Testimony of Joshua Rosner

Subcommittee on Capital markets and Government Sponsored Enterprises: Fannie Mae and Freddie Mac: How Government Housing Policy Failed Homeowners and Taxpayers and Led to the Financial Crisis:

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Room 2128 Rayburn House Office Building

Thank you Chairman Garrett, Ranking Member Maloney and members of the subcommittee for inviting me to testify on this important subject.

In July 2001 I authored a paper titled *"Housing in the New Millennium: A Home Without Equity is Just a Rental with Debt".*[1] That paper, written in the aftermath of the "dot com" crash, sought to answer questions about the relationship between the broader economy and the housing market and whether housing would be hurt by a faltering economy.

The executive summary of the paper noted *"there are elements in place for the housing sector to continue to experience growth well above GDP. However, we believe there are risks that can materially distort the growth prospects of the sector". Specifically, I warned, "it appears that a large portion of the housing sector's growth in the 1990's came from the easing of the credit underwriting process"* and that easing included:

• "The drastic reduction of minimum down payment levels from 20% to 0%";

• "A focused effort to target the "low income" borrower";

• "The reduction in private mortgage insurance requirements on high loan to value mortgages";

• "The increasing use of software to streamline the origination process and modify/recast delinquent loans in order to keep them classified as 'current'"; and

• "Changes in the appraisal process that have led to widespread over-appraisal/over-valuation problems."

I concluded: *"If these trends remain in place, it is likely that the home purchase boom of the past decade will continue unabated. Despite the increasingly more difficult economic environment, it may be possible for lenders to further ease credit standards and more fully exploit less penetrated markets. Recently targeted populations that have historically been denied homeownership opportunities have offered the mortgage industry novel hurdles to overcome. …**The virtuous circle of increasing homeownership due to greater leverage has the potential to become a vicious cycle of lower home prices due to an accelerating rate of foreclosures**."*

As you will see in my testimony, the GSEs, which were originally government agencies intended to provide liquidity to the secondary mortgage market, were repurposed by the Clinton administration to direct social policy through the housing and mortgage markets. The combination of using the GSEs as "tools"[2] of social policy and falling interest rates built the foundation of the housing bubble by supporting acceptance of low- and no-down payment loans, lower FICO scores, higher debt-to-income and loan-to-value ratios. These "benefits" are exemplified by the 1999 comments of Fannie Mae's Chairman that "a record of prompt utility bill and rent payments can be substituted for the traditional credit report to verify a potential borrower's willingness to pay a mortgage loan".[3]

In early 1993, the Clinton administration realized that, among the "available Federal resources", "capital investments for housing and community development" could be driven "through Fannie Mae, Freddie Mac, FHA, and HUD/USDA programs"[4] and HUD has established performance goals for Fannie Mae and Freddie Mac.

As Susan Wachter noted in 2003:

> ***"The goal of the federal chartering of Fannie Mae and Freddie Mac…is to achieve public policy objectives including the promotion of nationwide homeownership through the purchase and securitization of mortgages.*** *The Federal government provides a number of economic privileges to the GSEs, most important of which is the implied Federal government guarantee which decreases the enterprises' funding costs…*
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> *Fannie Mae and Freddie Mac have contributed to the expansion of homeownership in America, providing affordable residential mortgages for low- and moderate-income households who otherwise might not have the opportunity to become homeowners…GSEs have accomplished this in part through their special affordable lending programs but also importantly through lower mortgage and down payment rates that would not prevail but for the presence of the GSEs."*

In 1994, the Administration set about to "raise the ownership rate by 0.5% - 1.0% per year for the seven years, from 65% to 70% by the year 2000" and recognized this "can be done almost entirely off-budget-through creative leadership and partnerships with HUD, FHA, Fannie Mae, Freddie Mac, FHLBS, CDFls, the private mortgage and insurance companies, and the banks and thrifts".[5]

The Administration created a "National Homeownership Strategy"[6] which included the goal of using the GSEs to "provide low- and no-downpayment loans to eligible low- and moderate-income purchasers"[7] even to borrowers "the private mortgage market has deemed to be un-credit-worthy" [8].

In a 1998 memorandum, then Secretary of the Treasury Robert Rubin recognized many of the risks associated with increasing lending to the most 'at risk' borrowers noted:

- Lowering the down payment requirement is likely to reduce saving among low-income people who would like to be home owners;
- We may not want to encourage poor people especially those who cannot save, to purchase their homes. In an economic downturn, these home owners may be more vulnerable and more likely to lose their homes; and
- It is not clear that home ownership causes the effects attributed to homeowners.

Still, the Clinton Administration's plans continued.[9]

Reversing major trends, homeownership began to rise in 1995 and continued to rise through the late 1990's. Existing home sales grew from 27.5 million units in the 1970's to 29.8 million units in the 1980's and ended the 1990's at 40 million units. New home sales grew from 6.5 million units in the 1970's to 6.1 million units in the 1980's and ended the 1990's at 7.0 million. By 2000, US homeownership exceeded 67%.

"In 1989 only 7 percent of home mortgages were made with less than 10 percent down payment. By August 1994, low down payment mortgage loans had increased to 29 percent". This trend continued unabated throughout the 1990's and by 1999, over 50 % of mortgages had down payments of less than 10%. In 1976 the average down payment by first time homebuyers was 18% and by 1999 that down payment had fallen to 12.6%. In 1999, more than 5% of all residential mortgages had no equity or had negative home-equity. Eliminating down payment barriers has created a homeownership option for Americans who previously were forced to rent, due to savings or credit issues.[10] While the GSEs were certainly a key driver of these results other government actions,[11] fraud,[12] and the impact of falling interest rates also fueled the expansion.

By increasing investor confidence with low and no downpayment mortgage products, the GSEs seasoned the market. But they were surely not the only culprits. *In 2001, after much lobbying from the banking industry and rating agencies, the Basel Committee determined that AAA and AA rated private label securities should carry the same risk weightings as correspondingly rated GSE products.[13] This action, as much as any other, opened the floodgates to the reckless private label securitization of the most toxic mortgage products.*

Banks that had only a few years before sought to reduce their exposures to consumer lending used their branch network to originate loans to distribute through securitization markets. Investment banks, which had no branch networks, began to expand their provisioning of warehouse lines of credit to third party mortgage originators.

By 2002 the private label securitization (PLS) market was now at ease with changes made in 2000 by the GSEs "which expanded their purchases to include "Alt-A," A-minus, and subprime mortgages, in addition to private-label mortgage securities".[14] Private issuers began to aggressively target borrowers with lower down payments,

lower FICO scores, lower documentation, higher debt-to-income and higher loan-to-value ratios. PLS activity exploded. Conforming securitization rates increased from 60 percent in 2000 to 82 percent in 2005 and non-conforming securitization rates from 35 to 60 percent over that same period.

As the PLS market took off the investment banks and their third-party mortgage origination partners created more and more risky products, including many negative amortization products – with support of the credit rating agencies,[15] their absurd analysis[16] and the CDO market.[17] With strong investor demand for these relatively higher yielding debt securities the PLS issuers began to take significant market share from the GSEs.

As the "law of large number" made it increasingly difficult to find new homebuyers the entire industry sought to employ these riskier, negative amortization and hybrid products to take advantage of falling interest rates and refinance existing homebuyers, encourage cash-out refinancing and encourage the speculative frenzy for second homes and investment properties.

For the first few years, the GSEs avoided direct and aggressive competition with the looser standards of these lenders and instead, used their portfolios to become the largest purchasers of private label securities. By 2004, Freddie Mac decided to expand its direct exposure to Alt-A lending.

As I noted in a 2007 report, as early as 2004, 16% OF Fannie Mae's portfolio had FICO scores below 660 (S&P 12/06) and Fannie Mae's 2004 exposure to second homes and vacation properties was already about 8%. It also appears that prior to the Joint Guidance on non-traditional mortgages, one or both of the GSE were offering negative-amortization products that would not begin to fully amortize until after the reset period. ***As OFHEO noted in their April 2007 Annual Report to Congress, "higher-risk products such as interest-only, sub-prime, Alt-A and negative amortization loans are growing, but are currently about 20 percent of the book of business".*** *I also noted that "recently, 7 private mortgage insurers insured about 17% of the GSE's book (roughly $400BB) and it is unclear how the PMI industry's capital base (roughly $40BB) would have the ability to absorb the possibly sizeable impact to their first loss exposures to the GSE's book".*

In the fall of 2004 the Fed began to increase interest rates and with few new buyers and most mortgage market activity tied to refinancing, ownership peaked late that year. On November 16, 2005 I warned "we continue to expect consumer mortgage credit quality to show deterioration in the third quarter (largely from energy prices and Hurricane Katrina) and expect that it will continue to rise from there".

With many borrowers still seeking to lock in low but rising interest rates, refinancing and the 40%[18] of all sales that were investment or vacation homes continued to stoke the bubble. Informational asymmetry in PLS hid risks to investors and supported uneconomic activity.

By early 2006 it was clear that "dramatic shrinkage in the RMBS sector is likely to arise from decreased funding by the CDO markets as defaults accumulate. Of course, mortgage markets are socially and economically more important than manufactured housing, aircraft leases, franchise business loans, and 12-b1 mutual fund fees. Decreased funding for RMBS could set off a downward spiral in credit availability that can deprive individuals of home ownership and substantially hurt the U.S. economy".[19]

The GSEs: What Went Wrong:

There is nothing specifically wrong with the existence of entities whose purpose is to support liquidity in the secondary mortgage market. In fact, there is a substantial need for such a function to exist.

The problem was the use of quasi-private institutions as tools of social policy for the purpose of driving housing subsidies to the market through a perverse off-balance-sheet subsidy that was arbitraged by private market participants.

The GSEs were no longer merely supporting liquidity in the secondary market as they had been created to do. When their public mission was combined with the desire to provide outsized private returns to shareholders the increasing use of their portfolios and their purchase of almost 25% of private-label-securities, Fannie and Freddie fostered uneconomic and distortive excessive market liquidity.

Still, there is much to be lauded and recognized in the purpose and function of the GSEs as they existed prior to the 1990's. Some of those features are still in place and provide value both to the housing and mortgage market. Beside the GSEs' purpose as lender of last resort to banks seeking to fund conforming/conventional home mortgages, a purpose which while now distorted could be repaired, the GSEs offer standards still absent in the market, particularly as examples of standardized representations and warranties and pooling and servicing agreements.

While there are proposals to replace the GSEs with alternatives, many of those seem to transfer many of the subsidies the GSEs received to other private institutions.[20] Besides the other problems embedded in many of the proposals is the reality that such an approach does not seek, as a key purpose, the repayment of over $140 billion of funds owed to the U.S. Treasury. Moreover, merely replacing the GSEs will result in significant loss of value that exists in their proprietary data sets, millions of loans time series, patent processes, underwriting technology, connectivity on both the front end and the back end of the origination and servicing process, their securitization technologies or their existing capability for scale in securitization and investor relations.

Although it is understandable that the GSEs have become the subject of politically charged debate in Washington it is important to remember that, between the chartering of Fannie Mae (1938) and Freddie Mac (1970) and the 1990's, they served as valuable tools of financial intermediation. Repairing their failures is an achievable goal and would place them in their proper role as counter-cyclical buffers supporting the private mortgage market.

Any consideration of repair of the GSEs functions so that they could serve as Congress intended, in support of a functioning secondary mortgage market, should:

- Seek repayment of the almost $140 billion that the GSEs owe the U.S. Treasury[21];
- Sever the government's sponsorship to prevent the provisioning of an implied government guarantee or the inherent conflicts between the agencies' public, political and private purposes;
- Prevent the deterioration of underwriting standards through both private market mechanisms (greater data disclosure, accurately represented and warrantied mortgages with clear, standardized and enforceable putback remedies) and by better regulation
- Move pricing and credit risk bearing functions fully into the private sector with proper supervision;
- Limit the GSEs activities exclusively to prime borrowers to ensure that banks are able to use the GSEs, as originally intended, as liquidity tools for the funding of new mortgages rather than as risk transfer mechanisms.
  - Non-prime business should be left to either:
    - A standardized private market; or
    - Direct government programs intended to deliver explicit subsidies to specific borrower classes.
- Ensure proper equity capital levels:
  - raise guarantee-fees to market levels;
  - limit the portfolios to liquidity purposes only;
  - Regulate appropriate levels of capital.

[1]Rosner, Joshua, Housing in the New Millennium: A Home Without Equity is Just a Rental with Debt (June 29, 2001). Available at SSRN: http://ssrn.com/abstract=1162456or http://dx.doi.org/10.2139/ssrn.1162456

[2] Executive Office of the President, RE: Thursday Meeting on Urban issues, August 1,1994 03: 38pm p. 2 available at http://www.clintonlibrary.gov/assets/storage/Research%20-%20Digital%20Library/rascomeetings/Box%20058/005%20647140-urban-meeting-bob-rubins-office-5-august-1994-2-00-3-00-pm.pdf (See e.g. "Use tools of HUD, FHA, Fannie and Freddie to provide low- and no-downpayment loans to eligible low- and moderate-income purchasers")

[3]Private MI Today, Not Someday, MICA Membership Directory, 2000-2001 Fact Book, Washington, DC: Mortgage Insurance Companies of America

[4] The White House, Memorandum for the Vice President, "Community Empowerment: Resources and Strategy", October 5, 1993, p. 1, available at: http://www.clintonlibrary.gov/assets/storage/Research%20-%20Digital%20Library/Reed-Subject/105/647386-community-empowerment.pdf

[5] MEMORANDUM FOR CHRIS EDLEY & STEVE REDBURN, "HOUSING POLICY", PAUL DIMOND, CC: GALSTON, REED, WEINSTEIN, CASHIN, SEIDMAN, SPERLING , CUOMO, KATZ, RETSINAS, STEGMAN, May 31, 1994 available at: http://www.clintonlibrary.gov/assets/DigitalLibrary/BruceReed/Subject/Box%20114/647386-housing-ideas.pdf

[6] US Department of Housing and Urban Development, "The National Homeownership Strategy: Partners in the American Dream", The White House Washington May 2, 1995 Available at: http://confoundedinterest.files.wordpress.com/2012/05/nhsdream.pdf

[7] Executive Office of the President, RE: Thursday Meeting on Urban issues, August 1,1994 03: 38pm p. 2 available at http://www.clintonlibrary.gov/assets/storage/Research%20-%20Digital%20Library/rascomeetings/Box%20058/005%20647140-urban-meeting-bob-rubins-office-5-august-1994-2-00-3-00-pm.pdf

[8] Rubin, Robert, Secretary of the Treasury, Department of the Treasury, Memorandum for Gene Sperling, Director of the National Economic Council, "Meeting on tax Cut Options", December 2, 1998 p. 18 Available at: http://www.clintonlibrary.gov/assets/DigitalLibrary/BruceReed/Subject/Box%20126/647386-taxes.pdf

[9] White House, "Race Report Meeting", January 20, 1999, Oval Office, http://www.clintonlibrary.gov/assets/storage/Research%20-%20Digital%20Library/Reed-Subject/124/647386-race-book-1.pdf (See: "*Recommendation,'* Launch a major refocusing o f the large housing-related GSEs – FNMA, Freddie Mac and the Federal Home Loan Bank Board System… in general, GSEs commonly assert that they are "private" and cannot be expected to make uneconomic investments. But their profitability is fueled by their access to "cheap" money via a government debt guarantee or a discount Fed window…Specifically, the President should propose to: First, adopt new regulatory and statutory provisions to (a) press the GSEs to focus more of their housing activity on severely distressed

communities. and(b)give the GSEs more effective tools to promote targeted lending for community development purposes."

[10] See: Rosner, Joshua, Housing in the New Millennium p. 7

[11] E.g. - In 1999, the Congress enacted the "First-time Homebuyer Affordability Act of 1999". The premise of the Act is that "it is desirable to make funds available from individual retirement plans to encourage first-time homeownership". This legislation reduces the difficulty a potential buyer may have in financing a down payment, but with risks. In the event of a decline in real estate values or in the event of a foreclosure, some or that borrower's entire retirement asset may be lost. Also, in 2000, Congress enacted "The American Homeownership and Economic Opportunity Act of 2000". Title I of the Act is termed "REMOVAL OF BARRIERS TO HOUSING AFFORDABILITY". Among the bill's provisions is one that allows families receiving federal rental assistance to accumulate up to a year's worth of that assistance toward the down payment, appraisal and closing costs of a home. President George W. Bush, based on public comments, seems to have agreed with the previous administration that low-income families should be allowed to apply rental vouchers toward down payments.

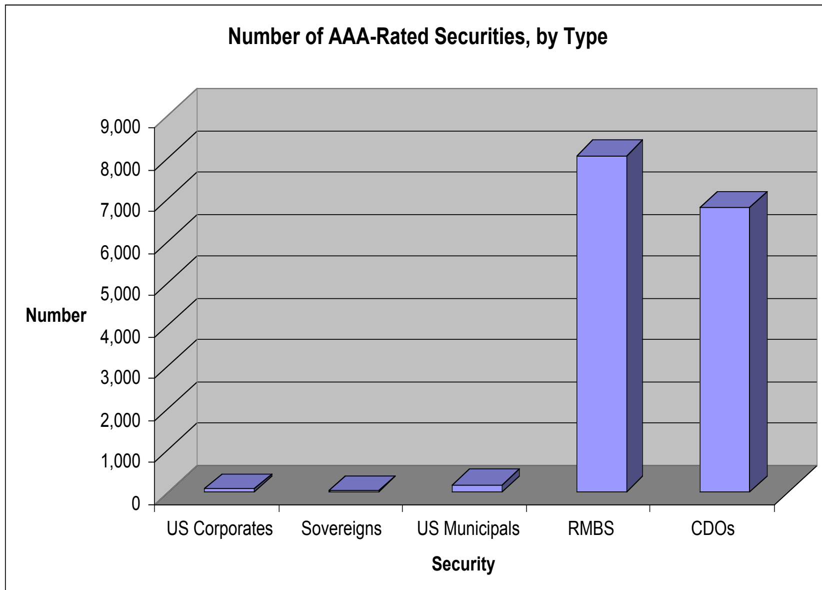
[12]Niesen Roger E., "Audit Report: Family Production Home Ownership Centers", March 30, 2000, US Housing and Urban Development, p. ii (HUD's 1999/2000 internal audit of single family FHA loan production found that56% of defaulted loans in their study had significant underwriting deficiencies that were not detected by HUD or the contractor. Those deficiencies included fraud, excessive ratios, source or adequacy of funds issues, improper income analysis and/or debt or credit issues.)

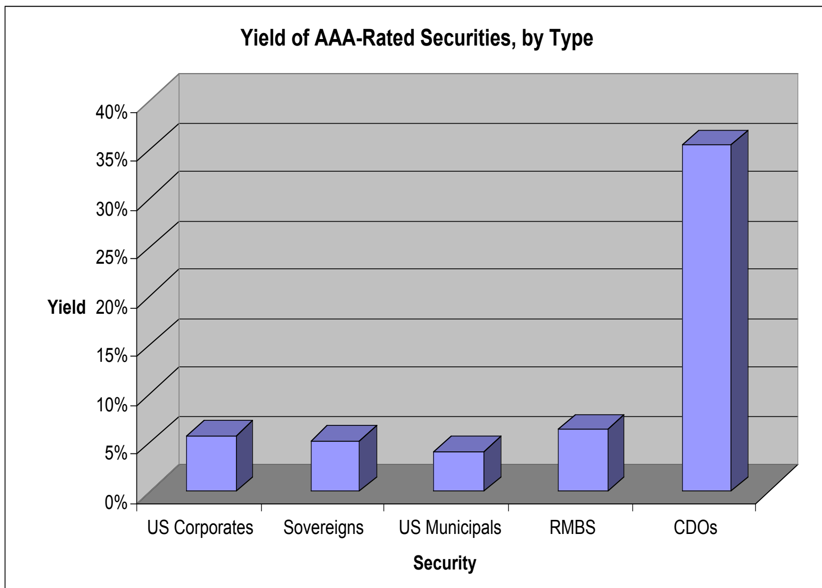
[13]Morgenson, Gretchen and Joshua Rosner, Reckless Endangerment, Times Books, New York, 2011 p. 141

[14]DeVenti, Theresa R. , "**Fannie Mae and Freddie Mac: Past, Present, and Future**", HUD Policy Briefs p. 236 http://www.huduser.org/periodicals/cityscpe/vol11num3/ch11.pdf

[15] See: Mason, Joseph R. and Rosner, Josh, Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions (May 3, 2007). Available at SSRN: http://ssrn.com/abstract=1027475or http://dx.doi.org/10.2139/ssrn.1027475

[16]Rosner, Joshua (2007) "Financial Services Exposures to Subprime, Why we are not 'Seeing Red'", Graham Fisher, 26 July





[17] See: Mason, Joseph R. and Rosner, Josh, How Resilient are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions? (February 13, 2007). Available at SSRN: http://ssrn.com/abstract=1027472or http://dx.doi.org/10.2139/ssrn.1027472

[18] See: http://www.scribd.com/doc/110442571/October-2012-Housing-Draft (National Association of Realtors data)

	Primary Residence	Vacation Hom	Investment Property
2003	67	12	22
2004	64	11	25
2005	60	12	28
2006	64	14	22
2007	67	12	21
2008	70	9	21
2009	73	10	17
2010	73	10	17
2011	62	11	27

[19]Mason, Joseph R. and Rosner, Josh, Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions (May 3, 2007), p. 75 Available at SSRN: http://ssrn.com/abstract=1027475or http://dx.doi.org/10.2139/ssrn.1027475

[20] "Housing America's Future: New Directions for National Policy", Bipartisan Policy Center, February 2013 Available at: http://bipartisanpolicy.org/sites/default/files/BPC_Housing%20Report_web_0.pdf

[21] Rosner, Joshua, OpEd Contributor, "Hey Fannie and Freddie, Pay Us Back!", The New York Times, November 19, 2012 Available at: http://www.nytimes.com/2012/11/19/opinion/a-140-billion-iou.html?_r=0