LEGISLATIVE HEARING ON IMMEDIATE STEPS TO PROTECT TAXPAYERS FROM THE ONGOING BAILOUT OF FANNIE MAE AND FREDDIE MAC

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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LEGISLATIVE HEARING ON IMMEDIATE STEPS TO PROTECT TAXPAYERS FROM THE ONGOING BAILOUT OF FANNIE MAE AND FREDDIE MAC

Thursday, March 31, 2011

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

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

Members present: Representatives Garrett, Schweikert, Royce, Biggert, Hensarling, Neugebauer, McCotter, Pearce, Fitzpatrick, Hayworth, Hurt, Grimm, Stivers; Waters, Sherman, Lynch, Miller of North Carolina, Moore, Perlmutter, Donnelly, Carson, Himes, Peters, Green, and Ellison.

Ex officio present: Representatives Bachus and Frank.

Also present: Representatives Miller of California, Renacci; and Watt.

Chairman GARRETT. Good morning. This hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises is hereby called to order.

Without objection, all members' opening statements will be made a part of the record. And at this point, I yield myself 1 minute for my opening statement.

And now that we actually have a gavel, it is official.

Today, we begin the process of considering specific legislation that will take immediate steps to protect taxpayers from the ongoing multi-billion dollar bailout of Fannie Mae and Freddie Mac.

I know those on the other side of the aisle will be critical of this Congress about the pace in which this committee has formally considered legislation to address Fannie and Freddie. However, unlike the last Congress, this committee is actually going to hold hearings and allow members to study and examine legislative proposals to end the bailouts and not simply pass legislation that actually would do the opposite, encourage more of them.

Last Congress, our friends across the aisle refused to have any real hearings on specific bills to address the largest bailouts of the financial crisis. And so with the complete disregard by our Democratic colleagues of this bailout, we were compelled then to offer a bill absent any time, really, to fully debate and formally examine legislative proposals addressing the GSEs.

It was literally the only opportunity that we have had to offer an alternative to respond to the complete absence by our Democratic counterparts to address the issues at all in the now sacrosanct Dodd-Frank Act.

Today, we begin to do this process the right way, with our first hearing on specific legislative proposals regarding the GSEs. And we are going to have these hearings and go through regular order to consider a wide array of proposals that this committee didn't have the opportunity to do last Congress.

So I look forward to reviewing the eight proposals before us today, many of which I believe and hope the Obama Administration will support. And I thank you all and look forward to the witnesses' testimony.

And with that, I yield to the gentleman from Massachusetts.

Mr. FRANK. Thank you. Let me just preliminarily, before I start, the ranking member of the subcommittee is on her way over from the Whip meeting, so she, Ms. Waters, will be here.

I will now begin my statement. I am not surprised that the chairman of the subcommittee began not with any positive statement about what he is planning to do, but by a defense of what they are doing. The contrast between their rhetoric of last year and their reality this year is overwhelming.

I am now hearing that the bill that they were very critical of us for not incorporating into legislation last year wasn't really ready for primetime and that was the best they could do. They had all year. The gentleman from Texas, Mr. Hensarling, introduced it in March. It was in July when they asked us to act on it, and were very critical when we didn't.

I have seen the extraordinary spectacle this year of people on the Republican side, Senator Corker, for one, asking for adult supervision from Secretaries Geithner and Donovan, people here being critical because the Obama Administration hasn't given them more guidance on what to do.

And it reminds me of the kind of classic scene of the man in the bar who is all ready to fight a very big guy and is being held back by his friends and insists that his friends turn him loose, and then they turn him loose, and he is immediately looking for somebody else to hold him back.

The Republicans spent all last year telling us that they were just ready to take on this tough issue of what to do about housing finance, after you get rid of Fannie Mae and Freddie Mac, and we said it is a very tough issue and we should get to it this year, and that was the way to deal with it, but they were raring to go, and they were very critical that we hadn't moved. They filed a bill in March, a comprehensive bill, and were very critical of us in July for not acting on this bill.

And the notion that because we didn't let them perfect it, they couldn't get it perfected, of course makes no sense. They could have talked to anyone they wanted to talk to. They could have had whatever conversations they wanted.

What happened, of course, is it turns out it is a tougher issue than they were prepared to acknowledge. And so what happens is, all last year, they were, “Let me at him, let me at him,” and they were being held back. They were being held back by their Minority status.

And then they got Majority status. Going from Minority to Majority status was equivalent to having your friend let go of your coat, and now you have no excuse not to go fight the guy. And so, they have been looking very much for someone to be the substitute coat-holder, and they found it, the Obama Administration.

It is extraordinary to me that my Republicans colleagues, who have been so disrespectful of virtually anything the Obama Administration has said, on this very difficult issue are trying to hide behind it and are trying to say that they can’t really deal with this until the Obama Administration tells them how to do it.

There are some specific pieces today, many of which I can support, and one or two which, I think, need some further work. But it is a far cry from the comprehensive solution they had. I am, however, prepared to take “yes” for an answer.

I will give myself—if I can take another minute out of our time, Mr. Chairman—I am prepared to take yes for an answer.

Chairman GARRETT. The gentleman is recognized for one additional minute.

Mr. FRANK. Thank you, Mr. Chairman. I have learned to take “yes” for an answer.

What the Majority is now saying is that it is not as urgent as they said. It is important, but the losses are not mounting. They appear, in fact, to be somewhat diminishing. Yes, we should deal with this. And much of what they are talking about now is relatively non-controversial. There are one or two controversial pieces, in the portfolio area mainly.

But the key question of, what do you do to replace Fannie and Freddie, which will be abolished and should be abolished, remains untouched. And so that tough issue, which they were so eager to tackle last year, they are now acknowledging is harder than they were prepared to acknowledge last year, and they are counting on the Obama Administration to hold them back until they can get some more time to figure out what to do.

We would reserve the balance of our time, Mr. Chairman, until the ranking member can get here.

Chairman GARRETT. Thank you. And we so appreciate the gentleman from Massachusetts exchanging his experiences in saloons.

And with that, I yield now to the gentleman from Alabama for 1 minute.

Chairman BACHUS. Thank you, Chairman Garrett.

As recent statistics and reports show, our housing markets remain very fragile, and housing is an important part of our overall economy and of consumer spending. We are not going to be able to revive our economy until we fix the housing market. And that is why Congress must take some action to bring some certainty.

But it has to be thoughtful and deliberative action. And we have started that with this process of introducing a number of measures to address the failures of Fannie and Freddie.

The main thrust of this is the—Freddie and Fannie had tremendous advantages over the private market, and over a several-year period, it drove everything into Fannie and Freddie, which were government-run funds. And, of course, what happened in 2008 and 2009 only precipitated that.

Going forward, what we need to do, bottom line, is diminish in a thoughtful way those advantages that Freddie and Fannie have and ultimately get the government out of the mortgage financing market and particularly the guarantee market.

So I appreciate that.

Chairman GARRETT. I thank the gentleman.

The gentleman from Massachusetts for 2 minutes.

Mr. LYNCH. Thank you, Mr. Chairman. I want to begin by thanking all the witnesses for coming before us here today and helping the committee with this work.

I just want to remind everyone that, together, Fannie and Freddie now provide about 90 percent of the financing or guaranteeing of all residential mortgages in the country today. This is an enormous market share, up from about 40 percent in 2006. And without the financial support of the Department of the Treasury and American taxpayers in 2008, the residential mortgage market would be in even more desperate shape than it currently remains.

I understand that my colleagues on the other side have introduced eight bills to eliminate the GSEs and wind down their prominence in the mortgage market. The question is, as my colleague from Massachusetts has asked, what will take their place?

I hope together we can devise a replacement for the GSE system that allows the 30-year fixed-rate mortgage to remain available at reasonable rates for creditworthy borrowers in a way that does not continue to put the taxpayer at tremendous risk.

I look forward to hearing from our witnesses on how we can move to the next generation of mortgage finance and wind down the taxpayers' investments in these GSEs.

Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. And I thank you.

The gentleman from California, Mr. Royce, for 1 minute.

Mr. ROYCE. Thank you, Mr. Chairman. I thank you, also, for your continued leadership on this issue.

The level of government intervention which contributed to the housing boom is well documented. As a matter of fact, what is often swept under the rug is the level of government intervention in the junk loan market during the boom years.

Over the years, the GSEs acquired more than $1 trillion worth of subprime and Alt-A loans, making them the largest buyer of junk loans. Much of it goes back to the 1992 GSE Act and the affordable housing goals, which for the first time mandated that the GSEs dedicate a sizable portion of their business to affordable housing.

This mandate on government-backed private institutions was a recipe for disaster. As former Chairman of the Federal Reserve Alan Greenspan said, their failure, Fannie and Freddie, is because they paid whatever price was necessary to reach the goal. And clearly, this was a mistake inspired by Congress.

That is why I introduced legislation to eliminate these goals and correct one of the many errors in the GSE charter. It should be made clear that the group of bills introduced this week is merely a first step. Over the coming months, it is my hope that we will move additional legislation, and I think this is the only way to end what Jamie Dimon labeled the biggest disaster of all time.

I yield back.

Chairman GARRETT. Thank you. The gentleman yields back.

The gentlelady from Illinois for 1 minute?

Mrs. BIGGERT. Thank you, Mr. Chairman.

As one of these eight bills, I have introduced H.R. 31, the Fannie Mae and Freddie Mac Accountability and Transparency for Taxpayers Act. H.R. 31 establishes in statute an inspector general with FHFA, something that Congress failed to do originally, and this is one agency that needs an independent watchdog.

It also gives this new IG authority—new authority to enforce the law and hire expert investigators that expose fraud and abuse within the GSEs and their regulator.

Three, it requires that this information be provided to the public in regular reports that outline taxpayer liabilities, investment decisions, and management details of Fannie and Freddie.

For example, one problem we found with Freddie and Fannie is that they maintain a short list of just a few law firms that are allowed to monopolize the foreclosure process by offering the quickest, cheapest, and probably the least reliable service. This has contributed to a broad array of problems, paperwork discrepancies and fraud. These issues have to be investigated and resolved for the sake of homeowners, for the sake of taxpayers, and for the sake of housing recovery.

This bill would ensure that effective oversight tools are in place. And with this bill, waste, fraud and abuse will no longer fly under the radar.

I yield back.

Chairman GARRETT. And the gentlelady yields back.

Mrs. BIGGERT. Mr. Chairman, if I may, could I ask unanimous consent to include a letter from the FHFA Inspector General on H.R. 31 in the record?

Chairman GARRETT. Without objection, it is so ordered.

And to the gentlelady from California for 3 minutes. Yes, 3 minutes.

Ms. WATERS. Thank you, Mr. Chairman, for organizing this hearing.

This is now our third hearing on GSE reform during the 112th Congress. As I have stated at those previous hearings, I am committed to working with my colleagues on a practical, comprehensive reform proposal to reshape our housing finance system.

That comprehensive proposal will inevitably need to include shorter-term provisions to address how we transition from where we are to where we want to be. Those measures must both encourage the return of private capital to the market, while also ensuring that we do not disrupt our housing finance system and shake our nascent economic recovery.

I think it is important to note that some shorter-term steps are already being addressed as the GSEs go into conservatorship. For example, the Federal Housing Finance Agency has raised guarantee fees, making GSE mortgages more expensive for borrowers, and more accurately pricing risk. FHFA has also prohibited the GSEs from launching new product lines.

The office of the FHFA Inspector General has been established, and the portfolios of Fannie Mae and Freddie Mac are being wound down. Many of the proposals that we will consider today are to a certain degree restatements of what is already occurring, and I am willing to work with my colleagues on some reasonable refinements of current practices. Some other aspects of the proposal accelerate what is already being done or include more prescriptive direction to regulators for how they should manage the conservatorships.

I think these are important debates for us to have, but we must consider that if we move too precipitously, we run the risk of destabilizing our economy. Three million more foreclosures are expected in the next year, and home prices are 3 percent lower than they were last year. Like many observers, I believe that the housing crisis is far from over.

I am also eager for the committee to consider whether adopting these shorter-term measures without considering comprehensive reform is the best strategy. I think that most stakeholders would like to know what is coming next before we start accelerating the wind-down of what we have now. We must also ensure that our regulators have the flexibility they need to respond to our still-volatile housing market conditions and that their hands are not tied by legislation that is too rigid.

Again, Mr. Chairman, I thank you for holding this hearing, and I look forward to learning more about these proposals. And, of course, I yield back the balance of my time.

Chairman GARRETT. And I thank the gentlelady.

The gentleman from Texas for 1 minute?

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

This is an important hearing. One of the things that was brought out is that 98 percent of the mortgages that are being originated in this country today have some form of government backing. And as my colleagues on the other side of the aisle said, we don't have anything to replace it with. That is because these entities enjoy a subsidized monopoly.

So what we need to do is to begin to provide space and opportunity for the private capital to come into the market, as long as we provide lower guarantee fees to sanitize these mortgages, and there is no incentive for private capital to come into these markets.

Our goal here is two things: first, to make sure that we shore up and reduce any additional losses that Fannie and Freddie may have; and second, to also provide opportunity for private capital to come back in so that we will have robust housing finance markets in this country.

But if we keep what we have been doing, we are going to keep getting what we have been getting. And I think the American people have spoken pretty loudly; they are tired of not only making their mortgage payment, but they don't want to make their neighbor's mortgage payment, as well, and basically if we continue down the road that we are on right now, that is the direction we are headed.

So I think this is a very important hearing, Mr. Chairman. And I will look forward to hearing from our witnesses today.

Chairman GARRETT. Thank you.

Mr. Pearce for 1 minute?

Mr. PEARCE. Thank you, Mr. Chairman. I appreciate the hearing today. I am looking forward to it.

And we have one of the pieces of legislation that simply says the debt has to be approved with each new issuance, and it is what used to be, and we are simply requesting that we go back to that kind of stable approach. But I am looking forward to the hearing today, and thank you very much.

Chairman GARRETT. The gentleman yields back.

Mr. Fitzpatrick, for 30 seconds.

Mr. FITZPATRICK. Thank you, Mr. Chairman, for the hearing. Today marks an important first step toward a major correction in our housing market and in our financial system. Fannie Mae and Freddie Mac control about 95 percent of the secondary mortgage market, and its access to easy capital has helped spur an unprecedented run on mortgages that, once it caught up to us, nearly brought the economy to its knees, and as the house of cards began to fall and implied government backing became a real one, to the tune of $150 billion.

So let's discuss how to get private capital back into the system and immediately in the bailouts, while protecting current and future homeowners.

Thank you, Mr. Chairman.

Chairman GARRETT. And I thank you.

And for the remainder of the time, which is, I think, 30 seconds, the gentleman from California, Mr. Miller?

Mr. MILLER OF CALIFORNIA. Thank you, Mr. Chairman.

I hope this can be a bipartisan issue, because it is definitely a national issue. We need to be very cautious in what we do. We need comprehensive reform. But we need to look and ask, "What did Freddie and Fannie do wrong? And how can we correct that?"

Without a doubt, they are outperforming the non-agency loans. So irrespective of that, they are losing money, and we have to determine what they did wrong to correct the problem.

But we need to be sensitive as this industry has been dramatically impacted in recent years. And what we do here is going to have an impact. My goal is to make sure it has a positive impact, rather than a negative impact.

And so I hope we will look at this issue in a comprehensive way, understanding the complexity that we are facing, and the impact of the results of what we do.

I yield back the balance of my time.

Chairman GARRETT. Thank you.

Mr. DeMarco, once again, we welcome you back to our committee. And as you know, your full statement will be made a part of the record. You are recognized for 5 minutes, and we welcome you to the committee.

STATEMENT OF EDWARD J. DeMARCO, ACTING DIRECTOR, FEDERAL HOUSING FINANCE AGENCY (FHFA)

Mr. DEMARCO. Very good. Thank you. Thank you, Mr. Chairman.

Chairman Garrett, Ranking Member Waters, and members of the subcommittee, thank you for inviting me here. My written statement covers the financial condition of Fannie Mae and Freddie Mac, how FHFA is carrying out its conservatorship responsibilities, and FHFA's views on certain proposals made this week by subcommittee members. I will touch on just the last two at this point.

As conservator, FHFA has a statutory responsibility to preserve and conserve the Enterprises' assets, which I would group into four broad categories: the legacy, pre-conservatorship book of business, including investments, mortgages owned and mortgages guaranteed; the post-conservatorship book of business; the business platforms, operations and processes of the two companies; and the people who work at the Enterprises, the human capital who run the business, manage the risk, and support the operations.

Preserving and conserving Enterprise assets protects taxpayers from further losses, ensures market stability and liquidity, gives lawmakers options for the future, and protects the future value of the Enterprises' intangible assets for future utilization and value recognition for the benefit of taxpayers and markets.

As conservator, we oversee these assets so that value may be returned to taxpayers from them in a manner to be determined by financial market developments and the decisions of lawmakers. These responsibilities entail challenging risk management issues.

For the legacy book of business, the key risk is further credit losses from delinquent mortgages. For the post-conservatorship book of business, the key risk management challenge is establishing appropriate underwriting standards and risk-based pricing. The Enterprises' business platforms, operations and processes present multiple risk management challenges. We need to develop and maintain the infrastructure supporting ongoing business in order to preserve and conserve the value of the securities being issued today, which have 30-year maturities backed by the taxpayer.

Finally, preserving and conserving assets includes maintaining each company's human capital in the face of a very uncertain future. Protecting taxpayer interests in the Enterprises requires each company having experienced, qualified people managing the day-today business operations.

I will now briefly summarize a few of my written comments on the bills introduced earlier this week. I will begin with risk retention.

The proposed rule on risk retention issued by the agencies this week does not classify Enterprise loans as qualified residential mortgages. It stipulates that Enterprise single-family mortgage securities are structured with a 100 percent risk retention by the securitizer, that is, the Enterprise, obviously, the maximum possible and far beyond the 5 percent retention required by Dodd-Frank.

If the Enterprises were subject to the risk retention requirements for non-QRM loans, they could be forced to hold on their balance sheet 5 percent of the securities they issue. To impose such a requirement would add nothing further to the Enterprises' skin-in-the-game or credit risk exposure. They already have 100 percent of the credit exposure. However, such a requirement would require the Enterprises to increase their portfolios by financing 5 percent of their mortgage-backed securities themselves.

Retained portfolios. We are on a path to reduce the retained portfolio of each Enterprise by at least 10 percent per year. The only material additions to the retained portfolios today come from removing delinquent mortgages from the Enterprises' mortgage-backed securities. While some faster reduction of the Enterprises' retained portfolios may be possible, a congressional mandate for a significantly faster reduction could cost taxpayers unnecessarily.

New activities. FHFA is not permitting the Enterprises to offer any new products or enter new lines of business. Their operations are focused on their existing core businesses and on loss mitigation. I support in principle a bill to codify this position of the agency. As the subcommittee deliberates such a mandate, it may wish to consider whether exceptions should be provided for products that advance other purposes of the transition.

Compensation. Retaining human capital and setting a compensation strategy in an environment of uncertainty requires a delicate balancing act. I am concerned that overhauling the compensation programs in place today by applying the Federal pay system to non-Federal employees carries risk for the conservatorship and, hence, the taxpayer. In my view, such an approach would increase costs to the taxpayers and risk further disruption in housing markets.

And finally, guarantee fees. Since the beginning of conservatorship, FHFA has been steadily—has been overseeing steady increases in guarantee fees for the Enterprises. FHFA expects to continue to evaluate further changes along these lines, and we look forward to working with Congress on legislative approaches for determining appropriate changes for the Enterprises' strategy for setting guarantee fees.

Thank you again for this invitation, and I look forward to our discussion.

[The prepared statement of Acting Director DeMarco can be found on page 97 of the appendix.]

Chairman GARRETT. I thank the gentleman for his testimony and his full testimony, which we have seen previously. And I would at this point yield myself 5 minutes.

Let's go to the first point and the legislation that I have dropped in, which deals with risk retention. This goes with Section 941, 15(g)(e)(3)(B) of the act of the law, which specifically exempts all assets which are insured or guaranteed by the United States toward any agency of the United States, but then the rest of the section specifically says what? That Freddie and Fannie are not agencies of the United States, and you, of course, agree with that.

So what is hard for me to see is that it is—Congress was explicit in what that they are saying, that these are not agencies of the United States, and therefore they should be under the same requirement as in the private sector. But you are claiming in your testimony here that you don't have to worry about that. Why? Because of the, what, 100 percent guarantee functionality for this type of risk, right?

Mr. DEMARCO. What I am stating, Mr. Chairman, is that what Section 941 is designed to do is to have securitizers—that is, issuers of an asset-backed security, including mortgage-backed securities, to retain a portion—some economic interest in the credit risk of the loans that are underlying that security.

The way Fannie Mae and Freddie Mac undertake their securitization, they are providing a 100 percent corporate guarantee of timely payment of principal and interest. That is retaining 100 percent of the credit risk. It can't retain more of the credit risk than that.

Chairman GARRETT. Yes, I understand that. I appreciate that. So what happens, then, on the private-sector side is what? If they are issuing an QRM, there is no problem? If they are issuing a non-QRM, that is when the—under the rule, it comes out, what, they have to retain the additional 5 percent?

Mr. DEMARCO. They have to retain 5 percent.

Chairman GARRETT. Right. And if they do that, what happens then? They have to have additional capital with regard to that 5 percent. What happens there? That means that there is an additional cost, right, to that transaction?

Mr. DEMARCO. Right.

Chairman GARRETT. Now, if the goal I think we have agreed on here, if the goal is to try to get them to be able to facilitate that marketplace and not simply have all the markets just continue to go over to the GSEs, we can't have that cost higher, right, than what is over the GSEs. So that is why set—at least in my legislation—we would want to try to bring them on par.

So if your position is such as it is, walk through it with me, what are some of the alternatives that we could do in order to make it on par? Could we, for example—what could we do? Could we raise the dividends that the GSEs are responsible paying back to the Treasury, for example, in which case there would be a higher cost here that would effectively go back and make these on a level playing field? There is other legislation with regard to G-fees, correct? Could we do something with G-fees, elevate them to an additional point, again, to make it on a level playing field?

If my legislation as it is crafted right now doesn't solve the problem on this area in risk retention, how can we do it, in your mind, that is equal—takes care of the problem?

Mr. DEMARCO. Right. Three things, Mr. Chairman. I appreciate the question. And you have already started to outline the answer.

Chairman GARRETT. Okay.

Mr. DEMARCO. The first is, in fact, G-fees. I do believe guarantee fee pricing and continuing to make gradual adjustments there is an important step. The second thing has to do with, whatever path is taken to gradually recede back to the private market a portion of the universe of mortgages originated that is not eligible for Enterprise purchase. And the conforming loan limit is the obvious mechanism for doing that.

So making adjustments with respect to the universe of mortgages originated that are eligible for Enterprise purchase would be the second way to gradually reintroduce a portion of the market that would have to be financed out of the private sector.

And the third is fundamentally what you are trying to do at this hearing and what the subcommittee is aiming to do over the long term, which is comprehensive housing finance reform, so that for private capital to truly come back into the mortgage market, it is not just about removing Fannie and Freddie. Private capital is going to want to know what the rules of the game are going forward—what is going to be the role of the government? What is going to be the kind of oversight and regulation requirements that are in place for private firms that want to enter into the secondary mortgage market?

Now, the Dodd-Frank Act and the some of the provisions being implemented—not just risk retention, but others—are part of that step of providing clarity to private financial institutions that would be considering re-entry in the market. So those are the three things.

Chairman GARRETT. And in just the last 10 seconds, outside of your field, what about the FHA, with the whole argument with regard to the exemption? Should we be doing actions over there so we don't have everything simply flow over to the FHA?

Mr. DEMARCO. I think that the role of the FHA is a very important aspect of what I would expect the subcommittee to be looking at in terms of housing finance reform. Whether risk retention is the way to get at articulating the role of the FHA, I would think maybe not. But I would really defer to the HUD Secretary on that.

Chairman GARRETT. Great. Thank you for your answers.

The gentlelady from California?

Ms. WATERS. Thank you very much, Mr. Chairman.

Let me wade into an area that has emerged as rather controversial. Mr. Royce has the GSE Mission Improvement Act. The bill would immediately repeal the GSEs' affordable housing goals. And you know what this is all about. In this whole discussion of the subprime meltdown, it has been said more than once, I suppose by Mr. Royce and others, that the GSEs' affordable housing goals are responsible for the GSEs' problems and its meltdown.

I know that there are those who believe that somehow there were too many people who could not afford mortgages who were extended mortgage opportunities. I want to know, did the GSEs change its criteria—its underwriting criteria, I suppose you would call it—for buying up these mortgages from Countrywide and other places? Did they somehow do something that would cause these goals to be undermined?

Mr. DEMARCO. Congresswoman Waters, I think it is pretty clear that Fannie Mae and Freddie Mac both took steps to reduce their underwriting standards, particularly in the 2005 to 2008 period. So, yes, they reduced their underwriting standards. They took on more risk. They did invest in mortgages of a quality that they, in earlier days, would not have.

And I believe that their pursuit of some of these riskier mortgages was motivated by three things: a loss of market share; wanting to make money; and housing goals.

Ms. WATERS. All right. If they had stayed with their criteria, would that have been a different story? Would the results have been different if they had maintained the criteria that had been established for purchasing these mortgages?

Mr. DEMARCO. If they had not reduced their underwriting standards, I think that the housing crisis that we have had, the losses they have had would not have been as great. But they still were taking on a lot of credit risk, and a lot of the losses that they have absorbed have come from prime, traditional mortgages, because of just the tremendous decline in house prices, and the tremendous and persistent unemployment that we have had, and because of the tremendous amount of leverage on the balance sheet of households—

Ms. WATERS. Can you tell me what percentage of the loss can be directly traced to the change in the underwriting criteria or just the economy? Do you know the difference?

Mr. DEMARCO. Sitting right here, Congresswoman Waters, I cannot tell you that breakdown.

Ms. WATERS. All right. Are you familiar with any threats to the GSEs by Countrywide or any of the other big banks indicating that if they did not take everything that they were writing that they would pull back all of their business and this would make the GSEs less profitable, less competitive? Have you heard that?

Mr. DEMARCO. I am not aware of such threats.

Ms. WATERS. Are you aware of any conversation from Countrywide that was reported in the newspapers of that nature?

Mr. DEMARCO. I am not recalling it. I am not saying it hasn't been reported and that I haven't even read about it. I am sorry, Congresswoman Waters. I am not recalling it just sitting here.

Ms. WATERS. I know you may not be recalling it, but what I am trying to find out is, as this meltdown took place, there was a lot written about what was going on. One of the stories that emerged—a lot of stories emerged, for example, around Countrywide. And one of those stories had to do Countrywide, because of the volume that they had involved with the GSEs, that they were in a position to either work with the GSEs and allow them to purchase these mortgages, or to block them and to not work with them, and thus put the GSEs in a less competitive situation. Are you not aware of that—those reports in any shape, form or fashion?

Mr. DEMARCO. I am aware that Countrywide was a major provider of mortgages to both Enterprises. I am aware that book of business has been particularly costly to both Enterprises. And I am aware that the Enterprises were concerned about the loss of market share as a result of mortgage originations by Countrywide and others being financed or securitized through mechanisms other than the two of them.

Ms. WATERS. All right. Thank you. I yield back.

Chairman GARRETT. Okay, thanks.

To the gentleman from Alabama, the chairman of the full committee.

Chairman BACHUS. Thank you. And I appreciate your appearance.

Two days ago, James Pressley wrote an article in Bloomberg where he reviewed a book by four professors from the NYU Stern School of Business. The title of the article is, "Godzilla Hedge Funds Fannie Mae and Freddie Mac Were Guaranteed to Fail."

It is a fascinating article about how they went from 4 percent of the mortgage market to about 42 percent right before the meltdown in 2008. And now they are financing well above that, 80 percent or 90 percent. It is fascinating.

And Pressley at the end asked two questions, which we have discussed for really 2 years. And one—and these are authors of the book, and I think most people on both sides of the aisle agree that we have to wind down Fannie and Freddie.

So my first question would be, how do you do that? Now, these professors—I don't know if you have read their book—

Mr. DEMARCO. I have not, Mr. Chairman.

Chairman BACHUS. Yes, they propose a bad bank, a good bank and a bad bank. But the second thing they say—and it is a trickier question, maybe—is what to do about Fannie Mae and Freddie Mac's second main function, to guarantee mortgages against default. So let's focus on that, because I only have about 4 minutes.

Mr. DEMARCO. Okay. So—

Chairman BACHUS. Government continued to guarantee these mortgages, whether they are private or public. And let me say this, you disputed the view that explicit government guarantees of mortgages could rectify the problems created by the GSEs. In your testimony to the last Congress you said that the argument for creating an explicit guarantee was built on the presumption that the market either cannot evaluate and price the risk of mortgage default, at least not at an acceptable cost, or that the private market cannot manage that amount of risk on its own.

And you added, "We might ask whether there is a reason to believe that the government will do better. If the government backstop is underpriced, taxpayers eventually may foot the bill again." And, that is the main concern on this side of the aisle, that if it is not priced right, it won't be the sellers or the buyers. It will be the taxpayers.

Mr. DEMARCO. Right. So several things there. In terms of what we can be doing now, I think the steps that we are taking are, in fact, designed to assist the Congress in preparing for an ultimate transformation.

And so that is why as conservator, we have taken the following steps, that we are restricting the Enterprises to their core business activities, we are gradually raising prices so as not to disrupt markets, but to move towards a more risk-based mechanism and a mechanism more reflective of what purely private firms would do. We are gradually shrinking the portfolio. As I said, the only thing that really is being added to the portfolio are delinquent mortgages being pulled from pools.

In terms of next steps, what we need is a clearer path forward. The path that is available to me in the legislation, in the law that exists today, would require us ultimately to—we are really at a stalemate. The only alternative left is to put them in receivership, which creates a limited life entity—which is, in essence, the bad bank that you were referring to—but it requires the FHFA to then re-issue the two charters as they exist under current law.

And, if I hear one consensus in the whole GSE realm, it was nobody wants that, and so we are awaiting Congress to give further direction in terms of what is the role of the government, including whether there is going to be a role for limited or maybe not even limited guarantee of mortgage credits in the United States, but to define that. Getting that definition clear is going to be one of the things that is going to allow private financial institutions to make a better business determination about where it is they can enter and actually apply their capital and make money in serving this sector.

So I think that while incremental steps are important and really can help move us, fundamentally the market is going to want to know what is the whole picture in order to know how they can deploy private capital to serve the mortgage market.

And with respect to your—the quotes from my testimony last year on guarantees, it can very well be a legitimate conclusion of lawmakers for there to be some form government guarantee of some portion of the mortgage market. I was trying to raise that it is not without costs and without risk, and that is what everyone is looking to lawmakers to sort of make those judgments.

Chairman BACHUS. And I guess what you have said is that the Congress needs to act or the Administration?

Mr. DEMARCO. Yes, sir.

Chairman BACHUS. Thank you.

Chairman GARRETT. And I thank you. Thank you.

The gentleman from Massachusetts?

Mr. FRANK. Thank you.

Mr. DeMarco, as I—and I appreciate your very specific testimony on the legislation. This is very helpful testimony. And I would say, there is a fairly—on the whole moderate package—and as been noted, a lot that the Administration agrees with—some of them are tying down what is already being done.

So I am supportive of—the one question I had—first of all, let me say, on risk retention, the gentleman from New Jersey is quite correct. He read the article—he read the bill. We covered them under risk retention. And I am sometimes told, oh, well, but they really are. Don't worry about it. And I go back to my fundamental principle of legislation: Prefer redundancy to ambiguity. If they really are, what is the problem with saying so?

And as I listen to your testimony—the one problem appeared to be—and I hope this is the only one that you see—that it would complicate the portfolio situation, because you would have to hedge—you would have to hold against them.

If we exempted—if we explicitly said—of this bill that you were covered by the risk retention 5 percent, and exempted anything held specifically for that from the portfolio, would that remove any objections you would have?

Mr. DEMARCO. I would have to think about that, Congressman Frank. This is really not about whether they hold a piece of the MBS. I don't think—as I understand, what is explicitly written in Dodd-Frank, the point of—

Mr. FRANK. Mr. DeMarco, let me put it this way. Look, nobody ever likes to be told what to do. I understand that. But I am trying to figure out what harm can come. I have to say, I am—

Mr. DEMARCO. There is no harm.

Mr. FRANK. No harm? If we—

Mr. DEMARCO. If the Congress of the United States is not concerned about them building or retaining a larger retained portfolio—

Mr. FRANK. But, Mr. DeMarco, though, in other words, if we were to exempt or add to the retained portfolio allowance an amount specifically equivalent to that 5 percent, then you would have no—it would not cause you any problem?

Mr. DEMARCO. As I understand the question, yes, sir, that is right.

Mr. FRANK. Okay. I thought the question was pretty clear.

Mr. DEMARCO. Well—

Mr. FRANK. Okay. The other issue, then, is on the retained portfolio. And I say that because I am struck by this notion—people are making this mistake that, oh, the downpayment percentage in the qualified residential mortgage is too high. The notion that people will not be able to make loans unless they can securitize without risk retention I think is a great mistake.

Mr. DEMARCO. I agree.

Mr. FRANK. Wells Fargo has said they will. Smaller banks—portfolio. We didn't use to have securitization, so—but I appreciate that, that it is only the portfolio.

The other impact in the portfolio—because the major difference between this set of bills and the Administration, as I read it in substance, is the rate at which the portfolios get reduced—now, your point is that a major—the offset to reducing the portfolios is the need to take some bad mortgages and put them in portfolio. And as I read your testimony, the problem is, you believe, if I am correct, that a requirement that you accelerate the sell-off will require you to sell prematurely some assets which you might be able to get more from if you held them. Is that accurate?

Mr. DEMARCO. Yes, sir.

Mr. FRANK. So if we were, again, in the portfolio limitation, in the portfolio reduction, to make some allowance, some distinction between sort of the good and the bad assets and gave you more time to sell off the bad assets so that the reduction would be unrestricted with regard to the good ones, but give you some discretion of the time you are selling the bad ones, again, that would meet your problem?

Mr. DEMARCO. That would be much easier for us to implement. I think it would be better for taxpayers.

Mr. FRANK. Okay, I appreciate that. Last point. I just want to talk appropriately in your testimony—this is not about the bill—about the legacy book of business and the post-conservatorship book of business, because this goes to the urgency of moving right away. And I believe that, since Congress gave the Bush Administration the power to establish the conservatorship—and that was done by Secretary Paulson in 2008—you are really talking about a very different set of GSEs.

You say here, since conservatorship, underwriting standards have been strengthened and several price increases have been initiated to better align pricing with risk. I know we can't be certain, but based on what has been done, is it reasonable to assume that you are not going to see future losses from the business now, anything like what we saw before the conservatorship?

Mr. DEMARCO. That is certainly our anticipation.

Mr. FRANK. You are not likely to see that?

Mr. DEMARCO. Right.

Mr. FRANK. Thank you. I yield back.

Chairman GARRETT. And if the gentleman will yield just for—

Mr. FRANK. Yes, I would yield to the chairman.

Chairman GARRETT. On your second point, with regard to putting some sort of language in there, with regard to saying they would have additional discretion for the bad book, for the bad loans, okay, I understand that. But is there something in the proposal now that would tie their hands in that regard?

Mr. FRANK. As I understand it—and I will be—

Chairman GARRETT. Yes, sure.

Mr. FRANK. As I understand it, if you have a general reduction of the portfolio, it doesn't differentiate.

Chairman GARRETT. Right.

Mr. FRANK. And that what they are saying is it—at the level at which the portfolio would be mandated by this bill—and I generally support portfolio reduction—that might force them to sell bad assets—

Chairman GARRETT. In one year, and then something might go wrong—

Mr. FRANK. Yes.

Chairman GARRETT. Okay.

Mr. FRANK. And so that they could have some discretion, maybe to make an exception with the bad assets. So, it doesn't specifically say it, but by covering the whole portfolio, it doesn't give them the ability to differentiate.

Chairman GARRETT. I understand. Thanks. I appreciate it.

And with that, I yield to the vice chair of the subcommittee, the gentleman from Arizona.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

Mr. DeMarco—and, first off, thank you. You have always—you have been very kind to me and very forthcoming with many of the questions we keep throwing at you. In sort of rapid fire, just as it helps me understand some things, how many units, how many residential units do you believe the GSEs presently have the deed to? How many do you own?

Mr. DEMARCO. A couple hundred thousand.

Mr. SCHWEIKERT. Are we over 200,000 now?

Mr. DEMARCO. Yes, indeed. You mean REO properties?

Mr. SCHWEIKERT. Yes, REO properties.

Mr. DEMARCO. A couple hundred thousand.

Mr. SCHWEIKERT. What is the mechanics right now? How many units are you getting sold every month? Any idea?

Mr. DEMARCO. The intake has slowed down a bit because of some of the foreclosure processing problems. And I know that they have been coming in at a faster rate than we have been able to get them back out. I could get you the exact number, Congressman. I don't know it off the top of my head.

Mr. SCHWEIKERT. Because even in my short time here, that number looks like it is already up—I have been here, what, about 84 days, 85 days, and I think that is up about 20,000 from where we were at the beginning of this year.

Mr. DEMARCO. That could well be.

Mr. SCHWEIKERT. And do you think some of the growth in inventory is—you are processing foreclosures faster? Your short sales aren't going as quickly? Or just the process has cleaned up and you are actually taking down the ones that had to be taken down?

Mr. DEMARCO. All of the above, plus the seasonality of the time of year we are in with respect to sales.

Mr. SCHWEIKERT. Mr. Chairman, Mr. DeMarco, on the non-performing portfolio of loans, how big is that? What is your best guess?

Mr. DEMARCO. About 5 percent of their book, 5 percent on 30 million mortgages.

Mr. SCHWEIKERT. And mechanically you hold those, and if you can't mitigate something out, they go into the foreclosure queue?

Mr. DEMARCO. That is correct. But, the real emphasis and priority is, when loans start to go delinquent, Fannie and Freddie want their mortgage servicers to be reaching out to delinquent borrowers immediately and beginning loss mitigation procedures. That is very, very important to us, and I think it is very important to the taxpayer that it be done. And there is a great of effort and energy on that effort.

Mr. SCHWEIKERT. I am hopeful I get to a second round of questions, because I have a whole bunch of things on the servicer side that—I am wondering if there are some better mechanics out there we could help.

On principal write-down, your opinion? And would you also—for many of us who have a great concern that—if that sort of becomes aggressive stated policy, the moral hazard of, do we also start to create an additional cascade of non-performing debt?

Mr. DEMARCO. Sir, I think the question of principal reduction is one for, really, the investor in the mortgage. There are investors in private-label securities who, as I understand it, at least some of them have expressed a desire and an interest that there is a way of doing a principal write-down with an underwater mortgage, particularly if that mortgage can then be, through an FHA short refi program, that the borrower goes over to FHA for a new mortgage, is one example, that allows them to cut their losses, get their principal back, and take that remaining principal and invest it elsewhere.

We have looked at that as conservator of Fannie and Freddie, and we have examined it relative to the loss mitigation tools that are available and their position in the marketplace as a more longer-term participant. And it has been our conclusion that it is not loss minimizing for Fannie and Freddie to be engaging in a general program of principal reductions.

I would say a couple of things. Fannie and Freddie's mortgage book—the portion of it that is underwater today is much less than the case in private-label securities. And the majority of it—the vast majority of it is still performing, so these are performing mortgages today, and we expect these households to continue to honor their financial commitment. And, frankly, I think the households themselves are anticipating and fully expect to fulfill their commitment.

So the moral hazard question that you raise is one that if you create an incentive for someone to find a way to not continue to make a mortgage payment that they are capable of making, in the Fannie and Freddie context, that would be shifting that loss to the taxpayer, and that is something we are trying to avoid.

In fact, what we are experiencing is that the loss mitigation programs through loan modifications are households that have income and are committed to staying in their house can and should be a very useful way to adjust the mortgage payments so that they can retain homeownership and we can minimize losses. And, frankly, the performance rate on loan modifications does not seem to be variant to what the current loan-to-value of those mortgages are.

The final point I would say about Fannie and Freddie, with respect to principal forgiveness, is that the way that book of business has been done by Fannie and Freddie, a lot of the underwater mortgages have mortgage insurance in front of them. So there is a loss mitigant there for taxpayers that I want to make sure that protection stays there, and principal forgiveness can complicate that, as can second liens.

Mr. SCHWEIKERT. I thank you, Mr. Chairman. And for my next half-an-hour of questions—oops, out of time.

Chairman GARRETT. Yes, okay.

Oh, the gentleman from California?

Mr. SHERMAN. Thank you, Mr. Chairman.

I can see how, once this crisis is over, we can divide up on philosophical lines. I have read the complete works of Ayn Rand, or at least I will claim I have, because I can state with confidence that Ayn Rand says nothing positive about either Fannie Mae or Freddie Mac. And if we were not in a crisis, we could divide up on the role of government and overall philosophy.

But we are in a crisis. The economy is fragile. And we need to be practical.

A double-dip recession is a very real possibility, and the most likely way that will occur is another precipitous drop or long slide in home prices. And loose talk here in Washington can add to that crisis.

There are those on another committee talking about ending the home mortgage deduction. That is a great philosophical debate for good times. But right now, what it means is, why should anybody in my district buy a home if a couple of years from now they are going to lose their home mortgage deduction, and 5 or 10 years after that, when they go to sell their home, it is going to sell 10 percent, 20 percent, 30 percent less than what it would otherwise, some would see an even greater drop?

If we were to end the system whereby a Federal agency guarantees qualifying conforming mortgage loans, we would see a dramatic increase in home mortgage costs, a dramatic decline in values. The dramatic decline in values would then lead to a dramatic increase in defaults, and we would have a double-dip recession.

That is why I am a little concerned about the title of these hearings, which talk about protecting taxpayers from the ongoing bailout of Fannie Mae and Freddie Mac. That may be a noble goal, but we also have to protect taxpayers from the precipitous removal of Fannie Mae and Freddie Mac from the housing system in this country, and we have to protect taxpayers from a double-dip recession. A second dip could mean double-digit unemployment and could make our situation even worse than that which we have recently experienced.

Now, Mr. DeMarco, one issue is the size of the portfolio held in the safes of Fannie Mae and Freddie Mac. How large is that portfolio, adding the two agencies together?

Mr. DEMARCO. $1.3 billion to $1.4 billion.

Mr. SHERMAN. Now if all of that was dumped on the market—

Mr. DEMARCO. Trillion. Sorry about that.

Mr. SHERMAN. What?

Mr. DEMARCO. Trillion dollars.

Mr. SHERMAN. Yes, I—I knew you meant trillion even without the correction. If that was precipitously dropped on the market, would Fannie Mae and Freddie Mac secure full value for the assets they were selling?

Mr. DEMARCO. No, sir, if you are talking about selling $1.3 trillion all at once, no.

Mr. SHERMAN. In fact, if there was even a precipitous decline in the size of that portfolio within any particular month, wouldn't that affect the market price of the assets being sold and cause Fannie and Freddie to not be able to secure full value?

Mr. DEMARCO. It could.

Mr. SHERMAN. I yield back.

Chairman GARRETT. I thank the gentleman.

The gentleman from Texas?

Mr. HENSARLING. Thank you, Mr. Chairman.

Welcome, Mr. DeMarco. Forgive me. I was at another meeting, missed part of your testimony, and came in on part of the questioning of the ranking member. So if we are covering a little bit of old ground, I apologize.

Following up on the questioning of the gentleman from California dealing in the reduction of their portfolio holdings, the GSE report from the Obama Administration itself says the PFPAs required reduction in this risk-taking by winding down their investment portfolios and an annual pace of no less than 10 percent. So I suppose that would be a minimum of a 10-year plan.

I think you mentioned in your written testimony—I didn't hear your oral testimony—I believe it was in your written testimony that the GSEs are "on track to meet or exceed the 10 percent reduction."

Mr. DEMARCO. Yes.

Mr. HENSARLING. I assume by definition, you do not define 10 years as acting precipitously. Is that correct?

Mr. DEMARCO. Ten years would not be precipitous, Congressman.

Mr. HENSARLING. Okay. Let's talk about 5 years, for example. One of the witnesses on the panel to follow you, Mr. Pinto, has said in his testimony, "The natural liquidation rate being experienced by these portfolios for 2010 had an annualized rate of 21 percent and continued at the same annualized rate in January of 2011." I think you also noted in your written testimony, "Some faster reduction of the Enterprises' retained portfolios may be possible."

So if I am—and I looked forward to questioning Mr. Pinto, when he—I see him sitting there now—on the second panel, but he seems to be under the impression that already these are being reduced on a 5-year timeframe, so was the 5-year timeframe too precipitous, yet 10 years is just right?

Mr. DEMARCO. Congressman, that question is basically impossible to answer, because one doesn't know what market conditions are going to be, and I can't tell you what is going to—or how much is going to be added to the portfolio—

Mr. HENSARLING. Thank you. I thought that was the answer, so you clarified that for me.

In the Administration's proposal—I say proposal, their list of three options that I know you are very well familiar with—it seems that option two and option three clearly include some form or facet of Federal guarantee mechanism in the secondary market.

About 6 months ago, I believe it was before the full committee in September, you seemed to question—call into question the government's ability to accurately price these guarantees. Reading from your testimony, you said the presumption behind the need for an explicit Federal guarantee is that the market either cannot evaluate and price the tail risk of mortgage default, at least at any price that most would consider reasonable or cannot manage that amount of mortgage credit risk on its own.

You went on to say, but we might ask whether there is a reason to believe that the government will do better. If the government backstop is underpriced, taxpayers eventually may foot the bill again.

When I look at the record of the National Flood Insurance Program, which is $19 billion in debt, when I look at the Federal Crop Insurance Program, which has cost the Federal Government almost $40 billion over the past decade, when I look at the PBGC, which has a debt, I believe the last number I have is $23 billion and counting, with an exposure of over $190 billion, I would seem to agree that the track record of government for accurately pricing this risk is questionable at best.

So my question to you is this. Have you changed your opinion in the last 6 months on whether or not there is a credible reason to believe that government could accurately price risk in the context of the Administration's proposal number two and three?

Mr. DEMARCO. Excuse me, Congressman. I have not changed my opinion in the context of what I stated in that testimony, that there would be risks and challenges for the government being able to do that. I have not changed that opinion.

Mr. HENSARLING. Thank you, last question. I see my time is winding down. I have heard many on the other side of the aisle offer criticisms of those who are proposing reform plans, but isn't it true that if we don't have a reform plan, the conservatorship that Fannie and Freddie are presently in could not continue in perpetuity? Is there a termination date—

Mr. DEMARCO. There is not a termination date set, no, sir.

Mr. HENSARLING. Okay. So if we don't bring forth a reform plan, we go to the status quo, and the status quo is conservatorship in perpetuity. And I think the last estimate from CBO is that, as opposed to $150 billion of taxpayer exposure, we would eventually end up at $400 billion. I see my time has expired. Thank you.

Chairman GARRETT. And I thank the gentleman from Texas.

The gentlelady from Wisconsin?

Oh, I am sorry. The gentleman from Massachusetts? You were preempted before by the gentleman from California.

Mr. LYNCH. No problem. Thank you, Mr. Chairman.

I want to thank Mr. DeMarco for your good work in helping the committee.

One of the bills—one of the eight bills that has been proffered by my friends on the other side of the aisle includes a provision offered by Mr. Royce of California, my friend, that is called the GSE Mission Improvement Act. However, part of this bill would repeal the mission of the GSEs to serve the section 202 elderly market. These are folks who are 62 years of age and older. We have a huge demographic in this country of people 62 years and over. As baby boomers retire, this is going to be a very critical part of the population served by section 202 housing.

As someone who grew up in the old colony housing projects in south Boston, and my involvement on the housing committee the last few years, this section 202 housing happens to be some of the most successful housing that we have in the country. It is the best-managed. It is the cleanest. It is the safest. It is the most desirable. And, again, with that demographic of folks coming into 62 years of age and older, it is desperately needed.

In my district, I have half the City of Boston, I have the City of Brockton, and 19 towns in between. I am at my wit's end trying to get more 202 housing in there.

I am very concerned about what this bill would do by eliminating the mission of serving this market. And I am hoping that you might be able to shed some light on that, what the impact would be for that market and for those seniors who are served. What happens? What happens when we stop serving this market and this 202 housing goes away?

Mr. DEMARCO. Congressman, I am not—I could do some research and get back to you about the particulars of the current activity of Fannie and Freddie with respect to the 202 program. What I would say is that, as I understand Congressman Royce's bill, this would be consistent with what the approach we are already taking in conservatorship, which is, if it is a line of business that Fannie and Freddie are not already in, that they would not start doing it.

I presume from your question that this is something where they are already active. And so my view of this that Fannie and Freddie's charter acts fundamentally require them to serve the full range of markets that is available to them, that is, for which they are eligible to participate, and I believe it would be our responsibility as both regulator and conservator to ensure that they remained active in serving all segments of the market that are available to them, that are part of their core business activities.

So I would not expect a reduction or elimination in housing goals to necessarily alter what it is that they would be doing, because I think that they have an overriding charter responsibility to be served in the housing market.

Mr. LYNCH. I appreciate that. I just hope that we don't forget the history here. Section 202 housing was developed for seniors. You have to be 62 years of age or older. You can't—

Mr. DEMARCO. Yes, sir.

Mr. LYNCH. There is no other way to get into that housing. And the reason that we had to come up with that model was because, in the general family housing and elderly handicapped housing model, because of the laws in this country, we had to include a lot of people in the old handicap/elderly model that their needs were much different than elderly people.

If they were drug-addicted, handicapped, we had some horrific experiences when we put seniors in the same housing with very young people who were handicapped because of addiction to heroin and whatnot. So we created this model to protect seniors and also to better serve those people who were in addiction, because they have a different set of needs. We bifurcated this. And so that is why have 202 housing.

Mr. DEMARCO. Thank you, Congressman. That helps. And so, again, to reiterate, my understanding of Congressman Royce's bill is it—the extent to which Fannie and Freddie are serving that market today, I do not understand that bill would preclude them from continuing to serve it, nor would I view it as responsible as either regulator or conservator for them to be walking away from a segment of the market just because the housing goals—

Mr. LYNCH. The bill would eliminate the provisions of HERA, which established a duty of the GSE to serve the 202 elderly market.

Mr. DEMARCO. And that is why—

Mr. LYNCH. If they are not going to serve that market, I think it goes away.

Mr. DEMARCO. So that is what I am trying to be—

Mr. LYNCH. You are doing 90 percent of the mortgages through the GSEs right now, so—

Chairman GARRETT. We will let the gentleman answer, and this will be the—

Mr. DEMARCO. I am simply trying to express that—I am not personally aware of what portion of activity Fannie and Freddie have in a 202 market today. If they are not serving it already, we are not going to get them to start serving it. But if they are serving it, I don't see how removing the duty to serve requirement would cause any change in their continued service to that segment of the market.

Chairman GARRETT. Okay, thank you.

Mr. DEMARCO. And that is being consistent in what we have set forth as conservator, that we are not getting them into new lines of business.

Chairman GARRETT. I thank the gentleman.

Mr. LYNCH. I have exhausted my time. Thank you, Mr. Chairman.

Chairman GARRETT. Thanks a lot. I appreciate it.

The gentlelady from Illinois?

Mrs. BIGGERT. Thank you, Mr. Chairman.

Mr. DeMarco, for a couple of years now, I think I have been asking this question. You probably know what it is. It is about Fannie and Freddie's exclusive list of law firms that have handled the foreclosures.

Reports have indicated that there are—that these few firms get paid by the foreclosure, and there has been a rush to process those foreclosures to increase earnings. And meanwhile, there are reports of fraudulent paperwork among other paperwork problems. And these have also been reported.

I would actually ask to submit for the record the Washington Post story dated December 23, 2010, "Rush to foreclose by Fannie, Freddie helped feed problems with legal paperwork."

Chairman GARRETT. I am sorry?

Mrs. BIGGERT. I asked to submit—

Chairman GARRETT. Without objection, it is so orderd.

Mrs. BIGGERT. Thank you. Back to the question.

What have you done to review the need for this exclusive list or whether it should exist? Have you initiated audits of these law firms? And how many?

Mr. DEMARCO. We have been doing a lot, in terms of taking a close review of these law firms. Fannie and Freddie certainly have. I think it is well known that a couple of them have caused a great deal of difficulty and loss to the Enterprises. They have been taking steps to expand, and they have been expanding the range of firms that are participating.

But, Congresswoman, to the core of your question, we are taking a fundamental look at the use of and reliance on these firms as part of the foreclosure process and process.

Mrs. BIGGERT. Has there been any—not just a review, but are they being charged with anything?

Mr. DEMARCO. There are several firms that have been dismissed, if you will, no further business is being done, and ongoing business has been transferred. And, yes, there has been a heightened scrutiny of those that are continuing.

Mrs. BIGGERT. And did you do audits of these law firms? Is that proper to do?

Mr. DEMARCO. We do audits of Freddie and Fannie in terms of how they manage counterparty risk. So as part of our examinations, we have been undertaking additional exam activities to look at how Fannie and Freddie are managing those counterparties. Fannie and Freddie in turn have been taking a closer look at the performance and controls of their law firm.

Mrs. BIGGERT. Okay. And should the FHFA Inspector General have access to all of FHFA's records, reports, audits, reviews, documents, papers, recommendations, or other material that is available to FHFA?

Mr. DEMARCO. As any other inspector general, yes, ma'am, and they do.

Mrs. BIGGERT. Okay. And that is provided in section 6(a)(1) of the Inspector General Act of 1978?

Mr. DEMARCO. I believe that is right. Our Inspector General, with all reference to the authorities there in the Inspector General Act of 1978, as amended.

Mrs. BIGGERT. Okay. Would this also include the books and records of the GSEs, which are available to FHFA?

Mr. DEMARCO. The books and records of the GSEs are available to FHFA, as both the regulator and the conservator. The role of FHFA's Inspector General is to oversee FHFA and how we are conducting and carrying out our responsibilities as both the regulator and now as the conservator. I think that our IG has been under way for 6 or 7 months, and has been very active. And I think we have been developing a good process for ensuring that the IG has access to the information he needs to carry out his audits and evaluations of FHFA.

Mrs. BIGGERT. But the answer would be "no?"

Mr. DEMARCO. The books and records are available to FHFA, yes, not to the IG.

Mrs. BIGGERT. Okay. Thank you.

Mr. DEMARCO. I will say that there are certain exceptions. Questions like that are difficult because there are circumstances and particular activities, such as criminal investigations and so forth, for which different answers apply.

Mrs. BIGGERT. So there would be some limitations?

Mr. DEMARCO. Yes.

Mrs. BIGGERT. Yes, okay. And then you have—in looking at the three options that the Treasury has proposed, has said there is a privatized system of housing finance, with the government insurance role limited to FHA, USDA, and Department of Veterans Affairs assistance. Could you provide us with some ideas as to how option one could work specifically for multi-family housing?

Chairman GARRETT. And the gentleman's answer is your final answer.

Mr. DEMARCO. Honestly, Congresswoman, that is a challenging question. I would like a little more opportunity to think about that.

Mrs. BIGGERT. Maybe you could put that into writing?

Mr. DEMARCO. I would be happy to get back to you on that.

Mrs. BIGGERT. Thank you. I yield back.

Chairman GARRETT. I thank the gentlelady.

The gentlelady now from Wisconsin is recognized.

Ms. MOORE. Thank you so much, Mr. Chairman.

I actually would like to follow up on Mrs. Biggert's questions. I have three specific questions. First, how does the absence of GSEs, what impact would that have on affordable housing? Isn't it sort of oxymoronic to talk about producing affordable housing and yet having a private entity provide the securitization?

Second, I wanted to ask you about the liquidity. On page four of your testimony, you talked about the importance of keeping the GSEs focused on their existing core business and generating earnings, therefore benefiting taxpayers. And you also say that, because the private mortgage securitization market is already banished by this time, there were no other effective secondary market mechanisms in place. So I would like your view on whether or not the private sector and privatization really can take the place of providing secondary mortgage markets.

And on page six, you talk about how the Nation's housing finance structure depends on institutions capable of absorbing the flows that a market of that magnitude generates. You talk about, for example, the single-family market being a $10 trillion market. So if we were to privatize the secondary securitization, would we not be, indeed, creating too-big-to-fail institutions?

Mr. DEMARCO. Congresswoman, let me take the questions in order. With respect to affordable housing, as I understood it, you were asking whether I thought that the affordable housing segment of the mortgage market would be served or could be served if we were operating with secondary mortgage market entities that were fully private, that it did not operate with a government guarantee.

I think that the answer to that is "yes." I don't see why it wouldn't, because that is a large market segment. It is one where profits can be made and where customers can be served.

Ms. MOORE. Without a lot of fees? What would the fee structure be?

Mr. DEMARCO. Congresswoman, I can't answer that, except to say that I would assume that the fees would be risk-based. And, there is a lot that has changed in our mortgage market in terms of private institutions serving low- and moderate-income households and serving the rental market.

This market has long had and continues to have today a great deal of government involvement, not just at the Federal level, but also at the State level. So in considering your question, assuming that there is still an array of Federal through FHA, State through State and local housing finance agencies, actors still involved, but I do think that in terms of thinking about the role that Fannie and Freddie have played in the conventional conforming mortgage market over the years, including serving low- and moderate-income households, I do think a portion of that can be served by private institutions.

With respect to your second question about, can the private sector take the place of Fannie and Freddie in the secondary mortgage market? I think fundamentally that is really, in essence, the question the Administration—

Ms. MOORE. Liquidity.

Mr. DEMARCO. —its White Paper.

Ms. MOORE. Would it wipe out the small banks, the community banks? How would they fare in this market with respect to liquidity?

Mr. DEMARCO. With fully private, I think that the more competitive that market is, the better served small- and mid-sized lenders would be. And so I would commend to the subcommittee that, in thinking about each reform of the secondary mortgage market, that the more competitive this marketplace is, I think the better for borrowers and the better for small- and mid-sized loan originators.

I think that this is really the core question. And I must say that, in terms of market participants that I talk to, I find an array of views about this, as to just how much of a $10 trillion or $11 trillion single-family mortgage market can be effectively financed by capital markets, whether domestic investors or foreign investors in U.S. mortgages, how much of that can be done without any connection or backstop or guarantee from the government?

So if you view the range as being between zero on the one hand and we have about an $11 trillion single-family mortgage market on the other, somewhere in there is an answer or a range of answers of how much can be done effectively by fully private firms. And I think that is the core question that the Congress is going to have to grapple with in determining the future of the secondary mortgage market.

Chairman GARRETT. I thank the gentlelady.

The gentleman from California?

Mr. ROYCE. Thank you, Mr. Chairman.

I wanted to ask you, Mr. DeMarco, I want to thank you for your testimony, but briefly, on the affordable housing goals legislation, you mentioned in your testimony that, “Similar to the housing goals, eliminating the duty to serve requirements could be consistent with the realities associated with the Enterprises operating in conservatorship.”

Could you please elaborate on that point? Walk us through that.

Mr. DEMARCO. Certainly. Congressman, the duty to serve requirement was new in the HERA legislation enacted in 2008. It does not set quantitative—Congress did not want FHFA to set quantitative goals, but instead identified three areas of the housing market where it identified Fannie and Freddie as having a duty to serve them, and the legislation was encouraging them to take innovative steps to develop more product and activity in that area.

In conservatorship, we are restricting Fannie and Freddie to their existing core business activities. It is inconsistent with conservatorship, in my view, to engage in new lines of business where you have to develop new infrastructure, new risk controls, new underwriting, and so forth, and new technology to service.

And so the approach we took in our proposed rule on duty to serve was to implement the duty to serve requirement in areas that Fannie and Freddie were already providing support and to those particular market segments, but not to require them to develop new products in order to satisfy duty to serve, because that was what was in an inherent conflict with the approach we are taking in conservatorship.

Mr. ROYCE. And also, with the experiences in the past, let me ask you—and we touched a little on this issue—but last month, the president of the Richmond Federal Reserve, Jeff Lacker, criticized proposals similar to the ones that will be touted on the second panel. And what Richmond President Jeff Lacker said was that many proposals would make government guarantees on home mortgages explicit and priced. Such proposals differ mainly in the nature of the intermediaries through which such guarantees would be channeled, but perpetuating guarantees for housing-related debt will continue to artificially stimulate the risky leverage that critically fueled the disastrous housing boom we have just experienced.

The devastating consequences of the housing bust suggest that government backstops for housing finance are not worth the price of overbuilt, overleveraged, and at times overheated housing markets, on top of the fiscal burden of large contingent liabilities.

You have made comments raising concerns with simply making a government guarantee explicit, rather than implicit. I wonder if you would comment on some of the other aspects of Mr. Lacker’s statement there. I would like to get your thoughts on that.

Mr. DEMARCO. Certainly. As an economist, I would share the general principles that Mr. Lacker has set forth. I would add to that—certainly economists recognize that where there are either market failures or where there are public policy objectives that are to be served, there can be a role for guarantees, subsidies, or other incentives provided by government to incentivize greater activity in an area relative to what purely private actors would create. And that is really a determination for lawmakers to make, not regulators.

Mr. ROYCE. My time is up, but, Mr. DeMarco, thank you very much.

Thank you, Mr. Chairman.

Chairman GARRETT. The gentleman has one more minute. Do you have another question? Okay.

The gentleman from Colorado?

Mr. PERLMUTTER. Thank you, Mr. Chairman.

Mr. DeMarco, let me begin with a couple of comments you made. In the conservatorship, you are not taking on any new products, new approaches. It is just trying to keep things going, right?

Mr. DEMARCO. We are trying to restrict the Enterprises to their existing core business activities, to remediate where they had weaknesses in those business activities, and to keep them from getting into new lines of business or new products, yes, sir.

Mr. PERLMUTTER. Anecdotally, I hear out there, 5, 6, 7 years ago, that 2003 to 2007 timeframe, anybody could get a mortgage if they were breathing. Obviously in this conservatorship mode, Freddie Mac and Fannie Mae are much more restrictive in what they will buy. Is that a fair statement?

Mr. DEMARCO. Their underwriting standards have been appropriately strengthened, yes, sir.

Mr. PERLMUTTER. What I have heard is the pendulum was very easy back in that 2003 to 2007 timeframe, much more difficult now.

Mr. DEMARCO. I would say that underwriting standards have strengthened and pricing has become more risk-based. And I would say, Congressman, that is probably where it is actually seen its effects, is we were under pricing credit risk, and now we are getting at least closer to having appropriate pricing of credit risk.

Mr. PERLMUTTER. Okay, and I will take your answer as a "yes."

Mr. DEMARCO. Yes, sir.

Mr. PERLMUTTER. I ask those questions because of some questions Mr. Hensarling posed to you, that there were some $150 billion in troubled loans that are part of the conservator's package and responsibility, but have those developed during the term of the conservator? Or were those things that preceded the conservatorship?

Mr. DEMARCO. Most of the troubled loans and delinquent mortgages we are dealing with, sir, were originated pre-conservatorship.

Mr. PERLMUTTER. Okay. So at this point, based on the underwriting standards, you wouldn't expect to have that level of troubled loans on a going-forward basis, would you?

Mr. DEMARCO. That is correct.

Mr. PERLMUTTER. Okay. There were a couple of areas where I did agree with Mr. Hensarling. Obviously, we have some financial issues we must confront in this country. He and I absolutely disagree as to how we got here. I believe when the Bush Administration took a voluntary pay cut, in effect, cut our taxes substantially in 2001, 2002, prosecuted a couple of wars to the tune of $1 trillion, and then we don't have enough police on Wall Street in 2008 and that put this country behind the financial eight ball.

But we are behind the financial eight ball, which brings me to a second question. Obviously, in this conservatorship, you are not taking on anything new, but there are places, I believe, and your counsel and I have talked about this in the past, which are called real estate mortgage investment conduits. Are you familiar with that concept, sir?

Mr. DEMARCO. With REMICs? Yes, sir.

Mr. PERLMUTTER. Okay. And the reason I am asking it is, there are certain portfolios—there are certain bonds that you have sold, either Fannie Mae or Freddie Mac has sold, that had very substantial interest rates back in the 1980s and the 1990s, compared to the interest rates today. So there is an opportunity in those older bonds to call those bonds and make some money. Are you familiar with that?

Mr. DEMARCO. I am familiar with this issue, yes, sir.

Mr. PERLMUTTER. Okay, I just want to bring it to your attention, because at least a couple of the proposals that the Republicans have brought forward—particularly for me, Mr. Schweikert's, and Mrs. Biggert's, have real merit in kind of advancing and continuing to build Fannie Mae and Freddie Mac. But I probably will want to reiterate the fact that the American taxpayer could make some money if some of those loans that are at higher interest rates were called today.

And so I will—don't be surprised if you see an amendment that, instead of focusing on NPR or Planned Parenthood or things that, in my opinion, didn't cause the debt this country faces, we actually do something where there is money on the table that would benefit the American taxpayer.

So I thank you for your service in this difficult time. I really do. And I thank you for your testimony today.

Mr. DEMARCO. Thank you.

Chairman GARRETT. The gentleman yields back. And we look forward to working with the gentleman on a number of those bills.

And with that, I yield to the gentleman from Texas.

Mr. NEUGEBAUER. Yes, thank you, Mr. Chairman. Thank you, Mr. Demarco, for being here.

A couple of thoughts here. One is, I appreciated your thoughts on raising the guarantee fee. You and I have had a number of conversations about that. And I guess the question is, is from a strategy standpoint, is the goal here to just keep raising the G-fee until you start to see some private activity foregoing sanitizing these mortgages through Freddie and Fannie and begin to see some private activity? Or what is going to be your criteria and your goal in your G-fee strategy?

Mr. DEMARCO. The approach we have been taking is to ensure, first of all, we have been focused on enhancing the risk-based characteristics of pricing, so that riskier mortgages are, in fact, charged a higher price. In the pre-conservatorship world, there is a tremendous amount of cross-subsidization going on from low-risk borrowers to high-risk borrowers, and we are trying to gradually correct that by enhancing the risk-based characteristics of the pricing.

And the other is that we are continuing to move in a direction of looking at the risk characteristics of a particular group of loans based on their characteristics, determine what is the appropriate amount of economic capital that would be required to back that, if these were operated as private entities, and then what the rate—at least getting to a rate of against that sort of imputed capital that would be needed to back that. So that is really the benchmark that we are looking at as we take these gradual steps with price adjustments.

Mr. NEUGEBAUER. I think you brought up something else that I agree with, and that is that, in order to continue to create some space for the private market, lowering the conforming loan limits has to be a part of that strategy, because basically what we have done is we have pushed the jumbo market way up there now with the current limits, and so basically all of the private activity that seems to be going on in the marketplace right now is at the jumbo level.

So I guess if you bring the jumbo level down some, you begin to create some space for the—do you have the authority as the conservator to say to the entities, "I am establishing new conforming loan limits, and from this point forward, this will be your conforming loan limit?"

Mr. DEMARCO. The conforming loan limit is driven by statutory direction and formula, and we simply implement that.

Mr. NEUGEBAUER. I think the man behind you is going to disagree with you here.

Mr. DEMARCO. Oh, okay, thank you. I am being advised that my answer is partially correct. It is established by formula, but apparently I have authority to go lower.

Mr. NEUGEBAUER. Would you consider doing that?

Mr. DEMARCO. Since I have just discovered that I have this authority, I would have to—I suppose I would consider it. What I would do with it, Congressman, I am not sure.

This has traditionally been something that has been really directed by Congress. The adjustments have been directed by Congress. And for me to make a change in that, as a regulator, I really want to think hard about that.

Mr. NEUGEBAUER. I would just say this to you, Mr. DeMarco, that you are a conservator for the taxpayers of the United States of America. And so if you feel like it is in the best interests of the American taxpayers to begin a process of lowering those conforming loan limits, we certainly would expect you to fill your fiduciary responsibility and consider that.

I want to go to another area where we were talking about the portfolio. And I agree with a number of my colleagues. I think the sooner we reduce our portfolio, the better. And I think sometimes—and there is an old banking saying that your first loss is sometimes your cheapest loss.

One of the things that I am concerned about is—and you and I have talked about this a little bit—that basically your portfolio reduction is actually being slowed down some by the fact that you are purchasing some of these troubled loans rather than paying the principal and the interest deficiency on those loans. And I guess you have been bringing them into your portfolio and trying to rework them. I think in some cases you are selling those properties and putting new borrowers in there.

And so my feeling is that, as we are really bringing the troubled loans into the portfolio, we are probably selling the better quality loans, and so basically the quality of the portfolio is probably deteriorating. Would that be a correct assumption?

Mr. DEMARCO. Certainly, the liquidity of the assets are deteriorating, because just as you quite rightly point out, the shift in the share of the mortgages that are financed on balance sheets by Fannie and Freddie are modified loans or otherwise troubled loans. And so that makes them much more difficult to sell.

Mr. NEUGEBAUER. Just one quick question. Have you considered looking at a liquidation of some of the portfolio loans without a Freddie or Fannie guarantee?

Mr. DEMARCO. The idea—

Mr. NEUGEBAUER. Kind of—

Mr. DEMARCO. The idea, in terms of REO, most of that is sold—

Mr. DEMARCO. You are talking about loans. The idea has occurred to us. And actually, in my written statement, my commentary about one of the bills, about no new products, was, in fact, making really by inference—that was one of the things I had in mind, Congressman—is that while I remain steadfast in my view that as conservator we should not have the Enterprises entering new businesses and new product lines, that at some point, we might want to revisit that question, if it is part of a considered transition mechanism, really worked out with the Congress, about moving from Fannie and Freddie as we have them today to greater private participation.

That is one mechanism that could be considered. And that needs to be balanced against the fact that it would be considered a new product.

Chairman GARRETT. I thank the gentleman. And perhaps just on that, if you have specific ideas in that area, the gentleman and the committee would probably like to hear as to what those specific areas would be needed in order to get into that transitional phase, that might want to be excluded from any area limited—with the limitation on new products.

Mr. DEMARCO. Certainly. I would welcome that discussion with any members of the committee. It is not something where I have a plan today. I am simply anticipating where we might find ourselves.

Chairman GARRETT. Okay. The gentleman from North Carolina is recognized.

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

Mr. DeMarco, you and I agree that the principal consideration, perhaps the only consideration for FHFA as conservator of Fannie and Freddie should be reducing the losses of taxpayers, but it appears pretty clear that the cycle we have of foreclosures leading to declining home values, declining home values leading to more borrowers, more homeowners being underwater, leads to more foreclosures, and on and on, it clearly is in the interest of taxpayers for FHFA, as conservator of Fannie and Freddie, to minimize the continuing decline in home values. Isn't that correct?

Mr. DEMARCO. Yes, sir.

Mr. MILLER OF NORTH CAROLINA. Okay. The power—and you and I have corresponded about this, and I appreciate your response to my earlier letter, that more than 50 other members signed. The GSEs, Fannie and Freddie, obviously have enormous market power in the mortgage market now. Not only are they 50 percent of legacy loans, but they are in essence the entire market for new loans. There is no PLS market now.

Mr. DEMARCO. Right. It is Fannie, Freddie, and the FHA, basically.

Mr. MILLER OF NORTH CAROLINA. Okay. Why would it not be in the taxpayers' interest for FHFA, as conservator of Fannie and Freddie, to use that market power to try to reform the market for servicers, servicers' conduct, with respect to your own servicers, that they not do all of the things that we have heard complained about, the dual track, the lack of a single point of contact, the failure to terminate the contracts with those servicers who keep losing paper, for instance.

Why is FHFA as conservator not using your market power to reform the servicing industry, which seems to be in dire need of reform?

Mr. DEMARCO. Indeed, I agree with you. And I would say that we are working very hard on the very set of things you just described. I made a presentation in the Mortgage Bankers Association's annual servicing conference last month, and I told them rather directly that we were working with Fannie and Freddie to revise and make consistent a whole set of practices, timelines, and penalties, with regard to mortgage servicing, so we wouldn't have this—Fannie wants it this way, but Freddie wants it that way. No, we are not doing that.

We are getting them consistent. We are going to be rigorous, and there are going to be penalties associated with failure to service properly based on this, and we are very much engaged in that activity.

Mr. MILLER OF NORTH CAROLINA. And are you using—are you applying those expectations, those standards to the same servicers in how they handle PLS mortgages?

Mr. DEMARCO. No, sir, I don't have regulatory authority over what mortgage servicers are doing.

Mr. MILLER OF NORTH CAROLINA. You have contractual authority.

Mr. DEMARCO. Pardon?

Mr. MILLER OF NORTH CAROLINA. Contractual authority.

Mr. DEMARCO. My contractual authority is what we were trying to exercise, yes.

Mr. MILLER OF NORTH CAROLINA. Your contract can say—why can't it not say that, with respect to your servicing standards generally, with respect to all clients, you must do these things?

Mr. DEMARCO. I will take that under consideration, check—and I will go back and see if that is feasible for us.

Mr. MILLER OF NORTH CAROLINA. Okay. And you and I have corresponded about principal reductions and the value of that. It seems that every study that has looked at the success of modifications has found that modifications that reduce principal, particularly—especially for those underwater, are much more successful if they reduce principal.

And you said that actually not that many of FHFA's—of Fannie and Freddie, the Enterprises' mortgages are underwater, and it certainly makes sense that your book of business would be substantially better than the PLS book of business.

But why are you not pushing them to reduce principal to the extent it is consistent with their contracts, PLS contracts?

Mr. DEMARCO. First of all, Congressman, some of these studies that purport to show principal forgiveness as superior, as minimizing losses, are actually combining principal forgiveness and principal forbearance, which are different concepts and matter a lot to me as conservator.

As conservator, some of the loan modifications that Fannie and Freddie are doing, in fact, include principal forbearance, which means that you are basically being charged a zero rate of interest on the principal, but we are retaining—the principal value is still owed.

And what that does, essentially, is that over time it retains for the Enterprises an upside should markets continue to improve, that households be able to maintain a good, steady payment on the modified loan. It has the potential to improve the net realized value on that mortgage for the Enterprise, whereas principal forgiveness, once it is forgiven, then that is it. There is no upside potential.

The other thing, in response to an earlier question, the vast majority of the Enterprises' underwater mortgages are continuing to perform. They are paying timely, and we would like to continue that, and it is our expectation that those households will continue to honor their financial commitments. So we are using principal forbearance as a tool in the loan modification process as a way of getting an affordable payment for consumers.

The other thing—the comment I had made earlier before you arrived, in response to another question, is that in our examination of data of households that have received loan modifications, the performance rate on those modified loans does not seem to vary much with what the actual current loan-to-value is.

So we see that there is a value in getting the borrower that is committed to their home into a payment that they can afford, and they then succeed in paying that modified loan regardless of what their loan-to-value ratio is.

So we have been trying very hard to take an empirical approach to looking at this—at this important question, because I agree with you. This is a very important question. And as I said in my correspondence to you, there may be well be other segments of the market, and particularly in the private-label realm, where principal forgiveness makes more sense.

Mr. MILLER OF NORTH CAROLINA. And, Mr. Chairman, my time has expired, but—

Chairman GARRETT. Your time is—

Mr. MILLER OF NORTH CAROLINA. If I could have 30 seconds?

Chairman GARRETT. You are a minute and 40 seconds over, so let me go to the gentleman from New Mexico, please.

Mr. PEARCE. Thank you. Thank you, Mr. Chairman.

Thank you, Mr. DeMarco. On page one, you refer to the business as doing much better, but you also refer to substantial credit losses. How much are those credit losses?

Mr. DEMARCO. The credit losses have been—I am sorry, on the order of $180 billion, I think—

Mr. PEARCE. —$180 billion, in this past year?

Mr. DEMARCO. No, sir. I am talking since—the losses against capital from 2008.

Mr. PEARCE. I understand, but you say it is significantly better, but it still has credit losses during the current—

Mr. DEMARCO. Oh, credit losses in 2010 were much smaller than in prior years.

Mr. PEARCE. How much are those?

Mr. DEMARCO. I am sorry, Congressman. I will get you the number.

Mr. PEARCE. You have an approximate ballpark?

Mr. DEMARCO. It is in the order of $20 billion to $30 billion.

Mr. PEARCE. Okay, so on page three, you refer to $28 billion drawdown, right?

Mr. DEMARCO. Yes, sir.

Mr. PEARCE. Is that then the amount of the credit losses?

Mr. DEMARCO. That is pretty close to it, sir, because some of the draws are due to having to make dividend payments—

Mr. PEARCE. Okay, that is—that will—

Mr. DEMARCO. —to make dividend payments.

Mr. PEARCE. So let me try to get this business model in mind. You have 30 million loans, and 1.5 million are nonperforming, right? And those are creating losses of $28 billion, which you drew down from the Treasury. Is that more or less correct? I see somebody shaking their head.

Mr. DEMARCO. We have been reserving for those losses as we go along, so they have built-up loan-loss reserves that have been reflected in part—

Mr. PEARCE. Okay. So you have basically 28.5 million loans that are performing, right?

Mr. DEMARCO. That would seem about right.

Mr. PEARCE. Yes. And those loans have the value of about $5.5 trillion. Is that right? That is on page four of your testimony.

Mr. DEMARCO. Yes, sir.

Mr. PEARCE. So how much do you make on the $5.5 trillion? What are your revenues off the $5.5 trillion? And where 90 percent, 95 percent are performing, what are your revenues then?

Mr. DEMARCO. The revenues that we are making on that are basically the guarantee fees that are being charged.

Mr. PEARCE. No, how much? What quantity?

Mr. DEMARCO. I am sorry, Congressman. I don't keep these numbers straight in my head—quite available.

Mr. PEARCE. Excuse me, sir. You are a conservator of $5.5 trillion, and you don't know how much money you are making? Can any of the people behind you tell us how—because what I am getting at is that, if you make 10 percent—and 10 percent is a very low value for a business model—you are sitting at $550 billion and yet you are drawing down from the Treasury. And I think the American people have a right to know that.

And for you to come to a meeting here on a business model where you are talking about conserving the value for the taxpayers, I think that is one of the most basic questions of a business model. You are in the business of business, and you don't know how much money you made in the last 12 months. Do any of the four people behind you know that?

Mr. DEMARCO. Total credit-related expenses for Fannie Mae last year was about $27 billion. Total credit-related expenses for Freddie Mac in 2010 was $21 billion. The net income for Fannie Mae last year was negative $14 billion, and it was the same for Freddie, a negative $14 billion.

Mr. PEARCE. Okay, let's hold up right here then. So let me get this clear. You have 28.5 million performing loans, and you have 1.5 million nonperforming loans, and your performing loans are outweighed so that you have $114 million net loss in revenue, net income.

Mr. DEMARCO. $14 billion net loss for the year.

Mr. PEARCE. $14 billion net loss. So you have 95 percent performing loans and 5 percent nonperforming loans. I think there are some serious flaws. If I have a business and I am performing at 95 percent capacity, I can go to 0 percent on the others and they should never, never, never outweigh.

So what you are asking me to believe is that the losses from 5 percent of your loans, from 1.5 million loans, outweighs the revenues from 28.5 million loans? That seems to me to be preposterous. If you look at it in large terms, you have $5.5 trillion of performing loans minus 5 percent. When I do the math, they are worth about $200,000 apiece, and I assume that $200,000 per loan goes across to the other side.

So you have 1.5 million nonperforming loans at $200,000 apiece, that is about $300 billion on our portfolio, thinking of $5.5 trillion? Something stretches—what is it that I am missing here?

Mr. DEMARCO. Congressman, I think—so I would welcome the opportunity to sit down with you and walk through this. But the thing about it is, I can't be making $200,000 on a loan when the average loan size is itself less than—

Mr. PEARCE. No, I am not saying you are making it. I am saying the loan size itself. The loan size itself—

Mr. DEMARCO. And so the earnings that the companies are making, they are securitizing these mortgages, and so they are making maybe—they are charging maybe 20 basis points, 15, 20, 25 basis points on a mortgage as the guarantee fee. And from the guarantee fee, they have to pay their operating expenses, cover their credit losses, and then the rest is their income.

Mr. PEARCE. I welcome the opportunity to visit with you in the office to look at it, because I don't see a market where you have 1.5 percent nonperforming, 1.5 million, 5 percent nonperforming, sinking the 95 percent performing.

Thank you, Mr. Chairman.

Mr. DEMARCO. Congressman—

Chairman GARRETT. And I thank you.

The gentleman from Texas?

Mr. GREEN. Thank you, Mr. Chairman. I thank the witnesses for appearing. And I think that we all agree that we have to do something with reference to Fannie and Freddie. The question becomes, what do we do? And also, when do we do it?

Would it be prudent to simply eliminate Fannie and Freddie and not have some idea as to what the market structure will be upon elimination?

Mr. DEMARCO. No, Congressman, I think the better course would be to have some sense of what the legal framework and institutional arrangements would be for the country's secondary mortgage market.

Mr. GREEN. And can you give some indication as to what we might have to confront if we don't give some prudent thought to this process, such that at the end of the day we have in place some structure that we can at least associate some degree of predictability with, in terms of how the market will react to it and how it will impact the market? What could be some of the consequences of simply repealing, capping, eliminating, without having some idea as to what the structure will be?

Mr. DEMARCO. One would expect that the implications would be higher mortgage rates and less liquidity in the mortgage markets.

Mr. GREEN. And what would these higher rates and the lack of liquidity or not as much as we might have, how would that impact an economy that is recovering?

Mr. DEMARCO. All else being equal, obviously, those things would make the recovery more difficult.

Mr. GREEN. I am asking you to give these kinds of answers, sir, because I think that while efforts to repeal, eliminate, and downsize are noble, I don't question the motives. I do think that we need to have a comprehensive approach that addresses not only what we would like to do in terms of downsizing Fannie and Freddie, but also what the structure is going to be at the end of the day if that happens.

Because my fear is that we may end up with a market that has much higher interest rates than we want. Many persons will not be able to afford a home, which will then impact other organizations. You have REALTORS® who do business and who depend on the opportunity to have interest rates that are reasonable, so that people can buy. And as a result, they have businesses that can continue to flourish. The domino impact of this can be huge.

And I am concerned about how that domino impact can impact the market. Do you have any thoughts on the impact that—we will go beyond simply just eliminating Fannie and Freddie and move to the broader economy and the dominos and how they may start to fall and collide with each other?

Mr. DEMARCO. Congressman, I actually have a great deal of—though I have been challenged the last few years—faith in the resiliency and robustness of private financial institutions and the financial system of this country.

I think that a gradual program of moving away from the degree of government support for the mortgage market to one that involves greater reliance on private capital and private institutions is something that is achievable and it is something to—that I understand most to be wanting to work towards.

Precipitous action in the economic state we are in could be problematic and could raise costs to taxpayers and could be further disruptive to the housing market.

But I agree with you that working on a gradual transition and transformation, something that we are doing as conservator of Fannie and Freddie would be helpful to the housing market, but we can move over time—

Mr. GREEN. If I may, because my time is about to expire. Would you simply define a phrase that you utilized, "precipitous action?" Would you define that, please?

Mr. DEMARCO. If I was told to shut things down tomorrow at Fannie and Freddie and they were no longer purchasing or securitizing mortgages, I would view that as a precipitous action.

Mr. GREEN. That would be an extreme action, obviously. Can you give me something that would be not quite as extreme, but also precipitous?

Mr. DEMARCO. Certainly, Congressman, there is a range of things.

Mr. GREEN. If you would, just give me the range, and I will yield back the balance of my time after you have done so, time that I do not have, by the way.

[laughter]

Mr. DEMARCO. There is a range of things that are being done as part of the unwind, so if we wanted to unwind the portfolio in 6 months, that would be precipitous.

Chairman GARRETT. I appreciate the gentleman's answer.

The gentleman from Virginia is recognized for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman.

Mr. DeMarco, thank you for being here and helping us work through these eight bills, legislative proposals. I don't want to cut too much into my time, but I was very intrigued by Mr. Pearce's line of questioning. And it seems like you might have had an answer.

I would like for the benefit of the committee to hear briefly your response to the numbers that he set forth, if you can.

Mr. DEMARCO. What I was trying to explain, I think maybe I was just either misunderstanding the Congressman or—but in thinking about the revenue stream that Fannie and Freddie get on $5.5 trillion of mortgages, that revenue stream is measured in fractions of a percentage point that is in the guarantee fee that is earned. And it is from that guarantee fee that they pay, they cover their credit losses, and they cover their operational and administrative expenses. That is all I was trying to get to. And we can do a breakdown of how the economics of that business works.

But the other point I was trying to make, so thank you for the opportunity, is that, prior to conservatorship, I think one of the things that has contributed to these dramatic losses is that the Enterprises substantially underprice credit risk that they were taking on.

And so the revenue stream that should have been coming off of these mortgages that were originated in the period prior to conservatorship has been inadequate to the losses that have been realized, because they were underpricing risk and, furthermore, they were operating with substantially less capital than would have been appropriate, something that the predecessor agency to FHFA had testified to numerous times, but was unable to materially change because the capital requirements were set in statute.

Mr. HURT. Do you think that what you have just set forth underscores the importance of trying to wind down Freddie Mac and Fannie Mae?

Mr. DEMARCO. I think it underscores the importance of what we are doing to try to adjust the pricing and the underwriting standards at the companies operating in conservatorship—that is being written now provides support to the country's mortgage market, but does so without creating risk to the taxpayer.

Mr. HURT. Obviously, we are here looking at eight legislative proposals that are being considered by this subcommittee. In the White Paper that the Administration and Treasury made public recently, there were identified four different things that could be done, it was stated, without legislative action, increasing the guarantee fees, which you have discussed, winding down the portfolios, which you have discussed.

The two other things were reducing conforming loan limits, which you indicated that you all had not considered. I would like to know why you haven't considered that. And then, finally, is increasing the downpayments. I would like to hear about that.

And I would also like to just—if you could speak generally about the objectives of the conservator in attempting to take some of these actions proactively, knowing that is where this legislation seems to be headed, it seems to be what the Administration may or may not be aggressively pursuing, but it seems to me that getting the GSEs out of the marketplace—or reducing—certainly diminishing their role is important.

So I would like to know what your objectives are as conservator in taking actions in advance of any legislation, because I think it would serve the marketplace generally, at least provide some of that—or reduce the precipitous action that you are talking about, helps us ease into it.

Mr. DEMARCO. Right. So I believe, in fact, as conservator, FHFA has been marching down this path for quite some time prior to either these particular bills or the Administration's White Paper. And some of the ways in which we have done that have been, in fact, through increasing G-fees, improving underwriting standards, and the reduction in the portfolio, and restricting the company's core business.

And you asked me about two other things, downpayments and—

Mr. HURT. Conforming loan limits.

Mr. DEMARCO. —conforming loan limits. So the question on conforming loan limit, this is—so whether FHFA has authority or not—and my staff is telling me we do—this has traditionally been something that the Congress and the United States has taken a very deep and specific interest in. And the practice for decades has been that the conforming loan limit has been something that has been stipulated by Congress and has simply been implemented by the regulator.

And, in fact, in each of the last several years, Congress has enacted temporary provisions to state what it wants the conforming loan limit to be, based upon its judgment of the condition of the economy and housing markets, and it has allowed for a series of temporary increases in the conforming loan limit as part of Congress' approach to providing support to the country's economy and to its housing market.

And that is why I think it is quite prudent for me to have a good bit of deference to Congress to determine what the conforming loan limit ought to be. Where we are in current laws is the conforming loan limit will come down October 1st of this year, if there is no further action by Congress.

I would be happy to provide you and all the members of the subcommittee—we put out a research note just this week describing the parts of the country that would be affected, if the—if Congress takes no further action with the conforming loan limits. So I have that research out already.

I am happy to share with you so you can see where these changes would take place. There are about 250 counties in the United States that would experience a reduction in the loan limits.

With respect to downpayments, we have, in fact, been taking—just like with pricing—gradual steps to increase downpayment requirements. I testified before the House Financial Services Committee last year about a particular program that I had made clear we were not going to continue with, and that was very low downpayment mortgages. Now that we have the Administration's White Paper, we are examining what would be appropriate gradual steps with respect to further tightening with respect to minimum downpayment requirements.

Chairman GARRETT. The gentleman's time has expired. And I thank you for your answer.

The gentleman is recognized for 5 minutes.

Mr. ELLISON. Thank you, Mr. Chairman.

Mr. DeMarco, we have had a lot of dialogue about whether Fannie and Freddie take up too much of the secondary mortgage market, and I think maybe there is a consensus that they do.

But my question is, after reform, what would be the proper balance? What should a GSE share of the secondary market be in, say, 10 years, assuming we were to have responsive reform?

Mr. DEMARCO. Congressman, I would like to, if I may, answer the question differently. The way I would approach the thought process is, what part of an $11 trillion single-family mortgage market should have the benefit of a government credit support?

Mr. ELLISON. Yes, that seems a good way to put it.

Mr. DEMARCO. And then that credit support can be provided through the existing government programs, the FHA, G.A., rural—VA, excuse me, rural housing, and Congress is free to look at making alterations to the scope or targeting of those particular programs, because here is where we want to have government credit support.

With respect to what the GSEs do today, then the question on the table is, does the government want to—or feel it is appropriate and is in the best public interest to provide some portion of the rest of that universe with a government guarantee that would somehow wrap a private guarantee of the mortgages that are being written in that space?

So whatever replaced Fannie and Freddie, whatever these private-sector securitizers are, presumably they would be in the first loss position with respect to mortgage credit. And the question is, can the capital market sufficiently and appropriately finance all of that without there being—

Mr. ELLISON. Mr. DeMarco, the analysis you are going through does make sense to me, but they only give us 5 minutes. So I guess—

Mr. DEMARCO. Sorry, sir.

Mr. ELLISON. I guess my question is, so it is clear to me, based on your answer to me, that you do see a role for a public-sector or quasi-public-sector institution in the mortgage market?

Mr. DEMARCO. Yes, sir. I continue to see a role for the FHA, the VA, the rural housing, that can be defined up or down from where it exists today, but I envision that would continue.

Mr. ELLISON. Let me ask you this. We have a lot of dialogue about the role Fannie and Freddie may or may not have played in the recent crisis, and the Financial Crisis Inquiry Commission said that GSEs played a contributing role, but certainly were not the primary cause.

Let me ask you the question this way. Do you believe that there is a public interest in the United States Government, through its programs for housing, having homeownership as a laudable and meritorious goal?

Mr. DEMARCO. Certainly, the evidence would suggest that the answer to that is yes, because there are numerous ways in which the Federal Government—and, frankly, State governments—provide subsidies, incentives, or otherwise support home ownership activity.

Mr. ELLISON. Yes. And it sounds—and I was reading in the document where it states that—where basically, I am wondering whether—I wanted to get your answer on that, because I was not sure where the Administration was coming from on homeownership as a laudable goal of a government program. It sounds to me like you are saying it is an important goal, and you don't plan on joining with any forces that want to eliminate it as something that we should pursue?

Mr. DEMARCO. I can affirmatively say yes to that question. But my role as the regulator is to implement what is being told to me by—

Mr. ELLISON. I know. I understand that.

Mr. DEMARCO. I am not a policymaker, per se—

Mr. ELLISON. Right.

Mr. DEMARCO. —in terms of being an advocate for the degree or form of government support for housing.

Mr. ELLISON. So you are saying that you don't really have any position on whether or not we should—I am just trying to get an understanding. I am not trying to—

Mr. DEMARCO. I understand.

Mr. ELLISON. —trick you or anything. I just want to—

Mr. DEMARCO. And I am not trying to be cagey. I am trying to respect that I am not a policymaker. I am a regulator. And I am trying to provide advice and perspective, where apt.

But in terms of being able to say what I think is the right spot in that spectrum for the government support, I don't feel comfortable answering that.

Mr. ELLISON. All right. Fair enough.

Chairman GARRETT. I think your time has expired, actually.

Mr. ELLISON. That quickly?

Chairman GARRETT. It goes by quickly when you are asking good questions.

Mr. ELLISON. I guess that is it.

Chairman GARRETT. When you are on the point with the questions, it just flies by.

The gentlelady from New York?

Dr. HAYWORTH. Thank you, Mr. Chairman.

Mr. DeMarco, this is more of a comment, I guess, than a question. And it is about something rather different. Perhaps it will be refreshing. But there is a great program called—it goes by the acronym PACE, the Property Assessed Clean Energy program. And as you know, it allows property holders to make energy-saving improvements on their homes via loans that are financed through their local property taxes. And it actually is a program that was designed to allow these improvements to be made for the sake of our general good, if you will, without costing taxpayers money.

I understand that there have been problems fitting PACE in with the GSE programs because that would be senior debt, but I know that there are efforts underway to see how we can fit PACE into the mortgage program for people who have Fannie Mae or Freddie Mac-related—GSE-related secondary mortgages.

So is your staff willing to work with us in the legislature about trying to get PACE going for these folks so that we can really do some good?

Mr. DEMARCO. Yes, we would be pleased to work with you and anyone on the Hill who would like to engage in this issue. And I appreciate the way you framed it, because I appreciate that in the way you framed it, you have recognized what our fundamental concern is. It is not that we are opposed to energy efficiency. It is that we are looking at mortgages that are done with a first lien, where it has been underwritten with the presumption that here is what the borrower's capacity to pay is and here is what the security is on this loan. And by a PACE loan then coming in after that and having a senior position for the first lien, ups that whole thing and creates credit risk where—after the loan has been finalized.

With that understanding, we would be very happy to try to work with—a way to make these energy efficiency loans more available to folks.

Dr. HAYWORTH. Great. I think it would just be a terrific good for all of us. Our staff is working on trying to get that PACE legislation going, so perhaps we can coordinate with your staff.

Mr. DEMARCO. We would be glad to meet with your team.

Dr. HAYWORTH. I appreciate it. And I yield back the balance of my time, Mr. Chairman. I think Mr. Fitzpatrick graciously allowed me to take his place in the order, so I am happy to yield my time to him, with your permission.

Chairman GARRETT. Since you were so gracious, then I will be, as well.

Mr. Fitzpatrick?

Mr. FITZPATRICK. Thank you.

And I thank the Director for his testimony.

Sir, you mentioned just a little while ago that revenue that Fannie Mae gets is measured in the G-fee. It was in response to questions from Mr. Hurt and Mr. Pearce. You say in your written testimony that FHFA supports the principle advanced by both the Administration and Representative Neugebauer that guarantee fees should continue to be gradually increased.

And so my question would be, what effect, if any, might an increase in the guarantee fee have on the market?

Mr. DEMARCO. An increase in the G-fee is going to translate to some increase in mortgage rates.

Mr. FITZPATRICK. But you recommend an increase in the G-fees, a gradual increase?

Mr. DEMARCO. I think that putting us on a path so that G-fees and, hence, mortgage rates are such that they are appropriate to the cost of capital and to the credit risk involved is an appropriate place to be moving towards. And we are trying to do so incrementally in a way that is less disruptive to the market and it is appropriate to the risk. So in response to an earlier question, I noted that one of the key things we have been doing is trying to enhance the risk-based characteristics of pricing.

Mr. FITZPATRICK. How and when is the Administration, FHFA going to require the Enterprises to revise their pricing so that the private market does not continue to be crowded out of the secondary market—

Mr. DEMARCO. We are actively working on that. And, in fact, both Enterprises had a round of G-fee price increases that just have gone into effect this month or this past month.

Mr. FITZPATRICK. Thank you.

Chairman GARRETT. The gentleman yields back.

The gentleman from Ohio, for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman.

I would like to thank Mr. DeMarco for being here today. And I want to thank you for what you are doing on G-fees, on portfolio reduction, and strengthening underwriting standards as conservator. I think we need to have a thoughtful approach that creates a legal framework for a post-Fannie and Freddie world, and I think that you bring—obviously, your key function is to protect the taxpayers, but the other advantage you bring to us is to help us with that transition, so I want to thank you for what you are doing there.

Mr. DEMARCO. Thank you, sir.

Mr. STIVERS. I have a couple of concerns about a couple of the proposals, similar to your concerns. And I want to focus on Mr. Schweikert's—new activities for a second, because I am a little concerned that your portfolios are becoming a little more nonperforming and a little more illiquid.

And my question to you is, do you have all the tools you need and the powers you need to deal with those loans and either get those loans in a position where they are performing or get them in productive hands again and, obviously, recapture whatever capital you can in that process? And does the Schweikert bill limit you in that ability?

Mr. DEMARCO. Very good. Thank you, Congressman. I appreciate the question. And the answer is, I don't believe it does.

I do not view loss mitigation activities that we undertake to be either a product of the firm.

Mr. STIVERS. Okay.

Mr. DEMARCO. That is not a line of business. It is not a product. It is loss mitigation. And so I don't view that as being covered by—

Mr. STIVERS. Perfect. That is good stuff.

And the second thing that I think you can sort of help us with is, as we sort of move to a new framework, I think we are on the right track with G-fees. You are already on that track, as well. I think the chairman of the subcommittee, his goal on risk retention is at least to make sure we level the playing field. And maybe you can help us with that in other ways.

I think the thing we need to try to do is to try to pave the way to a more private-sector market. And I guess my question for you is, do you see a role for Fannie and Freddie without a government guarantee as aggregators and securitizers in the marketplace potentially?

Mr. DEMARCO. Not as we have known Fannie and Freddie in the past. I do see a role for firms that are operating and specializing in the process of securitizing mortgages, because, again, in an $11 trillion market, that is not going to be financed on the balance sheets of depository institutions. We need to tap into capital markets, including global capital markets, and that requires securitization processes. It means you need entities that are engaged in the business of securitizing mortgages.

Mr. STIVERS. And that may not be the Fannie and Freddie? Certainly not in their current form, but a lot of the expertise that Fannie and Freddie have, I guess my point is, can be transferred to these new private entities that don't have a government—

Mr. DEMARCO. Absolutely, Congressman. I think that is an important consideration here, is that the single biggest economic stakeholder now in Fannie and Freddie is the American taxpayer. As I said my written statement, the business processes and platforms and the human capital of these companies are intangible assets for the company and are available for disposition as Congress figures out what the ultimate resolution of Fannie and Freddie are, but they are platforms and expertise that can be put back out into the marketplace in some fashion and perhaps some value realized back for the taxpayer in that process.

Mr. STIVERS. Great. And I think the conforming loan limits are an important part of that, so again, like a lot of other members, I would urge you to look at what your authority is and consider it.

Obviously, we are going to consider that as policymakers here, but our number is the top number, and you can certainly go below that. I believe you have the authority to, so I hope you would consider that, as well. And I am not going to ask you a question about that, because I think you have already answered that it is new to you, and that is certainly okay, and I appreciate what you are doing to focus on protecting the taxpayers.

The only other concern I guess I have is about the bill that forces Fannie and Freddie to be compensated as government employees. My goal is to have them move away from the government, not toward the government, and so I actually don't think I am going to be able to support that bill. And I guess if you could give us your thoughts, I know you mentioned them briefly earlier.

Mr. DEMARCO. I think to your point that if we are looking to put Fannie and Freddie and its employees in business platforms back out into the private sector, that keeping a private-sector compensation program in place would certainly be consistent with that. And my more immediate concern is the disruptiveness of making a change like that.

There is already tremendous uncertainty on the part of the 12,000-plus employees of these companies about what does it mean and kind of repeatedly hears we are going to be wound down and we are getting rid of Fannie and Freddie. But, the government has an exposure here on $5 trillion worth of mortgage securities, and as conservator, I would like to make sure that we have qualified people continuing to service that book of business on behalf of the taxpayer.

Mr. STIVERS. Thank you.

Thank you, Mr. Chairman. I yield back my nonexistent time.

Chairman GARRETT. The gentleman from New York?

Mr. GRIMM. Thank you, Mr. Chairman. I appreciate that.

Thank you, Mr. DeMarco, for coming today and for fielding these questions. They are extremely important to just about everyone I speak to within banking and mortgage business and my constituents back home in Staten Island and Brooklyn. They are concerned about the values of their homes and where we are going overall.

Just to piggyback, Mr. Stivers mentioned something that I had a question about. Many of those in the industry have spoken about the meltdown and the housing bust. And they talk about how some—a big part of the problem is unrelated brokers dealing with unregulated aggregators, and 60 out of 100 loans being done without a bank.

Specifically to the DUS program, how now is Fannie Mae being involved in aggregating and multi-family homes? What role is that playing? And is that not consistent with some of the problems we have seen?

Mr. DEMARCO. So, actually, the Fannie Mae DUS program, which is a program for financing multi-family loans where the underwriting is delegated to the loan originator, has been a pretty successful model, and it is one, actually, that builds in some fashion on some of the provisions of the risk retention rules we were talking about earlier in Dodd-Frank, with respect to there being exposure by the originator, credit exposure by the originator, but I think that program is continuing to work successfully. Both firms are continuing to provide service to the multi-family market.

And the other thing I would note about the multi-family—it hasn't gotten much attention in this hearing—but virtually all of the multi-family business both companies are doing is, in fact, being securitized today.

Mr. GRIMM. Just to switch back to maybe bring it back to the 30,000-foot level. Can you talk a little bit about the impact that a narrow qualified residential mortgage definition could have on excluding first-time homebuyers from purchasing a home?

Mr. DEMARCO. Congressman, the rule is out for comment. And as one of the agencies that has signed off on issuing this rule, I look forward to the public comments that are coming in. But the concept here, actually, is we understand what we were directed to do in Dodd-Frank was to establish an exemption through this qualified residential mortgage designation that was supposed to be reflecting very low-risk characteristics on the mortgages. And we think we have done that.

And, in fact, I think it helps first-time homebuyers that the QRM definition not be too liberal, because this—we fully expect there to be a robust market for mortgage lending that is not meeting the definition of QRM. And the richer that market is, the healthier it is, the better it is going—the more easily private firms are going to be able to make those loans and ultimately, when we resolve Fannie and Freddie, to be able for there to be a re-emergence of a private securitization market that securitized them.

This is not a penalty or an expectation that we will not have loans that don't have at least 20 percent down. Not at all. That is not the expectation, nor the intent.

And so I think that the issue of first-time homebuyers can be one that policymakers want to take a careful look at in the context of looking at the U.S. housing finance system, and in terms of visiting questions about, as a matter of public policy, do we want to have support or incentives for that?

But I don't view the QRM rule as proposed as being one that is directed at creating harm for first-time homebuyers. I think it is meant—what it is really meant to do is to address the problems Congress saw with securitization and with securitization activity taking place, whereas where the securitizers did not have a risk exposure to the mortgages they were making.

Mr. GRIMM. A little bit about your opinion regarding the impact of lowering the current loan limits on high-cost markets, such as California, New York, my district. Can you just elaborate a little bit on the impact this will have on housing affordability?

Mr. DEMARCO. I would be happy to provide you the mortgage research note we just issued that goes through the counties in the United States that would see a decline in the conforming loan limit if Congress takes no further action this year.

Frankly, for what Fannie and Freddie have been doing, they are not doing a whole lot of mortgages in that space. So I think that the—if you happen to be a buyer in that particular space, in that part of the country, you may feel like I have been affected here. But in terms of the overall—thinking about the country's housing mortgage market, this is not a very big piece of it.

Mr. GRIMM. My time—

Chairman GARRETT. Your time has expired. Thank you. The gentleman from California?

Mr. MILLER OF CALIFORNIA. Thank you, Mr. Chairman.

It has been an interesting conversation today, especially the last comments on that if you got it out of the high-cost areas, it would not be significant, then why get out of them? Speaking from a high-cost area, it would have a huge impact on the housing market in the areas that are high cost. If you are not there, nobody is there. When you are making 92 percent of the loans in those areas, it is dramatic.

I would encourage you—just going back to risk-based loans, underwriting standards have increased. And I remember going back to the 1970s when I was introduced—I would go to get a construction loan from a lender, and they made sure I met conforming standards, design criteria, sales criteria, because if we didn't do that, there was not an assured takeout on the other end when the home was sold, because there was not the guaranteed liquidity in the marketplace to be able to make that loan.

Now, if we are trying to stabilize Fannie and Freddie, I guess my main question to you is, under TARP, we charged banks 5 percent. Why are we charging Freddie and Fannie 10 percent interest on the money we lend them? Is that risk-based?

Mr. DEMARCO. Congressman, that was a determination made by the Treasury Department—

Mr. MILLER OF CALIFORNIA. Okay, thank you. I just wondered, because it seems like we are trying to doom them to failure. If you go back to 1970, 1980, 1990, prior to 2005, do you believe that the GSEs crowded the private sector out of the marketplace?

Mr. DEMARCO. Over that time period, increasingly, sir.

Mr. MILLER OF CALIFORNIA. What years?

Mr. DEMARCO. I think that the Enterprises' market share grows gradually over that time period, until we got to the mid 2000s, and the emergence of the private-label market and the rapid growth in subprime and non-traditional lending saw substantial decline in their market share.

Mr. MILLER OF CALIFORNIA. Yes. And they made bad loans to pick their market share back up, which was a huge mistake on their part.

Mr. DEMARCO. Yes, sir.

Mr. MILLER OF CALIFORNIA. Where would the housing market have been in mid-2007 if the GSEs weren't there? In a disastrous situation. And instead of lending the GSEs $120 billion, we might have lost $2 trillion in home equity, because you couldn't have bought a home or sold a home because there was no money in the marketplace to make a loan for a home. Is that not correct? Today they are only making 8 percent of the loans, the private sector. And those are very difficult at that. And FHA, Freddie and Fannie are picking up 92 percent.

But I am really gratified that you are using a risk-based loan criteria and you are assessing the risks you are lending on and you are using good underwriting standards, which should have been done all along.

Mr. DEMARCO. Yes, sir.

Mr. MILLER OF CALIFORNIA. It is inexcusable that an agency like that—understanding their purpose and their intent—would go out and make stupid loans just to pick up a larger percentage of the marketplace. But my concern is, if we say there is a private sector there to fulfill the void that the GSEs would create by backing out, I have never seen it. And if at any time in history, it would have been there, it would have been probably 2005, 2006, and 2007.

The only alternative we had was Countrywide and other groups like that. And I remember going back to 2001, introducing amendments to bills, and I probably got it into four bills defining predatory versus subprime. Had we defined predatory versus subprime in 2001, 2003, or 2005, Countrywide would have not done what they did, nor would the other organizations have done what they did to pass off these junk mortgage-backed securities, trying to replicate what a GSE mortgage-backed security was, which was safe and sound.

And if you invested in them, you were guaranteed a greater return, to the point at where the GSEs—most of their losses are taking those bad loans, nonperforming out, and replacing them with performing loans, so you—I have demonstrated integrity that the private sector abused during those periods of time.

And my concern is, if we look at what the purpose of GSEs has been to provide liquidity to the marketplace, they have done a pretty good job, but especially in recent years. And having been in the building industry since the 1970s, and looking at the criteria by most lenders that they placed on you to even get a loan, and the intent of that was that if, once your product was on the market, that there would be a secondary market to sell the loan off to, because the major market did not have the liquidity to make fixed 30-year loans and sit on those loans, because that took their capital and put them in loans that were sitting there that they were virtually out of business for any new accounts, so they could close down and just wait for their loans to pay back on those loans.

So when you say that they are in the 1970s, 1980s, and 1990s, that the GSEs played a more predominant role in the marketplace, I would say appropriately so, because there was no alternative to that. And if you had allowed the private market that went from about—4 lenders had 25 percent of the market to today those 4 have 75 percent of the market, that is dangerous, having 4 lenders control 75 percent of the marketplace.

And if it were not for the option of a GSE out there today, if something went wrong in those four, this country could be in serious, serious trouble. And—

Chairman GARRETT. And with that, I thank the gentleman.

Mr. MILLER OF CALIFORNIA. My time has expired?

Chairman GARRETT. Some time ago, actually.

Mr. MILLER OF CALIFORNIA. You are very generous. Thank you.

Chairman GARRETT. But I understand the other side of the aisle was probably encouraged—

Mr. MILLER OF CALIFORNIA. Can I have a point of order? I want to wish Mr. Frank a happy 71st birthday today.

Chairman GARRETT. Happy birthday.

[applause]

And I yield to the gentleman for a retort.

Mr. FRANK. I would simply say that, while the gentleman's time has expired, I am pleased to say that at least I have not, as yet.

[laughter]

Chairman GARRETT. And so with that—Mr. DeMarco, again, I appreciate your coming to the hearing, and I appreciate your forthright answers and the detail that you provided for those answers, as well.

Mr. DEMARCO. Thank you, Mr. Chairman. And I appreciate the opportunity. I look forward to continuing to work with all the members of the subcommittee.

Mr. FRANK. Mr. Chairman, if you would yield briefly?

Chairman GARRETT. I will yield, yes.

Mr. FRANK. I would just like to add, Mr. DeMarco's testimony was exactly what we need from witnesses. It was responsive, it was aimed at helping us legislate, and I not only want to express my appreciation, I hope other people will follow his example.

Chairman GARRETT. Thank you. I appreciate it.

Mr. DEMARCO. Thank you, Congressman Frank.

Chairman GARRETT. Thank you.

This panel is dismissed and everyone with it. And we will at this point bring up the next panel.

Okay. While you comport yourself there and get your papers in order, I welcome the second panel to this hearing. And I see we have six of you before us. So for the next half-hour, we will be listening eagerly to your testimony.

And as always, without any objections, your written statements, of course, will be made a part of the record. You will be each recognized for 5 minutes. And I know many of you have been here before, so you follow the lights.

Mr. Dalton, you are recognized for 5 minutes. And welcome to the panel.

STATEMENT OF THE HONORABLE JOHN H. DALTON, PRESIDENT, HOUSING POLICY COUNCIL, THE FINANCIAL SERVICES ROUNDTABLE

Mr. DALTON. Thank you very much, Mr. Chairman, Ranking Member Waters, and members of the subcommittee. Thank you for holding this important hearing, and thank you for the opportunity to participate.

My name is John Dalton, and I am the president of the Housing Policy Council of the Financial Services Roundtable. Our 32 member originate, service, and insure mortgages, and we do business with Fannie Mae and Freddie Mac.

Mr. Chairman, we see an emerging consensus that private capital needs to be the primary insurer of mortgage risk. The future system must have two goals: servicing homebuyers; and protecting taxpayers.

Homeownership is a pillar of the U.S. economy and the American way of life. A new housing finance system built on private capital and clear rules would deliver sound financing and keep homeownership within the reach of most Americans. Without an approach like this, owning a home in America could become a luxury for the few.

To make sure this does not happen, Congress needs to ensure reform enables the continuing availability of the 30-year fixed-rate mortgage, which has been the bedrock of our Nation's housing finance system for more than half a century. The 30-year fixed-rate mortgage is as American as opening day in baseball.

A fixed-rate mortgage provides peace of mind, because homeowners know that their biggest monthly bill is not going to change from month to month and year to year. Without this popular financing tool, many homeowners would experience in their mortgages the same wild swings they now feel at the gas pump. This is a rollercoaster ride most Americans would like to avoid.

Today, approximately 90 percent of newly originated mortgages and 95 percent of refinances are fixed-rate loans. Homeowners are clearly voting with their checkbooks. The predictability of a fixed-rate mortgage needs to be preserved for homebuyers, and peace of mind needs to be returned to the American taxpayer.

Several of the bills introduced this week by committee members would begin to limit the role of the current GSEs. This is part of a needed reform process toward a new stronger housing finance system. They are a good first step, but it must be accompanied by a comprehensive plan.

Important issues are addressed in the bills introduced this week. The Housing Policy Council agrees that G-fees gradually need to be increased, portfolios need to be wound down, a strong regulator needs to be in place, and specific housing goals need to be eliminated. These bills are a start, but simply cannot be the end of GSE reform.

The Housing Policy Council has laid out a comprehensive proposal to reform the secondary mortgage market, and we commend it to you. Our plan creates a new private-sector system that serves American homebuyers and it protects the American taxpayer. Our system ensures that multiple layers of private capital bear the risk of securing mortgages while setting clear rules for capital, licensing, and mortgage security investment.

These multiple layers include the downpayments on mortgages, private mortgage insurance, the capital of the private guarantee companies, and a reserve fund paid into by these companies. The layers of private capital would protect taxpayers from risk and come before a Federal backstop or guarantee.

Our full plan is in my written testimony.

Mr. Chairman, I appreciate your leadership and each of you on the committee for tackling this difficult issue. It is complicated, and I support your efforts to return private capital to the housing market. In order to have a full economic recovery, it is very important for reform of the housing finance system to move forward comprehensively.

There is much uncertainty in the housing market today, and a complete roadmap for GSE reform would go a long way to help lessen that uncertainty. The Housing Policy Council stands ready to work with this committee and other stakeholders to assist wherever we can.

Thank you very much for the opportunity to testify, and I look forward to responding to your questions.

[The prepared statement of Mr. Dalton can be found on page 88 of the appendix.]

Chairman GARRETT. I thank you for your testimony.

The gentleman is recognized for 5 minutes. And I will let you introduce—say your name correctly for me.

STATEMENT OF CHRISTOPHER PAPAGIANIS, MANAGING DIRECTOR, ECONOMICS21

Mr. PAPAGIANIS. Sure. My name is pronounced "Papagianis," Chris Papagianis.

Chairman Garrett, Ranking Member Waters, and members of the subcommittee, thank you for the opportunity to testify today. I am the managing director of a nonprofit think tank, e21, Economic Policies for the 21st Century.

Drawing on the expertise of practitioners and academics, our mission at Economics21 is to help foster a spirit of debate about the way forward on issues like housing finance. Previously, I was

Special Assistant for Domestic Policy to President George Bush. In this role, I helped guide the collaborative process within the Executive Branch to develop and implement policies, legislation, and regulations across numerous agencies, including Treasury and HUD.

Fannie Mae and Freddie Mac have been in conservatorship now for the past 30 months. Over this period, numerous proposals have been offered for how to reform or re-envision the Government-Sponsored Enterprises. Given how dominant Fannie and Freddie are in terms of market share today, reform of these institutions will have a significant impact on the future of the $11 trillion mortgage market.

In short, the stakes are quite high, and I agree with this committee's approach in assessing long-term solutions while at the same time considering reforms that could be advanced in the short term to protect taxpayers.

Importantly, some of the proposals before this committee, if enacted, would accomplish two distinct things. They would protect taxpayers in the near term, and the implementation experience would provide invaluable lessons and data that could inform the broader debate about the future of housing finance in this country.

One of the big analytical challenges before this committee is that the most egregious excesses of the previous GSE model are not necessarily the primary sources of taxpayer losses thus far. From my vantage point, this means that there is still a lot of taxpayer risk in the GSE system and that near-term reform proposals can have a positive impact.

It is for these reasons that I support near-term measures to try and hold the GSEs to the same standards as other private market participants, to improve the pricing practices for mortgage guarantees, to limit the types of mortgages that can be guaranteed or purchased, and to add new oversight measures that shed more light on how the GSEs issue debt to fund their activities.

In the end, important decisions still need to be made about the future of the GSEs and the government generally in the housing market. It might take some time to come to an agreement on a wind-down strategy or a lasting structure for housing finance. Ahead of these decisions, however, it is still important to make practice in protecting taxpayers and reducing the risk presented by the GSEs, while at the same time ensuring that families have adequate access to mortgages.

Thank you again for the opportunity to testify today.

[The prepared statement of Mr. Papagianis can be found on page 128 of the appendix.]

Chairman GARRETT. I thank the gentleman very much.

Mr. Pinto, for 5 minutes?

STATEMENT OF EDWARD J. PINTO, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. PINTO. Chairman Garrett, Ranking Member Waters, thank you for the opportunity to testify.

In its February 11th report to Congress, the Obama Administration asked Congress to work with it to fashion legislation to accomplish three broad goals: the winding down of Fannie Mae and Freddie Mac; the returning of FHA to its traditional role as a targeted lender of affordable mortgages; and a largely privatized system of housing finance, with an open question as to the level of government involvement as to a particular guarantee.

These three goals provide an opportunity for a bipartisan solution that truly reforms our housing finance market. Secretary Geithner, in testimony before the Financial Services Committee on March 1st, asked that these three goals be accomplished sooner rather than later during this Congress.

I, along with my co-authors, Peter Wallison and Alex Pollock, released a White Paper last week detailing a comprehensive approach for reforming the housing finance market under the Administration's option one. It builds on the foundation provided by the Administration and forcefully and directly addresses each perceived shortcoming.

It meets the principles for restoring stability to the Nation's housing finance system, as recently outlined by 16 industry groups. It demonstrates that a government guarantee is both unnecessary and undesirable. It provides a bipartisan solution that can and should be enacted by this Congress. It is the only plan that both creates a housing finance market we can be proud of and protects the taxpayers, and I commend it to your consideration.

My written testimony covers each of the eight bills. I will limit my oral remarks to a few key points.

First, increasing guarantee fees. Enactment of this bill is appropriate, as it would implement a key step recommended by the Administration to responsibly reduce the role of the GSEs in the mortgage marketplace and ultimately wind them down. It would eliminate the unfair capital advantages that the GSEs enjoy and reduce the gap between Fannie and Freddie subsidized pricing and private rates.

This increase in capital requirements would require the GSEs to raise their guarantee fee by perhaps 15, 25 basis points, and would be phased in over 2 years. The bill wisely stipulates that guarantees be set uniformly among lenders.

The Administration has also just suggested that the GSEs rely more on private capital. This subcommittee and the Administration should request that the FHFA Director explore various means of credit enhancement to reduce the liability of the GSEs for losses on mortgages, including the possibility of increased use of mortgage guarantee insurance.

Chairman Garrett and Ranking Member Waters, I commend you and over 30 other members for the letter on this topic that you sent to Acting Director DeMarco last October.

I am told—excuse me, subjecting GSEs to credit risk retention requirements in the Security Exchange Act of 1934. Enactment of a bill addressing this topic is essential, as it is needed to sort out the previously noted perpetuation of Fannie, Freddie, and FHA. This is an unfortunate consequence of the Dodd-Frank Act and is being reinforced by the proposed rulemaking that just came out this week.

I would recommend that the qualified residential mortgage standards be set by legislation, rather than by administrative rule. In appendix one, we set forth a proposed definition.

I would also suggest that you limit collateral backing private MBS to loans that meet the definition, as we have suggested. This would obviate the need for any risk retention and its attendant complexity and potential gaming of the system. Taking this step would return capital to the housing finance system in both a prudent and speedy manner.

Repeal of affordable housing goals clearly is appropriate, and I would also recommend you consider repealing affordable housing support fees enacted under HERA and currently suspended by FHFA. Compensation of certain Fannie-Freddie employees, I cover that in more detail in my testimony. But in light of the need to wind down Fannie and Freddie, I would suggest that you focus on how to incent employees over the long term to accomplish that goal.

Prohibit the GSEs from engaging in new activities or offering new products. Given their wind-down status, this bill is appropriate. It particularly needs to focus on efforts that might be undertaken to force the GSEs to undertake potentially risky activities such as energy retrofit programs, manufactured housing programs, and other programs involving mortgage write-down.

Finally, turning briefly to the recently introduced Hensarling bill, I would commend Representative Hensarling for his early and prescient attempts to wind down Fannie and Freddie. His bill provides the basis for undertaking a frank but crucial discussion between this subcommittee and the Administration. This discussion has been requested by Secretary Geithner and Representative Biggert. It is my hope it will lead to a privatized system of housing finance under option one.

Thank you.

[The prepared statement of Mr. Pinto can be found on page 145 of the appendix.]

Chairman GARRETT. Thank you. Mr. Nielsen, for 5 minutes.

STATEMENT OF ROBERT NIELSEN, CHAIRMAN OF THE BOARD, NATIONAL ASSOCIATION OF HOME BUILDERS (NAHB)

Mr. NIELSEN. Chairman Garrett, Ranking Member Waters, and members of the subcommittee, thank you for the opportunity to testify today. My name is Bob Nielsen. I am the 2011 National Association of Home Builders chairman of the board and a builder and a developer from Reno, Nevada.

Credit is the lifeblood of the housing sector. A reliable and adequate flow of affordable funds is necessary in order to achieve the Nation's housing and economic goals. Establishing a financing system that provides liquidity for the housing sector in all markets throughout the economic cycle is a prerequisite to achieving housing policy objectives.

Furthermore, a stable, effective, and efficient housing finance system is critical to the housing industry's important contribution to the Nation's economic performance and to the achievement of America's social goals.

The housing finance system is currently under a cloud of uncertainty. The Federal Government, through FHA and the housing GSEs, is currently accounting for nearly all mortgage credit flowing to homebuyers and rental properties. Even with the current heavy dose of Federal backing, fewer mortgage products are available, and loans are being underwritten on much more stringent terms.

In addition, Congress and regulators are piling on layers of regulation in an attempt to plug gaps in a system of mortgage regulation and prevent a recurrence of the mortgage finance debacle that is still playing out. This is not an arrangement that can continue indefinitely, and there is no clear picture of the future shape of the conforming conventional mortgage market.

One thing is clear. The status quo cannot be maintained. NAHB has been actively involved in discussions on changes to the financing framework for homebuyers and producers of housing. We presented our thoughts on the future of the housing finance system to this committee nearly one year ago today. And since then, Congress has passed the Dodd-Frank Act, and regulators are now busy implementing this massive law that has the potential to reduce the availability and increase the cost of housing and credit.

The housing landscape has seen little change during this period, as the housing market remains extremely weak. In fact, while economic growth has been weak by historic standards for an economic recovery, housing's performance has been even weaker. Unlike a typical recovery where housing grows at 28 percent in the first year after the end of a recession, housing's growth has been a paltry 5 percent in the first year of the current recovery.

Adding to the current housing crisis, decisions about comprehensive structural reforms to the U.S. housing finance system are stuck in a quagmire, despite the Administration's recent report outlining options for reforming the housing finance market.

Recently, NAHB joined a coalition with 15 other organizations outlining principles for restoring stability to the Nation's housing finance system. NAHB strongly supports these principles, which highlight the need for the continuing and predictable government role in housing finance to promote investor confidence and ensure liquidity and stability for homeownership and rental housing.

NAHB strongly supports efforts to modernize the Nation's housing finance system, including reforms to the Government-Sponsored Enterprises, Fannie Mae and Freddie Mac. Like the principles outlined earlier, NAHB believes strongly that a Federal backstop is needed to ensure the continued availability of affordable mortgage credit specifically to 30-year, long-term, fixed-rate mortgages.

We cannot go back to the system that existed before this great recession, but it is critical that any reforms be well conceived, orderly, and phased in over time. Proposals offered by this subcommittee for short-term dissolution of Fannie Mae and Freddie Mac and the support they provide for the housing finance system represent a piecemeal approach to reform that would disrupt the housing market even further and could push the Nation back into a deep recession.

These proposals, along with similar plans announced by the Obama Administration in February, show that many policymakers have clearly forgotten housing's importance to the economy.

America's homebuilders urge policymakers in the Administration and Congress to consider the potential consequences of their proposal. The subcommittee should not move forward with policies that would further destabilize a housing market that is already struggling. Housing can be a key engine of job growth that this country needs, but it cannot fill that vital role if Congress and the Administration make damaging, ill-advised changes to the housing system at such a critical time.

Thank you for the opportunity to testify today.

[The prepared statement of Mr. Nielsen can be found on page 113 of the appendix.]

Chairman GARRETT. I thank you for your testimony.

Mr. Phipps please, for 5 minutes?

STATEMENT OF RONALD PHIPPS, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS®

Mr. PHIPPS. Good afternoon.

Chairman Garrett, Ranking Member Waters, and members of the subcommittee, thank you for inviting me to testify today regarding GSE reform. My name is Ron Phipps. I am the 2011 president of the National Association of REALTORS®.

My family, now in Rhode Island, has been in the business of residential real estate for 4 generations. My passion is making the dream of homeownership a reality for American families. I am proud to testify on behalf of the more than 1.1 million REALTORS® who share that passion, as 75 million American families who own homes, and the 310 million Americans who require shelter.

REALTORS® agree that the existing system failed and reforms are needed. However, we caution you to heed the words of Treasury Secretary Timothy Geithner and Senator Richard Shelby that, "Housing finance must be addressed and reform passed. However, proper homework must be done before action is taken and Federal housing policies must be adequately assessed."

Today, we ask you to slow down the legislative process and begin a methodological, measured effort in order to yield a comprehensive solution that is in the best interests of all, most importantly, the taxpayers. Therefore, we oppose the GSE bills recently introduced to reform GSEs, because they represent a piecemeal approach to reforming the housing finance system and effectively work to make Fannie Mae and Freddie Mac not viable, without putting forth an adequate replacement secondary mortgage market mechanism.

NAR is collaborating with the offices of Congressmen Gary Miller and Brad Sherman to develop an alternative comprehensive approach to reform the secondary market. This legislation will be introduced shortly.

As you consider the future of Federal housing policies, we ask you to keep two things in mind: first, the immense value that sustainable homeownership provides for this country; and second, investors require certainty in order for markets to perform.

The proposed legislation introduces uncertainty that will cause our fragile recovery to slow and possibly stop. Right now, the market is not working as many believe it should, and change is required. Additionally, REALTORS® believe that the pendulum on mortgage credit has swung too far in the wrong direction and is hurting consumers and the economy. Quick decisions aimed at punishing certain market players or fostering theoretical ideology will only act to punish taxpayers by constraining their ability to access affordable mortgage financing and locking in current losses.

Let me be clear. REALTORS® agree that reforms are required to prevent a recurrence of the housing meltdown, but unnecessary implementation of rules that curtail access to affordable credit, i.e. raising downpayments or other mortgage costs, will have stark ramifications for that overall economy.

Let me speak specifically to a couple of proposed bills. The QRM is likely to shape housing finance for the foreseeable future. REALTORS® believe that Federal regulators and members of the House Financial Services Committee should honor the intentions of Senators Isakson and Landrieu by crafting qualified residential mortgage exemptions that accommodate a wide variety of staid, well-underwritten products such as 30-, 15-, and 10-year fixed-rate loans, 7/1 and 5/1 ARMs, and loans with flexible downpayments that require mortgage insurance.

A poor QRM policy that does not heed their intentions will displace a large portion of homeowners and could once again slow economic recovery and hamper job creation. As noted in American Banker yesterday, 69.5 percent of all loans originated in 2009 would not qualify under the QRM standard. Furthermore, increased GSE fees could really cause additional problems with up to 10 percent to 15 percent of other qualified buyers not being able to meet those stringent requirements. Approximately 500,000 sales would not happen.

In World War II, President Franklin Delano Roosevelt said the nation of homeowners is unconquerable. In the 1980s, President Ronald Reagan said the need to preserve the mortgage interest deduction in order to promote the most important asset of the American dream, homeownership, should be protected. We REALTORS® agree.

We ask you to be positive in your future. I thank you for this opportunity to present our thoughts on GSE reform. And as always, the National Association of REALTORS® is ready, willing, and able to work with you and our partners to make a bright future for America.

Housing is not a partisan issue, nor is it simply in the common interest. It is the national interest. Thank you.

[The prepared statement of Mr. Phipps can be found on page 138 of the appendix.]

Chairman GARRETT. Thank you.

And we look now to the professor, Professor Wachter, for 5 minutes.

STATEMENT OF SUSAN M. WACHTER, PROFESSOR, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

Ms. WACHTER. Chairman Garrett, Ranking Member Waters, and other distinguished members of the subcommittee, thank you for the opportunity to testify at today's hearing. I am honored to be here to discuss the proposed legislative initiatives and the broader need for a reinvented housing finance system.

While comprehensive reform is necessary for a stable housing finance system, the transition must be accomplished while taking into consideration the current extraordinary fragility of housing markets. With January prices in real dollars breaching the 2009 bottom and still falling, there is a danger of a double dip.

In the reformed system, private capital must be accountable and at-risk. However, today, in that part of the market in which Fannie and Freddie cannot operate, the jumbo market, there is still only a very limited supply of private capital. This points to the need for comprehensive reform to bring back private capital.

There is a need for rules of the game, standards and transparency to counter the information failures that caused reckless mortgage products and underwriting practices to drive the system to failure. There is an important role for collective or government action to mandate transparency standards and information to allow for all market participants—borrowers, regulators, and investors—to prevent risks from becoming uncontrollable. Investors are asking for this before they enter the market.

My written testimony addresses each of the legislative initiatives. I will limit my comments to two. First, the GSE Mission Improvement Act repeals affordable housing goals without suggesting what might replace them going forward. As we re-envision the housing finance system, there will be a need to address the goal of nondiscriminatory access to housing finance. In the academic literature, there is substantial evidence that the affordable housing goals were not the major factor responsible for the housing bubble and crash.

Second, the Portfolio Risk Reduction Act caps the GSEs' portfolios at $250 billion in 5 years. While it is ultimately both desirable and necessary to reduce the portfolio, constraining the path of reduction in this way is not, in fact, the way to optimize taxpayer returns.

Policymakers and the Nation as a whole must make fundamental decisions about the shape of our Nation's finance system going forward. The issues being considered today are of critical importance to the Nation's future.

I thank you for the opportunity to testify, and I welcome your questions.

[The prepared statement of Professor Wachter can be found on page 213 of the appendix.]

Chairman GARRETT. I thank the panel.

So I will begin by yielding myself 5 minutes. And I guess I will just start with Mr. Dalton.

One of your opening comments was to make a comparison to the first day of baseball, which is cute, but, of course, the Secretary—the Federal Government doesn't subsidize the first day of baseball, at least I hope they are not. Maybe it will be something we will discover during the C.R. discussion.

So can you run down and take a look at some of the things that we are doing right now? I am getting a little bit of a mixed message here. Some people on the panel are saying that we are moving too quickly, that we shouldn't be acting now, that despite, of course, the fact that it has been 2 years and we have been asking for hearings on this, and we haven't had anything. Now we are having hearings, and we are having the experts come up before us.

So do you believe that the legislation that you are seeing before, as far as the IG, additional powers there, and the rest, as far as the G-fees and the rest, will those things be moving too quickly if we begin to consider them and debate them and discuss them and move those along?

Mr. DALTON. Mr. Chairman, I think that there are positive aspects to a number of these bills, but I think it is very important that we have a comprehensive program in place before we—for example, one of the bills has the GSEs going out of business in 5 years. And I think to have that without having a new system in place—

Chairman GARRETT. Actually, let me just correct you there. I think you are talking about the portfolio language, which winds that down. Is that what you are talking about?

Mr. DALTON. That is right.

Chairman GARRETT. Yes, that just deals with the portfolio, shrinking the portfolio over 5 years, right? So—yes.

Mr. DALTON. I was referring to the Hensarling bill, that I believe does, in fact, within—at the end of a 5-year period, the GSEs—

Chairman GARRETT. So you are not opposed to the idea of having an acceleration, for example, of the portfolio so that we can try to wind down that $1.5 trillion deficit hanging around our head?

Mr. DALTON. No, sir. I think the winding down of the portfolio has merit.

Chairman GARRETT. Okay. Since we only have so much time, Mr. Pinto, in your testimony, you describe the advantages that the big banks somehow have over the small banks, in terms of one of the other bills with regard to the issue of G-fees. Can you just elaborate on that and explain that to us?

Mr. PINTO. Yes. Actually, in my testimony, I believe I quote Jay Brinkmann, the chief economist for the Mortgage Bankers Association, who about 2 weeks ago said that the history of the GSEs was to promote ever-larger consolidation among large financial institutions, controlling the housing finance market through their offering of discounts to the large financial institutions, Countrywide and the large banks.

The community banks and the other community financial institutions were charged what you would consider in hotels being called a rack rate, 20, 25 basis points. Countrywide and the other larger originators were charged 10 basis points, 12 basis points.

As I pointed out in my testimony, what you lose on each one, you cannot make up in volume. And I think Director DeMarco covered that when he said the G-fees were woefully inadequate. It was because they were discounting them for the big banks and trying to make it up with the little banks.

Chairman GARRETT. Let me just jump over to Mr. Phipps. You were the one who suggested that we may be moving too quickly, we don't want to move on a piecemeal approach. So let me just ask you, on some of the bills that are before us, for example, Mrs. Biggert's bill, with regards to giving more authority in creation of the IG, how would that be bad if we did that today? Wouldn't that have been good if we actually had that in place several years ago?

Mr. PHIPPS. The short answer is, we really believe that the principles that we spent the last 2 years working on articulate a comprehensive plan. And we believe that the replacement, the successor for this, is critical and needs to be put in that context.

Chairman GARRETT. And I am right with you on that. We have to figure out what the replacement is. But until we get there—and you have to admit, it is going to be pretty hard to get consensus on what that replacement is—until we get there, aren't there some other things we can do, as we lay out here today, that would be good? So you are supportive of the idea, right, that they should have—on the—

Mr. PHIPPS. —should be reformed.

Chairman GARRETT. And you are supportive of the idea with regard to Mrs. Biggert's bill, as far as additional authority with regard to the IG. You can't be opposed to the idea of—are you? Is anybody opposed to that idea, that they should have authority in that area? No? Is anybody opposed to the idea that—

Ms. WACHTER. Yes, in my written testimony, I did oppose that.

Chairman GARRETT. Okay. And if we had that—okay.

Ms. WACHTER. The reason I opposed it is that reporting to Congress with 7 days advance notice may simply not be practical.

Chairman GARRETT. Okay, just for the practicality. And just one last question, then. With regard to some of the other ideas, with regard to the Secretary signing off on the new debt issuance, is anyone opposed to that idea?

Mr. PHIPPS. We are not taking—

Chairman GARRETT. Besides this one. I know, besides Ms. Wachter, because you highlighted that. Okay. So there are some—and I suppose, Mr. Nielson, you want to—

Mr. NIELSEN. No. I think that Treasury already has that ability to sign off on that debt.

Chairman GARRETT. But this is a requirement that he would have to.

Mr. NIELSEN. But they have the ability to do it now, correct? Don't they have to sign off on—

Chairman GARRETT. They do.

Mr. NIELSEN. Okay.

Chairman GARRETT. They are not doing it, and we would say that they—and so I will just close on this and yield to the ranking member that I guess there is a little bit of unanimity that there are at least some things that we can do now, even though we don't have the final plan, which is going to take a little bit more time to accomplish.

With that, I yield to the gentlelady from California.

Ms. WATERS. Thank you very much, Mr. Chairman.

Let me thank all of our panelists who have come today to help us delve into this very, very difficult and complex problem of what to do about the GSEs. I think that it was said by one of you that this should not be a partisan issue, that this should be a bipartisan issue. And I agree with that.

There are several things that have been said today that I absolutely agree with. Starting with you, Mr. Dalton, and your love for the 30-year mortgage, I love it, too. And I think we should do everything possible to ensure that is a product that is available.

But let me delve a little bit into who you are and what you do. I see, Mr. Dalton, that you are the president of the Housing Policy Council of the Financial Services Roundtable. You are made up of individuals who are in this business of initiating loans, financing, extending mortgages, however you want to describe it. These are people who know what is going on in this mortgage industry. Is that correct?

Mr. DALTON. Yes, ma'am. That is accurate.

Ms. WATERS. And having said that, some researchers—particularly those from the American Enterprise Institute, whom Mr. Pinto represents on the panel today, contend that the 30-year fixed mortgage either isn't going for homeowners or could survive and could continue to be an affordable product for medium-income families without any government involvement in the housing finance system, but you were definite about 30-year mortgage. Do you want to say it again in a short sentence for us why you feel so strongly about the 30-year fixed mortgage?

Mr. DALTON. Yes, ma'am. I think it has been the bedrock of the Nation's housing finance system for more than a half a century. It is sustainable. It is safe. It delivers affordability, certainty, stability, and predictability.

The fact is that for those Americans who live on a budget, they know every month, year—month in and month out, year in and year out, that mortgage payment is going to be the same. And I think that predictability is very important for those Americans who are living on a budget and—

Ms. WATERS. You don't have to go any further. I think you have really said it. But what is interesting for me is, I think your background is Republican and you are willing to stand up for this 30-year mortgage. Is that right?

Mr. DALTON. My background happens to be Democrat, Madam Chairwoman.

Ms. WATERS. Oh, is that right? Oh, that is better.

[laughter]

Mr. DALTON. But I have served in both Democrat and Republican Administrations.

Ms. WATERS. Okay, thank you.

Now, if our housing finance system were completely privatized, as the plan under Representative Hensarling's comprehensive GSE reform bill, what would the implications be for small and community banks? Would they be able to compete with the large financial players? Would they easily be able to sell their homes on the secondary market? Would you tell me what you think about that plan? He wants to completely privatize.

Mr. DALTON. I am sorry?

Ms. WATERS. Under the Hensarling comprehensive GSE reform bill, he would like to completely privatize. And I want to know, if the system was completely privatized, what would the implications be for small and community banks? Would they be able to compete with the large financial players? Would they easily be able to sell their loans on the secondary market? What would this mean for the small banks?

Mr. DALTON. I have reservations about a completely privatized system, Congresswoman Waters. I think that the—our proposal is one that includes the private sector. And we welcome that.

But I think to go completely to the private sector, you wouldn't have the government guarantee of the 30-year fixed-rate mortgage. I think the mortgage market would shrink. I think long-term fixed-rate loans would be less available. And generally, I think it would be difficult for the institutions that you mentioned to be able to finance mortgages.

Ms. WATERS. Thank you very much.

I want to move quickly to Ms. Susan Wachter, professor, the Wharton School, University of Pennsylvania. One of the bills offered today by Representative Royce would eliminate the GSEs' affordable housing goals. While I don't believe that data suggests that those were major contributors to either the failure of Fannie and Freddie or the greater housing and economic crisis, I am open to perhaps restructuring how we support affordable housing in a future housing finance system.

Would you reiterate what you know about this accusation that these affordable housing goals somehow caused the crisis? And do you have any ideas about how we could provide support for moderate- and low-income folks—how could we restructure this?

Ms. WACHTER. Congresswoman Waters, may I take that question in reverse order? Support for working Americans is extremely important for the mortgage system. And for that, we do need a 30-year fixed-rate mortgage as a base because of its affordability through amortization.

So for working Americans overall, the starting point is that we need comprehensive reform that will allow sustainability of the 30-year fixed-rate mortgage.

Secondly, on the role of affordability, and housing goals in particular, it has been alleged that the Community Reinvestment Act and the GSEs' housing goals were somehow the cause of the crisis. The timing is simply wrong, number one. The Community Reinvestment Act and the housing goals were in place far earlier.

In addition, we had a commercial real estate bubble, as well. We had a boom and bust of equal dimensions. And when I say commercial, I am not simply talking about multi-family only. I am talking about office, industrial. That commercial real estate bubble certainly could not have been caused by the affordable housing goals or the CRE.

Chairman GARRETT. I thank the ranking member.

To the vice chair of the subcommittee, the gentleman from Arizona?

Mr. SCHWEIKERT. Thank you, Mr. Chairman. The joys of trying to do this in 5 minutes when you have dozens of different kinds of questions.

And forgive me. This is going to be a little bit shotgun. I think it might have been Mr. Nielsen, who spoke to sort of the housing policy or housing goals for the country. In, like, 25 seconds, what is that?

Mr. NIELSEN. In my mind, I think the housing goals should be that people who want to have a home should be able to find a mortgage, if they are creditworthy, to be able to buy a home. That seems to be the American dream, and we believe in that. And so we think that is extremely important.

And all of these discussions have to do with costs. We can create a system that is so expensive that only a very few people can access themselves to single-family homes. That, we think, would be wrong.

Mr. SCHWEIKERT. Mr. Chairman, Mr. Nielsen, and this is one of the concerns, because you are my brothers and sisters. I come from your industry. But I am being told that as much as 13 percent of our housing stock in this country is now empty. And much of the pricing structure out there right now may be half replacement costs. So those on the homebuilding side have a devastating type of structural competition.

You see the solution as what?

Mr. NIELSEN. I can tell you that in some of the most devastated markets, number one being Las Vegas, which I just visited, there are still homes being built and sold. This hangover is not of newly built unoccupied homes, of older foreclosed homes. There are going to be 5,000 homes built and sold in the worst market, the white hot center of foreclosure in this country. And those homes being sold, each one of them will employ 3.5 people.

Mr. SCHWEIKERT. Mr. Nielsen—having a little familiarity with some of the Vegas market, isn't that because, also those lots, the land, the infrastructure, those things basically were almost given away for—

Mr. NIELSEN. But, Congressman, still, those homes are being sold at way above the foreclosure prices. So people are willing to pay more for a home, a new home. It clearly is only 10 percent of where they were at one time, but the point is, there is still a market for new homes. And that exists across the country.

Whether you are in Florida or anyplace else, there are niches where people are desirous of homes.

Mr. SCHWEIKERT. But my great fear—and I am going to bounce along—is we are still sitting there with a massive number of vacant properties in many of my neighborhoods. And I know there is a hunger over here to build new products, but I still have this concern about what happens to my housing stock when I have 10 percent, 13 percent vacancies, up and down the country? And what does that mean?

For Mr. Phillips, let's—some of the financing side. What would make the REALTORS® happy? How about a system where much of the guarantee was actually coming through private mortgage insurance? Would that be helping us meet some of our mechanics and our goals?

Mr. PHIPPS. Certainly any pieces that can be brought to the table to minimize the exposure would be great. But when you are looking at the raw scale, at the end of the day, we need the government guarantee. We just do. And the secondary market is critical for the whole market, because you are talking about the impact of all 75 million—

Mr. SCHWEIKERT. You are saying—okay, Mr. Phillips—

Mr. PHIPPS. It is "Phipps."

Mr. SCHWEIKERT. Oh, excuse me, sir.

Mr. PHIPPS. "Phipps."

Mr. SCHWEIKERT. Okay. Glad I was paying attention. Sorry about that. Mr. Phipps, you need the government guarantee because you are concerned about bondholders' willingness to buy the bonds?

Mr. PHIPPS. No, actually—

Mr. SCHWEIKERT. The guarantee does what? In your eyes, it does what?

Mr. PHIPPS. The guarantee provides us with access to capital in a market where there are so few—

Mr. SCHWEIKERT. I need you to get more technical with me, Mr. Phipps. Is it because people are willing to buy the bonds because there is a guarantee and that creates liquidity?

Mr. PHIPPS. Essentially, yes. There is no confidence right now without the guarantee.

Mr. SCHWEIKERT. So ultimately our solution is, what makes it so people are willing to buy the bonds?

Mr. PHIPPS. The guarantee makes it possible that they are willing to invest. The certainty of the guarantee and the certainty of this government is what is facilitating it. It is a huge scale. Clearly, insurance will complement it.

Mr. SCHWEIKERT. But ultimately, if we sold that liquidity issue, of saying, look, I have the MBS, I need someone willing to buy the bonds, right now we do it through a GSE or a full faith and credit right now guarantee, but if it was a combination of that or something else, as long as someone is buying these bonds and it pushes down the liquidity outside the securitization into my home mortgages, we are accomplishing the goal?

Mr. PHIPPS. Provided the average consumer has access to competitive cost mortgage money, we get there. We don't see any alternative right now. And the principles outlined in my written testimony, really tell you how we have to transition to it.

The conversation is really problematic because the winding down causes uncertainty in the market, which causes the consumer to pause. That is a huge problem where the consumer doesn't understand—

Mr. SCHWEIKERT. That is at this end. I am trying to actually solve the problem on—if it is a liquidity issue.

Mr. PHIPPS. Thank you.

Mr. SCHWEIKERT. Sorry. I am now over my time. I look forward to another round.

Chairman GARRETT. The gentleman from Massachusetts?

Mr. FRANK. Thank you, Mr. Chairman.

Let me begin with Mr. Phipps. I want to echo what my colleague, Mr. Sherman, said. Others may have, as well. I think it is very important when we are trying to keep confidence in the housing industry to make it very clear that the mortgage interest deduction is going nowhere. The sun will disappear before it goes away.

Now, I will say this. If I were starting a new country, I would not have it. I don't think it is ideal tax policy. But given the extent to which people's legitimate vested interest, in the best sense, include that, trying to abolish it now, even if we were in a wonderful economy, would be unfair. You cannot do it without being disruptive to people. Houses are still a large part of the wealth for many people.

And I have to say, I don't think there are 50 votes to get rid of it. I understand people are afraid of it, but I think it would help us all if we could just make this clear that is staying around and then we can build on that.

And, having that said, I do note that there is a dilemma, I think—and I sense this from Mr. Dalton's testimony, whom I have enjoyed working with over the years. The specific bills that are proposed, in my judgment, are almost all reasonable. I do notice—frankly, if you don't mind my phraseology—even Mr. Pinto balked at the compensation one. I say, "even Mr. Pinto," because he has been most critical of the operations.

And since everybody agrees they are not going anywhere and we have a whole lot of complex tasks to talk about, I don't think a drastic reduction in everybody's salary is a realistic proposal. We did, I would note, in 2009 put a bill through the House that would have covered them under the TARP executive restrictions. My colleagues at that point opposed it. Now they—I think they went from being too relaxed to too rigid.

But it did seem to me—and I noticed one of my Republican colleagues had concerns about that. Others—I think Mr. DeMarco made a good point on the portfolio. I think we should make clear that securitization, risk retention applies to them, but I think you have to account for that in the portfolio. And making a distinction in the portfolio between bad assets and good ones, giving you the flexibility—we could work on those.

But I think there would be a lot of agreement. I have some questions about some of the goals, but here is—what I am struck by is that three very responsible organizations representing major economic interests concerned with housing—the Financial Services Roundtable, which is itself an amalgam of a number of different financial entities, the REALTORS® and the homebuilders.

And we have people who represent the financers, the people who build the house and people who sell them, all say the same thing. Yes, taken individually, these bills are reasonable, but to act on them now, in the absence of a broader approach, would be a problem.

Would you elaborate on what you think the negative would be? And I know Mr. Dalton mentioned the Hensarling bill, which is in limbo somewhere, and I think you are not supposed to mention it in polite company. It was filed to satisfy some obligation.

But what is the problem you see? I did sense agreement that the bills that were before us are mostly bills that—let's put it this way—they are bills everybody would want to see included in an overall proposal. What do you think is the reason not to go forward with some of them now, given that there is still no agreement on what happens at the end?

Let me start with you, Mr. Phipps.

Mr. PHIPPS. I think the short answer, Congressman, is that we want to go through with a comprehensive approach, because consumers need to know that there is a reliable source of financing. And, frankly, when I started in the business 30 years ago, there were—the top 5 lenders represented 25 percent of the market. The top 5 lenders now represent almost 75 percent of the market. So there is a concentration that really makes it hard for competition that is pro-consumer, and we need a successor to this—

Mr. FRANK. Can I say then—let me see if I can rephrase it—since confidence we all understand is an important part of this. We are asking people to make a huge decision. That is why I wanted to say that the MID isn't going anywhere.

Is it your concern that if we appear to be doing this in a piecemeal way that people will be reinforced in the sense that this is an uncertain future for the whole operation?

Mr. PHIPPS. Exactly. When you—

Mr. FRANK. Okay, if I got it right, then I am going to go on to Mr. Nielsen.

Mr. NIELSEN. I think you are exactly right. I think it is a comprehensive approach that needs to be taken so that there is consistency and people can see where we are going. I was listening to Mr. DeMarco very closely when he talked about the number of folks who worked for Fannie and Freddie and what they must be feeling today as they go forward.

And we still have an ongoing company there that has a whole lot of—

Mr. FRANK. I don't want to go over, and I know Mr. Dalton has essentially said the same thing. And I just want to say, here is the dilemma that my colleagues have. I want to take "yes" for an answer. I think the problem is this: My colleagues got themselves, frankly, into a corner by insisting last year that they knew what the ultimate solution was, by bringing forward a bill that had a longer-range thing, the Hensarling bill, that is, as I said, now in limbo. They offered it. They said it was our fault we didn't give a chance to have hearings to make it better.

But I have never known them to have to wait for me to do what they thought was best. They could talk to other people. They don't need my permission. And here is the problem. They are a little bit embarrassed, I think, that they were committed to something and haven't got the final thing, so they are putting forward these proposals to show they are at least doing something. And while they are in themselves, I think, reasonable, taken together, trying to do it that way instead of going forward with the overall approach may do more harm than good, and I am struck that it appears to be the view of those industry organizations that have this responsibility.

Thanks for the indulgence, Mr. Chairman.

Chairman GARRETT. Thank you. I didn't hear all of that; I just heard the part that they are reasonable.

[laughter]

I yield now to the gentleman from Ohio.

Mr. STIVERS. Thank you, Mr. Chairman.

And I would like to start with a question for Mr. Dalton. I think you and the ranking member of the subcommittee had a conversation about the 30-year fixed mortgage. I, too, like probably all the committee, support the 30-year fixed mortgage, and I am just curious if you can tell the committee whether the jumbo market that didn't have GSEs involved had a 30-year fixed mortgage involved in it for the past 20 or 30 years.

Mr. DALTON. Mr. Chairman—or, excuse me, Congressman—the concern I have about the—

Mr. STIVERS. No, I am asking a question. Did they have—did the jumbo market have a 30-year fixed mortgage? This is a yes-or-no question.

Mr. DALTON. Yes.

Mr. STIVERS. Thank you. The second question I have for Mr. Dalton is about the Federal Home Loan Banks. We have kind of not talked about them. And I think you and the ranking member of the subcommittee also had a conversation about community banks. Can you, in about 10 seconds, talk about the role of the Home Loan Banks with regard to community banks? Don't they give community banks liquidity on mortgages and provide a similar role to what the GSE does?

Mr. DALTON. The Federal Home Loan Banks did provide that role. Yes, sir—

Mr. STIVERS. And don't they help keep community banks competitive in the mortgage market, at least to the extent they can, without some huge—they don't have the volume of a lot of your members.

Mr. DALTON. Congressman, I would like to answer that for the record. I am not sure specifically—

Mr. STIVERS. No, we can back off of that one. But, I just wanted to make sure that we put all this in context, because it is a puzzle. And the Home Loan Banks have an important piece of it.

I do want to go to something Mr. Phipps said and talk quickly about the mortgage interest deduction and agree with the ranking member of the full committee that I think we all support mortgage interest deduction. I am for a flatter tax system, but I still believe that the mortgage interest deduction plays an important role here. And it is one way that we can support housing going forward.

I do want to go through and ask a question sort of all the members. Is there anyone on the panel who believes that risk-based pricing of the guarantee fees, the G-fees, is a bad idea?

Mr. NIELSEN. Let me respond to that. As I said before, you can create any kind of a cost structure that you want. All it does is take more and more people out of the mortgage market. So anytime you increase costs—

Mr. STIVERS. Okay, I understand that. So what you are saying is, it is fair for my neighbor, if I am a bad credit risk, to pay the same amount I pay—

Mr. NIELSEN. No, no.

Mr. STIVERS. —but take some of my risk, because that is what happens when you don't have a risk-based pricing system. Is that what you are for?

Mr. NIELSEN. No, no. That is not what I am for.

Mr. STIVERS. Okay. Then how do you reconcile that with the fact—

Mr. NIELSEN. No, no—

Mr. STIVERS. —increasing G-fees to a risk-based system?

Mr. NIELSEN. I am going back to my original analogy. The concept is, if anyone can create risk-based fees to a point where you have no risk almost—there is always some risk—but at what cost? What—

Mr. STIVERS. Okay—

Mr. NIELSEN. To what portion of the American public are you going to say, "You don't get to have a home?" "You don't get to have a mortgage."

Mr. STIVERS. The point is, people need to do as good a job of pricing risk. And if we can identify risk, it needs to be priced. Is there anybody on the panel who disagrees with that? You disagree with that?

Ms. WACHTER. In a nuanced way, yes.

Mr. STIVERS. Okay.

Ms. WACHTER. The fact of the matter is, what is even more important is that the system itself delivers what the credit risk of the system will be. So your actions going forward will determine how risky the system is.

Mr. STIVERS. That is fair. I think that is fair. And I don't disagree with folks that we need to figure out where we are going, but I think the point of these proposals is you can create a foundation that you can move forward with. And while I don't agree with all these, I agree with almost all of them. I think they create a foundation that allows us to move forward.

Is there anybody who disagrees with an Inspector General for Fannie and Freddie, which is one of the other proposals? I didn't think there would be.

Ms. WACHTER. That is not my understanding. I thought—they do have an Inspector General. I thought you were talking about specific roles of an Inspector General.

Mr. STIVERS. It is powers. It is powers for the Inspector General, but yes.

Ms. WACHTER. —very narrow, specific proposals, including that are—the problem—

Mr. STIVERS. So do you disagree with—

Ms. WACHTER. Yes, I do, in the following way.

Mr. STIVERS. Tell me. Okay.

Ms. WACHTER. I think the problem is, these are—when you say Inspector General, that is, of course, extremely reasonable, sir. But all of these are very narrow, and the problem is that the American people could say, "Is this all Congress can do in setting up a new system?" I think it undermines confidence.

Mr. STIVERS. I think what we are—the purpose is to set a foundation that everybody can agree on while we continue to move forward. And you will see more proposals coming forward, but I think most of these proposals are very reasonable. I support most of them, and I appreciate everybody's time. It looks like my time has expired, but I appreciate the opportunity to have a conversation with all of you today. And we want you included in the discussions going forward.

Thank you.

Chairman GARRETT. Thank you.

The gentleman from Colorado for 5 minutes.

Mr. PERLMUTTER. I thank the chairman, and I thank the panel for their testimony today. What I am getting from most everybody's testimony is that we have a fragile real estate market. It hasn't begun to move in the way that any of us want it to move. We know that so many millions of people are employed in housing and in real estate, in finance. And, we have to get people back to work.

And all of a sudden, we are starting to tinker with something that has been central to the real estate market since the 1930s, as if that is going to help stabilize and underscore strength in this market.

So I think my friends on the Republican side are just wrong on this. And I feel like I have to be the historian in this committee, because—

Chairman GARRETT. Please do.

Mr. PERLMUTTER. —I thought—I know the chairman always loves to hear me, because he and I really get going on this subject. But Fannie Mae and Freddie Mac in particular—Federal Home Loan Banks, I hope are not part of any of this GSE conversation. I don't think they are.

But as to Fannie Mae and Freddie Mac, we have had two trouble spots for Fannie Mae and Freddie Mac, once under Ronald Reagan and once under George Bush II. And I know, Mr. Phipps, you would like this to be a very bipartisan—and I appreciate that—but I see a pattern, quite frankly, where particularly 2003 to 2007, the Fannie Mae and Freddie Mac were used in a way—it was like just a cash register.

Now that stronger and tougher underwriting standards are back in place, we don't see the troubled loans. We didn't see the troubled loans before that. So in working with these particular agencies, companies, and that is something we have to look at, whether it is the Federal Government or private or both, and that is a legitimate concern. But none of that is really addressed here.

So, Mr. Nielsen, what I would like to—I did have one other historical nugget for you, Mr. Chairman, that I know you always like to hear.

Chairman GARRETT. About the President or—

Mr. PERLMUTTER. That is—no, this is about the former chairman, one of the former chairmen of this committee, Mr. Oxley, when in 2005, there was an effort to put some limitations on Fannie Mae and Freddie Mac and exactly what was going on there. And he pointed the criticism at the White House. He said all the hand-wringing and bed-wetting is going on without remembering how the House stepped up on this to modify it.

What did we get from the White House? We got a one-finger salute from the Bush—

Mr. SHERMAN. Will the gentleman yield? Did the former chairman indicate with which finger he was saluted?

Mr. PERLMUTTER. He did not, but I can picture it. And when the Democrats came in, in 2007, the very first thing we took on was Fannie Mae and Freddie Mac and the excesses—

Chairman GARRETT. Would the gentleman—will the gentleman just yield on that?

Mr. PERLMUTTER. I would yield to my friend from New Jersey.

Chairman GARRETT. So were you here when all that was happening?

Mr. PERLMUTTER. I was not.

Chairman GARRETT. Oh, okay.

Mr. PERLMUTTER. I am just reading what Mr. Oxley had to say.

Chairman GARRETT. Do you remember—that bill moved along in the House, right?

Mr. PERLMUTTER. It did move in the House. And it stalled in the Senate, apparently at the request of the White House, who I think was—

Chairman GARRETT. It came out of Senate Banking, right?

Mr. PERLMUTTER. —provided—

Chairman GARRETT. It came out of the Senate Banking Committee?

Mr. PERLMUTTER. No, it did not, did not come out of the Senate. But taking back my time, Mr. Chairman—

Chairman GARRETT. You may want to check your record on that. It came out of the Senate Banking Committee, and then it was stalled in the full Senate.

Mr. PERLMUTTER. All I am doing is reading from Mr. Oxley, the former chairman of this committee. So—

Mr. SHERMAN. If the gentleman would yield—

Mr. PERLMUTTER. I yield to my friend from California.

Mr. SHERMAN. I understand the chairman's position is that blame lies before the full Senate and not the Senate Banking Committee, that the Senate Banking Committee was wise up to take up the legislation in the full Senate?

Chairman GARRETT. Right. And it was the full Senate where we needed 60 votes in order to move the bill, and I guess we didn't get support—I guess from your side of the aisle, actually, in order to move that.

Mr. PERLMUTTER. I will take back my time, because I am just reading what Mr. Oxley had to say.

Now, the point being that here we have a fragile recovery, and I would turn to you, Mr. Nielsen, for just this question. If we were to take up all of these different efforts right now, what would we do to the housing business, to those 5,000 homes that you are talking about being built in Nevada?

Mr. NIELSEN. I guarantee it would be a miss. And to your earlier point, the secondary mortgage market that we have had in place since the 1930s is the envy of the world.

Mr. PERLMUTTER. You bet it is.

Mr. NIELSEN. Envy of the world. For us to look at two blips and say we should dump the whole thing, in my mind, seems inappropriate. And to that end, if you want to change the name or change little bits around the edge, that is fine. But please maintain that secondary mortgage market that has created a homeowner nation out of this country.

Mr. PERLMUTTER. Thank you. And I yield back to the Chair.

Chairman GARRETT. The gentleman from New York?

Mr. GRIMM. Thank you, Mr. Chairman, I appreciate it.

And I thank my colleague for the history lesson, I think.

[laughter]

It is amazing how so many different individuals can remember history differently. But I think what I am getting out of this—and, Ranking Member Frank, you mentioned how we could have had these hearings. I think the point is, we are having them now.

I am proud to be a part of a committee that is having this dialogue. I come from Staten Island, Brooklyn, where the real estate market is imperative. It is crucial and vital for our job sector and for our economy overall.

I am—I do have to admit—and maybe because it is his birthday—I agree with Ranking Member Frank, and that will be his birthday present, that the interest deduction should not go away. I also believe in the 30-year fixed, something my parents relied on when they bought their first and only house, the same house my mother still lives in.

That being said, this discussion is important, because I think we are all agreeing that we do need reforms. It is a matter of getting it right, though, and not—if I am understanding this panel—going so fast that we cut off our nose to spite our face and we make things worse, rather than better.

Professor Wachter, you mentioned that we have to recognize the fragility of the market. And just if you could expand a little bit on bringing back private capital and how you would propose on bringing back the private capital.

Ms. WACHTER. Thank you, Congressman. The market is at an extremely fragile point. And if we were to have a double dip, not down a few percentage but a serious double dip, a recurrence of what we had before, it would not only put people out of jobs, it has the potential to bankrupt our banking system again. So we are at a serious crossroads.

And the confidence in the housing market depends on confidence in there being financing for the housing market. That said, private capital is not where it could be. Private capital has not come to the fore in the jumbo market where Fannie and Freddie are not operating. And the suppliers there are asking for rules of the game so that they can bring in more capital.

In the short run, there is no alternative to a government guarantee, a catastrophic guarantee. Even if—

Mr. GRIMM. Professor, could I just—on that, would you agree, though, that the first step has to be, at a minimum, to start to unwind where Fannie and Freddie never should have been—

Ms. WACHTER. Absolutely, from the sense of—

Mr. GRIMM. —out competing in the marketplace—

Ms. WACHTER. Absolutely—

Mr. GRIMM. —putting them back to a secondary market, which is their original mission?

Ms. WACHTER. Absolutely. They should be—they should not have been part of the unwinding of credit standards, the reckless lending. They should not have been part of that. They didn't start it. They were late to the game. But they certainly were part of it. And—

Mr. GRIMM. So would you agree that in and of itself—

Ms. WACHTER. And it has been stopped.

Mr. GRIMM. —will be the beginning of starting to bring the private capital back?

Ms. WACHTER. No. One solution is to have private capital which has a government-guaranteed backstop. And in fact, that is what we have with the banking system. It is not correct to say that we don't have a government backstop. We have it implicitly in the banking system.

The question is, a backstop that will, in fact, allow a flourishing market for 30-year fixed-rate mortgages. And that is why we need a system, a secondary market system. It doesn't have to be exactly like Fannie and Freddie, and it certainly should not replicate the errors of Fannie and Freddie, but there is no secondary market system in the world—and we are the envy of the world—that doesn't have some government role.

Mr. GRIMM. I am almost out of time. Thank you.

Mr. Phipps, you mentioned the value of homeownership. And I don't think anyone in this room would disagree with you. What are you proposing, though? In general broad terms, I am hearing just an overall plan. Is it that you want to make sure that we don't move too quickly, that there is no secondary market at all and the bottom falls out because the private sector and the private money have not come to bear yet?

Mr. PHIPPS. Essentially, yes. And the reason homeownership matters is that even after all the market corrections, the average family who owns their house is worth $188,000. The average family who rents a house is worth about $4,600. If we want self-reliant people, homeownership is the perfect opportunity for that. It has been a benefit and a priority of this country for almost 100 years. We would like to see that for our children and grandchildren.

Mr. GRIMM. Thank you.

Mr. Dalton, we have met before. I am out of time, so I will just ask you yes/no. Are you really a Democrat, Mr. Dalton?

Mr. DALTON. I am a Democrat.

Mr. GRIMM. Okay, that is fine.

[laughter]

My time has expired.

Chairman GARRETT. And did you want to go down the rest of the row, too, with—

[laughter]

Just to be curious. And—anyway. And, of course, the professor's comment—of course, Dodd-Frank was to make sure that we are taking away all those explicit and implicit guarantees to the banking system, because they are no longer too-big-to-fail, and that is what the whole benefit of Dodd-Frank is, that we don't have that anymore.

But to the gentleman from California, for 5 minutes.

Mr. SHERMAN. I wish the gentleman from New Jersey was right and Dodd-Frank completely eliminated too-big-to-fail. As you know, we had a number of amendments to Dodd-Frank that might have allowed it to achieve that objective.

Chairman GARRETT. Achieve that, yes.

Mr. SHERMAN. I think Mr. Dalton is to be commended on his most recent answer—

[laughter]

And the wisdom that lies behind it.

Professor Wachter, I think, is right in that the worst thing we could do to our economy is to see a slide or precipitous drop in home prices. And the biggest thing we can do to protect Fannie Mae and Freddie Mac is to make sure that they are not buying subprime loans and Alt-A loans and liar's loans. And that we have already done.

The barn is much better now that we have closed the door. I don't know what changes we would have to make short term that exceed the importance of that.

Mr. Phillips, I just want to re-emphasize what you just said. The average non-homeowning family in this country has an average net worth, value of everything they own in the world, of under $5,000.

Mr. PHIPPS. Correct.

Mr. SHERMAN. That is a strong argument for promoting homeownership. I commend the gentleman from Staten Island on the importance—on his statement that we should keep the home mortgage deduction.

What is most likely to happen in Congress is we will have a lot of talk about eliminating the home mortgage deduction, and then we won't actually do anything. So whatever Federal revenues are available from not doing anything will be available. That is to say, zero.

But what effect does it have on today's home prices that people are reading that Congress might eliminate the home mortgage deduction, which means when you live in the home, you don't get the home mortgage deduction, and when you sell the home, you sell it for an awful lot less? I would think from your position, as president of the National Association of REALTORS®, you could give me some insight as to what this talk is doing to home prices.

Mr. PHIPPS. What all the conversations—and particularly the conversations on mortgage interest deduction and its elimination do—is cause people to pause. So when we have an overhang and an oversupply in the market, to discourage qualified, ready, willing, and able buyers from stepping into the market means that you have a further eroding of average price.

It is particularly challenging—and the conversation I personally find frustrating, because it is something that my grandparents, my parents, and I benefited from, to pay down and pay off the 30-year mortgages. It feels like generation theft that my kids and grandkids cannot enjoy the benefits that we have had in place since 1913.

Mr. SHERMAN. Fannie and Freddie hold portfolios of well over $1 trillion collectively. Their plan is to sell those off to reduce that holding of mortgages by about 10 percent. Is that too precipitous, too fast, both to keep the housing market in good shape and keep the funds flowing in the housing market and to make sure that Fannie and Freddie get full value for the assets that they are selling? Is 10 percent a year faster than it ought to be? Or should I prefer to—

Mr. PHIPPS. Actually, I would prefer you ask—I think the goal, frankly, is—

Mr. SHERMAN. Let me ask the professor.

Ms. WACHTER. I think that Director Ed DeMarco did actually respond to that in a way. He was asked whether 5 years is too precipitous, and he said there is no way that he can answer that question.

Mr. SHERMAN. But you are smarter.

Ms. WACHTER. —no, by no means—10 percent at this moment in time does not appear to be threatening the recovery.

Mr. SHERMAN. So we should encourage the 10 percent, but maybe not mandate it in a way—

Ms. WACHTER. Exactly, mandatory—

Mr. SHERMAN. —that would lock it in.

Ms. WACHTER. —is exactly where you do not want to be on this.

Mr. SHERMAN. Mr. Phillips, I come from a high-cost area, Los Angeles. If the conforming loan limit drops, what does that do to home prices in the 10 largest cities? And then I will ask the professor whether that likely drop in home prices would adversely affect the economy, but first—

Mr. PHIPPS. The answer is that it will actually force down prices. What is really interesting is it is portrayed as a coastal issue, when, in fact, we are looking at 29 States having high-cost areas, 206 counties, and it impacts 51 million Americans. So it is a significant portion of this country that has broad demographics.

Mr. SHERMAN. And if all of a sudden every home that used to be worth $800,000 in the L.A. area dropped to a value of $500,000, Professor, what would that mean for the national economy?

Ms. WACHTER. That would certainly create regional recessions and beyond that, of course, if we have a price—

Mr. SHERMAN. But only in our 10 biggest metropolitan markets.

Ms. WACHTER. —if we have a price fall of that magnitude.

Mr. SHERMAN. I yield back.

Chairman GARRETT. Great. Thank you.

The gentleman from Texas?

Mr. SHERMAN. The record should show that when I say only the 10 largest markets, that was facetious.

Mr. HENSARLING. Thank you, Mr. Chairman.

Mr. Pinto, I evoked your name in the earlier panel for some work that you did. Just to put it in the proper context, I believe you said that, under the normal rate at which Fannie and Freddie are dealing with their portfolio holdings, that is roughly 20 percent per year.

I had authored some legislation that would have essentially shrinked their portfolios on a stair step basis 700, all the way down to 250, over a 5-year timeframe. So did I understand correctly—and I didn't hear Mr. DeMarco necessarily disagree—that your data is accurate?

I know that you have spent quite a part of your professional career studying the GSEs, and I certainly have spent some time poring over the paper that you did along with Mr. Wallison.

So, can you give us a little bit more detail about your observation on reducing the portfolio of holdings? And is 5 years a reasonable time period?

Mr. PINTO. Yes, thank you, Congressman.

Fannie and Freddie report monthly. They have a monthly report. And in that, there is a section on their portfolio, and it shows what it consists of, what the additions are, what the subtractions are, and it has a liquidation rate.

And the liquidation rate over the last year, 2010, it is known as an annualized liquidation rate. It varies a little bit month by month, so you annualize it. And so you are getting 21 percent is what it was last year. And if you look in January of this year, the first month that is reported, it has an annualize rate of 21 percent.

So it is running in January the same. It could drop a bit. It could go up a bit. But that is roughly what it has been running.

And when I put that against your stair step, as you described it, you started off a little more slowly and then accelerated, and so over time, over 5 years, it came out to be—I don't remember the exact number—it was about a 15 percent reduction per year, annualized 15 percent. So it seemed that if the liquidations are 21 percent today, if you assume it slows up a bit, that 15 percent seemed to be in the ballpark and, therefore, shouldn't be troublesome.

I would add that I believe the reduction over the last year-and-a-half has been slower than the liquidation. So in effect, they have been adding to the portfolio, not—if they were just sticking to the liquidation rate, it would be lower than where it is today.

Mr. HENSARLING. Mr. Pinto, in the paper, the AEI paper that you presented back in January along with Mr. Pollock and Mr. Wallison, you stated that the alternative plans in Washington that still retained a government guarantee in the secondary mortgage market were flawed. I quote from the paper, "These plans are based on a fundamental error that the government can act like an insurance company and set a correct price for the risk it is taking."

So we know on the menu of options that the Administration has presented to us, certainly, option two and option three would still have the government setting a price for risk-taking. Can you tell me why you and the other AEI scholars have concluded that the government cannot correctly price for risk?

Mr. PINTO. Yes, thank you. Basically—and it echoes what Director DeMarco said last September before the full committee—the government doesn't have a means for figuring out how to price for risk. It doesn't have a profit motive. It doesn't have the ability to do that.

And time and time again, it has been proven—and I think there were some comments by various members earlier, the number of cases that the government has had where it hasn't properly figured out the pricing of risk. And so that is your first problem.

The way the government doesn't provide capital backing that for the most part, whereas the private sector does. So if the private sector actually has a thick cushion of capital at risk, it has to do a very good job of pricing for risk. And if it doesn't, it loses that capital.

In fact, we issued a final White Paper last week that outlined a completely private system, save for FHA, which we talked about earlier, that would rely totally on private capital, and it would put that capital at risk if it were not properly priced.

And we priced that with experts in the industry, and we came up with pricing that is not that much higher than where we are today, and certainly within the confines of both what Secretary Geithner said on March 1st, a moderate increase in interest rates, and, secondly, the Center for American Progress proposal, which relies on a government guarantee, calls for a 40 basis point increase per year, and ours is less than that.

Mr. HENSARLING. I see my time has expired. Thank you.

Chairman GARRETT. And I thank the gentleman from Texas.

The gentleman from Indiana is recognized for 5 minutes.

Mr. DONNELLY. Thank you, Mr. Chairman.

It seems to me that one of the key ingredients here, more than almost anything else, is common sense, that we have to have a glide path into a product that doesn't disrupt and tear apart the housing market as we move forward, that we can't one day be here and the next day be completely here and pray that everything turns out right in the process, because in the process of doing that, Mr. Nielsen, for instance, how many people are involved in the home-building industry today?

Mr. NIELSEN. We have 160,000 members that are involved in the home-building industry. They represent about 6 million total employees. And that is down dramatically from just a year or two ago.

Mr. DONNELLY. And, Mr. Phipps, just a little background, the first house I bought was a 30-year fixed mortgage, 30-year fixed-rate mortgage. And what we were able to do, it enabled us to get into the house. And then after some years, we were able to refinance into a 15-year mortgage, when we were able to handle a little bit more payment.

But what it did was enable us to raise our family there, to be our greatest wealth instrument, and at the same time, the 30-year fixed got us into the opportunity to be part of this.

What happens to the real estate market if what we do is not a smooth transition as we move away from the way Fannie and Freddie is? If we do not handle this properly, what will happen to the real estate market?

Mr. PHIPPS. An unpredictable market and a market with uncertainty is a challenge, because prices go down. It is interesting. Our number-one priority as an organization is a reliable flow of capital, of mortgage capital, because at the end of the day, we live on the river on which capital creates, and it impacts all 75 million American families.

If you take that away and it is not reliable, and it is not understood to be available, then it causes people to pause, prices go down, unemployment will increase. It is a challenge.

And I would add one other interesting nuance. The pendulum has swung so far in terms of tight credit now that the average credit score that Fannie and Freddie are buying is 750, rather than 700 to 720. So we need to get back toward medium, because there is about 15 percent of the market that should have access to credit, that if you look at their whole profile, certainly have the ability to pay it back. And they are being disenfranchised, and, frankly, that 750,000 additional transactions this year could generate 350,000 to 375,000 additional private-sector jobs. We are very much a jobs business.

Mr. DONNELLY. Thank you.

Mr. Secretary, first, thank you for your service, sir. And then I just have one question for you, and that is, what would happen to the real estate market if there wasn't a 30-year fixed-rate product available?

Mr. DALTON. Thank you for your nice compliment, Congressman Donnelly. With respect to what happens, I think you can see that the American people want 30-year fixed-rate mortgages, in that in the last quarter of 2010, 95 percent of the refinances went into a long-term fixed-rate mortgage. Whatever people had before, this is what they want. And so I think clearly we need to do that.

In terms of what would happen without it, I think you would see homeownership less available to many Americans. I think they want predictability, and that is what the long-term fixed-rate mortgage gives them. I think without it, you would have uncertainty. And one of the things that we have learned is that nothing spooks the marketplace more than uncertainty.

Mr. DONNELLY. Thank you, Mr. Secretary.

Mr. Chairman, I yield back my time.

Chairman GARRETT. Thank you.

Mr. DONNELLY. Thank you, sir.

Chairman GARRETT. Thank you very much.

The gentleman from Ohio?

Oh, he is already gone. The gentleman from—unless the gentleman from California would like to yield to the gentleman from Ohio?

Mr. MILLER OF CALIFORNIA. No, no, I didn't. I was waiting for my time. You are wishing I would yield, but I won't.

Chairman GARRETT. Would you like to yield to anyone?

Mr. MILLER OF CALIFORNIA. No, I would love to take my time. I am a history buff. I love history. If we go back to 490 B.C. and discuss Athenian democracy or we look at the issue of the GSEs—I enjoyed Mr. Dalton's comments that everybody supports the fixed 30-year loan. I do, too. I attended a major seminar by all the major lenders in 1982 when they said there would never be a fixed 30-year loan again. Remember that? Because of the bad times. And the GSEs got that moving, where the jumbo market came back in and participated in the fixed 30-year loan, so I totally agree with that.

Now, Mr. Pinto, did you say that the GSEs or the government is not capable of pricing risk? Was that your comment?

Mr. PINTO. The government is not capable of pricing risk.

Mr. MILLER OF CALIFORNIA. The GSEs are not capable of—

Mr. PINTO. I said the government is not—

Mr. MILLER OF CALIFORNIA. Okay, good. I hope you said that, because if that were true, the private sector is doing horribly, because the GSEs are outperforming the non-agency market by far. Have they made mistakes? Yes. The default rates are lower. We can't argue that.

So they have made mistakes, without a doubt. And we tried in 2005—and I would like to correct history—we sent a very good bill to the Senate. It required a strong regulator, good underwriting standards, a fair standard as applies to all lenders. It got out of committee, but the Senate Democrats filibustered it, but everything else was correct in the statement, except that last part.

So perhaps if we had done that, we wouldn't be where we are today. In 2001, I started introducing amendments that probably got the Senate 4 or 5 times defining subprime versus predatory. And if we had done that, we would not have seen a Countrywide and the predatory loans they made, and perhaps we wouldn't have seen the debacle we have today.

But if you look at the GSEs in history, if you go back from 1970 to 2000, 1985, when Fannie lost some money that one year—they have always made money—in fact, they have always paid money into the Treasury. They have actually made money for the government.

So instead of looking at the history of where they went wrong, what they did wrong, and what years they did it wrong in, and correcting that, we are looking at other things.

And I think we need to say that, if they are outperforming the private sector—and this economic downturn in housing was global, and yet not one of the other countries that suffered the downturn had the same form of lending practice that we have here, yet they suffered the same identical type of a downturn percentage-wise, we should say, what did they do wrong? How can we fix this? And how can we make the lending market solvent and strong for future generations?

Now, what I have seen, based on the history of being a builder, is—and I think many REALTORS® and builders acknowledge that—when—lenders, if you couldn't meet conforming standards, they didn't want to deal with you, because they realize there wasn't the liquidity in the private sector to make those fixed 30-year loans and hold those fixed 30-year loans because it ate up all their liquidity, in most cases.

If we had an alternative to the GSEs, I would like to see it, because it wasn't there at the height of the market, 2005, 2006, and 2007, when you would have seen it. All you saw was Countrywide and the like issuing junk bonds out there to people and telling them they equaled mortgage-backed securities by the GSEs, which they didn't.

So if we didn't have a GSE, I would like to hear from the builders and REALTORS®, what impact on the housing market do you think that would have today?

Mr. NIELSEN. Probably the major problem would be, who is going to be there in another downturn? There is no question that private capital is private. And as a private capital, they get to go in or get out of any market they want to.

So when the market is tough, they are not going to be there. What we have been able to count on in the past, is for the GSEs and FHA to take up that mantle when we had a problem. It concerns me greatly to think that the only folks we would have out there to help us out in a crisis is private capital.

Mr. MILLER OF CALIFORNIA. And I am extremely pleased to hear that the GSEs are using risk-based loan standards and principles and strong underwriting standards. Had they done that in recent years, instead of acting like a company that is owned by stockholders trying to get a larger market share regardless of the cost or the risk, they wouldn't be where they are at today.

But today, the government owns them. Now, the government has an opportunity to make them solvent, to get paid back every dime we lent them, but charging them 10 percent interest doesn't do that. So we have an opportunity to reform the GSEs, to put them back to their original intent, to provide liquidity to the marketplace, in times like today when we need them, and not put taxpayers at risk, as a matter of fact, make money for the taxpayers like they have done in all the years they have been in business until recent years.

So if we are looking at what they have done, there is not a lender in the private sector historically that has performed as well as the GSEs, when they only lost money in one year. Find me one lender that has done that in history. There are none.

So should we be fixing them? Yes. Should we be correcting the mistakes they made? Yes. But first, let's find out what they did wrong and let's fix it. I yield back the balance of my time.

Chairman GARRETT. Thank you.

To the gentleman who is standing up from Texas, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. I want to stand up for homeownership.

Chairman GARRETT. There you go.

Mr. GREEN. I want to stand up for builders who are trying to help us recover.

Chairman GARRETT. And the taxpayers, too.

Mr. GREEN. I want to stand up for all taxpayers, including you, Mr. Chairman. I stand for making sure that we have a 30-year affordable homeownership opportunity. And I am appreciative of what was said. Someone said that housing is not partisan. I made a note of it, and I had to step away. I believe it was the REALTOR® who said it. I concur. And I want to work across lines to make sure that we get this right.

Ultimately, however, after—let me do this—I thank all of you for coming. I want to especially thank, however, the REALTORS®, the builders, and the Roundtable, simply because you are there where the rubber meets the road. And a lot of what you have presented is based upon your experiences, and your talking to people, and your actual knowledge of what is going on from the user's perspective.

And I don't mean to in any way demean the academicians. I thank you for what you have done, as well.

Ultimately, what we have to decide is, what will the role of the Federal Government be? That really is where the rubber meets the road right now. And until we do that, it is difficult to do all of these other things, because we could find ourselves moving in one direction, when, in fact, we have gone too far or we have done something that we will regret and we will have to try to unwind something that we placed in place.

So I want to say to you—I believe it was Mr. Nielsen with the builders—you said that you think that there should be a Federal backstop. And, Mr. Pinto, I believe you are of the opinion—and if I am incorrect, I would like for you to correct me—there should be no Federal involvement at all, no Federal capital should be at risk in any way.

Mr. PINTO. That is not correct.

Mr. GREEN. Okay, thank you. Please correct me. And do it as quickly as you can, because I have a question.

Mr. PINTO. FHA, VA, and the Department of Agriculture programs we believe are appropriate.

Mr. GREEN. But as it relates to the GSEs, absolutely not?

Mr. PINTO. We don't—

Mr. GREEN. Or anything similar?

Mr. PINTO. We don't believe there should be any GSEs.

Mr. GREEN. Anything similar to that? Okay. So, now, the question becomes, in this new paradigm, however, I am sure you are aware that there is—we are thinking about a paradigm that will include FHA, VA, and some other things that may be unnamed at this time or some other paradigm, some system by which we will continue to have mortgages promulgated.

And, of course, your answer would be, "Just let the private market take care of it." Is that correct?

Mr. PINTO. Our answer is, we laid out a very comprehensive approach of how the private market—

Mr. GREEN. Okay. But is it—in essence, when we get to the bottom line, it is the private market, is this correct?

Mr. PINTO. A private market, yes.

Mr. GREEN. And that would be it. Okay. Now, there are some other people who are similar to Mr. Nielsen, and they think that the Federal Government, while not the primary, maybe not the secondary, maybe not the tertiary, but possibly the quaternary, somewhere in there, there is a role for the Federal Government. And without saying where it is right now, those who think that there is a role for the Federal Government, we need to know who you are so that we can know what we are supposed to do, at least based upon your perspective.

So let me just start with the lady. And it is interesting to note that one lady can counterbalance one, two, three, four, five men. [laughter]

Ms. WACHTER. I don't know—

Mr. GREEN. And you have done well. So where do you stand on it? And I regret that I must ask that you say yes, some Federal role, or no, no Federal role—

Ms. WACHTER. Yes, on the Federal role.

Mr. GREEN. Yes. All right, that is a yes.

Mr. PHIPPS. An enthusiastic yes.

Mr. GREEN. That is another yes. That is two. Yes, sir?

Mr. NIELSEN. Yes, sir.

Mr. GREEN. That is three.

Mr. PINTO. No for—

Mr. GREEN. No, all right.

Mr. PAPAGIANIS. Some Federal role.

Mr. GREEN. All right. That is four, and—

Mr. DALTON. Yes. Yes, sir, we do.

Mr. GREEN. All right. So now we have—let the record reflect, please, let the record reflect that all persons, saving one, believe that there is some role for the Federal Government. And the record might also reflect that two of the academicians are having a gentle conversation about that. My suspicion is that there is—

Mr. PAPAGIANIS. I think we agree. It is FHA.

Mr. GREEN. Okay. Then let's—extracting FHA, so we will get it right. I don't want to trap you. I want to know what your thoughts are. Extracting FHA, removing VA, is there a role for the Federal Government? Now let's do this again. Ma'am?

Ms. WACHTER. Yes.

Mr. GREEN. Sir?

Mr. NIELSEN. Yes.

Mr. GREEN. Sir?

Mr. PINTO. No.

Mr. GREEN. No.

Mr. PAPAGIANIS. I say no, but we have a ton of subsidies in the—

Mr. GREEN. Okay, you are a no. Okay. All right.

Mr. DALTON. Yes.

Mr. GREEN. Yes. So we have two of our academicians who think not, and those who, where the rubber meets the road, seem to think yes. Now, if we have this opportunity to have some role for the Federal Government, isn't it reasonable and prudent—my time is up, so I have to be quick here—isn't it reasonable and prudent to have some idea as to where we are going with this, so that we can have a comprehensive approach to this, as opposed to deciding that maybe we ought to do a few things here and a few things there?

I think what people are saying to us is, let's get some certainty, and the way to get the certainty is to take this comprehensive approach and deal with it to make sure that we don't make another big mistake. If I could just get people to say yes or no, I will be honored.

Ms. WACHTER. Yes.

Mr. PHIPPS. Yes.

Mr. NIELSEN. Yes.

Mr. GREEN. All right. You didn't understand the question. That is all right. We will leave you out. You didn't understand the question. Yes, sir?

Mr. DALTON. Nor did I, sir.

Mr. GREEN. Okay.

Chairman GARRETT. Thank you for your questions.

Mr. GREEN. Okay.

Chairman GARRETT. Votes are going to be called shortly, but before the panel leaves, as they did with another hearing, we have a little bit of time left, so what we are going to do now is to go into what we call a lightning round, because votes are going to come very quickly, so we will just go for 2 minutes or so for each person, and then we will conclude.

So, very quickly, following up on your last question, which members who had indicated yes to a government role or government guarantee or taxpayer-supported backstop have a financial interest in it if they were to have the taxpayers bail it out? Ms. Wachter?

Ms. WACHTER. I do not.

Chairman GARRETT. Would you—

Mr. PHIPPS. Not personally, but—

Chairman GARRETT. Not you, personally. I am asking on behalf of those you represent.

Mr. PHIPPS. We certainly would benefit.

Mr. NIELSEN. Yes.

Chairman GARRETT. Yes?

Mr. PINTO. No.

Chairman GARRETT. You didn't vote yes, so—

Mr. DALTON. No, just the investor would have—

Chairman GARRETT. Thank you. Excuse me?

Mr. DALTON. I said just the investor, because of the government guarantee on the mortgage-backed securities.

Chairman GARRETT. So a partial yes. Mr. Papagianis? There we go. Can you tell us, some of the proposals that were laid out before, some before us right now, would do what to the cost of mortgages? And then, secondly, depending upon your answer to what it will do to the cost of mortgages, what will it actually do at the end of the day with regard to the homeowner, prospective homeowner, as far as his ability to buy a house?

Mr. PAPAGIANIS. Which proposal? You are talking about the bills before the committee?

Chairman GARRETT. Bills before the committee, yes.

Mr. PAPAGIANIS. The bills before the committee are, in my opinion, as a package. And we can go through individual bills. But it would be a—it would send an important signal to the market to—so private capital could come back in.

I think the most important one is actually on the G-fees. And I would go back to comments that Mr. DeMarco made, that even on the 2010 book of business—and, obviously, they are pulling forward losses from the past—but that the G-fee is still not appropriately calibrated.

Chairman GARRETT. Right. And so that you may see costs go up, as far as the credit costs?

Mr. PAPAGIANIS. I think so. I think that, I am sort of where the Treasury Department is, where—that any reasonable plan, pathway forward is going to include marginal price increases—

Chairman GARRETT. What does that do to the price of the house?

Mr. PAPAGIANIS. Price of the house?

Chairman GARRETT. Yes.

Mr. PAPAGIANIS. The price of the house would go down.

Chairman GARRETT. What does that do to the homeowner, as far as buying a new house?

Mr. PAPAGIANIS. It makes it more affordable.

Chairman GARRETT. It makes it more affordable, so more—actually that—more sales and actually more construction and more building potential.

Mr. PAPAGIANIS. That is right.

Chairman GARRETT. Okay. And the last question is dealing with the 30-year fixed. Secretary, you said that people want a 30-year fixed mortgage. Isn't it true that people actually want the cheapest mortgage that they can possibly get? For a long period of time, they actually wanted 1-year and 2-year and 3-year and 5-year and 7-year ARMs, because those were the cheapest things out there? Doesn't the public really want whatever is most affordable to them, whether it is 30-year or anything else?

Mr. DALTON. I think they want predictability, Mr. Chairman. And that is what the 30-year fixed-rate mortgage gives them.

Chairman GARRETT. And even if it is more expensive, they will go with the 30-year fixed, if it is predictable, even if there are cheaper things on the market?

Mr. DALTON. I think that is what they showed in the last quarter of 2010, yes, sir.

Chairman GARRETT. Thank you. In the last quarter of 2010, because that is really all that was available? But prior to that, when there are other things available in the marketplace, won't people go for what is cheapest available? Does anybody else have a comment as to whether people go for the higher-priced 30-year mortgage or the cheaper?

Mr. NIELSEN. I think it is still predictability. I think if you go back and look at ARMs and what was happening, I think the 30-year fixed has always been the mortgage of choice.

Mr. PHIPPS. And it was part of the problem that we had in the predatory lending period. People did exactly what you are saying. They went for the least expensive without realizing they were going to reset in 2 years. So there is a lesson that we learned as a country that predictability and knowing what the payments are of a long term, it is something we really need to do for sustainable homeownership and literacy.

Chairman GARRETT. Mr. Green?

Mr. GREEN. Thank you, Mr. Chairman.

I wanted to make that very comment, so I will continue with what you were saying. Also, if we examine the empirical evidence, we will find that many of the people who went for the teaser rate didn't qualify for the adjusted rate. And I think we have to factor that into this equation.

But people do seem to want to have certainty. Certainty means something not only to investors, but also to consumers. Everybody is looking for certainty. And I think that what we need to do, as has been indicated, is to move towards this comprehensive approach.

Now, let's talk about persons who have a vested interest. Is it not true that everybody has a vested interest in this? Because if we don't—

Mr. PHIPPS. Congressman, all 75 million American families who own homes have a vested interest in it.

Mr. GREEN. Thank you.

Mr. PHIPPS. It is their livelihood.

Mr. GREEN. Exactly, because when they buy that home, they want to be able to pay for it, so it has to be affordable. And builders have an interest not only in what they sell, but also they have people who are employed by them. They have people who are going to—who are taxpayers and who benefit from this, as well.

So the notion that because you happen to provide something that the American people need somehow skews your judgment, if we take that attitude, then we will never hear from anybody but academicians. And I would also point out that we get a lot of anecdotal evidence that we put a lot of credence in, and I don't think that we ought to stop allowing anecdotal evidence to be presented.

But also I think this evidence from people who are actually there on the ground makes a real difference. And I appreciate the testimony that you have presented.

Let's go back now to Mr. Dalton. Mr. Dalton, let me just ask you one final question before my time is up. You said you had 32 members?

Mr. DALTON. Yes, sir.

Mr. GREEN. And your 32 members, you have had an opportunity to poll them. And when you speak today, you are speaking for the 32 members. Is this correct?

Mr. DALTON. I am. Yes, sir.

Mr. GREEN. Okay. And I assume that you are speaking for REALTORS® when you say that you are here today as a representative of REALTORS® —

Mr. PHIPPS. The 1.1 million, but also on behalf of the 310 million Americans who need shelter and the 75 million Americans who own homes.

Mr. GREEN. And let me just go to Mr. Nielsen. Are you speaking for builders across a—you can't speak for every one of them, but across the length and breadth of the country, you are in communication with them?

Mr. NIELSEN. Correct.

Mr. GREEN. And you are speaking for them, in terms of what we need to do as we move forward?

Mr. NIELSEN. That is right.

Mr. GREEN. Thank you.

Chairman GARRETT. Thank you.

The gentleman from Ohio?

Mr. STIVERS. Thank you, Mr. Chairman.

First, I would like to address Professor Wachter and let her—say I am glad to hear from the gentleman from Texas that the University of Pennsylvania is where the rubber meets the road, but I am sorry. I do find you an academician. He said you weren't an academician, and I do think the University of Pennsylvania is a fine academic institution. And, I am just joking around there.

But I do want to know how many of the folks at the table represent an organization that has a plan on GSEs? A lot of you do. Raise your hand if you do. Four—five of you have plans. Have any of you been involved in working together with the other groups to come together with one plan, for example?

Because, for example, I know that the Financial Services Roundtable plan and the REALTORS®' plan and the homebuilders' plan have been different components. The two that are closest probably are the REALTORS® and the homebuilders. But have you guys worked together on a plan that you would—or talked at least about a plan?

Mr. PHIPPS. We talk.

Mr. STIVERS. Do you have one plan at this point? I know you have—I know there are five plans, but is there one plan that you have come together on?

Mr. NIELSEN. No, I don't think there is one plan. But, frankly, we haven't been asked to coalesce in that way. We have gone out and developed these on our own—

Mr. STIVERS. I will ask you to do it.

Mr. NIELSEN. Okay.

Mr. STIVERS. So, please, I would like—I would be curious to hear how you could come around on one plan. The other thing I want to address just quickly is, I do feel like that, on the 30-year mortgage, I support it, but it has to be an option in the marketplace. To Mr. Dalton, to me, it is about what is appropriate for each individual borrower. And that may include affordability. It may include predictability. It would probably include a range of factors for each individual borrower.

This is not the Soviet Union, and I do not want to force any product down borrowers' throats. So while I stand for the 30-year fixed mortgage, I stand for it as an option, and I believe that is the position of everybody at the table, although from hearing some of you, it sounded like that is not the case.

Mr. DALTON. Congressman, my point is that we want to keep the 30-year fixed-rate mortgage available.

Mr. STIVERS. I agree. And that is exactly where I am. I just wanted to make sure we weren't talking about having that as the only option, because, frankly, there are—and I will quickly ask the REALTORS®, because I think I am out of time—the average length somebody stays in their home is about—

Mr. PHIPPS. Seven to 8 years.

Mr. STIVERS. That is what I thought. Okay. Thank you. And I support the 30-year fixed mortgage, but I want to recognize that it is not always the right option for each individual borrower. Thank you for your time, and thank you, Mr. Chairman, for including me.

Mr. GREEN. Mr. Chairman, may I be recognized to ask a question, please? Would the Chair entertain a super-lightning round?

[laughter]

Chairman GARRETT. Sure. I yield to the—the gentleman is yielded 10 seconds. No, just kidding.

Mr. GREEN. That would be faster than lightning, Mr. Chairman.

Chairman GARRETT. Go ahead.

Mr. GREEN. How much time?

Chairman GARRETT. Do you have just a couple of questions? Another minute.

Mr. GREEN. Okay, thank you. I want to follow up, because I concur with what my friend has said, that we are talking about options. And what we don't want to do is rule out what appears to be a significant option. And if we are not careful in terms of how we structure this, we may find ourselves with a 30-year fixed-rate that is not affordable. It has to be affordable. It is just not enough to have a 30-year fixed-rate. It has to be affordable.

That is what we have been trying to get to, affordability. And what do we have to do to make sure that we have affordability in this marketplace? Because builders can construct when they know how these are going to be sold. REALTORS® can sell houses when they know that the interest rate is going to be one that Americans can afford. And bankers can lend. And that is what affordability addresses. We have to make sure that all of these things are in this equation.

And if we are not careful, we are going to find ourselves privatizing our way back to the way it was in the 1920s, when we had the private market and you had to put down 20 percent, 30 percent, 40 percent, 50 percent, when you had balloons at the end of a very short period of time. Yes, there was a private market, but it was not an affordable market that gave every American the opportunity to fulfill the dream of homeownership. Not everybody can afford one, but those who can ought to be able to buy one.

I yield back.

Chairman GARRETT. All right. And I will yield myself a minute and then the gentleman from Ohio.

For those of you who have looked and advocated for the 30-year mortgage, saying that we need to keep that, can you tell me in detail what you have looked at as opposed to the traditional government backing for this in order to guarantee that, as opposed to investor interest in this area as far as drilling down into the structures and making sure that there are some other mechanisms in place in order to provide the guarantee to them, whether you have a vertical—yes, Mr. Pinto?

Mr. PINTO. Yes, we actually—in developing our approach, we went to the securitization market and had a 30-year fixed-rate—in this case, freely prepayable, because we wanted to compare it to today's Fannie Mae loan. We had them run those numbers, and we found that there was a very modest increase in interest rate. And if one takes into account what has been discussed here by both Director DeMarco and the committee members, increasing the G-fees some, the difference is quite modest.

We do believe—and the important point is, you have to do this over time. It takes time to develop that transition, and we have proposed that, as I think most of the committee members do. And if you do that, you will have a robust market, including 30-year fixed-rate loans.

Chairman GARRETT. My time is up. But who else did a comparable drilling down, as far as other approaches on this?

Ms. WACHTER. I have.

Chairman GARRETT. Okay. How about the other gentleman?

Mr. PHIPPS. We have.

Chairman GARRETT. And what is your analysis, that it will not work?

Mr. PHIPPS. That it is not—it doesn't have the capacity to absorb what we need to absorb right now, that is, the market—

Chairman GARRETT. It doesn't have the capacity? It has the capacity or the structure that you would analyze—

Mr. PHIPPS. Both.

Chairman GARRETT. Can you provide—since we don't have much time—can you provide the analytical breakdown of the—and down to whether vertical, horizontal tranches that you would have on this to show us that this would not work, with regard to capacity or just as percentage of the marketplace?

Mr. Nielsen, do you have—

Mr. NIELSEN. I was just going to say, it is a cost issue, again. We could certainly provide you with those numbers.

Chairman GARRETT. Okay. Anybody else?

Mr. STIVERS. Thank you, Mr. Chairman.

What we are talking about today is a way forward, and there are several legislative proposals in front of us which several of you opposed, but I guess I would ask you to work together and come to some consensus about what then you think the way forward is, because I think these are modest first steps that get us down the road to where we need to be.

I guess something Mr. Pinto said just brought up a question. You talked about how we need to be thoughtful and it is going to take time for a robust marketplace to develop. What does that mean, in number of years or how long?

Mr. PINTO. We have suggested 5 years, and we outlined a plan that would wind down Fannie and Freddie over 5 years, and then we demonstrate how the private sector will definitely fill in behind that and absorb that retreat by Fannie and Freddie and do it in a way that is cost-effective.

Mr. STIVERS. Great. And I think we all agree with the gentleman from Texas that we want an affordable option in the 30-year fixed mortgage. It is not enough just to say we want a 30-year fixed-rate mortgage. Clearly, if it is not affordable, it is not a real option.

So thank you for your time. I again would challenge you to work together to come to some kind of consensus that we can all work with you on, because we are committed on the way forward to making sure that we limit taxpayer exposure and find a robust marketplace so that we do have options. Thank you so much.

Thank you, Mr. Chairman.

Chairman GARRETT. And for the last word on this, 1 minute?

Mr. SCHWEIKERT. Thank you, Mr. Chairman, as we do the lightning round.

Mr. Pinto, earlier, I think, in some of the discussions, we were bouncing back and forth. The point I was trying to get to is, our great concern is liquidity, the ability to have money, the ability to finance these mortgages. I have a fixation of the number of vacant homes out there so we can start getting the velocity.

Give me a vision that you have worked on that produces that liquidity so there is money out there for these deeds of trust and these home mortgages without a full faith and credit?

Mr. PINTO. Great question. Thank you, Representative.

The proposal that we have made, which relies on a combination of portfolio investment roughly at the levels they are at today, but expands the private mortgage-backed securities market substantially, and that market relies on mortgage insurance, a traditional approach, but with much more robust capital, which we outline, and securitization through the traditional tranches, but, again, only for prime loans.

When you do that—and just take $10 billion, everyone talks about a $10 billion market. Let's take today's dollars, so we are not worrying about inflation or anything. So in 10 years, we want to handle a $10 trillion market. Let's assume 20 percent of it is the Federal Government, FHA, VA, some non-prime loans. Let's assume that is 20 percent. I think that is consistent with the Administration's statements on the size of FHA, etc.

You are now down to $8 trillion. Let's assume that half of that is covered by mortgage-backed securities. Let's assume a different half that also overlaps is also covered by mortgage insurance. So what you are looking for is two things. At the end of that 10 years, you want to have enough bond investors who will buy $5 trillion of mortgage bonds, private mortgage bonds, to support that market.

When we talk to bond investors and we talk to, for example, one of the largest insurance companies in this country, with a $130 billion portfolio, they say we need private mortgage-backed securities for two reasons. There is only a $30 trillion investable private market in this country. That may sound like a lot, but they have investments to make of $30 trillion, and so there is a rough match. So there is $30 trillion in investable assets.

The government has, in effect, taken $10 trillion off the table by nationalizing the housing finance system. And so you are left with $20 trillion. What that does is two things. One is, it doesn't allow you to invest in the private securities, because there virtually aren't any, but more importantly—or as important—it also concentrates your risk in the $20 trillion, so you now don't have the diversification that you need, which is becoming a concern. So that is number one.

Number two, on the private mortgage—excuse me, private mortgage guarantee side, let's assume you had, again—you had $4 trillion of mortgage guarantee that you needed. They would cover a 25 percent exposure, which is what we suggested. That is $1 trillion. They would have, at the end of 10 years, about a 10 percent or 12 percent capital. You would end up needing $80 billion to $100 billion of capital. That is very doable. We outline how that is done.

By definition, that would probably involve 10 companies. None of them are too-big-to-fail. And each one has so much capital at risk that they have to be careful, but if they do fail, they fail on their own because of their own capital.

Mr. SCHWEIKERT. Okay, Mr. Chairman—Mr. Pinto, so you think there is—sorry, I was going to tease you a bit about the ability—

Mr. PINTO. It was a little bit—

Mr. SCHWEIKERT. —very short answer on—last thing. Mr. Chairman, this one is sort of an open-ended and a little bit on the ethereal side. How important is it to having a healthy housing market if we had products that someone could buy a home with less than 20 percent down, assuming we can make it quality paper, so, whether it be through a private PMI or some other mechanic? For those of us who have been—and I first became a member of—as a REALTOR® when I was 18 years old. I got my license when I was in high school, so it has been my whole life.

And I will tell you, probably the majority of properties that I have sold over those years were 10 percent, 15 percent down. Do we need that to have—do we need to have something less than a 20 percent down option out there?

Ms. WACHTER. I believe we do.

Mr. PHIPPS. Yes—

Mr. PINTO. Absolutely.

Mr. NIELSEN. Yes, particularly for home purchase.

Mr. DALTON. Yes, sir, absolutely.

Mr. PAPAGIANIS. Same, yes.

Mr. SCHWEIKERT. So our mandate here is to find out if there is a way to make that quality enough paper that the bond markets are willing to securitize and the bond markets are willing to buy it?

Okay. Thank you, Mr. Chairman.

Chairman GARRETT. I thank you for that. And I thank the panel. As always, there may be more questions. And for that reason, without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

Also without objection, I will be entering into the record the statement of the National Association of Credit Unions, dated March 30th, with regard to today.

And with that, I thank the panel once again. And this hearing is adjourned.

[Whereupon, at 2:30 p.m., the hearing was adjourned.]

A P P E N D I X

March 31, 2011

HPC

HOUSING
POLICY
COUNCIL

Testimony of

The Honorable John H. Dalton

President of the Housing Policy Council

on behalf of the Housing Policy Council

of the Financial Services Roundtable

Before the House Financial Services Committee

Subcommittee on Capital Markets and Government Sponsored Enterprises

"Legislative Proposals to Reform the Government Sponsored Enterprises (GSEs)"

March 31, 2011

Mr. Chairman and Members of the Committee thank you for holding this important hearing and thank you for the invitation to participate.

My name is John Dalton, and I am the President of the Housing Policy Council of The Financial Services Roundtable. The Housing Policy Council is thirty-two of the leading national mortgage finance companies. HPC members originate, service, and insure mortgages, and do business every day with Fannie Mae and Freddie Mac.

Mr. Chairman, we believe that reform of the secondary mortgage market is a critical priority and it should be based on creating a new structure based on private capital. This new system must have two primary goals: serving homebuyers and protecting taxpayers.

Homeownership is a pillar of the US economy and the American way of life. The new private sector system, built on private capital and clear rules, should help deliver sound financing that will keep homeownership within the reach of most Americans. Without an approach like this, owning a home in America could become a luxury for the few.

One important way to avoid this from happening is to ensure continued availability of the 30-year fixed rate mortgage, which has been the bedrock of our nation's housing system for more than a half century. Let me explain why.

The 30-year fixed rate mortgage has made homeownership sustainable for millions of American households. A fixed rate mortgage continues to be the overwhelming choice for American consumers. Today, approximately 90 of new loans are fixed rate mortgages. In the fourth quarter of 2010, 95% of refinances were for fixed rate loans. The 30-year fixed rate mortgage delivers affordability, certainty and stability for homebuyers that might not otherwise exist, which is why it is the most popular form of home financing in our country.

Predictability is one of the greatest benefits of the 30 year fixed rate mortgage, and very important for Americans on a budget. A fixed rate mortgage provides incredible peace of mind, because homeowners know that their biggest monthly bill, their mortgage, is not going to change from month to month and year to year. Without this popular finance tool, many homeowners would experience in their mortgages the same wild swings they now feel at the gas pump. That's a rollercoaster ride most Americans would prefer to avoid.

In addition to serving homebuyers, we strongly agree that a new private sector-based system must protect American taxpayers. Members of the House Financial Services Committee have introduced several bills that identify a number of issues that must be addressed as part of a careful transition to a new, stronger housing finance system. In my testimony, I will discuss the Housing Policy Council's proposal to reform the secondary market system and also comment on some of the legislation that has just been introduced to begin the reform of the existing GSES.

Guarantee Fees and Portfolio Limits

The legislation just introduced addresses the important issues of guarantee fees and portfolio limits. We support steps to continue the gradual reduction in the size of the portfolios maintained by Fannie Mae and Freddie Mac, and a gradual increase in the amount of the guarantee fees (G-Fees) charged by the GSEs. Guarantee fees and portfolio limits are issues that should continue to be addressed with the current GSEs and as part of the larger reform effort.

The guarantee fees charged by the GSEs should be at a level that reflects the risk they are taking and that also allows private competition to develop. In hindsight, it is clear that guarantee fees charged by Fannie Mae and Freddie Mac were insufficient to cover the risks of the mortgages they acquired. In early 2008, the GSEs began to impose additional fees, but in earlier years, the GSEs' guarantee fees and their capital levels were inadequate to support the risks they were taking. Given this experience, HPC supports the gradual implementation of guarantee fees that are more properly aligned with the credit risk assumed by the GSEs. Today, the GSEs' G-Fees have become more accurately priced and additional increases in the G-Fees should be phased-in over a period of time to avoid any undue disruption to the housing recovery.

In the past, the size of the GSEs' portfolios grew far beyond what was necessary to facilitate the securitization of mortgage loans. The portfolios are now being reduced and that process should continue. Additional reductions in the portfolios should be managed in a manner that the market can absorb. Some limited portfolios are needed to facilitate the securitization of mortgages, to warehouse whole loans from community banks, to make a market in less liquid loans, such as multifamily housing loans. The regulator should have the authority and flexibility to manage the gradual reduction of the portfolios in a manner that does not negatively affect the current fragile housing market.

Under a reformed secondary mortgage market system, new private companies performing the credit guarantee role of the GSEs should not have large portfolios, but only those needed for the purposes explained above to facilitate the smooth functioning of mortgage securitizations.

Elimination of Numerical Affordable Housing Goals

HPC supports the elimination of specific housing goals for the GSEs. While the affordable housing goals were not a major factor in the failure of the GSEs, these goals did detract from their primary mission. The GSEs should have a single purpose – ensuring a steady flow of reasonably priced conventional mortgages. Affordable housing is best supported directly by other federal programs, such as FHA. In a reformed system, we could support a contribution from the GSEs or their successors to affordable housing programs managed by HUD and/or state housing finance agencies. Such a transfer payment would help to address affordable housing needs, but would not require the GSEs, or their successors, to direct attention away from their main mission.

Reforms to Current GSEs and Transition to New System

Mr. Chairman, the series of bills just introduced identify and seek to address valid problems with the current GSE system. These bills are a start to the reform effort, but should not be the end of the legislative process on GSE reform. They should be part of more comprehensive reform legislation that provides for the transition from Fannie Mae and Freddie Mac to the simultaneous creation of a new, privately-based secondary market system for conventional mortgages. The Housing Policy Council has made a proposal to reform the secondary mortgage market and to transition from Fannie Mae and Freddie Mac.

Housing Policy Council GSE Reform Proposal

HPC's proposal addresses the problems inherent in the structure of Fannie Mae and Freddie Mac and is intended to achieve several objectives:

- Encourage private sector capital to support the secondary mortgage market;
- Ensure a steady flow of reasonably priced conventional mortgages to borrowers;
- Limit the role of the Federal Government and the risks taken by the taxpayer in the secondary mortgage market;
- Provide strong oversight and regulation of new system; and
- Provide a flow of funding to support affordable owner-occupied and rental housing.

We propose to achieve these objectives by dividing the existing functions of Fannie Mae and Freddie Mac with private companies and capital assuming the primary roles and risk.

Privately Capitalized "MSICs" Should Assume Credit Enhancement Function of the GSEs

A central feature of the HPC proposal is the creation of new privately capitalized firms to perform the credit enhancement or guarantee function of the GSEs. Currently, the GSEs purchase mortgages from mortgage originators, package those mortgages into securities, and guarantee the payment of interest and principal on those securities. In exchange for the guarantee, the GSEs charge mortgage originators a "guarantee fee." We propose that these functions be assumed by privately capitalized firms called Mortgage Securities Insurance Companies, or "MSICs."

A MSIC would --

- purchase conventional mortgages from mortgage originators;
- guarantee the payment of principal and interest on the securities; and
- Charge mortgage originators a fee for the guarantee.

Under our proposal, these privately capitalized entities would be chartered and supervised by a strong federal regulator, much like national banks and federal savings and loans are chartered and supervised by the Federal Government. However, these companies would NOT be backed by the Federal Government, either explicitly or implicitly.

We do not propose a particular organizational structure for the MSICs. Instead, we propose that the investors in a MSIC determine the most appropriate organizational and governance structure for the entity. The validity of the organizational structure and the ability of the investors to manage the entity would be reviewed as part of the chartering process.

We believe multiple MSICs are needed but do not call for a specific limit on the number. We assume that at least 4 will be needed to serve the market, but probably not more than 8 are necessary. The greater the number of MSICs, the better insulated the housing finance market would be from the failure of any one MSIC. On the other hand, too many MSICs -- with different underwriting systems and procedures -- could be overly burdensome to lenders, particularly smaller lenders.

An Explicit – But Limited -- Federal Guarantee is needed

An explicit federal guarantee is needed to ensure a steady flow of mortgage finance at a reasonable cost to borrowers. While MSICs would not be backed by the Federal Government, our proposal does call for the Federal Government to provide an "explicit" backup or catastrophic guarantee on the mortgage securities (MBS) that are issued by MSICs. To be clear, this guarantee would not apply to the MSICs themselves; it would guarantee the payment of principal and interest to investors in mortgage backed securities packaged by MSICs. A MSIC would pay a fee to the government for this guarantee, and this fee would be placed in a reserve.

The challenge we face is designing a secondary market system that ensures a steady flow of reasonably priced mortgages to borrowers while protecting the taxpayers from undue risk. Our proposal addresses this challenge by putting several layers of private capital in front of the limited federal guarantee, and as I discuss below, subjecting MSICs to "world class" regulation.

Standing before the federal guarantee would be --

- The down payment on a mortgage made by the homebuyer;
- Private mortgage insurance or other credit enhancement on the mortgage loan;
- The shareholders' equity in the MSIC; and
- The reserve established by fees paid by MSICs in return for the government's guarantee.

These layers of private capital should insulate the taxpayers from paying claims on the guarantee. However, in the event of a catastrophe that exhausts all of these private resources and the Federal Government is called upon to make payments under the guarantee, we support the imposition of a "special assessment" on MSICs to recoup any costs incurred by the government. Thus, the system we propose would operate much like the Federal Deposit Insurance Fund does today.

Finally, if the fees for the federal guarantee are set properly, the federal guarantee would be budget neutral. Under existing federal credit procedures, the cost of federal credit activity in a budget year is the net present value of all expected future cash flows from guarantees and direct loans disbursed in that year. For loan guarantees, cash inflows consist primarily of fees charged to insured borrowers, and cash outlays consist mostly of payments to lenders to cover the cost of loan defaults. FHA and Ginnie Mae are models for this budgetary treatment. In the case of both FHA and Ginnie Mae, the fees paid for the federal guarantee normally cover claims on the guarantees and other operational expenses.

Capitalizing New Private Companies (MSICs)

Attracting sufficient private capital to MSICs is a key to the success of our proposal. Based on our initial research and discussions with capital markets participants, we believe that a range of private investors would be willing to invest in these new companies. The capital levels for these new companies would be set by their federal regulator and would be significantly higher than those of the current GSEs. This model could produce a reasonable return to investors and provide the capital needed to cover losses in a severe housing down-turn.

World Class Regulator

To ensure the safe and sound operation of MSICs – and further reduce the need for the Federal Government ever to perform on its guarantee – we propose that MSICs be subject to "world class" regulation, by a strong and independent federal regulatory agency. This regulatory regime should include:

- Strong prudential standards – MSICs' should be subject to capital, liquidity and other prudential standards set by the chartering agency;
- Underwriting Standards for Mortgages in MBS – MSICs should be prohibited from purchasing mortgages that do not meet underwriting standards set by the chartering agency. These standards should provide that mortgages purchased by in a MSIC are prudentially underwritten.
- Loan Limits – The federal chartering agency should set, by regulation, limits on the size of mortgages that could be included in mortgage backed securities insured by a MSIC.
- Portfolios -- MSICs should not be permitted to establish and hold portfolios purely for investment purposes. Small portfolios should be permitted to facilitate the development of new products and certain types of loans for which there are limited markets such as multifamily mortgages. MSICs also could use this portfolio capacity to warehouse loans before securitization, to purchase whole loans from smaller banks and for loss mitigation and REO disposition purposes.

Central Securitization Facility and a Single MBS

Our proposal also calls for the creation of a single Mortgage Backed Security (MBS) Securitization Facility to provide administrative services related to MBS packaged by MSICs. The Facility would process payments on those MBS from the lenders/servicers to the investors. It also would place and administer the federal catastrophic guarantee on the MBS. In other words, this Facility would perform functions similar to those performed by Ginnie Mae for FHA. We recommend that the Facility be part of the Federal Government, and that Ginnie Mae be tapped to perform the services of the Facility, either directly or on a contract basis.

The creation of this Facility also would facilitate the creation of a single MBS. Today, there are some differences in the terms and repayment characteristics of the MBS marketed by the two GSEs. These differences can, from time to time, result in differences in market liquidity. We propose that all MSICs be required to adhere to a standard form of MBS that has the same repayment terms and other conditions. A single MBS would promote better understanding of the MBS by investors, and it would enhance the liquidity of the market. This would help ensure home buyers have consistent access to reasonably priced home financing.

A single MBS does not mean that all MBS would be composed of the same type of mortgages, only that the basic legal structure, terms and conditions governing repayment and other administrative features of the MBS would be the same. MBS backed by MSICs could be composed of loans from a single lender or multiple lenders allowing lending institutions of all sizes access to this liquidity.

Like existing GSE securities, these MBS should be exempt from SEC registration requirements. Such an exemption is necessary to maintain the "To Be Announced" (TBA) market. The TBA market is used by the lending industry to reduce risks in the origination process and reduce borrowing costs for consumers. The TBA market allows borrowers to lock in rates in advance of closing a mortgage loan and permits lenders to hedge the corresponding interest rate risk. The TBA market is based upon a trade of a MBS on a future date, and at the time of the trade the MBS to be included in the trade may not be identified. Therefore, it is impractical to apply standard SEC registration and disclosure requirements. To overcome this practical problem, the GSEs currently disclose information to investors about the composition of each pool of mortgages backing a security, including the average loan-to-value ratio, the average debt-to-income ratio, the average borrower credit score, the number and value of mortgages from each state, the distribution of mortgage coupon rates and whether the mortgages were originated in broker or non-broker channels. MBS issued by MSICs should be subject to a similar disclosure requirement.

Affordable Housing

Finally, we propose that MSICs contribute to supporting owner-occupied and rental housing for extremely-low and very-low income families. This requirement was placed on the GSEs in the Housing and Economic Recovery Act of 2008. That Act directed the GSEs to annually set aside approximately 4 basis points of the total dollar amount of new mortgages that they acquire and transfer 65 percent of such amount to the Housing Trust Fund and 35 percent of such amount to the Capital Magnet Fund.

The Housing Trust Fund, which is to be administered by HUD, would provide grants to the States primarily for the production, preservation and rehabilitation of rental housing for extremely low-income and very low-income families. The Capital Magnet Fund, which is to be administered by the Treasury Department, is designed to leverage private sector capital for the development of housing for extremely low-income families, very low-income families, and low-income families. It also is designed to promote economic and community development projects to help such families. We support this transfer payment in lieu of the application of specific housing goals on MSICs. MSICs should not be subject to specific housing goals.

Transition

While in conservatorship, both Fannie Mae and Freddie Mac have performed their three primary responsibilities well: continuing to promote liquidity for housing finance, finding solutions to help keep borrowers in their homes and conserving the assets of the two enterprises. Without the continued operation of Fannie Mae and Freddie Mac during the crisis, the flow of housing finance would have been severely disrupted. The GSEs will need to operate until a well defined and careful transition is formulated and put into place.

Key transition issues that must be considered include:

- The transition must ensure borrowers have uninterrupted access to reasonably priced housing finance along with other benefits they enjoy today (for example, access to 30 year fixed rate mortgages and the ability to lock a rate while loans are in process).
- The transition must ensure the continued liquidity of today's agency MBS market and the 'to be announced' (TBA) MBS market in particular which allows lenders to better insulate consumers from the uncertainty of markets and to hedge their risks (thereby reducing borrowing costs).
- The transition must seek the right balance between sufficient capitalization of future credit risk guarantors and how different capitalization requirements impact the costs of home ownership for consumers.
- The transition should also seek to achieve an explicit government guarantee of the MBS with as little actual government risk as possible (achieved by placing sufficient private capital in front of the government).
- The transition must find a fair and equitable way to deal with the legacy assets and liabilities of Fannie Mae and Freddie.
- The transition should seek to utilize the valuable infrastructure of Fannie Mae and Freddie Mac.
- The transition must ensure low and extremely low income borrowers have access to housing while avoiding lending requirements and/or targets for private lenders/guarantors.
- The transition should be allowed sufficient time for proposed changes to be clearly communicated. Where possible, gradual steps should be used and 'tested' before proceeding to broader implementation. Given the size, importance, and complexity of the housing finance system, expectations should be for this transition to potentially take multiple years to be realized.

A Note on Other Proposals

A number of other secondary market reform proposals share key features of the plan proposed by HPC and while some call for more or less government involvement, all agree that promotion of liquidity for housing finance is the objective. Several recommendations also call for an explicit guarantee of MBS (not the corporate entities) and for stronger capitalization and regulation. We believe that those recommendations that call for complete nationalization miss the benefits to consumers of innovation and efficiency that private capital will allow and expose the taxpayer to more risk than is necessary to optimize MBS liquidity. Recommendations to completely privatize miss the necessity of some government guarantee to ensure consistent functioning of MBS markets under all economic conditions.

Mr. Chairman, we appreciate your leadership and those on this committee who must tackle this important issue, and we realize it is complicated and complex. We support your efforts to reform the system and move away from a GSE-model, but we believe it is important for the economic recovery, financial markets and for the housing sector to proceed carefully and create a roadmap to a new, privately-based system. There is still much uncertainty in the housing market at this time. This uncertainty makes it especially important to couple limits on changes to the existing GSEs with a plan for a new system.

We stand ready to work with you, the committee and other stakeholders on this issue, and look forward to your questions.

Statement of

Edward J. DeMarco
Acting Director
Federal Housing Finance Agency

Before the U.S. House of Representatives

Subcommittee on Capital Markets, Insurance, and

Government-Sponsored Enterprises

"Legislative Proposals: Overhaul of Housing-Related Government Sponsored Enterprises"

March 31, 2011

Statement of Edward J. DeMarco
Acting Director
Federal Housing Finance Agency
Before the U.S. House of Representatives
Subcommittee on Capital Markets, Insurance, and
Government-Sponsored Enterprises

March 31, 2011

Chairman Garrett, Ranking Member Waters and members of the Subcommittee, thank you for inviting me to speak this morning on the Federal Housing Finance Agency's (FHFA) role as conservator of Fannie Mae and Freddie Mac (the Enterprises) and on proposals regarding the future of the Enterprises.

It is critically important that Congress and the Administration begin the work to define the long-term structure of housing finance. While substantive disagreements about the features of that structure exist, there is near universal agreement that we should not follow the old paradigm. We appreciate the efforts that the Subcommittee has taken to start this process.

In my testimony today I will address three broad topics. First, I will review the current performance and financial condition of the Enterprises. Second, I will describe how FHFA is carrying out its conservatorship and oversight responsibilities while Congress and the Administration consider the future of housing finance. Finally, as requested I will share some of FHFA's views on certain current proposals to limit the Enterprises' role in housing and ultimately unwind or transform them from their current situation.

Current Financial Performance and Condition

The Enterprises' financial results in 2010 were much better than in recent years, which resulted in smaller draws from the Treasury under the Senior Preferred Stock Purchase Agreements (PSPAs) with the Enterprises. In part, these results reflected much-improved underwriting on their post-conservatorship books of business. Still, the Enterprises had substantial losses for the year as they continued to experience credit losses associated with mortgages originated principally between 2005 and 2008.

Mortgage Market Presence

The Enterprises continued to provide the vast majority of liquidity to the residential housing market in 2010, guaranteeing 70 percent of single-family mortgage-backed securities issued. Mortgage origination for home purchases and refinances dropped 13 percent in 2010 from 2009, but refinance activity picked up in fourth quarter 2010 as mortgage rates remained near historic lows.

Credit Quality

During conservatorship, the Enterprises have improved the quality of new mortgages purchased. In addition to purchasing very few non-traditional mortgages in 2010, underwriting standards continued to remain strong. In 2010, the average borrower credit score using the Fair Isaac (FICO) credit score was over 750, and the average loan-to-value ratio was below 70 percent. Serious delinquency rates on the overall credit book declined during the year after peaking at the end of the first quarter of 2010.

Loss Mitigation Activity

Loss mitigation activities increased substantially in 2010. Since the fourth quarter of 2008, the first full quarter in which the Enterprises were in conservatorship, completed loss mitigation actions by the Enterprises totaled nearly 1.5 million. The majority of those actions, nearly 950,000, were completed in 2010. Loan modifications accounted for the majority of loss mitigation actions in 2010, more than tripling from the level in 2009 to 575,000 modifications in 2010.

Retained Portfolio

As of year-end 2010, mortgage investment assets of the Enterprises remained below the limit of $810 billion set by the PSPAs. Fannie Mae's mortgage investment assets increased from $773 billion at the end of 2009 to $789 billion at the end of 2010. For Freddie Mac, mortgage investments declined from $755 billion to $697 billion. Importantly, nearly all of the mortgages added to the Enterprises' investment portfolios were delinquent mortgages removed from mortgage-backed securities pools guaranteed by the Enterprises. Early in 2010 both Enterprises changed their practice with regard to removing delinquent mortgages from pools so that such loans are removed once they are 4 months delinquent. This approach reduces the Enterprises' costs associated with delinquent mortgages and is also consistent with their efforts to modify or otherwise mitigate losses associated with these loans.

Capital

Combined Treasury support through draws under the PSPAs declined in 2010 to $28.0 billion from $66.1 billion in 2009 as a result of a decline in losses at the Enterprises. The Enterprises' single-family credit guarantee business continued to be the largest contributor to the charges against their capital and the corollary need to draw on the Treasury. Investments segment results were positive in 2010, partially offsetting single-family segment performance. The single-family segment accounted for $181 billion, or 78 percent of combined charges against capital of $232 billion since the end of 2007.

FHFA as Conservator

I would like to turn now to a discussion of FHFA's current activities as conservator. Until a new system of mortgage finance is established in the United States, mortgage finance is centered on Fannie Mae and Freddie Mac. I would like to describe some of the steps FHFA is taking to meet its statutory mission as conservator to preserve and conserve the Enterprises' assets while ensuring the Enterprises continue to meet their statutory mandate to support a stable and liquid secondary mortgage market.

The Housing and Economic Recovery Act of 2008 (HERA), which created FHFA, specified two conservator powers, stating that the Agency may "take such action as may be:

(i) necessary to put the regulated entity in a sound and solvent condition; and

(ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity." (Section 1367(b)(2)(D) as amended, of the Federal Housing Enterprises Financial Safety and Soundness Act)

From the outset, FHFA stated that the goals of the conservatorships were to help restore confidence in the companies, enhance their capacity to fulfill their mission, and mitigate the systemic risk that contributed directly to instability in financial markets. Because the private mortgage securitization market had already vanished by this time and there were no other effective secondary market mechanisms in place, the Enterprises continued operations were necessary for continued liquidity in the secondary market and for mortgage originations to continue.

Today, FHFA is balancing three responsibilities: preserve and conserve assets, ensure market stability and liquidity, and prepare the Enterprises for an uncertain future. While the long-term course of housing finance is being debated and ultimately determined, FHFA meets these responsibilities by overseeing the Enterprises management of, and limiting the costs to taxpayers from, the Enterprises' $5.5 trillion position in the market. I would like to describe now how FHFA is balancing these responsibilities. I will begin with a broad view of operational priorities focused on the near-term and then consider what it means to conserve and preserve assets over a conservatorship period of uncertain length, which may have a long run still ahead. I will then describe the risks we must manage and the risk management approach we are employing.

FHFA has already taken important steps to accomplish the goals of conservatorship. For example, it is important to keep the Enterprises focused on their existing core business, not venturing into new products or lines of business. This approach ensures ongoing liquidity in the mortgage market, preserves the Enterprises' core business processes, and generates earnings, thereby benefiting taxpayers.

We are looking beyond just a holding pattern, though. Where appropriate and feasible, we are working with the Enterprises to make long-term improvements to the functioning of the housing finance system, improvements that should bring dividends down the road irrespective of the ultimate outcome of housing finance reform. We have announced two such initiatives, each of which is now well underway.

The first such initiative was announced last May when FHFA directed the Enterprises to develop uniform standards for data reporting on mortgage loans and appraisals. This Uniform Mortgage Data Program is designed to improve the consistency, quality, and uniformity of data that are collected at the front end of the mortgage process. By identifying potential defects at the front end of the mortgage process, the Enterprises will improve the quality of mortgage purchases, which should reduce repurchase risk for originators. This initiative will be phased in over the course of this year and next.

Developing standard terms, definitions, and industry standard data reporting protocols will also decrease costs for originators and appraisers. It will allow new entrants to use industry standards rather than having to develop their own proprietary data systems to compete with other proprietary data systems already in the market. The credit and pricing decisions Fannie Mae, Freddie Mac, or any future secondary market firm make based on the data, of course, will be where market participants compete. Proprietary reviews of appraisal and loan information will depend on each firm's own unique business models and policies. But common data definitions, electronic data capture, and standardized data protocols will improve efficiency, lower costs and enhance risk monitoring.

The second initiative started at the beginning of this year, when FHFA announced the Joint Servicing Compensation Initiative. On January 18th, 2011, FHFA directed Fannie Mae and Freddie Mac, in coordination with FHFA and HUD, to consider alternatives for future mortgage servicing compensation for their single-family mortgage loans. The goals of the joint initiative are to improve service for borrowers, reduce financial risk to servicers, and provide flexibility for guarantors to better manage non-performing loans, while promoting continued liquidity in the To Be Announced mortgage securities market.

As conservator, I have appeared before this Committee several times and have reported on FHFA's approach to meeting its statutory obligation to preserve and conserve assets and property. As the Committee begins to consider particular legislative next steps, it may help for me to review in more specific detail what are we preserving and conserving, why, and for whose benefit. In considering these questions, it is useful to think about the Enterprises' assets and property as having four broad categories:

- The legacy, pre-conservatorship book of business, including investments, mortgages owned and mortgages guaranteed;

- The post-conservatorship book of new business;

- The business platforms, operations, and processes; and

- The people who work at the Enterprises – the human capital that run the business, manage the risk, and support the operations.

The first two categories define the tangible assets that exist today and the latter two define the intangible assets that support the tangible assets and also create opportunities for undertaking profitable business tomorrow.

Given the structure of the Treasury PSPAs with the Enterprises, the entity with the greatest economic interest in the Enterprises today is the taxpayer. Thus, we are preserving and conserving the assets principally for taxpayers so that they may realize the greatest possible return from these assets, whatever the final form of the companies' transformation ends up being. We do this with a clear expectation that at some time in the future Fannie Mae and Freddie Mac, as we have known them, will no longer exist. But we do not know when, or in what fashion, this will happen. Each company, in whole or in pieces, may be transformed in some fashion so that taxpayers realize value from this investment in the way lawmakers determine is in the country's best interest.

What we do know is that the single-family mortgage market in the United States is more than a $10 trillion market. The nation's housing finance structure depends on institutions capable of absorbing the flows that a market of that magnitude generates. The coming debate will be about what those institutional arrangements look like, what degree of government support or subsidy will be involved, and what degree and role of government oversight is desired.

Turning to the "why" question – why preserve and conserve these assets – I offer this: to protect taxpayers from further losses, to ensure market stability and liquidity, to give lawmakers options for the future, and to protect the future value of the Enterprises' intangible assets for future utilization and value recognition for the benefit of taxpayers and markets. Even though we do not know the future of the companies, it makes no sense to diminish, denigrate, or erode their tangible or intangible assets. As conservator, we oversee these assets so that value may be returned to taxpayers from them in a manner to be determined by financial market developments and the decisions of lawmakers.

Finally, let me turn to risk management issues in conservatorship. The risks and challenges associated with each of the four categories of assets are unique, so I will take them one at a time.

First, for the legacy book of business – the mortgages acquired or guaranteed pre-conservatorship – the key risk is further credit losses from delinquent mortgages. FHFA and the Enterprises' boards of directors, senior management teams, and staff are focused on effective loss mitigation strategies to avoid foreclosure where practical and to minimize further credit losses through loan modifications and other loss mitigation strategies.

Second, for the post-conservatorship book of business, the key risk management challenge is establishing appropriate underwriting standards and risk-based pricing. Since conservatorship, underwriting standards have been strengthened and several price increases have been initiated to better align pricing with risk. FHFA will continue seek more progress in these areas, but pacing changes in underwriting standards and pricing will be a challenge. Because government-supported mortgage activity constitutes nearly the entire mortgage market today, we will need to balance contraction of Enterprise business with what we trust will be a growing capacity of private firms to step in. Having better data and an improved mortgage servicer compensation model, such as we are seeking through the initiatives I mentioned earlier, are also important steps in support of improved risk management of future business.

Third, the Enterprises' business platforms, operations, and processes, present multiple risk management challenges. FHFA and others have reported previously on the operational and risk management shortcomings that contributed to the Enterprises ending up in conservatorship in the first place. Both companies have been remediating those deficiencies and much progress has been made.

Beyond that, how do you build for the future when you do not control the ultimate fate of the companies? A fundamental responsibility of a corporate board is strategic planning, preparing a company for the challenges and opportunities that lie ahead, and directing corporate investments in infrastructure and operations to maximize profit opportunities. For a company in conservatorship, and unlikely to continue to exist in its current form, thinking about whether and how to invest in and develop infrastructure and operations presents unique and difficult challenges.

Standing still is not the answer, and would be inconsistent with the goals of conservatorship. In particular, the mortgages guaranteed by the companies and backed by the taxpayer are 30-year assets. We need to continue to develop and maintain the infrastructure supporting these securitizations in order to preserve and conserve the value of those securities and enhance the overall control structure. On the other hand, some long-term investments in overhauling information technology and other infrastructure may not be appropriate. Finding the right balance is a key challenge.

Finally, how does one preserve and conserve the value of a company's human capital in the face of an uncertain future? Recruiting and retaining executives and staff is one of FHFA's principal risk management challenges as conservator. The boards, senior management, and staff at each Enterprise who have remained since conservatorship, or joined one of the companies since that time, should be acknowledged for the hard work that has been and is being done to fix each company's shortcomings, to develop and execute improved loan loss mitigation strategies, and to ensure the continued functioning of the country's secondary mortgage market.

Leadership changes will continue to take place. Already in 2011 we have seen several key executive-level departures at each company. The Enterprises need to be able to continue to attract and retain executive-level talent and professional staff to navigate through this period of uncertainty. For the duration of the conservatorships, I believe the best way to protect taxpayer interests in the Enterprises is by ensuring each company has experienced, qualified people managing the day-to-day business operations. Any other approach puts at risk the management of more than $5 trillion in mortgage holdings and guarantees supported by taxpayers through the Treasury PSPAs.

Legislative Proposals

Now I would like to address some broad areas where Congress is considering changes to various portions of the Enterprises' activities and operations. The Administration also suggested changes in some of these areas. At the outset I would like to note that the ultimate resolution of the Enterprises in conservatorship awaits Congressional action. While Congress or the Administration may propose or take intermediate steps toward that end, ultimately Congress will need to define a structure and transition path for the role in housing finance the Enterprises are currently playing. Achieving that solution may take time and much debate, so considering some near-term changes may be appropriate. This is especially the case given that while the Enterprises are operating under conservatorship, they are still operating under their congressionally granted charters and other statutory provisions that generally were not designed for conservatorships of extended duration and uncertain futures. As Congress considers legislation to restrict, limit, transform and wind down the Enterprises, I respectfully ask that care be taken to provide FHFA, as conservator, with sufficient flexibility to use its best judgment to preserve and conserve the Enterprises' assets as it has done since September 2008.

As requested, I will now offer some comments on the topics covered in various specific pieces of legislation introduced by members of the Subcommittee earlier this week.

Risk Retention

Earlier this week, the federal agencies charged in the Dodd-Frank Act with implementing Section 941 of the Dodd-Frank Act issued a proposed rule on risk retention. Chairman Garrett's bill would clarify that Enterprise loan purchases and securities do not affect the underlying status of the loans for purposes of this rule. We are still studying the proposed legislation but I would like to clarify that the agencies' proposed rule does not classify Enterprise loans as qualified residential mortgages; it stipulates that Enterprise single-family mortgage securities are structured with a 100 percent risk retention by the securitizer (i.e., the Enterprise), obviously the maximum possible and far beyond the 5 percent retention required by Section 941. So, the proposed rule does not classify the loans as qualified residential mortgages (QRM), but it acknowledges that the risk retention by the Enterprises is already complete. Furthermore, since the risk retained by the Enterprises is itself backed by the Treasury through the PSPAs, not by private capital, it is unique from any other 100 percent risk retention structure that might some day exist.

If the Enterprises were subject to the risk retention requirements for non-QRM loans, they would be forced to hold on their balance sheet five percent of the securities they issue backed by non-QRM loans. To impose such a requirement would add nothing further to the Enterprises' "skin in the game" or credit risk exposure as they already have 100 percent of the credit exposure. However, such a requirement would require the Enterprises to increase their portfolios by financing five percent of their mortgage-backed securities themselves. This outcome is inconsistent with the current 10 percent per-year wind down in the retained portfolios contained in the PSPAs, and other efforts to seek faster reductions in the retained portfolios. It also is not clear how having the Enterprises meet the risk retention requirement as described above would encourage private capital to enter the market.

Reducing the Enterprises' Retained Portfolios and Limiting Debt Issuance

The risk associated with Enterprises' retained portfolios and questions about whether they served any meaningful public purpose generated a considerable amount of attention prior to enactment of HERA. However, it was not the interest rate risk associated with the retained portfolios that led to the Enterprises' financial problems, but rather credit losses associated with investments in private label mortgage backed securities and credit losses in the Enterprises' Single-Family guarantee business.

Recognizing the risk posed by the Enterprises' retained portfolios, the PSPAs contain a provision that provides for a 10 percent per-year reduction in the retained portfolio of each Enterprise. The portfolio limit under the PSPAs was $810 billion as of year-end 2010. At that time Fannie Mae's retained portfolio totaled $789 billion, and Freddie Mac's retained portfolio was $697 billion. Both companies are on track to meet or be below the $729 billion limit as of year-end 2011.

The only material additions to the retained portfolios today come from removing delinquent mortgages from the Enterprise's mortgage-backed securities. Adding these mortgages, along with the normal run-off of other mortgage investments has fundamentally changed the composition of the Enterprises' retained portfolios relative to pre-conservatorship days. In particular, the Enterprises' portfolios are no longer predominantly made up of liquid mortgage-backed securities. The majority comprises non-performing and illiquid whole loans and private-label securities. While some faster reduction of the Enterprises' retained portfolios may be possible, a Congressional mandate for a significantly faster reduction could cost taxpayers unnecessarily, as some of the illiquid assets may recover some or much of their lost value over time.

Requiring specific Treasury approval for the Enterprises to issue debt could serve as another way to reduce the Enterprises' retained portfolios. However, any potential faster reduction in the retained portfolio could be achieved in a number of ways, and it is unclear how adding an additional procedural hurdle would provide an effective mechanism. Given a choice between focusing on reducing assets through portfolio reductions on the one hand, and limiting debt issuance by adding constraints to the debt issuance process on the other, I would suggest Congress focus on asset reduction.

As I noted, the Enterprises are on track to meet or exceed the current 10 percent per-year reduction in their retained portfolios. We would be glad to work with Congress on evaluating the impact of alternative approaches to reducing the Enterprises' retained portfolios.

Limiting New Activities

FHFA is not permitting the Enterprises to offer any new products or enter new lines of business. Their operations are focused on their existing core businesses and on loss mitigation. This limitation on new business activity is consistent with the standard regulatory practice when dealing with financially troubled companies – and it is even more pertinent for the Enterprises given their uncertain future and reliance on taxpayer funds.

I understand Representative Schweikert's bill to codify this position of the agency and, in principle, I support doing that. As the Subcommittee deliberates the particulars of such a mandate, it may wish to consider whether any exceptions should be provided for products that advance other purposes of the transition. For example, if the mandate is too narrow it could preclude the development of Enterprise risk-sharing structures that could meet the goal of attracting more private capital to the market and reduce the taxpayers' exposure. Perhaps a prohibition on new products should have an exception for activities that might attract private capital inflows or otherwise promote the statutory mandate of the conservatorship. Otherwise, though, I support the concept and FHFA is already operating in a manner consistent with that approach.

Enterprise Housing Goals

The Enterprises' housing goals, and the refinements in HERA, were put in place for a different operating environment than conservatorship. The housing goals reflected, in part, an arrangement between Congress and two private companies that effectively acknowledged the unique benefits Congress had provided those companies by establishing certain housing goals to ensure those benefits were made available to the targeted parts of the market.

Working with the statutory structure that is in place today, FHFA has finalized housing goal regulations for the Enterprises that effectively require that the Enterprises' involvement in the affordable housing markets should mirror the industry's participation in those markets and not lead the market. This approach was chosen to acknowledge that the Enterprises still have a housing goal mandate, but that mandate should more closely reflect their current situation of operating in conservatorship.

Given that the housing goal structure was not designed to address the extended period of time that the Enterprises have been operating in conservatorship, eliminating the goals could be consistent with the current state of the Enterprises. Similarly, the Enterprises' duty to serve requirements that were put in place under HERA, were designed to stimulate the Enterprises to innovate and undertake other activities to address particular markets. Similar to the housing goals, eliminating the duty to serve requirements could be consistent with the realities associated with the Enterprises operating in conservatorship.

Eliminating these requirements would, at the margin, reduce operational and compliance burdens at the Enterprises and at FHFA but need not result in less attention to these market segments. The Enterprises charters require them to serve the affordable housing segments of the market and the various reporting regimes in place to monitor their activity in these segments could be retained or modified to ensure some public accountability in these areas.

Reports to Congress on Activities of Enterprises

FHFA is pleased that HERA provided an Inspector General (IG) to assist FHFA in carrying out its duties. At the most basic level, it is FHFA's responsibility to oversee the Enterprises and the Federal Home Loan Banks, and to carry out its duties as conservator of the Enterprises. It is the IG's responsibility to oversee FHFA, and evaluate and report on FHFA's activities. Establishing a requirement for the IG to submit quarterly reports to Congress during the conservatorship summarizing the activities and condition of Fannie Mae and Freddie Mac would have those responsibilities reversed. FHFA would be glad to work with the Subcommittee to establish reasonable reporting requirements as envisioned in the proposed bill. Indeed, FHFA already reports on many of the activities of the Enterprises voluntarily.

In short, FHFA supports the thrust of Representative Biggert's bill and would be glad to work with her and the Subcommittee on enhancing the reporting regime. But, FHFA believes it should be FHFA and not the FHFA-IG that carries out the reporting function. The FHFA-IG would have a proper role in overseeing FHFA's preparation and reporting in response to any such mandate.

Guarantee Fees

Since the beginning of conservatorship, FHFA has been steadily overseeing increases in guarantee fees for the Enterprises. We are required to report to Congress on the Enterprise guarantee fees and will complete our third annual report in July 2011. FHFA supports the principle advanced by both the Administration and by Representative Neugebauer that guarantee fees should continue to be gradually increased to those that best approximate what a fully private company might charge for the same risk. As described earlier, since being placed into conservatorship, the Enterprises' underwriting standards have been strengthened and several price increases have been initiated to better align pricing with risk. FHFA expects to continue to evaluate further changes along these lines, and we will continue to work with the Congress on legislative approaches for determining appropriate changes to the Enterprises' strategy for setting guarantee fees and a timing for those changes that might encourage additional private sector capital to come into the housing market.

Enterprise Employee Compensation

As I stated above, retaining human capital in the face of a very uncertain future is a difficult task and setting a compensation strategy in such an environment requires a delicate balancing act. The combined assets of the Enterprises exceed $5 trillion, and sudden changes in their compensation structure would put the management of those assets at risk and increase taxpayer exposure to greater losses. It is difficult to make compensation comparisons to government programs like the Federal Housing Administration and Ginnie Mae, as the underlying structures of those programs were designed over many years to operate with government oversight of private sector participants. This is not the case with the Enterprises where the underlying structure was developed based solely on private sector interactions between the Enterprises and their business partners.

As conservator, we have reduced the Enterprises' compensation overall. Since conservatorship, there has been a 40 percent decrease in overall executive compensation at the Enterprises. Average executive pay is at the same level it was 12 years ago. Consistent with the approach taken for Federal workers, FHFA directed each Enterprise to maintain 2011 compensation for all employees at 2010 levels. When higher compensated employees leave, the companies seek to fill those positions at lower compensation levels than paid to the departing employee, including at the executive level. FHFA is very mindful of keeping Enterprise compensation costs down, while retaining the talent to carry out the operations of the companies.

With these considerations in mind, I am concerned that legislation to overhaul the compensation levels and programs in place today with the application of a federal pay system to non-federal employees carries great risk for the conservatorships and hence the taxpayer. I understand and have sympathy for what might motivate such a proposal, but I must report to this Subcommittee my firm view that such an action would, on balance, increase costs to taxpayers and risk further disruptions in housing market.

Conclusion

Much uncertainty lies ahead for the future of our Nation's housing finance system, both in the direction that Congress will take and in the path outside the legislative arena. While a lengthy transition is probable, we are pleased that Congress is beginning to consider legislative approaches.

I would be happy to discuss any of these ideas with you and look forward to working with the Congress on any of the pending housing reform issues, including an ultimate resolution of the Enterprises. I recognize you have difficult and important decisions to make in the coming months and FHFA is glad to offer technical assistance in considering policy alternatives.

NAHB

National Association
of Home Builders

Testimony of Robert Nielsen

On Behalf of the

National Association of Home Builders

Before the

House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing on

"Immediate Steps to Protect Taxpayers from the Ongoing Bailout of Fannie Mae and Freddie Mac"

March 31, 2011

Introduction

Chairman Garrett, Ranking Member Waters and members of the Subcommittee on Capital Markets and Government Sponsored Enterprises, I am pleased to appear before you today on behalf of the National Association of Home Builders (NAHB) to share our views on the long-term future of the housing finance system and legislative proposals designed to reduce the role played by the government-sponsored enterprises (GSEs) in the U.S. mortgage market in the short term. We appreciate the invitation to appear before the Subcommittee on this important issue.

My name is Bob Nielsen and I am the 2011 NAHB Chairman of the Board and a home builder from Reno, Nevada. NAHB represents over 160,000 member firms involved in building single family and multifamily housing (including participants in the Low Income Housing Tax Credit program), remodeling, and other aspects of residential and light commercial construction. Each year, NAHB's builder members construct about 80 percent of all new housing in America.

Credit is the life's blood of the housing sector. A reliable and adequate flow of affordable funds is necessary in order to achieve the nation's housing and economic goals. Establishing a finance system that provides liquidity for the housing sector in all markets throughout the economic cycle is a prerequisite to achieving housing policy objectives. In fact, achieving affordability in credit for single and multifamily housing reduces the resources required to address the nation's housing needs. A stable, effective and efficient housing finance system is critical to the housing industry's important contribution to the nation's economic performance and to the achievement of America's social goals.

The housing finance system currently is under a cloud of uncertainty. The federal government, through the Federal Housing Administration (FHA) and Fannie Mae/Freddie Mac, is currently accounting for nearly all mortgage credit flowing to home buyers and rental properties. Even with the current heavy dose of federal support, fewer mortgage products are available and these loans are being underwritten on much more stringent terms. In addition, Congress and the regulators are piling on layers of regulations in an attempt to plug gaps in the system of mortgage regulation and to prevent a recurrence of the mortgage finance debacle that is still playing out.

This is not an arrangement that can continue indefinitely and there is no clear picture of the future shape of the conforming conventional mortgage market. One thing that is clear is that the status quo cannot be maintained. Policy discussions are underway on what should become of Fannie Mae and Freddie Mac following the current, still-indefinite conservatorship period, and what, if anything, should change in the structure and operation of the Federal Home Loan Banks (FHLBanks). A key consideration is how to get from the current structure to a future arrangement without undermining ongoing financial rescue efforts and disrupting the operation of the housing finance system.

NAHB has been actively involved in discussions on changes to the financing framework for home buyers and producers of rental housing. We presented our thoughts on the future of the housing finance system to this Committee nearly one year ago today. Since then Congress has passed the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* (Dodd-Frank Act). Regulators are now busy implementing this massive law that has the potential to reduce the availability and increase the cost of housing credit. The housing landscape has seen little change during this period as the housing market remains extremely weak and decisions about the future of the housing finance system are stuck in a quagmire, despite the Administration's recent report outlining options for *Reforming America's Housing Finance Market*.

NAHB strongly supports efforts to modernize the nation's housing finance system, including reforms to the government sponsored enterprises Fannie Mae and Freddie Mac. We cannot go back to the system that existed before the Great Recession, but it is critical that any reforms be well-conceived, orderly and phased in over time. Short-term proposals to reduce the support Fannie Mae and Freddie Mac provide for the housing finance system represent a piecemeal approach to reform that would disrupt the housing market and could push the nation back into a deep recession. These proposals, along with similar plans announced by the Obama Administration in February, show that many policy makers have clearly forgotten housing's importance to the economy.

America's home builders urge policymakers in the Administration and Congress to consider the potential consequences of their proposals. Don't move forward with policies that would further destabilize a housing market that is already struggling. Housing can be the engine of job growth this country needs, but it cannot fill that vital role if Congress and the Administration make damaging, ill-advised changes to the housing finance system at such a critical time.

NAHB's testimony today will expand on these thoughts within the context of current housing market conditions and other recent developments affecting the housing finance system.

<u>Housing Market Conditions</u>

The housing market has not experienced the same tentative growth path that the rest of the economy is experiencing. Overall economic growth has been weak by historic standards for an economic recovery, but housing's performance has been even weaker. Unlike a typical recovery where housing grows at 28 percent in the first year after the end of a recession, housing's growth has been a paltry 5 percent in the first year of the current recovery.

The first two months of 2011 have not provided any positive news for housing. February new home sales were the lowest on records going back to 1963. The 10 worst months on record for new home sales have been recorded in the last 10 months.

Housing construction has reflected the poor sales performances as total building permits in February 2011 were the lowest on records going back to 1960. February single family housing starts were only 4 percent above the lowest ever recorded.

House prices continue to fall in many locations as foreclosed and distressed sales continue to absorb what little demand there is. Oddly, low mortgage rates and very affordable house prices should be a stimulus to home buying, but the consumer remains uncertain about future government moves against housing. Mortgages are affordable, but credit standards and downpayment requirements are keeping many potential home buyers out of the market.

Proposals to Reform the Housing Finance System

In February, the Obama Administration released its report on *Reforming America's Housing Finance Market* (Report). As required by the Dodd-Frank Act, the Report provides recommendations for ending Fannie Mae and Freddie Mac's conservatorship and the proper role of the federal government in the nation's housing finance system. The report lays out a path toward transition that will significantly reduce the government's role in housing finance by winding down Fannie Mae and Freddie Mac and, over time, restoring the private sector's role in mortgage finance. The Administration stresses that the transition should be a careful and deliberative process that will take several years to implement.

During the transition, the Administration proposes a number of steps to reduce government support including lower loan limits, increased downpayment requirements and higher fees for conforming and FHA-insured mortgages. As Fannie and Freddie's role in the housing market is reduced, FHA's presence would be scaled back to its pre-crisis role as a targeted provider of credit access for low – and moderate income and first-time homebuyers. Program changes at FHA would ensure that the private market – not FHA - would pick up new market share as the Fannie/Freddie role is reduced. Reforms at the FHLBanks would include restricting member banks to only one FHLBank, capping the level of advances for any institution and reducing the FHLBanks' investment portfolios.

The Administration proposes three options for the long-term framework of the housing finance system, but does not endorse a specific option:

- Option 1 would establish a privatized system of housing finance with government support limited to assistance by FHA, USDA and VA for a narrowly targeted group of borrowers.
- Option 2 is a similar to Option 1, but would provide a federal government guarantee for private mortgages that would be triggered only during time of economic stress.
- Option 3 would permit the government to provide catastrophic federal re-insurance for the securities backed by a targeted range of mortgages that are already guaranteed by private insurers.

This past week, several members of this Subcommittee and the Financial Services Committee introduced bills that represent immediate steps that Congress could take to build a private-sector based housing finance system. These bills are briefly described below:

- **H.R. 31, The Fannie Mae and Freddie Mac Accountability and Transparency for Taxpayers Act:** The bill increases oversight over Fannie Mae and Freddie Mac by establishing an Inspector General within the Federal Housing Finance Agency (FHFA) to submit regular reports to Congress on GSE business activities.

- **The Equity in Government Compensation Act of 2011:** The bill suspends the current compensation packages for all employees of Fannie Mae and Freddie Mac and establishes a compensation system consistent with the Federal Government. The legislation further expresses the sense of the Congress that the 2010 pay packages given to Senior Executives at Fannie Mae and Freddie Mac were excessive and that the money should be returned to taxpayers.

- **The GSE Subsidy Elimination Act:** The bill would direct the FHFA to phase in a guarantee fee increase over two years to ensure that Fannie Mae and Freddie Mac price such guarantees as if they were held to the same capital standards as private financial institutions.

- **The GSE Risk and Activities Limitation Act:** The bill would prohibit Fannie Mae and Freddie Mac from offering, undertaking, transacting, conducting or engaging in any new business activities.

- **The GSE Debt Issuance Approval Act:** The bill would require the Department of Treasury to formally approve any new debt issuances by the GSEs.

- **GSE Credit Risk Equitable Treatment Act of 2011:** The bill clarifies that Fannie Mae and Freddie Mac will be held to the same standards as other secondary mortgage market participants. A GSE loan purchase or asset-backed security issuance would not affect the status of the underlying assets. If the GSEs purchase a loan that falls outside of the Qualified Residential Mortgage (QRM) definition or issue asset-backed securities backed by non-QRM assets, all lender risk-retention requirements would apply.

- **The GSE Mission Improvement Act:** The bill would permanently abolish Fannie Mae and Freddie Mac's affordable housing goals.

- **The Portfolio Risk Reduction Act:** The bill would accelerate and formalize the reduction in the size of the GSE's portfolios by setting annual limits on the maximum size of each retained portfolio and lowering the limits over five years until they have reached $250 billion.

NAHB Position on Housing Finance Reform

Key Principles

NAHB has had a strong and longstanding interest in the maintenance of an efficient secondary mortgage market and the role of the GSEs in facilitating the flow of capital to housing. NAHB, along with a number of other housing and financial trade associations, including some that are on this panel, have developed *Principles for Restoring Stability to the Nation's Housing Finance System*, which were released on March 28. We believe the following principles should help guide efforts to restore and repair the nation's housing finance system:

- A stable housing sector is essential for a robust economic recovery and long-term prosperity. Housing, whether through homeownership or rental, promotes social and economic benefits that warrant it being a national policy priority.

- Private capital must be the dominant source of mortgage credit, and it must also bear the primary risk in any future housing finance system.

- Some continuing and predictable government role is necessary to promote investor confidence and ensure liquidity and stability for homeownership and rental housing.

- Changes to the mortgage finance system must be done carefully and over a reasonable transition period to ensure that a reliable mortgage finance system is in place to function effectively in the years ahead.

We agree with the Administration that private investment capital is critical for a robust and healthy mortgage marketplace, and the current government-dominated mortgage system is neither sustainable nor desirable. As critical as it is to attract private money to the mortgage markets, an appropriate level of government support is essential to preserving financial stability. To facilitate long-term fixed-rate mortgages, affordable financing for low- and moderate-income borrowers, and financing affordable rental housing – particularly during times of crisis and illiquidity – it is important to establish a clearly defined role for the federal government in developing effective insurance and guarantee mechanisms. While the goal should be to move toward a largely private secondary market, the private and public sectors should work as partners in creating a variety of financing options to ensure that safe, stable, and affordable financing is available to all credit-worthy borrowers.

<u>NAHB Proposal for New Secondary Market System</u>

NAHB believes that it is crucial for the federal government to continue to provide a backstop for the housing finance system to ensure a reliable and adequate flow of affordable housing credit. The need for such support is underscored by the current state of the system, where Fannie Mae, Freddie Mac, the FHLBanks, FHA and Ginnie Mae are the only conduits for residential mortgage credit. NAHB feels the federal backstop must be a permanent fixture in order to ensure a consistent supply of mortgage liquidity as well as to allow rapid and effective responses to market dislocations and crises.

A workable system must be established to perform the basic roles served by Fannie Mae and Freddie Mac. These GSEs should not be converted to government agencies, nor should their functions be completely turned over to the private market. Last year NAHB presented this Committee a proposal recommending major changes in the structure and operations of the secondary mortgage market. The operation of the new secondary market for conforming conventional mortgages is illustrated in the diagram attached to this statement.

NAHB's proposal is similar to the Administration's third option for the long term structure of the housing finance system. Key features of NAHB's proposal are summarized below.

- Private entities, called conforming mortgage conduits, would purchase and securitize mortgages but would receive no direct or implicit federal government support.
- The federal government would guarantee the timely payment of principal and interest of the mortgage-backed securities issued by the conforming mortgage conduits.
- Conforming mortgage conduits would have significant capital requirements (minimum and risk-based requirements) and also would be required to contribute to a fund to cover losses on the mortgages they pool and sell.
- Therefore, the federal government would incur only catastrophic risk beyond the risk covered by securitizers' capital and fund.
- Primary mission of conforming mortgage conduits would be to provide mortgage market liquidity through securitization activities.
- These conduits would be permitted to maintain limited portfolios to facilitate transactions as well as to hold loans that do not have a secondary market outlet.
- Conforming mortgage conduit activities should be directed at a broad range of housing market needs to enable Americans at all income levels to achieve decent, safe and affordable housing. (No specifics on affordable housing requirements.)
- Conforming mortgage conduits would deal in mortgages with well understood and reasonable risk characteristics (including standard 30-year fixed rate loans, ARMs and multifamily mortgages).

Impact on the Federal Home Loan Bank System

Discussion of housing finance system reform has focused almost exclusively on the future of Fannie Mae and Freddie Mac. While this is understandable given the magnitude of problems facing those companies, their open-ended line of support from the U.S. Treasury, and their ongoing operation under conservatorship, attention must also be accorded to the FHLBank System.

NAHB also views the FHLBank System as an essential component of the U.S. housing finance framework that has served as a key source of liquidity for institutions providing loans to home buyers and home builders as well as credit for community and economic development. The FHLBanks are significantly different from Fannie Mae and Freddie Mac in structure and operations and these differences should be acknowledged and respected during the consideration of the future structure of the housing finance system.

NAHB urges policymakers to undertake any changes to the housing finance system in a manner that will not diminish the favorable cost of funds for the FHLBanks or impair the role of the FHLBanks in supplying liquidity to institutions providing mortgage and housing production credit, support for community and economic development, and resources to address affordable housing needs. The FHLBanks should continue their current activities to serve as an ongoing key liquidity source for institutions providing housing credit.

Transition Considerations

The housing sector is struggling to regain its footing and begin contributing to a recovery in economic output and jobs. The current environment is rife with instability and uncertainty. Many markets throughout the country, however, have returned to a position where consumers are shopping for new homes and housing production can begin to move back to more normal levels.

It is critical that the housing finance system facilitate this emerging recovery rather than stifle it. Under these circumstances, finding a means of moving to a new secondary market framework may be as great, or greater, a challenge as developing the new conforming conventional secondary market structure. NAHB urges Congress to carefully consider and address the short-term, unintended consequences that could occur during the transition to a new housing finance system.

Any changes should be undertaken with extreme care and with sufficient time to ensure that U.S. home buyers and renters are not placed in harm's way and that the mortgage funding and delivery system operates efficiently and effectively as the old system is abandoned and a new system is put in place. Every effort should be made to reassure borrowers and markets that credit will continue to flow to creditworthy borrowers and that mortgage investors will not experience adverse consequences as a result of changes in process.

It that light, NAHB does not believe the piecemeal approach represented by the eight bills introduced by members of this Subcommittee and the Financial Services Committee aimed at reducing the activities of Fannie Mae and Freddie Mac is appropriate. Such action would surely cause further damage to fragile housing markets and impede economic recovery. NAHB strongly supports housing finance system reform but believes the changes should be comprehensive, coordinated and undertaken in a careful and deliberate manner that does not unnecessarily disrupt a struggling housing recovery. Furthermore NAHB does not agree that the future housing finance system should be left completely to the private sector. The historical track record clearly shows that the private sector is not capable of providing a consistent and adequate supply of housing credit without a government backstop. Therefore, NAHB believes it is premature to begin dismantling the current housing finance system until there is a clear vision for a workable future system and a carefully designed path for a non-disruptive transition to the new framework.

Impact on 30-year Fixed Rate Mortgage

NAHB believes that any new housing finance system must support the continued availability of the 30-year, fixed-rate mortgage (FRM). Borne out of the Great Depression, the 30-year FRM has played a pivotal role in helping to increase the national homeownership rate so that today two out of three Americans own a home of their own.

It has become an industry standard for several reasons:

- **Affordability.** These loans are geared toward affordability; 30-year terms lock in low monthly payments, allowing households with average incomes to comfortably budget for their home loan.

- **Inflation protection.** Knowing their monthly housing costs will remain the same year in and year out regardless of whether interest rates rise provides households with a sense of financial security and also acts as a hedge against inflation.

- **Long-term planning.** Many young buyers know that as their incomes rise, their housing costs will stay constant and become less of a burden, enabling them to prepare for other long-term obligations, such as college tuitions and retirement savings.

- **Tax advantages.** In most instances, all of the interest and property taxes borrowers pay in a given year can be fully deducted from their gross income to reduce taxable income. These deductions can result in thousands of dollars of tax savings, especially in the early years of a 30-year mortgage when interest makes up most of the payment.

The key to the sustainability of the 30-year FRM is a securitization outlet because originators (banks and thrifts) do not have the capacity to hold such long-term assets which are funded with short-term deposits. Fannie Mae and Freddie Mac provided the securities vehicle along with an implicit government guarantee for investors. It is not clear whether a private housing finance system would be capable of supporting this type of product without some government backing. At a minimum, the cost of 30-year FRMs would increase under a private system.

The Administration's Report analyzes the impact of its three options on the cost and availability of the 30-year FRM to assess the impact of each option on the housing finance market. Option 1 would likely eliminate the 30-year FRM for non-FHA mortgages. Under Option 2, the 30-year FRM could be preserved, but would be very expensive. The 30-year FRM would be most likely to survive under Option 3, but it would be more expensive than at present.

As the private market transitions to assume a greater role, a strong federal backstop is necessary to maintain a stable and adequate supply of credit for home buyers and ensure that the 30-year FRM remains readily available to first-time home buyers and working American families. Otherwise private financial institutions will turn the 30-year mortgage into a luxury product, with high interest rates, fees and downpayments that would price millions of middle-class households out of the market.

Multifamily Financing

The focus of the discussion on the future of housing finance reform largely has been on single family homeownership. Less attention has been paid to the multifamily rental housing segment of the housing finance system, even though almost one-third of Americans live in rental housing, and demand for rental housing in the future is expected to increase.

In particular, NAHB estimates that the aging of the "echo boom" generation will result in demand for between 300,000 and 400,000 multifamily housing units on average per year over the next ten years. The timing of this demand will depend on the pace of economic recovery, but the housing needs of these households will not be postponed indefinitely. The current average pace of multifamily housing starts of less than 120,000 annually is insufficient to meet this demand. Production of multifamily housing will undoubtedly increase above the current extraordinary low levels. It is important that the financing mechanisms to support that production are available.

In spite of the crisis affecting single family housing, the multifamily sector has performed well. Multifamily loans held or guaranteed by Fannie Mae and Freddie Mac have very low default rates, and both businesses are profitable. In addition, the multifamily business of the GSEs finances a wide range of multifamily rental properties, which provide housing for very-low to middle income households. The FHA multifamily mortgage insurance programs also fill a need in the multifamily rental market, although its loan volume capacity is limited.

Private market sources of capital for multifamily financing are not available for all segments of the multifamily market. Life insurance companies tend to focus on large projects in the strongest markets and typically serve the highest income households. Once they meet their own portfolio investment targets, life insurance companies retract their lending. Banks do not provide long-term financing and are subject to significant restrictions in terms of capital requirements. While the commercial mortgage backed securities (CMBS) market was significant at one time, it has not recovered from the financial crisis and is not expected to resume its past levels of volume.

These facts point to the need to maintain a viable, liquid and efficient secondary market for multifamily rental financing where the federal government continues to play a role. In addition, the secondary market must be structured to ensure that the appropriate range of products is available to provide the capital needed to develop new and preserve existing rental housing, as well as to refinance and acquire properties. An adequate flow of capital will ensure that demand for rental housing is met and that affordable options are available for a range of households.

As we suggest for the single family market, on the multifamily side, the federal government should provide an explicit guarantee of the timely payment of principal and interest on securities backed by conforming conventional mortgages, in the same manner that Ginnie Mae now provides guarantees for investors in securities representing interests in government-backed mortgages. Again, the federal government should only be called on to support the conforming conventional mortgage market under catastrophic situations when the capital and self-funded insurance resources of private secondary market entities are exhausted.

However, multifamily loans do not lend themselves to standardization as easily as single family loans, which points to the need to retain the ability to hold some volume of multifamily loans in portfolio.

NAHB Concerns with the Administration's Proposal for Multifamily Financing

The administration's report emphasizes that Americans must have access to a range of affordable housing options, whether they own or rent. The report notes that renters face significant affordability challenges and says that the housing finance system must promote liquidity and capital to support affordable rental options that alleviate high rent burdens on low-income households.

The report states that, in the near term, the administration will begin to strengthen and expand FHA's capacity to support both lending to the multifamily market and for affordable properties that are underserved by the private market. Options include risk-sharing with private lenders and development of programs dedicated to hard-to-reach segments, such as small rental properties. However, NAHB believes that the current structure, staffing levels and resources available to the FHA may not be sufficient to take on such additional responsibilities, nor does FHA have the institutional flexibility to respond to the range of market needs quickly and efficiently. If the role of FHA is to change, much more discussion is needed in this regard.

Of particular importance, the report states that the administration is committed to finding more effective ways to provide financing for small rental properties, underserved markets and rural areas. NAHB is pleased that this proposal is included in the report, as financing for such properties continues to be a challenge.

However, NAHB is concerned that less thought has been given to a future financing system that will meet the needs of moderate and middle income renters. The administration acknowledges that Fannie Mae and Freddie Mac have developed expertise in providing financing to the middle of the rental market, where housing is generally affordable to moderate income families. But the administration does not suggest any alternatives to this model, nor does it set forth a viable transition plan as Fannie Mae and Freddie Mac are wound down. NAHB believes that it is critical to find ways to maintain funding to this segment of the market, and more thought needs to be devoted to solving this aspect of the housing finance system.

Also of concern to NAHB is the continued heavy reliance on non-profit partnerships to address the needs of low- and moderate-income renters. Unfortunately, there has been a long-standing bias favoring non-profits for expertise on these issues. This has been true in this and other administrations. NAHB believes the criteria in selecting program participants should be based on their competence and capacity for producing housing in the most cost-effective way. For-profit businesses are successful, and the government should look to partner with for-profit businesses when appropriate.

Recent Regulatory Developments – QRM

Of great concern to NAHB at present are the credit risk retention rules required by Section 941 of the Dodd-Frank Act, which were unveiled this week by the six agencies charged with implementing that section of the law. NAHB believes the proposed rules contain an unduly narrow definition of the important term "Qualified Residential Mortgage" (QRM), featuring a minimum downpayment of 20 percent, which would seriously disrupt the housing market by making mortgages unavailable or unnecessarily expensive for many creditworthy borrowers. By stipulating such a large downpayment for a loan to be considered a QRM, the Administration and federal agencies are preempting congressional efforts to reform the housing finance system by imposing a narrow and rigid gateway to the secondary mortgage market.

This extreme proposal could not have been put forward at a less opportune time. The housing market is still weak, with a significant overhang of unsold homes, and an equally large shadow inventory of distressed loans. A move to a larger downpayment standard at this juncture would cause renewed stress and uncertainty for borrowers who are seeking or are on the threshold of seeking affordable, sustainable homeownership. We believe a more balanced QRM exemption is imperative in light of the enormous potential impact it would have on the cost and availability of mortgage credit at this precarious point in the housing cycle.

Risk retention is intended to align the interests of borrowers, lenders and investors in the long-term performance of loans. This "skin in the game" requirement, however, is not a cost-free policy option. Borrowers who can't afford to put 20 percent down on a home and who are unable to obtain FHA financing will be expected to pay a premium of two percentage points for a loan in the private market to offset the increased risk to lenders, according to NAHB economists. This would disqualify about 5 million potential home buyers, resulting in 250,000 fewer home sales and 50,000 fewer new homes being built per year. Such a drastic cutback would have a disproportionate impact on minorities and low-income families who are struggling to achieve the dream of homeownership.

The exclusion of FHA and VA and, at least temporarily, Fannie Mae and Freddie Mac from the risk retention requirement provides some short-term cushion to the impact of the proposal but that relief would be short-lived and is eroded by the tighter underwriting and higher costs already imposed by those agencies. Further exacerbating the situation, the Obama Administration has announced its intention to shrink FHA's share of the marketplace, lower FHA and conventional conforming loan limits and further increase fees on FHA, Fannie Mae and Freddie Mac home loans. These changes, combined with the effects of an overly restrictive QRM, would make it even more difficult for buyers to access affordable housing credit.

It appears to NAHB that the agencies did not give sufficient weight to statutorily required considerations in formulating their QRM proposal, which directed that the definition be based on objective, empirical data rather than subjective presumptions. The statute also requires a multifactor approach to establishing the parameters of the QRM in order to promote sound underwriting practices without arbitrarily restricting the availability of credit. The agencies have admitted that they deliberately selected an extremely conservative approach to create a very limited QRM basket.

Creating an inordinately narrow QRM exemption would cause significant disturbances in the fragile housing market. Today's credit standards are tougher than they have been in decades. As a result, credit availability is extremely tight even for very well qualified borrowers. NAHB strongly urged the banking regulators to consider the negative ramifications of setting further limits on the availability of credit through a comparatively narrower QRM exemption. Under the proposed standard, millions of creditworthy borrowers would be deemed, <u>by regulatory action</u>, to be higher risk borrowers. As a result, they would be eligible only for mortgages with higher interest rates and fees and without the protections required by the statutory QRM framework that limit risky loan features.

An overly restrictive QRM definition also would drive numerous current lenders from the residential mortgage market, including thousands of community banks, and enable only a few of the largest lenders to originate and securitize home loans. This sharp dilution of mortgage market competition would have a further adverse impact on mortgage credit cost and availability.

A QRM definition that is too narrow would prohibit many potential first-time homebuyers from buying a home especially if the definition includes an excessively high minimum down payment requirement. Repeat buyers and refinancers also would be adversely impacted if the QRM includes exceedingly high equity requirements. In other words, the important goal of clearing historically high foreclosure inventory – a necessary condition for a stabilized housing market – will be undermined.

The purpose of the QRM is to create a robust underwriting framework that provides strong incentives for responsible lending and borrowing. Loans meeting these standards will assure investors that the loans backing the securities meet strong standards proven to reduce default experience. The exemption also will keep rates and fees lower on QRMs, which will provide incentives for borrowers to document their income and choose lower risk products. In turn, the market will evolve to establish the appropriate mixture of QRM to non-QRM borrowing.

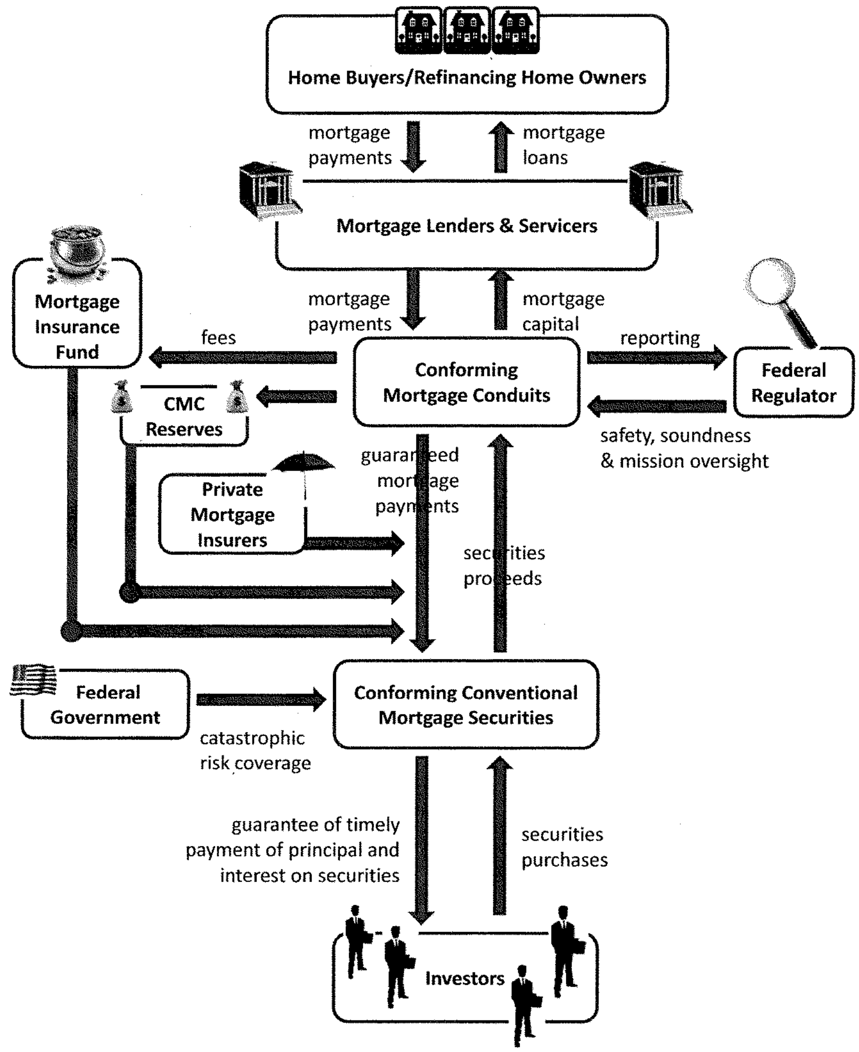
The majority of industry participants (lenders, home builders, realtors, mortgage insurers) and the sponsors of the QRM language in Dodd-Frank support a broad QRM definition that would encompass the bulk of residential mortgages that meet the lower risk standards of full documentation, reasonable debt-to-income ratios and restrictions on risky loan features. In addition, most believe that loans with lower down payments that have risk mitigating features, most notably mortgage insurance, should be included in the QRM exemption.

NAHB recommends the broadest criteria possible should be utilized in defining a QRM exemption that will ensure safe and sound operation of the mortgage market while accommodating a wide range of viable mortgage borrowers.

<u>Conclusion</u>

Thank you for the opportunity to participate in this important and timely hearing. NAHB looks forward to working with all stakeholders to develop an effective as well as safe and sound means to provide a reliable flow of housing credit under all economic and financial market conditions.

Conforming Conventional Mortgage Secondary Market



e21 Economic Policies for the 21st Century

Statement by Christopher Papagianis

Managing Director & Policy Director e21: Economic Policies for the 21st Century

Before the Subcommittee on Capital Markets and Government Sponsored Enterprises

"Legislative Hearing on Immediate Steps to Protect Taxpayers

from the Ongoing Bailout of Fannie Mae and Freddie Mac"

March 31, 2011

Christopher Papagianis is Managing Director and Policy Director at e21: Economic Policies for the 21st Century. e21 (also known as Economics21) is a nonprofit, nonpartisan organization dedicated to economic research and innovative public policy development. Mr. Papagianis was previously Special Assistant for Domestic Policy to President George W. Bush. In this role, he guided the collaborative process within the Executive Branch to develop and implement policies, legislation, and regulations across numerous agencies, including the Departments of Treasury and Housing and Urban Development. He briefed the President primarily on housing and finance issues. Prior to joining the administration, Mr. Papagianis worked in the U.S. Senate as one of the top policy advisers to Senator Jim Talent. Mr. Papagianis helped the Senator develop housing and public finance policy. Before serving in the U.S. government, Mr. Papagianis was awarded the prestigious Peabody Fellowship by Harvard University to pursue research related to public policy issues. Mr. Papagianis is a graduate of Harvard College.

Chairman Garrett, Ranking Member Waters, and Members of the Committee, thank you for the opportunity to testify on the important topic: "Immediate Steps to Protect Taxpayers from the Ongoing Bailout of Fannie Mae and Freddie Mac." I am the Managing Director of the non-profit think tank e21: Economic Policies for the 21st Century (a.k.a Economics21). We aim to advance free enterprise, fiscal discipline, economic growth, and the rule of law. Drawing on the expertise of practitioners, policymakers, and academics, our mission is to help foster a spirited debate about the way forward for democratic capitalism. We are supportive of free markets while recognizing the need to devise and implement a reasonable structure of law and regulation that will help ensure our markets avoid catastrophic events in the future. We are therefore focused on developing policies that advance market performance and implementing rules to prevent market malfunction.

Previously, I was Special Assistant for Domestic Policy to President George W. Bush. In this role, I helped guide the collaborative process within the Executive Branch to develop and implement policies, legislation, and regulations across numerous agencies, including the Departments of Treasury and Housing and Urban Development.

Fannie Mae and Freddie Mac have been in conservatorship now for the past 30 months. Over this period, numerous proposals have been offered for how to reform, or re-envision, the government-sponsored enterprises (GSEs).[1] Given how dominant Fannie and Freddie are in terms of market share today, reform of these institutions will have a significant impact on the future of the $11 trillion market for residential mortgage finance.[2] In short, the stakes are quite high – and I agree with this committee's approach in assessing long-term solutions while at the same time considering reforms that can be advanced in the short-term to protect taxpayers.

Importantly, some of the proposals before this committee, if enacted, would accomplish two distinct things. They would protect taxpayers in the near-term and the implementation experience would provide invaluable lessons and data that could inform the broader debate about the future of housing finance in this country.

Before commenting on the individual proposals, I want to describe briefly what I think is the key analytical challenge before this committee – namely, that the most egregious excesses of the previous GSE model are not necessarily the primary sources of taxpayer losses (so far). The key take-away from this, I believe, is that there is still a lot of taxpayer risk in the GSE system. This means that near-term reform proposals can have important benefits even if they do not get at the root cause of most of the GSE losses over the past few years.

For example, the first instinct of many reformers would be to ensure that the GSEs (or their successors) are never again allowed to amass big mortgage portfolios. The second instinct

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[1] A white paper released last month by the Treasury Department outlined three options.
[2] Federal Reserve data: http://www.federalreserve.gov/releases/z1/current/z1r-4.pdf

would probably be to strictly limit the mortgages that would qualify for purchase (or guarantee) by the GSEs.

Both of these reforms make sense – and should be pursued today. At the same time, addressing just these two issues now would not "fix" the problem with the GSEs or make the GSE model sustainable in the long-term. Of the GSEs' combined $226 billion in losses, over $166 billion (73%) are from the guarantee business.[3] The investment portfolio accounts for just $21 billion (9%) of the losses. Had the investment portfolios been eliminated, in say 2005 as proposed by some in Congress, the GSEs would have still suffered losses from guaranteed mortgages that would have wiped out their capital base several times over.

But, in seeing that over 70% of the losses came from mortgage guarantees, one might reasonably ask why wouldn't better limits on the types of mortgages that are accepted be the right way to go to protect future taxpayers? Again, I want to be clear that advancing this sort of limitation now would make for a sound near-term reform to protect taxpayers. But, just like with the mortgage portfolios, it's also important to acknowledge that restricting the types of mortgages that are accepted will not address the fundamental flaw (or question) in the GSE model: how exactly to accurately price the insurance – or what amounts to the cost of providing a government guarantee?

Put another way – for many, the challenge ahead appears to be designing a strategy to maintain a government guarantee for mortgage credit risk while attenuating some of the more egregious elements of the old GSE model. The problem with operating under this framework is that it was the mispricing that arose from the government guarantee that really turned out to be the big source of taxpayer losses. The argument for *only* limiting the types of mortgages that qualify presumes that the government or its agencies can accurately price the baseline credit risk and were just unable to price the incremental risk posed by lower FICO scores, higher loan-to-value ratios, or nontraditional payment features. In reality, pricing the baseline credit risk is every bit as difficult as pricing the relative increase in risk posed by nontraditional features.

It's for this reason that the most promising path for Congress appears to be putting the GSEs into receivership with the goal of liquidating their operations over a 5 to 7 year period. Any shortfalls would continue be covered by taxpayers so no creditor loses anything in a wind-down or is tempted to sell their securities. In the future, Congress would keep Federal Housing Administration (FHA) mortgages available for borrowers under certain income and mortgage loan thresholds and leave the rest of the market to the private sector.

The likely result would be higher mortgage costs generally, as the old (mispriced) government guarantees would be paid for by mortgage borrowers (upfront) instead of by taxpayers (over the

[3] Federal Housing Finance Agency. Conservator's Report on the Enterprises' Financial Performance. Second Quarter 2010. http://www.fhfa.gov/webfiles/16591/ConservatorsRpt82610.pdf

long-term). But, as the Treasury department commented in their recent white paper: "mortgage rates are likely to rise somewhat under any responsible reform proposal."[4] If Congress wants to offset some of this cost increase, it has options[5] – it could explore ways to explicitly subsidize low-income borrowers through on-budget housing programs or through mechanisms like interest rate swaps.[6]

Mortgage Portfolios

Both GSEs issued debt with an implicit guarantee to build massive portfolios of the same mortgage-backed securities (MBS) they issued. Once a pool of mortgages was converted into GSE-guaranteed MBS notes, there was no need for them to then issue additional debt to repurchase the guaranteed MBS.

As argued by former Federal Reserve Chairman Greenspan and others, these portfolios served "no credible purpose"[7] aside from serving as a profit center for GSE shareholders and management. The profits came from the huge gap between the yields on mortgages and the interest rate Fannie and Freddie paid on their own borrowings, which was just slightly greater than Treasury rates thanks to government sponsorship (and the implicit guarantee of GSE debt).

The large investment portfolios made only modest contributions (at best) to reducing mortgage rates and improving liquidity. They did, however, create massive risks. For every $100 of mortgages added to the portfolio, the GSEs committed just $3 of equity capital, borrowing the remainder. Even this $3 per share was overstated because the GSEs could count deferred tax assets and "temporary" reductions in the market value of securities as capital. The risk was that a sudden increase in interest rates[8] could wipe out the GSEs' notional capital, or a sudden fall in interest rates could set off a wave of refinancing, causing the interest income on the new

[4] Reforming America's Housing Finance Market: A Report to Congress. February 2011. http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf
[5] Papagianis, Christopher. Testimony before the House Financial Services Committee. September 29, 2010. http://financialservices.house.gov/Media/file/hearings/111/Papagianisl092910.pdf
[6] Calomiris, Charles. Columbia University, Graduate School of Business. A Three Part Program for Housing Finance Reform. October 12, 2010. http://shadowfed.org/wp-content/uploads/2010/10/Calomiris-A-Three-Part-Program-for-Housing-Finance-Reform.pdf
Date, Raj. Cambridge Winter Center. A Framework for Evaluating Housing Finance Alternatives. August 18, 2010. http://cambridgewinter.org/Cambridge_Winter/Archives/Entries/2010/8/18_GSE_DECISION_TREE.html
[7] Greenspan, Alan. Federal Reserve Chairman. Remarks to the Conference on Housing, Mortgage Finance, and the Macroeconomy. May 19, 2005. http://www.federalreserve.gov/boarddocs/speeches/2005/20050519/
[8] Papagianis, Christopher. Economics21. The GSE Black Hole. November 19, 2009. http://www.economics21.org/commentary/gse-black-hole

mortgages to fall below the cost of existing borrowings. In short, the GSEs had far too little high-quality capital to serve as a buffer in front of taxpayers.

The future of housing finance in this country should not involve the GSEs (or their successors) building up big portfolios. Removing portfolios from the current equation would leave the GSEs buying and guaranteeing mortgages, converting the mortgage payments to guaranteed cash flows from MBS notes, and standardizing MBS notes to enhance investor acceptance and market liquidity.

In this world, the investors in GSEs (or the government) would capture the guarantee fees on the mortgages and pass through the rest of the mortgage payments to investors in the MBS. Under Section 1109 of the Housing and Economic Recovery Act of 2008 (HERA), the GSEs are set to reduce their mortgage portfolios by 10% a year until they reach $250 billion. At that point, no further reduction in the maximum limit is currently required.

The combined value of the portfolios today is ~$1.5 trillion. Through the 1990s, the portfolios as a share of the total number of U.S. mortgages outstanding stayed below a 6% market share. By 2000, they reached a market share of approximately 19%, but then fell back down to a 12% share by 2009.[9] These numbers are useful because they reveal just how dominant market investors and commercial banks are in terms of *holding* U.S. mortgage assets (88%). Therefore, it should not be difficult for market investors and banks to take-up the market share of the GSEs if they are directed to accelerate sales from their portfolios.

It's important to remember that basically all mortgage investments originate in the capital markets. They can be funded through deposits, GSE retained portfolios, private MBS investments, or covered bonds. In general, when one access point is limited, growth in another channel can usually provide the offset. Professor Dwight Jaffee of the University of California at Berkley has made this point before. He has also noted that as the "GSE retained mortgage portfolios run off, so will the debt that funded these portfolios...[and] the investors in this debt are thus one example of a set of investors who could replace the GSEs as mortgage holders."

<u>Limiting New Activities and Mortgage-types</u>

New limits should be implemented on the mortgages that would qualify for purchase (or guarantee) by the GSEs. This seems to be precisely what the Obama Administration has in mind, as the maximum mortgage that would qualify for purchase would be $625,000, down from the largely non-binding current cap of $729,000.[10] Since the government provides a subsidy when it

[9] Jaffee, Dwight. University of California, Berkley. Reforming the U.S. Mortgage Market Through Private Market Incentives. January 31, 2011. faculty.haas.berkeley.edu/jaffee/Papers/JaffeeMortgageReform.pdf
[10] In the Treasury Department's white paper, the Administration expressed that it would like to see Congress let the law (HERA) that temporarily increased the loan limits to expire, as it's scheduled to do on October 1, 2011.

allows a mortgage to have a guarantee, the question is whether this subsidy with its attendant cost should be provided to people buying homes with $700,000+ mortgages?

In addition, the GSEs should be blocked from engaging in any new activity or business that would further risk taxpayer dollars. This should include restrictions on the types of assets they can buy or guarantee, as well as strict limits on plans that would commit taxpayer dollars to try and prevent, or delay, foreclosures. On this later point, FHFA should have to present any new plans to Congress so that it can make its own determination, especially in instances where actions may help some homeowners at the expense of others. It would also be useful if the FHFA would present Congress and its scorekeepers with more data to estimate the effectiveness of mortgage modification programs. Currently, many modification programs are scored as reducing ultimate taxpayer losses from delinquent mortgages in spite of evidence that re-default rates are 58% after twelve months in the case of loans modified in the third quarter of 2009.[11]

The affordable housing goals for Fannie and Freddie should also be eliminated. There are other avenues through which support for affordable housing activities can be carried out, including through the Department of Housing and Urban Development and the Federal Housing Administration. One of the lessons from the crisis is that public subsidies for affordable housing or higher risk lending should be subject to the regular checks-and-balances of Congressional oversight and appropriations.

Guarantee Fee Pricing (G-Fee)

The reforms highlighted above would have made for a solid GSE reform agenda back in 2005. The data and lessons from 2006 until conservatorship demonstrate that more needs to be done now to protect taxpayers (both in the near term and long term) – and that takes us to the fundamental issue of how to price the insurance or what's known as the mortgage guarantee.

The conforming mortgage limit was $417,000 when the GSEs rapidly expanded acquisitions of subprime and Alt-A mortgages in 2005-2007. The average mortgage purchased by the GSEs is still about $217,000.[12] While it makes sense to limit government involvement to more modest mortgages moving forward, the loan limit issue is less about protecting taxpayers and more about ensuring that ongoing subsidies are properly targeted (and aren't captured by affluent borrowers).

Perhaps the best way to understand the pricing problem is to review the credit risk of some of the highest quality mortgages guaranteed by the GSEs (where quality is based on FICO,

[11] Fannie Mae 2010 Credit Supplement. January 24, 2011. See slide 16: http://www.fanniemae.com/media/pdf/newsreleases/q42010_credit_summary.pdf
[12] Fannie Mae Earnings Report. 3rd Quarter 2010. See page 84: http://www.fanniemae.com/ir/pdf/earnings/2010/q32010.pdf

downpayment, and other measures of a borrower's ability to pay). To unpack the data, a good place to start is Fannie Mae's monthly funding summary from December 2010.[13] It shows that 4.5% of all loans were 90 days past due. Based on the 2010-Q3 credit supplement,[14] 28.2% of all loans had some non-traditional feature and these loans had an 11% delinquency rate. This means that the 71.8% of traditional prime, 30-year fixed rate mortgages must have a serious delinquency rate of 1.95%.[15]

While this seems low, consider that the GSEs charge only 20 basis points per year to guarantee these mortgages. But a foreclosure typically results in a 30% loss, including the decline in property value, which means that credit losses on the highest quality mortgages will be about 58 basis points, or three times as much as the fee charged to guarantee them. (It is important to remember that today's delinquency rate is down by one-fifth from the peak of 5.6% recorded in 2010, so losses during the worst months of the crisis would have exceeded GSE income by an even larger magnitude.) Finally, this calculation is very conservative, as losses on prime interest-only loans and prime loans with an LTV greater than 90 with mortgage insurance and on all subprime and Alt-A loans are excluded.

How much would the government entity have to charge to cover these costs? Perhaps about 75 basis points to 1 percentage point -- once overhead costs and risk premiums are included, or more than three-times the rates it normally charges. But, this is only an estimate. The scope of the problem is not just figuring out how much to charge in addition to this 0.75% to 1% to cover nontraditional features. Rather, the purpose of this analysis is to reveal just how difficult (if not impossible) it is for a government enterprise to price just the base-line credit risk.

An important intermediate step would be to require an increase in the guarantee fees as if Fannie and Freddie were held to the same capital standards as private banks or financial institutions. This principle was articulated by the Administration in their white paper.[16] Advancing legislation that codifies some of the consensus ideas like this one will send important signals to the market. For example, it will reduce any uncertainty around intent and administrative implementation. Under previous rules, the GSEs were only required to hold 45

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[13] Fannie Mae Monthly Summary. December 2010.
http://www.fanniemae.com/ir/pdf/monthly/2010/123110.pdf

[14] Fannie Mae 3rd Quarter Credit Supplement. November 5, 2010.
http://www.fanniemae.com/ir/pdf/sec/2010/q3credit_summary.pdf

[15] $.045 = (.282*.11+.718*X)$

[16] "We support ending the unfair capital advantages that Fannie Mae and Freddie Mac previously enjoyed and recommend FHFA require that they price their guarantees as if they were held to the same capital standards as private banks or financial institutions. This will mean that the price of the guarantee offered by Fannie Mae and Freddie Mac explicitly reflects its risk, and will help the private market compete on a level playing field, reducing Fannie Mae and Freddie Mac's market share over time. Although the pace of these price changes will depend significantly on market conditions, such changes should be phased in over the next several years." Reforming America's Housing Finance Market: A Report to Congress. February 2011.

basis points in capital against their guarantees. If Fannie and Freddie were instead required to hold their guaranteed MBS at fair value and hold 5% minimum capital against their entire book of business, the GSEs' financial resources would probably be equal to their guarantees. As with many of the near-term ideas covered in this testimony, it makes sense for Congress to advance legislation on this issue as it tries to restore some of the checks-and-balances with the Administration and regulators.

GSE Debt Issuance

The charters for Fannie and Freddie require that the Treasury secretary approve all their plans to issue new debt. For decades this practice was carried out in a manner that was consistent with the letter of the law: the GSEs submitted reports on each new debt issuance plan for prior approval by the department. But, this process was deemed too burdensome during the Clinton Administration and the process was shelved despite the fact that it weakened Treasury's oversight.

As Emil Henry, former Assistant Secretary of the Treasury, has commented:

> By the mid-2000s, the GSEs' process of debt approval had devolved to a simple notification of the Treasury, without any formal process of approval. The pace of debt issuance was so rapid that such notifications came to the Treasury weekly, typically on one piece of paper that simply listed proposed issuances without supporting data (such as income statements or balance sheets) upon which to make informed judgments.[17]

Congress should make clear that it wants a more robust process to review GSE debt issuance. The authority to do so already exists; and it should be used by the Treasury. The GSEs (working with FHFA) should provide Treasury with a full justification for debt issuances, including all relevant financial data. Re-instating this process would also open up another path for winding down the GSEs, should either the Administration or Congress decide it wants to move forward. By resuming its authority to sign-off on debt issuance, the Treasury department could one day decide to start limiting GSE debt issuances. New restrictions could be calibrated with private market activity to ensure that mortgage market liquidity is maintained.

Risk Retention Policy

Under Dodd-Frank, federal regulators must define what a "qualified residential mortgage" is and then require lenders to retain 5% of the credit risk on any mortgages that don't meet the QRM directive.

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[17] Henry, Emil. How to Shut Down Fannie and Freddie. The Wall Street Journal. November 11, 2010. http://online.wsj.com/article/SB10001424052748704635704575604570042260954.html

The federal regulators released their proposal this week. While the rule isn't final and public comments still need to filed and reviewed, this draft did propose exempting the GSEs (or deeming their mortgages as "qualified"). This is a very important decision and one that Congress should consider carefully.

First, let's put aside whether a new risk retention provision was necessary or wise.[18] Exempting the GSEs from the QRM rule could serve to maintain (if not expand) their dominance relative to the private market. It will be difficult for a private market to develop if government-sponsored mortgage products are exempt from a provision that directly impacts mortgage costs and prices. The development of a private market for non-QRM mortgages will also be hindered because the origination channel will orient itself towards mortgages that qualify for GSE purchase as had been the case in the past.

The draft rule also proposes that qualified mortgages have a 20% downpayment. Coupled with an exemption for the GSEs, this means that private lenders could end up originating low downpayment loans only to try and sell them to the GSEs.[19] In plain economic terms, this is adverse selection – and it is taxpayers who will once again be exposed through GSE purchases and guarantees to riskier loans that have lower downpayments. If low downpayment loans are too risky to allow private lenders to originate and distribute (without any risk retention), it is appropriate for Congress to question whether they are not also too risky for government-backed entities.

During the debate around the Dodd-Frank law, and specifically the QRM section, Members considered the question of how to treat all the government agencies that either guarantee or insure mortgages. The final language of Dodd-Frank, as it was enacted, specifically did not exempt the GSEs (as it did FHA and the other explicitly guaranteed government mortgage operations). If the regulators believe a GSE exemption is now good policy, Congress should consider weighing in through new legislation. Exempting the GSEs would mean that more than 90% of today's housing market is carved out.

The current situation (post-crisis) presents an opportunity to provide a coherent strategy for moving to a new housing finance system. Instead of embracing this moment, the QRM proposal – as it currently stands – could provide an entirely new competitive advantage for the GSEs and make the risks of dislocation to moving to an entirely new system even greater.

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[18] Many would argue that there had been too much risk retention (in mortgage-related assets) at the big banks before the crisis – and that this concentrated (and leveraged) exposure was why many banks needed to be bailed out.

[19] The GSEs can purchase loans with less than a 20% downpayment, as long as some form of credit enhancement is included.

FHFA Inspector General and GSE Employee Compensation

The last two proposals before the committee concern the authority or powers of the FHFA Inspector General and the compensation levels of GSE employees.

The FHFA Inspector General should have the tools to serve as a check on the FHFA – and to ensure that it is protecting taxpayers consistent with its role as conservator. New legislation in this area would be consistent with some of the other aforementioned proposals. For example, requiring that the IG report to Congress on a quarterly basis would provide a useful avenue for a Congressional check on GSE activities. In conservatorship, the GSEs act like an arm of the government and they it makes sense that they should be overseen as such.

With regards to the compensation question, I would point to the fact that there is a consensus now that the GSE-model is broken and not to be reconstituted. Whereas the employees at Fannie and Freddie used to work on behalf of shareholders, it is clear that they are now working on behalf of taxpayers. As such, it is reasonable for Fannie and Freddie employees to be transitioned to a pay-scale that is consistent with other government agencies, like the Federal Housing Administration and the Government National Mortgage Association (Ginnie Mae).

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Important decisions still need to be made about the long-term role of the GSEs and the government in the U.S. housing finance system. It might take some time to come to an agreement on a wind-down strategy or a lasting structure for housing finance. Ahead of these decisions, however, it is still important to make progress in reducing the risk presented by the GSEs and protecting taxpayers – while at the same time ensuring that families have adequate access to mortgages.

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2011 PRESIDENT
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SUBMITTED FOR THE RECORD TO THE

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

HEARING TITLED

LEGISLATIVE HEARING ON IMMEDIATE STEPS TO PROTECT TAXPAYERS FROM THE ONGOING BAILOUT OF FANNIE MAE AND FREDDIE MAC

MARCH 31, 2011

INTRODUCTION

On behalf of the 1.1 million members of the NATIONAL ASSOCIATION OF REALTORS® (NAR), thank you for holding this hearing on the need for reform of our Nation's housing finance system.

My name is Ron Phipps, and I am the 2011 President of the National Association of REALTORS. I am proud to be part of a four-generation, family-owned residential real estate business in Rhode Island. My passion is making the dream of home ownership available to all American families. I am proud to testify today on behalf of the more than 1.1 million REALTORS who share that passion, and the 75 million Americans who own homes and the 310 million Americans who require shelter.

REALTORS® agree that the existing system failed and reforms are needed. However, we caution you to heed the words of Treasury Secretary Timothy Geithner and Senator Richard Shelby that, "…housing finance must be addressed and reform passed. However, proper homework must be done before action is taken and federal housing policies must be adequately assessed."

The speed at which the Capital Markets Subcommittee is moving – having a hearing today on GSE reform legislation that was only recently introduced, and planning subsequent hearing in 4 days to mark-up this legislation – constitutes what we believe is moving too quickly, and in too simple a fashion, in an attempt to resolve an issue that is extremely complex and that requires a comprehensive analysis and solution. Therefore, today we will speak in opposition of the bills introduced because they represent a piecemeal approach to reforming the housing finance system, and effectively make Fannie Mae and Freddie Mac nonviable without putting forth an adequate replacement secondary mortgage market mechanism. In an attempt to offer an alternative solution, NAR is collaborating with the offices of Congressmen Gary Miller and Brad Sherman to develop a comprehensive approach to reform the secondary mortgage market.

REALTORS® are fervent in their belief of "free markets", and the need for private capital to reduce Federal government financial support of the housing sector if the housing finance system is to right itself. However, REALTORS® are also practical and understand that in extreme economic conditions, private capital will retreat from the market, requiring the participation of entities that will participate in the market regardless of economic conditions. Secondary mortgage market entities created to support this specific mission are the only way that taxpayers will be assured that they will is always have access to mortgage capital.

REALTORS® agree that taxpayers should be protected, open-ended bailouts should end, private capital must return to the housing finance market, and that the size of the government participation in the housing sector should decrease if the market is to function properly. Where there is disagreement is around the "how" these aspirations should be accomplished. When reviewing proposed legislation that effectively constrains Fannie Mae and Freddie Mac and relies only on private capital to operate the secondary mortgage market, one need only examine the miniscule activity in the jumbo and manufactured housing markets in order to understand the implications of just having private capital form the foundation of the housing market. In both instances, mortgage capital became nearly non-existent, which prohibited qualified borrowers from access to the funds required to purchase a home.

REALTORS® believe that reform of the U.S. housing finance system must be a methodical, measured, and comprehensive effort based on practical market experience, and not just theory. Recently, NAR signed onto an industry letter that espouses the fundamental principles that we all believe are required to ensure a viable secondary mortgage market going forward (see appendix). NAR believes that the industry's basic principles, in concert with our own, form a good foundation on which the secondary mortgage market can be reformed.

KEY GSE REFORM POINTS BASED ON NAR's PRINCIPLES

- An efficient and adequately regulated secondary market is essential to providing affordable mortgages to consumers. The secondary market, where mortgages are securitized and/or combined into bonds, is an important and reliable source of capital for lenders and therefore for consumers.

  Without a secondary market, mortgage interest rates would be unnecessarily higher and unaffordable for many Americans. In addition, an inadequate secondary market would impede both recovery in housing and the overall economic recovery.

- We cannot have a restoration of the old GSEs with private profits and taxpayer loss system. The current GSEs should be replaced with government chartered, non-shareholder owned entities that are subject to sufficient regulations on product, revenue generation and usage, and retained portfolio practices in a way that ensures they can accomplish their mission and protect the taxpayer.

- Government-chartered entities have a separate legal identity from the federal government but serve a public purpose (e.g. the Export-Import Bank). Unlike a federal agency, the entities will have considerable political independence and be self-sustaining given the appropriate structure.

- The mission would be to ensure a strong, efficient financing environment for homeownership and rental housing, including access to mortgage financing for segments of the population that have the demonstrated ability to sustain homeownership. Middle class consumers need a steady flow of mortgage funding that only government backing can provide.

- The government must clearly, and explicitly, guarantee the issuances of the entities. Taxpayer risk would be mitigated through the use of mortgage insurance on loan products with a loan to value ratio of 80 percent or higher and guarantee or other fees paid to the government. This is essential to ensure borrowers have access to affordable mortgage credit. Without government backing, consumers will pay much higher mortgage rates and mortgages may at times not be readily available at all (as happened in jumbo and commercial real estate loans)

- The entities should guarantee or insure a wide range of safe, reliable mortgages products such as 30 & 15 year fixed rate loans, traditional ARMs, and other products that have stood the test of time and for which American homeowners have demonstrated a strong "ability to repay."

- For additional safety, sound and sensible underwriting standards must be established for loans purchased and securitized in MBSs, loans purchased for portfolio, and MBS purchases.

- The entities should price loan products or guarantees based on risk. The organization must set standards for the MBS they guarantee that establish transparency and verifiability for loans within the MBSs.

- Political independence of the entities is mandatory for successful operation (e.g. the CEOs will have fixed terms so they cannot be fired without cause, they should not be allowed to lobby, and the authorities should be self-funded – no ongoing appropriations).

- In order to increase the use of covered bonds, particularly in the commercial real estate arena, the entities should pilot their use in multifamily housing lending and explore their use as an additional way to provide more mortgage capital for residential housing. The entities should be allowed to pave the way for innovative or alternative finance mechanisms that meet safety criteria.

- There must be strong oversight of the entities (for example, by the Federal Housing Finance Agency – FHFA or a successor agency), that includes the providing of timely reports to allow for continual evaluation of the entities' performance.

PRIVATE CAPITAL PARTICIPATION, BUT NOT A FULLY PRIVATE SECONDARY MORTGAGE MARKET

REALTORS® believe that full privatization is not an effective option for a secondary market because private firms' business strategies will focus on optimizing their revenue / profit generation. This model would foster mortgage products that are more aligned with the business' goals (e.g. based upon significant financial risk-taking) than in the best interest of the nation's housing policy or the consumer. This situation, we believe, would lead to the rescinding of long-term, fixed rate mortgage products (e.g. 30-year fixed-rate mortgage products), and an increase in the costs of mortgages to consumers, or both.

According to research provided to NAR by economist Susan Woodward, there is no evidence that a long-term fixed-rate residential mortgage loan would ever arise spontaneously without government urging. Ms. Woodward points out that a few developed countries have encouraged the use of amortizing long-term loans, but in all instances (save for Denmark), the loans have adjustable rates and recast every 5 years. She goes on to indicate that the United States is unique in supporting a residential mortgage that is long-term, amortizing, fixed-rate and pre-payable, and that Americans have come to view this product as one of their civil rights. Ms. Woodward highlights that in early 2000, when Former Federal Reserve Chairman, Alan Greenspan, hinted at its abandonment, the public outcry was such that he eagerly abandoned that position.

Second, the issue of the size of the US residential mortgage market arises. Currently, the US residential mortgage market stands at $10.6 trillion, with the GSEs owning or guaranteeing $5 to $6 trillion of mortgage debt outstanding and providing capital that supports roughly 70% of new mortgage originations. REALTORS® believe that it is extremely unlikely that enough pure private capital – without government backing - could be attracted to replace existing mortgage funding, or assume the GSEs market share, and make mortgage lending available in all types of markets.

Finally, our members fear that in times of economic upheaval, a fully private secondary mortgage market will cease to exist as has occurred in the jumbo mortgage, the commercial mortgage, and the manufactured housing mortgage markets. When the economy turns down, private capital rightfully flees the marketplace, and should that occur in the residential market it would come to an abrupt and complete halt. Should that happen in the residential mortgage market space, the results for the entire economy – because of the plethora of peripheral industries that support and benefit from the residential housing market – would be catastrophic.

REASONABLE QUALIFIED RESIDENTIAL MORTGAGE (QRM) DEFINITION

The definition of what constitutes a QRM is likely to shape housing finance for the foreseeable future. REALTORS® believe that Federal regulators and members of the House Financial Services Committee should honor the intentions of the concept's authors, Senators Isakson and Landrieu, by crafting a qualified residential mortgage (QRM) exemption that includes a wide variety of traditionally safe, well underwritten products such as 30-, 15-, and 10-year fixed-rate loans, 7-1 and 5-1 ARMs, and loans with flexible down payments that require mortgage insurance. A poor QRM policy that does not heed their intention will displace a large portion of potential homebuyers, which in turn will slow economic growth and hamper job creation.

Strong evidence shows that responsible lending standards and ensuring a borrower's ability to repay have the greatest impact on reducing lender risk. A balance must be struck between reducing investor risk and providing affordable mortgage credit. Better underwriting and credit quality standards will greatly reduce risk. Adding unnecessarily high minimum down payment requirements will only exclude hundreds of thousands of buyers from home ownership, despite their creditworthiness and proven ability to afford the monthly payment, because of the dramatic increase in the wealth required to purchase a home.

NAR is concerned that a narrowly defined QRM will also require severe tightening of FHA eligibility requirements and higher FHA premiums to prevent huge increases in its already robust share of the market, adding additional roadblocks to sustainable home ownership.

Saving the necessary down payment has always been the principal obstacle to buyers seeking to purchase their first home. Proposals requiring high down payments will only drive more borrowers to FHA, increase costs for borrowers by raising interest rates and fees, and effectively price many eligible borrowers out of the housing market.

CONCLUSION

The National Association of REALTORS® supports a secondary mortgage market model that includes some level of government participation, but protects the taxpayer while ensuring that all creditworthy consumers have reasonable access to mortgage capital so that they too may attain the American Dream – homeownership. Our members recognize that this is just one of many conversations regarding how we mend and improve the housing finance system that has served us well for many years. We believe that the key points that we mentioned will help Congress and our industry partners design a secondary mortgage model that will be in all of our nation's best interest today, and in the future.

I thank you for this opportunity to present our thoughts on reforming our housing finance system, and as always, the National Association of REALTORS® is at the call of Congress, and our industry partners, to help continue the housing and national economic recovery.

Principles for
Restoring Stability to the Nation's Housing Finance System

March 28, 2011

The nation's housing finance system is at a historic crossroad. As policymakers debate options to restore vitality, integrity and stability to the secondary mortgage market, including an appropriate role for the federal government in supporting homeownership and rental housing, it is essential that care is taken in weighing the choices ahead. The policy decisions in this area will have profound implications for the nation's economic recovery and for generations of future homebuyers and renters, with broad ranging social and economic consequences.

The undersigned organizations, representing a variety of stakeholders in single- and multifamily housing, believe the following principles should help guide efforts to restore and repair the nation's housing finance system:

- A stable housing sector is essential for a robust economic recovery and long-term prosperity. Housing, whether through homeownership or rental, promotes social and economic benefits that warrant it being a national policy priority.

- Private capital must be the dominant source of mortgage credit, and it must also bear the primary risk in any future housing finance system.

- Some continuing and predictable government role is necessary to promote investor confidence and ensure liquidity and stability for homeownership and rental housing.

- Changes to the mortgage finance system must be done carefully and over a reasonable transition period to ensure that a reliable mortgage finance system is in place to function effectively in the years ahead.

Private investment capital is critical for a robust and healthy mortgage marketplace, and the current government-dominated mortgage system is neither sustainable nor desirable. However, investors must be confident that they understand the risks and rules that can affect them. As policymakers move forward with Dodd-Frank Act rulemakings and similar regulatory efforts, it will be important to provide clarity and certainty to the marketplace in a manner that promotes recovery and growth. As such, the future mortgage system should seek to ensure a workable balance between sound underwriting principles, consumer protection and the need for responsible innovation and risk-taking.

As critical as it is to attract private money to the mortgage markets, an appropriate and clearly defined role for the government is essential to preserving financial stability. Government support through various insurance and guarantee mechanisms is especially important to facilitate long-term fixed-rate mortgages, affordable financing for low- and moderate-income borrowers, and financing rental housing in all parts of the country including rural areas. While the goal should be to move toward a largely private secondary market, the private and public sectors should work as partners in creating a variety of financing options to ensure the availability of safe, stable, and affordable financing.

Accomplishing all of these goals will require an on-going dialogue between policymakers and other key stakeholders, including industry and consumer groups. Our organizations stand committed to being part of this process.

American Bankers Association
American Financial Services Association
Community Mortgage Banking Project
CRE Finance Council
Housing Policy Council of the Financial Services Roundtable
Independent Community Bankers of America
Manufactured Housing Institute
Mortgage Bankers Association
Mortgage Insurance Companies of America
National Apartment Association
National Association of Home Builders
National Association of Realtors
National Council of State Housing Agencies
National Multi Housing Council
Real Estate Roundtable
Securities Industry and Financial Markets Association

American Enterprise Institute
for Public Policy Research

Statement before the Financial Services Committee
Capital Markets & Government Sponsored Enterprises Subcommittee
On "Legislative Hearing on Immediate Steps to Protect Taxpayers from the Ongoing Bailout of Fannie Mae and Freddie Mac"

Edward J. Pinto
Resident Fellow
American Enterprise Institute

March 31, 2011

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Hearing before Capital Markets & Government Sponsored Enterprises Subcommittee, US House of Representatives Financial Services Committee

Submitted testimony by Edward Pinto, resident fellow of the American Enterprise Institute and former executive vice president and chief credit officer of Fannie Mae (1987-1989).

Chairman Garrett and Ranking Member Waters, thank you for the opportunity to testify today.

In its February 11 Report to Congress, the Obama administration asked Congress to work with it to fashion legislation to accomplish three broad goals of housing finance market reform:

- The winding down of Fannie Mae and Freddie Mac (the GSEs);
- Returning FHA to its traditional role a targeted lender of affordable mortgages; and
- A largely privatized system of housing finance with an open question as to the level of government involvement.

These three goals provide the opportunity for a possible bi-partisan solution that could result in true reform of our housing finance market. I congratulate this subcommittee for its contributions towards achieving this consensus that the GSEs must be wound down. I will address this opportunity later on in my testimony.

Secretary Geithner in testimony before the full Financial Services Committee on March 1 asked that these three goals be accomplished sooner rather than later during this Congress. It is therefore a pleasure to testify today on the thrust of these eight proposed bills which aim to move forcefully forward on achieving this necessary and critical goal.

I will now address each bill separately:

1. Increase in guaranty fees:

   Enactment of this bill is appropriate as it would implement a key step in responsibly reducing the role of the GSEs in the mortgage market and, ultimately, wind down both institutions. The administration also recommends this step. This can be accomplished by raising the GSEs' capital requirements to equal those of national banks. It would eliminate the unfair capital advantages that the GSEs did and do enjoy and reduce the gap between Fannie and Freddie's subsidized pricing and private-market rates. This increase in capital requirements would require the GSEs raise their base guarantee fee by perhaps fifteen to twenty-five basis points. This fee increase could be phased in over two years and would apply to new volume only.

   This bill stipulates that guarantee fees be set uniformly among lenders. This makes sense as credit guarantee fees should solely be based on credit quality, not volume. Just two weeks ago the Mortgage Bankers Association chief economist Jay Brinkmann stated that the pricing strategies Fannie and Freddie pursued contributed to the concentration of mortgage lending within the largest banks. The GSEs offered reduced 'guarantee fees' for their largest customers such as Countrywide, which placed smaller lenders at a competitive 'disadvantage'.

The administration also suggested that the GSEs rely more on private capital. This subcommittee and the administration should request the FHFA director to explore various means of credit enhancement to reduce the liability of the GSEs for losses on mortgages, including the possibility of increased mortgage guaranty insurance. Chairman Garrett and Ranking Member Waters I commend you and over thirty other members for the letter on this topic sent to FHFA's acting director DeMarco last October.

Regarding the need for greater reliance on private capital, one of the unfortunate consequences of the Dodd-Frank Act combined with the exemption for Fannie and Freddie from the retention requirements as proposed by regulators is to perpetuate the dominance of Fannie, Freddie, and FHA. This poses great risk to the taxpayers. This continued dominance makes it almost impossible for private capital to come into the mortgage sector. It is imperative that this Congress address comprehensive reform of the private housing finance market and soon. I, along with my co-authors Peter Wallison and Alex Pollock released last week a white paper detailing such an approach for reforming the housing finance market under the administration's Option 1. It meets the "Principles for Restoring Stability to the Nation's Housing Finance System" as recently outlined by 16 industry groups. I ask that our white paper be entered into the record of this hearing.

2. Prohibition of new debt without the advance approval of the Secretary of Treasury:

   Enactment of this bill is appropriate since it would help assure that the GSEs are not operating like government-backed hedge funds, a past practice noted by the administration in its report.

3. Subjecting the GSEs to the credit risk retention requirements of the Security Exchange Act of 1934.

   Enactment of this bill is essential since it would help assure that the GSEs are appropriately protecting the tax payers from further risk and remove a barrier to private capital coming into the market. I would recommend that such qualified residential mortgage (QRM) standards be set by legislation rather than by administrative rule. Appendix 1 of my testimony sets forth a proposed statutory definition of QRM as applicable to both the GSEs and to private mortgage backed securities generally. This would accomplish two goals: the wind down the GSEs and the attraction of new private capital in a harmonious fashion. At the same time, I would suggest limiting the collateral backing private MBS to loans that meet the definition set out in appendix 1. This would obviate the need for any risk retention and its attendant complexity and potential gaming of the system. I would also suggest that FHA be brought within the purview of such QRM legislation.

4. Repeal of the affordable housing goals for the GSEs.

   The repeal of these goals is appropriate. There is now near unanimous agreement that these goals had a polluting effect on the GSEs.

I recommend that you also consider repealing the affordable-housing support fees enacted under HERA and currently suspended by FHFA).[1]

5. Compensation of certain Fannie and Freddie employees.

   In light of the administration's strong recommendation that Fannie and Freddie be wound down, it is appropriate to legislate certain limitations of both key and all employees. However I would suggest a different approach – one that keeps salaries within reasonable bounds but also focuses staff attention on a successful wind down of the GSEs:

   - Key employees: There should be an overall annual compensation cap of set for the top five officers of each GSE. This compensation shall consist of salary, fringe benefits, and annual bonus. There should be no compensation based on profits or losses or stock value. Each key employee may be eligible for a long-term bonus based on accomplishing a successful wind down by December 31, 2016. This long-term bonus is intended to retain such key personnel for the duration of the wind down period.
   - Other employees: Other employees shall receive compensation appropriate for their positions and in light of the GSEs' wind down status. This compensation shall consist of salary, fringe benefits, and annual bonus. There should be no compensation based on profits or losses or stock value. Each employee may be eligible for a long-term bonus based on accomplishing a successful wind down by December 31, 2016. This long-term bonus is intended to incent the retention of such personnel for the duration of the wind down period.

6. Prohibit the GSEs from engaging in any new activities or offering new products.

   Given the GSEs wind down status, the enactment of this bill is appropriate. This bill is particularly needed given efforts designed to force the GSEs to undertake potentially risky activities such as energy retrofit and manufactured housing loan programs, and potentially costly programs such as mortgage write-downs.

7. Increase the rate of the required annual reductions in the retained portfolios of the GSEs.

   The administration noted in its report that Fannie and Freddie were allowed to behave like government-backed hedge funds and therefore conclude that Fannie and Freddie's investment portfolios should be wound down. It also noted that it would seek opportunities for accelerating their withdrawal. Under the current structure, which predates the administration's decision to wind down Fannie and Freddie, the partial wind down of the massive portfolios of the GSEs could take as long as twelve years and still leave them with investments of up to $500 billion in 2022. This is much too slow.

[1] Supra. Housing and Economic Recovery Act of 2008 (HERA). HERA imposed a 4.2-basis-point fee on Fannie and Freddie's mortgage purchases (currently suspended by FHFA).

This rate of wind down does not even keep up with the natural liquidation rate being experienced by these portfolios. Natural runoff should substantially reduce their portfolios even more quickly over time. For 2010 this run-off had an annualized rate of 21% and continued at the same annualized rate in January 2011. This was well in excess of actual reductions.

This bill closely matches to the expected natural run-off over the next 5 years. If this proposed wind down plan were to create a small mismatch, this could easily be handled by the offsetting these sales with a similar reduction in the already contemplated agency MBS sales planned by the Fed and Treasury over the next few years.

8. Require quarterly Inspector General reports.

   This is a prudent step.

9. I suggest adding the following provisions which would add in meeting the administration's goal of a timely and final wind down of Fannie and Freddie as GSEs:

   - Dividend on preferred stock held by Treasury. The dividend should be set by statute to yield not less than 10 percent annually. Secretary Geithner embraced this policy at the March 1, 2011, hearing before the House Financial Services Committee.

   - Recoupment of costs of federal guarantee. Beginning on January 1, 2014, the GSEs should be required to make quarterly payments to the Treasury equal to an annualized thirty basis points times the average aggregate outstanding credit risk of the GSE. This provision will enable the taxpayers to recoup the value of the government guarantee of the GSEs' mortgage portfolios and MBS.[2]

Each of the above bills supports of the administration's goal of a responsible but deliberate wind down of Fannie and Freddie. They provide the critical legislative support necessary to advance this goal. They also establish a foundation for a strong bi-partisan solution that results in the reform of the housing finance market.

Turning briefly to the recently introduced Hensarling bill, I commend Rep. Hensarling for his early and prescient commitment to winding down Fannie and Freddie. His bill provides the basis for undertaking a frank but crucial discussion between this subcommittee and the administration. This discussion has been requested by both Secretary Geithner and Rep. Biggert. It is my hope that it will lead to a privatized system of housing finance as embodied under the administration's Option 1.

Thank you for the opportunity to testify. I look forward to your questions.

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[2] This level of guarantee fee is consistent with the CBO's budget estimates, which price the value of the government's backing of the GSEs at 4.4 percent in 2009, reducing to .20 percent (twenty basis points) in 2014 and thereafter. Thirty basis points seems a good middle point, consistent with the CBO study. See Congressional Budget Office, *CBO's Budgetary Treatment of Fannie Mae and Freddie Mac* (Washington, DC: January 2010), table 2, www.cbo.gov/ftpdocs/108xx/doc10878/01-13-FannieFreddie.pdf (accessed March 22, 2011).

Appendix 1: Definition of a Qualified Residential Mortgage (Prime Loan)

In addition to meeting the safe-harbor standards for qualified mortgages as set forth in Section 1412 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, qualified residential mortgages (QRMs) shall also meet the following standards:

- A conventional loan on a property occupied as a primary or secondary residence.
- Home purchase loans to have a loan-to-value (LTV) of 90 percent or less commencing on January 1, 2016. During the five-year GSE wind down and private-market transition period, an LTV limit of 95 percent would be permitted until December 31, 2012, and an LTV limit of 92.5 percent would be permitted until December 31, 2015.
- Rate and term refinances to have a LTV of 80 percent or less with a maximum loan term of twenty-five years.
- Cash-out refinances to have a LTV of 75 percent or less with a maximum loan term of twenty years.
- Any loan with an LTV greater than 60 percent could be insured by mortgage guaranty insurance down to 60 percent; however, a fully amortizing loan with a term of fifteen years or less and an LTV greater than 80 percent could be insured by mortgage guaranty insurance down to 70 percent.
- Loans to borrowers with a demonstrated willingness to meet their obligations as represented by a FICO credit score of 660.
- No second mortgage at loan origination and prohibited by the mortgage documents for a period of six months after origination. The mortgage documents also grant the mortgage holder and mortgage insurer (if any) the right of prior approval with respect to any second mortgage taken out after six months.
- The mortgage note and mortgage shall:
    - Require the borrower to declare his or her intent regarding owner occupancy;
    - Require the borrower to acknowledge that if the intent to occupy changes within twelve months of the date of the loan, the borrower has an affirmative obligation to notify the lender;
    - Advise the borrower that upon receipt of such notice, the lender has the right to increase the interest rate on the loan by a stipulated percentage; and
    - Provide that if the borrower fails to notify the lender, the lender may call the loan and require its immediate repayment, and such loan, if not already recourse to the borrower, becomes recourse and not dischargeable in bankruptcy.
- Loans to have housing and total debt-to-income ratios of less than 33 percent and 38 percent, respectively commencing on January 1, 2016. During the five-year GSE wind down and private-market transition period, housing and total debt-to-income ratios of less than 36 percent and 41 percent respectively for the years 2012 and 2013 and 39 percent and 45 percent respectively for the years 2014 and 2015. Also during the wind down period when 95% and 92.5% LTV loans are permitted, 28 percent and 33 percent on 95 percent and 92.5 percent respectively.
- Underwritten based upon verified income, assets, and credit.
- If an adjustable-rate mortgage or balloon, an initial fixed rate for seven years or more, with the borrower qualified at the maximum rate permitted during the first seven years.

- If a prepayment fee is charged, it may not provide for a fee in excess of 3 percent of principal for the first year, 2 percent for the second, and 1 percent for the third, and the originating lender must offer the applicant the option of a similar loan with no prepayment fee.

The following are the standards that federal regulation should require of mortgage insurers for prime loans:

- Maintain minimum risk-to-capital ratios by amortized LTV based on the lesser of sales price (if applicable) or original appraised value, as set forth below:

Amortized LTV (%)	Suggested risk-to-capital ratio for thirty-year fixed-rate loans[3]	Current risk-to-capital ratio
92.51–95.00	8 to 1	25 to 1
90.01–92.50	10 to 1	25 to 1
85.01–90.00	13 to 1	25 to 1
80.01–85.00	16 to 1	25 to 1
75.01–80.00	29 to 1	25 to 1
70.01–75.00	31 to 1	25 to 1
65.01–70.00	38 to 1	25 to 1
60.01–65.00	41 to 1	25 to 1

- Coverage must be maintained until the original loan balance amortizes to 60 percent (70% in the case of a fully amortizing loan with an initial term of 15 years or less) based on the lesser of original sales price (if applicable) or original appraised value. For example, on a 90 percent LTV loan, MI would provide 34 percent coverage, which would insure down to 59.4 percent.
- Fifty percent of gross premiums required to be placed in statutory premium reserve for a fixed period of ten years and may only be used to pay nonnormal or catastrophic stress-based losses due to periodic but unpredictable general economic risks as described earlier. The other 50 percent of premium revenue is required to support normal claims related to

[3] Fixed-rate loans with shorter amortization periods pose a lower risk of default due to faster buildup of borrower equity and therefore would have somewhat higher risk-to-capital requirements (requires that less capital be held). For example, fifteen-year term loans at an 80 percent LTV might have a thirty-eight-to-one risk-to-capital ratio, the same as for a 70 percent LTV loan with a thirty-year term.

specific or actuarially based credit losses, general and administrative expenses, taxes, other expenses, dividends, and profits.

- Monoline. A monoline insurer's business is limited to one line of insurance, in this case mortgage guaranty insurance on prime single-family first mortgages.
- Coverage is loan based with a maximum coverage of 35 percent after 2015 and a maximum coverage of 38 percent during the five-year transition period.
- No pool coverage or guaranty of securities. MI companies are limited to covering individual loans rather than pools of loans.
- No originator, aggregator, conduit, or issuer (or affiliates or parents) may own or operate a private mortgage insurer.
- Restricted to prime loans. This limits MI companies to prime loans, which have more predictable and lower default rates than nonprime loans. No sharing of premiums with lenders or investors and any discounts must be risk based, not volume based.

Taking the Government Out of Housing Finance: *Principles for Reforming the Housing Finance Market*

An American Enterprise Institute
Policy White Paper

Peter J. Wallison Alex J. Pollock Edward J. Pinto

March 24, 2011

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Executive Summary

We recommend that the US housing finance market of the future should be governed by four basic principles:

> Principle I: The housing finance market can and should principally function without any direct government financial support.
>
> Principle II: Ensuring mortgage quality and fostering the accumulation of adequate capital behind housing risk can create a robust housing investment market without a government guarantee.
>
> Principle III: All programs for assisting low-income families to become homeowners should be on-budget and should limit risks to both homeowners and taxpayers.
>
> Principle IV: Fannie Mae and Freddie Mac should be eliminated as government-sponsored enterprises (GSEs) over time.

With the release of the Obama administration's thoughtful report[1] on housing finance reform (February 2011), which was broadly consistent with these ideas, a bipartisan agreement on the future of housing finance has become possible.

The administration's paper outlines three options, the first of which is a largely private market. By including this idea as a key option for a Democratic administration, the report was a game changer: whether most housing in the United States should be financed in a private market is now open for consideration. In its paper, the administration raised some reasonable concerns about this option and suggested two alternatives. We address these concerns and show how to produce a robust, stable private system for originating and financing mortgages, while protecting the taxpayers.

There are two theories about the financial crisis of 2007–2008. One holds that it was caused largely by a lack of effective government regulation;[2] the other that government housing policy was primarily at fault.[3] Whether one looks at this debacle as a failure of regulation or a failure of housing policy, it is undeniable that large parts of the previous US housing finance system were guided and guaranteed by the government and that once again the taxpayers will bear the immense costs of government failure.

Many of the proposals for reforming the US housing finance market reflect the belief that institutional investors will buy securities backed by US mortgages (MBS) only if they are somehow guaranteed by the US government. To the contrary, we propose a superior alternative

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[1] Department of the Treasury and Department of Housing and Urban Development (HUD), *Reforming America's Housing Finance Market: A Report to Congress* (Washington, DC, February 11, 2011).
[2] Financial Crisis Inquiry Commission, *Financial Crisis Report* (Washington, DC, January 2011).
[3] Peter J. Wallison, *Dissent from the Report of the Financial Crisis Inquiry Commission*, (Washington, DC: American Enterprise Institute, January 2011), www.aei.org/paper/100190.

to government guarantees—remembering that such government market interventions have led to large-scale taxpayer bailouts twice in the last generation.

Our alternative is to ensure that only prime-quality mortgages, which comprise the vast majority of US mortgages, are allowed into the securitization system. The very low delinquency and default rates on prime mortgages will be attractive investments for institutional investors and will enable the housing finance secondary market to function effectively with no government support. This will eliminate the potential for additional taxpayer losses in the future; reduce the likelihood and severity of housing price booms, busts, and attendant bubbles; and allow the eventual elimination of the GSE charters of Fannie Mae and Freddie Mac.

The four basic principles we recommend (initially outlined in an earlier draft of this paper issued in January 2011) line up remarkably well with Option 1 in the report issued by the administration. This provides an opportunity to replace Fannie Mae and Freddie Mac and adopt other housing finance reforms that will protect the taxpayers against further losses and significantly reduce the chances of another financial crisis.

The following explanations summarize our four central principles:

I. The housing finance market—like other US industries and housing finance systems in most other developed countries—can and should principally function without any direct government financial support.

Under this principle, we note that the huge losses associated with the savings and loan (S&L) debacle of the 1980s and Fannie and Freddie today did not come about *in spite of* government support for housing finance but *because of* that government backing. Government involvement not only creates moral hazard but also sets in motion political pressures for increasingly risky lending such as "affordable loans" to constituent groups.

Although many schemes for government guarantees of housing finance in various forms have been circulating in Washington since last year, they are not fundamentally different from the policies that caused the failures of the past. The fundamental flaw in all these ideas is the notion that the government can successfully establish an accurate risk-based price or other compensatory fee for its guarantees. Many examples show that this is beyond the capacity of government and is in any case politically infeasible. The problem is not solved by limiting the government's risks to MBS, as in some proposals. The government's guarantee eliminates an essential element of market discipline—the risk aversion of investors—so the outcome will be the same: underwriting standards will deteriorate, regulation of issuers will fail, and taxpayers will take losses once again.

II. Ensuring mortgage quality, and fostering the accumulation of adequate capital behind housing risk, can create a robust housing investment market without a government guarantee.

This principle is based on the fact that high-quality mortgages are good investments and have a long history of minimal losses. Instead of relying on a government guarantee to reassure investors in MBS, we should simply ensure that the mortgages originated and distributed are predominantly of prime quality. We know the characteristics of a prime mortgage, which are defined later in this white paper. They do not have to be invented; they are well known from many decades of experience.

Experience has also shown that some regulation of credit quality can prevent the deterioration in underwriting standards, although in the last cycle regulation promoted lower credit standards. The natural human tendency to believe that good times will continue—and that "this time is different"—will continue to create price booms in housing, as in other assets. Housing bubbles in turn—by suppressing delinquencies and defaults—spawn subprime and other risky lending; investors see high yields and few defaults, while other market participants come to believe that housing prices will continue to rise, making good loans out of weak ones. Future bubbles and the losses suffered when they deflate can be minimized by interrupting this process—by focusing regulation on the maintenance of high credit quality.

III. All programs for assisting low-income families to become homeowners should be on-budget and should limit risks to both homeowners and taxpayers.

The third principle recognizes that there is an important place for social policies that assist low-income families to become homeowners, but these policies must balance the interest in low-income lending against the risks to the borrowers and the interests of the taxpayers. In the past, "affordable housing" and similar policies have sought to produce certain outcomes—such as an increase in homeownership—which turned out to escalate the risks for both borrowers and taxpayers. The quality of the mortgages made in pursuance of social policies can be lower than prime quality—taxpayers may be willing to take risks to attain some social goods—but there must be quality and budgetary limits placed on riskier lending to keep taxpayer losses within known and reasonable bounds.

IV. Fannie Mae and Freddie Mac should be eliminated as government-sponsored enterprises (GSEs) over time.

Finally, Fannie and Freddie should be eliminated as GSEs and privatized—but gradually, so the private sector can take on more of the secondary market as the GSEs withdraw. The progressive withdrawal of the GSEs from the housing finance market should be accomplished in several ways, leading to the sunset of the GSE charters at the end of the transition. One way would be successive reductions in the GSEs' conforming loan limits by 20 percent of the previous year's limits each year. These reductions would apply to conforming loan limits for both regular and high-cost areas. This should be done according to a published schedule so the private sector can plan for the investment of the necessary capital and create the necessary operational capacity. The private mortgage market would include banks, S&Ls, insurance companies, pension funds, other portfolio lenders and investors, mortgage bankers, mortgage insurance (MI) companies, and private securitization. Congress should make sure that it facilitates opportunities for additional financing alternatives, such as covered bonds.

Introduction

On February 11, 2011, the Departments of Treasury and Housing and Urban Development released the administration's report to Congress, titled *Reforming America's Housing Finance Market*. The paper outlined three options: a largely private system with government support only for low- and moderate-income housing (Option 1); a government-backed standby system, necessary only in the event of a housing market crash (Option 2); and a system for government backing of MBS issued by specially chartered companies (Option 3). No preference was expressed among them, and the report suggested deficiencies in all of them. However, the areas of agreement between the administration's approach and our initial white paper draft suggest that housing finance reform based largely on private-market principles is possible. For example, the administration's report accepts as a viable option:

- A privatized housing finance market as the primary source of mortgage credit, with private capital playing the predominant role in housing finance;
- Robust oversight in support of strict underwriting standards;
- Government assistance to low-income borrowers as a limited adjunct to a largely private financing system; and
- The need to wind down and privatize or eliminate Fannie Mae and Freddie Mac.

In effect, then, there is a rough agreement between our four principles and the administration's Option 1.

The administration recognizes the following advantages in a financing system that relies primarily on private financing:

> The strength of this option is that it would minimize distortions in capital allocation across sectors, reduce moral hazard in mortgage lending and drastically reduce direct taxpayer exposure to private lenders' losses. With less incentive to invest in housing, more capital will flow into other areas of the economy, potentially leading to more long-run economic growth and reducing the inflationary pressure on housing assets. Risk throughout the system may also be reduced, as private actors will not be as inclined to take on excessive risk without the assurance of a government guarantee behind them. And finally, direct taxpayer risk exposure to private losses in the mortgage market would be limited to the loans guaranteed by FHA [Federal Housing Administration] and other narrowly targeted government loan programs: no longer would taxpayers be at direct risk for guarantees covering most of the nation's mortgages.[4]

We share these conclusions. However, the administration sees the following deficiencies in a private-sector system:

> Though these are indeed significant benefits, this option has particularly acute costs in its potential impact on access to credit for many Americans. While FHA would continue to provide access to mortgage credit for low- and moderate-income Americans, the cost of mortgage credit for those who do not qualify for an FHA-insured loan—the majority of

[4] Departments of Treasury and HUD, *Reforming America's Housing Finance Market*, 27.

> borrowers—would likely increase. While mortgage rates are likely to rise somewhat under any responsible reform proposal, including the three outlined here, the effect could be larger under this option. In particular, it may be more difficult for many Americans to afford the traditional pre-payable, 30-year fixed-rate mortgage. Additionally, smaller lenders and community banks could have a difficult time competing for business outside of the FHA segment of the market, which may in turn impact access in the communities they have traditionally served more effectively than larger institutions.[5]

In testimony before the House Financial Services Committee, Treasury Secretary Timothy Geithner added that, if not addressed, Option 1 might result in mortgage-credit risk shifting from taxpayer liability under the GSE structure to taxpayer liability under the banking system, where some of the largest banks might be seen as too big to fail.

We believe there are sound responses that address the administration's concerns; we address them below in discussing our four principles.

[5] Ibid., 27–28.

I. The housing finance market—like other US industries and housing finance systems in most other developed countries—can and should principally function without any government financial support.

Our Principle I (combined with Principle III below) is virtually identical to the administration's Option 1, which proposes a "[p]rivatized system of housing finance with the government insurance role limited to FHA, USDA [US Department of Agriculture] and Department of Veterans' Affairs' [VA] assistance for narrowly targeted groups of borrowers." As noted above, the administration's support for a private system is based on the view that it eliminates taxpayer risk, reduces moral hazard and related risks throughout the housing finance system, and results in better allocation of resources by reducing overinvestment in housing. These are also the major reasons why we believe that substituting a private mortgage finance system for a government-backed system would be good policy.

Given the spectacular failures of US housing finance and the enormous cost to taxpayers of two massive bailouts in twenty years, the housing industry should be required to show why it needs government support again.[6] No other developed country provides anything that approaches the support for housing provided by the US government, and—as shown below—many of these other systems produce higher homeownership rates,[7] lower mortgage-interest rates (see table 1), and fewer losses when defaults occur (see table 2).

In the last twenty years, US taxpayers have had to pay for bailouts of two major elements of the housing finance system: the S&Ls in the late 1980s and early 1990s and the GSEs Fannie Mae and Freddie Mac beginning in 2008.[8] As two commentators described it, the S&L crisis of the 1980s and early 1990s "produced the greatest collapse of US financial institutions since the Great Depression. Over the 1986–1995 period, 1,043 thrifts with total assets of over $500 billion failed. The large number of failures overwhelmed the resources of the Federal Savings and Loan Insurance Corporation (FSLIC), so US taxpayers were required to back up the commitment extended to insured depositors of the failed institutions. As of December 31, 1999, the thrift crisis had cost taxpayers approximately $124 billion and the thrift industry another $29 billion, for an estimated total loss of approximately $153 billion."[9]

Today, taxpayers face even larger losses arising from the insolvency of Fannie Mae and Freddie Mac, both of which are now operating in conservatorships controlled by the government. Thus far, the Treasury has contributed approximately $150 billion to keep the two GSEs solvent, but the Federal Housing Finance Agency (FHFA), the GSEs' regulator, has estimated that their losses will fall between $221 billion and $363 billion. If housing prices continue to fall, many observers believe the total losses of the GSEs will eventually exceed $400 billion.

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[6] In Principle III, we discuss how the government should proceed with respect to providing financial support for social policy purposes.

[7] *Testimony of Alex J. Pollock, Subcommittee on Security and International Trade and Finance, US Senate Committee on Banking, Housing, and Urban Affairs*, 111th Cong. (September 29, 2010).

[8] A government-induced overreliance on the freely prepayable thirty-year fixed-rate loan was instrumental in both bailouts.

[9] Timothy Curry and Lynn Shibut, "The Cost of the Savings and Loan Crisis: Truth and Consequences," *FDIC Banking Review*, December 2000, http://fcx.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf (accessed January 14, 2011).

The taxpayer losses in both the S&L and GSE debacles are related; as we will show, they are the inevitable result of extending government guarantees or subsidies to the housing finance industry. Before Congress considers any action on the future of housing finance, it should ask those who are pressing for government backing to explain why the taxpayers should be put at risk again.

Recent research by Dwight Jaffee, set out in table 1, documents that, notwithstanding the absence of government guarantees in most cases, many housing finance markets have achieved better outcomes than the US market along a number of critical dimensions.[10] For example, as table 1 shows, the United States has one of the highest mortgage debt levels (column 1) and among the highest mortgage interest rates (column 5) and spreads (column 6), yet is only average in owner occupancy rates (column 2). This is not an enviable record, and certainly not what American taxpayers deserve for all the losses they have covered to support the housing industry.

Table 1: The Performance of European Mortgage Markets in Comparison with the US Markets*
(Statistical measures computed with annual data by country for 1998–2008)

	(1)	(2)	(3)	(4)	(5)	(6)
	Mortgage to GDP Ratio (%)	Rate of Owner Occupancy (%)	Coefficient of Covariation Housing Starts (%)	Standard Deviation of House Price Inflation (%)	Mortgage Interest Rate Average Level (%)	Mortgage Interest Rate Average Spread** (%)
	2008	2008				
Western Europe						
Austria	25.3	57.0	8.3	2.6	5.12	0.66
Belgium	39.8	78.0	16.3	4.0	5.87	1.37
Denmark	95.3	54.0	40.8	6.1	5.96	1.41
Finland	47.5	59.0	11.0	3.4	4.50	0.05
France	35.9	57.4	16.4	5.5	4.93	0.53
Germany	46.1	43.2	30.1	0.8	5.27	0.97
Iceland	129.0	82.5	56.3	9.8	5.01	0.64
Ireland	80.0	74.5	35.8	11.5	4.69	0.22
Italy	19.8	80.0	47.0	3.1	5.25	0.64
Luxembourg	43.5	75.0	19.2	4.3	4.33	-0.16
Netherlands	99.1	57.0	10.2	5.5	5.17	0.77
Norway	55.7	77.0	21.1	5.0	6.54	1.61
Portugal	63.3	76.0	31.5	5.4	5.15	0.61
Spain	62.0	84.5	32.5	2.5	4.38	-0.09
Sweden	60.6	52.0	53.9	5.1	4.05	-0.49
UK	80.5	59.0	10.5	5.0	5.32	0.42
Euro Average	**61.5**	**66.6**	**27.6**	**5.0**	**5.10**	**0.57**

[10] Dwight M. Jaffee, "Reforming the US Mortgage Market through Private Market Incentives" (presentation, Federal Reserve Bank of St. Louis, November 17, 2010), http://research.stlouisfed.org/conferences/gse/Jaffee.pdf (accessed January 14, 2011).

US Average	**83.6**	**67.8**	**24.9**	**5.5**	**6.57**	**1.82**
US Rank (of 17)	**4th**	**9th**	**9th**	**4th**	**1st**	**1st**

Notes:
* Unless noted otherwise, the data are all from *European Mortgage Federation* (2008), an annual fact book that contains comprehensive mortgage and housing market data for 1998 to 2008 for the sixteen Western European countries and the United States.
** The mortgage interest rate spread equals the mortgage interest rate (column 5) relative to the government bond rate of each country derived from the International Financial Statistics of the International Monetary Fund.

Moreover, Jaffee's research also shows that when recent bubbles deflated in these other countries, the number of delinquencies and foreclosures was much lower than in the United States. All the countries in table 2 below had housing bubbles during the 2000s, some of them even larger than the one in the United States, but the outcomes in these countries were far better.

Table 2: Troubled Mortgages: Western Europe and the United States

	≥ Three-Month Arrears (%)	Impaired or Doubtful (%)	Foreclosures (%)	Year
Belgium	0.46			2009
Denmark	0.53			2009
France		0.93		2008
Ireland	3.32			2009
Italy		3.00		2008
Portugal	1.17			2009
Spain		3.04	0.24	2009
Sweden		1.00		2009
UK	2.44		0.19	2009
US All Loans	9.47		4.58	2009
US Prime	6.73		3.31	2009
US Subprime	25.26		15.58	2009

Source: European Mortgage Federation (2010) and Mortgage Bankers Association for US Data.

With this background, it is time to examine why the US housing finance system fails so consistently, even though since the 1930s it has been supported or backed by a growing phalanx of government agencies and enterprises (Federal Housing Administration, Fannie, Freddie, FSLIC, Federal Home Loan Banks or FHLBs, Ginnie Mae, VA, and the USDA). The reason, we believe, is that the US system fails *because of* its connection to the government. Government guarantees create moral hazard on two levels. First, by assuring the housing industry of a steady supply of underpriced funds, government support encourages overbuilding and speculation. The administration's report, as noted above, also cites the overinvestment in housing—calling it "distortions in capital allocation"—that results from government backing. In other industries, variations in the availability of funding suppress risk taking. In addition, by relieving investors of risk through a guarantee, government support makes it possible for mortgage originators to offer liberal lending terms such as zero or low down payment loans, loans without documentation, and loans to credit-impaired borrowers.[11] As the administration noted in its report, a private mortgage finance system reduces risk. "Risk throughout the system may also be reduced," simply because of the fact that it is private: "private actors will not be as inclined to take on excessive risk without the assurance of a government guarantee behind them."[12]

However, the result of a government-backed system is not the stability the industry is seeking but a repetitive volatility—the growth and deflation of housing bubbles leading to credit crises such as (but smaller than) the one that occurred in 2008. It is because of excessive government intervention in the housing market that we now have both historically high borrower leverage (homeowner mortgage debt in relation to housing values) and a clearly inadequate amount of capital backing a debt market consisting of $10.6 trillion in first and second mortgages.[13]

Accordingly, for the six reasons outlined below, our first principle is that the housing finance market should be free of any government assistance in the future, other than for social policy reasons through FHA and other explicit and on-budget government programs.

1. The government cannot successfully price for risk. Many of the plans currently making the rounds in Washington depend on government backing at some level—usually as a guarantor of MBS issued by a financial intermediary. Two of the three options set out in the administration's report depend on government backing:

- Option 2: A largely privatized system of housing finance, with assistance for targeted groups of low-income borrowers from FHA and other government agencies and a guarantee mechanism to scale up government support during times of crisis in housing finance; and
- Option 3: A system of government reinsurance behind private issuers of MBS, coupled with FHA and other government assistance to low-income borrowers.

These plans are based on a fundamental error: that the government can act like an insurance company and set a correct price for the risk it is taking. The administration itself recognizes this problem:

> While the government can charge market participants an insurance premium for accepting that risk, pricing the risk can be difficult. If the government does not charge a fair price, it may encourage excessive risk-taking and increase the likelihood that the taxpayer will be forced to bear the cost of the government's losses. Political pressure to

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[11] Additional commonly used provisions include negatively amortizing loans (option ARMs), ARMs as an affordability aid, liberal terms for cashing out equity, minimal right to recourse or enforcement of same, second mortgages (sometimes hidden), and loans to investors or speculators masquerading as prospective homeowners.
[12] Departments of Treasury and HUD, *Reforming America's Housing Finance Market*, 27.
[13] See Board of Governors of the Federal Reserve System, "Flow of Funds Accounts of the United States: Flows and Outstandings, Fourth Quarter 2010," March 10, 2011, www.federalreserve.gov/releases/z1/current/z1.pdf (accessed March 18, 2011). Fannie and Freddie, with no capital of their own, guarantee about 45 percent of all outstanding mortgages. The FHA, with about $5 billion in regulatory capital, guarantees another 10 percent, and commercial and savings banks own another 25 percent, which on a mark-to-market basis are substantially underwater. Most of the remainder is in the form of private MBS, also substantially underwater.

lower the price of government support increases the odds that the government will misprice risk and put taxpayers at risk.[14]

Expanding on this summary, we see three reasons why the government cannot successfully price risks:

(i) Unlike an insurance company, the government has no profit incentive to price for risk, and because risk pricing can seem arbitrary and unrelated to current conditions, the government has many incentives to avoid the political controversy that risk pricing entails;

(ii) If the government actually attempted to set a price based on risk associated with any particular mortgage, it would be discriminating among its citizens, since some present greater risks than others; this would inevitably bring the risk-pricing project to a halt; and

(iii) Successful insurance systems require the buildup of substantial reserves during good times to pay claims during the inevitable bad times, but the government lacks the discipline and incentives to follow through. During the good times, the government comes under political pressure not to increase a reserve fund by continuing to collect fees or premiums.

The administration's report notes this tendency. "Political pressure to lower the price of government support increases the odds that the taxpayer will be forced to bear the cost of the government losses."[15] The argument is made that times are different, that the fund is large enough, or even that the industry is strapped for investment capital. These pressures cause the government to let it ride, to refrain from collecting the necessary fees or premiums. This has occurred with the National Flood Insurance Program,[16] the Pension Benefit Guaranty Corporation,[17] the FHA,[18] and the Federal Deposit Insurance Corporation (FDIC).

Recent FDIC experience is symptomatic of government's tendency to avoid collecting the necessary premiums. When the deposit-insurance system was reformed in 1991 in response to the failure of the FSLIC, Congress placed a limit on the size of the deposit-insurance fund that the FDIC could accumulate to meet the demands of a future crisis. Since 1996, the FDIC has been prohibited by law from charging premiums to well-capitalized and stable institutions. As a result, between 1996 and 2006, institutions representing 98 percent of deposits paid no deposit-insurance premiums. In 2009, FDIC chair Sheila Bair observed: "An important lesson going

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[14] Departments of Treasury and HUD, *Reforming America's Housing Finance Market*, 26.
[15] Ibid., 26.
[16] "FEMA Administrator Craig Fugate says the debt results partly from Congress restraining insurance rates to encourage the purchase of coverage, which is required for property owners with a federally backed mortgage. . . . 'It is not run as a business,' Fugate said. Congress' Government Accountability Office said in April that the program is 'by design, not actuarially sound' because it has no cash reserves to pay for catastrophes such as Katrina and sets rates that 'do not reflect actual flood risk.' Raising insurance rates or limiting coverage is hard. 'The board of directors of this program is Congress,' Fugate said. 'They are very responsive to individuals who are being adversely affected.'" (Thomas Fink, "Huge Losses Put Federal Flood Insurance Plan in the Red," *USA Today*, August 26, 2010.)
[17] As of the end of FY2010, the Pension Benefit Guaranty Corporation (PBGC) reported a deficit of $23 billion. "In part, it is a result of the fact that the premiums PBGC charges are insufficient to pay for all the benefits that PBGC insures, and other factors." Pension Benefit Guaranty Corporation, "2010 PBGC Annual Report," www.pbgc.gov/about/ar2010.html (accessed January 14, 2011).
[18] Barclays Capital estimates that the FHA has drastically underpriced the risk of its guarantees and could face losses of up to $128 billion. Barclays, "US Housing Finance: No Silver Bullet," December 13, 2010.

forward is we need to be building up these funds in good times so you can draw down upon them in bad times."[19] Instead, once the bad times hit, the FDIC was forced to raise its premiums at the worst possible moment, thereby reinforcing the impact of the down cycle.

Principle II will discuss in greater detail the necessity for entities taking broad mortgage credit risk to build up thick contingency reserves through countercyclical reserving policies.

2. A government guarantee of MBS alone will have the same effect in creating taxpayer losses as any other guarantee. Several ideas recently advanced for government backing of the housing market, including the administration's Option 3, have suggested that the government's guarantee would extend only to MBS and not to the issuers of these securities. These plans would obligate the government to pick up losses only after the capital of an MBS issuer has been exhausted and would require the issuer to pay a fee to the government to cover the government's risks. This idea is presented as though it will prevent losses similar to those that have resulted from the operations of Fannie and Freddie—that the government's risks will be reduced and the likelihood of taxpayer losses will be minimized.

This is an illusion. As noted above, the fee to cover the taxpayers' risks cannot be effectively set by the government. Even if government had the incentives and capabilities to assess a proper fee, the assessment would be seen and attacked as an unfair tax on those who are using the government's services. For example, when the Office of Management and Budget suggested near the end of the Clinton administration that Fannie and Freddie pay a fee for the government's risk on its implicit backing of their obligations, the idea was immediately derided as a tax on homeownership, the administration was inundated with protests from the housing industry, and the proposal was promptly abandoned. Apart from whether a fee can be credibly established, it is fanciful to believe that any government will have the political fortitude to impose a fee that burdens homeowners or the housing industry because of the risks they pose to taxpayers.

Nor is the problem solved—as many of the supporters of these guarantee plans suggest—if the government is liable for losses on guaranteed MBS only after the issuer of the MBS has absorbed the first losses and exhausted its capital. It is true that in this case issuers will have an incentive to be cautious about risk taking, but the government guarantee eliminates an important element of market discipline—the risk aversion of investors. These securities will undoubtedly be sold worldwide as US government credit. The existence of a government guarantee will mean that no MBS buyer needs to be concerned about the quality of the underlying loans or the financial stability of the issuer. This is exactly analogous to the effect of deposit insurance on risk taking by banks. As is well known, deposit insurance permits bank depositors to ignore the risks a bank is taking—the principal reason that so many banks fail. As in the case of deposit insurance, government backing of MBS will eliminate investor concerns about both the financial stability of the issuer and the quality of the mortgages underlying the MBS. This will introduce destructive moral hazard into the housing finance market, allowing the expansion of risks through the securitization of very low-quality mortgages.

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[19] Center on Federal Financial Institutions, "Federal Deposit Insurance Corporation," August 10, 2005, www.coffi.org/pubs/Summaries/FDIC%20Summary.pdf (accessed January 14, 2011). See also Congressional Budget Office, "Modifying Federal Deposit Insurance," May 9, 2005, "Currently, 93 percent of FDIC-insured institutions, which hold 98 percent of insured deposits, pay nothing for deposit insurance."

A companion risk will also spontaneously arise: these entities, chartered and regulated by the government, and carrying out a government mission, will inevitably be seen as functioning under government sponsorship. As such, they will be imbued with an implicit guarantee and might even be expected to perform other governmental functions such as supporting affordable housing. As we saw with Fannie and Freddie, both elements almost always accompany the performance of a government mission.

The protection of the government and the taxpayers in these cases will then supposedly come through regulation—another prescription of the advocates of government backing for MBS. They argue that regulation of the issuer is necessary to ensure that it has sufficient capital to cover the risks it is taking and thus to protect the government and the taxpayers from loss. But experience with bank regulation has shown that it does not prevent excessive risk taking and does not ensure sufficient capital to cover risks. Moreover, regulators are frequently unable to determine the financial condition of a regulated entity until it is too late. In these cases, the taxpayers will once again end up holding the bag.

3. Government backing distorts prices, resource allocation, and competition. The fact that the government cannot price for risk should be an important clue about the distorting effect its guarantee will have on competition. For the reasons outlined above, the government's charge for supporting one sector of the housing market will be lower than what the actual risk would demand, so its backing will operate as a subsidy for the sector of the housing market it is actually covering. For an equivalent risk, all other things being equal, the government-guaranteed mortgage will always be cheaper than the privately backed mortgage. This simply means that the taxpayers are providing a benefit to the borrower and the lender. The real costs to society appear later. As we will see, however, with appropriate reforms, it is possible that private-sector mortgage costs will reach the same level as those with government backing, while still protecting the taxpayers against loss.

In the housing finance system as it exists today, however, private competitors will be driven out of any sector of the market where the government guarantee is offered. Moreover, political pressures will make it attractive to extend the benefits of the lower-cost government-backed mortgage to more constituents, expanding the size of the sector that will be covered by the guarantee, and thus gradually extending the government's obligations to cover a larger sector of the market.

We have seen this before. With Fannie and Freddie able to borrow at much lower rates than others because of their implicit government backing, they drove all potential private competition out of the secondary market for fixed-rate prime loans at or below the conforming loan limit, and most mortgage originators preferred to direct their production to Fannie and Freddie, which could offer them the best pricing. Political pressure—to allow more members of the public to get the benefits of the taxpayer subsidy—also extended the subsidized market into an area that had previously been reserved for private activity. Thus, when Congress enacted the Housing and Economic Recovery Act of 2008,[20] it raised the conforming loan limit for Fannie and Freddie so buyers of million-dollar homes would have access to the benefits of the taxpayer subsidy provided free to Fannie and Freddie. In 1992, Congress pushed the subsidy in the other direction, requiring Fannie and Freddie to make what were called "affordable housing" loans to

[20] Housing and Economic Recovery Act of 2008 (HERA), Pub. L. No. 110-289 (July 30, 2008).

borrowers at or below the median income in the areas where they lived. Accordingly, if a government guarantee is again introduced into the housing sector, it will gradually grow to squeeze out private nongovernmental financing of mortgages. In other words, it is unlikely that Congress, once it allows any portion of the housing market to be covered by a government guarantee, will be able to place any effective limits on the extent of the taxpayers' risks.

4. It is a myth that only a government guarantee can make a thirty-year fixed-rate mortgage available. The administration's report suggests that without a government role in the housing market the thirty-year fixed-rate mortgage will not be available to American homebuyers. On its face, this is not true, since anyone can go to the Internet and find lenders offering jumbo fixed-rate thirty-year loans—which, by definition, have no government backing. It is true that, at this point, a thirty-year fixed-rate mortgage is somewhat more expensive than a government-backed thirty-year fixed-rate mortgage, since the lender is taking a longer-term risk on interest rates, but the lower cost of the government mortgage simply means that the taxpayers—as well as all other mortgage borrowers who are not taking thirty-year fixed-rate mortgages—are providing a subsidy to the person who wants a government-backed mortgage with these terms.

History has shown—and simple economics would anticipate—that a government subsidy for a thirty-year fixed-rate mortgage is not good policy. The subsidy causes most borrowers to choose the thirty-year loan, since in general it offers a fixed, low monthly payment with a government-subsidized "free" prepayment option. Supporters, including the administration in its Option 3, point to the apparent stability it provides to borrowers. This "stability," however, carries with it several serious deficiencies. A thirty-year loan amortizes slowly, keeping the homeowner's equity low and debt level high for a good portion of the loan period. If the home is sold after seven years (the average duration of occupancy), the homeowner has not accumulated much equity.[21] In addition, the "free" prepayment option encourages equity withdrawal through serial refinancing.

For these reasons, it is peculiar that the proponents of government backing are never asked to explain why the taxpayers and other mortgage borrowers should be subsidizing a thirty-year fixed-rate mortgage. This is not to say that this mortgage should not be available, but only that homeowners who want such a loan should not expect the taxpayers to subsidize its availability. In today's market, it is available at a slightly higher cost without a taxpayer subsidy.

There is an additional benefit to a market without government guarantees. Borrowers would have a variety of solidly underwritten loan choices.[22] What the interest rates would actually be depends, of course, on monetary and fiscal policy in the United States. As an example of what the loan menu might look like, we take a historically typical spread of about 2 percent over the ten-year Treasury rate for a thirty-year fixed-rate jumbo loan and assume a 4 percent yield on the ten-year Treasury note. (From 2002 to 2008, the average spread on a thirty-year fixed-rate jumbo loan was a little under 2 percent, and the average ten-year Treasury yield was about 4 percent.) This gives a base price of 6 percent for a thirty-year, fixed-rate, freely

[21] See, for example, Peter J. Wallison, "What's So Special about the 30-Year Mortgage?" *Wall Street Journal*, February 1, 2011, www.aei.org/article/103092.

[22] Loan-performance data demonstrate that loans with a fixed-rate period of seven years, ten years, and thirty years (all with a thirty-year amortization) have similar default experiences.

prepayable jumbo mortgage. A loan with the same structure, but guaranteed by Fannie or Freddie, would be slightly less costly because of the government subsidy. A 2005 study estimates the differential at about thirty basis points;[23] a Federal Reserve study in 2005, however, estimates the differential at seven basis points.[24] Whichever is correct, the benefit associated with the government subsidy is far outweighed by the detriments a government role carries with it.

In the list below, we use the 6 percent jumbo fixed-rate mortgage as a benchmark to estimate the range of probable rates for a series of mortgages with different characteristics that would be available in a nongovernment market. In this market, we would expect some borrowers to select a thirty-year fixed-rate freely prepayable loan at an interest rate of 6 percent with others selecting a different option based on their needs and cost. These options offer a lower rate for a shorter maturity and/or a lower rate if borrowers choose a loan with a prepayment fee:

6.00%	thirty-year fixed-rate term with no prepayment fee
5.625%	thirty-year fixed-rate term with a 3-2-1 prepayment fee[25]
5.375%	thirty-year amortization with fifteen-year fixed-rate term and a 3-2-1 prepayment fee
5.375%	fifteen-year fixed-rate term with no prepayment fee
5.125%	fifteen-year fixed-rate term with a 3-2-1 prepayment fee
5.00%	seven-year adjustable-rate mortgage (ARM) with thirty-year amortization underwritten at fully indexed seven-year rate with no prepayment fee
4.75%	seven-year ARM with thirty-year amortization underwritten at fully indexed seven-year rate with a 3-2-1 prepayment fee

5. Should the government guarantee a steady flow of credit for housing? One of the key arguments for government support in housing finance is that only with such support can a steady flow of credit to the housing market be assured. Originally, this argument was based on past experience, which is no longer relevant. Government regulation of interest rates, specifically the old Regulation Q deposit-rate ceilings, caused frequent periods when banks and S&Ls could not offer competitive rates for savings. The result was that mortgage lending, housing construction, and home sales were severely impaired. After Regulation Q was eliminated, this ceased to be a problem.

Now the argument has changed; in the event of a financial crisis, it is said, the government should make sure housing gets credit and funding in preference to manufacturing, commerce, consumer credit, or anything else. As the administration noted in its report, this effect

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[23] Anthony B. Sanders, "Measuring the Benefits of Fannie Mae and Freddie Mac to Consumers: Between De Minimis and Small?" July 2005, http://fic.wharton.upenn.edu/fic/papers/05/0536.pdf (accessed January 14, 2011).
[24] Wayne Passmore, Shane M. Sherlund, and Gillian Burgess, "The Effect of the Housing Government Sponsored Enterprises on Mortgage Rates," Federal Reserve Board Finance and Economics Discussion Series, January 2005, www.federalreserve.gov/pubs/feds/2005/200506/200506abs.html (accessed March 18, 2011).
[25] A prepayment fee of 3 percent in year one, 2 percent in year two, 1 percent in year three, and zero percent thereafter.

is not good policy: "The increased flow of capital into the mortgage market [encouraged by a government guarantee] could draw capital away from potentially more productive sectors of the economy and could artificially inflate the value of housing assets."[26] It is hard to defend this preference for housing on economic grounds. Indeed, most of the time, the involvement of the government in housing finance creates the danger of excess supply of credit to housing relative to all other sectors. The administration again sees the issue the same way: "With less incentive to invest in housing, more capital will flow into other areas of the economy, potentially leading to more long-run economic growth and reducing inflationary pressure on housing assets."[27]

Government involvement helps encourage homebuilders to overbuild, lenders to overlend, and borrowers to overborrow. In other words, it is a source of moral hazard. If participants in the housing market are insulated from changes in the market, they will take more risks and be less prudent in their investment decisions. The possibility that financing for housing could be subject to disruption or financing restrictions is, of course, one of the risks the housing industry fears, but that fear will reduce the overbuilding and excessive leverage that have caused volatility and repeated housing bubbles in the past. Other industries, of course, manage perfectly well to survive fluctuations in the availability or cost of funding. This issue will be discussed further under Principle II.

A related and frequently cited reason for a government role in housing finance is what is known as TBA—or "To Be Announced" funding. TBA permits homebuyers to "lock in" an interest rate with a bank or other financing source when they agree to purchase a home. This can be replicated in a fully private market if the originating or funding bank uses a hedging strategy to ensure that when the funds are called on, it will be able to supply them at the interest rate originally agreed with the homebuyer, even if market rates have changed. The bank's hedging strategy has a cost, and it will be included in the rate that the bank quotes for the loan. The additional hedging cost is not a major factor in the interest rate, so there is no reason for the government to be involved in this or for the taxpayers to support a whole system of government enterprises to make sure it is available.[28] Under Principle II, we outline why we expect this activity to reemerge in a private MBS market without the taxpayer risks associated with a government guarantee.

6. Is a government guarantee necessary to sell MBS to institutional investors and others? Finally, there is the argument—sometimes explicit and otherwise implicit—that institutional investors will only buy US mortgages, or MBS backed by US mortgages, if they are supported by a government guarantee. This is probably the key reason that government backing of housing finance continues to enjoy support in Washington. It would certainly be a weighty argument if the quality of the mortgages were generally low; in that case, delinquency rates and defaults would be high, and the risks of investment in mortgages or MBS could well be unacceptable for institutional investors such as insurance companies, pension funds, mutual funds, and others. Even in that case, it is questionable whether the taxpayers should support a housing market in which mortgage quality was generally low. But as discussed below, there is no

[26] Departments of Treasury and HUD, *Reforming America's Housing Finance Market*, 30.
[27] Ibid., 27.
[28] See Kevin Villani, "The Future of US Housing Finance: Why a Competitive Market Oriented Housing Finance System Is Still Best," November, 2010, http://chicagoboyz.net/blogfiles/TheFutureVIL.pdf (accessed January 14, 2011).

reason why mortgages have to be low quality, especially the mortgages allowed into the securitization market.

Until the introduction of the affordable-housing requirements for Fannie and Freddie, the GSEs maintained high underwriting standards and never suffered substantial losses on the mortgages they held or guaranteed. Indeed, their charter required them to purchase only prime loans. Section 1719 of Fannie's charter stated: "[T]he operations of the corporation . . . shall be confined . . . to mortgages which are deemed by the corporation to be of such quality, type, and class as to meet, generally, the *purchase standards imposed by private institutional mortgage investors*."[29]

Even in the current crisis, the GSEs' delinquency rates among *prime* mortgages have been less than 3 percent, while their delinquency rates on the subprime and Alt-A loans they acquired largely because of the affordable-housing goals have ranged from 13.3 to 17.3 percent.[30] Accordingly, the key to a successful mortgage market is not a government guarantee—which will inevitably cause serious losses to the taxpayers—but ensuring that the mortgages that are sent into the securitization market are of prime quality.

Under Principle II, we will show that by implementing policies that ensure good-quality mortgages, it is possible to create a stable housing finance system that attracts institutional investors without the need for any government involvement.

[29] Cornell University Law School, "US Code: § 1719. Secondary Market Operations," www.law.cornell.edu/uscode/html/uscode12/usc_sec_12_00001719----000-.html (accessed March 18, 2011). Emphasis added.
[30] Edward J. Pinto, "Government Housing Policies in the Lead-Up to the Financial Crisis: A Forensic Study," November 4, 2010, chart 53, www.aei.org/docLib/Government-Housing-Policies-Financial-Crisis-Pinto-102110.pdf.

II. Ensuring mortgage quality and fostering the accumulation of adequate capital behind housing risk can create a robust housing investment market without a government guarantee.

Many observers have noted that when Congress adopted the Dodd-Frank Act (DFA) it failed to address the real causes of the financial crisis—the government housing policies that enhanced the size and duration of the housing bubble and encouraged the creation of 27 million subprime and Alt-A loans. These weak loans fed the growth of an unprecedented housing bubble, and as the bubble grew it suppressed the delinquencies and defaults that usually signal to investors that acquiring low-quality mortgages entails substantial risks. When the bubble finally began to deflate, these weak and high-risk loans began to default at unprecedented rates, weakening financial institutions in the United States and around the world that were holding either these mortgages or the MBS they backed. If Congress had properly diagnosed the causes of the financial crisis before it began drafting the enormously complicated and unnecessary DFA, it would instead have enacted legislation to correct the deficiencies in government policy and the mortgage market that were the source of the bubble, the unprecedented number of weak and high-risk mortgages in the US financial system, the financial crisis of 2008, and the serious recession that followed.

Generally, economic theory suggests that regulation is only appropriate when there is a market failure. The development of housing bubbles, and their tendency to suppress the normal signals associated with risk, demonstrates that conventional market-control mechanisms—key elements such as market discipline—are not capable of preventing the downward slide in mortgage underwriting standards as a bubble develops. This is exactly what happened before the onset of the financial crisis. By the early 2000s, government investment in subprime and other low-quality mortgages had built a bubble that was almost five years old and still growing.[31] With delinquencies and defaults suppressed, subprime lending seemed highly profitable. By 2002, potential investors around the world could see that high yields were available on MBS based on pools of subprime loans with relatively few losses. In other words, these securities appeared to have high risk-adjusted returns. This accounts for the extraordinary growth of the private subprime MBS market—a market that had never existed before—beginning in 2002 and extending until the collapse of the bubble in 2007.

It is typical to see increasing leverage (and expanding demand) during the growth portion of the cycle. Homeowners seek mortgages that will enable them to buy larger homes with nearly the same monthly payment. Increased borrower leverage results from reduced down-payment and debt-to-income requirements, increased reliance on so-called affordability products such as adjustable-rate and interest-only loans, and extended eligibility for loans among borrowers with impaired credit. As prices outpace incomes, nontraditional lending expands to meet the new or greater affordability gap. Lenders accede to these requests because they have become excessively optimistic and believe that rising home prices will continue to rise and limit their risk

[31] Josh Rosner, "Housing in the New Millennium: A Home without Equity Is Just a Rental with Debt" (presentation, 2002 Mid-Year Meeting, American Real Estate and Urban Economics Association, National Association of Home Builders, Washington, DC, May 28–29, 2002), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1162456 (accessed March 18, 2011). Rosner noted that government efforts to reduce down payments and promote housing targeted to low-income borrowers had already been a major catalyst to the nineties housing boom.

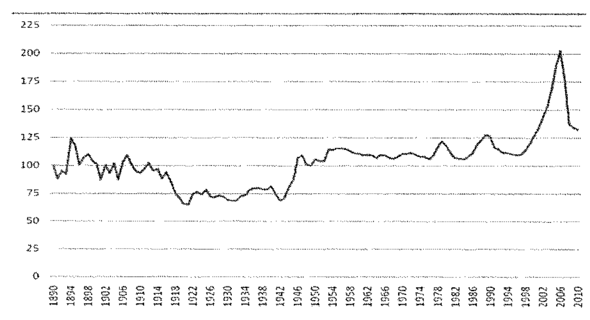
of loss. Indeed, increasing home prices have suppressed the delinquencies and defaults that typically signal to lenders and investors that the risks are rising. This may keep the "up" portion of the cycle growing, but it weakens the underlying stability of the market, adding particular vulnerability for the most recent borrowers. We have enough experience with housing bubbles now to realize that they are artifacts of human nature and will occur to some extent no matter what we do. However, we can reduce their frequency and the damage when they deflate by ensuring the maintenance of sound credit standards.

One of the characteristics of bubbles is that they are difficult to recognize while you are inside, but very easy to recognize in hindsight. Also, the fact that they occur in many assets other than mortgages suggests that they reflect the human tendency to explain away unusual circumstances on the ground as "this time it's different." However, real estate bubbles have been particularly harmful to the US economy when they collapse; the prescriptions in this paper—while they will not entirely prevent bubbles—will go a long way toward making them less likely, less widespread, and smaller.

Since the 1920s, there have been at least four real estate booms followed by two serious corrections and two busts.[32] The boom periods were the 1920s (17 percent real home-price increase), the late 1970s (16 percent real home-price increase), the late 1980s (20 percent real home-price increase), and 1997–2006 (85 percent real home-price increase).

Figure 1 shows the trend of real home prices since 1890. The real-price trend clearly shows the recent bubbles in 1979, 1989, and 1997–2006.

Figure 1: Real Home Prices, 1890–2010[33]



There are common elements in these episodes: government support for increasing homeownership, widespread use of second mortgages to reduce down payments, excessive

[32] The real-price boom that occurred over 1942–1955 (72 percent real-price growth) is excluded given the unusual circumstances relating to World War II and the postwar baby boom. By 1955, real prices had recovered to their late 1890s to early 1900s trend line.

[33] Compiled from Robert Shiller's updated historical housing market data used in his book, *Irrational Exuberance* (Princeton University Press, 2000; Broadway Books, 2001; 2nd edition, 2005). Data available at www.econ.yale.edu/~shiller/data.htm.

leverage, reliance on adjustable-rate and negatively amortizing loans, higher debt-to-income ratios, and extensive use of low- and no-doc loans. This suggests that with limited regulatory intervention, particularly by ensuring mortgage quality, the effects of bubbles in the United States can be mitigated. That is, bubbles will occur, in housing as in other fields, but when they deflate, they will not be as destructive as in the past. If we can address these common elements through regulation focused on credit quality, we can accomplish what the DFA will fail to do: prevent another financial crisis arising from a proliferation of weak mortgages.

Accordingly, beyond removing government subsidies and guarantees from housing finance, much can be accomplished simply by adopting seven policies for the regulation of housing finance in the future:

1. Ensure that a high preponderance of loans are prime. We should adopt policies to ensure that a high preponderance of all mortgages in the future will be of prime or high quality. This should not be difficult, nor will it unreasonably limit the availability of mortgages. According to a Federal Reserve study, over 70 percent of all individuals with credit records in the United States (not just all homeowners with credit records) have FICO credit scores that are 660 or above—the foundation for a prime loan. Well over a majority (58 percent) have credit scores above 700.[34] In both 1989[35] and 2010,[36] 87 percent of borrowers taking out a mortgage loan had a FICO score of 660 or greater. In 1991, the great majority of conventional loans (defined as being Fannie eligible, other than by loan size) had the following characteristics:

- 98 percent were loans on properties occupied as a primary or secondary residence.[37]
- 94 percent were loans with a loan-to-value ratio (LTV) of 90 percent or less.[38]
- 98 percent were to borrowers with one or no mortgage late payments at origination and 85 percent had two or fewer nonmortgage late payments at origination.[39]
- 90 percent were loans with housing and total debt-to-income ratios of less than 33 percent and 38 percent, respectively.[40]
- All loans had to be underwritten based upon verified income, assets, and credit.[41]

Nevertheless, to ensure the continuing quality of mortgage loans, it will be necessary to define the characteristics of loans with relatively low default rates. The characteristics of a prime loan do not generally change over time, an experience confirmed over long periods in the United

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[34] Board of Governors of the Federal Reserve System, "Report to Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit," August 2007, www.federalreserve.gov/boarddocs/rptcongress/creditscore/creditscore.pdf (accessed March 18, 2011).

[35] Letter in author's file dated October 30, 1989, to Ed Pinto from Equifax enclosing odds charts for new real estate accounts developed by Fair, Isaac Company (FICO).

[36] FICO presentation at American Securitization Forum 2011, "Consumer Metrics and Evaluation," February 6, 2011.

[37] Data from Fannie Mae's random-sample review covering single-family acquisitions for the period October 1988–January 1992, dated March 10, 1992. Document contained in the authors' files.

[38] Ibid.

[39] Ibid.

[40] Ibid.

[41] Fannie stopped acquiring low-doc or no-doc loans in 1990. Freddie followed suit in 1991. See "Haste Makes . . . Quick Home Loans Have Quickly Become Another Banking Mess," *Wall Street Journal*, July 5, 1991.

States and other developed countries. Historically, prime fixed-rate loans had a default rate of less than one in one hundred loans,[42] prime loans with an LTV of 81–90 percent have had a default rate of about 2.5 in one hundred loans, and loans with private MI (both fixed rate and ARMs and LTVs up to 97 percent) have experienced a default rate of about five in one hundred loans.[43] Loans with FHA insurance have experienced a default rate in excess of ten in one hundred loans.[44] In appendix 1, we provide the details for defining a prime loan.

2. Correspondingly, nonprime loans should be a relatively small percentage of all loans. Given that the market share of nonprime loans tends to grow as a boom develops, these loans—characterized by low or no down payments, increased debt ratios, impaired credit, reduced loan amortization, loans to investors or speculators, and other underwriting standards not present in prime loans—must be limited to a relatively small percentage of all mortgage loans. It is the accumulation of these loans that first buoy, then capsize, a regional or national housing market. Nonprime loans are unsuitable to serve as collateral for private MBS and covered bonds.[45]

3. Allow securitization only for prime loans. The DFA proposes a cumbersome and possibly unworkable system of risk retentions in cases where loan securitizations do not involve a Qualified Residential Mortgage (QRM), which is to be defined by regulation. In light of the earlier discussion of bubbles—in which we described the relationship between declining underwriting standards and the growth of bubbles—it makes more sense simply to require that the securitization market be used only for prime loans. That would do away with retentions and the need for a QRM. Nonprime loans could then be held in the portfolios of banks, insurance companies, pension funds, and other financial institutions, but only if the market transparency described in number six below allows investors, rating agencies, and others to understand how many of these nonprime loans are outstanding.

4. A potentially valuable structure would require MI for securitized loans with LTV ratios higher than 60 percent. Despite their underlying quality, prime mortgages with LTVs higher than 60 percent require some form of credit enhancement to be attractive to investors. Below is a Fannie Mae table showing the loan-level pricing adjustment (LLPA) fees that Fannie now adds to the mortgages it acquires.[46] These are a form of self-insurance; the table shows fees applied in varying amounts to virtually all loans with LTVs greater than 60 percent, but not to loans with LTVs below that level. The table also shows that as FICO scores rise, loan-level fees decline for loans with equivalent LTVs.[47]

[42] Derived from Freddie Mac data.
[43] Standard & Poor's Ratings Direct Report, December 27, 2008.
[44] FHA's 2010 and 2003 Actuarial Studies.
[45] Ginnie Mae securities backed by government agency loans would be exempt.
[46] There are some miscellaneous loan-level fees not shown on this chart, virtually all of which are applied to loans with an LTV greater than 60 percent.
[47] See Fannie Mae, "Loan-Level Price Adjustment (LLPA) Matrix and Adverse Market Delivery Charge (AMDC) Information," December 23, 2010, https://www.efanniemae.com/sf/refmaterials/llpa/pdf/llpamatrix.pdf (accessed March 18, 2010). LLPAs take into account specific credit risks associated with down payment size and credit score. These types of risks may be determined on an actuarial basis and are generally uncorrelated.

Table 2: All Eligible Mortgages (Excluding MCM): LLPA by Credit Score/LTV

PRODUCT FEATURE	LLPAs by LTV Range								
	≤ 60.00%	60.01 – 70.00%	70.01 – 75.00%	75.01 – 80.00%	80.01 – 85.00%	85.01 – 90.00%	90.01 – 95.00%	95.01 – 97.00%	SFC
Representative Credit Score	Applicable for all mortgages with greater than 15-year terms For whole loans purchased on or after April 1, 2011, and loans delivered into MBS with issue dates on or after April 1, 2011. (LLPA changes highlighted in bold)								
≥ 740	-0.250%	0.000%	0.000%	0.250%	0.250%	0.250%	0.250%	0.250%	N/A
720 – 739	-0.250%	0.000%	0.250%	0.500%	0.500%	0.500%	0.500%	0.500%	N/A
700 – 719	-0.250%	0.500%	0.750%	1.000%	1.000%	1.000%	1.000%	1.000%	N/A
680 – 699	0.000%	0.500%	1.250%	1.750%	1.500%	1.250%	1.250%	1.000%	N/A
660 – 679	0.000%	1.000%	2.000%	2.500%	2.750%	2.250%	2.250%	1.750%	N/A

These are the requirements for what one would call "normal loss experience" on prime mortgages. Additional MI or other credit enhancement would be necessary to address catastrophic conditions, such as a housing price decline of as much as 35 percent. Fitch Ratings, for example, proposed in a recent report that each loan have sufficient loss protection to experience a severe stress event as represented by a 35 percent price decline, again focusing on the risks associated with loans with an LTV above 60 percent.[48]

Today, Fannie and Freddie are required by statute to have MI coverage (or other third-party credit enhancement) for all loans where the LTV is higher than 80 percent. As noted above, since 2008, Fannie Mae and Freddie Mac have been applying LLPAs to most mortgages with LTVs above 60 percent to cover their additional risks beyond the required insurance coverage. Because of their implicit government backing, they can avoid any further credit enhancement in order to sell their MBS.

The private securitizations that we envision could use other forms of credit enhancement—a combination of subordinated tranches and private MI—to achieve an AAA rating for the MBS. In the traditional private securitization, the AAA-rated securities are credit enhanced largely by subordination; the lower tranches in a securitized pool (say, BBB-rated) are generally not entitled to any payment until the AAA tranches have been paid in full. The size or thickness of the subordinated tranches provides the assurance that investors in AAA-rated securities need; the riskier the pool, the larger the subordinated tranches have to be. In other words, the existence of a thick subordinated layer can make the pool a reliable counterparty for an institutional investor.

However, a thick subordinated layer also adds to the cost of credit enhancement. In addition, the lower tranches in a securitized pool of mortgages are only available to support the AAA securities based on that pool. By adding private MI, we can lower the cost of credit enhancement. This is because the companies that issue MI coverage are required by insurance regulators to establish capital reserves that are available to cover losses on all covered mortgages

[48] Fitch Ratings, "US Prime RMBS Loan Loss Model Criteria: Exposure Draft," February 1, 2011. A severe stress event is usually associated with an economic downturn such as a deep recession with its attendant increased unemployment, which puts stress on incomes, employment, and home prices. This type of risk may not be actuarially determined; instead stress tests are based on worst-case depression scenarios. While these risks result in losses that are generally correlated; the impact can be kept manageable with sound underwriting and the accumulation of substantial reserves able to withstand such a level of stress.

in multiple pools and book years. MI is thus a more efficient—and less costly—form of credit enhancement than added thickness to the subordinated layers.

MI also has important advantages for the coverage of losses that occur in catastrophic conditions. Under current insurance regulation, 50 percent of premium revenues must be transferred to required reserves, and they are intended to be used only for catastrophic conditions. Normal claim payouts along with normal expenses have to be handled out of the remaining 50 percent. This reserve level has been in force since the establishment of the modern MI business in 1957, following the industry's collapse during the Great Depression and its reorganization according to new principles.[49] These principles, including the establishment of required reserves, enabled virtually the entire MI industry to survive the recent financial crisis while meeting its coverage obligations. Over time, the buildup of these required reserves will fully protect the holders of privately issued MBS against the possibility of another financial crisis.

The specific elements of the MI coverage and insurer standards that we envision are outlined in appendix 1 but may be summarized as follows. The MI firms will issue coverage only for prime loans as defined in appendix 1. They will be state-regulated monoline companies—operating independently of originators, issuers, or others; maintaining minimum risk-to-capital ratios;[50] and allocating 50 percent of gross premiums to catastrophic contingency reserves (required by state insurance regulations to be held for ten years). Over time, these reserves will likely lead to even lower risk-to-capital ratios.

Accordingly, under our proposed private financing system, prime mortgages with LTVs higher than 60 percent would be credit enhanced with MI down to the 60 percent level. This would apply to any loan with a term of sixteen to thirty years and an LTV greater than 60 percent. Fully amortizing loans with a term of fifteen years or less perform markedly better than loans with longer terms; therefore, these loans will require MI only if they have an LTV greater than 80 percent, and then only down to 70 percent.

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[49] Thomas Herzog, "History of Mortgage Finance With an Emphasis on Mortgage Insurance", 2009, http://www.soa.org/library/monographs/finance/housing-wealth/2009/september/mono-2009-mfi09-herzog-history.pdf

[50] Current regulations require an MI company to maintain a twenty-five-to-one risk-to-capital ratio, regardless of risk profile. The industry entered the crisis with a much lower risk-to-capital ratio of 13.9 to 1, due to the accumulation of statutorily required catastrophic reserves. When the housing crisis hit in late 2007, 64 percent of MI companies' primary risk in force had an LTV of greater than 90 percent and 96 percent had an LTV of greater than 85 percent. It is now estimated that the industry will suffer a projected conditional claim rate of 17 percent. This severe claims experience represented a loss event at the ninety-sixth percentile, meaning that out of all possible loss scenarios, this event was worse than 95 percent of them. An MI rated AA is expected to survive 99.5 percent of all such loss scenarios. This explains why MI companies have been able to pay virtually all eligible claims, with only the smallest MI company with about an 7 percent share being in run-off and still likely to pay an estimated 70 percent of its claims. We propose that MI companies be restricted to prime loans only, as defined in appendix 1. After the anticipated five-year GSE wind-down period, it is expected that 80 percent of the new risk in force will have an LTV of 80 percent or less. With initial risk-to-capital ratios ranging from thirteen to one for prime 90 percent LTV loans to forty-one to one for prime 65 percent LTV loans, these initial capital levels are sufficient to cover a stress event well beyond the severity of the one we have just experienced. For comparison purposes, Fannie had an overall risk-to-capital ratio requirement of 220 to 1 for its MBS guaranty business, with much of its capital invested in mortgages and housing tax credits.

The catastrophic reserve is designed to build up over a ten-year cycle. Before that buildup, we believe that the risk-to-capital ratios we recommend will be more than sufficient to withstand the level of stress experienced during the recent financial crisis. This will make the MI industry a reliable counterparty for institutional investors. At the same time, the use of risk-adjusted risk-to-capital ratios will have countercyclical effects; an upward trend in high LTV lending will require larger amounts of capital. After about eight years, the combination of normal capital along with the accumulated catastrophic reserve should be adequate to allow an MI company's risk-to-capital ratio to meet the AAA standard. This higher level of capital will allow for the continued extension of credit on a prudent basis during times of stress.

We have consulted with members of the MI industry and have been advised that if the mortgages they insure are prime mortgages as defined in appendix 1, they can maintain the risk-to-capital ratio scale noted in appendix 1, allocate 50 percent of their premium revenue to reserves as required, and still operate profitably. Accordingly, once it becomes clear that the MI industry will be participating in the private securitization process we envision, the industry should have no trouble recapitalizing itself to achieve an AA rating. Indeed, new companies are already entering the MI industry—most recently Essent US Holdings, a venture of Goldman Sachs, JP Morgan Chase, and two reinsurers, among others, with initial capitalization of $500 million.[51]

In our consultation with members of the MI and securitization industry, we were advised that the combined cost of MI for the coverages specified above, along with required subordinated (risk-bearing) tranches, would initially permit private MBS to fund a freely prepayable thirty-year fixed-rate prime loan with an all-in annual cost about twenty-five to forty basis points higher than Fannie's current cost for the same instrument. In this connection, we note that the program outlined by the Center for American Progress, which requires an explicit federal guarantee, would nevertheless result in a rate increase of about forty basis points.[52] If the administration's proposal to increase Fannie and Freddie's guarantee fees resulted, as expected, in a fifteen-basis-point higher fee, the indicated rate under the nongovernment MBS program would likely be only ten to twenty-five basis points higher than Fannie's new rate. Over time, one might expect the spread between the private MBS execution and a Fannie execution to narrow as the MI industry's catastrophic reserves build and demand increases for these securities.

MI companies reserve the right to rescind coverage on a finding of fraud. During the recent financial crisis period, when a growing bubble and declining underwriting, led to rampant mortgage fraud, misrepresentation, and appraisal errors,[53] the MI industry rescinded large

[51] James McGee, "Essent CEO Says Time Is Very Good to Start a Mortgage Insurer," Bloomberg.com, February 18, 2011, www.bloomberg.com/apps/news?pid=newsarchive&sid=axq7O3CVgCxs (accessed March 22, 2011).
[52] Mortgage Finance Working Group, *A Responsible Market for Housing Finance* (Washington, DC: Center for American Progress, January 27, 2011), www.americanprogress.org/issues/2011/01/responsible_market.html (accessed March 22, 2011).
[53] See Financial Crisis Inquiry Commission, *Financial Crisis Report*, xxii. "For example, our examination found, according to one measure, that the percentage of borrowers who defaulted on their mortgages within just a matter of months after taking a loan nearly doubled from the summer of 2006 to late 2007. This data indicates they likely took out mortgages that they never had the capacity or intention to pay. You will read about mortgage brokers who were paid 'yield spread premiums' by lenders to put borrowers into higher-cost loans so they would get bigger fees, often never disclosed to borrowers. The report catalogues the rising incidence of mortgage fraud, which flourished in an

numbers of claims with such errors. MGIC, the largest MI company with a market share of 20–25 percent, reports that it paid 72 percent of claims presented.[54] This claims payment percentage seems roughly in line with the rate of mortgage fraud that was said to have occurred during the bubble period.

5. Require a one-page mortgage-information disclosure form. This form would present clear, straightforward key information that allows borrowers to answer the question, "Can I afford this loan now and in the future?" See appendix 3 for an example of what this form should contain.

6. Counter government policies that promote bubbles. For many years, especially through the affordable-housing requirements imposed on Fannie and Freddie, government policies have focused on expanding homeownership by reducing the cost of credit while at the same time promoting looser credit standards. This resulted in increased demand, higher debt levels, leverage, and inflation in adjusted and real home prices. These policy choices reinforced the tendency of the market to rely increasingly on nonprime loans as a boom progresses and the bubble grows. Regulation is necessary, then, to counter the propensity of the government to enact only expansionary policies and limit the incentives government creates for the private sector to originate nonprime mortgages.

The loan standards and accumulation of capital described above are countercyclical. They will promote steady growth and work against credit-induced housing booms and bubble formation. The following counterexpansionary and countercyclical policies, which automatically apply the brakes as risk levels rise, would provide additional protection.

- **Countercyclical leverage requirements for high LTV or Combined Loan-to-Value (CLTV) loans.** Homeowner and investor leverage tend to grow as housing prices rise; lenders respond to homebuyer demands for loans that will allow them to buy a more expensive house while keeping low monthly payments. Not only are down payments reduced, but LTVs are also increased by combining first and second mortgages to create high combined LTVs. A well-designed countercyclical policy would require, for example, that LTVs and CLTVs be automatically reduced (that is, down payments would be increased) when housing prices have risen by a given percentage in a local area. This would slow housing-price growth by directly reducing the leverage that homeowners can use to increase the price they will pay for homes. As housing prices return to normal levels, LTVs and CLTVs would do the same. In addition, second mortgages or other junior lien mortgages should only be permitted where the first mortgage holder has given its consent.

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environment of collapsing lending standards and lax regulation. The number of suspicious activity reports—reports of possible financial crimes filed by depository banks and their affiliates—related to mortgage fraud grew 20-fold between 1996 and 2005 and then more than doubled again between 2005 and 2009. One study places the losses resulting from fraud on mortgage loans made between 2005 and 2007 at $112 billion."

[54] 2008–2010: $5 billion of claims paid
$2 billion of loss mitigation as a result of rescissions
71.5 percent of claims paid

At year-end 2010, MGIC had $5.9 billion in reserves. Derived from MGIC Investment Corporation, "10-K," March 1, 2011, 158 and 44, http://phx.corporate-ir.net/phoenix.zhtml?c=117240&p=irol-sec (accessed March 22, 2011).

- **Countercyclical loan-loss banking reserves.** Under current accounting standards, loan-loss reserves for banks and others are set based on recent delinquency and loss rates. However, bad loans are made in good times, when they seem good. The lean years inevitably follow the fat years, but under current reserve practices reserves are at their lowest levels at the beginning of a bust. Reserves should be built during good times, not bad.

- **Better appraisal practices.** Appraisers should report an estimated value using both the principle of substitution based upon comparable sales[55] and the principle of income capitalization based upon investment value as a rental.[56] Additionally, appraisals have long suffered from a lack of transparency in the selection of comparables.[57] This process would be remedied by identifying all appropriate comparables and using statistical techniques to help the appraiser select and reconcile all appropriate comparables. Transparency would allow the reader to validate and re-create the appraiser's comparable selection process. These provisions would be applicable to all federally related mortgages[58] and mortgages serving as collateral for private MBS and covered bonds.

7. Align economic interests and provide market transparency so investors, rating agencies, and guarantors are able to determine the number and quality of mortgages outstanding both at the point of origination and over time. Mortgage markets work best when aggregate risk levels are low and stable and when the economic interests of the various parties are aligned. It is now well understood that second mortgages do not met this test; on the contrary, the interests of the parties are actually in conflict. The interests of credit enhancers such as MI companies are generally aligned with investors' interests. Since MI generally attaches at loan origination, MI companies can take on the role of "cop on the beat"[59] because they could perform underwriting reviews prior to loan closing and conduct random sample reviews on a postclosing basis. Once these reviews are completed to the MI company's satisfaction, it might indicate that after a period of timely payments (say, twenty-four to thirty-six months), a loan will be presumed to be properly underwritten unless there are material shortcomings such as fraud, misrepresentation, or a significant property value discrepancy. To avoid adverse selection, this must rightly remain the responsibility of the originator. To reduce conflicts, the MI policy should provide for binding arbitration if a claim is denied.

Additionally, market participants must understand the true conditions in the market so they can properly assess the risk of investment. Nonprime loans increased rapidly over the period 1991–2007. This is best demonstrated by the rapid growth of home-purchase loans with little or no down payment. In 1990, one in two hundred home-purchase loans had a down payment of 3 percent or less; by 1999, it was one in ten; 2003, one in seven; and 2007, one in two and a half.

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[55] The cost of acquiring a comparable property fixes the upper limit of valuation. This is accomplished by identifying and evaluating suitable comparable properties that recently sold.
[56] The capitalization of expected income (rents) fixes an upper limit of valuation.
[57] Edward Pinto, unpublished study, 1991.
[58] Generally, loans originated by institutions regulated by banking regulators or purchased or guaranteed by a federal agency or sponsored enterprise.
[59] This role was historically played by MIs however the advent of Fannie and Freddie's automated underwriting systems in the late-1990s largely displaced the MIs from being involved in the loan approval process.

The extraordinary level of nonprime lending created a fragile market that adversely affected homeowners, mortgage insurers, and mortgage investors. It is not clear that anyone in the market or in government in 2007 and 2008 understood the dimensions of the nonprime mortgage problem. Fannie and Freddie did not disclose the number of subprime and other nonprime mortgages they were buying, holding, and securitizing, and thus even close students of the mortgage markets did not know what they did not know. Accordingly, the first line of defense is to make sure that the mortgage finance market has the information necessary to understand the amount of nonprime lending that is occurring.

It is important to reduce the tendency of homebuyers, lenders, and investors to believe that just because housing prices are rising, it is sensible or prudent to originate or buy a mortgage loan that will be repaid only if housing prices *keep* rising. This could be achieved in part by better disclosure of the characteristics and delinquency rates of mortgages originated, sold, and held by investors, and postlending due diligence by the lending and securitization industry to confirm that originated loans are as described—particularly with respect to owner occupancy and the presence of second mortgages. The results of this due diligence would be disclosed.

Response to the Administration's and Others' Concerns

In its report, while seeing advantages in a private housing finance system, the administration also identifies drawbacks. We will address those below and show that none of them is an obstacle to the implementation of a stable mortgage market.

An increase in mortgage rates. Although the administration recognizes that any changes in the current system—including the reforms the administration itself is recommending—are likely to moderately increase mortgage loan rates and that this in itself has policy advantages, it did not specify the amount by which mortgage rates might increase. As noted above, it is likely that the private housing finance system we propose will be able to deliver mortgages at costs that are a modest ten to twenty-five basis points higher than a GSE loan after taking into account the higher GSE capital requirement that the administration has recommended. We also believe that even this spread will narrow as more liquidity comes into a growing and competitive securitization market in the future.

The thirty-year fixed-rate mortgage. We have already noted that thirty-year fixed-rate mortgages are readily available in the jumbo market, without any government backing, and pointed out that as a matter of public policy there is no reason for the taxpayers to subsidize these loans.

Access to capital in a crisis. The administration's report expresses concern about whether—in a fully private market—there will be sufficient access to mortgage credit during a crisis. The administration argues, "absent sufficient government support to mitigate a credit crisis, there would be greater risk of a more severe downturn, and thus the risk of greater cost to the taxpayer."[60] This idea gave rise to the administration's Option 2, which is a private market with a government backstop that would be invoked only in the event of a financial crisis that makes credit unavailable for housing. Government involvement in this case is said to be necessary because in the event of a crisis its guarantee will reassure investors and keep money flowing to housing. Earlier, we discussed the moral-hazard element of this and its tendency to cause overbuilding and harmful bubbles, while never adequately compensating the taxpayers for the risks they are underwriting.

If one assumes that some backstop is necessary, however, we point out that the Federal Reserve and the Treasury Department will still be there and have demonstrated their capacity for crisis intervention. Any intervention would be made easier by the fact that the outstanding mortgages would be largely of prime quality and could be backed by MI. As noted above, MI has the capacity to accumulate the reserves that would supply capital to back the mortgages in a fully private-sector market that has suffered a catastrophic decline. We do not believe it would be good policy to set up a government backstop for crisis conditions, since the tendency will be to use it even when there is no legitimate crisis. Instead, in a market where there are MI-backed prime mortgages insured down to 60 percent LTV, the Fed should be able to step in without significant credit risk to provide liquidity assistance in crisis conditions.

Shifting mortgage risk to too-big-to-fail (TBTF) institutions. In congressional testimony after release of the administration's report, Secretary Geithner observed that simply

[60] Departments of Treasury and HUD, *Reforming America's Housing Finance Market*, 28.

eliminating Fannie and Freddie and substituting a private financing system might amount to shifting mortgage risk from the GSEs to the major banks. If these banks are, as many believe, too big to fail (TBTF), then, he suggests, we have done nothing to relieve the taxpayers of potential liability. This is an important point, but there are a number of responses.

1. Banks have substantially larger capital requirements than did Fannie and Freddie and are far more diversified. They are able to bear greater losses without becoming insolvent. Moreover, to the extent that banks are holding mortgages or MBS, those loans are likely to be prime mortgages or MBS based on prime mortgages, not the subprime mortgages that caused the GSEs' insolvency.

2. Our proposal envisions a larger role in the mortgage system for securitization—involving only prime mortgages—than for banks. The major banks will of course be originators of a large percentage of the mortgages that will be made in the future, but most of these will be securitized and sold to institutional investors. In a securitization, the losses, if any, are taken by the subordinate tranches, not by the entity that structures the securitization or originated the loans. Thus, even assuming that the major banks are also the principal securitizers of the mortgages they originate, they will not be bearing the credit or interest-rate risk for these loans.[61]

3. To the extent that banks hold the loans they originate, or MBS backed by these loans, the credit risks they bear will likely be small, since the loans themselves will likely be prime quality and the MBS will be backed by prime loans with some form of credit enhancement.

4. Finally, we expect that banks and other institutional investors will be able, if they choose, to originate and hold whole mortgages that will not be of prime quality. Under our plan, these mortgages cannot be securitized and will expose the banks holding these loans to more credit risk than exposure to prime loans. For this reason, we propose that banks be assessed a higher capital charge for holding nonprime mortgages.

All of these elements, we believe, substantially reduce the likelihood that TBTF banks might impose losses on the taxpayers.

Preserving the "to be announced" (TBA) market. The TBA market depends on hedging to protect forward sellers of mortgages against interest rate and basis risk. As noted earlier, the benefits of TBA can be obtained at relatively small cost through hedging by the originating banks. This cost can be reduced further if the quality of the mortgages to be originated and sold in the future is clearly understood in advance. The GSEs were able to sell their mortgages for future delivery (the essence of the TBA system) because they were generally providing mortgages of uniform quality with narrow coupon spreads. Investors understood, before committing to purchase, what they would be getting in the future sale. This system was strengthened by the industry application of "good delivery" rules that substantially eliminated cherry-picking. We believe that the approach we have outlined in this white paper—because it

[61] Originators would presumably remain responsible for representations and warranties relating to compliance with loan origination standards.

creates prime mortgages of generally uniform quality—will allow a TBA market for private MBS to develop without subsidies or government guarantees. As the GSEs are wound down over a five-year period, the GSE TBA market will continue to be available for use as a hedging vehicle. As the private MBS market becomes larger and more liquid, a non-GSE TBA market for these securities will develop.

Preserving access to mortgage credit for credit-worthy American families. The administration's report notes that a fully private system "has particularly acute costs in its potential impact on access to credit for many Americans. While FHA would continue to provide access to mortgage credit for low-and-moderate income Americans, the cost of credit for those who do not qualify for an FHA-insured loan—the majority of borrowers—would likely increase." We addressed above the issue of increased cost for mortgage credit. What about the issue of access? As we noted earlier, according to a Federal Reserve study, over 70 percent of all individuals with credit records in the United States (not just all homeowners with credit records) have FICO credit scores that are 660 or above—the foundation for a prime loan. Well over a majority (58 percent) have credit scores above 700.[62] In both 1989[63] and 2010,[64] 87 percent of borrowers taking out a mortgage loan had a FICO of 660 or greater. In other words, these numbers show that the vast majority of potential homebuyers already have the basic requirement for a prime mortgage—a FICO credit score of at least 660. Further, the private approach we suggest preserves down payments as low as 10 percent on conventional prime loans for home purchase.

In this white paper, we are proposing to substitute prime mortgages for government backing as the foundation of a stable and robust housing finance system, primarily because government programs that have attempted to assist home construction or homeownership in the past have eventually become huge losses for taxpayers. Homeownership has long been a goal of US government policy, but the recent financial crisis shows that the government goes too far when it tries to make mortgage credit available to large numbers of borrowers who do not have the resources to sustain homeownership. The result was massive losses for Fannie and Freddie, which taxpayers will eventually have to pay, and a financial crisis and recession that are the worst since the Great Depression. If we must choose between government efforts to increase homeownership that result in huge costs for taxpayers, or a self-sustaining private system that provides stable financing for the vast majority of American families who are capable of sustaining homeownership—without any cost to taxpayers—the better choice is obviously private financing.

Small lenders and community banks could have difficulty competing. This is an important and legitimate issue, but it is based on mistaken facts and assumes incorrectly that the world will remain fundamentally the same after a private financing system is adopted. The government's involvement in the housing finance market through Fannie and Freddie distorted

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62 Board of Governors of the Federal Reserve System, "Report to Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit," August 2007, www.federalreserve.gov/boarddocs/rptcongress/creditscore/creditscore.pdf (accessed March 18, 2011).
63 Letter in author's file dated October 30, 1989, to Ed Pinto from Equifax enclosing odds charts for new real estate accounts developed by Fair, Isaac Company (FICO).
64 FICO presentation as American Securitization Forum 2011, "Consumer Metrics and Evaluation," February 6, 2011.

the market's structure. Because the GSEs were able to bid more for mortgages than any competitors, they drove competitors from the secondary mortgage market and created a duopsony (a market with only two buyers). They were then able to discriminate among their suppliers, providing better returns to those, such as Countrywide,[65] who provided the mortgages that they wanted, and penalizing those—primarily the small banks and S&Ls—that were unable to compete in the volume they could supply. In reality, then, although the GSEs bought many of their best loans from the small banks, community banks were victims, rather than beneficiaries, of the GSEs.

The private market that will develop if our proposal is enacted will be entirely different. Most mortgages will be prime loans—the kinds of loans that the small and community banks usually originate. These loans will be highly sought after because they will not only be good investments, but also the only type of mortgages that could be securitized. Since most mortgages will have the same prime characteristics, the key function in this new market will be aggregating the mortgages into pools for securitization. This is a role that can be performed by the small and community banks, capturing the profits that they previously had to give up to Fannie and Freddie. All that is necessary is regulatory approval to set up one or more joint ventures that will aggregate the mortgages produced by the members and prepare them for sale through underwriters, or to institutional buyers who want to hold whole mortgages. The more competitors in this field, the more innovation there will be and the lower they will push mortgage rates. This will be possible because the approach we have described relies on prime loans, a core competency of community banks and risk-based pricing.

[65] "Mortgage Bankers Association chief economist Jay Brinkmann said the pricing strategies that Fannie and Freddie pursued contributed to the concentration of mortgage lending within the largest banks. The GSEs offered reduced 'guarantee fees' for their largest customers, which placed smaller lenders at a competitive 'disadvantage,' he told the NABE annual conference." See "NY Fed Thinks Megabanks May Be the New GSEs," *National Mortgage News*, March 16, 2011.

III. All programs for assisting low-income families to become homeowners should be on budget and should limit risks to both homeowners and taxpayers.

There are good policy reasons for government to assist low-income families to become homeowners, but the value of this policy has to be weighed against the failure rate imposed on those ostensibly being helped and the cost to the taxpayers. Referring to the affordable-housing requirements imposed on Fannie and Freddie, even former House Financial Services Committee chair Barney Frank (D-MA) has noted that "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."[66] Moreover, any program of this kind must be on budget and contain mortgage-quality standards that do not create market conditions similar to those that brought on the financial crisis. Finally, after all the years of trying and failing to increase homeownership without adding risk to the markets, perhaps it is time for Congress to rethink whether homeownership really should be given so many advantages over renting. With a more even-handed policy, rental properties would offer improved housing for people who are unable to—or should not be required to—take on the obligations of homeownership.

One of the ways to do this is to rein in FHA by limiting the scope of its lending, making sure its losses are sustainable over the long term, and putting it on budget through a mechanism more effective in identifying risks and losses than the Federal Credit Reform Act. Most of the administration's discussion of FHA in its report suggests that the administration shares these objectives, although at some points there is vague and troubling language suggesting that it has not yet learned the lesson of the Fannie and Freddie's financial collapse. "We will consider measures to make sure that secondary market participants are providing capital to all communities in ways that reflect activity in primary markets, consistent with their obligations of safety and soundness."[67] This is almost word for word what HUD was saying as it was deliberately undermining the safety and soundness of Fannie and Freddie and other market participants. At this point, everyone should understand that HUD's affordable-housing policies were directly responsible for the losses of Fannie and Freddie that the taxpayers will have to bear.

What is particularly pernicious about both the affordable-housing requirements and the rules concerning lending by insured depository institutions under the Community Reinvestment Act (CRA) is that they attempt to carry out government social policies by imposing requirements on private-sector entities. There are no controls on such a system. The private-sector entities are required to make loans they might not otherwise make, and the losses are passed along to the unwitting consumers of their services. The government has no incentive to reduce its pressures—as we saw, these pressures eventually drove Fannie and Freddie into insolvency—and the private-sector entities have no way to avoid the costs. The administration's report does not explicitly say that it will abandon these policies, but it does not say the opposite either. The political pressures to retain the CRA will be enormous, but the administration's arguments in

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[66] Larry Kudlow, "Barney Frank Comes Home to the Facts," GOPUSA, August 23, 2010, www.gopusa.com/commentary/2010/08/kudlow-barney-frank-comes-home-to-the-facts.php#ixzz0zdCrWpCY (accessed September 20, 2010).
[67] Departments of Treasury and HUD, *Reforming America's Housing Finance Market*, 21.

favor of a private housing finance market and government agencies as the sources of support for low-income borrowers would seem to be inconsistent with making private-sector corporations the instruments for government social policies.

Much of the support for a government role in mortgage finance comes from groups that see housing finance as an opportunity to advance a social policy that expands homeownership. This is a worthwhile goal, but it must be carefully controlled if we are to avoid the problems that eventually forced Fannie and Freddie into insolvency. During much of their history, Fannie and Freddie safely and successfully facilitated the development of a liquid secondary market in middle-class mortgages. In 1992, however, they were given an affordable-housing mission, which eventually required them to take on the credit risk of almost $2 trillion in subprime and other weak mortgages.

What set US losses apart from those in other countries was the fact that—before the financial crisis began—about half of all mortgages in the United States, 27 million loans, were weak and liable to default when the housing bubble deflated. Of the 27 million high-risk mortgages, 19 million were on the books of Fannie and Freddie, FHA, insured banks and S&Ls under the CRA, and other lenders under additional government programs. All of these programs were intended to increase homeownership by low-income families, but they were instituted and operated without any controls over the risks that were being taken under government mandates. Eventually, their high rates of default drove down housing prices nationally and crippled the financial system.

Government assistance to low-income families must not be undertaken without quality standards that limit the risks to homeowners, the government, and taxpayers. By prescribing an outcome without limiting the means, the government encouraged loans and underwriting standards that were "flexible and innovative." This inevitably led to greater lending with minimal down payments along with lending to borrowers with impaired credit and higher debt ratios.

These policies assumed that borrowers who benefited from these flexibilities would be nearly as safe as borrowers with good or unimpaired credit. However, the risks that resulted from these underwriting concessions were well documented. A 1996 Fed study titled "Credit Risk, Credit Scoring, and the Performance of Home Mortgages"[68] pulls together unequivocal evidence from multiple sources on the high risks posed by "innovative or flexible" loan features such as low down payments and impaired credit/low FICO scores. This clearly shows the link between the government's insistence on loosened and flexible lending and the certainty of heightened mortgage default risk. See appendix 5.

Thus, if Congress wants to encourage homeownership for low-income families, then the mortgages intended to implement this social policy must be subject to a defined set of quality standards—not standards as high as those for prime mortgages, but standards that will ensure that losses do not get out of hand or, as they did with Fannie and Freddie and the FHA, cause substantial burdens for taxpayers. The nation's experience with the FHA demonstrates not only

[68] Federal Reserve, Division of Research and Statistics, "Credit Risk, Credit Scoring, and the Performance of Home Mortgages," *Federal Reserve Bulletin*, July 1996, www.federalreserve.gov/pubs/bulletin/1996/796lead.pdf (accessed January 14, 2011).

that standards are essential, but also that Congress has to avoid the political and other pressures that tend to erode the standards over time. See appendix 6.

Any social policy intended to increase homeownership, including the FHA, should be operated to achieve Congress's social policy goals while limiting homeowners' and taxpayers' risks. This can be achieved through the following steps.

1. On budget. Necessary subsidies must be on budget, so they are visible to members of Congress and voters. In the past, through Fannie and Freddie and the CRA, the subsidies have been hidden in the financial statements of GSEs and private-sector entities, which were required to make subsidized loans and pay for them with more expensive loans to prime borrowers. This, of course, is unfair to prime borrowers, who are being forced to pay for a social policy the cost of which should be borne by all taxpayers. But perhaps even more important, hiding the cost of the subsidies in private and GSE balance sheets obscures the cost to society. There are very good policy reasons for supporting low-income housing subsidies, but those costs should be made clear.

2. A sustainable loss rate. Although the FHA contends that it covers its losses adequately with fees, there are many who disagree with this view. A recent Barclays study concluded: "[W]e project cumulative default rates in the 20% area on average, with loss given default rates of 60%. This represents average losses of about 12pts, of which 8.5pts could flow back to taxpayers. On an original balance of $1.4trn, this translates to $130bn."[69] The administration seems to agree here, too, noting in its report that it will take steps to strengthen FHA's capital position and that it had already announced an insurance-premium increase.

3. Assist low-income borrowers without competing with private-sector lending. Lending to low-income borrowers increases the opportunity for families that cannot meet prime lending standards to gain the benefits of homeownership. Since it is done for social policy reasons—increasing homeownership among low-income families—taxpayers should take some risk. This risk, however, must be subject to some limits. The following low-income mortgage lending standards would provide credit for families that cannot meet prime loan standards but would still enable low-income families to become homeowners without exposing them or taxpayers to excessive foreclosure risk.

4. Limit to low-income borrowers. The FHA's benefits should be limited to low-income borrowers who are demonstrably unable to meet prime lending standards. This is important to ensure that the FHA is fulfilling its social policy purposes and not becoming a backdoor way for people who could otherwise meet prime lending standards to obtain mortgages at government-backed rates. Accordingly, the mortgage limit should be capped at 100 percent of median house values measured on the local level, the income limit should be capped at 80 percent of the area median income, and loans should be limited to home purchases and fixed-rate and term refinances. Although the administration was not as specific, it seems to be seeking to achieve the same goals. This would be accomplished in part by a series of reductions in FHA's mortgage limits, by allowing the temporary increase in loan limits to expire as scheduled on October 1, 2011. It also called for targeting FHA to creditworthy borrowers that have incomes up to the median level for their area and for reducing its risk exposure. All these policies are consistent

[69] Barclays, "US Housing Finance: No Silver Bullet," 6.

with our view that a private housing finance system is compatible with assistance to low-income home buyers as long as the taxpayers' liability for FHA's losses is clear and limited.

5. A sustainable lending underwriting standard. As outlined in appendix 6, the FHA seems to believe that a 10 percent average claim rate is acceptable. It is disappointing that, year in and year out, 10 percent of homeowners with an FHA loan should fail in the average year. Congress should establish a sustainable loan-underwriting standard that achieves an expected cumulative risk of default not to exceed 4 percent during good times and 9–10 percent during bad times.[70] This would result in an average expected claim rate of about 5 percent. The standards needed to achieve this claims level include the accumulation of adequate borrower equity by way of a reasonable down payment from the borrower's own funds, scheduled amortization during the first five years of the loan, evidence of a willingness to pay, and debt-to-income ratios that do not leave borrowers burdened with excessive debt right from the start. This supports a major goal of single-family affordable housing programs—wealth building through increased equity in a home.

6. Transition. Because the FHA currently has such a large portion of the home-lending market, transitioning to a sustainable lending standard will take a few years. Table 3 presents a possible path to achieve this result.

Table 3: FHA Transition to Sustainable Lending Standards
(FHA has already proposed or suggested changes with respect to the highlighted headings)

	LTV	Maximum seller concession	Maximum total debt ratio	Purpose	Mortgage limit (high/normal)	Income	Credit
2010	96.5% (current level)	6%	>45% for 37% of borrowers	Home purchase and refinance	$729,750/ $271,050	No limit	Current
2011	96%	3%	45%	Home purchase and rate and term refinance	$250,000 or area median home price if above $250,000	100% of area median	620–660 FICO[71]
2012	95.5%	3%	43%	Home purchase and rate and term refinance	$200,000 or area median home price if above $200,000	80% of area median[72]	620–660 FICO
2013	95%	3%	41%	Home purchase and rate	$150,000 or area median home price if	80% of area median	620–660 FICO

[70] During the boom years of 1995–2003, the FHA's cumulative claim rate averaged nearly 8 percent. During the bust periods (1980–1985 and 2005–2008), it averaged 18 percent. See the FHA's 2010 Actuarial Study.
[71] As noted previously, the FHA's serious delinquency rate on loans with a FICO score of 580–619 is 19.6 percent.
[72] The goal is to reduce the FHA's dollar limit back to a level commensurate with its low- and moderate-income housing mission. The FHA should serve homebuyers with an income less than or equal to 80 percent of the median. While regional adjustments would be appropriate, nationally, for a family of four, this equates to an income of $54,000 and below. A household with an income of $54,000 getting a 6 percent fixed-rate thirty-year mortgage could afford the median-priced house in the United States—about $175,000.

				and term refinance	above $150,000		
2014	95% for a twenty-five-year term* 90% for a thirty-year term*	3%	41%	Home purchase and rate and term refinance	100% of median home price by area	80% of area median	620–660 FICO

* By setting a twenty-five-year loan term on 95 percent LTV loans and a thirty-year loan term on 90 percent LTV loans (both at an interest rate of 5 percent), each borrower would have about 16–17 percent equity (based on original sales price) after five years. This compares to about 11 percent equity (based on original sales price) for an FHA borrower with a 96.5 percent LTV loan with a thirty-year loan term. This last borrower barely has enough equity to cover the selling expenses in the event of a sale.

7. Down payments and savings. The FHA provides its benefits through the traditional means used in the United States—by subsidizing the cost of a mortgage loan. However, that is not the only way—and possibly not the most effective way—to achieve its purposes. Studies by the US Census Bureau have shown that the greatest obstacle to homeownership among low-income families is not the monthly cost of the mortgage but the savings necessary for a down payment.[73] Accordingly, one of the ways for Congress to assist homeownership among low-income families within the lending standards we suggest would be to establish a program for providing down payment assistance to these families. Such a program should be designed to promote real savings by the potential homebuyer. For example, Congress could set up a tax-preferred savings plan to which the government contributes an amount each year that matches a family's savings. The funds would accumulate in an FDIC insured account and could be used only as a down payment for a home.

[73] Howard A. Savage, *Who Could Afford to Buy a House in 1995?* (Washington, DC: US Department of Commerce and US Census Bureau, August 1999).

IV. Fannie Mae and Freddie Mac should be eliminated as GSEs over time.

Fannie Mae and Freddie Mac violate every principle of sound and sustainable housing finance. The history of these two hybrid firms, and the immense costs they have imposed on taxpayers, provides the best argument for the principles we have outlined in this paper. Through Fannie and Freddie, government policies exponentially increased taxpayer risks, now realized as actual losses, by using the two firms to compete with the FHA in pursuing a political strategy of high-risk loans. Fannie was "privatized"—really, GSE-ized—in 1968 for the explicit purpose of keeping its costs out of the federal government's budget. Congress then copied the model with Freddie. But the costs have returned to the budget with a vengeance. Fannie and Freddie distorted resource allocation, prices, and credit, and were leading contributors to inflating the disastrous housing bubble that collapsed in 2007. As a result, almost everyone now agrees, including almost everyone in Congress, that Fannie and Freddie's GSE status should be eliminated.

This leaves two questions: What should replace the GSEs? How should the transition be structured? We conclude that the GSEs should be—and can be—replaced by a housing finance market that is for the most part free of government guarantees and the distortions they create.

In its report, the administration recognized that no private-sector market for financing mortgages will be able to develop fully until competition from Fannie and Freddie is first reduced and then eliminated. To this end, the administration's report calls for a transition away from the dominance of Fannie and Freddie, thus allowing private financing mechanisms to grow. Accordingly, while we and the administration target the elimination of Fannie and Freddie as GSEs, we both propose a gradual wind down.

A key transition feature that now appears to be generally accepted calls for a gradual reduction in the conforming loan limit that sets the maximum size of the mortgages that Fannie and Freddie can purchase. As this limit is reduced, Fannie and Freddie will be taken out of the market for loans above the limit. This will enable the private market to expand its activity gradually. The administration proposes to start this process by recommending that the temporary increase in loan limits be allowed to expire as scheduled on October 1, 2011.

The elements of the transition away from GSE status should include:

- **Reduce conforming loan limits.** While the administration appears to agree that the loan limits must be reduced, its report makes no recommendation beyond the small initial step noted above. We believe it is critical for the private market to be provided a definite schedule of reductions for the next three years. This will allow the necessary investments to be planned and made. We recommend lowering the conforming loan limit by 20 percent of the previous year's cap each year, starting with the current general limit for one-unit properties of $417,000 and the high-cost area limit of $729,750. These limits, for loans, mean house prices of over $500,000 and over $1,000, 000, respectively, are financed by the government. In contrast, according to the National Association of Realtors, the median US house price is $171,300. The general limit for a one-unit property would decrease to $334,000 in year one, $267,000 in year two, $214,000 in year three, $171,000 in year four, and $139,000 in year five. The high-cost area limit for a one-unit property would decrease to $584,000 in year one, $467,000 in year two,

$374,000 in year three, $296,000 in year four, and $237,000 in year five. Final termination or "sunset" of GSE status would take place at the end of year five.

- **Wind down investment portfolios and limit nonmortgage investments.** While Treasury and HUD note that Fannie and Freddie were allowed to behave like government-backed hedge funds and therefore conclude that Fannie and Freddie's investment portfolios should be wound down, the schedule is painfully slow. Under the current structure, which predates the administration's decision to wind down Fannie and Freddie, this could take as long as twelve years and still leaves them with investments of up to $500 billion in 2022.

Table 4: Limited Wind Down of GSEs' Portfolios under Current Policy

As of Dec. 31:	Fannie limit	Fannie actual	Freddie limit	Freddie actual
2009	$900 billion	$773 billion	$900 billion	$755 billion
2010	$810 billion	$789 billion	$810 billion	$697 billion
2011	$729 billion	*	$729 billion	*
2012	$656 billion	*	$656 billion	*
2013	$590 billion	*	$590 billion	*
2014	$531 billion	*	$531 billion	*
2015	$478 billion	*	$478 billion	*
2016	$430 billion	*	$430 billion	*
2017	$387 billion	*	$387 billion	*
2018	$349 billion	*	$349 billion	*
2019	$314 billion	*	$314 billion	*
2020	$282 billion	*	$282 billion	*
2021	$254 billion	*	$254 billion	*
2022	$250 billion[74]	*	$250 billion*	*

Note: * = Unknown
Source: Derived from Fannie and Freddie 2010 10-Ks, December 2010 Monthly Reports, and "Second Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement," dated December 24, 2009, www.svb.com/pdfs/sam/fannie509amendment.pdf (accessed March 22, 2011).

A better approach and one consistent with the wind-down goal would prohibit Fannie and Freddie from adding existing or newly acquired single-family or multifamily loans or MBS to their portfolios, with exceptions only for newly acquired loans held for a short period before securitization and the purchase of delinquent or modified loans out of an existing MBS. With no additions allowed, natural runoff should substantially reduce their portfolios over time. Establishing a specific requirement for sales in any year could allow the government to be gamed or arbitraged. While hard to predict, these changes should reduce taxpayer portfolio exposure to a combined $500 billion (a reduction of two-thirds) by 2016 compared to the current trajectory, and do so without putting pressure on housing or MBS prices. To the extent a GSE has portfolio assets remaining at the fifth-year sunset, these should be put in a liquidating trust and defeased or sold to other

[74] Once the portfolio limit is reduced to $250 billion, no further decreases are required.

investors. During the wind-down period, Fannie and Freddie should be allowed to buy only prime loans as defined in appendix 1.

The administration recommended a move in this direction by calling for an increase in the GSEs minimum down payment requirement from 3 percent to 10 percent. We suggest doing this in phases: the FHFA director would direct the GSEs to set a maximum single-family CLTV limit of 95 percent in 2011. This CLTV ratio would decrease to a maximum of 92.5 percent on January 1, 2014, and would be applicable until the sunset of the GSE charters at the end of 2015.

Going forward, the GSEs' new nonmortgage investments should consist only of Treasury securities.

- **Raise the GSEs' capital requirements to equal those of national banks and rely more on private capital.** The administration also recommends this step. It would eliminate the unfair capital advantages that Fannie and Freddie did and do enjoy and reduce the gap between Fannie and Freddie's subsidized pricing and private-market rates. An increase in capital requirements would require the GSEs to raise their base guarantee fee by perhaps fifteen to twenty-five basis points (this fee currently averages twenty-five basis points), a step already taken by the administration and one that would result in a gradual reduction in the GSEs' pricing advantage over the private sector. As suggested by the administration, the FHFA director should explore various means of credit enhancement to reduce the liability of the GSEs for losses on mortgages, including the possibility of increased mortgage guaranty insurance.

- **Dividend on preferred stock held by Treasury.** The dividend should be set by statute to yield not less than 10 percent annually. Secretary Geithner expressed this policy at a March 1, 2011, hearing before the House Financial Services Committee.

- **Recoupment of costs of federal guarantee.** Beginning on January 1, 2014, the GSEs should be required to make quarterly payments to the Treasury equal to an annualized thirty basis points times the average aggregate outstanding credit risk of the GSE. This provision will enable the taxpayers to recoup the value of the government guarantee of the GSEs' mortgage portfolios and MBS.[75]

- **Repeal affordable-housing goals and taxes.** Consistent with Principles I and III above, repeal the GSE (including the FHLB) affordable-housing goals and affordable-housing support fees.[76]

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[75] This level of guarantee fee is consistent with the CBO's budget estimates, which price the value of the government's backing of the GSEs at 4.4 percent in 2009, reducing to .20 percent (twenty basis points) in 2014 and thereafter. Thirty basis points seems a good middle point, consistent with the CBO study. See Congressional Budget Office, *CBO's Budgetary Treatment of Fannie Mae and Freddie Mac* (Washington, DC: January 2010), table 2, www.cbo.gov/ftpdocs/108xx/doc10878/01-13-FannieFreddie.pdf (accessed March 22, 2011).

[76] Supra. Housing and Economic Recovery Act of 2008 (HERA). HERA imposed a 4.2-basis-point fee on Fannie and Freddie's mortgage purchases (currently suspended by FHFA).

- **Privatization.** At the sunset date, the conservatorship will be converted to a receivership, the equity below the Treasury's holdings will be wiped out, and the GSEs will be divided into good bank/bad bank structures. If there are buyers for the GSEs as going concerns (no longer in GSE form), or capital is available for their restructuring as fully private nongovernment entities, the good banks will be sold and the bad banks will be liquidated by creating a liquidating trust that contains all remaining mortgage assets, guaranty liabilities, and debt. The obligations of the trust will be defeased with the deposit of Treasury securities. As obligations arise that exceed the revenues of the trust (from mortgage payoffs or refinancing), the Treasury securities will be liquidated to meet the obligations. The GSE net worth shortfall will unjustly—but at this point unavoidably—be borne by taxpayers, including Treasury's writing off its preferred stock.

- **Dispositions of properties other than through privatization.** If there are no buyers for the GSEs in the good bank/bad bank structure, all their intellectual property, systems, securitization platforms, goodwill, customer relationships, and organizational capital should be auctioned off. The proceeds would reduce the Treasury's and taxpayers' losses.

The reasons for winding down Fannie and Freddie imply other policy choices that should be considered as part of a thorough reform of the US housing finance system:

1. Coincident with the wind down of Fannie and Freddie, Congress should establish a legal structure that allows for a number of private financing options. Although we believe a combination of a market based on portfolio lending and securitization of loans would be the most effective immediate replacement for a government-backed housing finance market, there are many other alternatives. Covered bonds would make a sensible additional fixed-rate funding alternative for mortgages. With covered bonds, banks issue debt for which they remain liable (thus, having 100 percent "skin in the game"), secured by loans.

This could include incorporating some of the benefits of the Danish system, which divides the credit and interest-rate risks on mortgages, and the German system, which has strict mortgage credit standards. In the Danish system, the interest rate on mortgages is set by the market directly, and the credit risk is taken by specialized mortgage banks that also function much like mortgage guarantors. Throughout the more than two-hundred-year history of German covered bonds, there has never been a default of a German Pfandbrief or covered bond[77] or a default by a Danish mortgage bank. For such a system to work, there must be statutory (not just regulatory) protection of the right of the bondholders to the collateral in the event of the failure of the issuer, as well as a requirement that the mortgages covering the bonds be of prime quality. Thus, any framework that establishes requirements for mortgage quality should be compatible with a variety of mortgage financing structures, all of which should be able to operate simultaneously in the US market.

The political obstacle in the United States has been the objections of the FDIC, which fears that in the event of a failure, it will lose assets that would otherwise be part of a bank and

[77] Association of German Pfandbrief Banks, "The Pfandbrief—A Safe Investment," www.hypverband.de/cms/bcenter.nsf/docsbykey/65192645/$file/Flyer+EN_Pfandbrief_a+safe+investment.pdf?openelement (accessed January 14, 2011).

thus increase its losses to its deposit-insurance scheme, like what happens with FHLB advances. This concern can be addressed by limiting the extent of collateralization of the covered bonds (for example, the percentage of overcollateralization might be limited to the capital ratio of a bank, so the excess collateral is in effect funded by capital, not deposits).

2. FHLBs: Reduce risks these GSEs present to taxpayers and focus their support on small- and medium-sized financial institutions. The administration noted that the FHLBs "developed significant weaknesses as the housing market evolved that should be addressed as part of housing finance reform." Also noted was the need to address the FHLBs' advance funding (lending secured by loans) to very large banks. The suggested reforms address fundamental banking principles that expose the taxpayers either directly (as a result of the FHLBs' GSE status) or indirectly (as a result of the combination of the FHLBs' implicit guarantee with the FDIC's explicit guarantee). We agree and suggest the following:

- **Adopt a loan-to-one-borrower limit.** This universal financial concept applies to all other banks. The administration recommended limiting the level of advances to any given institution. Dodd-Frank limits maximum exposure to one borrower to 25 percent of capital, but FHLBs were excepted in the Senate negotiations. This should be reconsidered. Even limiting them to 50 percent of capital would be a major constraint on their use of the implied guarantee, since individual FHLBs lend multiples of their capital to certain borrowers. For example, FHLBs lent $50 billion to Countrywide, $90 billion to Citigroup, $40 billion to WaMu, and $10 billion to IndyMac.

- **Stop the double leveraging of the FHLBs through the banking system.** When banks buy stock in the FHLBs, they are allowed to create high leverage for this equity investment (sixty to one in risk-based terms—20 percent risk weighting). Instead, they should have to hold dollar-for-dollar equity of their own, or at least have a much higher capital requirement for FHLB stock investments. These equity investments are financed by deposits, and there is very little equity in the FHLB banking system viewed on a consolidated basis. The disaster of bank investments in Fannie- and Freddie-preferred stock demonstrated this problem, since numerous banks took large losses and some failed because of their highly leveraged investments in GSE equity.

- **Reducing portfolio investments.** Treasury/HUD noted that similar to Fannie and Freddie, several of the FHLBs had built up sizable investment portfolios. Using their GSE status, these banks were able to use their implicit guarantee to earn arbitrage profits. Treasury/HUD recommend that the size of these portfolios should be reduced and their compositions changed to better support legitimate liquidity needs and reduce credit exposure.

- **FHLBs take very large collateral haircuts to secure their advances.** In the event of bank failure, these haircuts cause losses to be passed on to the FDIC and—in the S&L bailout of 1989—to the taxpayers. For example, when the FHLB of San Francisco made advances to IndyMac secured by risky mortgage loans, it required 100 percent overcollateralization. To a large measure, this excess collateral was financed with FDIC-guaranteed deposits rather than bank capital and contributed to the FDIC's estimated $10 billion loss. This is the same problem the FDIC points out in its opposition to covered bonds. A limit on the extent of overcollateralization by FHLBs is appropriate.

3. The four principles outlined in this white paper are equally applicable to multifamily housing finance. The federal government has long supported the multifamily housing finance market. This support includes government insurance (FHA), MBS guarantees (Fannie, Freddie, and Ginnie), on-budget subsidies (HUD and USDA), off-budget mandates (Fannie and Freddie), off-budget subsidies (FHLBs), and low-income tax credits (before Fannie and Freddie's collapse, they were the largest purchasers). Before the GSEs' involvement, life-insurance companies, pension funds, and banks supported a robust conventional multifamily lending market.

In the late 1970s, HUD pushed Fannie and Freddie to undertake multifamily lending as part of its early efforts to enforce a GSE affordable-housing mission. These programs proved to be high risk, with Freddie completely exiting the multifamily business in the late 1980s after sustaining substantial losses.[78] By imposing affordable-housing requirements for multifamily as well as single-family mortgages, the 1992 act forced Freddie back into multifamily finance and both GSEs were required to greatly expand their programs. As was the case with single-family financing, the private sector had an ever more difficult time competing with the GSEs' charter advantages. Today Fannie and Freddie,[79] along with FHA, have now largely taken over the multifamily finance market.

Many of the proposals for reform of the housing finance market argue for continued federal government financial support for multifamily housing,[80] either through an explicit or

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[78] Fannie also lost substantial sums on a $5 billion portfolio of 6 percent multifamily loans it had acquired from HUD when long- and short-term interest rates topped 15 percent in the early 1980s.

[79] "In the current market, the GSEs hold 35 percent of total outstanding multifamily mortgage debt and are providing nearly 90 percent of all mortgage capital to the market." See Ingrid Gould Ellen, John Napier Tye, and Mark A. Willis, "Improving US Housing Finance through Reform of Fannie Mae and Freddie Mac: Assessing the Options," Furman Center for Real Estate & Urban Policy, Institute for Affordable Housing Policy, and What Works Collaborative, May 2010, http://furmancenter.org/files/publications/Furman_Center_GSE_Reform_White_Paper_May_2010.pdf (accessed March 21, 2011).

[80] Ibid. See also "MBA's Recommendations for the Future Government Role in the Core Secondary Mortgage Market," Mortgage Bankers Association, August 2009, www.mbaa.org/files/News/InternalResource/70212_RecommendationsfortheFutureGovernmentRoleintheCoreSecondaryMortgageMarket.pdf (accessed March 21, 2011); *Housing Finance—What Should the New System Be Able to Do? Testimony Before the House Financial Services Committee*, 111th Cong. (April 14, 2010) (statement of Jack E. Hopkins, Independent Community Bankers Association), http://financialservices.house.gov/Media/file/hearings/111/Printed%20Hearings/111-121.pdf (accessed March 21, 2011); *The Future of Housing Finance—A Review of Proposals to Address Market Structure and Transition, Testimony Before the House Financial Services Committee*, 111th Cong. (September 29, 2010) (Michael J. Heid, Housing Policy Council), http://financialservices.house.gov/Media/file/hearings/111/Heid092910.pdf (accessed March 21, 2011); *Housing Finance -What Should the New System Be Able to Do? Testimony Before the House Financial Services Committee*, 111th Cong. (April 14, 2010) (statement of Sheila Crowley, National Low Income Housing Coalition), www.nlihc.org/doc/Testimony-of-Sheila-Crowley4-14-2010.pdf (accessed March 21, 2011); and Mortgage Finance Working Group, *A Responsible Market for Housing Finance*, (Washington, DC: Center for American Progress, December 2009), www.americanprogress.org/issues/2009/12/pdf/housing_finance.pdf (accessed March 21, 2011).

implicit government guarantee of agency or private MBS or the need for a GSE or other similar entity with substantial ongoing portfolio capacity. A detailed treatment of multifamily housing finance is beyond the scope of this white paper. However, the lessons from the single-family disaster have direct applicability to multifamily housing finance and the risks posed to taxpayers. While the multifamily lending business is less than $1 trillion, or under 10 percent of the single-family finance market, it is even more complex and risky. Although the GSEs' recent multifamily lending efforts have resulted in low losses, there is a long history of costly multifamily failures at the GSEs and at FHA. It is also clear from the various industry proposals for future GSE participation in multifamily lending that there will be pressure to move the GSEs and FHA into riskier types of loans. Combine this with continued federalization of multifamily mortgage credit and the risks to taxpayers are substantial.

The four principles outlined in this white paper should be applied to multifamily housing finance. The inability to price risk, or create reserves for potential losses, and the moral hazard created by government financial support for the industry will have the same adverse effect in multifamily housing as it has had in the single-family market. Federal guarantees and mandates will distort the incentives and behavior of borrowers, lenders, and investors alike and prevent the multifamily market from developing normally with private-sector support. Good-quality mortgages backed by good-quality rent rolls can restore a private market in multifamily housing.

As is the case with single-family finance, a gradual removal of government support by the GSEs and FHA, and the resulting price advantage, will be necessary to give traditional financing sources time to re-enter the business. This will allow a private multifamily financing sector to develop based on solid underwriting and the use of financing mechanisms already available.

Appendix 1:

Definition of a Prime Loan

A prospective prime borrower needs to be qualified based on a demonstrated ability to repay the loan, a demonstrated willingness to meet his or her obligations, and sufficient equity to reduce the likelihood of default to a reasonable level.[81]

We define *prime first mortgage loans* as loans with the following characteristics:

- Conventional loans on properties occupied as a primary or secondary residence.[82]
- Home purchase loans with an LTV of 90 percent or less commencing on January 1, 2016.[83] During the five-year GSE wind down and private-market transition period we recommend, an LTV limit of 95 percent would be permitted until December 31, 2012, and an LTV limit of 92.5 percent would be permitted until December 31, 2015.
- Rate and term refinances with an LTV of 80 percent or less with a maximum loan term of twenty-five years.[84]
- Cash-out refinances with an LTV of 75 percent or less with a maximum loan term of twenty years.[85]
- As noted, research shows that loans with an LTV of 60 percent or less sustain virtually no losses. Therefore, any loan with an LTV greater than 60 percent could be insured by mortgage guaranty insurance down to 60 percent; however, a fully amortizing loan with a term of fifteen years or less and an LTV greater than 80 percent could be insured by mortgage guaranty insurance down to 70 percent.
- Loans to borrowers with a demonstrated willingness to meet their obligations as represented by a FICO credit score of 660.[86] No second mortgage at loan origination and prohibited by the mortgage documents for a period of six months after origination. The mortgage documents also grant the mortgage holder and mortgage insurer (if any) the right of prior approval with respect to any second mortgage taken out after six months.
- The mortgage note and mortgage shall:
  - Require the borrower to declare his or her intent regarding owner occupancy;

[81] These represent the traditional Three Cs of mortgage risk:

Credit or willingness to pay—generally represented by evaluation of a credit report.

Capacity or ability to pay—generally represented by evaluation of income and liability information measured against housing and other debt ratios.

Collateral underlying the mortgage—generally represented by evaluation of amount and source of down payment information and an appraisal to determine the value of a property for lending purposes.

[82] In 1991, over 98 percent of Fannie's loans met this standard. Data from Fannie Mae's random sample review covering single-family acquisitions for the period October 1988–January 1992, dated March 10, 1992. Document contained in the authors' files.

[83] Ibid. In 1991, over 91 percent of Fannie's home-purchase loans had LTVs of 90 percent or lower.

[84] Ibid. In 1991, over 93 percent of Fannie's loans had LTVs of 80% or lower.

[85] Ibid. In 1991, over 92 percent of Fannie's loans had LTVs of 75% or lower.

[86] Ibid. In 1991, over 98 percent of Fannie's loans had one or no mortgage late payments at origination and 85 percent had two or fewer nonmortgage late payments at origination.

  - Require the borrower to acknowledge that if the intent to occupy changes within twelve months of the date of the loan, the borrower has an affirmative obligation to notify the lender;
  - Advise the borrower that upon receipt of such notice, the lender has the right to increase the interest rate on the loan by a stipulated percentage; and
  - Provide that if the borrower fails to notify the lender, the lender may call the loan and require its immediate repayment, and such loan, if not already recourse to the borrower, becomes recourse and not dischargeable in bankruptcy.
- Housing and total debt-to-income ratios of less than 33 percent and 38 percent, respectively[87] (28 percent and 33 percent on 95 percent and 92.5 percent loans during the five-year transition period).
- Underwritten based upon verified income, assets, and credit.[88]
- If an adjustable-rate mortgage or balloon, an initial fixed rate for seven years or more, with the borrower qualified at the maximum rate permitted during the first seven years.
- If a prepayment fee is charged, it may not provide for a fee in excess of 3 percent of principal for the first year, 2 percent for the second, and 1 percent for the third, and the originating lender must offer the applicant the option of a similar loan with no prepayment fee.

The following are the standards that federal regulation should require of mortgage insurers for prime loans:

- Maintain minimum risk-to-capital ratios by amortized LTV based on the lesser of sales price (if applicable) or original appraised value, as set forth below:

Amortized LTV (%)	Suggested risk-to-capital ratio for thirty-year fixed-rate loans[89]	Current risk-to-capital ratio
92.51–95.00	8 to 1	25 to 1
90.01–92.50	10 to 1	25 to 1
85.01–90.00	13 to 1	25 to 1
80.01–85.00	16 to 1	25 to 1
75.01–80.00	29 to 1	25 to 1
70.01–75.00	31 to 1	25 to 1
65.01–70.00	38 to 1	25 to 1
60.01–65.00	41 to 1	25 to 1

[87] Ibid. In 1991, over 90 percent of Fannie's loans met this standard.
[88] Fannie stopped acquiring low-doc or no-doc loans in 1990. Freddie followed in 1991. See "Haste Makes . . . Quick Home Loans Have Quickly Become Another Banking Mess," *Wall Street Journal*, July 5, 1991.
[89] Fixed-rate loans with shorter amortization periods pose a lower risk of default due to faster buildup of borrower equity and therefore would have somewhat higher risk-to-capital requirements (requires that less capital be held). For example, fifteen-year term loans at an 80 percent LTV might have a thirty-eight-to-one risk-to-capital ratio, the same as for a 70 percent LTV loan with a thirty-year term.

- As noted, MI is required on all loans with an LTV above 60 percent up to the prime loan LTV limit of 90 percent (except as provided for the five-year period during which the GSEs are wound down. This coverage is required down to 60 percent.[90] For example, on a 90 percent LTV loan, MI would provide 34 percent coverage, which would insure down to 59.4 percent. Under the above risk-to-capital requirement, MI would be required to maintain a minimum equal to 7.7 percent (the inverse of the thirteen-to-one risk-to-capital ratio) times coverage of 34 percent or 2.62 percent against this prime-loan risk. This compares to 4 percent (the inverse of the twenty-five-to-one risk-to-capital requirement) times coverage of 25 percent or 1 percent against loans that in the last decade consisted of many nonprime loans.
- Fifty percent of gross premiums required to be placed in statutory premium reserve (same as current requirement) for a fixed period (current period is ten years) and may only be used to pay nonnormal or catastrophic stress-based losses due to periodic but unpredictable general economic risks as described earlier. The other 50 percent of premium revenue is required to support normal claims related to specific or actuarially based credit losses, general and administrative expenses, taxes, other expenses, dividends, and profits.
- Monoline (same as current). A monoline insurer's business is limited to one line of insurance, in this case mortgage guaranty insurance on prime single-family first mortgages.
- Coverage is loan based with a maximum coverage of 35 percent after 2015 and a maximum coverage of 38 percent during the five-year transition period (current practice). No pool coverage or guaranty of securities (new provision). MI companies are limited to covering individual loans rather than pools of loans.
- No originator, aggregator, conduit, or issuer (or affiliates or parents) may own or operate a private mortgage insurer (new provision). The Alger report noted a need to avoid conflicts of interest between originators and credit enhancers.[91]
- Restricted to prime loans (new provision). This limits MI companies to prime loans, which have more predictable and lower default rates than nonprime loans. No sharing of premiums with lenders or investors (a new provision designed to prohibit captive subsidiaries) and any discounts must be risk based, not volume based (current practice). A captive subsidiary is an MI reinsurer controlled by the loan originator. Countrywide was an early and large participant in the practice. Its prohibition helps eliminate conflicts of interest. In terms of pricing, Fannie and Freddie offered large volume-based discounts, whereby lenders such as Countrywide were charged a guaranty fee of about ten basis points, while community banks were charged twenty basis points or more.

[90] Coverage must be maintained until the original loan balance amortizes to 60 percent based on the lesser of original sales price (if applicable) or original appraised value.

[91] Report to the governor of New York by Commissioner George Alger (Alger Report) regarding the operation, conduct, and management of mortgage guaranty corporations dated October 5, 1934. Document contained in the authors' files.

Appendix 2:

Nonprime Loans

As noted under Principle II, nonprime loans are inappropriate for inclusion in private MBS or covered bonds. This means that nonprime loans will have to be held in the portfolio of a bank or other entity.

Additionally, nonprime loans contained in the portfolios of leveraged entities such as depository institutions should be subject to a variable capital requirement that adjusts as the share of nonprime loans in the origination market changes.[92] This would be accomplished by setting capital requirements that automatically adjust as nonprime loans' share of all originations changes. Implementing this requirement necessitates tracking the quality characteristics of all mortgage loans. This allows for a determination of the percentage of prime and nonprime loan originations entering the market on a quarterly basis.

Loans held in portfolio need to be backed by capital to address three risks: normal credit risk, interest-rate risk, and catastrophic risk.

- Prime fixed-rate loans would be subject to a 1 percent capital requirement for credit risk, 3 percent for interest-rate risk, and zero percent for catastrophic risk. Different capital requirements would be applicable to ARM loans.
- Nonprime fixed-rate loans would be subject to a 5 percent capital requirement for credit risk, 3 percent for interest-rate risk, and a range from zero percent to 6 percent for catastrophic risk. A different capital requirement would be applicable to ARM loans. The catastrophic risk capital component for fixed-rate loans would be determined based on the following:

Nonprime percentage of loan originations for a quarter (%)	Catastrophic risk capital requirement applicable to all nonprime loans held in a bank's portfolio (%)
0–20	0
20.01–25	1
25.01–30	2
30.01–40	4
40.01–50	6
>50	8

[92] FHA and other social policy loans would be included in this calculation.

This countercyclical policy yields two results: increased capital as a cushion against loan losses and/or reduced originations of higher-risk nonprime loans to fuel an unsustainable boom.

Appendix 3:

THE BASIC FACTS ABOUT YOUR MORTGAGE LOAN

Borrower:______________________ Property address: ______________________________
______________________ ______________________________
____

Lender:____

Amount of loan: $__________________, which is______ % of the property's appraised value.
Your loan is for ________ years.
The type of loan you have:____

Your beginning interest rate is ______%. This rate is good for ________ months/years. The rate and your payment can go higher by up to ____% on and each ______ months after that.

One estimate of what your future rate could be, called the fully indexed rate, is ______________%.
The maximum possible rate on your loan is ________%. You were qualified for approval using a rate of ______%.

THIS LOAN IS BASED ON YOUR MONTHLY INCOME OF $___________.

Your beginning rate = a monthly loan payment of $________________ = __________% of your income.
-including taxes and insurance this is about $________________ = __________% of your income.

The fully-indexed rate = a loan payment of $________________ = __________% of your income.
-including taxes and insurance this is about $________________ = __________% of your income.*
*This is called your fully indexed housing expense ratio.

Special factors you must be aware of:
-A prepayment fee of____________________ must be paid if________________________.
-A "balloon payment" of $__________________ to pay off your loan will be due on____________.
-You do/do not have a loan with possible "negative amortization". If you do, make sure you really understand what this means. Start with the definition on p. 3.

Total "points" plus estimated other costs and fees due at closing are $______________________________.

FOR QUESTIONS CONTACT: Name:____

Phone:____________________ e-mail:________________________

See definitions of underlined terms and guidelines on pages 2–3.
DO NOT SIGN THIS IF YOU DON'T UNDERSTAND IT!

		Borrower	Date
Authorized Signer of Lender	Date	Borrower	Date

The Basic Facts about Your Mortgage Loan

This form gives you the basic facts, but some mortgage forms may use terms not listed here. For a good, borrower-friendly information source, try the Mortgage Professor online (www.mtgprofessor.com), which includes detailed explanations of the technical mortgage terms in its glossary and much other helpful information.

Definitions and Guidelines Used in This Form

The *appraised value* is what a professional appraisal estimates the house could be sold for in today's market.

The *type of loan* determines whether and by how much your interest rate can increase. If it can, your monthly payments will also increase—sometimes by a lot. For example, in a thirty-year fixed rate loan, the interest rate is always the same. In a one-year ARM, it will change every year. Other kinds of loans have various patterns, but the interest rate may go up a lot. Make sure you understand what type of loan you're getting.

The *beginning interest rate* is the interest you are paying at the beginning of the loan. It is the rate which you will hear the most about from ads and salespeople. But how long is it good for and when will rates increase? In many types of loans, the rate can go up by a lot. You need to know.

The *fully-indexed rate* is one indicator of what can happen to your interest rate and your monthly payments. It is calculated by taking a defined "index rate" and adding a certain number of percentage points, called the "margin." For example, if the rate formula on your loan is the one-year Treasury rate plus 3 percent, and today the one-year Treasury rate is 5 percent, your fully-indexed rate is 5% + 3% = 8%. This will almost always be higher than your beginning rate.

The index rates are public, published rates, so you can study their history to see how much they change over time. If the index rate stays the same as today, the rate on your loan will automatically rise to the fully-indexed rate over time. Since the index rate itself can go up and down, you cannot be sure what the future adjustable rate will be. In any case, you must *make sure you can afford the fully-indexed rate*, not just the beginning rate, which is often called a "teaser rate" for good reason.

The *maximum possible rate* is the highest your interest rate can go. Most loans with adjustable rates have a defined maximum rate or "lifetime cap." You need to think about what it would take to make your interest rate go this high. How likely do you think that is?

Your *monthly income* means your gross, pre-tax income per month for your household. This should be an amount which you can most probably sustain over many years. Make sure the monthly income shown on this form is correct!

Your *monthly payment including taxes and insurance* is the amount you must pay every month for interest, repayment of loan principal, house insurance premiums, and property taxes. Expressed as a percent of your monthly income, this is called your housing expense ratio. Over time, in addition to any possible increases in your interest rate and how fast you must repay principal, your insurance premiums and property taxes will tend to increase. Of course, your monthly income may also increase. How much do you expect it to?

Your *fully-indexed housing expense ratio* is a key measure of whether you can afford this loan. It is the percent of your monthly income it will take to pay interest at the fully-indexed rate, plus repayment of principal, house insurance, and property taxes. The time-tested market standard for this ratio is 28 percent; the greater your ratio is, the riskier the loan is for you.

A *prepayment fee* is an additional fee imposed by the lender if you pay your loan off early. Most mortgages in America have no prepayment fee. If yours does, make sure you understand how it would work before you sign this form.

A "*balloon payment*" means that a large repayment of loan principal is due at the end of the loan. For example, a seven-year balloon means that the whole remaining loan principal, a very large amount, must be paid at the end of the seventh year. This almost always means that you have to get a new loan to make the balloon payment.

A "*loan with possible negative amortization*" means that in the years immediately after securing a mortgage loan, you can pay even less than the interest you are being charged. The unpaid interest is added to your loan, so the amount you owe gets bigger. The very low payments in early years create the risk of very large increases in your monthly payment later. Negative amortization loans are typically advertised using only the very low beginning or "teaser" required payment, which is less than the interest rate. You absolutely need to know four things: (1) How long is the beginning payment good for? (2) What happens then? (3) How much is added to my loan if I pay the minimum rate? 4) What is the fully-indexed rate?

"Points" are a fee the borrower pays the lender at closing, expressed as a percent of the loan. For example, two points mean you will pay an upfront fee equal to 2 percent of the loan. In addition, mortgages usually involve a number of *other costs and fees* which must be paid at closing.

Closing is when the loan is actually made and all the documents are signed.

The *For Questions Contact* section gives you the name, phone number, and e-mail address of someone specifically assigned by your lender to answer your questions and explain the complications of mortgage loans. Don't be shy: contact this person if you have any questions.

Finally, *do not sign this form if you do not understand it.* You are committing yourself to pay large amounts of money over years to come and pledging your house as collateral so the lender can take it if you don't pay.

Ask questions until you are sure you know what your commitments really are and how they compare to your income. Until then, do not sign.

Appendix 4:

Historical Background on the Mortgage Insurance Industry: Lessons from the Great Depression

During the 1920s and early 1930s, a large volume of MBS (called mortgage certificates),[93] backed by mortgage guarantee companies, was sold to the public. By 1934, the mortgage certificates were in default and the guarantee companies had failed. The governor of New York (where most of the activity had taken place) appointed George Alger as commissioner to investigate the operation, conduct, and management of mortgage guarantee companies.[94] Commissioner Alger was specifically charged with "once again instilling public confidence in real estate as an investment." This is not unlike the challenge we face today as we endeavor to reform our housing finance market and re-instill investor confidence.

Commissioner Alger's report provides useful insights into both the causes of the most recent collapse and policy recommendations for avoiding a repeat occurrence. While it would be twenty-three years before any mortgage guaranty company would be formed in the United States,[95]Alger's recommendations formed the backbone of the state-based regulatory structure governing the formation and operation of mortgage guaranty insurance companies. This structure largely remains in place today and, in substantial measure, explains why the US mortgage guaranty insurance industry has largely survived intact, still paying claims and writing new business,[96] while Fannie Mae and Freddie Mac—along with many bond insurers, securities issuers, lending institutions, and private MBS—failed.

A few quotes from the Alger report demonstrate its relevance:

> "If . . . the sale of guaranteed mortgage certificates is again to be permitted, anything remotely resembling protection to the certificate holder must, I think, be based upon the doubly assured soundness of the guarantee itself. Our recent experience has shown us that this form of conducting the mortgage business is intrinsically hazardous and should not be permitted except upon the requirement of a ratio of capital funds to guaranties adequate to insure against another major depression, instead of the present complete absence of such requirement.

[93] For details on private-backed securities issuance volumes before World War II, see Kenneth A. Snowden, "The Anatomy of a Residential Mortgage Crisis: A Look Back at the 1930s" (National Bureau of Economic Research Working Paper 16244, Cambridge, MA, July 2010), www.nber.org/papers/w16244.pdf?new_window=1 (accessed March 22, 2011).

[94] Report to the governor of New York by Commissioner George Alger (Alger Report) regarding the operation, conduct, and management of mortgage guaranty corporations dated October 5, 1934. Document contained in the authors' files.

[95] The Mortgage Guaranty Insurance Corporation (MGIC) was formed pursuant to Wisconsin insurance law in 1957 by Max Karl. It remains the largest mortgage guaranty company in the United States.

[96] Going into the mortgage crisis there were seven companies. Six continue today and are paying claims and writing new business. Traid, the smallest of the seven, has ceased writing new business and is in run-off. It is paying claims at a reduced percentage and a final result is unknown. A new company, Essent, has formed since the crisis, returning the industry to seven members.

> The business of guaranteeing mortgages is not an ordinary banking function, and the public would have been better off if none of the companies had owned or been affiliated with banking institutions, or in turn had not been owned by them."[97]

Commissioner Alger concluded that the mortgage guaranty business was subject to periods of boom and bust and that the MI industry had to be required by statute to put away reserves sufficient to be prepared for that event. A significant portion of the premium paid by borrowers in the boom years had to be locked up in reserves to be available to provide coverage during the inevitable bust years. This reserving had no relationship to the level of claims; in fact, that was the point—to put aside reserves during the fat years to be prepared for the lean. Accumulate a large enough reserve and it would be truly countercyclical. That is, it will act as a drag on over exuberance in the good years and be available to pay claims and provide capital to fund new business in the lean years.

Commissioner Alger made a series of recommendations for the regulation of "mortgage guarantee companies." These became the foundation of the modern mortgage guaranty industry established in 1957:[98]

1. "No other business to be done except the sale of guaranteed mortgages and mortgage and real estate servicing."
2. "No company, except with the consent of the superintendent of Banks, to invest in or own more than 10% of the stock of any company, or be itself more than 25% owned by any person, firm or corporation."
3. "The total of outstanding guarantees computed by taking the aggregate of 10% of the face amount of all outstanding mortgages guaranteed as to principal . . . shall at no times exceed the aggregate of capital and surplus."
4. "25% of capital and surplus to be set aside and earmarked as a guaranty fund, and invested and kept invested in bonds of the United States, or the state of New York, or other legal investments for trust funds (other than mortgages) approved by the Banking Department."
5. "Guarantees to be of first mortgages only."
6. "No mortgage to be guaranteed . . . which exceeds 2/3 of the appraised value of the real estate."[99]

He observed, "[u]nder no illusions of perfection, I entertain no faith that all risks of loss can be avoided in this field any more than any other field of investment. With adequate statutory safeguards, however, a fair approximation can at least be made to a system of general supervision over this basic form of investment.[100]"

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[97] Report to the governor of New York by Commissioner George Alger (Alger Report) regarding the operation, conduct, and management of mortgage guaranty corporations dated October 5, 1934. Document contained in the authors' files.
[98] Within five years, a total of eleven private mortgage guaranty companies had been established under various state laws, all of which followed the Wisconsin regulatory structure.
[99] Report to the governor of New York by Commissioner George Alger (Alger Report) regarding the operation, conduct, and management of mortgage guaranty corporations dated October 5, 1934. Document contained in the authors' files.
[100] Ibid.

How is this experience from the 1930s relevant today? Mortgage lending presents three risks, two normal and one extraordinary. First, specific credit risks associated with the borrowers and their individual loan characteristics. This type of risk may be determined on an actuarial basis. Loans with small down payments or low FICO scores are riskier than those with larger down payments and higher FICO scores. These types of risks are largely uncorrelated (unless rules against concentration of risk are violated). Second, general economic risks associated with substantially increased unemployment, recessions, and other events that put stress on incomes, employment, and home prices. This type of risk may not be actuarially determined; instead stress tests based on worst-case depression scenarios are used. While these risks result in losses that are generally correlated; the impact can be kept manageable with sound underwriting and the accumulation of substantial reserves. The third risk is extraordinary. If lending standards become greatly weakened resulting in extraordinary levels of nonprime loans, specific loan-level risks become correlated and lead to a general collapse in loan performance. As a result, poor loan performance begins before any general triggering economic event such as a recession. It was the 27 million weak nonprime loans described in the main text of this white paper that led to the extraordinary mortgage meltdown that began while unemployment was under 5 percent.[101] This risk can be contained by setting a standard for a prime loan and measuring and limiting the accumulation of nonprime originations.

There are two risks that can be priced and reserved for:

- Actuarially determined risk-based pricing can price for known specific risks. For example, a 90 percent LTV loan is generally twice as risky as an 80 percent, an 80 percent twice as risky as a 70 percent, and a 70 percent twice as risky as a 60 percent. FICO score bands follow similar relationships.
- Sufficient reserves and capital to cover normal, general risks may be determined by stressing credit portfolios against the loan-default rates experienced during two extraordinary periods of risk (the Great Depression and the recent Great Recession). If structured properly, this counter-cyclical method of reserving has the potential to both reduce the size of the booms and busts and provide a source of capital needed to maintain prudent lending and liquidity during a crisis.

This approach has other salutary features relevant to the boom/bust nature of real estate lending. It is countercyclical since reserves are built during good times and available during times of stress. Further, by forcing industry participants to operate from 50 percent of their premium income, there is an even sharper focus on managing risk, keeping expense ratios low (including salaries), and paying sustainable dividend levels.

[101] US Department of Labor, Bureau of Labor Statistics, "Databases, Tables & Calculations by Subject," http://data.bls.gov/pdq/SurveyOutputServlet?data_tool=latest_numbers&series_id=LNS14000000 (accessed March 22, 2011).

Appendix 5:

Relative Foreclosure Rates

The following two tables set forth data from the 2005 Federal Reserve study. The first[102] covers loans from 1994 and demonstrates that it was well documented in 1996 that as FICO scores go down and/or LTVs increase,[103] the risk of foreclosure rises dramatically.

Table A5.1: Relative Foreclosure Rates by Credit Score Range (FICO >660 and LTV<=80% indexed to 1)

LTV	FICO <621	FICO 621–660	FICO >660
<=80%	26.9	7.9	1.0
>80%	47.6	15.3	3.3

The second covers both conventional and government fixed-rate loans from 1990 to 1993 and demonstrates that in 1996 it was well documented that as FICO scores decline, the risk of foreclosure increases dramatically for both types of loans.[104] Common sense dictates that forcing conventional lenders and investors to emulate government (that is, FHA) lending could only lead to disaster.

Table A5.2: Relative Foreclosure Rates for Conventional and Government Loans by Credit Score Range (FICO >660 and conventional fixed rate indexed to 1)

Loan type	FICO <621	FICO 621–660	FICO >660
Conventional fixed rate	28.5	7.3	1.0
Government fixed rate	45.0	12.8	3.0

These data date from the period before HUD began to increase affordable-housing requirements and encourage reductions in mortgage underwriting standards through the elimination of down payments, expansion of lending to credit-impaired borrowers, and other weakened lending standards. These efforts, taken pursuant to the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (GSE Act), forced the GSEs and the entire market to emulate the FHA's already high-risk lending, which got even riskier as the FHA further weakened its lending from the early 1990s onward.

[102] Derived from Federal Reserve, Division of Research and Statistics, "Credit Risk, Credit Scoring, and the Performance of Home Mortgages," table 6. The index sets the average foreclosure rate equal to one for loans with a borrower FICO score of more than 660 and an LTV of <=80 percent. Data are from Freddie Mac over the period 1994–95.

[103] The relationship between high-LTV and lower-LTV loans is understated by these data. In 1994, almost all of Freddie's loans had an LTV of 90 percent or less, with a small percentage having LTVs of 91–95 percent. Virtually none had an LTV >95 percent. As a result of HUD's mandates, Freddie (and Fannie) began acquiring 97 percent LTV loans in 1994 and 100 percent LTV loans in 2000.

[104] Derived from Federal Reserve, Division of Research and Statistics, "Credit Risk, Credit Scoring, and the Performance of Home Mortgages," table 2. The index sets the average delinquency rate equal to one for conventional fixed-rate loans. Data are from the period 1990–93.

Appendix 6:

FHA lending

From its creation in 1934, the FHA has been one of Congress's main tools to support low- and moderate-income single-family housing. Since its establishment in 1934, the FHA has led the entire market to ever-higher LTVs and longer loan terms. The figures below[105] show LTV and mortgage term trends over the last sixty years:

Figure A6.1: Postwar Trends in New Home Mortgage Loan-to-Value Ratios, 1947–67

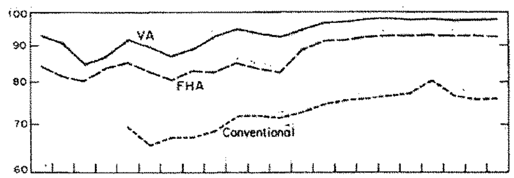


Figure A6.2: Postwar Trends in Existing Home Mortgage Loan-to-Value Ratios, 1947–67

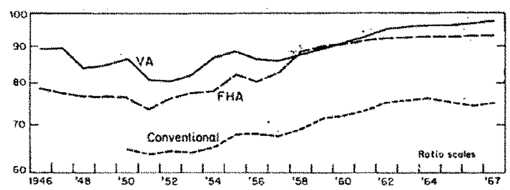
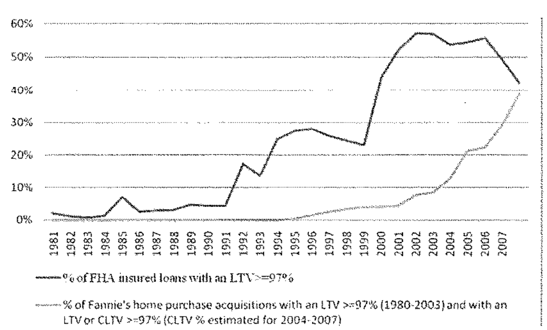
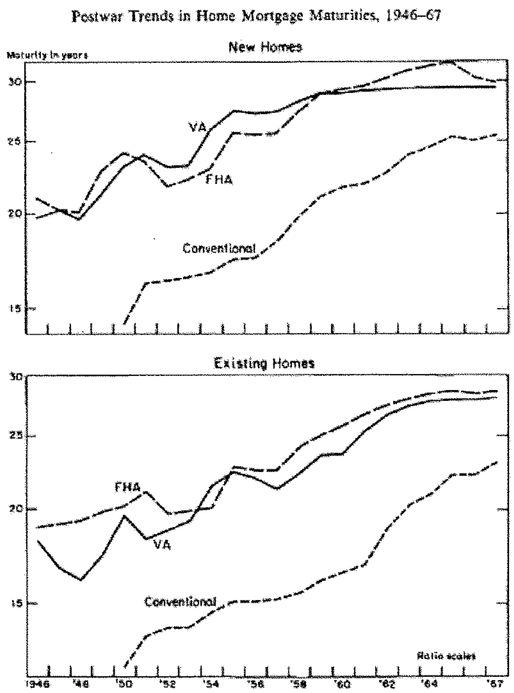


Figure A6.3: Trend of FHA and Fannie Loans with No Down Payments[106]



[105] John P. Herzog and James S. Earley, *Home Mortgage Delinquency and Foreclosure* (Cambridge, MA: National Bureau of Economic Research, 1970), www.nber.org/books/herz70-1 (accessed March 21, 2011).
[106] Edward J. Pinto, "Government Housing Policies in the Lead-Up to the Financial Crisis: A Forensic Study," chart 15.

Figure A6.4: Postwar Trends in New and Existing Home Mortgage Maturities, 1947–67



Beginning its operations during the Great Depression, the FHA admirably performed its role through World War II and the postwar boom. As noted, Congress periodically increased the FHA's LTV limit or extended its maximum loan term (or both). This was presumed to come at no cost and was likely justified on the basis of the FHA's previous experience. From 1934 through 1954, the FHA insured 2.9 million mortgages. For this period, during which house prices increased by 57 percent, the FHA paid claims on 5,712 properties for a cumulative claims rate of 0.2 percent[107] and had revenue of $494 million and expenses of $246 million.[108] The FHA's apparent success encouraged Congress to periodically loosen underwriting standards (see table A6.1).

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[107] To put this in perspective, the FHA had twice this number of claims during the single month of October 2010. Federal Housing Administration, Department of Housing and Urban Development, "Monthly Report to the FHA Commissioner Department of Housing and Urban Development on FHA Business Activity," October 2010, www.hud.gov/offices/hsg/rmra/oe/rpts/com/10oct.pdf (accessed January 14, 2011).

[108] John P. Herzog and James S. Earley, *Home Mortgage Delinquency and Foreclosure*.

Table A6.1: FHA's Transition to Unsustainable Lending

Year	Maximum LTV limit	Maximum loan term	Monthly payment*	Homeowner equity after five years (with no increase in house prices)	Mortgage payment-to-income ratio	Income needed to buy median-priced home*
1934	80%	20 years	$670	30%	Not available	Not available
1938	90%[109]	25 years[110]	$695	17%	Not available	Not available
1948	90%	30 years	$660	14%	17% (average)	$26,600 income/ $44,600 home[111]
1956	95%	30 years	$697	10%	Not available	Not available
1984	97%	30 years	$712	8%	38% (maximum)[112]	$23,000 income/ $80,000 home[113]

* For comparison, all examples are based on the purchase of a $100,000 home at the maximum LTV and term with an interest rate of 8 percent, except for median-home-price calculation, which uses applicable median home price.

As seen from table A6.1, the FHA started out with both a substantial down payment (20 percent) and loan amortization, so by the end of the first five years of the loan, the homeowner had equity of 30 percent. Further, debt ratios were low. In the late 1940s, the FHA had an average mortgage-payment-to-income ratio of 17 percent.[114] By the early 1980s, a buyer would only have equity of about 8 percent after five years, and mortgage payments had about doubled relative to income.[115] Reliance on house-price inflation and lending to highly leveraged borrowers had become necessary parts of FHA's financing structure.

As figure A6.4 demonstrates, there was a cost. As FHA took on more risk, foreclosures increased.

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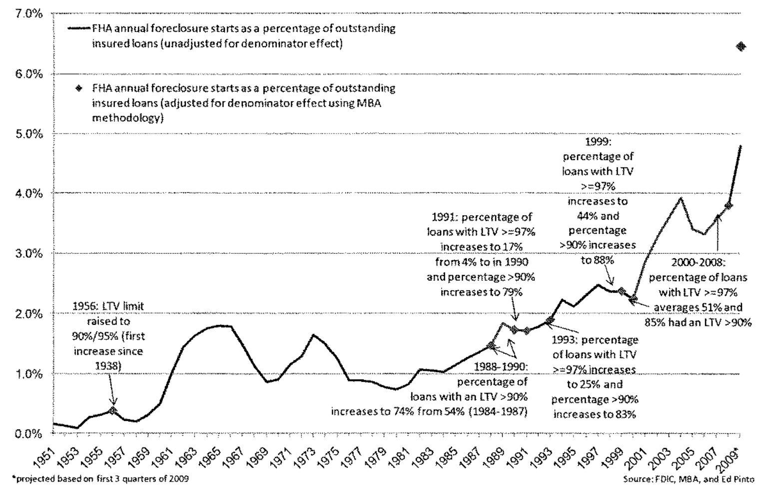
[109] Ibid.
[110] Ibid.
[111] Median price data for 1950. See US Census Bureau, "Census of Housing," www.census.gov/hhes/www/housing/census/historic/values.html (accessed January 14, 2011).
[112] Stephen Moore, "How Congress Can Diffuse the Federal Housing Time Bomb," Heritage Foundation, July 29, 1986, 7, www.policyarchive.org/handle/10207/bitstreams/9281.pdf (accessed January 14, 2011).
[113] US Census Bureau, "Median and Average Sales Prices of New Homes Sold in United States," www.census.gov/const/uspriceann.pdf (accessed January 14, 2011).
[114] John P. Herzog and James S. Earley, *Home Mortgage Delinquency and Foreclosure*.
[115] Stephen Moore, "How Congress Can Diffuse the Federal Housing Time Bomb."

Figure A6.4: FHA's Increasing LTVs on Annual Foreclosure Starts as a Percentage of Insured Loans



By 1961, the FHA was experiencing a foreclosure start rate of 1.00 percent per year—over six times the rate in 1951.[116] Equally disconcerting was the fact that the private sector, in order to compete, followed the FHA's lead by increasing LTV, loan-term, and debt ratios.

As a result of the FHA's risky underwriting standards, its claim rate has been excessive for many decades. Over a thirty-five-year period (1975–2009), the FHA's cumulative claim rate averaged 10.5 percent, and over 1992–2009 it averaged 10 percent. Even during the boom years of 1995–2003, the cumulative claim rate still averaged nearly 8 percent. During bust periods (1980–85 and 2005–2008), it averaged 18 percent—over two times the rate in good times. For 2010–17, the FHA has projected an 8 percent average claim rate even with an expected 33 percent increase in home prices over 2011–20.[117] Relying on home-price inflation to attain a default rate of nearly one in ten is not sustainable lending.

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[116] This increase led *Time* magazine to observe: "Homeowners of a new and unattractive breed are plaguing the Federal Housing Administration these days. Known as 'the walkaways,' they are people who find themselves unable to meet their mortgage payments—and to solve the problem simply move out their belongings at night, drop their house key in the mailbox and disappear." See "Credit: Beware of the Walkaways," *Time*, July 27, 1962, www.time.com/time/magazine/article/0,9171,827500,00.html (accessed January 14, 2011).

[117] FHA Actuarial Studies for 2010 and 2000.

"TOWARD A NEW HOUSING FINANCE SYSTEM"

Testimony prepared for

"IMMEDIATE STEPS TO PROTECT TAXPAYERS FROM THE ONGOING BAILOUT OF FANNIE MAE AND FREDDIE MAC"

ON

MARCH 31ST, 2011

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT-SPONSORED ENTERPRISES

U.S. HOUSE OF REPRESENTATIVES

WRITTEN TESTIMONY
SUSAN M. WACHTER
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Chairman Garrett, Ranking Member Waters, and other distinguished members of the Subcommittee:

Thank you for the invitation to testify at today's hearing on the "Immediate Steps to Protect Taxpayers from the Ongoing Bailout of Fannie Mae and Freddie Mac." It is an honor to be here today to discuss the proposed legislation and the broader need for a reinvented housing finance system. Transition issues are important. It is necessary to take steps to reduce the current near-total reliance on federal support for housing. Nonetheless before we can dismantle the current system we will need a comprehensive set of reforms to reinvent the housing finance system.

In a reformed system, among other goals, private capital must be accountable and at risk. However, today in the part of the market in which private capital is not competing with federal supported mortgage finance, the jumbo market, there is a very limited supply of private capital. This absence of financing activity points to the need for comprehensive reform to address the substantial absence of private financing even in those portions of the market that are not served by the GSEs.

Comprehensive rules of the game to support a transparent and accountable system and to prevent the recurrence of systemic failure are not yet in place. Until they are, we will not be able to replace the current reliance on federally supported supply of capital with functioning capital markets. Thus, the important challenge is restructuring a system to encourage private capital flows to re-enter the market and to ensure a sustainable housing finance system going forward.

A number of proposals have set forth necessary components of a comprehensive system. They have in common shared goals. These include systemic stability, consumer and taxpayer protections, and private capital accountability.

These proposals have in common a role for the federal government in preventing races to the bottom and the undermining of sensible lending standards to assure a sustainable system going forward.

In my own research, I stress the need for standards and transparency to counter the information failures that allowed reckless mortgage products and underwriting practices. There is an important role for collective or government action to mandate transparency, standards, and information to allow for all market participants, investors, borrowers and regulators, to prevent risks from becoming uncontrollable through market discipline and regulatory oversight. In the absence of standardized information and reporting such discipline and oversight are not feasible.

While numerous explanations exist for the housing bubble that precipitated the financial crisis of 2008, including monetary policy, encouraging affordable homeownership, and irrational expectations, none of these can fully explain the housing bubble, much less the parallel commercial real estate bubble. In co-authored research with Adam Levitin, "Explaining the Housing Bubble" (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1669401 and forthcoming in the *Georgetown Law Review*), we demonstrate that the bubble was a supply-side phenomenon attributable to the underpricing of risk.

Due to complexity and the lack of transparency and standardization, it was difficult for investors and regulators to identify the extraordinary increase in mortgage credit risks as reckless underwriting and risky mortgage products increasingly overtook the system. We show that the market failed to identify these risks and in fact lowered the price of risk as risk increased in unparalleled ways. Neither regulators nor investors could be aware in real-time of the growth of tail risk and the growth on the margin of risky products and underwriting practices.

While proposed legislation being considered today addresses the underpricing of the government guarantee fee, it is also true that the private market significantly underpriced risk. In fact, the private sector was first to underprice risk. The resulting information failure enabled low mortgage rates, risky products and reckless underwriting to persist causing the housing price boom, which concealed the risk.

This underlying information failure must be addressed if mortgage securitization is to be sustainable going forward. Sustainable mortgage securitization is important for the continued availability of the long-term fixed-rate mortgage, which itself is critically important to limit the negative consequences of imposing interest-rate risk on borrowers. Homeowners lack the capacity to take measures to hedge this risk, with potentially severe consequences for household financial stability and for the stability of the overall economy.

Moreover, while comprehensive reform is necessary for a stable housing finance system in the long run, the transition to a new system must be accomplished while taking into consideration the current fragility of housing markets.

On March 29, Standard & Poor's released the latest update to the Case-Shiller Home Price Indices, which show, from January 2010 to January 2011, home prices fell 3.1% in the twenty-city composite index. In inflation-adjusted terms, housing prices have breached their 2009 bottom and are again on the decline. Part of this decline is due to a weak labor market, with unemployment at 8.9%; part is due to the excess inventory, including the shadow supply of houses; and part is due to the tightening availability of credit. Expectations of decline could once again become self-fulfilling leading to a downward spiral of prices. Federal housing support is still critical to preventing this; thus, legislative proposals need to be considered in the context of the weak housing markets.

Now I turn to addressing each of the specific legislative proposals. The first three raise questions of implementation.

"The Fannie Mae and Freddie Mac Accountability and Transparency for Taxpayers Act," proposed by Representative Biggert , imposes reporting requirements on the Inspector General of the Federal Housing Finance Agency. While reporting is of course useful, the appropriateness of reporting every communication between the Fed or Treasury and the

GSEs, as this law requires should be considered in light of market-moving implications and the potential for market-moving outcomes that are not consistent with fundamentals.

"The GSE Debt Issuance Approval Act," proposed by Representative Pearce, requires the Treasury to approve new debt issuance by Fannie and Freddie and to justify approval of GSE debt issuance, seven days before issuance. My understanding is that the Treasury already had the authority to do this and it should. The specific seven-day oversight of this by Congress may or may not be practical. More to the point, the overarching question is whether this encourages the intended outcome of less reliance on federal support for housing finance.

"The GSE Risk and Activities Limitation Act," proposed by Representative Schweikert, prohibits the FHFA Director from approving any new GSE product. This is consistent with the current prohibition by FHFA with one major exception. This exception currently allows for adding new products for loan modification purposes. Prohibiting this could inhibit or prevent the implementation of techniques to resolve current or impending loan defaults, a problem which is part of the shadow supply overhang that is impeding the housing market recovery.

"The GSE Mission Improvement Act," proposed by Representative Royce, repeals affordable housing goals, without suggesting what might replace them. As we re-envision the housing finance system, there will be a need to re-envision the goal of non-discriminatory access to housing finance. In the academic literature, there is substantial evidence that the affordable housing goals were not responsible for the housing bubble, evidenced that is reviewed in my previously cited paper, "Explaining the Housing Bubble." We note there also that the housing bubble coincided with an equal commercial real estate bubble and bust, which could not have been prevented by removing the affordable housing goals.

On the "The GSE Credit Risk Equitable Treatment Act of 2011," proposed by Chairman Garrett, I agree the comments made today by Edward DeMarco, Acting Director of the Federal Housing Finance Agency, who stated that "Enterprise single-family mortgage securities are structured with a 100 percent risk retention by the securitizer (i.e., the Enterprise)," which is beyond the five percent retention required by Dodd-Frank. Nonetheless, the broader issues raised by Section 941 are perhaps the most important of everything that is being considered today. Empirical evidence on risk points to the importance of sound underwriting. Based on the evidence, assuming well-structured mortgage markets, the requirement of twenty percent down payments without a mortgage insurance offset is way beyond what is necessary for a safe and sound housing finance system.

Now let me turn in brief to the three remaining proposed laws. Each constrains management decisions and, while well-intentioned, could raise costs to taxpayers.

"The Equity in Government Compensation Act of 2011," proposed by Representative Bachus, constrains compensation.

"The Portfolio Risk Reduction Act," proposed by Representative Hensarling, caps the GSEs' portfolios at $250 billion in five years. While it is ultimately desirable and necessary to reduce the portfolio, constraining the path of reduction in this way may not optimize taxpayer returns.

Finally, "The GSE Subsidy Elimination Act," proposed by Representative Neugebauer, directs the GSEs to increase guarantee fees within two years to a level that "appropriately reflects risk of loss as well the cost of capital allocated to similar assets held by other fully private regulated financial institutions." Fannie and Freddie have credit risk but not interest rate risk, as banks do which needs to be taken into consideration. Moreover, the very level of the necessary guarantee fee should be determined by the expected default risk, including the potential for systemic risk. This is indeed the important issue going forward.

Policymakers and the nation as a whole must make fundamental decisions about the shape of our Nation's finance system going forward. The issues being considered today are of critical importance to the Nation's future. I thank you for the opportunity to testify today, and I welcome your questions.

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B. Dan Berger
Executive Vice President
Government Affairs

March 30, 2011

The Honorable Scott Garrett
Chairman
House Financial Services Subcommittee on Capital Markets
and Government Sponsored Enterprises
United States House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters
Ranking Member
House Financial Services Subcommittee on Capital Markets
and Government Sponsored Enterprises
United States House of Representatives
Washington, D.C. 20515

Dear Chairman Garrett and Ranking Member Waters:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association exclusively representing the interests of our nation's federal credit unions, I write today with respect to tomorrow's hearing on "Immediate Steps to Protect Taxpayers from the Ongoing Bailout of Fannie Mae and Freddie Mac." As you know, the future of housing finance is of great importance to our nation's credit unions.

I would also like to take this opportunity to recognize the first series of legislative initiatives unveiled by several Financial Services Committee Republicans earlier this week. We understand these eight proposals, in addition to the proposals put forward by the Treasury Department earlier this year, represent only the beginning of vigorous debate and discussion on the issues surrounding GSE reform, and we intend to remain fully engaged moving forward.

NAFCU would like to stress the importance of retaining a system that provides credit unions with the liquidity necessary to serve the mortgage needs of their 92 million members. As you begin consideration of legislative proposals, NAFCU would like to reiterate a core set of principles we believe must be considered to ensure that credit unions are treated fairly during any housing finance reform process:

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- A healthy and viable secondary mortgage market must be maintained. A secondary mortgage market, where mortgage loans are pooled and sold to investors, is essential in providing the liquidity necessary for credit unions to create new mortgages for their members.

- There should be at least two Government Sponsored Enterprises (GSEs). To effectuate competition in the secondary market and to ensure equitable access for credit unions, NAFCU supports the creation or existence of multiple GSEs that would perform the essential functions currently performed by Fannie Mae and Freddie Mac. These entities should have the ability to purchase loans and convert them into mortgage backed securities (MBSs), each of these functions serves to facilitate mortgage lending.

- The U.S. government should issue explicit guarantees on the payment of principal and interest on MBSs. The explicit guarantee will provide certainty to the market, especially for investors who will need to be enticed to invest in the MBSs and facilitate the flow of liquidity.

- Fannie Mae and Freddie Mac have been crucial partners for credit unions and have served an important function in the mortgage lending industry. Both have been valuable entities to the nation, particularly to the nation's economy. It is important that during any transition to a new system (whether or not current GSEs are to be part of it) credit unions have uninterrupted access to the GSEs, and in turn, the secondary market.

- We could support a model for the GSEs that is consistent with a cooperative or a mutual entities model. Each GSE would have an elected Board of Directors, be regulated by the Federal Housing Finance Agency, and be required to meet strong capital standards. The GSEs should also meet other appropriate regulatory standards to limit their ability to take on risk while ensuring safety and soundness. Rigorous oversight for safety and soundness is also paramount.

- A board of advisors made up of representatives from the mortgage lending industry should be formed to advise the FHFA regarding GSEs. Credit unions should be represented in such a body.

- While a central role for the U.S. government in the secondary mortgage market is pivotal, the GSEs should be self-funded, without any dedicated government appropriations. GSE's fee structures should, in addition to size and volume, place increased emphasis on quality of loans. Credit union loans provide the quality necessary to improve the salability of agency securities.

- Fannie Mae and Freddie Mac should continue to function, whether in or out of conservatorship, and honor the guarantees of the agencies at least until such time as necessary to repay their current government debts. <u>Legislation to reform the</u>

GSEs should ensure that taxpayer losses are not locked in, but should allow for time for the GSEs to make taxpayers whole.

- At this time, NAFCU does not support full privatization of the GSEs because of serious concerns that small community-based financial institutions could be shut-out from the secondary market.

- The Federal Home Loan Banks (FHLBs) serve an important function in the U.S. mortgage market. Most importantly, they provide their credit union members with a reliable source of funding and liquidity. Throughout the financial crisis, despite experiencing financial stress, the FHLBs continue to be a strong partner for credit unions. Reform of the nation's housing finance system must take into account the consequence of any legislation on the health and reliability of the FHLBs. Importantly, access to FHLBs for small lenders should not be impeded in any way.

In summary, NAFCU strongly believes that any reforms must not disrupt the fragile housing finance system that is slowly beginning to recover. As you know, any such disruption could trigger a "double-dip" recession and such an occurrence will have a devastating impact on our country's economy as well as the global finance system. In addition, we believe it is critical that the essential functions of Fannie Mae and Freddie Mac are retained until taxpayer capital that the federal government injected into the GSEs is recovered. The essential functions include, but are not limited to, purchasing and guaranteeing mortgages originated by credit unions.

We thank you for this opportunity to provide our input on this crucial issue and NAFCU would welcome the opportunity to provide additional views on housing finance reform as the legislative process moves forward. If my colleagues or I can be of assistance to you, or if you have any questions regarding this issue, please feel free to contact myself, or NAFCU's Vice President of Legislative Affairs, Brad Thaler, at (703) 842-2204.

Sincerely,

B. Dan Berger
Executive Vice President of Government Affairs

cc: Members of the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises.

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March 30, 2011

Honorable Scott Garrett, Chairman
Subcommittee on Capital Markets and
Government Sponsored Enterprises
2129 Rayburn House Office Building
Washington, DC 20515

Honorable Maxine Waters, Ranking Member
Subcommittee on Capital Markets and
Government Sponsored Enterprises
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Garrett and Ranking Member Waters:

On behalf of the Office of the Inspector General for the Federal Housing Finance Agency ("FHFA-OIG"), I am pleased to respond to the Subcommittee on Capital Markets and Government Sponsored Enterprises' request for comments on H.R 31, the "Fannie Mae and Freddie Mac Accountability and Transparency for Taxpayers Act of 2011" ("H.R. 31"). As discussed in detail below, FHFA-OIG enthusiastically supports the goals expressed in H.R. 31, and believes that the success of the legislation could be further ensured if several proposed changes are made.

BACKGROUND

FHFA-OIG was established by the Housing and Economic Recovery Act of 2008 ("HERA," Public Law No. 110-289), which amended the Inspector General Act of 1978 (Public Law No. 95-452), to conduct audits, investigations, and other activities of the programs and operations of the Federal Housing Finance Agency ("FHFA"); to recommend policies that promote economy and efficiency in the administration of such programs and operations; and to prevent and detect fraud and abuse in them. The operations of FHFA-OIG are not financed with appropriated funds.

As you know, FHFA is responsible for both the regulation and supervision of the housing government-sponsored enterprises ("GSEs"): Fannie Mae, Freddie Mac (together, the "Enterprises"), and the 12 Federal Home Loan Banks. Currently, the GSEs hold or guarantee approximately $9 trillion in mortgages, mortgage-backed securities, and other assets, and they employ about 12,000 employees. Additionally, FHFA is the conservator of the Enterprises, and the U.S. Department of Treasury has invested over $153 billion in the Enterprises to reinforce their capital levels. FHFA-OIG cannot effectively oversee FHFA without examining the Enterprises under its control.

I was sworn in as the first Inspector General of FHFA on October 12, 2010. At that time, I had no permanent staff. Since then, FHFA-OIG has grown into an organization of 40 highly-experienced, professional employees, and it will be issuing several reports in the coming weeks.

FHFA-OIG supports fully the goals of H.R. 31: increased accountability and transparency for the GSEs. At the same time, the objectives of H.R. 31 are likely to be more efficiently realized if H.R. 31 better delineates FHFA's and FHFA-OIG's disparate regulatory and oversight responsibilities. Accordingly, as described below, FHFA-OIG offers revisions to H.R. 31 to reflect the separate roles of FHFA and FHFA-OIG. Additionally, during the first five months of operation, FHFA-OIG identified a number of administrative limitations inhibiting the efficiency and effectiveness of its operations. Described below, are several proposed new sections for H.R. 31 to remedy these limitations. All of the proposals described below can be found in the attached red-lined copy of H.R. 31.

PROPOSALS TO EXISTING TEXT OF H.R.31

Section 2 of H.R. 31 requires that FHFA-OIG produce a series of quarterly reports containing data describing the liabilities, executive compensation, foreclosure mitigation initiatives, fraud prevention activities, investments, portfolio sizes, and underwriting standards of the Enterprises. The compilation, aggregation, and quarterly reporting of this Enterprise-related information are appropriate functions of the regulator and conservator of the Enterprises: FHFA. This information is readily available to FHFA because it serves as both regulator and conservator of the Enterprises, and it has offices that are responsible for analyzing the relevant data. Moreover, the information is integral to the success of FHFA's mission to provide effective supervision, regulation and housing mission oversight of the GSEs, to promote their safety and soundness, support housing finance and affordable housing, and reinforce a stable and liquid mortgage market.

By contrast, FHFA-OIG's mission is to oversee FHFA. As such, FHFA-OIG is well poised to independently verify and validate the quarterly reports generated by FHFA, pursuant to the terms of H.R. 31. Accordingly, FHFA-OIG proposes a revision of H.R. 31 to require:

(1) FHFA to generate the quarterly reports of specific financial data of the Enterprises as required by H.R. 31; and
(2) FHFA-OIG to conduct independent reviews of the integrity of the information reported to Congress, within 60 days of FHFA's completion of the reports.

ADDITIONS TO H.R. 31

FHFA-OIG is not financed with appropriated funds. Consequently, the following proposed additions to H.R. 31 have been determined by the Congressional Budget Office to have no score.

On the basis of its first five months of operations, FHFA-OIG has determined that a few minor technical changes to its authorizing statutes ("FHFA-OIG technical proposals") will dramatically enhance its capacity to accomplish its mission effectively and efficiently. FHFA-OIG technical proposals, if enacted, would give FHFA-OIG enhanced hiring authorities for a very limited duration. These proposals also would provide FHFA-OIG authorities and discretion enjoyed by other presidentially-appointed Inspectors General. Lastly, FHFA-OIG technical proposals would clarify that FHFA-OIG's financial and budget practices and authorities are parallel to those of FHFA: the Agency that FHFA-OIG is charged with overseeing.

Issue 1: FHFA-OIG Personnel

Two provisions of the FHFA-OIG technical proposals would revise the Federal Housing Enterprises Safety and Soundness Act of 1992 to allow FHFA-OIG to use direct hire and annuity offset waiver authorities to bring its staff up to necessary operating levels and to ensure that staff members possess the expertise necessary to fulfill the mission of FHFA-OIG, as designated by Congress. These provisions are modeled on section 3 of the Special Inspector General for the Troubled Asset Relief Act of 2009, Pub. Law No. 111-15, which proved to be essential to the development of the Office of the Special Inspector General for the Troubled Asset Relief Program, when it, like FHFA-OIG, was in its critical start-up phase.

Direct Hire

Direct hire is a temporary appointing authority that provides the needed flexibilities to effectively recruit, and quickly hire qualified candidates to fill critical positions. The use of this authority would provide FHFA-OIG with the ability to hire quickly the experienced staff with needed expertise to meet mission requirements, which include investigations, audits, and evaluations relating to FHFA's programs and operations. The inability to hire staff quickly will greatly and negatively impact FHFA-OIG's ability to timely initiate and fulfill its oversight duties.

OPM has provided FHFA-OIG with six months of direct hire authority. As a result, this temporary authority expires in June 2011, *i.e.*, in two months. To date, FHFA-OIG has successfully filled about 40 positions. Although FHFA-OIG is making progress using direct hire authority along with other recruitment flexibilities, the June 2011 expiration of direct hire authority will greatly impact its recruitment efforts. FHFA-OIG's proposal would provide it with 12 months of direct hire authority.

Annuity Offset Waivers

FHFA-OIG uses various recruitment flexibilities, including the reemployment of federal retirees to fill critical positions that often require specific areas of expertise, such as experience investigating mortgage financing and mortgage modification fraud. OPM has given FHFA-OIG authority to hire a limited number of retired annuitants without an offset against their salaries. OPM's authorization expires in June 2012, and, if not extended, the expiration will likely result in FHFA-OIG losing indispensable staff before their vital start-up work is completed. The legislative proposal would authorize FHFA-OIG to use the 36 months following enactment of H.R. 31 to hire retired annuitants, who bring unique skills and knowledge of best practices to the table, and who serve as a consulting resource for addressing difficult Agency issues.

Issue 2: FHFA-OIG Operations and Independence

Two provisions of the FHFA-OIG technical proposals would provide FHFA-OIG law enforcement authority and direct access to all records and employees of the GSEs.

Law Enforcement Authority

In the case of law enforcement authority, FHFA-OIG was omitted from an exception to an onerous approval requirement included in the Inspector General Act of 1978, as amended. FHFA-OIG was not in existence at the time that the exception was added. As a result, a number of significant FHFA-OIG criminal investigations are being adversely affected, and, thus, FHFA-OIG seeks remedial legislation.

Access to Records of the GSEs

Section 6(a)(1) of the Inspector General Act of 1978 provides that FHFA-OIG "is authorized to have access to all records, reports, audits, reviews, documents, papers, recommendations, or other material available to" FHFA. *See* 5 U.S.C.A. App 3 § 6(a)(1). Hence, because the books and records of the GSEs are available to FHFA, they are also available to FHFA-OIG under section 6(a)(1). Nonetheless, to avoid any misunderstandings—given that $9 trillion and the Nation's housing finance system are at stake—FHFA-OIG seeks clarification of the Federal Housing Enterprises Safety and Soundness Act of 1992 to the effect that FHFA-OIG has direct access to the records and employees of the GSEs.

For an example of why it is essential that FHFA-OIG have direct access to the GSEs' records and employees, one needs look no farther than FHFA's role as conservator. As stated above, FHFA is both the regulator of the GSEs and the conservator of the Enterprises. Under the conservatorship, FHFA now not only oversees the Enterprises, but also sometimes directs their activities. In order to assess FHFA's effectiveness and compliance, it is crucial that FHFA-OIG have direct access to the records and employees of the GSEs. Without guaranteed access to these records, FHFA-OIG's ability to ensure that FHFA fulfills its mission will be impaired, and, in time, FHFA-OIG's ability to provide transparency will suffer.

Issue 3: FHFA-OIG Budgeting Process

FHFA-OIG is not financed with appropriated funds. Instead, FHFA assesses the GSEs to finance the operations of FHFA-OIG. At this time, FHFA-OIG is thus required to negotiate its funding with FHFA management, which it is charged with overseeing. This arrangement threatens FHFA-OIG's independence, and, therefore, FHFA-OIG proposes a clarifying revision to the Federal Housing Enterprises Safety and Soundness Act of 1992. The clarification would provide that FHFA-OIG's annual budget shall be established in the same manner as FHFA's budget. In other words, FHFA-OIG would be authorized to determine its budget independently of FHFA, and the GSEs would then be assessed to finance this oversight budget. Section 1316(f)(2) the Federal Housing Enterprises Safety and Soundness Act of 1992 supports this clarification, stating that any assessment under it shall not construed to be government or public funds, or appropriated money.

In closing, I greatly appreciate this opportunity, and should you require any additional information regarding this of any other matter, please do not hesitate to contact me.

Sincerely,

Steve A. Linick
Inspector General

Attachment

Cc: Honorable Spencer Bachus
Honorable Barney Frank
Honorable Judy Biggert
Honorable Luis Gutierrez

[DISCUSSION DRAFT]

112TH CONGRESS
1ST SESSION

H. R. __

To require the ~~Inspector General of the~~ Federal Housing Finance Agency to submit quarterly reports to the Congress during the conservatorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation~~.~~, and to insure that ~~the~~ the Inspector General of the Federal Housing Finance Agency review such reports.

IN THE HOUSE OF REPRESENTATIVES

Mrs. BIGGERT introduced the following bill; which was referred to the Committee on ______

A BILL

To require ~~the Inspector General of~~ the Federal Housing Finance Agency to submit quarterly reports to the Congress during the conservatorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation~~.~~

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Fannie Mae and Freddie Mac Accountability and Transparency for Taxpayers Act of 2011".

SEC. 2. QUARTERLY REPORTS DURING CONSERVATORSHIP.

(a) REPORTING REQUIREMENT.—For each reporting period~~, the Inspector General of~~ the Federal Housing Finance Agency shall submit to the Congress a report for each enterprise that summarizes the activities of the ~~Inspector General FHFA~~Federal Housing Finance Agency with respect to such enterprise, and the activities and condition of such enterprise, during such reporting period.

(b) CONTENTS.—Each report required under this section for an enterprise for a reporting period shall include the following information:

(1) A description, including dollar amount, of total liabilities of the enterprise as of the reporting date, with a detailed breakdown of the potential level of risk to the Federal Government inherent in the dollar amount of each separate type of liability and a quantification as to how the risk to the Federal Government has changed from the previous reporting period, distinguishing between changes attributable to volume and changes attributable to changes in risk levels.

(2) An explanation of, including rationale for, all compensation and bonuses paid to any executive officer (as such term is defined in section 1303 of the Housing and Community Development Act of 1992 (12 U.S.C. 4502)) of the enterprise, and any retention decisions made, by the enterprise during such period regarding its executive officers.

(3) A description of foreclosure mitigation activities of the enterprise during such period, including any related data, a list of law firms and attorneys approved or retained by the enterprise for handling foreclosure and bankruptcy matters relating to mortgages held or securitized by the enterprise, and the eligibility criteria used for such approval or retention and reasons for limiting such list, and the number of mortgage loans held by the enterprise that were refinanced in 2008, 2009, and 2010 through foreclosure mitigation activities of the enterprise that have, during such period, entered into default.

(4) A description of any mortgage fraud prevention activities undertaken by the enterprise during such period and data describing the extent of mortgage fraud during such period, including descriptions of the efforts of the enterprise to prevent or detect

mortgage fraud, of the pervasiveness of mortgage fraud, and of the most prevalent types of mortgage fraud detected.

(5) A listing with description of any formal or informal communication between Governors and staff of the Board of Governors of the Federal Reserve System and executives in the enterprise and any formal or informal communication between officials and staff of the Department of the Treasury and the Governors and staff of the Board of Governors of the Federal Reserve System and executives in the enterprise regarding the purchase or sale of any enterprise-related securities.

(6) A description of any investments, holdings, and activities of the enterprise during such period that are not consistent with the mission of the enterprise as provided under Federal law.

(7) A description of the reasons for any equity investments in the enterprise by the Department of the Treasury during such period and any increase during such period in the authorized amount of equity investments by such Department.

(8) An analysis of the capital levels and portfolio size of the enterprise during such period and their impacts on the safety and soundness of the enterprise.

(9) A description and analysis of the underwriting standards of the enterprise applicable during such period, including the criteria for safety and soundness of mortgage loans for single-family, multi-family, and condominium residential homes securitized by the enterprise and the ability of such criteria to ensure such safety and soundness.

(10) An analysis of actions taken by the enterprise that had a beneficial or harmful effect on holders of enterprise-related securities, in particular, preferred stock issued prior to September 6, 2008.

~~(11) Any other information that the Inspector General considers relevant or important with respect to the enterprise, and the activities and condition of the enterprise.~~

(c) REPORTING PERIODS; TIMING OF REPORTS.—

(1) INITIAL PERIOD.—The first reporting period for each enterprise shall be the period that began upon the commencement of the conservatorship period for the enterprise and that ends upon the date of the enactment of this Act. The reports required under this section for such period shall be submitted not later than the expiration of the 60-day period beginning on the date of the enactment of this Act.

(2) QUARTERLY PERIODS.—After the first reporting period, the reporting periods for each enterprise shall be each calendar quarter that concludes ~~after the date of the enactment of this Act~~March 31, June 30, September 30, and December 31. Each report for each such reporting period shall be submitted not later than the expiration of the 60-day period beginning upon the conclusion of such reporting period.

(3) RECEIVERSHIP.—Notwithstanding paragraph (2), if at any time a receiver is appointed for an enterprise pursuant to section 1367 of the Housing and Community Development Act of 1992 (12 U.S.C. 4617), the reporting periods for the enterprise during such receivership shall be each calendar month (or such shorter period as ~~the Inspector General~~the Federal Housing Finance Agency consider~~ed~~s appropriate). Each report for each such reporting period shall be submitted not later than the expiration of the 30-day period beginning upon the conclusion of such reporting period.

(4) NATIONALIZATION.—Notwithstanding paragraph (2), if at any time the Federal Government or any agency or entity of the Federal Government obtains control of an enterprise under law or through ownership of voting stock of the enterprise, or the ~~Inspector General~~Federal Housing Finance Agency determines that the enterprise has otherwise been nationalized, the reporting periods for the enterprise after such nationalization occurs shall be the consecutive 6-month periods (the first such period beginning upon such nationalization (or such shorter period ~~as the Inspector General~~as the Federal Housing Finance Agency consider~~ed~~s appropriate). Each report for each such reporting period shall be

submitted not later than the expiration of the 60-day period beginning upon the conclusion of such reporting period.

(d) Review of Reports by the Office of the Inspector General..-----

~~The Inspector General shall:~~

(1) The Inspector General shall conduct ~~a~~ reviews of the periodic reports prepared by the ~~FHFA~~Federal Housing Finance Agency, pursuant to the provisions set forth above, to insure the integrity of the information provided to Congress.

(2) Th~~is~~ese reviews shall be conducted within ~~x~~60 ~~calendar~~work days of submission of the Federal Housing Finance Agency's reports to Congress, and the Inspector General shall report its findings and recommendations~~ and information shall be provided to Congress with the results of those findings~~.

(~~d~~e) PUBLIC AVAILABILITY. ~~—The Inspector GeneralInspector General shall—~~

(1) The Federal Housing Finance Agency shall publicly disseminate its periodic reports ~~make information regarding the activities of the Inspector General, including each audit,and evaluation report~~ submitted to the Congress pursuant to this section, ~~available to the public~~. Such public dissemination shall include re-publishing on the ~~, including through a~~ World Wide Web site of the Federal Housing Finance Agency~~; and~~.

(2) ~~establish an electronic mail address and a toll-free telephone number, and shall publicize the availability of such address and number, by which the public may report waste, fraud, or abuse by an enterprise~~The Inspector General shall publicly disseminate its findings and recommendations concerning the Federal Housing Finance Agency's periodic reports, including re-publishing on the World Wide Web site of the Federal Housing Finance Agency.

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(e) DEFINITIONS.—For purposes of this section, the following definitions shall apply:

(1) CONSERVATORSHIP PERIOD.—The term "conservatorship period" means, with respect to an enterprise, the period that—

(A) began upon appointment of the Federal Housing Finance Agency as conservator for the enterprise on September 6, 2008, pursuant to section 1367 of the Housing and Community Development Act of 1992 (12 U.S.C. 4617); and

(B) ends upon the termination of such conservatorship of the enterprise.

(2) Federal Housing Finance Agency.----The term "Federal Housing Finance Agency" means the Agency created pursuant to section 1311 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4511).

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(~~2~~3) INSPECTOR GENERAL.—The term "Inspector General" means the Inspector General of the Federal Housing Finance Agency, appointed pursuant to section 1317(d) of the ~~Housing and Community Development Act of~~Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4517).

(~~3~~4) ENTERPRISE.—The term "enterprise" means the Federal National Mortgage Association ~~and~~ or the Federal Home Loan Mortgage Corporation.

(~~4~~5) REPORTING PERIOD.—The term "reporting period" means a period described in paragraph (1), (2), (3), or (4) of subsection (c).

SEC. 3. AMENDMENTS TO CERTAIN PROVISIONS OF THE FEDERAL HOUSING ENTERPRISES FINANCIAL SAFETY AND SOUNDNESS ACT OF 1992 ESTABLISHING AN INSPECTOR GENERAL.

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Section 1317 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4517) is amended by striking subsection (d) and inserting the following new subsection:

"(d) INSPECTOR GENERAL.—

"(1) APPOINTMENT.—There shall be within the Agency an Inspector General, who shall be appointed in accordance with section 3(a) of the Inspector General Act of 1978.

"(2) ACCESS.—Inspector General of the Agency shall have access to all records, reports, audits, reviews, documents, papers, recommendations, other materials, including all drafts and electronic materials, and employees of the Agency and the regulated entities, as the Inspector General deems necessary to carry out this Act and the Inspector General Act of 1978, as amended.

"(3) DIRECT HIRE AUTHORITY.—

"(A) APPOINTMENT AUTHORITY.—Subject to subparagraph (B), the Inspector General of the Agency may appoint candidates to any position in Office of the Inspector General of the Agency—

"(i) in accordance with the statutes, rules, and regulations governing appointments in the excepted service; and

"(ii) notwithstanding any statutes, rules, and regulations governing appointments in the competitive service.

"(B) APPLICABILITY.—Subparagraph (A) shall apply with respect to any position within the Office of the Inspector General of the Agency, and the authority under such subparagraph shall be effective only during the 12-month period beginning upon the enactment of this Act.

"(4) ANNUITY OFFSET WAIVER AUTHORITY.—

"(A) WAIVER AUTHORITY.— Subject to subparagraph (B) and notwithstanding section 8468 of title 5, United States Code, or any other statute, rule, or regulation prescribing the termination of retirement annuities or the offset of such annuities for annuitants who are re-employed by the Federal Government, if an annuitant receiving an annuity from the Civil Service Retirement and Disability Fund becomes employed in a position within the Office of the Inspector General of the Agency, the annuity of such annuitant shall continue without termination or offset. An annuitant so reemployed shall not be considered an employee for purposes of chapter 83 or 84 of title 5, United States Code.

"(B) APPLICABILITY.—Subparagraph (A) shall apply with respect to any position within the Office of the Inspector General of the Agency, and the Inspector General's authority to grant waivers to new re-employed annuitants under such subparagraph shall be effective only during the 36-month period beginning upon the enactment of this Act.

"(5) LAW ENFORCEMENT AUTHORITY.—The Office of the Inspector General of the Agency shall be treated as an office included under section 6(e)(3) of the Inspector General Act of 1978 (5 U.S.C. App.), relating to the exemption from the initial determination of eligibility by the Attorney General.".

SEC. 4. AMENDMENTS TO CERTAIN PROVISIONS OF THE FEDERAL HOUSING ENTERPRISES FINANCIAL SAFETY AND SOUNDNESS ACT OF 1992 TO ENSURE INSPECTOR GENERAL INDEPENDENCE

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SECTION 1316 OF THE FEDERAL HOUSING ENTERPRISES FINANCIAL SAFETY AND SOUNDNESS ACT OF 1992 [12 U.S.C. § 4516] IS AMENDED:

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(1) by striking "and" after the semicolon at the end of subsection (a)(3);

(2) by replacing the period at the end of subsection (a)(4) with "; and"; and

(3) by adding the following new subsection (a)(5):

"the reasonable and necessary expenses of the Inspector General, as independently determined by the Inspector General."

Washington Post

Rush to foreclose by Fannie, Freddie helped feed problems with legal paperwork

By Zachary A. Goldfarb and Ariana Eunjung Cha
Washington Post Staff Writers
Thursday, December 23, 2010; 12:00 AM

As the housing market came crashing down in 2008, the giant mortgage company Fannie Mae took an unprecedented step to help tackle the rising tide of foreclosures. It named an exclusive group of law firms that would help rapidly carry out the unsavory task of filing legal paperwork to remove homeowners from their homes.

Today, problems with documents handled by firms on Fannie's list - and a similar one created by its smaller rival Freddie Mac - are at the heart of federal and state probes over faulty foreclosure practices that now threaten to further undermine the housing market.

Fannie and Freddie, the largest mortgage companies, shaped the practices being challenged in courtrooms around the country. They picked law firms that could foreclose fast and paid them based on how many foreclosures they could process. Speed was essential because delays cost the companies money - and, after they were taken over by the government two years ago, meant losses for taxpayers, too.

Not only did the companies urge swift foreclosures, but in at least one case Fannie executives also greenlighted working with a firm that they knew firsthand had engaged in legally questionable practices, according to documents and interviews with lawyers and industry officials.

That firm was the Law Offices of David J. Stern in Florida, which built a hundred-million-dollar-plus business foreclosing on the tens of thousands of borrowers who lost their homes in the housing crash.

In 2000, the Fannie executive responsible for overseeing outside law firms in Florida was questioned about Stern's firm in connection with a class-action lawsuit alleging it had charged borrowers bogus fees based on fraudulent paperwork.

In a deposition, Susan Reid, an associate general counsel who oversaw Stern's firm for Fannie until two months ago, was asked by a lawyer representing borrowers why her company hired law firms such as Stern's to handle foreclosures.

"We felt that timelines and the time it took to foreclose on a piece of property . . . could be improved," she responded. She explained that with "every month" that passed, "we're losing money."

Did Fannie, she was then asked, have any safeguards to ensure that law firms, rushing to foreclosure, followed the law? "I don't know of any policies and procedures," she answered.

To the contrary: Fannie and Freddie over the years have prodded law firms and mortgage servicers that collect payments to move even faster.

When law firms or servicers have taken too long to foreclose, Fannie and Freddie have threatened to charge them a penalty fee, according to industry sources and documents. And every few months, the two mortgage companies have sent servicers report cards ranking them on how rapidly they completed foreclosures compared with their peers.

A giant footprint

Fannie and Freddie occupy a unique place in the mortgage world. They are the biggest buyers of pools of home loans, accounting for trillions of dollars of mortgages. These purchases provide an essential source of funding to lenders to make more loans.

Since September 2008, Fannie, based in the District, and Freddie, based in McLean, have also been government-run, seized by federal officials as the financial crisis threatened to topple them. They have cost taxpayers more than $130 billion.

As wards of the state, they have competing imperatives. One is to help borrowers - and the housing market - by modifying the terms of home loans to make them more affordable. The aim is to reduce foreclosures. Another is to protect taxpayer dollars by ensuring that foreclosures don't drag on, causing additional losses.

Both before the government takeover and after, Fannie and Freddie have pressured the outside mortgage servicers they use to work with specific law firms. Although Fannie required servicers to use specific firms, Freddie urged them to do so but didn't demand it.

Florida Attorney General Bill McCollum is examining the relationship between law firms and Fannie and Freddie as part of a broad probe into possible illegalities in the foreclosure process. Other law firms on Fannie's list - in Maryland, New York, Pennsylvania and Texas - have been criticized by judges for their handling of foreclosures, investigated by federal and state authorities for potential wrongdoing or sued by borrowers for mistreating them.

"Given that just a handful of law firms are handling foreclosures for over half the nation's mortgages, it's no wonder this paperwork problem has spread so widely," said Rep. Judy Biggert (R-Ill.), who raised questions about Fannie and Freddie's lawyers a year before the concerns over foreclosure practices broke into public view. "Many Americans may be losing their homes because of a system that was set up to send foreclosures through law firms that were the quickest cheapest and least reliable."

Only in recent months did Fannie and Freddie sever ties with Stern, after reports of abusive foreclosure practices started to surface nationally. The two companies stopped referring new business to the firm in October and started removing cases from it last month.

Stern's attorney, Jeffrey Tew, declined to comment for this article. Stern and his lawyers have said previously that the firm has done nothing improper.

Spokesmen for Fannie and Freddie said the companies have worked to ensure that servicers and law firms have enough time to conduct the foreclosure process properly. The spokesmen say protracted foreclosures not only cost taxpayers but also lead to vacant homes, which degrade the housing stock and nearby home values, and prolong the real estate crisis. They say they tell their law firms and servicers to focus on modifying mortgages for troubled borrowers when possible and to foreclose in a timely fashion when it's not.

"At all times, Fannie Mae has had a reasonable expectation that our servicers and the law firms adhere to proper procedures and conduct under the law," said Amy Bonitatibus, a Fannie Mae spokeswoman. "When allegations regarding the Stern firm came to our attention, we promptly investigated and took appropriate responsive action."

Prompted by the surge of foreclosures in Florida, Fannie Mae hired a consultant this year to audit Florida law firms. These examinations did not discover evidence of abuses in the foreclosure process.

Sharon McHale, a Freddie Mac spokeswoman, said there is no rush to foreclose when homeowners default on its loans, noting that borrowers must be delinquent for at least 300 days before a foreclosure sale can take place.

"We incent our servicers to find ways to help borrowers avoid foreclosure and give them ample time to do so," she said. "Servicers have the authority to stop the process anytime there is a viable alternative to foreclosure."

Early warning signs

But Fannie's relationship with Stern, in particular, highlights the mortgage giant's complicated role in the foreclosure crisis.

Florida homeowners first raised a red flag about Stern in their 1998 class-action lawsuit.

Claude Walker, a lawyer who represented them, said Fannie ignored their complaints. "They wanted to get these foreclosures through the process as fast as possible. That was their goal."

Fannie officials held an internal discussion in 1999 about the issues posed by the lawsuit, Reid said in the deposition. As Fannie's in-house lawyer, Reid said she was primarily concerned with whether Fannie might also be sued. She said neither she nor anyone else at Fannie investigated the allegations made in the lawsuit.

Reid declined to comment on the deposition for this article.

Still impressed with Stern, Fannie named Stern its "lawyer of the year" in 1998 and 1999, according to the law firm's filings with the Securities and Exchange Commission. A Fannie spokeswoman said she had no details but did not dispute the account.

In 2000, Stern paid $2.2 million to settle the class-action lawsuit. He was also reprimanded by the Florida Bar in 2002 for his firm's questionable conduct.

For a time, according to one industry source, Fannie distanced itself from Stern, concerned about whether it would face legal liabilities. But Stern continued to work to nurture his relationship with Fannie, Freddie and the servicers who managed loans for the companies.

And when the mortgage crisis struck, Stern was well placed to get a spot on Fannie Mae's coveted list of lawyers that servicers must use to foreclose.

Stern's foreclosure caseloads jumped from nearly 15,000 in 2006 to 70,400 last year. Total firm revenue, which included foreclosures and related work, swelled from $41 million to $260 million annually by the end of last year, according to a filing made in connection with an effort to raise money from investors.

Stern focused on tending to the needs of Fannie and Freddie, depositions with Stern's former employees show.

"Freddie Mac and Fannie Mae were number one for his firm," Kelly Scott, a former Stern employee, said in a deposition with the Florida attorney general. "David Stern had a very close relationship with Freddie Mac and Fannie Mae."

Seven or eight times in 2008, Fannie and Freddie employees came to Stern's firm to review the files. Stern arranged for their hotels, catered lunches and chauffeuring, and picked up some of those expenses, according to Scott.

Fannie and Freddie had a singular message for Stern's firm, Scott said: "Pick up the speed." She said Stern told his employees working on Fannie and Freddie cases "they need to pump out as much as they can for the month so they can meet the quota." She said that she didn't know what the quota was but that it was clear that Fannie and Freddie "weren't happy" with the progress.

Fannie and Freddie officials said in interviews that they did not pressure Stern to rush foreclosures and in fact imposed a general freeze on foreclosures in late 2008 through early 2009. The officials also said employees covered their own expenses when visiting Stern's firm and went there every few months, at most.

Still, though, through this year Fannie continued pressing firms to foreclose. In a memo dated Aug. 31, Fannie Mae warned mortgage servicers that fees may be imposed based on "the length of the delay and any costs that are directly attributable to the delay."

But Freddie was having second thoughts. It was hearing from one of its loan servicers, Ally Financial, that there were problems in the paperwork Stern's firm was using to foreclose on loans

Freddie owned. So Freddie urged Ally Financial and other servicers to suspend all foreclosures being handled by Stern.

On Sept. 20, Ally Financial suspended foreclosures in about half the states, with Stern's firm and others. Other major mortgage companies soon followed suit.

A few days later, Rep. Alan Grayson (D-Fla.) wrote to Fannie, asking, "Why is Fannie Mae using lawyers that are accused of regularly engaging in fraud to kick people out of their homes?"

About two weeks after that, Fannie stopped sending new cases to Stern.

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http://www.washingtonpost.com/wp-dyn/content/article/2010/12/22/AR2010122205828_pf.html

HOUSING POLICY COUNCIL
THE FINANCIAL SERVICES ROUNDTABLE

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April 5, 2011

The Honorable Steve Stivers
1007 Longworth House Office Building
Washington, D.C. 20515

Dear Congressman Stivers:

I am writing to provide some additional information in response to the questions you posed at the Capital Markets and Government Sponsored Enterprises Subcommittee hearing titled *"Legislative Hearing on Immediate Steps to Protect Taxpayers from the Ongoing Bailout of Fannie Mae and Freddie Mac"* held on March 31, 2011.

Role of the Federal Home Loan Banks

You asked my view of the Federal Home Loan Bank (FHLB) system in a reformed secondary mortgage market system. The Housing Policy Council strongly supports the FHLB system. Many of our member companies are members of the FHLB system, and we believe the system continues to serve both large and small institutions well. We think the system operated well during the recent housing crisis, and we do not believe the FHLB system needs major reform. The Housing Policy Council's GSE reform proposal focuses on addressing the problems in the structure and operations of Fannie Mae and Freddie Mac and gradually replacing those government sponsored enterprises with a secondary mortgage market structure that is based on private capital and protects the American taxpayer. An explanation of our plan is part of our written testimony submitted for the March 31 hearing. Another copy of my testimony is attached for your reference.

Future of the 30 Year Fixed Rate Mortgage

You also asked if "the 30 year fixed rate mortgage should be mandated." That is not our view. Consumers should have the choice to select the type of mortgage they want based on their individual financial goals and income qualifications. Our recommendation is that reform of the secondary mortgage system be done in a manner that keeps the 30 year fixed rate mortgage available and affordable to potential homeowners. The Housing Policy Council's GSE reform proposal is based on the goal of keeping the 30 year fixed rate mortgage widely available. We discuss this in more detail in our written testimony.

The key message of my testimony was that the individual bills the Committee is considering to limit and reform the operations of the current GSEs -- Fannie Mae and Freddie Mac -- should be coupled with action on a comprehensive housing finance reform plan, such as the one the Housing Policy Council has proposed. We look forward to working with you on these issues to achieve a strong and sustainable secondary mortgage market that serves prospective homebuyers and protects the American taxpayer.

Sincerely,

John H. Dalton

John H. Dalton

HPC

HOUSING
POLICY
COUNCIL

Testimony of

The Honorable John H. Dalton

President of the Housing Policy Council

on behalf of the Housing Policy Council

of the Financial Services Roundtable

Before the House Financial Services Committee

Subcommittee on Capital Markets and Government Sponsored Enterprises

"Legislative Proposals to Reform the Government Sponsored Enterprises (GSEs)"

March 31, 2011

Mr. Chairman and Members of the Committee thank you for holding this important hearing and thank you for the invitation to participate.

My name is John Dalton, and I am the President of the Housing Policy Council of The Financial Services Roundtable. The Housing Policy Council is thirty-two of the leading national mortgage finance companies. HPC members originate, service, and insure mortgages, and do business every day with Fannie Mae and Freddie Mac.

Mr. Chairman, we believe that reform of the secondary mortgage market is a critical priority and it should be based on creating a new structure based on private capital. This new system must have two primary goals: serving homebuyers and protecting taxpayers.

Homeownership is a pillar of the US economy and the American way of life. The new private sector system, built on private capital and clear rules, should help deliver sound financing that will keep homeownership within the reach of most Americans. Without an approach like this, owning a home in America could become a luxury for the few.

One important way to avoid this from happening is to ensure continued availability of the 30-year fixed rate mortgage, which has been the bedrock of our nation's housing system for more than a half century. Let me explain why.

The 30-year fixed rate mortgage has made homeownership sustainable for millions of American households. A fixed rate mortgage continues to be the overwhelming choice for American consumers. Today, approximately 90 of new loans are fixed rate mortgages. In the fourth quarter of 2010, 95% of refinances were for fixed rate loans. The 30-year fixed rate mortgage delivers affordability, certainty and stability for homebuyers that might not otherwise exist, which is why it is the most popular form of home financing in our country.

Predictability is one of the greatest benefits of the 30 year fixed rate mortgage, and very important for Americans on a budget. A fixed rate mortgage provides incredible peace of mind, because homeowners know that their biggest monthly bill, their mortgage, is not going to change from month to month and year to year. Without this popular finance tool, many homeowners would experience in their mortgages the same wild swings they now feel at the gas pump. That's a rollercoaster ride most Americans would prefer to avoid.

In addition to serving homebuyers, we strongly agree that a new private sector-based system must protect American taxpayers. Members of the House Financial Services Committee have introduced several bills that identify a number of issues that must be addressed as part of a careful transition to a new, stronger housing finance system. In my testimony, I will discuss the Housing Policy Council's proposal to reform the secondary market system and also comment on some of the legislation that has just been introduced to begin the reform of the existing GSES.

Guarantee Fees and Portfolio Limits

The legislation just introduced addresses the important issues of guarantee fees and portfolio limits. We support steps to continue the gradual reduction in the size of the portfolios maintained by Fannie Mae and Freddie Mac, and a gradual increase in the amount of the guarantee fees (G-Fees) charged by the GSEs. Guarantee fees and portfolio limits are issues that should continue to be addressed with the current GSEs and as part of the larger reform effort.

The guarantee fees charged by the GSEs should be at a level that reflects the risk they are taking and that also allows private competition to develop. In hindsight, it is clear that guarantee fees charged by Fannie Mae and Freddie Mac were insufficient to cover the risks of the mortgages they acquired. In early 2008, the GSEs began to impose additional fees, but in earlier years, the GSEs' guarantee fees and their capital levels were inadequate to support the risks they were taking. Given this experience, HPC supports the gradual implementation of guarantee fees that are more properly aligned with the credit risk assumed by the GSEs. Today, the GSEs' G-Fees have become more accurately priced and additional increases in the G-Fees should be phased-in over a period of time to avoid any undue disruption to the housing recovery.

In the past, the size of the GSEs' portfolios grew far beyond what was necessary to facilitate the securitization of mortgage loans. The portfolios are now being reduced and that process should continue. Additional reductions in the portfolios should be managed in a manner that the market can absorb. Some limited portfolios are needed to facilitate the securitization of mortgages, to warehouse whole loans from community banks, to make a market in less liquid loans, such as multifamily housing loans. The regulator should have the authority and flexibility to manage the gradual reduction of the portfolios in a manner that does not negatively affect the current fragile housing market.

Under a reformed secondary mortgage market system, new private companies performing the credit guarantee role of the GSEs should not have large portfolios, but only those needed for the purposes explained above to facilitate the smooth functioning of mortgage securitizations.

Elimination of Numerical Affordable Housing Goals

HPC supports the elimination of specific housing goals for the GSEs. While the affordable housing goals were not a major factor in the failure of the GSEs, these goals did detract from their primary mission. The GSEs should have a single purpose – ensuring a steady flow of reasonably priced conventional mortgages. Affordable housing is best supported directly by other federal programs, such as FHA. In a reformed system, we could support a contribution from the GSEs or their successors to affordable housing programs managed by HUD and/or state housing finance agencies. Such a transfer payment would help to address affordable housing needs, but would not require the GSEs, or their successors, to direct attention away from their main mission.

Reforms to Current GSEs and Transition to New System

Mr. Chairman, the series of bills just introduced identify and seek to address valid problems with the current GSE system. These bills are a start to the reform effort, but should not be the end of the legislative process on GSE reform. They should be part of more comprehensive reform legislation that provides for the transition from Fannie Mae and Freddie Mac to the simultaneous creation of a new, privately-based secondary market system for conventional mortgages. The Housing Policy Council has made a proposal to reform the secondary mortgage market and to transition from Fannie Mae and Freddie Mac.

Housing Policy Council GSE Reform Proposal

HPC's proposal addresses the problems inherent in the structure of Fannie Mae and Freddie Mac and is intended to achieve several objectives:

- Encourage private sector capital to support the secondary mortgage market;
- Ensure a steady flow of reasonably priced conventional mortgages to borrowers;
- Limit the role of the Federal Government and the risks taken by the taxpayer in the secondary mortgage market;
- Provide strong oversight and regulation of new system; and
- Provide a flow of funding to support affordable owner-occupied and rental housing.

We propose to achieve these objectives by dividing the existing functions of Fannie Mae and Freddie Mac with private companies and capital assuming the primary roles and risk.

Privately Capitalized "MSICs" Should Assume Credit Enhancement Function of the GSEs

A central feature of the HPC proposal is the creation of new privately capitalized firms to perform the credit enhancement or guarantee function of the GSEs. Currently, the GSEs purchase mortgages from mortgage originators, package those mortgages into securities, and guarantee the payment of interest and principal on those securities. In exchange for the guarantee, the GSEs charge mortgage originators a "guarantee fee." We propose that these functions be assumed by privately capitalized firms called Mortgage Securities Insurance Companies, or "MSICs."

A MSIC would --

- purchase conventional mortgages from mortgage originators;
- guarantee the payment of principal and interest on the securities; and
- Charge mortgage originators a fee for the guarantee.

Under our proposal, these privately capitalized entities would be chartered and supervised by a strong federal regulator, much like national banks and federal savings and loans are chartered and supervised by the Federal Government. However, these companies would NOT be backed by the Federal Government, either explicitly or implicitly.

We do not propose a particular organizational structure for the MSICs. Instead, we propose that the investors in a MSIC determine the most appropriate organizational and governance structure for the entity. The validity of the organizational structure and the ability of the investors to manage the entity would be reviewed as part of the chartering process.

We believe multiple MSICs are needed but do not call for a specific limit on the number. We assume that at least 4 will be needed to serve the market, but probably not more than 8 are necessary. The greater the number of MSICs, the better insulated the housing finance market would be from the failure of any one MSIC. On the other hand, too many MSICs -- with different underwriting systems and procedures -- could be overly burdensome to lenders, particularly smaller lenders.

An Explicit – But Limited -- Federal Guarantee is needed

An explicit federal guarantee is needed to ensure a steady flow of mortgage finance at a reasonable cost to borrowers. While MSICs would not be backed by the Federal Government, our proposal does call for the Federal Government to provide an "explicit" backup or catastrophic guarantee on the mortgage securities (MBS) that are issued by MSICs. To be clear, <u>this guarantee would not apply to the MSICs themselves</u>; it would guarantee the payment of principal and interest to investors in mortgage backed securities packaged by MSICs. A MSIC would pay a fee to the government for this guarantee, and this fee would be placed in a reserve.

The challenge we face is designing a secondary market system that ensures a steady flow of reasonably priced mortgages to borrowers while protecting the taxpayers from undue risk. Our proposal addresses this challenge by putting several layers of private capital in front of the limited federal guarantee, and as I discuss below, subjecting MSICs to "world class" regulation.

Standing before the federal guarantee would be --

- The down payment on a mortgage made by the homebuyer;
- Private mortgage insurance or other credit enhancement on the mortgage loan;
- The shareholders' equity in the MSIC; and
- The reserve established by fees paid by MSICs in return for the government's guarantee.

These layers of private capital should insulate the taxpayers from paying claims on the guarantee. However, in the event of a catastrophe that exhausts all of these private resources and the Federal Government is called upon to make payments under the guarantee, we support the imposition of a "special assessment" on MSICs to recoup any costs incurred by the government. Thus, the system we propose would operate much like the Federal Deposit Insurance Fund does today.

Finally, if the fees for the federal guarantee are set properly, the federal guarantee would be budget neutral. Under existing federal credit procedures, the cost of federal credit activity in a budget year is the net present value of all expected future cash flows from guarantees and direct loans disbursed in that year. For loan guarantees, cash inflows consist primarily of fees charged to insured borrowers, and cash outlays consist mostly of payments to lenders to cover the cost of loan defaults. FHA and Ginnie Mae are models for this budgetary treatment. In the case of both FHA and Ginnie Mae, the fees paid for the federal guarantee normally cover claims on the guarantees and other operational expenses.

Capitalizing New Private Companies (MSICs)

Attracting sufficient private capital to MSICs is a key to the success of our proposal. Based on our initial research and discussions with capital markets participants, we believe that a range of private investors would be willing to invest in these new companies. The capital levels for these new companies would be set by their federal regulator and would be significantly higher than those of the current GSEs. This model could produce a reasonable return to investors and provide the capital needed to cover losses in a severe housing down-turn.

World Class Regulator

To ensure the safe and sound operation of MSICs – and further reduce the need for the Federal Government ever to perform on its guarantee – we propose that MSICs be subject to "world class" regulation, by a strong and independent federal regulatory agency. This regulatory regime should include:

- Strong prudential standards – MSICs' should be subject to capital, liquidity and other prudential standards set by the chartering agency;
- Underwriting Standards for Mortgages in MBS – MSICs should be prohibited from purchasing mortgages that do not meet underwriting standards set by the chartering agency. These standards should provide that mortgages purchased by in a MSIC are prudentially underwritten.
- Loan Limits – The federal chartering agency should set, by regulation, limits on the size of mortgages that could be included in mortgage backed securities insured by a MSIC.
- Portfolios -- MSICs should not be permitted to establish and hold portfolios purely for investment purposes. Small portfolios should be permitted to facilitate the development of new products and certain types of loans for which there are limited markets such as multifamily mortgages. MSICs also could use this portfolio capacity to warehouse loans before securitization, to purchase whole loans from smaller banks and for loss mitigation and REO disposition purposes.

Central Securitization Facility and a Single MBS

Our proposal also calls for the creation of a single Mortgage Backed Security (MBS) Securitization Facility to provide administrative services related to MBS packaged by MSICs. The Facility would process payments on those MBS from the lenders/servicers to the investors. It also would place and administer the federal catastrophic guarantee on the MBS. In other words, this Facility would perform functions similar to those performed by Ginnie Mae for FHA. We recommend that the Facility be part of the Federal Government, and that Ginnie Mae be tapped to perform the services of the Facility, either directly or on a contract basis.

The creation of this Facility also would facilitate the creation of a single MBS. Today, there are some differences in the terms and repayment characteristics of the MBS marketed by the two GSEs. These differences can, from time to time, result in differences in market liquidity. We propose that all MSICs be required to adhere to a standard form of MBS that has the same repayment terms and other conditions. A single MBS would promote better understanding of the MBS by investors, and it would enhance the liquidity of the market. This would help ensure home buyers have consistent access to reasonably priced home financing.

A single MBS does not mean that all MBS would be composed of the same type of mortgages, only that the basic legal structure, terms and conditions governing repayment and other administrative features of the MBS would be the same. MBS backed by MSICs could be composed of loans from a single lender or multiple lenders allowing lending institutions of all sizes access to this liquidity.

Like existing GSE securities, these MBS should be exempt from SEC registration requirements. Such an exemption is necessary to maintain the "To Be Announced" (TBA) market. The TBA market is used by the lending industry to reduce risks in the origination process and reduce borrowing costs for consumers. The TBA market allows borrowers to lock in rates in advance of closing a mortgage loan and permits lenders to hedge the corresponding interest rate risk. The TBA market is based upon a trade of a MBS on a future date, and at the time of the trade the MBS to be included in the trade may not be identified. Therefore, it is impractical to apply standard SEC registration and disclosure requirements. To overcome this practical problem, the GSEs currently disclose information to investors about the composition of each pool of mortgages backing a security, including the average loan-to-value ratio, the average debt-to-income ratio, the average borrower credit score, the number and value of mortgages from each state, the distribution of mortgage coupon rates and whether the mortgages were originated in broker or non-broker channels. MBS issued by MSICs should be subject to a similar disclosure requirement.

Affordable Housing

Finally, we propose that MSICs contribute to supporting owner-occupied and rental housing for extremely-low and very-low income families. This requirement was placed on the GSEs in the Housing and Economic Recovery Act of 2008. That Act directed the GSEs to annually set aside approximately 4 basis points of the total dollar amount of new mortgages that they acquire and transfer 65 percent of such amount to the Housing Trust Fund and 35 percent of such amount to the Capital Magnet Fund.

The Housing Trust Fund, which is to be administered by HUD, would provide grants to the States primarily for the production, preservation and rehabilitation of rental housing for extremely low-income and very low-income families. The Capital Magnet Fund, which is to be administered by the Treasury Department, is designed to leverage private sector capital for the development of housing for extremely low-income families, very low-income families, and low-income families. It also is designed to promote economic and community development projects to help such families. We support this transfer payment in lieu of the application of specific housing goals on MSICs. MSICs should not be subject to specific housing goals.

Transition

While in conservatorship, both Fannie Mae and Freddie Mac have performed their three primary responsibilities well: continuing to promote liquidity for housing finance, finding solutions to help keep borrowers in their homes and conserving the assets of the two enterprises. Without the continued operation of Fannie Mae and Freddie Mac during the crisis, the flow of housing finance would have been severely disrupted. The GSEs will need to operate until a well defined and careful transition is formulated and put into place.

Key transition issues that must be considered include:

- The transition must ensure borrowers have uninterrupted access to reasonably priced housing finance along with other benefits they enjoy today (for example, access to 30 year fixed rate mortgages and the ability to lock a rate while loans are in process).
- The transition must ensure the continued liquidity of today's agency MBS market and the 'to be announced' (TBA) MBS market in particular which allows lenders to better insulate consumers from the uncertainty of markets and to hedge their risks (thereby reducing borrowing costs).
- The transition must seek the right balance between sufficient capitalization of future credit risk guarantors and how different capitalization requirements impact the costs of home ownership for consumers.
- The transition should also seek to achieve an explicit government guarantee of the MBS with as little actual government risk as possible (achieved by placing sufficient private capital in front of the government).
- The transition must find a fair and equitable way to deal with the legacy assets and liabilities of Fannie Mae and Freddie.
- The transition should seek to utilize the valuable infrastructure of Fannie Mae and Freddie Mac.
- The transition must ensure low and extremely low income borrowers have access to housing while avoiding lending requirements and/or targets for private lenders/guarantors.
- The transition should be allowed sufficient time for proposed changes to be clearly communicated. Where possible, gradual steps should be used and 'tested' before proceeding to broader implementation. Given the size, importance, and complexity of the housing finance system, expectations should be for this transition to potentially take multiple years to be realized.

A Note on Other Proposals

A number of other secondary market reform proposals share key features of the plan proposed by HPC and while some call for more or less government involvement, all agree that promotion of liquidity for housing finance is the objective. Several recommendations also call for an explicit guarantee of MBS (not the corporate entities) and for stronger capitalization and regulation. We believe that those recommendations that call for complete nationalization miss the benefits to consumers of innovation and efficiency that private capital will allow and expose the taxpayer to more risk than is necessary to optimize MBS liquidity. Recommendations to completely privatize miss the necessity of some government guarantee to ensure consistent functioning of MBS markets under all economic conditions.

Mr. Chairman, we appreciate your leadership and those on this committee who must tackle this important issue, and we realize it is complicated and complex. We support your efforts to reform the system and move away from a GSE-model, but we believe it is important for the economic recovery, financial markets and for the housing sector to proceed carefully and create a roadmap to a new, privately-based system. There is still much uncertainty in the housing market at this time. This uncertainty makes it especially important to couple limits on changes to the existing GSEs with a plan for a new system.

We stand ready to work with you, the committee and other stakeholders on this issue, and look forward to your questions.

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