantor/issuers serve a national market and have a duty to equitably serve all lenders. Otherwise, if some guarantors/issuers can choose to cream the market, serving only the large lenders and the most lucrative markets, the remaining guarantors will not have sufficient loans from the full market to be able to provide pricing parity to small lenders and still compete in the overall market. In order to provide this parity, the guarantor/issuers also must be able to pool the credit risk that they hold and reinsure. If all but the catastrophic credit risk is transferred before the loans are purchased by the guarantor/issuers, there is insufficient revenue remaining for the guarantors/issuers to pool the costs and provide viable pricing to small lenders. If substantially all of the credit risk is sold and priced before the loans are acquired by the guarantor/issuer, then these other parties control the access and pricing and they will favor the larger lender transactions, which will be more profitable.

Provisions for a small lender security or issuer are offered in some plans to address this problem, but they are inadequate. Securities resulting from small groups of loans from many lenders will be measurably more expensive to assemble. They would also still lack the size to create enough loans to provide the large volume of securities for the economies of scale and liquidity that investors in securities desire, and would also reduce the price community banks received for the mortgages.

Other aspects of the mortgage market already have headwinds for community lenders. Many components of the production of mortgages favor large lenders due to their market size. These larger lenders can demand lower prices for many of the third-party services provided to lenders, and overall they have the advantage of economies of scale over smaller lenders. These conditions make it all the more important that the government elements of the mortgage provide a level playing field and not contribute to the squeezing out of community bank mortgage lending.

III. Further Changes in the Housing Finance System Must Build on The Substantial Reform Already Implemented

A. Enactment of HERA

One of the major reforms in response to the financial crash was Congressional action to strengthen and improve the regulatory structure of the housing market. The Housing and Economic Recovery Act (HERA) substantially changed the regulatory landscape of the housing finance system.[44] As we pursue further reform we need to build upon the current market and regulatory structure, which was

[44] 12 U.S.C. § 4501 et. seq.

substantially strengthened by HERA. In fact, after the passage of HERA substantial GSE reform has already been implemented, and these reforms should be continued, expanded, and made permanent.

Congress' creation of FHFA was a central reform of the housing finance system. HERA abolished the Office of Federal Housing Enterprise Oversight (OFHEO) and the Federal Housing Finance Board, and established FHFA – a strong independent regulator with the legal authority and tools required to supervise the full activities of the GSEs. Prior to HERA, oversight of the GSEs was split between OFEO and the Secretary of HUD. The absence of a primary and comprehensive regulator resulted in the lack of robust and efficient enforcement. OFHEO, an independent agency within HUD, was the safety and soundness regulator, and the Secretary of HUD was the mission regulator. The affordable housing goals were under the Secretary of HUD's purview. This regime was problematic for many reasons, but the most significant issue was that OFHEO did not possess the legal authority necessary to adequately supervise the GSEs or enforce the law. As FHFA's General Counsel stated in congressional testimony in 2013, "At OFHEO much had to be done with implied authorities; HERA corrected that, providing explicit authorities and language regarding 'incidental authority.'"[45]

OFHEO's authority over the GSEs was weak and not comparable to other financial regulators. The agency did not have sufficient authority to establish prudential standards, including internal controls, audits, risk management, and management of the portfolio. In contrast, HERA empowered FHFA with the legal authority to comprehensively and robustly regulate the GSEs. FHFA has the tools to ensure adequate capital,[46] establish prudential standards,[47] review and approve new product offerings,[48] place a regulated entity into receivership,[49] and closely supervise the full activities of the GSEs.

Furthermore, OFHEO did not hold adequate enforcement authority. OFHEO had to rely on the Attorney General to sue on the agency's behalf. HERA provided FHFA with a broad range of administrative enforcement tools, including cease and desist orders, civil money penalties, debarment of officials, and the ability to act against entity-affiliated parties.[50] FHFA may also access the courts through its independent litigation authority.[51] Additionally, while OFHEO funded operations through assessments on the GSEs, it could only collect the assessments when approved through appropriations. Consequently, OFHEO was perpetually underfunded. HERA corrected this so FHFA would not be subject to the appropriations process and the politics accompanying it.[52]

In addition, HERA corrected the bifurcated authority issue that OFHEO experienced. On the mission side, HERA provided FHFA with authority over the affordable housing goals and established a duty to serve underserved markets requirement. The purpose of this requirement is to increase the liquidity of mortgage investments and improve the distribution of investment capital available for mortgage financing

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[45] Housing Finance Reform: Powers and Structure of a Strong Regulator, Statement of Alfred M. Pollard before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Nov. 21, 2013), *available at* https://www.fhfa.gov/mobile/Pages/public-affairs-detail.aspx?PageName=Housing-Finance-Reform-Powers-and-Structure-of-a-Strong-Regulator.aspx.
[46] 12 U.S.C. §§ 4611-4613.
[47] 12 U.S.C. § 4513b.
[48] 12 U.S.C. § 4541.
[49] 12 U.S.C. § 4617.
[50] 12 U.S.C. §§ 4581, 4631.
[51] 12 U.S.C. § 4635.
[52] 12 U.S.C. § 4516.

for very low-, low-, and moderate-income families in manufactured housing, affordable housing preservation, and rural markets.[53] FHFA's authority to administer the duty to serve requirement plus the affordable housing goals should be applied robustly to expand affordable homeownership opportunity.

These important HERA reforms should be continued and expanded. For instance, FHFA has required reinsuring of credit risk and it has greatly shrunk portfolios to reduce taxpayer exposure. The ban on lobbying and campaign activity should be made permanent, portfolios should be further reduced and limited to necessary business purposes (such as modifying loans and supporting the TBA market), and capital standards should be set and achieved. Utility regulation and returns for the GSEs would further prevent excessive risk taking. Much authority already exists to continue advancing this reform while Congress considers GSE legislation.

B. Credit Risk Transfers

One of the major reforms of HERA was to provide the FHFA Director with the authority to ensure that the GSEs did not have excessive risk. A main objective of FHFA has been that the GSEs share credit risk with private investors. Utilizing credit risk transfer products, the GSEs can carry out their Congressional mandate to serve all markets and drive affordable access to housing finance, while simultaneously reducing their underlying risk, thereby protecting taxpayers from market downturns. By creating a wide variety of credit transfer products, the GSEs ensure that a sufficient number of investors will remain in the market through all phases of a housing price cycle, creating reliable liquidity and funding.[54] This objective was meant to work alongside, and strengthen, the underlying mission of the GSEs to serve all markets and foster affordability and access to the housing finance system. As discussed above, the back-end nature of most of the GSEs' credit risk transfer activity effectively introduces private capital to insulate taxpayers without facilitating differential pricing, which undermines access and affordability goals. By reducing the underlying risk of the GSEs, and preserving their role in the housing market as drivers of access and affordability for all markets and borrowers, credit risk transfer is a large part of how the GSEs can function in a financially sound manner, while at the same time providing access to affordable home loans, especially for communities of color and credit worthy LMI borrowers.

In fact, the GSEs have been very effective in this mission. In total, from 2013 to December 2016, the GSEs have transferred almost $49 billion of credit risk on $1.4 trillion of UPB.[55] In 2016 alone, the GSEs transferred $18 billion of credit risk on mortgages with an UPB of $548 billion, utilizing various credit transfer products and the capital markets.[56] Furthermore, from 2013 through 2016, the GSEs transferred an additional $186 billion of credit risk and $731 billion of UPB to primary mortgage insurers.[57] This transfer results in a reduced risk to taxpayers, greater market stability, and does not disrupt the TBA market, while also empowering the GSEs to provide broad national secondary market liquidity for residential mortgage financing and carry out their affordability and duty to serve goals.

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[53] 12 U.S.C. § 4565; 12 C.F.R. 1282, Subpart C.

[54] See, FHFA Report Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions, August 2015, *available at* https://www.fhfa.gov/ABOUTUS/REPORTS/REPORTDOCUMENTS/CRT-OVERVIEW-8-21-2015.PDF.

[55] Id.

[56] Id.

[57] Id.

The GSEs have developed a portfolio of diverse credit transfer products including: Credit risk debt issuances (STACR/CAS) transactions; insurance/reinsurance transactions; senior-subordinate securities; and collateralized lender recourse transactions.[58] Credit risk transfer has become a regular part of the GSE business structure, and they are currently transferring a substantial amount of the credit risk on almost 90 percent of the loans that comprise the majority of the GSEs' underlying credit risk.[59] Of this amount, the debt issuances (STACR/CAS) make up 72 percent of the total amount transferred, 25 percent of the transfers were made via insurers and reinsurers, and the remaining 4 percent transferred through front-end transactions.[60] FHFA has also recognized that the success of the GSEs credit risk transfer products depends on broad investor participation. Since 2013, the GSEs have transferred credit risk to numerous private market participants such as asset managers, hedge funds, insurance and reinsurance companies, banks, sovereign funds, REITs, and lenders.[61] Up until December 2016 more than 100 unique investors have participated in both the CAS and STACR programs.[62] The success of the GSEs to reduce their underlying risk and fulfill their Congressional charter is in large part due to their ability to offer credit risk transfer products. The enactment of any restrictions that altered the GSEs' ability to transfer and pool risk in this manner would severally limit the progress that has been made since 2013 under the direction of FHFA.

IV. <u>Principles for Housing Finance Reform</u>

As shown by the data and discussion above, leading up to the financial crisis the GSEs certainly made critical mistakes and took excessive risks, though substantially less so than actors in the private label security market. At the same time, both pre-crisis and post crisis, they provided essential mortgage credit that supported not only the housing market, but the overall economic recovery. In addition, their operations have been critical for community banks, credit unions and other small lenders, who must compete with much larger institutions in the mortgage market. Similarly, the GSEs have extended additional credit to rural borrowers, LMI borrowers and communities of color, who all struggle to get access to affordable home loans. The challenge of housing finance reform is to build on those features that have served the market well and reform those that need to be fixed, at the same time ensuring that the overall system is viable and protects taxpayers. Fortunately, as set out above, HERA and subsequent actions by FHFA have implemented many of the needed reforms to achieve these goals.

A. Features of the current housing finance system that must be preserved going forward include the following:

- **Ensure equal treatment for small lenders**. This includes maintaining the cash window, with critical pricing parity to securities, and requiring all issuer-guarantors to serve all qualified lenders. It also requires structuring risk transfer transactions in a way that does not disadvantage small lenders.

[58] Id.
[59] See, FHFA Report Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions. August 2015, *available at* https://www.fhfa.gov/ABOUTUS/REPORTS/REPORTDOCUMENTS/CRT-OVERVIEW-8-21-2015.PDF
[60] See Credit Risk Transfer Progress Report, December 2016, *available at* https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRTProgressReport_Dec2016.pdf
[61] Id.
[62] Id.

- **Serve all markets across the country throughout the business cycle.** Prior to the GSEs there were significant differences in mortgage pricing and availability among different areas of the country. Issuer-guarantors must have an explicit duty to serve a national market rather than creaming the market by serving only lucrative markets and leaving other less lucrative markets, such as rural markets, unserved.
- **Serve all credit worthy borrowers.** Rural borrowers, new emerging households, LMI borrowers and borrowers of color all face obstacles to receiving competitive and affordable mortgage loans. Current provisions include important measures to further service of these markets: the mandate to serve the broad market, even at a lower rate of return; affordable housing goals; the duty to serve under-reached markets; and the affordable housing funds. These were all included in or reaffirmed by HERA, which passed with strong bipartisan support. These bipartisan compromises, worked out over nearly a decade, must be preserved and expanded in order to meet the current and future mortgage market, which will include large proportions of these borrowers. Equally important, credit risk transfers must continue to be done by the issuer-guarantors through mechanisms that do not price these borrowers or small lenders out of the market. This means credit risk transfers must be executed through reinsurance structures that permit pooling of loans and risk, and not through deeper upfront risk transfers.
- **Promote cost-effective loan modifications.** Notwithstanding the recent long stretch of economic growth, the business cycle will return and there will periods of decline in the economy and the housing market. During these times, the issuer-guarantors must be able to serve the market and service distressed mortgages, as the most mobile funding will be unavailable, as has occurred in the recent and other past downturns. In order to do this, the issuer-guarantors must have the liquidity to modify distressed loans. This will require a limited but critical government back stop when necessary, to be able to finance the acquisition and holding of distressed loans while they are modified. A very limited backstop is also required to ensure during periods of deep crisis that the issuer-guarantors have sufficient liquidity to be able to purchase and aggregate loans to securitize. There should be appropriate limitations to ensure these loans do not morph into the arbitrage strategies of the past.
- **Preserve the 30-year fixed rate mortgages and the TBA market.** Thirty-year fixed rate mortgages provide families the ability to set their mortgage payments and plan on them into the future. They also permit borrowers to build in a future cushion of financial protection, including for retirement. Without the government credit guarantee, it is very difficult for other parties to hold the interest and credit risk of thirty year mortgages. In addition, the TBA market is critical for both borrowers and lenders alike. First, borrowers are dependent on being to determine and lock in their monthly payment obligation. Without a TBA market, this become difficult, as increases in interest rates before loan closing can dramatically increase their required payments. Lenders, and especially smaller lenders, are likewise dependent on being able to lock in an interest rate and price at which they can sell their mortgages to an issuer-guarantor.

B. Areas that need continuing reform include the following:

- **Maintain a strong regulator.** The FHFA is a dramatic change from the handcuffed authority of OFHEO. OFHEO had limited authority, with appropriations control of its funding (often thwarted by the GSEs) and limited enforcement authority. FHFA, in contrast, has extensive authority both in regular circumstances and conservatorship, as described above. This authority should be maintained and expanded consistent with other recommendations set out below.

- **Provide an explicit and fully paid for government guarantee.** The housing market is such a critical part of the US economy – approximately 20 percent of the overall economy – that it will be difficult for the US government, or any government, to permit it to collapse. Instead, the government should make its guarantee explicit and charge an appropriate fee for this guarantee. In addition, as is done with federal deposit insurance, premiums for this backstop should be put into a guaranty fund so they will be available in the event they are needed.
- **Put more private capital in front of the government guarantee.** There is widespread agreement that the GSEs were substantially undercapitalized prior to the enactment of HERA. HERA gives the Director of FHFA the responsibility and authority to require the GSEs to maintain adequate capital. This authority must be maintained and implemented. While sufficient capital is essential, excessive capital requirements place a heavy fee on all homebuyers. In determining the appropriate level of capital, several factors should be kept in mind. First, when comparing the capital of the GSEs to banks that hold mortgages, it is important that banks hold substantial interest rate risk on the mortgages, while that risk is sold off to investors for the loans the GSEs guarantee. Second, when the level of risk is compared to the financial crash, a number of fundamental changes have dramatically reduced the risk of a crash of that severity. First, and most important, requirements that loans have full documentation and determination of the borrowers' ability to repay greatly reduce the level of default of mortgages. The types of loans that caused the mortgage crisis are largely prohibited today. Second, the overall financial system is safer due to these mortgage protections and systemic protections for other financial actors.
- **Prevent portfolio arbitrage.** There is also widespread agreement that the GSEs exploited their implicit government backstop to borrow at advantaged interest rates and used this funding to arbitrage the purchase and holding of an outsized mortgage portfolio. Doing so produced much higher rates of return than just guaranteeing loans that they securitized. However, this placed additional risk on the books of the GSEs. Such arbitrage should be prohibited, and the GSEs have dramatically reduced the size of their portfolios in recent years under pressure from FHFA and Congress. However, some portfolio is necessary for the aggregation of TBA loans, the modification of distressed loans and the holding of specialized loans. Borrowing for these limited purposes should continue to be permitted and should be protected in times of stress. Otherwise, when the need for these services is greatest for the benefit of the overall economy, funding will be unavailable or unaffordable.
- **Require mutual ownership and/or utility regulation.** The structure of the GSEs created a conflict that has been noted by many. While they had public purposes and goals, their structures made them accountable to shareholders who expected maximum returns. This created an incentive for them to take on more risks to increase returns. It also encouraged the GSEs to focus on the most lucrative segments of the market, underserving small lenders and rural and LMI borrowers. To counteract this conflict, issuer-guarantors should

be restructured as either mutual owned organizations or regulated utilities. Mutual ownership has a long and successful history in the Federal Home Loan Banks, which have this structure and provide mortgage financing, yet required no bail out in the financial crisis. However, both large and small lenders worry that they will be disadvantaged by the other in a mutual structure. Utility structure, under which investors are provided a lower, but less volatile, rate of return, has many advantages. It also includes closer oversight of the entities, including regulation of fees, as has been done in conservatorship of the GSEs. Either or both of these changes in structure would prevent the present conflict of interest created by the GSEs' structures. Other reforms that would also better align the issuer-guarantors with their public goals include making permanent the ban on their political and lobby activities, and continuing the prohibition on any vertical integration of their activities into the retail mortgage market.

Conclusion

Our housing finance system plays a key role in the lives of American families and it affects our overall economy. As changes are considered, we do so with the benefit of substantial recovery from the financial crash and with many reforms already implemented. The pre-crisis housing finance system and market has already been profoundly changed for the better, and fortunately no longer exists. Further changes must be undertaken with great care to preserve the many benefits of stable, affordable, and widely available mortgages for American families and lenders.