Statement before the House Committee on Financial Services
On "A Legislative Proposal to Protect American Taxpayers and Homeowners by Creating a Sustainable Housing Finance System"

# Testimony on the Protect American Taxpayers and Homeowners Act


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Chairman Hensarling, Ranking Member Waters, and Members of the Committee:

Thank you for this opportunity to testify on the Protecting American Taxpayers and Homeowners Act of 2013. This act is particularly well-named; by taking the government out of our housing finance system we will create a stable system for financing homes in the future while protecting taxpayers from further bailouts and homeowners from the dangers of foreclosure.

Although there seems to be a near-consensus that Fannie Mae and Freddie Mac should be eliminated, there is no consensus on what should replace them. Since the financial crisis in 2008, almost every plan that has been put forward in Washington has involved one or another ingenious way to wind down Fannie and Freddie while keeping the government involved in the housing business.

This reflects a kind of delusion—that Fannie and Freddie were bad but the government's involvement in housing finance is somehow good. In reality, Fannie and Freddie did what they did, and became insolvent doing it, because they were backed by the government. If Congress adopts another plan for the government to back the housing finance system we will end up the same way—with a huge mortgage meltdown, a major recession, taxpayers on the hook for billions of dollars, and millions of families losing their homes.

The last point finally got to a former chairman of this committee, Barney Frank, who said in 2010, "I hope by next year we'll have abolished Fannie and Freddie. It was a great mistake to push lower-income people into housing they couldn't afford and couldn't really handle once they had it." And he added, "I had been too sanguine about Fannie and Freddie."

It's easy to see how government-induced declines in underwriting standards happen. Every member of this committee knows how hard it is to cut spending. That's because every member of Congress wants to do something for the people who elected him or her. Congress likes to spend because the voters like it.

All the better, then, when the benefits for constituents do not involve spending. Fannie and Freddie were and are examples of this. Because they were controlled by the government, they could be manipulated to give subprime and other low quality mortgages what was in effect a government guarantee, so that financial institutions and others would buy these mortgages when in any other world they would not think of taking such a risk.

This was a gift to constituents who did not have the financial resources or the credit standing to get a mortgage. It was no different from the usual spending program, except that it did not involve appropriations or increases in the debt—until the whole system crashed because of low-quality mortgages in 2008.

Housing finance is a particularly good example of this process because Congress also saw fit to extend the benefits of the GSEs and the FHA to wealthy constituents, allowing people who were buying million dollar homes to get the benefits of FHA insurance or a GSE mortgage.

What makes anyone think that this won't happen again if the government is going to back mortgages? The Corker-Warner bill, which has received a lot of favorable attention because it is bipartisan, is an example of the proposals that will eliminate the GSEs but put another government program in its place. Investors would be protected, but the government insurance program that would replace Fannie and Freddie will eventually be pressured by Congress to make the same risky mortgages that brought down the financial system in 2008. We should recall that FHA started its life requiring 20 percent downpayments. Now it requires 3 percent or less—and needs a taxpayer bailout.

This history should tell all of us that the bill now before this committee is the way to go. It would take the government out of most of the housing finance market, although it would provide for a new and more prudent FHA for first time low-income home buyers.

I have some suggested improvements for this bill—detailed in my written testimony—but on the whole it shows the way out of the repetitive cycles of failure that have been the story of the housing finance market under the government's control since the end of the Second World War.

Instead of yet another government program—and another meltdown in the future—the PATH Act would open the way for private securitization to become a major source of housing finance.

In this, the draft is following the views of former Fed chair Paul Volcker, who said in 2011:

> There is one very large part of American capital markets calling for massive structural change that so far has not been touched by legislation. The mortgage market in the United States is dominated by a few government agencies or quasi-government organizations. The financial breakdown was in fact triggered by extremely lax, government –tolerated underwriting standards, an important ingredient in the housing bubble. The need for reform is self-evident and the direction of change is clear. We simply should not countenance a residential mortgage market, the largest part of our capital market, dominated by so-called Government-Sponsored Enterprises.
>
> The residential mortgage market today remains almost completely dependent on government support. It will be a matter of years before a healthy, privately supported

market can be developed. But it is important that planning proceed now on the assumption that Government-Sponsored Enterprises will no longer be a part of the structure of the market.

Before turning to the specifics of the bill, I'd like to address a number of fallacies that are used to support the idea that government must be involved in the housing finance market.

**The government is necessary for 30 year, fixed rate mortgages**. Anyone can prove this is a fallacy, simply by going to Google and typing in "30-year jumbo fixed rate mortgage." The word "jumbo" is mortgage market jargon for loans that are too large to be bought by Fannie or Freddie, or insured by the Federal Housing Administration. That means a jumbo mortgage is not backed in any way by the government. Still, a Google search will return many offers of jumbo fixed rate 30 year loans. I found one offered by Wells Fargo last Friday at 4.5%, which was *less* than the 4.625% offered by Wells for a conforming (Fannie and Freddie) 30 year fixed rate loan.[1]

The idea that government backing is required for a 30-year, fixed-rate loan has some surface plausibility. Many people who don't follow the financial markets might assume that lending money for that long a period at a fixed rate would be too risky for the private sector. However, our flexible and innovative private financial markets offer hedging opportunities that make this possible.

Just about everyone in Congress seems to have been visited by a representative of the Government Mortgage Complex—Realtors, homebuilders and community activists—claiming that the 30 year mortgage would not exist without government backing. If that's what they're telling you, keep a copy of the rate sheet I've cited below in your desk and ask them to explain how it could be that Wells Fargo is offering a 30 year fixed rate mortgage without government backing.

**The investors in MBS are rate buyers; they do not want to take credit risks.** Without government backing and the assurance of a risk-free investment, it is argued, we would not be able to find investors for MBS in the US and around the world.

This argument confuses cause and effect. It is true that most of the buyers of GSE and Ginnie MBS today do not want to take credit risk, but that's only because these government-backed securities *attract* investors who do not want to take risks. According to the Fed's Flow of Funds data, the principal buyers of Ginnie Mae and GSE mortgage-backed securities (MBS) are US banks, foreign central banks, and Federal, State and local pension funds. If there were no Ginnie or GSE MBS, they would be buyers of Treasuries.

Virtually the entire private sector, however, is financed by the private bond market, where institutional investors like insurance companies and private pension funds are willing to take prudent risks in order to gain the higher yields than they can get on government securities. In the private sector, investors are compensated for taking these risks. Privately securitized mortgages would be a perfect investment for financial institutions like life insurers, private pension funds and mutual funds, which have about $13 trillion to invest. This would be a win-win for our economy, providing long term high quality and stable assets for life insurers, pension

[1] Wells Fargo, Today's Mortgage Rates, accessed on July 12, 2013, https://www.wellsfargo.com/mortgage/rates/

funds and others looking for long term assets while also providing a long term source of financing for mortgages.

**The government will step in anyway, so it should charge in advance to protect the taxpayers.** Almost all the proposals for a government backstop for mortgages are premised, implicitly or explicitly, on the idea that if there is ever a problem in the housing market the government will step in. Accordingly, the argument runs, we should have a system in place that compensates the government in advance and sets up the mechanism for the government's inevitable intervention. There are many problems with this argument, including the fact that the government recently stepped in to rescue two automobile companies, one of them for the second time. This means that the government is liable to step in whenever there is a serious problem in any market where large numbers of people are employed, or where something is manufactured or where a service is performed that is widely used. If the argument in support of government backing for housing is correct, we should also have a similar system for every other part of the economy. The moral hazard consequences of that can hardly be imagined.

But the history of housing finance makes clear that the government's role in the housing market—even if only as a brooding presence ready to act if the market collapses—will so distort the market that the government is eventually *required* to step in. This is a repeating pattern. For one example, the government had to rescue the S&Ls in the late 1980s and early 1990s because the government's own support for and regulation of the S&L industry had made it impossible for the industry to survive the changes in market structure that are inevitable in an evolving financial system. Similarly, the reason we are here today, and considering what to do about the GSEs, is the result of government housing policies that forced Fannie Mae and Freddie Mac to degrade their underwriting standards.

Government backing of the housing finance market cannot be separated from government policies that will weaken mortgage quality. The government is in the business of providing benefits to its constituents—that is, US voters—and when it controls a sector of the economy it makes sure that the maximum number of people receive the benefits of the government's support. This is normal in a democracy, but it is devastating to markets. It means that mortgage quality will inevitably be reduced so that more borrowers can qualify for mortgages, and that in turn is what brought on the great housing bubble, the mortgage meltdown of 2007 and 2008 and the financial crisis.

We should have learned by this and earlier experience that government intervention in the housing finance market is made more *likely* by government's backing of the housing finance market. So if we want a stable market we are more likely to get it with one that does not rely on government support—much like every other industry in the US—than one in which the government is involved.

**Without government backing there would be no TBA market and interest rates for all mortgages would rise**. This is also incorrect. The TBA (To Be Announced) market is a hedging mechanism, which allows lenders to hedge the possibility of interest rate changes between the time they lock in a rate for a borrower and the time the loan actually closes. This is done by selling the pool of mortgages forward, just as a farmer might sell his wheat or corn crop forward. Then, if the price falls, he is protected. The buyer is speculating that wheat will be worth more when delivered than it is on the date of the forward sale. So in the same way, the mortgage lender sells its pool of mortgages forward to a buyer who is speculating that the mortgages will be worth more in the future when they are ultimately delivered.

There are two keys to the effective operation of a TBA market—market liquidity and a general agreement on the principal terms of the mortgages in a MBS pool. In the current TBA market, in which the GSEs are the principal players, liquidity is created by a convention among market participants about what they will accept as sufficient information about a particular mortgage pool that is offered for sale. The agreement covers six factors—issuer, maturity, coupon, price, par amount and settlement date. Participants in the market agree to buy a pool of mortgages that all fall within these previously-agreed parameters. It's the agreement on these parameters—so hedging counterparties know what they are buying—that creates the hedging opportunity, not a government guarantee of the credit risk. The credit risk is occasionally a factor, but the purpose of the TBA market is to hedge interest rate risk, not credit risk.

Once the private market becomes active enough so that there is a liquid market for the purchase and sale of mortgage pools a TBA market will function. The independent platform's utility, proposed in section 322 of the PATH Act, should make this happen sooner than it would in a fully private market, but there is no question that TBA would develop in a fully private market just as it would in a market dominated by a government agency.

**Without government involvement, a steady flow of credit to housing cannot be guaranteed.** This idea raises an important question: why should housing, as distinguished from any other industry, be guaranteed a steady flow of credit? Every other industry has to live with the prospect that interest rates will rise and credit will tighten. This encourages prudence and care in making commitments, reduces overbuilding and the use of leverage that has contributed to housing bubbles in the past. A steady flow of credit to housing has, ironically, been the cause of much of the volatility and instability in the housing market in the past. It would be better, accordingly, if the housing market were not guaranteed a steady flow of credit. If credit in the market in general is insufficient for any reason, the Fed has the necessary resources to address the problem. A separate system for housing is not necessary and would be affirmatively harmful.

## The Protect American Taxpayer and Homeowners (PATH) Act

The act has four Titles, and my comments on the most important elements in each title follow.

### Title I

Title I covers the wind-down of Fannie and Freddie. This is an important objective of the act. There are many technical issues that should be discussed with the committee's staff, but the following discussion addresses what I think are the most significant issues.

**Section 104**. This section winds down the GSEs over a five year period, ending with a receivership that presumably wipes out their stock. This is a good idea for several reasons. It assures the private sector that Fannie and Freddie will disappear in a known period of time and thus encourages the private market to begin making the capital investments and other preparations for a return of private securitization. However, winding down the GSEs to a conforming loan level floor of $250,000 is not a rapid enough decline. It will leave a very large portion of the available housing finance business still within the GSEs' conforming loan limit and thus in competition with the private sector. This slow withdrawal of the GSEs will slow the entry of private securitizers and the liquidity available to those private securitizers who have already entered, keeping their rates somewhat higher than they would be if they had a larger proportion of the market to work with. It could also create a cliff-like effect on rates when the five year period ends, and that might induce a future Congress to postpone the elimination of Fannie and Freddie. In my view, the conforming loan limits for Fannie and Freddie should be steadily reduced to $100,000 or less at the end of five years.

**Section 104 (c)** repeals the housing goals adopted in 1992. The affordable housing goals, which sought to increase mortgage lending to moderate and low income borrowers, required Fannie and Freddie to radically reduce their underwriting standards between 1992 and 2008. Because they were the dominant players in the housing finance market, when the GSEs reduced their underwriting standards everyone else had to follow suit. It was not possible to limit the reduced standards to low and moderate income buyers. Eased credit terms and more buyers built the largest housing bubble in US history between 1997 and 2007. By 2008, half of all mortgages in the US market—28 million loans—were subprime or Alt-A, and when the bubble deflated these mortgages defaulted in unprecedented numbers, bringing on the mortgage meltdown, the financial crisis and the resulting recession. During and after this period, many families lost their homes. By eliminating the affordable housing goals, the PATH Act prevents this from happening again by preventing the government from taking control of and reducing mortgage underwriting standards. This is one of the act's major contributions to future housing finance market stability.

**Section 106**. Mandatory risk-sharing with the private sector could work well for the GSEs while they are being wound down. It will help the FHFA properly price the risk of securitized pools by providing a private sector estimate of the risk of a particular pool. However, for the system to work most effectively, private risk-sharers should take the first loss, with the GSEs taking any losses above that level. Risk-sharing in which the risk-sharer takes the first loss may not work well in other contexts, such as the Corker-Warner proposal, where it may force the government insurer to reduce its insurance premiums in order to keep mortgage costs low.

**Section 107**. The requirement in this section that the GSEs may only purchase "qualified mortgages" as defined by the CFPB could have a very serious adverse effect on mortgage quality in the future. The CFPB's QM regulation assumes, incorrectly, that if a lender ascertains that a borrower can repay the mortgage at the time the contract is written that is a sufficient indicator of the mortgage's quality. Then it compounds the problem by providing that if the automated underwriting systems (AUS) of the GSEs or another government agency approves or accepts the mortgage the lender gets a safe harbor against the penalties that the Dodd-Frank Act has written into TILA and the defenses to foreclosure in Sec 1413 of Dodd-Frank. Requiring compliance with the QM rule implies that this is the standard of mortgage quality that Congress expects. That would be a very troubling result. With the exception of a debt-to-income (DTI) ratio limitation of 43 percent, the QM rule requires no underwriting standards; a loan can qualify under QM even if it has no downpayment and is made to a borrower with a credit score of 580 or 600.

The fact that the borrower can repay the loan at the moment it is agreed to does not mean that the borrower has the *intention* or will have the *capacity* to repay the loan in the future, despite the many financial problems—loss of employment, divorce, illness, etc.—that are part of life and have the effect of changing a borrower's priorities. A dataset recently released by Freddie Mac and involving over 15 million fixed rate, fully documented loans since 1999 shows that a home purchase loan like that described above (30 year fixed, fully documented, home purchase, no downpayment and a 600 FICO score ) had an incidence of default of 26%, even if the DTI is 42%. Compare this to a 1% default rate on a loan with 20% down, a DTI below 38%, and a FICO score of 720, which is about the median FICO score in the U.S. Section 107 should make clear that the objective of the GSEs' lending should be to return to an incidence of default of 1% or less in normal times—the rate that prevailed before the adoption of the affordable housing requirements in 1992. This will create the stable mortgage market that the bill correctly seeks.

## Title II

Title II provides a new charter for the FHA, turning it into a corporate body (**Sec 211**) that will function outside the control of the Department of Housing and Urban Development (HUD). This is a very good idea, especially when combined with some of the safeguards that are built into the proposal to keep the new entity from becoming a cost to the taxpayers. However, there are a few areas where additional provisions are necessary or where existing provisions should be improved.

Sections that contain excellent ideas are **211(d) and 235 (c)** that require FHA to be self-supporting by covering its own costs, including its administrative costs; **Sec 234**,which reduces FHA's insurance 10% per year until it reaches 50%; **Sec 235**, which sets a minimum premium of .55%, allows risk-based premiums or risk-based underwriting, and requires a statement for borrowers at the time the loan is originated telling them of the likelihood of default and foreclosure; **Sec 251**, providing for FHFA to act as prudential supervisor of FHA; **Sec 253**, requiring that FHA use GAAP accounting (although the language should specify private sector GAAP in order to exclude federal GAAP); **Sec 256**, which establishes a capital reserve of 4% (but it should not include net present value of inflows and outflows, which FHA has shown are susceptible to manipulation); **Sec 263**, which imposes a 3% limitation on seller concessions (I assume this is 3% of mortgage cost, not "closing" costs as stated in draft); and the **Sec 267** requirement for a review of a borrower's residual income.

The sections that should be improved are **214 and 215**, which provide for the board of directors and officers. If FHA is to be independent of HUD, the HUD secretary should not be the chairman of the board. The chairman normally establishes the agenda, and that alone can keep the FHA from addressing key issues. In addition, although the draft says that there should be a president and vice president their duties are not specified. Since the duties of the chief risk officer are specified, this sets up a conflict with the president, who has no assigned duties. All these problems can be solved by providing that the president is the CEO and giving him or her the power to set the agenda (as well of course as running the organization), even though the chairman of the board is the HUD secretary. I would even suggest removing the HUD secretary as the chairman of the board and providing only that HUD and the Department of Agriculture have representatives on the board. I understand why the chief risk officer is made independent of the board, but that's not a good idea. Every decision involves some risk, and the reason to have a board is to make balanced decisions on risk based on the issues the chief risk officer brings to them.

**Sec 232** is probably the most important provision in this title, and it is inadequate. There is a considerable risk that the FHA and RHS, as the only government agencies authorized to insure mortgages under the bill, will become competitors for private securitizers to the same extent that they and the GSEs are today. That's why both the house price and income restrictions in Sec 232 have to be very tightly drawn. The bill does not do this; in fact, in Sec 232(a)(1)(B)(i) it prescribes the *highest* median price level in any metro area (the median price level in the highest priced county) as the standard to be used for determining what is 115% of the median housing price in the metro area. Within any metro area there can be high priced and low priced counties. 115% of house prices in the highest priced county would mean that houses in the counties with the lowest house prices could have most houses qualifying for 115% of median, and most mortgages in that county would end up going to FHA or RHS, even though Congress intended that only home purchase mortgages for low-priced homes would be eligible for insurance from the FHA. This provision has to be modified if a robust private securitization market is to come back on anything but the jumbo level.

The same problem occurs with the income restrictions in Sec 232. There are none for first time buyers and those turn out to be 75% of FHA's home purchase loans today. This in itself is a huge loophole. Many first time home buyers will be able to get the benefit of FHA insurance, even though they are not low-income, and that could take a large chunk of the market away from private securitizers. Non-first time buyers are subject to a limitation of 115% of area median income, but again without a tighter definition of this standard in the statute FHA would be able to compete with the private sector for the business of many borrowers who are not low income and do not need the help of FHA insurance. In this respect, the income eligibility restrictions in the bill refer back to the house price provisions of 232 (a)(1)(B)(i). That would make large numbers of higher-income borrowers in lower-income counties—who would otherwise go to the private markets—eligible for the favorable terms at FHA, such as the 5% downpayment, that Congress intended only for low-income borrowers.

One way to deal with both the housing price and income definition problems is base both of these determinations on median incomes by county not metro areas. FHFA should have this data, or can produce it. That would not a perfect solution, but it would help to cabin FHA and restrict the competition that FHA would provide for the private market that the bill is intended to revive.

Beyond these two issues, it is necessary to consider how FHA will be able to provide the benefits it should to low-income borrowers and still remain a self-sustaining independent firm. There is a difficult balance here. It is possible for FHA to avoid losses and still provide benefits to low-income borrowers. In this connection, downpayments of 3.5% and 5% are certainly the kind of benefit that FHA should provide, but not if they are layered with slowly amortizing 30-year terms, low FICO scores, and high DTIs. Based on FHA's experience, a 30 year fixed rate FHA mortgage with a downpayment of 3.5% has a 20% likelihood of default if accompanied by a FICO score of 640 and a DTI ratio of more than 43%. The purpose of the FHA can be served by using a balanced approach, which employs various elements of good underwriting to compensate for the weaknesses in the insurance applications of some low-income borrowers, such as a low FICO score. For example, although a 30 year fixed rate loan with a downpayment of 3.5%, a FICO score of 640, and a DTI of 43% would have a 20% likelihood of default, the same loan with a loan term of 20 years would have a 10% likelihood of default. Combining the effect of other changes in this bill, such as reducing coverage to 50% over 5 years and limiting seller concessions to 3%, could reduce the default rate to an estimated 7%.

Sec 232 also makes some reference to pro-cyclicality, since it eliminates FHA income limits when the market is declining. But a declining market is literally only half the story. The financial crisis was caused by the opposite—a bubble in housing prices. It is necessary for the bill to have countercyclical provisions for both abnormal rises as well as abnormal declines in market prices. My colleagues and I at AEI would be pleased to have the opportunity to work with the committee staff on this. One way for such a system to work would be to require decreases in LTV ratios when housing prices exceed certain predetermined limits, but other ideas are also feasible.

**Sec 257**. Finally, the stress testing provision in sec 257 is an excellent idea, but it isn't carried out well enough. First, the stress cannot simply be downturns of "average severity" since 1950. This may be a drafting question. The downturns of average severity during that period may not have resulted in any significant decline in house prices. A better test would in some way include the severity of the most recent downturn, which was 30 percent, by including it in the average. Another way to do it is to assume that, if house prices are above a long-term trend as established by FHFA, they will revert to trend. The FHFA has already done substantial work in this area. A properly structured stress test along these lines could serve as a countercyclical device applicable to FHA when the market is booming, but it is also necessary to have a countercyclical device that applies to the broader market in these circumstances, and there is none in the bill. Second, while a 4% capital requirement is appropriate, the test should assume that the FHA has 4% capital *after* the stress event, not that it has something above 0 capital.

## Title III.

The Utility is a good idea, but the committee should be concerned about giving an independent company control over something as vital as the private securitization system without any control by participants in the market it is affecting. We have not had good experiences with government- created monopolies, oligopolies or monopsonies like Fannie and Freddie, FINRA, and the rating agencies, all of which have profited excessively from the fact that the government provided them with a special license to perform services in a particular field. Even though the Utility is to be a not-for-profit organization, it has a position that could be profitable for its management. One way to address this problem would be to provide for the Utility's board of directors to consist of a majority from the housing and housing finance businesses. That isn't a perfect solution, but it would have some effect in assuring that what the Utility does is in the interests of the industry and not in the interests of the Utility's management.

**Sec 322** appears to be designed for assisting the development of a TBA market. If so, that ought to be expressed somewhere in the language. Right now, the language could be interpreted to give the Utility control of "underwriting criteria," –very broad term that could be abused unless its use is circumscribed for a particular purpose.

**Sec 322(j)** provides for mandatory arbitration, but it doesn't provide that the result of the arbitration is the exclusive remedy for the complainant. Without that, the arbitration provision may simply create an expensive hurdle before getting to litigation.

**Sec 343** adds qualified securities to the list of securities exempt from the application of the Securities Act. It might be better to provide that qualified securities are eligible for shelf registration with the SEC—with descriptions of the underlying mortgages limited to the six elements now disclosed—which will facilitate the development of a TBA market.

**Title IV**

Some of the most important changes in law necessary to stimulate the development of a robust securitization market are already included earlier in the bill, but Title IV contains some provisions of major importance. **Sec 407**, for example, repeals the risk retention provisions in section 941 of the Dodd-Frank Act. This provision required securitizers to retain 5% of the risk of an issue of securities unless all the mortgages in a securitized pool were qualified residential mortgages (QRMs). QRMs were intended to be very high quality mortgages, but the regulators who were to design this mortgage have not up to now been able to agree on what the QRM was supposed to look like. In any event, the requirement for risk retention was impossible for smaller securitizers to meet, and virtually guaranteed that all the business would go to the large banks with balance sheets large enough to hold 5% of their securitizations for an indefinite period. In addition, FHA and probably the GSEs were exempt from risk retention, which would make them the preferable place for mortgages to be securitized. If the GSEs were difficult for the private sector to compete with in the past, this provision would have made competition nearly impossible unless all the mortgages the private sector securitized were QRMs.

**Sec 408**. The bill contains provisions that protect lenders who portfolio loans or who are securitizing qualified securities (as defined) against liability under the CFPB's QM rule. This is appropriate because that rule creates a harsh system of penalties for very little purpose. As noted above, complying with the QM and TILA requirement that the lender establish the buyer's ability to repay (ATR) the loan at the time the mortgage is agreed to is not a significant underwriting standard. It allows loans with no downpayment and 580 FICO scores, which will always produce high rates of default and return the housing finance system to the condition it was in when the mortgage meltdown occurred in 2007 and 2008. At that time, at least half of all mortgages in the US financial system—28 million loans—were subprime or Alt-A.

However, the penalties under the QM rule did have one valuable element. If it were not for the fact that the CFPB's rule confers safe harbor protection on a lender who gains the approval or acceptance of the loan under the AUS of the GSEs or another government agency, the penalties under TILA would have created a strong incentive for lenders to use traditional underwriting standards in order to reduce as much as possible the likelihood of defaults by borrowers.

However, by eliminating the penalties in the QM rule for certain mortgages and securities, the bill does not itself create any new incentive for lenders to use traditional underwriting standards. The Freddie dataset cited above demonstrates that when traditional underwriting standards are used to create prime mortgages the likelihood of default is reduced to

1% or less. As was true before the enactment of the affordable housing goals, prime loans are consistent with a homeownership rate of 64 percent. A predominance of prime loans in the housing finance system is what would create the stable market that the bill seeks.

One way to encourage this outcome would be to require that the GSEs only acquire prime loans or approve prime loans through their AUS. Prime loans could be defined in the bill or in regulations by FHFA under guidelines established in the bill. No one should object to this, because the GSEs are now operating on the taxpayers' dime and should not be taking any risks on mortgages. This would shut the loophole created by the CFPB's rule, which would still apply to loans that are not portfolioed or run through the Utility's platform. If the GSEs were limited to acquiring only prime loans, and the mortgages eligible for FHA and RHS were limited as described above, lenders would then have an incentive to use traditional underwriting standards.

**Sec 413.** This provision requires that a second lien creditor notify the servicer of the senior lien of the existence of the new mortgage. This is insufficient. When a junior lien is added to an existing mortgage it changes the quality of the mortgage for the first lien holder. A mortgage that once might have had a downpayment of 20 percent now, in effect, has none. The homeowner has eliminated his or her equity in the home, which was seen by the first lienor as protection against default. A sensible compromise would be to allow second liens, but if they occur within 6 months of the date of the mortgage the holder or servicer of the first lien can recognize the additional risk by increasing the rate on the mortgage. This provision would protect investors in privately securitized mortgages, who currently have no protection against second liens added after a mortgage is securitized.

### Other Provisions that May Adversely Affect Private Securitization

**Volcker Rule.** Although justified as preventing the use of insured deposits for risky trading, this rule, enacted in the DFA, prohibits "bank related entities" from engaging in proprietary trading and thus extends far beyond the insured banks it was intended to cover. The term "bank related entities" includes bank holding companies and their subsidiaries, which do not have access to insured deposits. In addition, "proprietary trading" is so difficult to define that the most recent draft regulation covers almost 200 pages and poses over 1000 separate questions to assist the regulators in drafting the final rule. Hedging is a regular and important element of every securitization because it is necessary to protect the issuer against a change in interest rates between the time a mortgage rate is "locked in" with the borrower and the time a complete pool can be assembled for a securitization. Hedging transactions involve buying and selling of securities for the issuer's own account, and could be interpreted to be proprietary trading. Until there is a bright line definition of proprietary trading, it is unlikely that many banks or bank-related entities will take the risk of engaging in a securitization. It is unlikely that the complexity associated with proprietary trading can be adequately defined in a statute, and it may not be possible to define it clearly enough in a regulation. Accordingly, the Volcker Rule may stand permanently as a serious obstacle to private securitization. There are two ways to solve this problem: repeal the Volcker Rule, or apply it solely to insured banks and not the broader "bank-related entities." This will enable bank holding companies and their affiliates to engage in securitization without fear of violating the highly technical Volcker Rule when the regulation is ultimately finalized.

**Provisions for Community banks**. Community banks generally originate high quality mortgages, but their ability to sell those mortgages through the securitization system is restricted. First, they do not want to sell their mortgages to the large banks that are serving as aggregators and securitizers. They regard these large banks as competitors and argue that the large banks use the information on borrowers to steal the customers of community banks. The bill should address this problem directly. I think it is possible for community banks to create a jointly-owned conduit for their mortgages that will enable them to securitize their mortgages directly, without going through a large bank. The best way to determine whether this is possible would be to assign to the FHFA the task of studying this issue and suggesting the mechanism for how this might be done at the least cost to the community banks.