

**SUSTAINABLE HOUSING FINANCE:  
PRIVATE SECTOR PERSPECTIVES ON  
HOUSING FINANCE REFORM, PART II**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON  
HOUSING AND INSURANCE  
OF THE  
COMMITTEE ON FINANCIAL SERVICES  
U.S. HOUSE OF REPRESENTATIVES  
ONE HUNDRED FIFTEENTH CONGRESS  
FIRST SESSION

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# CONTENTS

|                        | Page |
|------------------------|------|
| Hearing held on:       |      |
| November 2, 2017 ..... | 1    |
| Appendix:              |      |
| November 2, 2017 ..... | 41   |

## WITNESSES

THURSDAY, NOVEMBER 2, 2017

|   |    |
|---|----|
| Stevens, Hon. David H., President and Chief Executive Officer, Mortgage Bankers Association .....   | 6  |
| Howard, Jerry, Chief Executive Officer, National Association of Home Builders .....   | 8  |
| Goodwin, Dan, Director of Mortgage Policy, Structured Finance Industry Group .....  | 10 |
| Edelman, Sarah, Director of Housing Policy, Center for American Progress .....  | 12 |
| Brown, Kevin, Chair, Conventional Financing and Policy Committee, National Association of Realtors .....  | 13 |
| DeWitt, Robert, Chairman, National Multifamily Housing Council on behalf of the National Multifamily Housing Council and the National Apartment Association ..... | 15 |

## APPENDIX

|                             |     |
|-----------------------------|-----|
| Prepared statements:        |     |
| Brown, Kevin .....          | 42  |
| DeWitt, Robert .....        | 52  |
| Edelman, Sarah .....        | 93  |
| Howard, Jerry .....         | 105 |
| Goodwin, Dan .....          | 117 |
| Stevens, Hon. David H. .... | 136 |

## ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

|   |     |
|---|-----|
| Duffy, Hon. Sean:   |     |
| Community Associations Institute: Private Sector Perspectives on Housing Finance Reform ..... | 204 |
| Hultgren, Hon. Randy:   |     |
| Written responses to questions for the record submitted by Mr. DeWitt ....                    | 216 |
| Written responses to questions for the record submitted by Mr. Stevens ...                    | 218 |
| Written responses to questions for the record submitted by Mr. Goodwin .                      | 221 |



**SUSTAINABLE HOUSING FINANCE:  
PRIVATE SECTOR PERSPECTIVES ON  
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**Thursday, November 2, 2017**

U.S. HOUSE OF REPRESENTATIVES,  
SUBCOMMITTEE ON HOUSING AND INSURANCE,  
COMMITTEE ON FINANCIAL SERVICES,  
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 2:03 p.m., in room 2129, Rayburn House Office Building, Hon. Sean P. Duffy [Chairman of the subcommittee] presiding.

Present: Representatives Duffy, Ross, Royce, Luetkemeyer, Stivers, Hultgren, Rothfus, Zeldin, Trott, MacArthur, Budd, Hensarling, Cleaver, Capuano, Sherman, Beatty, Kildee, Kihuen, and Green.

Chairman DUFFY. The Subcommittee on Housing and Insurance will come to order. Today's hearing is entitled Sustainable Housing Finance, Private Sector Perspective on Housing Finance Reform 2.0.

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time. Without objection, all members will have 5 legislative days within which to submit extraneous materials to the Chair for inclusion in the record. Without objection, members of the full committee who are not members of this subcommittee may participate in today's hearing for the purpose of making an opening statement and questioning the witnesses.

Now, the Chair now recognizes himself for 3 minutes for an opening statement.

I first want to thank our panel for their participation in today's subcommittee hearing. This is our second in our series on housing finance reform. For those of you who may have watched the hearing last week, I think you might have noticed a common theme and that theme was expected from many of us. I suspect that you will hear similar themes today and probably similar questions from the panel today for all of you. But we are looking for your feedback and what is most important to your organizations as we craft our vision for housing finance reform.

I want to be clear that I believe that if we are going to be successful not just in the House but in the Senate, we have to address this on a bipartisan level. And that is why Mr. Cleaver and I have been working on scheduling meetings and seeing if we can start painting off the same canvas as we look at housing finance reform.

Obviously, we are better off being nonpartisan and actually having a housing finance reform that works for the American people.

In reforming housing finance, we have to figure out how to get private capital back into the system. That means we have to provide certainty to investors that will track private capital by making the rules of housing finance system transparent and enforceable.

I believe the government can help in providing that certainty to the marketplace at the catastrophic level. While I expect to hear from some of our panelists that the government should give an explicit guarantee on mortgage-backed securities, we must also ensure that our taxpayers are protected. I want to know that your vision of—I want to know what your vision of a guarantee is and at what level should that guarantee actually kick in. What does it look like?

I hope that you will all agree with me that any housing finance reform should be based on market discipline. We have learned from the lessons of the past and need to ensure that private shareholders are not able to profit in good times, but when times go bad, they leave taxpayers holding the bag. The concept that we have capitalism on the way up and socialism on the way down, I would argue doesn't work well for anybody. We absolutely have to deal with Fannie and Freddie. This is consistent with what you have heard, from both sides of the aisle. We can't have these entities exist as they are today and continue to grow. Their risk is ultimately borne by the taxpayer in the form of a bailout should we see another 2008-esque crisis.

And finally, we have to address the FHA (Federal Housing Administration). Since the crisis, the FHA has grown from a program for helping first-time home buyers and has expanded into availability for higher income individuals. Ultimately, this is crowding out the private sector.

So I am looking forward to a vigorous, frank, lively, honest discussion today with all of you. This is your opportunity to give us your feedback on what you think housing finance reform should look like. So we can hit some 30,000-foot points. But also, it is nice to get into the weeds on the finer points of the housing finance.

So I thank you all for coming. My time has expired. I now recognize the Ranking Member, the gentleman from Missouri, Mr. Cleaver, for 4 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman. Thank those of you who come to provide us with testimony that will help us eventually deal seriously with some of the problems that all of us are familiar with. And I think the Chair is absolutely right that, if we can continue to work together, I think the two of us can for sure, but if we can get partners who are willing to work, we can come up with something that would be good for the country. And it also gives us the time to hear stakeholders' input on housing finance reform.

It has been 9 years since Fannie Mae and Freddie Mac were put in conservatorship. Though a number of reforms have been put in place during that time, this arrangement, I can assure you, was never intend to be permanent. This hearing will give us a chance to assess many of the GSE (government-sponsored enterprise) reform proposals that have been offered by you, our witnesses. And as I mentioned last week, I remain hopeful that this committee will



be able to work together in a bipartisan manner to reform the housing finance system. At the forefront of this conversation should be the need for this subcommittee, and Congress, as a whole, to preserve the 30-year fixed mortgage. This has played a crucial role in helping families purchase homes and in financially muscling up the middle class. Any attempt to dismantle it I believe could have a devastating impact on our communities and in the housing market.

The rates for homeownership have already been in decline, and we need to take steps to improve access to mortgage credit, not just for the wealthy but all. Communities of color struggle to gain access to housing market, and our efforts need to improve on this.

As this conversation continues, Mr. Chairman, I look forward to working with you, and I would yield the remaining time to Mr. Sherman from California.

Mr. SHERMAN. Thank you. We are focused on sustainable housing finance, the old system.

Chairman DUFFY. Mr. Chairman, could I just interrupt? I know you are going to get a minute as well. Maybe we just yield all 3 minutes to you at this time so we don't break up your opening.

Mr. SHERMAN. Oh, thank you.

Chairman DUFFY. So yield the gentleman from California for 3 minutes.

Mr. SHERMAN. Thank you.

What was not sustainable is the old system where Fannie and Freddie had private shareholders and private management, and the upside went to the private sector and the downside went to the public sector. What is sustainable is what we have now: Basically government entities ensuring loans. This will sustain our current system of a 30-year fixed-rate pre-payable mortgage which is what our constituents expect. It not only is sustainable, but it provides a role for the private sector.

There are trillions of dollars of private sector money invested in home mortgages today, most of it where Fannie and Freddie are guaranteeing the bond. But keep in mind, it is the private sector taking the interest rate risk. And it is this allocation where a government agency ensures the debt risk, the private sector assumes the risk that interest rates will go up but the mortgage will be paid over 30 years. That is working and working well. What is not, there are two risks to sustainability. The first is the tax bill that was released limiting the home mortgage deduction to \$500,000 unindexed, which means that is 10 years from now, 12 years from now, a quarter million dollars. Also, it is deceptive in that it says if you have a mortgage now that is over \$500,000, you are fine except when you go to sell your house. And no one can buy it at today's prices, and so the value of that house goes down.

And that poses a risk not only to home buyers and home sellers in communities. But if I can think of any risk to Fannie and Freddie, it is the decline in home values that will occur if a tax bill takes away the home mortgage deduction from a big part of the market, including homes in LA County that are below average in price where our median home income is way above \$600,000.

Second, we have a system dealing with subprime mortgages where we still have the issuer selecting and paying the bond rating

agency. The last time we tried that, we got bond rating agencies giving Aaa to Alt-A, and they will do it again once memory fades. We need a system where, if you need a bond rating agency to rate mortgage-backed securities that are difficult to value, that are not prime, that are not guaranteed, that the bond rating agency is not beholden to the issuer, it is not selected by the issuer, and does not generate more profits by getting more issuers to select them.

So I look forward to these hearings, and I thank the Chair and Ranking Member for the time.

Chairman DUFFY. The gentleman yields back. The Chair now recognizes the Vice Chair of the subcommittee, the gentleman from Florida, Mr. Ross, for 2 minutes.

Mr. ROSS. Thank you, Chairman, and thank the witnesses for being here today.

We spend a great deal of time discussing things which we are divided. But I feel that obscures where we are really all in agreement. First, people should be able to afford a place to live. Second, homeownership is important not only for home buyers but also for communities and businesses that rely on a flourishing housing market. Third, losing a home, whether it be through a natural disaster or through a financial crisis, is a tragedy, the root causes of which should never be the consequences of misguided Federal policy. I think we all agree on that.

I think there is even consensus that our current housing finance system is unsustainable. The question is how do we proceed? We have enjoyed a lot of benefits from the GSEs since they were first formed. But the financial crisis revealed a massive downside. I believe we can find a path to a more sustainable, more robust housing financing policy by steadily moving the government away from its historical role in rewarding the GSE's risk taking.

I say it all the time: America should be the home of risk takers, but those risks shouldn't be suicidal. Ultimately, I would like to see a system which Fannie and Freddie and their shareholders are responsible for their own risks and not taking those risks with a nudge and a wink at the U.S. taxpayers.

According to AEI's Edward Pinto and Peter Wallison, in June 2008, before the crisis, 56 percent of all U.S. mortgages were subprime or otherwise low quality. Of these, 76 percent were on the books of government agencies or institutions that were controlled by government policies with the GSE's holding or guaranteeing about two-thirds. The common denominator is government policy which means that it is our responsibility as legislators to think critically about what needs to change.

When I ask why we are encouraging these loans, I am not denying the need for affordable housing. Rather, I want to make sure that we are not committing the moral hazard of putting people in a bad situation, one where they have no choice but to default. In that circumstance, no one succeeds.

We all want America to be able to own that slice of the American dream. We all want to empower the housing market to thrive, and we all want to make sure that no one loses their home. But time and again, Americans have seen their Federal Government engage or incentivize risky and reckless lending. We need to find a better way that doesn't lead people into trouble. We need to find a better

way to protect taxpayers. I believe we can work together toward that solution, and I yield back.

Chairman DUFFY. The gentleman yields back.

Mr. ROYCE. Mr. Chairman, could I ask unanimous consent for 1 minute to address the committee?

Chairman DUFFY. Without objection.

Hearing none, the gentleman from California is recognized for 1 minute.

Mr. ROYCE. Well, thank you, Mr. Chairman. And thanks for this hearing.

Housing finance reform remains the great undone work of the financial crisis. And a nationalized mortgage market, frankly, is an unsustainable status quo. Sadly, the situation we find ourselves in today was a predictable one. In 2003, I introduced legislation and again in 2005 which would have reined in the GSEs allowing them to be regulated for systemic risk. Alan Greenspan backed my amendment, but it was not enough to overcome the outsized political pressure brought by the GSEs themselves.

While claiming that Fannie and Freddie posed no threat to the financial markets and the systemic risk was a theoretical term, the opponents of my amendment won the day. But they do not have to win today. We have a chance to learn from the past and to put to rest the model of private gains and public losses once and for all. Increasing private sector involvement in the secondary housing market through increased credit risk transfer and a truly common securitization platform is the first step in presenting another bail-out paid for by the American taxpayers.

Thank you, Mr. Chairman.

Chairman DUFFY. The gentleman yields back.

Mr. KILDEE. Mr. Chairman, I also ask unanimous consent to speak for 1 minute.

Chairman DUFFY. The Chair now recognizes the Vice Ranking Member of the committee for 1 minute.

Mr. KILDEE. Is that right? You can say Assistant to the Regional Manager, if you would like.

Chairman DUFFY. Duly noted.

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

And I just want to raise an issue, and I know this is obviously a really important topic. It is the topic that attracted me to this committee in the first place, and it is a subject that obviously I think we should spend significantly more time on.

The particular point that I want to make is that, when it comes to questions around housing finance, I want to caution us to keep in mind that even in periods where data might suggest that there is a return of functionality to the marketplace, and I think we have seen some resettling of the market post crisis, that there are particular regions and within communities particular—or within regions, particular communities that have really yet to recover from not only the crisis, the acute crisis that we faced starting in 2007, 2008, but from the long slide that those communities had experienced even leading up to that crisis.

The chronic housing crisis in older cities, distressed communities, was made worse and, in fact, exacerbated in ways that they haven't yet recovered from in—as a result of the acute crisis. So if you can

address in your comments the particular needs in weak markets, I think it would be really helpful. And I appreciate the indulgence of the Chairman.

I yield back.

Chairman DUFFY. The gentleman from Michigan's time has expired.

We now welcome our panel today, which is a large panel for this subcommittee. We welcome our first witness, Mr. David Stevens President and CEO of the Mortgage Bankers Association.

Our next witness, Mr. Jerry Howard, CEO of the National Association of Home Builders.

Our third witness, Mr. Daniel Goodwin, is the Director of Mortgage Policy for the Structured Finance Industry Group.

We next have Sarah Edelman, the Director of Housing Policy at the Center for American Progress.

Then we have Mr. Kevin Brown, Chairman of the National Association of Realtors, Conventional Financing and Policy Committee.

And finally last but not least, Mr. Robert DeWitt, President and CEO of the GID Investment Advisors on behalf of the National Multifamily Housing Council and the National Apartment Association.

To all of you, welcome.

In a moment, the witnesses will be recognized for 5 minutes to give an oral presentation of their testimony. Without objection, the witnesses' written statements will be made part of the record following their oral remarks. Once the witnesses have finished presenting their testimony, each member of the subcommittee will have 5 minutes within which to ask all of your questions.

I would just note that, on your table, there are three lights. The green light means go, the yellow light means you have 1 minute left, and the red light means your time is up. So I will try to pay attention to the lights up here. But if you would help and pay attention from your position, that would be helpful. Your microphones are sensitive. So you want to make sure that you are speaking directly into them.

And if I could just make one note to our panel, I believe that votes are going to be called in roughly 10 minutes. So we are not trying to be rude, but we will have a couple votes on the floor. I think we have a House picture that is also going to be taken, which can take a lot of time, or it can take not much time. But we will get back as quickly as possible. So we should be able to get through most of the panel, but we may not get through all of it, just for your information.

With that, Mr. Stevens, you are recognized for 5 minutes.

#### **STATEMENT OF THE HONORABLE DAVID H. STEVENS**

Mr. STEVENS. Thank you. Thank you, Chairman Duffy. Thank you, Ranking Member Cleaver, members of the subcommittee. Thank you for the opportunity to testify here today.

Nine years have passed since the GSEs were placed in conservatorship, and yet their long-term status remains unresolved. Extending conservatorship is economically and politically unsustainable, and it is an unacceptable long-term outcome. With-

out comprehensive reform, borrowers, taxpayers, and lenders will all face increased risk and uncertainty about the future.

I will cut right to the chase: The time to act on comprehensive legislative reform is now. Despite the positive steps FHFA (Federal Housing Finance Agency) has taken as conservator, only Congress can provide the legitimacy and public confidence needed for long-term stability in both the primary and secondary mortgage markets. That is why, to build on prior work surrounding GSE reform, and in the hopes of spurring legislative action, MBA (Mortgage Bankers Association) convened a task force reflecting the full composition of MBA's membership: Residential and multifamily, bank and nonbank, small, medium, and large. Our task force truly represented the full depth and breadth of the entire real estate finance industry rather than the narrow interest of any one specific market segment.

We tasked this group with developing a proposal that would address the future of the secondary mortgage market and, in particular, an end-state model that can also fulfill an affordable housing mission. Our proposal, which I have included as part of my written testimony, ensures equitable access for all lenders to the secondary market, prohibiting special pricing or underwriting deals based on loan volume as occurred prior to the conservatorship, preserving the cash window, small pool execution options, and eliminating the opportunity for vertical integration by the largest market participants.

Our proposal recognizes the need for any comprehensive GSE reform plan to balance three major priorities: Consumer cost and access to credit, taxpayer protection, and investor confidence. To achieve these policy objectives, MBA's plan recommends recasting the GSE's current charters and allowing a multiple guarantor model that features at least two entities and preferably more. Guarantors would be monoline, regulated utilities owned by private shareholders operating in the single-family and multifamily markets. The core justification for a utility style regulation is that privately owned utilities attract patient capital and derive certain benefits by virtue of their Federal charters. The guarantors would be subject to rigorous capital requirements that would provide financial stability without unduly raising the cost of credit for borrowers.

These requirements would be satisfied through multiple layers of private capital including proven means of credit risk transfer. The implicit government guarantee that existed before the conservatorship of Fannie Mae and Freddie Mac would be replaced with the legislated explicit guarantee only on the mortgage-backed securities. The guarantee would be supported by a Federal insurance fund with appropriately priced premiums paid by the guarantors, much like banks pay for FDIC insurance.

Our plan explicitly calls for deeper first loss risk sharing that is transparent, scalable to all lenders, and capable of limiting taxpayer exposure to only catastrophic risk. The task force also developed recommendations in two areas that have vexed past reform efforts. One, the appropriate transition to a new system, and, two, the role of the secondary market in advancing national affordable housing strategies.

Our proposal specifically notes the importance of leveraging the assets, infrastructure, regulatory framework, and more of the current system. We also believe that any workable transition must utilize a clear roadmap and be multiyear in nature. We developed an affordable housing framework that covers both renters and homeowners of various income levels. Our plan suggests other improvements to better serve the full continuum of households including updating credit scoring models and better capturing nontraditional income. Our framework has outcomes that are transparent, well-defined, measurable, and enforceable.

Mr. Chairman, as I noted, FHFA has put in place a number of policies and procedures to improve access to the secondary market and reduce risk to taxpayers. Now is the time for Congress to act and lock in these improvements. Only Congress can alter the existing charters, establish an explicit Federal Government guarantee, and create a regulatory mandate to maintain a level playing field amongst all lenders. We cannot go back to a housing finance system that provides private gains when markets are strong yet relies on taxpayers when losses occur.

Calls to simply recapitalize the GSEs and allow them to operate without further structural changes are misguided. Under such plans, the post-crisis administrative reforms already achieved could be reversed by regulation. The American people rely on a mortgage finance system that enables them to access quality, affordable rental housing, buy their first home, or build a nest egg for their children. We owe it to them to proceed with the hard work of reform without delay.

Thank you again for the opportunity to testify, and we are committed to work with you and the committee as you further this endeavor.

[The prepared statement of Mr. Stevens can be found on page 136 of the Appendix]

Chairman DUFFY. Thank you.

Mr. Howard, you are recognized for 5 minutes.

#### **STATEMENT OF JERRY HOWARD**

Mr. HOWARD. Mr. Chairman, Ranking Member Cleaver, members of the subcommittee, NAHB (National Association of Home Builders) is proud to have the opportunity to appear here before you today.

We applaud you, Mr. Chairman, Mr. Hensarling, and the others for the work you have already done in helping to advance the debate on housing finance reform.

NAHB also believes that 9 years in conservatorship is too much. And we believe that it is time now to move forward, and we are eager to be a constructive partner. While some have called on the FHFA director to allow Fannie and Freddie to recapitalize in order to avert a need for further draw from Treasury, NAHB believes that this would be counterproductive to achieving comprehensive housing finance reform. Allowing the enterprises to recapitalize would encourage their release from conservatorship prior to meeting full reform, and would reestablish the failed GSE model.

To ensure a stable housing finance system that will support home ownership and affordable multifamily housing in America, Congress must fix the structural flaws inherent in Fannie and Freddie's charters, though they contributed so significantly to the housing finance crisis. Regulatory solutions or piecemeal legislative steps are simply not adequate.

NAHB believes strongly that a bipartisan legislative solution would not only protect the American taxpayer who, absent reform, is on the hook for any losses stemming from the \$6.29 trillion in federally guaranteed mortgages, but the legislative fix would also ensure that the housing finance market has a reliable and adequate flow of affordable housing credit that would not face uncertain availability from one administration to another.

As an organization representing members who construct approximately 80 percent of all new housing, single and multifamily, NAHB's priority in the system is to ensure liquidity for the housing sector in all markets throughout every economic cycle. This is only possible if the market participants know that there is a Federal Government backstop that will maintain stability in catastrophic circumstances.

While NAHB agrees that the current degree of government intervention is unsustainable, an ongoing though more limited government role must be maintained to avoid future interruptions in the flow of credit to mortgage borrowers.

Since 2008, numerous lawmakers, housing and consumer advocates, academic and industry stakeholders have proposed plans for a reformed housing finance system. NAHB members themselves have spent countless hours debating reform proposals, crafting our own proposal, and generally seeking a bipartisan road forward. Many of the early reform proposals called for a complete restructuring of the secondary market, and several proposed a full dismantling of both enterprises. These plans were untested, often complex, and would have required a transition that could have been considerably disruptive to the housing finance market.

Thankfully, over the past 9 years in the light of regulatory and policy changes throughout the industry, the continued functioning of the mortgage market, there has been a gradual moderating of the approach to reform. And consensus is forming around broad principles. Importantly, recent proposals call for legislation that preserves areas of the market that are working, including the significant infrastructure and resources of Fannie and Freddie themselves.

Of specific note, many plans include the following key elements that are consistent within NAHB's vision. One, an insurance fund capitalized by market participants that would stand in front of the Federal Government explicit backstop. The Federal Government and taxpayers would be at risk only in the case of catastrophic loss. Two, the system will rely primarily on private capital. Three, the Federal Government backstop would apply to mortgage-backed securities but not to the private companies themselves. Four, there would be a level playing field for lenders of all sizes. Five, the enterprises or their successors must have appropriate capital requirements. And, six, government-supported securities would be backed by single-family loans that meet qualified mortgage requirements

as well as prudently underwritten multifamily mortgages. Finally, number seven, there should be careful transition to avoid market disruptions.

Mr. Chairman, given the significant role that housing finance plays in the economy and that housing itself plays, we urge this committee and Congress to take a long-term holistic approach to housing finance system reform.

We thank the committee for its leadership on this issue and stand ready to work with you to achieve such reforms and provide certainty and stability to this critical sector of the economy. Thank you.

[The prepared statement of Mr. Howard can be found on page 105 of the Appendix]

Chairman DUFFY. Thank you, Mr. Howard.

Mr. Goodwin, you are recognized for 5 minutes.

#### **STATEMENT OF DAN GOODWIN**

Mr. GOODWIN. Chairman Duffy, Ranking Member Cleaver, and members of the subcommittee, thank you for the opportunity to testify today. My name is Daniel Goodwin, and I am the director of the Mortgage Policy, Structured Finance Group. SFIG is a trade association that represents over 350 corporate members from all sectors of the structured finance and securitization market. A key element of SFIG's mission is to educate and advocate on behalf of the structured finance and securitization industry with respect to policy, legal, regulatory, and other matters affecting the securitization markets.

I thank you for the opportunity to address the committee regarding housing finance reform, including finding an appropriate balance of private and public funding for the housing finance system.

The disproportionately large role of the government in today's housing finance system is the outcome of many factors, but it is arguably in an unhealthy condition. SFIG believes this condition can be remedied but must be done in a manner which minimizes market volatility and keeps credit flowing.

In considering reforms inherently critical to the U.S. housing market and the economy as a whole, we suggest there is a guiding principle that should be considered. In order to provide consumers access to credit at competitive rates, there must be a stable, liquid, and efficient market. This market must allow responsible lenders to compare funding costs easily across competing sources and readily access those same funding sources on a level playing field.

Historically, these funding sources have fallen under two broad categories: Publicly supported funding and privately supported funding. Any considerations of housing reform should encourage a healthy and sustainable mix of both, eliminate hidden or implied guarantees or subsidies which may distort costs and minimize the risk to taxpayers and the economy.

We strongly encourage steps to restore the private-label securitization market in order to remove risk from the taxpayers, diversify economic risk, encourage economic innovation, and ultimately reduce borrowing costs. We also believe that the continued presence of publicly supported funding is essential to act as a



source of 30-year fixed-rate mortgage credit, support affordable housing goals, provide countercyclical stability, and support the TBA (to be announced) market.

As detailed in my written testimony, this smooth functioning of the TBA market is critical in that it is the cheapest and most efficient way for mortgage borrowers and lenders to lock in an interest rate when a mortgage loan is approved thereby minimizing the cost of borrowing passed on to the consumer.

The TBA market is dependent on a government guarantee making it imperative that any reform legislation include provisions that preserve such a guarantee. Also, without the backing of the Federal Government, it is unlikely that the 30-year fixed-rate mortgage would exist in its current state. The 30-year fixed-rate mortgage is an essential financing tool for home buyers. The fixed interest rate provides certainty allowing a family to budget their housing costs and make long-term financial plans without the fear of future interest rate swings. While the government guarantee provides significant benefits that should be maintained, in some ways, private capital has been crowded out. SFIG believes we should strive to encourage an appropriate and healthy balance between public and private funding to protect the taxpayer, promote competition, and drive innovation.

The GSE's credit risk transfer programs are examples of notable success in the reintroduction of private capital into the mortgage market. Those programs have clearly demonstrated that there is private capital eager to invest in newly originated mortgaged credit risk so long as investors feel their interests are protected and there is a reasonable amount of regulatory and legal certainty.

We believe that the GSE should build on their success and expand their programs to include an even greater percentage of their portfolios, perhaps even explore selling more of the existing risk they retain on the CRTs (credit risk transfers) to further reduce risk to the taxpayer. It is important to note that CRT, although reliant on private capital, is not a replacement for private label securitization. The PLS market once represented a far greater share of the mortgage funding ecosystem. Market excesses and bad actors across the mortgage market led to the collapse in housing that fed the Great Recession. In response to that crisis, legislation and regulation were put into place with the goal of preventing the kinds of excesses we witnessed a decade ago.

Despite the imposition of significant regulation, this market has not recovered. However, it has begun to show green shoots, and we should seek ways to encourage responsible growth. Areas for consideration are capital relief for non-GSE issuers of credit, paring back certain onerous capital and liquidity standards, and reducing conforming loan limits.

As this committee is considering housing finance reform and ways to attract private capital, lawmakers should review policies which may have created an uneven playing field or inadvertent biases.

Thank you again for the opportunity to testify, and I look forward to answering your questions.

[The prepared statement of Mr. Goodwin can be found on page 117 of the Appendix]

Chairman DUFFY. Thank you, Mr. Goodwin.  
Ms. Edelman, you are recognized for 5 minutes.

#### STATEMENT OF SARAH EDELMAN

Ms. EDELMAN. Thank you, Chairman Duffy, Ranking Member Cleaver, and members of the House Subcommittee on Housing and Insurance. My name is Sarah Edelman, and I am the director of Housing Policy at the Center for American Progress.

I am here today to remind you that what matters most in a discussion about the housing finance system is whether the families you represent can get a sustainable mortgage regardless of where they live or whether they are wealthy and, until they are qualified to buy, that they can find an affordable rental.

The housing finance system determines who can borrow money, what they will pay, and whether financing is available for affordable rental housing. As Congress considers how to strengthen the housing finance market for decades to come, we offer the following three recommendations.

First, policymakers should build on what has worked. Prior to the 1930s, home ownership was only an option to those who could make a 40 percent down payment. And even then they had to repay or refinance within just a few years. Starting in the 1930s, the Federal Government began supporting affordable home ownership through Federal mortgage insurance programs and through the government-chartered enterprises Fannie Mae and Freddie Mac. These interventions helped to grow the middle class significantly. Going forward, the enterprises or their successors should retain their strong mission as well as the tools to deliver on a mission that has served America well.

Second, Congress should support reforms already underway to fix what hasn't worked and consider new reforms where appropriate. The housing crisis was not caused by Fannie Mae or Freddie Mac. As detailed in my written testimony, the problems that caused the crisis arose from the private label securitization system and predatory lending practices. While Fannie Mae and Freddie Mac didn't cause the crisis, though, they did stray from their mission in the years leading up to it. And as the private securitization market grew, their income declined and they made bad business decisions to generate quick profits and to please shareholders. These decisions eventually landed them in conservatorship.

Since the crisis, Congress has taken important steps to reform the housing finance system. Congress established protections for consumers and reined in Wall Street through the Dodd-Frank Wall Street Reform and Consumer Protection Act. Congress also passed the Housing and Economic Recovery Act which established a strong regulator, the FHFA, to oversee the enterprises. Left for Congress to address are the shareholder incentives that could drive bad decisions at the enterprises or their successors. And Congress also needs to decide how to ensure that the government guarantee, which was implicit for decades, is paid for.

Finally, as Congress considers reforms, policymakers need to make sure that they don't make changes to the system that could actually make matters worse for consumers, taxpayers, and the

housing market. For instance, several of the proposals under consideration make the mistake of setting competition as a goal of housing finance reform. It was not the lack of competition in the secondary market that caused a crisis, and a larger number of firms guaranteeing or issuing government-backed securities will not necessarily make taxpayers safer. As finance expert and former SFIG executive committee member Andrew Davidson explains in a new paper, even if there are multiple guarantor entities, it is likely that if one is failing that the others are likely to be under pressure. Government might still have to intervene. Further, the risk isn't just that they fail but the damage that is done as they race toward bottom.

Our concern is that these proposed structures may create conditions for the irresponsible behavior we saw in the private-label securitization market in the lead up to the crisis, except this time, the securities will be guaranteed by the Federal Government. Congress should also help ensure that mortgage pricing is relatively stable and homogenous across the market. This is important for a healthy mortgage market and for ensuring that working families continue to have access to fairly priced mortgage credit.

In recent years, the GSEs have shifted toward pricing risk at the loan level which has raised costs significantly for borrowers with average credit scores. Instead, the cost of ensuring risk should be spread more evenly across all borrowers. Any reforms considered by Congress should encourage fair pricing and should not solidify the current practices or move further toward a market where only the wealthiest among us can get a mortgage at a fair price.

Thank you for the opportunity to be here and for your efforts to strengthen the housing market. How you decide to proceed will have consequences for America's home buyers and renters alike, and we look forward to working together.

[The prepared statement of Ms. Edelman can be found on page 93 of the Appendix]

Chairman DUFFY. Mr. Brown, you are recognized for 5 minutes.

#### **STATEMENT OF KEVIN BROWN**

Mr. BROWN. Chairman Duffy, Ranking Member Cleaver, and members of the subcommittee, my name is Kevin Brown. I am currently the Chairman of the National Association of Realtors (NAR) Conventional Finance and Policy Committee, and I served as a president of the California Association of Realtors in 2014. I am the broker of Better Homes Realty, Rockridge, in Oakland, California, and I have over 39 years of experience servicing the cities of Oakland, Berkeley, Albany, El Cerrito, and Sacramento in California, and the city of Portland in Oregon.

NAR is America's largest trade association. Realtors are involved in all aspects of both the residential and commercial real estate industries. I would like to start by thanking Chairman Duffy and Committee Chairman Hensarling for your leadership on flood insurance. It was a pleasure collaborating with both of you and your staff on this important issue. NAR looks forward to working closely together on housing finance reform as well.

As part of the comprehensive housing finance reform, Realtors believe that it is crucial for Congress to ensure that affordable mortgage capital will always remain available in all markets for creditworthy Americans. In order to ensure a steady flow of affordable mortgage capital in both good times and bad, NAR believes that Congress must include an explicit government guarantee for the future housing finance system. Moreover, Realtors believe the enterprise that should be converted into government chartered, non-shareholder-owned authorities that are subject to tighter regulation on products, profitability in minimal retained portfolio practices in a way that ensure the protection of taxpayers' moneys.

Realtors believe that any entity with private profits that are implicitly backed by public losses, as enterprises were structured before the conservatorship, is flawed and problematic. This model allows enterprises to take excessive risk, focus on revenue and profit generation based on assumptions that taxpayers would step in when the losses begin to mount. Additionally, realtors desire a smooth transition that will pose the least amount of market disruption.

As mentioned earlier, realtors strongly support a secondary mortgage market model that maintains an explicit government guarantee. That guarantee will protect taxpayers by ensuring that all creditworthy consumers have reasonable access to affordable mortgage capital so that they too can attain the American dream of home ownership. Furthermore, NAR urges Congress to address the enterprise's declining capital.

Under the terms of their agreements with U.S. Treasury, the enterprise's capital reserves will decline to 0 on January 1, 2018. It is important to have a buffer between any losses and the taxpayer. This is especially the case if comprehensive housing finance reform legislation has not yet been adopted. It makes sense to build that buffer now while the enterprises have positive cash-flows. To address this concern, a prudent intermediate step would be to establish a mortgage market liquidity fund, or MMLF, through legislation or under existing regulatory authority. A portion of the enterprise's profits could be deposited into the fund controlled by FHFA director which could cover future losses due to market fluctuations as I have described.

The FHFA director could release funds from this account to buffer against further U.S. Treasury involvement. As a result, some capital will be in place to avoid significant market disruption and provides Congress with the necessary time to enact comprehensive housing finance reform. Realtors recognize that this is an extensive and important conversation regarding how we mend and improve a housing finance system that can serve us well into the future. Realtors believe that recommendations provided today will help commerce and our industry partners design a secondary mortgage model that will be in our Nation's best interest today and in the future.

Thank you for the opportunity to testify, and I look forward to answering any questions.

[The prepared statement of Mr. Brown can be found on page 42 of the Appendix]

Chairman DUFFY. Thank you, Mr. Brown.

Mr. DeWitt, you are recognized for 5 minutes.

**STATEMENT OF ROBERT DEWITT**

Mr. DEWITT. Thank you, Chairman Duffy, Ranking Member Cleaver, and Ranking Member Waters, and members of the subcommittee. It is my privilege to appear before you on behalf of the National Multifamily Housing Council and the National Apartment Association to provide the multifamily industry's perspective on housing finance reform.

My name is Bob DeWitt, and I am the President and CEO of GID, a Boston-based owner/operator/developer of multifamily properties. I serve currently as the Chairman of the National Multifamily Housing Council.

The apartment sector is a competitive and robust industry that helps nearly 39 million people live in homes that are right for them. We help build vibrant communities by offering housing choice, supporting local small businesses, creating millions of jobs, and contributing to the fabric of communities across the country. Today we are experiencing fundamental shifts in our housing dynamics as more people are moving away from buying houses and choosing to rent apartments. More than one in three Americans rent, and 19 million of those households are building their lives in apartments.

In the past 5 years, an average of 600,000 new renter households were formed every year. This increased demand will generate a need for 4.6 million new apartments at all price points by 2030. To meet that demand, we will need to build an average of at least 325,000 new apartment units every year. Yet, on average, just 244,000 apartments have been built from 2012 through 2016.

The apartment industry is extremely capital-intensive; therefore, it is critical that housing finance reform provide consistent access to debt capital across geographies, markets, and product types if we are going to meet the current and future demand for rental housing in America.

Today, private capital dominates multifamily markets. Banks, insurance companies, commercial mortgage-backed securities, and, to a lesser extent, pension funds and private mortgage companies are all key sources of capital for the multifamily industry.

Unfortunately, private capital alone is insufficient. Even during healthy times, the private market has been unwilling or unable to meet the totality of the multifamily industry's capital needs. For example, banks are limited by capital requirements and have rarely been the source of long-term fixed rate financing. Life insurance companies typically comprise less than 10 percent of the market and finance only higher-end properties. And CMBS (commercial mortgage-backed securities) has also not fully returned to pre-crisis levels.

As this committee considers housing finance reform, it is critical to remember the enterprises have ensured capital availability regardless of prevailing economic conditions. They have operated with great distinction even during the financial crisis, and the committee should build on the success to ensure liquidity, stability, and affordability in a growing multifamily housing market.

In this regard, we urge you to consider the following key six principles. First and foremost, it is essential that a reformed housing finance system maintain an explicit paid-for Federal guarantee for multifamily backed mortgage securities available in all markets at all times.

Second, recognizing the inherent differences between the single family and the multifamily sectors both in how we operate and how they have performed will require different solutions to avoid putting at risk the nearly 39 million Americans who rely on the apartment industry for their housing. The positive performance of the GSE's multifamily programs are a direct result of their adherence to prudent underwriting standards, sound credit policy, and, most importantly, placing private capital at risk in front of the taxpayer.

Third, we share the view that private capital should dominate the multifamily sector wherever and whenever possible. Reform should ensure continued private sector participation.

Fourth, Congress should protect taxpayers by continuing risk sharing and private capital participation. Each GSE utilizes its own risk sharing multifamily model that protects it from losses by placing private capital in the first loss position. These models worked effectively through the great financial crisis in shielding taxpayers from the bill for credit losses.

Fifth, Congress must maintain the successful components of the existing multifamily programs in whatever succeeds them. Establishing a new business model for multifamily businesses would only serve to disrupt capital flows to the industry. The enterprise's technology, processes, and personnel must be preserved as the committee evaluates a new housing finance system.

Six, Congress should avoid market disruptions during the transition to a new system by clearly defining the government's role in a reform system in the timeline for transition.

Finally, it is critical that the Federal Housing Administration continue to be a reliable source of construction and mortgage debt. FHA ensures mortgages and is a source of construction and long-term debt for affordable and work force housing.

Thank you for the opportunity to testify today, and I look forward to answering your questions.

[The prepared statement of Mr. DeWitt can be found on page 52 of the Appendix]

Chairman DUFFY. Thank you, Mr. DeWitt.

And it looks like votes have been pushed back, thankfully. So the Chair now recognizes himself for 5 minutes.

To the mortgage bankers, home builders, and realtors, how did your members fare during the 2008 crisis?

Not well, did they?

Mr. STEVENS. No.

Chairman DUFFY. They lost a ton of people because they went under.

Mr. STEVENS. That is right.

Chairman DUFFY. I know a lot of home builders went out of business, and a lot of realtors lost their jobs as well. And it impacted a lot of my constituents, people all over America.

So this is an issue that affects, I think, everybody equally. And making sure we get reform right is critically important, because

when we get it wrong you see your membership roles drop considerably because it has a huge impact.

Mr. Brown, would you just take a moment. You have discussed a government charter versus government sponsored. Can you explain what you mean by that and how you envision that working?

Mr. BROWN. The government charter—what we want to do is we want to have a government-chartered entity with an explicit guarantee. The most important thing is the explicit guarantee to preserve the 30-year fixed-rate mortgage. I think out in the private market, if the government guarantee wasn't there, the 30-year fixed-rate mortgage would not exist.

Chairman DUFFY. Does it exist in the jumbo market?

Mr. BROWN. Does what exist?

Chairman DUFFY. Thirty year.

Mr. BROWN. In the jumbo market, does the government guarantee—

Chairman DUFFY. Can you get a 30-year mortgage in the jumbo market?

Mr. BROWN. Yes. Yes, you can.

Chairman DUFFY. So when you look at having a government charter, are you guaranteeing the entity or the security?

Mr. BROWN. The security.

Chairman DUFFY. OK. So it is different in what we have right now, where we are guaranteeing the entity, right?

Mr. BROWN. Yes, explicit guarantee.

Chairman DUFFY. Right.

Mr. Stevens, in regard to your proposal where we are going to have an insurance fund to help with losses, what skin in the game does the lender have should one of their mortgages go bad?

Mr. STEVENS. If they are selling to a government agency, they are on the hook for representations and warranties that they met the standards that would be required to be able to sell a mortgage backed ultimately by the explicit guarantee.

Chairman DUFFY. So you can come back to the lender?

Mr. STEVENS. Correct.

Chairman DUFFY. And recoup some of those losses?

Mr. STEVENS. Absolutely.

Chairman DUFFY. Have you taken a look at Bright DeMarco by chance?

Mr. STEVENS. Yes

Chairman DUFFY. And why is your proposal better than a Bright DeMarco-esque proposal where we are looking at—they are looking at a Ginnie Mae model as opposed to the insurance fund model.

Mr. STEVENS. Honestly, they are very close, and there is a lot of similarities between the two proposals, because they are both a multiple guarantor model with several consistencies around capital requirements and more. Ours does use the CSP (common securitization platform) versus Ginnie Mae. And I think the critical difference between a Ginnie Mae execution and having that be the platform is the lenders act as their own issuer. There is, for example, no cash window at Ginnie Mae for small lenders.

And in our view, going forward, if you are going to have the customer base that the GSEs have today, which is a couple thousand lenders, the regulation and the safety and security net is better

managed if you have a few guarantors versus a couple thousand lenders all issuing through a government platform.

There are many other complexities to that topic which I would love to follow up with you on. But, in essence, there is a lot of agreement between Bright DeMarco in terms of structure, the plumbing differences we talked about, whether it is a CSP or Ginnie Mae comes down to a lot of nuance that I would love to explore with you beyond the time that is allowed here today.

Chairman DUFFY. I welcome that future meeting.

I asked this in the last hearing, and I don't think that I had a really good answer. But does everyone on the panel agree there needs to be a government guarantee or a catastrophic government guarantee in this space? Anyone disagree with that?

And so if we are going to offload credit risk, how much credit risk can we offload? What does that number look like? We can debate how we do it, but—

Mr. STEVENS. Yes. From our view, you are going to offload all credit risk except for the pure catastrophic level of credit risk.

Chairman DUFFY. And what is that?

Mr. STEVENS. We would have to get in a discussion of what—in basis points. But let's just assume that you would essentially load off the first 50 percent or so of the loan to value that is being guaranteed by the government. That would break you through all measures of risk modeling, that would take into account every recession we have been through, including the most recent Great Recession.

So there would be private capital—multiple layers of private capital ahead of that risk so that the government would only be on the hook once you burn through all layers, down to a very low loan to value that would have withstood the worst recessions.

We have laid it out in detail in our paper. It is another one that—of course, it is a bit complicated. But through the multiple risk transfer structure that we put in place, you ultimately truly put the government in a catastrophic risk level, and I would assume that most economists would agree with that as well.

Chairman DUFFY. My time is up, but I look forward to having a more vigorous conversation with all of you on these topics as we move forward. I would just hope that there is going to be agreement, one, on a government backstop but also that we want market principles at play, because what might feel good today, we are all doing well with being this close to the crisis, we know that time heals all those memories, and we start to behave poorly. And market discipline is a great way to make sure that 2008 doesn't happen again.

So my time has expired.

I now recognize the gentleman from Missouri, the Ranking Member, Mr. Cleaver, for 5 minutes.

OK. I do not recognize the Ranking Member.

I now recognize the gentleman from Massachusetts, Mr. Capuano, for 5 minutes. And I would just note that he has his jacket on which means he is going to be well-behaved.

Mr. CAPUANO. Thank you, Mr. Chairman. It is because we have had this hearing half a dozen times yet and thus far haven't heard anybody change your opinions. You like the system the way it was before they met their excesses. You like the idea of a government



backstop to mortgages. And we all agree we ought to keep the 30-year fixed mortgages.

Did I say anything that anybody disagrees with? So anybody have any idea why we just can't do this? Why hasn't it been done? Anybody know? I can't figure it out.

Everybody in the world agrees with the real basic premise of what we have to do except one or two extreme, out of the mainstream whack job think tanks. All of us think it is pretty easy. I don't have a clue why we keep doing these hearings, except, of course, I love seeing you all. But this is something we could just do. And why don't we just do it and stop talking about it?

So I am not going to talk about it, because we all agree. I do want to take a second and thank Ms. Edelman for mentioning something I thought I was the only one that has ever mentioned it, but you did it. What mortgages were like before Fannie and Freddie.

Now, my numbers are just slightly different but not much. It was a 50 percent down payment. Fifty percent down payment. The rates were about the same rates as we have today except there was a 5-year pay back. Five year. Not 30, not 15, 5. Which meant your monthly mortgage was about two to three times what it is today for the same house. And home ownership was close to 0.

So it is something we need—we have done the private thing already. It didn't work out too well. And I don't hear anybody who thinks we should change it.

But I do want to ask my real estate guys here today. Today, many of us have been trying to rip through this 400-page tax bill trying to figure out what is in it and what it all does. And I can't pretend. I haven't digested the whole thing yet, and I might be wrong in some of the things I see. But I am just curious. All the people in the business, do you think that it is a good idea to exclude—to repeal the current exclusion for the sale of a principal residence, therefore, make it taxable income? Would that help the business? Anybody think that helps the business?

Mr. BROWN. I think it is terrible. And I also think doubling the standard deductions neutralizes home ownership, and I think that is terrible as well. You know, we are a Nation of homeowners. Nobody aspires to rent a house. But we are afraid. Especially in California, renters are, in another 10 years, 12 years, there are going to be more renters than homeowners.

And I think that maybe tax reform might even accelerate that in its current form if they take the incentives out of homeownership.

Mr. CAPUANO. I really appreciate that comment, there are going to be more renters than homeowners. Again, we are always going to have some renters. I own a two-family home. I live in a two-family home. To my knowledge, I am the only Member of Congress who does. Why do I do that? Because when I could afford to buy a home, I needed the rent to pay the mortgage, and I have stayed. And I know that nobody here knows what a triple decker is or what a two decker is. In Boston, they are pretty common, and they are usually occupied by people trying to get into the housing market. It is usually the first house you own, because you use the rent to pay it off. And I will tell you that in Boston and New York and

LA, and Chicago—I guess another question, it appears as though they are trying to reduce the cap on mortgage interest deduction to homes only up to \$500,000.

Does anybody here think that is going to help your business? It may not change your business in big chunks of the country, because \$500,000 homes are kind of big homes in most of the country. But \$500,000 in Washington, D.C. might get you a parking space, maybe, maybe two, but that is about it. So does anybody here think that that cap, that reduction of that cap would help increase home ownership or help business?

Mr. HOWARD. We don't think so, sir. We are very concerned about the impact of the tax bill on housing. While we differ from the realtors in that we are in favor of the doubling of the standard deduction, we think that there are ways—revenue neutral ways that the tax bill could solve the problem that it creates with housing.

We have presented some of them to the Republican leadership and to Chairman Brady, and we are hopeful that ultimately a bill will put something in there, more specifically a home ownership tax credit that would be geared toward the middle class.

Mr. CAPUANO. I appreciate it. There are other provisions of this bill too. My time is running out, and they are going to call votes. But I will tell you that we need your voices here with this tax bill, because even if we finally get around to doing the right thing on GSEs, which I think we might some day in my lifetime, even if we do that, if we then kill it on the other end by making homeownership unaffordable to the entry-level people because of various tax provisions, not going to help you, not going to help us, it might help some people on Wall Street.

It will not help the people building homes. It will not help the people selling homes. It will not help the people trying to finance those people who want to buy homes.

So we may help one segment of the economy, but we will hurt another big segment of the economy that matters to my constituents.

Thank you, Mr. Chairman, for your indulgence.

Chairman DUFFY. The gentleman yields back. I wish I had more time to address the tax issue, but I don't.

I now recognize the Vice Chairman of the subcommittee, the gentleman from Florida, Mr. Ross, for 5 minutes.

Mr. ROSS. Thank you, Chairman.

I, again, thank the panelists for being here.

You know, it is interesting, because I agree with Mr. Capuano. I think we all believe that there should be a solution here with a backstop. As was pointed out earlier, I think everybody agrees that a government backstop should be there.

The problem we have is to what extent the government is responsible for that backstop. And I think the details are what we are talking about here. Mr. Goodwin, I think, believes that there should be a balance between private and government. Ms. Edelman, I believe, thinks that on the front end we should have the government there. And Mr. Stevens, I think, that you believe in a private sector one, which I, of course, support.

And my first question is, is there anybody here that believes that without a government backstop we cannot have a sustainable 30-year mortgage, despite the jumbo market? Is it necessary to have a government backstop in order to maintain a sustainable 30-year mortgage?

Mr. STEVENS. Yes.

Mr. HOWARD. Yes.

Mr. ROSS. Would anyone disagree with that? OK. Good.

Mr. Goodwin, do you agree?

Mr. GOODWIN. Yes.

Mr. ROSS. OK. My concern is where we are crossing lines here between the primary and the secondary mortgage. There has been an issue about that bright line.

And, Mr. Stevens, to what degree have there been examples of the GSEs kind of crossing that bright line into the primary mortgage market?

Mr. STEVENS. Well, thank you for the question. It is a great concern to our industry. Freddie Mac and Fannie Mae should play a role purely in the secondary market, and in a general sense, they do.

But they have had scenarios that we need to be concerned about. Contacting the owners of apartment buildings versus the lender lending to the owner of the apartment building, or creating pilot programs where the vendors are selected without an open and public and transparent process, or giving terms of business to select institutions and pilots that ultimately last far longer and give advantages to certain lenders in the marketplace, or building web capabilities that are focused on consumers versus institutions.

Our view is that they should stay behind the bright line, remain as a secondary market participant only, and not compete with the private sector.

Mr. ROSS. And you have discussed your utility rate-like program. That, in essence, just engages the private market and would provide for a stable long-term rate. Is that correct?

Mr. STEVENS. Absolutely. The advantage of the utility model versus the predecessor to the conservatorship of the GSEs where there was unending pursuit for shareholder gains is utility investors tend to be more patient investors, long-term investors not expecting the grandiose returns, and therefore they put less pressure on the guarantors that are involved in the system.

Mr. ROSS. And there is enough capacity out there in the private sector to make this happen. Would you agree?

Mr. STEVENS. Absolutely. Yes.

Mr. ROSS. Mr. Brown, how do you feel about that, about that particular type of backstop, with the utility rate-type—

Mr. BROWN. You are talking about the bright line?

Mr. ROSS. Yes.

Mr. BROWN. We believe in the bright line and—

Mr. ROSS. Oh, I am sorry. Not the bright line. I apologize. But go ahead. Go ahead.

Mr. BROWN. And we think that large financial institutions should not be working both sides.

Mr. ROSS. And I appreciate that. But with regard to specifically Mr. Stevens' proposal for a government backstop that is private

shareholders with a rate regulation-type environment that is used in utilities, how do you feel about that? I mean, do you think that is going to—

Mr. BROWN. What we are calling for is a mortgage market liquidity fund. That is the rainy day fund. There is actually a lot of private capital in the market now. And they would have to, say, if there were losses, for instance, there is the downpayment and the equity that a homeowner has in the house. There are the G fees, PMI, and—

Mr. ROSS. It would provide the liquidity up front.

Mr. BROWN. Yes, yes. But losses would have to eat through all that. And what we are proposing, that this fund, that profits can be put into now to establish this fund for catastrophic losses.

Mr. ROSS. Ms. Edelman, how do you feel? To what degree should the backstop be structured in terms of the homeowner, the lender, the government? At what level do each of these parties participate?

Ms. EDELMAN. So, yes, the home buyer puts up a down payment which acts as a buffer. And then we do want a situation where the government is really just the backstop.

Mr. ROSS. Market of last resort.

Ms. EDELMAN. Yes.

Mr. ROSS. Absolutely.

Ms. EDELMAN. But to your question on the private utility, we think utility structure is really interesting. The idea of capping the returns to get at some of the incentives that get messed up with shareholders.

One of the problems is how do you make sure that the regulator stands strong. You look at private utility models all over the country and it is a constant battle between the utility commission and the regulated entity.

Mr. ROSS. But that is the beauty of the system. It is a constant ebb and flow, because of market demands, because of consumer demands, because of natural disasters. I mean, utility rates are never static. And I don't think that mortgage rates would ever be static either.

Ms. EDELMAN. I think the greater concern is how much are the investors getting paid and how much are the entities incentivized to try and create businesses that are going to create more returns for the investors. I think that is the sticking point.

Mr. ROSS. Thank you. My time has expired. I yield back.

Chairman DUFFY. The gentleman yields back.

As the panel can see, votes have been called. I would just note for your timing, I believe we have three votes and then a House function, which is a picture. So I would just guess, it is probably going to be 45 minutes to an hour before we resume. So you can deal with your time in that fashion.

So with that, the committee now stands in recess. We will reconvene after the beautiful House photo. With that, the committee stands in recess.

[Recess.]

Chairman DUFFY. The committee is recalled to order. The Chair now recognizes the gentleman from California, Mr. Sherman, for 5 minutes.

Mr. SHERMAN. Thank you.

I believe I usually have a graphic here showing the debt. I don't know if staff can put that up. I don't know if staff is listening. OK.

Mr. Brown, in your testimony you support a two-guarantor system, a Fannie and a Freddie. You haven't asked for a Mark or a Tom. You seem to focus on having two. Why are two guarantors optional? And should we only have one? Should we have three or four?

Mr. BROWN. We think that having one would not be good. If something happened to that entity, there is nobody else in the space. Having two we think is a perfect balance. We think that that has led to competition and innovation. So that has worked out well so far with the GSEs.

Having more than two, having multiple guarantors, we just think it would be a race to the bottom in terms of pricing and then we would have liquidity problems in the market.

Mr. SHERMAN. Now, we need to have enough capital or reserve funds for the GSEs. Sometimes they are going to do better, sometimes they are going to do worse. And if they have too much capital, that may tempt some to say, well, capitalize—catch and release or capitalize and release. And if they have too little, they are going to need to draw against the Treasury. And that will be a political firestorm, or could be, depending upon how it is characterized.

You have raised concerns about the enterprises drawing on their line of credit with the U.S. Treasury. Wouldn't it be prudent to, perhaps, when they remit funds to the Treasury, to put that in a separate part of the Treasury line item in the Treasury so that if it was needed by the enterprises on a rainy day, it would be clear that they were just drawing down money they had previously transferred to the Treasury?

Mr. BROWN. Mr. Sherman, that is exactly what we want to see happen, is that rainy day fund created, a mortgage market liquidity fund.

When the GSEs have that, then they can really focus on home ownership. And they can also engage in countercyclical activities in weaker markets. It would be a fund for catastrophic losses. After the system went through private capital, then that would be the fund of last resort, and so it would cover the taxpayer from that respect. And that is kind of our mantra: What can we do to protect the taxpayer?

Mr. SHERMAN. Thank you. And I agree with you.

Mr. DeWitt, Fannie and Freddie are major sources of mortgage capital for the multifamily market. There is a growing shortage and increased demand for multifamily rental housing. Do you think private capital alone will meet the need to build the apartment buildings that people need to rent?

Mr. DEWITT. Congressman Sherman, no, I don't think that that is possible, to have the private market provide all of the capital that is required. And just as evidence of that, we haven't ever seen the private market be able to provide 100 percent of the capital that the multifamily industry consumes.

Certainly during the 2008 to 2010 great financial crisis private capital disappeared entirely. And without Fannie and Freddie, we would have had a severe liquidity crisis that would have put a lot

of properties in maturity foreclosures when their loans became due and we had no other source of funding to refinance those.

So we don't believe that it is possible. And the rationale for that, if you look at the commercial banks who provide most of the construction financing, and they provide some short-term variable rate financing or floating rate financing, they are constrained by the regulations imposed by Dodd-Frank and Basel III and others.

Mr. SHERMAN. We have certainly heard about those in this room.

I am going to try and sneak in one more question for Mr. Stevens.

Are there risks associated with a rollback or reversal of the Federal Housing Finance Agency's policies? Mel Watt will not be there forever. I enjoyed sitting next to him on this committee for many years. What legislation could mitigate the risk of being whipsawed between one set of policies and another set of policies?

Mr. STEVENS. With what little seconds are left, yes. Unless we lock in some of the reforms that the director has put in place, they can always be subject to change. And legislating an explicit guarantee, legislating real capital standards, legislating the level playing field for all lenders, large and small, so that they compete evenly, these are just three of several things that Congress can do.

Mr. SHERMAN. Mr. Stevens, I am going to give you a homework assignment, and that is, can you produce a proposed piece of legislation designed to lock in the best of Mel Watt's work?

Mr. STEVENS. Absolutely.

Mr. SHERMAN. Thank you.

Chairman DUFFY. The gentleman yields back.

The Chair now recognizes the gentleman from California, the Chairman of the Foreign Affairs Committee, but also a great member of this committee, Mr. Royce, for 5 minutes.

Mr. ROYCE. Mr. Chairman, thank you very much.

Let me start with Mr. Stevens. And, Mr. Stevens, as you know, I and Gwen Moore have put forward a bipartisan bill that would direct Fannie and Freddie to increase the amount and the types of credit risk transfer transactions. And we would do it to the maximum level that is economically viable, that is commercially viable.

And when we had FHFA Director Watt here before the committee, it was October, he was here in October, and he told me that when they are looking to encourage—that in terms of the timing, they are looking at encouraging more front-end credit risk transfers at Fannie and Freddie. And I am not sure when they are going to do that, but I was going to ask you, how do you think they intend to accomplish that goal, and do you think deeper mortgage insurance is part of the equation?

Mr. STEVENS. Well, thank you, Congressman. And I appreciate your leadership on this subject.

Credit risk transfer is critical to almost every model that is being presented going forward. And to date, the credit risk transfer model has been mostly in the form of structured finance through CRT executions that have taken place.

We believe to have a truly functioning, deep first loss credit enhancement market, you need to utilize both institutional risk transfers via mortgage insurance and the reinsurance markets, as well as structured, and that FHFA should be directed to do this

sooner rather than later. Because we believe ultimately proving that point will bring more capital into the markets through good markets and bad, regardless of whether credit spreads are wide or narrow. So it is something we encourage FHFA to pursue, and we appreciate your efforts to try to do the same.

Mr. ROYCE. Well, thank you, thank you.

And let me ask Mr. Goodwin, in your testimony you highlighted the work SFIG has done around the revitalization of the private label securities market. Outside of lowering conforming loan limits, which you have already spoken to, can you highlight some of the recommendations you have that we, as legislators, can undertake to help on that front?

Mr. GOODWIN. Sure. Thank you.

There are three broad areas that I think would need focus. One is an industry-focused area of providing alignment of interests, clear roles and responsibilities, and that is part of the undertaking that SFIG is doing under its RMBS 3.0 umbrella. So that is an industry self-regulating piece.

I think we should continue the work that we have been doing over the last several years with prudential regulators and the CFPB (Consumer Financial Protection Bureau) to clarify liability around investors and to tailor regulatory and capital rules to better suit the products that we are working with.

And then finally, we should continue to work to reduce the GSE footprint.

Mr. ROYCE. Yes.

And let me go back to Mr. Stevens on another issue, because Mr. Brad Sherman and I share some of your criticism of the PACE (property-assessed clean energy) loan program. And on the face of it, helping homeowners improve energy efficiency is certainly a good thing, but the structure of these loans and the sales practices really have raised some concerns.

What role should the GSEs play in addressing these concerns, in your opinion?

Mr. STEVENS. Thank you for the question.

The PACE program we view as a great danger to the average homeowner.

Actually, one of the problems is it is not a loan, it is a tax assessment, which means it is not subject to the traditional consumer disclosures and consumer protections that have been established under the CFPB's consumer disclosure requirements.

And as a result, it creates this opportunity for a cottage industry of whoever can invent the next energy enhancement without oversight can go sell it to consumers who may have no idea whether the value is there. And it also takes first lien rights after the fact.

So our view is that the GSEs should be forbidden from allowing PACE loans in their portfolio, as well as the FHA.

Mr. ROYCE. Let me let Mr. Brown jump in here, too, if he wants to on this.

Mr. BROWN. Sure. I totally agree. I think that there needs to be a consumer educational component. I think most consumers that get these PACE loans don't really understand what they are, and then it takes a first lienholder position. So I very much agree.

Mr. ROYCE. Thank you, Mr. Brown, Mr. Stevens. Thank you, Mr. Goodwin, and the entire panel here. I appreciate it very much.

And I yield back, Mr. Chairman.

Chairman DUFFY. The gentleman yields back.

The Chair now recognizes the Ranking Member, Mr. Cleaver, for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman.

Mr. DeWitt, any time we start talking about dealing with the issue of housing, whether we want to or not, it inevitably is going to lead to some discussion about FHA. And I am wondering what you see as a role for FHA, considering the role they played in helping us get beyond the economic crisis of 2008.

Mr. DEWITT. Thank you. The FHA, I think they provide some construction financing for the apartment sector, and that is important for those who can't get the construction financing from the commercial banking system. So I think that is really the primary role that they are playing for us today, important provider of capital.

Mr. CLEAVER. Do you think we still—is there still a need for FHA?

Mr. DEWITT. You know, it depends entirely on what you are going to do with Fannie and Freddie. But I think so. I think that you would still need that construction lending capability which doesn't exist in the two GSEs.

Mr. CLEAVER. Ms. Edelman.

Ms. EDELMAN. I just wanted to emphasize how important FHA is to both the rental market and the home ownership market. FHA traditionally has been how many first-time home buyers, lower-wealth borrowers, are able to buy homes.

There are ways that we can strengthen FHA, including giving them the funds they need to have the technology systems in place to really serve the market well. But proposals that have been on the table to either raise prices for consumers or narrow the footprint and who is eligible, I think, really could undermine what FHA does.

Mr. CLEAVER. Thank you.

Mr. Stevens, the multifamily housing in our country was just blasted into little bits from 2008. What happened? And what do you think we need to put in place to create a whole new spirit of multifamily housing, understanding that most builders are not anxious to do that because they are not going to make money? So what do we do, because we know we need it?

Mr. STEVENS. Yes. I was the FHA Commissioner in 2009. And actually, there was a line at the door of FHA to finance apartment buildings that couldn't get financing everywhere else because the CMBS markets had all but disappeared for a period of time.

Multifamily requires a variety of capital sources to provide for the varieties of multifamily financing in the market. The greatest challenge we have today is the affordable entry-level rental housing stock. You can see just here in Washington, D.C., that the units that are being built are A-quality units, but the gentrification process can ultimately impact the affordable rental side of the community.



LIHTC (Low-Income Housing Tax Credit) has been helpful in that effort, but there needs to be more focus in being able to make sure that we have both consistency of liquidity to the apartment markets, and that there are other incentives to provide opportunities to build more affordable entry-level apartment housing stock as well.

Mr. CLEAVER. Well, in a lot of the urban centers there are vacant apartment buildings. In Missouri, both Kansas City and St. Louis, you can find many of them. But the rehab cost is prohibitive. And so you have the potential, but unless there is some gap financing from somewhere, from somebody, those buildings will eventually just be knocked down or unless the government comes up with something creative to save them.

Do any of you have any concrete, flawless comments on how to preserve these buildings?

Ms. EDELMAN. Well, two opportunities. First, the Duty to Serve rule, Fannie and Freddie have been instructed to serve three underserved markets. One of them is around affordable rental preservation, and they should be running with that.

Another opportunity is for FHFA to set more rigorous, affordable goals for multifamily. Fannie and Freddie are soaring past the goals that have been set while the percentage of the portfolios that is actually affordable has been in decline.

So I think there are a couple of opportunities to really push what we have got right now.

Mr. CLEAVER. Thank you.

Chairman DUFFY. The gentleman yields back.

The gentleman from Nevada, Mr. Kihuen, is recognized for 5 minutes.

Mr. KIHUEN. Thank you, Mr. Chairman, and thank you, Mr. Ranking Member. And thank you all for being here to testify.

As most of you know, I represent the Fourth Congressional District of Nevada, which is one of the most diverse districts in the country. Geographically, demographically, it is basically a microcosm of the United States of America. We have rural, we have urban, suburban, Latino, African American, Asian, younger, older. I mean, it reflects what this country looks like.

Now, the question is more for the panel, but according to the Urban Institute, among others, mortgage credit standards are excluding good credit risks, and this is disproportionately impacting minority borrowers.

Do you agree with this? And if so, what could be done to improve access to credit in the GSE space?

Mr. BROWN. You know, the National Association of Realtors is very much in favor of alternative credit scoring. We realize that a lot of people that are being underserved are being shut out of the housing market. And so we are open to exploring alternative ways of people having their credit measured so that they can get a loan.

People pay, even though they are renters, they pay utility bills, they pay telephone bills. If they are paying those bills on time, why can't that be part of their credit score. So we are totally open to alternative measures to get more of those people in the marketplace.

Ms. EDELMAN. Fannie Mae and Freddie Mac have also changed their pricing approach in recent years and now they have moved toward risk-based pricing. So you pay a higher fee if you are a borrower who has a 680 credit score relative to somebody with a 780.

So while they have, theoretically, this big credit box that they can lend into, it doesn't make economic sense for anybody to really get a loan from Fannie and Freddie if you have a credit score from really under 700.

So we think they should move toward how they more traditionally price credit across the book of business instead of at the individual level. That would be one thing.

And then another piece, and I will defer to Mr. Howard on this, there are serious inventory shortages at the starter home level. And so a lot of time folks aren't even coming to the door to a bank because they can't find a place to buy.

Mr. KIHUEN. Right. Thank you.

Mr. STEVENS. I would just add that I think it is a really important question. This is a precipice that we need to all get engaged in. We have families in this country that come from oftentimes countries that were unbanked or underbanked, and so the trust in the banking system was something that wasn't part of the family culture. We have multiple family members living together, in some occasions contributing to the mortgage, which doesn't fit into the traditional square peg, square hole underwriting.

And to the point made previously, alternative forms of credit needs to be something that becomes more main stream. Thin-file, creditworthy sustainable borrowers have to become underwritten in a way that allows them access to home ownership, again, assuming that the rest of their profile is sustainable.

Mr. KIHUEN. Thank you.

And my next question is for Ms. Edelman, and I know you have been here before, and thank you for always being accessible.

Now, as you all know, we have a staggering home ownership gap between white and minority households in this country. The home ownership rate for a white household is 72 percent, while it as low as 42.3 percent for black African American households and 45.5 percent for Hispanic households.

Why do you think it is important to acknowledge this history and resulting trends in the next context of debating housing finance reform?

Ms. EDELMAN. Thanks so much for the question.

When you look back through the history of housing finance policy in the U.S., as I mentioned in my opening statement, government intervention in the housing market through insurance programs, the chartered entities, built the middle class. But all that time when they were building the middle class, the 1940s through the 1970s, black homeowners were shut out, other homeowners of color were shut out completely.

And so since then, we have been trying to make up for that deficit, and instead of really expanding sustainable home ownership, instead in the early 2000s, we got predatory lending, which just stripped wealth from communities of color.

So the wealth gap is staggering, and the decisions that are made about what the housing finance system looks like going forward

will determine whether home ownership can be a tool to help build wealth or whether we are going to continue to solidify the trends that are ongoing.

Mr. KIHUEN. Thank you.

Mr. GOODWIN. I would like to make a brief comment from the private label security side of things. This is another reason to encourage the growth of private capital in the mortgage space. Its flexibility in using alternative credit models, in providing alternative solutions, especially around nonstandard credits and thin-credit files, when done in a responsible way, can help expand home ownership.

Mr. KIHUEN. Thank you.

Thank you, Mr. Chairman.

Chairman DUFFY. The gentleman yields back.

The Chair recognizes the gentleman from Illinois, Mr. Hultgren, for 5 minutes.

Mr. HULTGREN. Thank you, Chairman Duffy.

Thank you all so much for being here. I appreciate it very much.

I am going to address my first question to Mr. Stevens, if I may. I would like to get your opinion on FHFA's somewhat recent rules to limit the eligibility of FHLB (Federal Home Loan Banks) membership through captive insurance companies.

As you point out in your written testimony, and I quote, "In eliminating this category of members, FHFA removed some companies that are active sources of private capital in the mortgage market, such as market REITs," end quote.

I absolutely agree that this should be revisited. It is why I have been working with my friend and colleague from the other side of the aisle, Representative Gwen Moore from Wisconsin, to reduce the Housing Opportunity Mortgages Expansion Act.

As you might know, the two States served by the Federal Home Loan Bank of Chicago, Illinois and Wisconsin are arguably hardest hit by FHFA's rule. For example, Redwood Trust, one of the bank's largest members and an exemplar of private capital in the mortgage market, will lose its membership.

So I wondered, in general, can you comment on the role that mortgage REITs (real estate investment trusts) play in contributing private capital to the housing market and how permitting FHLB membership for mortgage REITs augment their ability to contribute private capital to the housing market?

Mr. STEVENS. Well, thank you for the question, and thank you for your leadership on this issue.

As we have learned over these past several years, the distribution of capital sources has gone beyond just banks to nonbanks and a variety of other capital sources. Real estate investment trusts are critical providers of capital and liquidity to the mortgage finance markets. Many were members of the Federal Home Loan Bank System for many, many years prior to the modification of the rule by the director. And the Federal Home Loan Banks provide an important source of liquidity to the real estate investment trusts that can ultimately be distributed to communities across the country.

We strongly support the effort to allow those, at minimum, the real estate investment trusts that had access to the Federal Home Loan Bank system prior to the rule, that they should be allowed

to be retained in the program. They provided no risk to the Federal Home Loan Bank model whatsoever and brought a lot of private capital and liquidity to the marketplace.

Mr. HULTGREN. Thank you.

Mr. Goodwin, if I could address the next few questions to you, if that is all right.

I believe I share the view of most when I say that the government should not be subsidizing homes with values around half a million dollars. The role of government is to help those who need it the most. Your testimony suggests private capital can step in with no or negligible increase in the cost of the mortgage if conforming loan limits are reduced.

I wondered, how much can these limits be reduced and how quickly? For example, 5 percent a year, 10 percent a year? What do you think?

Mr. GOODWIN. I hesitate to put a specific number on it. I think you are absolutely right, that it can be done. We see now the difference between mortgage rates offered in the jumbo space and mortgage rates offered in the agency space are very, very close, which indicates the fact that there isn't a substantial difference in financing cost to the consumer.

I think that it should be done in a measured way. I think that there is enough private capital which has shown interest in the mortgage space, as evidenced by the health of the CRT market and the fact that other mortgage yields are clearing out there, points to the fact that there is liquidity. But I think, like in everything, that things should be done in moderation and in a measured way.

Mr. HULTGREN. Following up, do you have any recommendations for updating conforming loan limits to maximize private capital without impairing affordability? And also, do you believe there are any issues with tying conforming loan limits to average housing prices?

Mr. GOODWIN. I don't—membership doesn't have an opinion on tying it to home limits. I think that is something that is worth discussing with membership, and that I would be happy to come back at another time and discuss with you.

Mr. HULTGREN. That would be great. Let me move on with my last minute here, a little bit about the QM (qualified mortgage) patch. As you know, all agency loans are deemed to be qualifying mortgages, providing lenders more legal certainty. It also provides an unlevel playing field with private capital. This QM patch is set to be phased out at the earlier of the GSEs' existing conservatorship or January 10, 2021.

How significant is QM status for lenders and what does this mean for the cost of financing for the mortgagees?

Mr. GOODWIN. Thanks for bringing this up. I think this is an important point that does not get as much attention as it should.

The QM patch provides the GSEs with an advantage over the rest of the originating institutions out there, basically gives them a pass on a lot of the rules that other lenders are subject to. And with it expiring in the earlier end of conservatorship or 2021, I think we need to begin the work of transitioning to the time when that patch is no longer available.

And whether that means that we begin the work of standardizing QM across all lenders, GSE or non, or bringing, expanding the non-QM patch to other lenders, I think the work needs to start happening to get us so that we avoid a disruption in the marketplace when it expires and we avoid a situation where it drives up our end cost.

Mr. HULTGREN. Thank you. My time has expired. I have more questions. I may follow up in writing, if that is all right. Thank you all so much.

I yield back.

Chairman DUFFY. The gentleman's time has expired.

The Chair now recognizes the gentleman from Texas, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman.

I thank the witnesses for appearing.

And I thank the Ranking Member for all of his services to this committee as well as to his country. Same to you, Mr. Chairman.

Friends, I am concerned about the housing market, and I am concerned about the mortgage interest deduction. As you know, there is a move afoot to move it from \$1 million to \$500,000. Does that cause anybody else concern? If so, would you raise your hand?

OK.

Let me tell you why it causes me some consternation, and then you give me your indications. It causes me consternation because if we lower it from a million to 500,000, we will probably lower it to 250,000, and we will probably lower it to something else.

My fear is that this is the next step in elimination of the home mortgage interest deduction. I don't support that. I don't support elimination. And I am concerned that this is a step in that direction.

So let me ask my friend who is with the National Association of Home Builders your position on it as tersely as you can state it, please, sir.

Mr. HOWARD. We are angry. That is about as tersely as can I put it. We think it is very bad policy. We think it picks geographic winners and losers. We think it is going to lower house values, and it could lead to a housing recession. We think it is a very misguided proposal.

Mr. GREEN. And if I may go to Mr. Brown, who is with the realtors, please.

Mr. BROWN. We feel the same way. We feel that—in fact, our—the comments came up with a number, with the repeal of the SALT (State and Local Tax), as well as doubling the standard deduction, and we feel that it is going to be like a 10 percent drop across the Nation, nationwide.

As far as the \$500,000 deduction, we don't know how much, if you throw that in, how much it will—or the \$500,000 cap, we don't know how much that would reduce the housing market further, but it is significant, especially in the high-priced States.

Mr. GREEN. The question now becomes whether or not this will be allowed as a part of a Christmas package. There seems to be an indication that this is something that should be done by Christmas. A sad Christmas for a lot of people who are hopeful and want to buy homes. I know that \$1 million to \$500,000 may not seem

like a lot, but when you understand that that is only one step and there can be a lot more, I think it is going to cause some heartburn.

But I appreciate what you have said in terms of how it will impact the market. And my hope is that we will find reason to let people know that we have this consternation. You are doing a great job here today, but we may have to do more.

Now, with reference to the alternative credit scoring, we were talking about that just a moment ago, I believe. We have a bill, H.R. 123, that addresses this question to a certain extent. But we found it better to call it additional credit scoring as opposed to alternative, because we are adding more. We are not taking one thing or another thing. We are adding more.

It is my belief that people should have additional credit scored if it really is credit. And if you pay your light bill, your gas bill, your phone bill, your water bill, why not have it scored if you pay it timely, if it can make a difference in your credit score.

In examining this, we found that a good many people would benefit. In fact, there are people who are paying more for rent than they would pay to purchase a home if we had additional credit scoring.

So it is H.R. 123. I would commend it to you and ask that you review it for your consideration. H.R. 123.

This passed the House, by the way. It is not something that is new to us. And we had with HUD (Housing and Urban Development) to develop an automated system for us to examine and see how it worked. And we had a 5-year window and it didn't get done. This is in the interest of full disclosure.

So my hope is we will get it passed again and this time we will get the automated system.

There are some institutions that do this on a case-by-case basis, so it is not anything new, additional credit scoring, it is just that we would like to see it done so that a good many more people can benefit from it.

I greatly appreciate your time. I have 6 seconds left. So thank you.

And I will yield back to the Chair 1 minute—1 second, excuse me.

Chairman DUFFY. The gentleman is over by 1 second but yields back none the same.

We are now going to go into a second round of questions, and the Chair recognizes himself for 5 minutes.

Just to follow up on Mr. Green's point. I think it was—Mr. Ellison and I were partners in the alternative credit scoring issue. I agree with it. We want to look at all factors to make sure if you are qualified to get a home you can actually purchase a home.

Mr. GREEN. Would the Chair be so kind as to yield for a positive comment?

Chairman DUFFY. No, because I only have 5. I will give you 5 minutes, though, if you stick around.

Mr. GREEN. That works for me.

Chairman DUFFY. What concerns me is Mr. Stevens comes out and says, "Listen, those lenders who might make a bad loan, they

might have some skin in the game.” You are OK with them having skin in the game.

Mr. STEVENS. Yes.

Chairman DUFFY. On the realtor front—which, by the way, the realtors and I get along well. My dad was a realtor. We have worked well on FUD together. But once you get your 6 percent, you are out. You have no skin in the game after the sale. That shouldn’t taint the remarks, but as we look at housing finance, I think those are considerations, as we talk about policy, we have to consider.

We have had a lot of conversations about tax. Now I want to get to that as well.

Mr. HOWARD, so we have gone from the mortgage interest deduction, this proposal, from \$1 million down to \$500,000. In your world actually what should it be? If you are able to write the bill, it should be unlimited?

Mr. HOWARD. Prior to 1986, it was unlimited, sir. So I think we have been operating fine for the last 30 years at the million-dollar level.

Taking it down to \$500,000 and not indexing it for inflation I think is a policy mistake.

Chairman DUFFY. How many middle-income folks do you know are buying a house for \$1 million.

Mr. HOWARD. It depends on where you live, sir. Middle income here is different than middle income in Wisconsin.

Chairman DUFFY. Do you know what the mean home cost in D.C. is?

Mr. HOWARD. I don’t know off the top of my head.

Chairman DUFFY. \$538,000.

Mr. HOWARD. That is mean.

Chairman DUFFY. That is right. But my concern is, you have heard a debate: No tax breaks for the rich. This is economic warfare.

But then when, you know—listen, a million-dollar home? A million-dollar home and we have people who go, “Oh, my gosh, I don’t want to give tax breaks to the rich.” But when there is a reduction in write-offs for the wealthy, they are the first ones to grab the microphone and go, “Whoa, whoa, whoa, this isn’t fair, this isn’t right. We have to make sure the SALT is still in place so I can write off my mortgage interest.”

And, by the way, I don’t disagree with you. But as a matter of policy and the debate that happens here, you have people talking out of both sides of their mouth.

Mr. HOWARD. Mr. Duffy—

Chairman DUFFY. “I want to go after the rich.”

Mr. HOWARD. Mr. Duffy—

Chairman DUFFY. Until you go after the rich, and then they are like, “Well, those are my people.”

Because guess what? Do the rich live in my district? No. Do they live in Boston? In New York? In San Francisco? Yes. And who represents those districts? The very people who are arguing to raise their taxes, and the very people, when we meet the call to raise their taxes, they complain about it. And I find that to be rich and frustrating.

If you want to give tax breaks to the rich, say it. Let's all go, "You know what, if you buy a \$2 million home, we want to let you write off that interest."

Mr. HOWARD. Mr. Duffy, are you aware of the alternative proposal that the National Association of Home Builders brought to the Ways and Means Committee and the House leadership?

Chairman DUFFY. No. I am on Financial Services, not Ways and Means. But if you want to send it my way, I will be happy to look at it.

Mr. HOWARD. We would be happy to do that, sir.

Chairman DUFFY. But to Mr. Brown, I want to throw another question by you.

Mr. BROWN. Can I comment, Chairman, on—

Chairman DUFFY. Let me give you a question and I will give you time to respond.

Mr. BROWN. OK, OK. All right.

Chairman DUFFY. Because I think I heard you say that the realtors are in a position where we go, "You know what, I want to make sure that Americans are itemizing for their mortgage interest deduction." And that is a good thing for home ownership.

I am going to give you some pushback, because I have to tell you what I think. Most people in my district go, "I don't want to itemize for that. If you give me a standard deduction of \$24,000 and I don't have to go to my accountant and itemize my taxes, I am applauding."

So I think we have to be cautious. Is this good for realtors or is this good for Americans? And I think most Americans go, "I don't want to itemize, and I want the deduction."

And if you come in—and I think you are in the hardest place. I told you this before, we had this conversation. I think you are in a hard place arguing that you want Americans to itemize their mortgage interest deduction. That is a hard place to be because they don't want to do it. It is complicated. They want our plan to go, "Right here, baby, one sheet, you can put it on all there."

You can go, Mr. Brown.

Mr. BROWN. Chairman Duffy, I disagree with you.

Chairman DUFFY. You can go to both things, too, if you want to hit me on both of them.

Mr. BROWN. What we are in favor of is home ownership, and we are against anything that diminishes home ownership.

You know, the Federal Reserve just came out with some numbers not long ago, and what they said is the average net worth of a renter is falling, from \$2,900 to \$2,100.

The average net worth—since 2010. Since 2010, the average net worth of a homeowner has gone from approximately \$168,200 to \$232,000.

That information is from the Federal Reserve. We believe in home ownership. If you take the incentives out of home ownership, people will not buy homes.

Chairman DUFFY. Mr. Brown—

Mr. BROWN. And people have, if I can just finish.

Chairman DUFFY. Sure.

Mr. BROWN. I will make it quick.



You know, there are so many tangible and intangible benefits of home ownership. I mean, people use their equity to invest to send their kids to school, to invest in their family. It is security. I mean, those people that are building equity and not throwing it away, they could care less about a postcard. They care about that equity in the home.

Chairman DUFFY. Home ownership is the American Dream. People want to own a home. And I am telling you what, maybe where you come from in California it is different from Wisconsin, but no one says, "I want to buy a house because I get to itemize my taxes and get a mortgage interest deduction." They don't talk about that. What they say is, "I want to buy a house. What is it going to cost me? What is the impact on me?"

And if you are saying that they really think about their taxes and itemizing the deduction, I think you are absolutely wrong. My dad, my best friend, some of my best supporters, they are all realtors, and I love you guys. But I think you are wrong on this one because that is not what people are thinking about.

Mr. BROWN. And I strongly disagree with you, because I think that is what—that is exactly what many people are thinking about. If those incentives are taken away, why buy a house? Why not just rent?

Chairman DUFFY. Because you own your house. It is an equity builder. And it is like yours. That is great.

I mean, I love Mr. DeWitt, but people want to go and rent or they want to go buy? I want to buy a house, and I want Mr. Howard to build it for me, because it is mine. I don't do it for taxes.

And I am way over my time. But I think we can't—we have to be honest about this conversation.

Mr. BROWN. I am being honest.

Chairman DUFFY. And, again, I come at this with a pure heart, and I love you guys, but I think on this issue you are playing a set of cards that I don't think benefit most Americans. Maybe the industry, but not most Americans.

My time is up by 2 minutes.

Mr. BROWN. Mr. Duffy.

Chairman DUFFY. I am going to give it to Mr. Cleaver.

Mr. BROWN. Chairman Duffy, can I say one more thing?

Chairman DUFFY. My time has expired. The Ranking Member, Mr. Cleaver, is recognized for 5 minutes.

Mr. BROWN. Can I say just one more thing, Chairman?

Mr. CLEAVER. Take 45 seconds to finish your response.

Mr. BROWN. What I was going to say is that, don't forget the impact that home ownership has on the economy. If you take real estate and all the ancillary services and businesses that are involved in real estate, the construction and so forth, multifamily, it is a huge part of the economy. It is perhaps 16, 17, 18 percent. In some States, like California, it is even higher. It is closer to 20 percent.

Tinkering around with tax laws could jeopardize that. That, in and of itself, could push us back into recession. Some economists feel it could push us back into recession.

So I am just saying, be careful what you wish for in terms of changes with the tax law. We don't want to do anything that is

going to negatively impact the housing market and home ownership.

Mr. CLEAVER. Mr. Goodwin, are you—are any of you—concerned that next year the capital buffer will drop to zero? Does that cause any of you to tremble a bit?

Mr. GOODWIN. Speaking for membership, we really don't have an opinion on whether there is—money is—a small amount of capital is set aside to GSEs or if they draw on the Treasury line. I think the only concern that we would have is that to the extent that that then leads to a recapitalization and relief, our concern is the absence of the guarantee under that scenario would cause the markets some serious concern.

Mr. CLEAVER. Yes, Mr. Stevens.

Mr. STEVENS. Congressman, what concerns us about the dialog on capital is it takes our focus off reform. These two entities have been in conservatorship for 9 years. They have a line of credit in excess of \$260 billion. If you talk to investors globally, they have no concern about this capital question. They have full faith that the MBS, that these institutions put into the market, are backed by the extensive line of credit.

And our goal is to have Congress work on the real job of GSE reform. And our worry, quite frankly, is if there is something arbitrarily done on retention of capital, that that could cause even more consternation in the political arena that could cause even greater damage.

So again, our goal is not to talk about capital because it is not an issue when they have \$260 billion-plus and a lot of credit protecting them today.

Mr. CLEAVER. All right. Because time is running, I may have to move around a bit.

And to Ms. Edelman, you are familiar with 202 and 232 HUD?

Ms. EDELMAN. Uh-huh.

Mr. CLEAVER. You know, we have this affordable housing issue. What do we need to do with the 202 project—I mean, why do you think we are not doing more 202 projects? Is it we don't have enough Federal money going into it, we are not able to get adequate rental payments from the seniors?

Ms. EDELMAN. Ranking Member Cleaver, I would love to think about this more and get you a more robust response. But in the short term, I will say that one thing that—the budget proposal, the President's budget proposal, for instance, would be very bad for the 202 program.

And I think that as Congress moves toward a budget in the coming—before the end of the year, or another CR, that the 202 program be prioritized because we don't want to go further backward. But I will get you a more robust response on how to improve it.

Mr. CLEAVER. And 232. One final question. I am preoccupied with multifamily housing. Put on your creative hats right now. What can we do, either in terms of Federal participation, trying to put some kind of attraction so that we can get public-private participation? Do any of you have any ideas on what we can do to trigger some affordable housing projects, affordable housing projects all over the country?

Mr. DEWITT. If I might, Ranking Member Cleaver.

So the National Multifamily Housing Council is strongly in favor of almost anything that we could do to enhance the supply of affordable housing. And we recognize that the cost to develop new affordable housing and the State and local impediments to being able to develop affordable housing make it very difficult to do so.

We do have, obviously, scarce Federal resources, and how we deploy those scarce Federal resources most efficiently to create more housing, affordable housing. Two ways that we currently have, one, obviously the LIHTC program. So to the extent—and I know that NMHC has advocated for additional funds to flow through the LIHTC program, in fact, to expand that to a MIHTC program for middle-income tax credits.

But to get the credit to the builders who have found land and found a community that is willing to accept affordable or middle income housing would be a terrific start.

On the rent side, of course, we have Section 8, which can be used to subsidize the income levels of people who can find housing in other neighborhoods.

But I would say utilizing the two avenues that we currently have and just expand them makes the most amount of sense to us.

Mr. HOWARD. Mr. Cleaver, the Low Income Housing Tax Credit Program is the subject of a bill introduced by Mr. Tiberi, which would make several changes to it to make it more efficient. That is one way to go.

Another thing to be aware of is that the recently proposed tax bill also does away with a State's ability to issue private activity bonds for housing. Those bonds are very important because they are generally combined with the Low Income Housing Tax Credit Program to produce affordable rental housing.

Chairman DUFFY. The gentleman's time has expired.

The Chair now recognizes the gentleman from Texas, Mr. Green, for 5 minutes. And I will just note that we have 7 minutes on the clock to vote.

Mr. GREEN. Thank you, Mr. Chairman. I will speak quickly.

Let me go back to you, Mr. Howard. You had something that you wanted to say about the tax credit?

Mr. HOWARD. Yes, sir. Going back to the question of home ownership, we disagree with our friends the realtors on whether the standard deduction should be raised. We think it should be raised. We think putting money into the pockets of the American people is a good thing.

What we proposed is a revenue-neutral—revenue-neutral by tax standards—tax credit to be taken in addition to the standard deduction to promote home ownership. If the value of upper-income housing is being diminished by changes in the Tax Code, one way to stop a housing recession from coming is to put money in the pockets of the American middle class so that they push the value up from the bottom, from the entry-level rung up.

We proposed that credit to the House Ways and Means Committee and we are proposing it to the leadership. And I look forward to the opportunity to explain it to all of you gentleman as well.

Mr. GREEN. Well, just remember that I support the home builders. And nobody can accuse me of favoring you because you support me.

So now let's talk about what I think is important here, this is the home mortgage deduction. I said at the genesis of my commentary that I am afraid we are going to lose it. And, Mr. Howard, you indicated that before 1986 it was unlimited. Now it is a million dollars. If we pass this bill, it will be \$500,000.

Where does the decline end, is the question.

Mr. HOWARD. Mr. Green, I agree with you that the tax bill—

Mr. GREEN. Just saying you agree with me is enough for me.

Now let's go on to Mr. Brown. Mr. Brown, you sell property. Where are you located currently?

Mr. BROWN. Oakland, California.

Mr. GREEN. In Oakland, California, a \$500,000 house, is that a mansion?

Mr. BROWN. No.

Mr. GREEN. Tell us, generally speaking, what you can get for about \$500,000.

Mr. BROWN. I really don't know what you can get for \$500,000. You can get a starter home in probably a less desirable area. A lot of people would not want to live in some of the areas where you can buy a \$500,000 home. I mean, our median price in the East Bay is \$868,000-some-odd thousand dollars, I believe.

Mr. GREEN. Well, for the record, I am trying to protect the home mortgage interest deduction. I want to maintain it. And to maintain it, I am afraid we cannot continue to diminish it. At some point, it will go to zero.

And by the way, for edification purposes, when we started this debate, there were my friends across the aisle who wanted to eliminate it completely. So somewhere along the way, they have made a compromise at \$500,000.

I am not a part of the compromise because I see that as the next step in the elimination of it. Nothing to do with millionaires. Everything to do with hardworking Americans who don't have the benefit of all of these lawyers to help them so that they can have a deduction that will be a benefit to them.

And finally this, on the H.R. 123, the bill that I called to your attention. I am honored to know that Mr. Duffy has worked on a similar bill. And I would love to work with him and anyone else so that we can try to get this done so that persons who pay all of their bills can have this additional credit scoring.

And finally this. My heart is pure. And you are right. My heart is pure, too. So thank you very much.

And I will give you back a minute and 15 seconds, Mr. Duffy. I will yield to you, Mr. Duffy. I think after having said my heart is pure, I will yield you the rest of the time.

Chairman DUFFY. I appreciate the gentleman with the pure heart yielding.

Anyone else want to respond to it? My time was up and I shut you all down. So if you want to respond to what I was saying.

Or, Mr. Stevens, you have your hand up.

Mr. STEVENS. Yes. Actually, MBA and our membership, which has a Tax Policy Committee, is open-minded to and looks forward

to working on tax reform, because we agree with you it is complex. And there are benefits to MID (mortgage interest reduction), but for entry-level home buyers, many of them don't itemize. So are there better solutions? The tax credit concept suggested by the Home Builders is something that goes along those lines.

As we analyze the initial—the proposed tax legislation, it is the combination of factors that ultimately is something that we are looking closely at. It is the impact to capital gains, it is the cap on property tax deductions, and it is the MID deduction, the collective potential impact to real estate. We are not going to be dogmatic on the issue. We just want to make certain that we don't create a disincentive for real estate that ultimately—

Chairman DUFFY. If I can reclaim the gentleman's time.

What is unique is we can fight about a lot of stuff, but we agree that home ownership is a good thing. We want to make sure that people can afford a house, they can get a loan when they have the right credit, that the realtors and the home builders and the mortgagers, I mean, this is a good American issue. And I think we just have to think through it as a group of folks who care about it, are in the policy weeds on this stuff.

And so I appreciate the gentleman from Texas yielding to me.

I want to thank our witnesses for their testimony today. And what I would just ask all of you, as this committee is working through these issues, we look for your partnership and your insight and your expertise to make sure we get this right and, again, do what is best for the homeowner as we go through this process.

And so with that, without objection, all members will have 5 legislative days within which to submit additional written questions to the Chair, which will be forwarded to our great panel of witnesses.

I would ask the witnesses to please respond as promptly as possible should we have questions that are submitted to you.

And with that, and without objection, this hearing is now adjourned with 1 minute on the clock for votes.

[Whereupon, at 5 p.m., the subcommittee was adjourned.]



# **A P P E N D I X**

November 2, 2017



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**STATEMENT OF THE**

**NATIONAL ASSOCIATION OF REALTORS®**

**SUBMITTED FOR THE RECORD TO THE**

**THE UNITED STATES HOUSE FINANCIAL SERVICES**

**SUBCOMMITTEE ON HOUSING & INSURANCE**

**HEARING TITLED**

**“SUSTAINABLE HOUSING FINANCE: PRIVATE SECTOR**

**PERSPECTIVES ON HOUSING FINANCE REFORM, PART II”**

**NOVEMBER 2, 2017**

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### Introduction

Chairman Duffy, Ranking Member Cleaver and members of the Subcommittee; my name is Kevin Brown. I am the broker of Better Homes Realty, Rockridge. I have over 39 years of experience servicing the cities of Oakland, Berkeley, Albany, El Cerrito, and Sacramento in California, and the city of Portland in Oregon. I am currently the Chairman of the National Association of REALTORS® (NAR) Conventional Financing and Policy Committee and served as the President of the California Association of REALTORS® in 2014.

I am here to testify on behalf of the nearly 1.3 million members of NAR, who thank you for the opportunity to present our views on “Sustainable Housing Finance: Private Sector Perspectives on Housing Finance Reform, Part II.”

### REALTORS® Perspective

While the housing industry has generally improved since the financial crisis, REALTORS® recognize that the current conservatorship of Fannie Mae and Freddie Mac (Enterprises) is unsustainable. REALTORS® also strongly believe that policymakers need to address the mounting risks and challenges facing the secondary mortgage market and overall housing market which could have a severe impact on taxpayers and American households’ ability to access affordable mortgage credit.

The main risks to the housing industry include, but are not limited to, inadequate housing inventory, low levels of single-family construction, rising interest rates, declining affordability, tight mortgage credit conditions, stagnate job and wage growth, increased student loan debt levels, and low levels of home purchases by the Millennial generation.

These risks are accompanied by the substantial challenges facing the secondary mortgage market. These include declining capital reserves at the Enterprises, volatile profits at the Enterprises, the need for a steady flow of capital, standardization of mortgage-backed securities (MBS), liquidity over the economic cycle, limited private label securities (PLS) participation, narrow participation in credit risk transfers (CRTs) or equity capital, and the impact of the Federal Reserve’s wind down of its reinvestment position and long-term decline in demand for Agency MBS.

In order to minimize the effects of these threats, NAR urges Congress to enact comprehensive housing finance reform legislation. As part of comprehensive reform of the secondary mortgage market, NAR urges policymakers to prioritize the establishment of capital reserves to prevent disruptions from losses during market fluctuations and economic downturns until comprehensive reform is completed.

### Protect & Preserve FHA

In addition to the important role that the Enterprises play, NAR believes that the Federal Housing Administration (FHA) is a critical component of our nation’s housing finance system. The Great Recession demonstrated the significant counter cyclical role of FHA. Mark Zandi of Moody’s

Analytics reported that “if FHA lending had not expanded after private mortgage lending collapsed, the housing market would have cratered, taking the economy with it.”<sup>1</sup> Moody’s has estimated that without FHA, housing prices would have dropped an additional 25 percent, and American families would have lost more than \$3 trillion of home wealth. The Enterprises benefited from the symbiotic relationship with the FHA, as the FHA helped stabilize home prices as private capital fled the market. As President Trump’s nominee to lead the FHA, Brian Montgomery said in his testimony before the U.S. Senate Banking Committee: “FHA played no role in the housing boom or collapse, but it was FHA that stepped in and provided more than \$1 trillion in mortgage liquidity that helped more than 8 million families purchase or retain their homes between 2008 and 2012.”<sup>2</sup>

Proposals that would limit eligible borrowers, increase premiums, or reduce the loan limits will disenfranchise millions of qualified families from purchasing a home, with equally significant ramifications for local communities. Converting to a partial guarantee could make credit less available and more costly, as found by a recent CBO study. That same study illustrated that lowering the loan limits could hurt the taxpayers, because it would “exclude many low risk, high income borrowers” from the Mutual Mortgage Insurance Fund (MMIF).<sup>3</sup> It would also unfairly penalize those American who happen to live in high cost areas. Narrowing the eligibility of FHA to first time homebuyers or those below a certain income would also affect the MMIF. Repeat buyers are generally lower risk, as are higher income borrowers. Eliminating those borrowers from the pool would add risk to the MMIF.

NAR believes that small reforms can protect taxpayers and retain access to affordable, safe credit for American families. Separating the FHA Home Equity Conversion Mortgage (HECM) program from the MMIF would give Congress a more accurate picture of FHA’s financial state, which has continued to be strong following the aftermath of the housing crisis. NAR also supports allowing FHA to utilize their own receipts to upgrade their technology. Many HUD systems continue to operate on obsolete hardware and software. Nominee Montgomery said that improving technology would be his highest priority for FHA, and that “doing so will help reduce the financial risk to taxpayers and ensure that FHA can operate on a stable platform for years to come.”<sup>4</sup>

The only way that FHA can be available to play its counter-cyclical role, is for it to be available to all qualified buyers in all markets at all times. Any policy changes that diminish that ability could have dire consequences for our nation when the next economic crisis hits.

<sup>1</sup> Zandi, Mark, Obama Policies Ended Housing Free Fall, *The Washington Post*, September 28, 2012.

<sup>2</sup> Testimony of Brian D. Montgomery, Nominee, HUD Assistant Secretary for Housing-Federal Housing Commission, Senate Committee on Banking, Housing, and Urban Affairs, Thursday, October 26, 2017, [https://www.banking.senate.gov/public/?a=Files.Serve&File\\_id=F3169219-FF5B-45D0-9FD2-9D6A80C74502](https://www.banking.senate.gov/public/?a=Files.Serve&File_id=F3169219-FF5B-45D0-9FD2-9D6A80C74502).

<sup>3</sup> Congressional Budget Office, *Options to Manage FHA’s Exposure to Risk From Guaranteeing Single-Family Mortgages*, September 2017.

<sup>4</sup> Ibid.

### NAR's Comprehensive Housing Finance Reform Recommendation

There were two primary issues that REALTORS® believe must be addressed if the U.S. housing finance sector is to improve. First, REALTORS® want to ensure that in all markets affordable mortgage capital will always remain available for creditworthy Americans. Second, REALTORS® believe that taxpayer dollars should be protected. These are the driving forces behind our organization's updated housing finance reform principles (see Appendix A) which are the drivers behind the recommendations that the Association puts forward today.

In order to ensure a steady flow of capital into the mortgage market in both good times and bad, NAR believes the Enterprises should be converted into **government-chartered, non-shareholder owned authorities that are subject to tighter regulations on products, profitability, and minimal retained portfolio practices in a way that ensures the protection of taxpayer monies.**

The new government-chartered non-shareholder owned authorities must ensure that there is liquidity in the marketplace for those standard mortgage products (e.g. long-term fixed-rate mortgages along with traditional adjustable rate mortgages with reasonable annual and lifetime caps) that are the foundation of our housing finance market. Additionally, the establishment of no less than two authorities will create the competition needed to continue to foster innovative mortgage products that can expand consumer choice for safe and reliable mortgages. With the new authorities offering standard and innovative products, private capital will be free to compete and pursue opportunities to offer products in addition to those offered by the new authorities. With the full recovery of the market, the conversion of the Enterprises into these new authorities, and a return of private capital, the nation will see the appropriate balance of government, government-hybrid, and private activity in the secondary mortgage market.

#### Key Elements of NAR's Recommendation

REALTORS® believe that any entity with private profits that is implicitly backed by public losses, as the Enterprises were structured before conservatorship, is flawed and problematic. NAR proposes a structure that is not driven by shareholders' desire to maximize profits. Instead, the authorities' mission is clarified and their federal backing is made explicit.

NAR believes a "government-chartered" structure with clearly defined roles and enhanced safeguards is the best model for the new authorities because this structure establishes a separate legal identity from the federal government, while serving a public purpose (e.g. the Export-Import Bank of the United States). Unlike a federal agency, government-chartered organizations are established to be politically independent and often are self-sustaining—not requiring appropriations from Congress. The ability of the authorities to focus on their mission (providing affordable liquidity to the housing market), without the need to chase risky profit-driven opportunities, is an important criteria for REALTORS®.

Moreover, a government-chartered authority should remove any ambiguity regarding the government's backing of these secondary market authorities. REALTORS® believe that explicit government backing of new authorities is required in order to instill confidence in potential investors of the authorities' mortgage-backed securities (MBS). Without the confidence of these investors, the ability of the authorities to raise capital for the purpose of providing liquidity to the secondary mortgage market will be limited.

However, REALTORS® also believe that the authorities should not be operated as if the government/taxpayers are in the first loss position. The authorities should be self-sufficient (need no appropriations) and price risk effectively to cover potential losses. Most importantly, the new authorities must utilize any profits to establish capital reserves to alleviate losses that occur during market fluctuations and economic downturns.

Lastly, REALTORS® believe that the conversion of the existing government-sponsored enterprises (Fannie Mae and Freddie Mac) into government-chartered authorities will pose the least amount of market disruption, and ensure a continuous flow of capital to the secondary mortgage market during the transition period. Because of their existing capabilities and infrastructure, the current Enterprises are best positioned to be government-chartered authorities. With this in mind, REALTORS® also suggest that the new authorities import the best components from the current Enterprises such as their ability to create MBS and their automated underwriting systems.

#### Why not Full Privatization or Nationalization?

##### *Privatization*

NAR considered a number of different models for the future structure of the Enterprises. Our members first considered fully private and fully federal systems. REALTORS® believe that neither would effectively solve the two issues deemed necessary to address the challenge of restructuring the secondary mortgage market.

REALTORS® believe that full privatization, even a private utility, is not the most effective option for the secondary market because a private firm's business strategy will inevitably focus on optimizing its revenue/profit generation or dividend distribution. This model would foster mortgage products that are more in line with the business's goals (e.g. higher profits and inconsistent risk-taking) than in the best interest of the nation's housing policy, the economy, or consumers. The situation would likely lead to a decline in access to long-term, fixed-rate mortgage products like the 30-year fixed-rate mortgage, an increase in the costs of these products to consumers, or both. Or worse, the market could experience a surge in risk taking by private players akin to 2001 through 2006.

Additionally, there is no evidence that a long-term fixed-rate residential mortgage loan would ever arise spontaneously without a strong federal backstop. Some other developed countries have encouraged the use of fully amortized long-term fixed-rate loans. However, in all instances save for

Denmark, loans typically have adjustable rates and reset frequently. The United States is unique in supporting a residential mortgage that is long-term, amortizing, fixed-rate and pre-payable. Americans have come to view this product as critical to sustainable ownership and a hedge against unforeseen life events. Lastly, it is important to note that in early 2000, when former Federal Reserve Chairman, Alan Greenspan, hinted at its abandonment, the public outcry was such that he quickly abandoned that position.

Second, the size of the U.S. residential mortgage market must be considered. Currently, the U.S. residential mortgage market stands at \$9.8 trillion, with the Enterprises owning or guaranteeing \$4.8 trillion of mortgage debt outstanding and providing capital that supports roughly 47 percent of new first-lien mortgage originations. REALTORS® believe that it is extremely unlikely that enough purely private capital could be attracted to support existing mortgage funding and continue to make mortgage lending available in all types of markets.

Finally, REALTORS® fear that in times of economic upheaval, a fully private secondary mortgage market will severely contract. This contraction occurred during the financial crisis in the markets for private label securities (PLS), commercial mortgages, and manufactured housing mortgages. When the economy turns down, private capital rightfully flees the marketplace. Should that happen in the residential mortgage market, the results for the entire economy would be catastrophic.

#### *Nationalization*

In contrast to privatization, full nationalization places the government/taxpayer in the first loss position should the housing market turn down and these institutions run into financial trouble. A priority of NAR is to reduce the taxpayer exposure to losses of these authorities. Converting the Enterprises to federal agencies, or merging them with the FHA, conflicts with this goal of REALTORS®.

Moreover, nationalization would yield a number of undesirable consequences. First, establishing one public secondary mortgage market entity may remove competition and incentives for innovation in the secondary mortgage market. Though REALTORS® favor more vigorous regulation of the products that the new authorities will purchase, they also recognize that innovation is required in order to foster more efficient and less costly products for consumers.

In addition, a single entity that dominates the secondary mortgage market could lose focus on specific housing missions. For example, an entity that combines the FHA with the Enterprises could lose focus on either low- and moderate-income housing mission or ensuring that the middle market has access to affordable mortgage capital.

#### Protecting Excess Revenue

REALTORS® believe that it is prudent to have the new authorities invest excess revenue earned in strong markets into a capital reserve fund so that they can pursue countercyclical activities in weaker

markets, as well as store capital to prevent the need for taxpayer funds during economic downturns. Again, a primary goal of NAR is to ensure that the government and taxpayers are not immediately on the hook even if a serious downturn occurs.

#### Utilization of Retained Portfolio

NAR believes that the authorities should maintain a portfolio for the purpose of funding their daily operations to use in a countercyclical fashion when the market turns down and private capital inevitably leaves the market place. It could also be used to test innovative products and house mortgages on products that are not easily securitized (e.g. multi-family housing loans and rural mortgages). The use of the portfolio will ensure that there is a continual flow of capital into the secondary mortgage market during downturns thus preventing a crisis within the housing market, as well as provide much needed capital to those portions of the housing market that don't traditionally have access to large amounts of private capital.

REALTORS® do not recommend a specific size for the portfolio. They do believe that the portfolio should be large enough to support the authorities' business needs, the products that lack private capital, and when necessary ensure a stable supply of capital consistent with market conditions. REALTORS® insist that the portfolio size should not be driven by profit motives.

#### Increased Sustainable Homeownership & Assumability

As first-time homebuyers continue to sit on the sideline and the housing market experiences inconsistent growth, NAR believes that the authorities should focus their mission on encouraging increased sustainable homeownership by providing safe and affordable mortgage financing and refinancing, especially if lenders, capital sources and other mortgage product providers benefit from an explicit government guarantee.

Moreover, NAR believes that any new secondary mortgage market must allow for mortgages that are syndicated through explicitly government-guaranteed MBS to be assumable. REALTORS® believe that when interest rates rise, especially in high cost areas, the ability to assume a lower-rate mortgage on a property may become the most affordable source of financing for a qualified buyer.

#### **Addressing the Enterprises' Declining Capital Reserves**

Under the terms of their agreements with the U.S. Treasury, the Enterprises' capital reserves will decline to zero by January 1, 2018. NAR believes that, as Congress contemplates reforming the secondary mortgage market, the amount of capital reserves needed in the system will be an important question that will not only have immediate implications for taxpayers but ultimately Americans' access to credit and homeownership.

While there is less concern that a draw on the Enterprises' line of credit at the U.S. Treasury due to accounting rules would disrupt mortgage markets, it is important to have a buffer between any losses and the taxpayer. This is especially the case if comprehensive housing finance reform

legislation has not yet been adopted. It makes sense to build that buffer now while the Enterprises have positive cash flows.

To address this concern, a prudent intermediate step would be to establish a Mortgage Market Liquidity Fund (MMLF) through legislation or under existing regulatory authority. A portion of the Enterprises' profits could be deposited into the fund, controlled by the Federal Housing Finance Agency (FHFA) Director, which would cover future losses due to market fluctuation as described above. The FHFA Director could release funds from this account to buffer against further U.S. Treasury involvement. As a result, some capital will be in place to avoid significant market disruptions and to continue to ensure that Americans have access to affordable mortgages.

The MMLF would protect taxpayers by reducing the need for the Enterprises to draw additional funding from the U.S. Treasury. Finally, the fund would provide Congress the necessary time to enact comprehensive housing finance reform.

### **Conclusion**

The stakes have never been higher for the housing market and the broader economy. Yet, there are sizeable challenges and risks associated with the ongoing conservatorships of the Enterprises. Comprehensive housing finance reform enacted by Congress will help address many of these issues. However, any misstep in the implementation of a new housing finance system could cause serious harm to our housing market and economy. In the balance hang many potential homebuyers with the desire and ability to purchase a home. Any disruption to the housing finance system could injure these aspiring new homeowners, as well as existing homeowners.

REALTORS® support a secondary mortgage market model that includes an explicit government guarantee. That guarantee protects the taxpayer while ensuring that all creditworthy consumers have reasonable access to affordable mortgage capital so that they too can attain the American Dream – homeownership. REALTORS® recognize that this is an extensive and important conversation regarding how we mend, and improve, a housing finance system that has served us well for many years.

Furthermore, if Congress is unable to enact reasonable and comprehensive housing finance reform in the near term, NAR strongly urges policymakers to consider addressing the declining capital reserves at the Enterprises through the creation of a MMLF. This will ensure hardworking Americans have continued access to affordable mortgage credit while protecting taxpayers from unnecessary threats.

NAR's recommendations 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.

## Appendix A

Updated: May 2017

### NAR Principles for Housing Finance Reform

NAR supports restructuring the secondary mortgage market to ensure a reliable and affordable source of mortgage capital for consumers, in all types of markets, to avoid a major disruption to the nation's economy that would result from the total collapse of the housing finance sector. Restructuring is required in response to the failure of Fannie Mae and Freddie Mac, which has been under government control since entering conservatorship in September 2008.

- **An efficient and adequately regulated secondary market is essential to providing affordable mortgages to consumers.** The secondary market, where mortgages are securitized, 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, a poorly functioning secondary market will impede both recovery in housing sector and the overall economy.
- **The old GSE system with private profits and taxpayer loss must be replaced.** The current GSEs (Fannie Mae and Freddie Mac) should be replaced with government-chartered, non-shareholder owned authorities 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 to support long-term mortgage financing and protect the taxpayer.
- **Reforms should ensure a strong, efficient financing environment for homeownership and rental housing.** The mission of the new authorities must include increasing sustainable homeownership, providing access to mortgage financing and refinancing for consumers who have demonstrated the ability to sustain homeownership. Creditworthy consumers require a steady flow of mortgage funding that, even during economic downturns, will continue to be available as insured by an explicit government guarantee.
- **The government must clearly, and explicitly, offer a guarantee of mortgage instruments facilitated by the authorities that meet the Qualified Mortgage (QM) standards.** This is essential to ensure qualified, creditworthy borrowers have access to affordable mortgage credit. Without government backing, consumers will pay much higher mortgage interest rates and mortgages may at times not be readily available at all-as happened in jumbo and commercial real estate loans. Taxpayer risk would be mitigated through the use of mortgage insurance on loan products with a loan-to-value ratio higher than 80 percent, or through other fees paid to the government.
- **The new authorities should guarantee or insure a wide range of safe, reliable mortgage products.** These mortgage products include 15-year and 30-year fixed rate loans, traditional adjustable-rate mortgages (ARMs), and other products that have stood the test of time and for which American homeowners have demonstrated a strong "ability to repay."
- **Provide a self-sufficient mechanism whereby safe, sound, transparent, and insured Mortgage Backed Securities (MBS) may be packaged and sold.** There must be an option for an explicit government guarantee or insurance for all offered MBS within the secondary mortgage market. The creation of a not-for-profit "utility" facility is needed to receive, package, sell and guarantee MBS.



The authorities should operate with similar insurance and enforcement components as the FDIC. This option must minimize taxpayer exposure.

- **Sound and sensible underwriting standards must be established.** Establish standardized, sound underwriting principles and products that provide the foundation for responsible, credit worthy borrowers to be able to achieve homeownership goals. For additional safety, these standards must also be applied to securities (MBSs), purchased for portfolio (to a limited extent).
- **The authorities should price loan products or guarantees based on risk.** In addition, the new authorities must set standards for the MBS they guarantee that establish transparency and verifiability for loans within the MBSs.
- **Ensure solid, verifiable, current loan level data is available to investors that empowers and enables them to conduct their own risk analysis.** There is a strong consensus among multiple market participants that solid loan level data is the essential foundation from which to rebuild the private mortgage security industry. Investors want to be empowered and enabled to conduct their own analysis. With properly structured loan level data the mortgage collateral supporting a regulated, securitized instrument will lead to a verifiable, current predictable instrument of cash flow and thus will attracting private capital.
- **The reformed authorities must have a separate legal identity from the federal government but serve a public purpose.** Unlike a federal agency, the authorities will have considerable political independence and be self-sustaining given the appropriate structure.
- **The GSEs should remain politically independent.** Political independence of the authorities is mandatory for successful operation. CEOs should have fixed terms so they cannot be fired without cause, and they should not be allowed to lobby. Additionally, the authorities should be self-funded instead of receiving ongoing appropriations.
- **There must be strong oversight of the authorities.** The new authorities should be overseen by the Federal Housing Finance Agency (FHFA) or a successor agency that would make timely reports to allow for continual evaluation of the authorities' performance.
- **Restore investor confidence and trust in the Representations and Warranties via the standardization of pooling and servicing contracts.** Standardization of Representations and Warranties is imperative. Pooling and Servicing Agreements (PSAs) must be simple with clear terms and definitions so they are easily understood by investors. They must have clear disclosures of any deviations from "Federal Best Practice Standards", clearly define "buy back" rules, and servicer operational policies must be consistent with their fiduciary duties to the investor.
- **The new system must allow for mortgages that are syndicated through explicitly government guaranteed mortgage-backed securities (MBS) to be assumable.** When interest rates rise, especially in high cost areas, the availability of an assumable low rate mortgage on a property may become the most affordable source of financing for a qualified assuming buyer.



TESTIMONY BY  
ROBERT E. DEWITT  
VICE CHAIRMAN, PRESIDENT & CHIEF EXECUTIVE OFFICER  
GID INVESTMENT ADVISERS (“GID”)

ON BEHALF OF THE  
NATIONAL MULTIFAMILY HOUSING COUNCIL  
AND THE  
NATIONAL APARTMENT ASSOCIATION

BEFORE THE  
HOUSE COMMITTEE ON FINANCIAL SERVICES  
HOUSING AND INSURANCE SUBCOMMITTEE

FOR A HEARING ENTITLED  
SUSTAINABLE HOUSING FINANCE: PRIVATE SECTOR PERSPECTIVES ON HOUSING  
FINANCE REFORM, PART II

NOVEMBER 2, 2017

Chairman Duffy, Ranking Member Cleaver, esteemed members of the Subcommittee, it is my privilege to appear before you today to speak on behalf of the multifamily industry, the National Multifamily Housing Council, and the National Apartment Association regarding housing finance for apartment communities. My name is Bob DeWitt, and I am the President and CEO of GID Investment Advisers. Founded in 1960, we are a privately-held, vertically-integrated, diversified real estate operating company that develops, owns and manages a portfolio of existing and under-development properties valued in excess of \$13 billion. We have offices in Boston, New York, San Francisco, Washington, Atlanta, Denver and Orange County. GID owns and manages 110 properties in 16 states and employs over 650 real estate professionals.

For more than 25 years, the National Multifamily Housing Council (NMHC) and the National Apartment Association (NAA) have partnered to provide a single voice for America's apartment industry. Our combined memberships are engaged in all aspects of the apartment industry, including ownership, development, management and finance. NMHC represents the principal officers of the apartment industry's largest and most prominent firms. As a federation of more than 160 state and local affiliates, NAA encompasses over 73,000 members representing nearly 9 million apartment homes globally.

I appreciate the opportunity to be here today to present the multifamily industry's perspective on the role of the Government Sponsored Enterprises (Enterprises), Fannie Mae, Freddie Mac, and the Federal Housing Administration (FHA) and specifically how the meaningful differences between the multifamily market and single-family market require very different solutions in the context of housing finance reform. I will also discuss why we believe there will be a continued need for federal involvement in the multifamily sector in a reformed housing finance structure.

Before I do that, however, allow me to describe some key aspects of the apartment market and how changing demographics will demand a continued flow of capital into this sector if we are to meet the nation's current and future housing needs.

The apartment sector is a competitive and robust industry that helps nearly 39 million people live in homes that are right for them. We help build vibrant communities by offering housing choice, supporting local small businesses, creating millions of jobs and contributing to the fabric of communities across the country. And we are an increasingly important sector in the housing industry.

### **State of the Multifamily Market**

We are experiencing fundamental shifts in our housing dynamics, as more people are moving away from buying houses and choosing to rent apartments. More than one in three

Americans rent, and 19 million of those households are building their lives in apartments<sup>1</sup>. In the past five years, an average of 600,000 new renter households was formed every year. This increased apartment demand creates a critical need for 4.6 million new apartments at all price points by 2030 according to a new study conducted by Hoyt Advisory Services and commissioned by the National Multifamily Housing Council (NMHC) and the National Apartment Association (NAA)<sup>2</sup>. To meet that demand, we will need to build an average of at least 325,000 new apartments every year; yet, on average, just 244,000 apartments were delivered from 2012 through 2016<sup>3</sup>.

The apartment industry is a capital-intensive industry. Capital sustains and grows the multifamily industry; therefore, it is critical to get housing finance reform right to provide consistent access to capital across geographies, markets, and product types if we are to meet the current and future demand for rental housing in America.

### **Rental Housing – The Supply-Demand Imbalance**

Housing affordability is a significant challenge facing many Americans today who are seeking to rent an apartment. The number of households renting their homes stands at an all-time high, thus placing significant pressure on the apartment industry to meet the demand. This is making it challenging for millions of families nationwide to find quality rental housing that is affordable at their income level. For many families, the shortage of rental housing that is affordable creates significant hurdles that make it even more difficult to pay for basic necessities like food and transportation. Ultimately, this also impacts their future financial success.

This issue is not unique to lower income households and, in fact, is encroaching on the financial wellbeing of households earning up to 120 percent of area median income as this Committee learned in testimony by NMHC and NAA on March 22, 2016. Affordability is an issue impacting the very fabric of communities nationwide, including teachers, firefighters, nurses and police officers.

According to Harvard's Joint Center for Housing Studies<sup>4</sup>, in 2015 more than one in four renter households – approximately 11.1 million – paid more than half of their income for rental housing. Setting aside that real (inflation adjusted) incomes in the U.S. are only slightly above their 2000 levels– clearly the key factor driving the affordability crisis – housing industry leaders agree that promoting construction, preservation and rehabilitation are three of the vital ways to meet the surging demand for apartment homes.

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<sup>1</sup> U.S. Census Bureau, 2016 American Community Survey 1-Year Estimates.

<sup>2</sup> Hoyt Advisory Services; NMHC/NAA

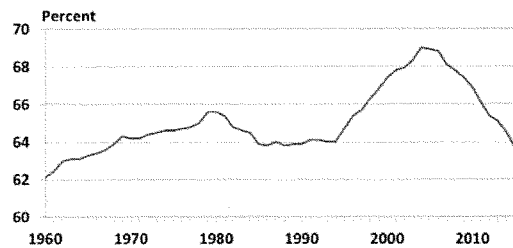
<sup>3</sup> U.S. Census Bureau, New Residential Construction.

<sup>4</sup> Harvard Joint Center for Housing Studies, "The State of the Nation's Housing 2017", Appendix Tables.

### Rental Housing – Changing Housing Dynamics

America is experiencing fundamental shifts in our housing dynamics, as more people are choosing apartments. More than 75 million people between 18 and 34 years old are entering the housing market, primarily as renters. However, renting is not just for the younger generations anymore. Increasingly, Baby Boomers and other empty nesters are trading single-family houses for the convenience of rental apartments. In fact, more than half of the net increase in renter households over the past decade came from the 45-plus demographic cohort<sup>5</sup>.

#### MORE HOUSEHOLDS ARE CHOOSING APARTMENTS



The drop in homeownership rate has increased demand for apartments  
1% decline in homeownership = increase of 1.2 million households renting

Source: Census Bureau.

NMHC NAA

The western U.S. as well as states such as Texas, Florida and North Carolina are expected to have the greatest need for new apartment housing through 2030, although all states will need more apartment housing moving forward. Across all markets, the supply of multifamily housing at a variety of price points will play a role in promoting economic growth, attracting and retaining talent, and encouraging household stability for all American families.

<sup>5</sup> NMHC tabulations of 2016 Current Population Survey, Annual Social & Economic Supplement, U.S. Census Bureau.

There will also be a growing need for renovations and improvements on existing apartment buildings, which will provide a boost in jobs (and the economy) nationwide. Hoyt's research found that 51 percent of the apartment stock was built before 1980, which translates into 11.7 million units that could need rehabilitation or renovation by 2030.

As I have publicly stated previously, the growing demand for apartments – combined with the need to renovate thousands of apartment buildings across the country – will make a significant and positive impact on our nation's economy for years to come. For frame of reference, apartments and their 39 million residents contribute \$1.3 trillion to the national economy annually<sup>6</sup>. As the industry continues to grow, so will this tremendous economic contribution.

While many factors influence the apartment industry's health and ability to meet the nation's growing demand for rental housing, the availability of consistently reliable and competitively priced capital is the most essential.

#### **Multifamily Performance: A Success Story**

September marks nine years since the federal government placed Fannie Mae and Freddie Mac (the Enterprises), critical providers of capital for the housing industry, in conservatorship. Importantly, conservatorship was conceived as a temporary solution, an interim fix to prevent economic Armageddon while a more lasting prescription for the nation's housing finance system could be determined.

The bursting of the single-family housing bubble exposed serious flaws in our nation's housing finance system. Yet, those shortcomings were confined to the single-family residential sector. Unfortunately, the losses experienced in their single-family divisions have overshadowed the strong mortgage financing and credit performance of the multifamily programs. The multifamily programs of the Enterprises were not part of the meltdown, and have generated over \$31 billion in net profits since the two firms were placed into conservatorship<sup>7</sup>. It is important to note that the multifamily divisions' profitability at the Enterprises has not come at the expense of market discipline, quality underwriting, or taxpayer exposure. Since 2008, both Enterprises have sustained industry leading loan performance with delinquencies well below 1 percent through a generationally disruptive market downturn, and this in spite of the fact that the Enterprises did not retreat from the market when nearly all other debt sources exited.

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<sup>6</sup> NMHC and NAA, "The Trillion Dollar Apartment Industry"

<sup>7</sup> Fannie Mae 10-K, Freddie Mac 10-K

Now in the tenth year of conservatorship of the Enterprises, the need to address the current status of conservatorship is vitally important. Today, when reforming a system as complicated as housing finance, policy makers should not ignore the lessons of the crisis. I encourage you to instead begin your efforts with a strong cornerstone. We believe the multifamily system of the Enterprises can, and should, serve as a model for reform, having operated with distinction during the great financial crisis. A reform effort built on this strong foundation will ensure liquidity, stability, and affordability in the housing market—especially for multifamily, which has been a growth engine for the housing market during the economic recovery.

These positive performance metrics are as a result of the GSE multifamily programs' adherence to prudent underwriting standards, sound credit policy, effective third-party assessment procedures, conservative loan portfolio management, and, most importantly, risk-sharing and risk-retention strategies that place private capital at risk ahead of taxpayers.

As originally designed and subsequently proven during the housing crisis, the Enterprises' multifamily programs serve a critical public policy role balanced with excellent loan performance. Even during normal economic times, private capital alone cannot fully meet the industry's financing demands.

#### **Principles of Multifamily Housing Finance Reform**

Many factors influence the apartment industry's health and its ability to meet the nation's growing demand for rental housing, but the availability of consistently reliable and competitively priced capital is absolutely essential.

NMHC and NAA urge the Committee to recognize the unique needs of the multifamily industry. We believe the goals of a reformed housing finance system should be to:

- Maintain an explicit, appropriately priced and paid-for federal guarantee for multifamily-backed mortgage securities available in all markets at all times;
- Recognize the inherent differences of the multifamily business from the single-family business;
- Promote private market competition;
- Protect taxpayers by keeping the concept of the Enterprises' multifamily first-loss risk sharing models;
- Retain the successful components of the existing multifamily programs in whatever succeeds them;
- Avoid market disruptions during the transition to a new finance system.

These core set of principles for housing finance reform provide a solid foundation as the Committee addresses the multifamily industry.

***Maintain an Explicit Federal Guarantee***

Given the market failure of the private sector to meet the apartment industry's broad capital needs, an explicit federal guarantee for multifamily-backed mortgage securities should be available in all markets at all times. A private-only housing finance system would result in an abundance of capital for high-end properties in top-tier markets but leave secondary and tertiary markets like Madison, Wisconsin, or Jefferson City, Missouri, underserved.

Any federal credit facility should be available to the entire apartment sector and not be restricted to specific housing types or renter populations. Moreover, it would be impossible to turn on and off a government-backed facility without seriously jeopardizing capital flows. The benefit of any Federal guarantee should only accrue to the investors of multifamily mortgage-backed securities; it should not apply to the underlying multifamily mortgages or the entities issuing the securities. Borrowers should pay for this credit-enhancement guarantee in the form of an appropriately priced credit enhancement fee that actuarially insures taxpayers against future losses. The pricing of this guarantee should reflect its underlying value to the industry and the risks it presents to the taxpayers. This guarantee is the single most important determinant of liquidity in the marketplace -- without it, liquidity becomes unavailable during recessions and periods of capital markets disruption. The industry can bear the cost paid for this liquidity, but it cannot survive without constant access to liquidity.

Fannie Mae and Freddie Mac have served as the cornerstone of the multifamily housing finance system, successfully attracting private capital to the sector. Unlike any other single source of capital, they offer long-term debt for the entire range of apartment properties (market-rate workforce housing and subsidized properties, large properties, small properties, etc.), and they are active in all markets (primary, secondary and tertiary) during all economic conditions.

When credit markets have been impaired for reasons that have nothing to do with multifamily property operating performance, the federally-backed secondary market has ensured the continued flow of capital to apartments.

For example, when private capital left the housing finance market in 2008, the apartment industry relied almost exclusively on Fannie Mae, Freddie Mac and FHA/Ginnie Mae for capital. Between 2008 and 2010, the GSEs provided \$94 billion in mortgage debt to the apartment industry. Without the critical backstop provided by the Enterprises, thousands of otherwise performing multifamily mortgages would have gone into default because there were no private capital sources willing to refinance maturing loans. This could have meant



disruption to millions of renter households. The GSEs served a similar role during the 1997-1998 Russian financial crisis and in the post-9/11 recession of 2001.

This is pointed out in an effort to highlight how large a chasm private capital would have to fill and to emphasize the public policy mission the existing system has served, ensuring liquidity and avoiding widespread adverse effects for the millions who rent.

#### ***Recognize Differences Between Multifamily and Single-Family Businesses***

A one-size-fits-all solution will not work. The two sectors operate differently, have divergent performance records and require distinct reform solutions. The capital sources for multifamily are not as wide or as deep as those financing single-family, and the loans themselves are not as easily commoditized.

The GSEs' multifamily programs adhere to a business model that includes prudent underwriting standards; sound credit policy; effective third-party assessment procedures; risk-sharing and risk-retention strategies; effective loan portfolio management; and standardized mortgage documentation and execution.

Moreover, the financing process; mortgage instruments; legal framework; loan terms and requirements; origination; secondary market investors; underlying assets; business expertise; and systems are all separate and unique from single-family home mortgage activities.

We strongly recommend that any reform measure include a separate multifamily title. This separate title should not only address the successors to the GSEs' multifamily programs, but also how the transition to that new system will be handled.

#### ***Promote Private Sector Competition***

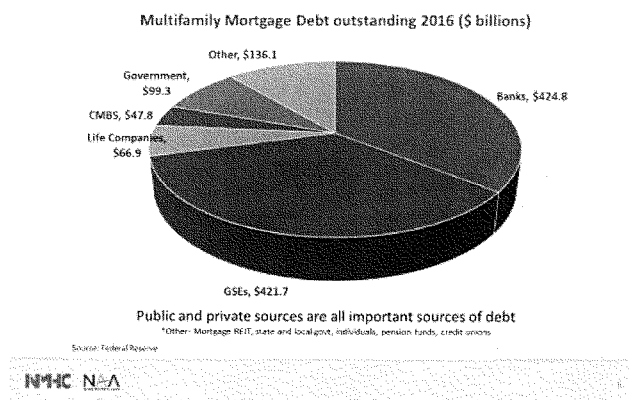
We share the collective desire to have a marketplace where private capital dominates, and that's been the case in the multifamily markets. Private capital has always been an integral part of the multifamily housing finance system. In fact, the apartment industry relies on many private capital sources to meet its financing needs, including banks, life insurance companies, the commercial mortgage-backed securities market, and, to a lesser extent, pension funds and private mortgage companies.

However, even during healthy times, the private market has been unwilling or unable to meet the totality of the rental housing industry's capital needs. For example, banks are limited by capital requirements and have rarely been a source of long-term financing. Life insurance companies typically make up less than 10 percent of the market, lend primarily to newer and high-end properties, and enter and exit the multifamily market based on their investment needs. And a stricter regulatory environment post-financial crisis has kept the

private-label commercial mortgage-backed securities market from returning to previous volumes.

Historically, the apartment industry has relied on a variety of capital sources, each with its own focus, strengths and limitations, to meet its borrowing needs. These capital sources together have provided the apartment sector with debt—reaching as high as \$269 billion in 2016<sup>8</sup>—to develop, refinance, purchase, renovate and preserve apartment properties.

### COMPETITIVE MULTIFAMILY DEBT SOURCES



#### Commercial Banks: Short-Term Financing for Smaller, Local Borrowers

Commercial banks and thrifts generally serve as a source of credit for many borrowers to finance construction, acquisitions and ownership. They typically provide floating rate or short-term fixed rate debt, and often their willingness to extend this credit is based on the availability of permanent take-out financing offered by the GSEs.

The banks currently hold 36 percent (\$424.8 billion) of outstanding multifamily mortgage debt.<sup>9</sup> Between 1990 and 2016, they provided 33 percent (\$297.5 billion) of the total net increase in mortgage debt<sup>10</sup>. They provided limited amounts of capital to the industry during the financial crisis but have taken a much more active role in lending

<sup>8</sup> Mortgage Bankers Association

<sup>9</sup> US. Federal Reserve, "Mortgage Debt Outstanding 4Q2016".

<sup>10</sup> US. Federal Reserve, "Mortgage Debt Outstanding 4Q2016".

since. Banks face constraints on maintaining the recent level of activity due to higher risk-based capital requirements, and new Basel accounting standards, which impose meaningful limits on the ability of banks to provide capital to commercial real estate. During 2016 the multifamily market saw meaningful pullback by depositories, especially in construction lending, due to regulatory and credit concerns.

**Life Insurance Companies: Target High-Quality Properties, Capital Allocations Change with the Market**

Life insurance companies tend to restrict their lending to a handful of primary markets and to high-quality, newer construction apartment properties. They do not generally finance affordable apartments, and their loan terms typically do not extend beyond 10 years. Importantly, they enter and exit the multifamily market based on their investment needs and economic conditions. On average, they generally provide 10 percent or less of the annual capital needed by the multifamily industry, but that number has gone as low as 3 percent. They currently hold 6 percent (\$66.9 billion) of outstanding multifamily mortgage debt. Between 1990 and 2016, they accounted for 4 percent (\$36.1 billion) of the net increase in multifamily mortgage debt.

**FHA\GNMA: Reliable Capital Source but Limited Mortgage Products and Capacity Issues**

Some have suggested that **the Federal Housing Administration (FHA)** could step in and fill the liquidity provided by Fannie Mae and Freddie Mac. This solution is unrealistic. FHA serves a very different market from Fannie Mae and Freddie Mac, focusing on construction lending and affordable rental properties not served by other sources of capital.

FHA offers high-leverage, long-term mortgages with 35-year terms and 80-83 percent loan-to-value ratio for the construction, substantial rehabilitation, acquisition and refinancing of apartments. The loans FHA offers are frequently used for construction lending and the financing of affordable apartments. Ginnie Mae securitizes FHA loans and offers them with a full government guarantee.

After the 2008 financial collapse, they became a vital source of construction capital and permanent financing for apartments, and now FHA/Ginnie Mae currently holds 8 percent (\$99.3 billion) of outstanding multifamily mortgage debt. Between 1990 and 2016, they accounted for 10.0 percent (\$87.2 billion) of the total net increase in mortgage debt.

Capacity issues, long processing times and statutory loan limit requirements prevent FHA from serving a larger share of the multifamily market.

**CMBS/Conduits: Volatile Capital Source**

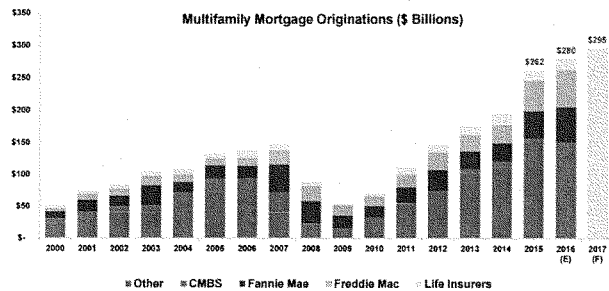
The CMBS market did not become a material source of capital to the apartment industry until the mid-1990s, peaking at 16.5 percent of the market, \$21.4 billion, in the housing bubble year of 2007.

The CMBS market completely shut down after the 2008 crisis. Today, the CMBS market is showing some signs of recovery; however, regulatory changes imposed by financial regulatory reform legislation will mean that it will probably not return to its pre-bubble levels of lending.

The CMBS market now holds 4 percent (\$51.1 billion) of the outstanding multifamily mortgage debt, however, it is no longer a major source of debt for the apartment industry and this share is expected to continue to shrink.

It must be noted that in 2012 the GSEs each produced a report commissioned by the Federal Housing Finance Agency (FHFA) that estimated the potential consequences to the apartment sector of eliminating the federal guarantee<sup>11</sup>. According to that research, which was undertaken by the GSEs and independent third-party experts, interest rates would rise, and debt financing capital would fall by 10 percent to 20 percent. That could result in a 27 percent drop in apartment supply, which could, in turn, cause rising rents to increase nationwide and significant spikes in tertiary geographic markets.

HISTORIC MULTIFAMILY DEBT SOURCES



<sup>11</sup> <https://www.fhfa.gov/PolicyProgramsResearch/Policy/Documents/FNMMF2012ScorecardResponse.pdf>  
[https://www.fhfa.gov/PolicyProgramsResearch/Policy/Documents/FREReport\\_MF\\_MarketAnalysis.pdf](https://www.fhfa.gov/PolicyProgramsResearch/Policy/Documents/FREReport_MF_MarketAnalysis.pdf)

***Protect Taxpayers by Continuing Risk Sharing & Private Capital Participation***

Each Enterprise utilizes its own risk-sharing models that protect it from losses and places private capital sources in the first loss position. These models worked effectively through the economic downturn in protecting taxpayers from footing the bill to pay for credit losses. As further proof of the proper alignment of interest the credit losses experienced by the Enterprises multifamily programs were much less than compared to the losses experienced by the other sources of capital to the multifamily industry.

Not only have the GSEs' multifamily programs operated in a fiscally sound manner, they have done so while offering a full range of mortgage products to meet the unique needs of the multifamily borrower and serve the broad array of property types. This includes conventional market rental housing, workforce rental housing and targeted affordable housing (e.g., project-based Section 8, state and local government subsidized and Low-Income Housing Tax Credit (LIHTC) properties).

In short, the GSEs' multifamily models hit the mark. They have attracted enormous amounts of private capital; helped finance millions of units of market-rate workforce housing without direct federal appropriations; sustained liquidity in all economic climates; and ensured safety and soundness of their loans and securities. As a result of the liquidity provided by the GSEs, the United States has the best and most stable rental housing sector in the world.

***Retain Successful Components of Multifamily Programs in Future System***

The multifamily programs serve as a model for any successor system for housing finance reform. Replacing and starting a new business model for the multifamily businesses would only serve to disrupt the capital flow to the apartment industry. Preservation of the Enterprises technology, processes, and personnel must be a guiding principle as the Committee evaluates a new housing finance system.

***Avoid Market Disruptions During Transition***

To avoid market disruption, it is critical that policymakers clearly define the government's role in a reformed system and the timeline for transition. Without that certainty, private capital providers are likely to limit their exposure to the market, which could cause a serious capital shortfall to rental housing. In addition, as has been the case since the GSEs were placed into conservatorship in 2008, it is vital to continue to retain many of the resources and capacity of the existing Enterprises. The two GSEs have extensive personnel and technological expertise, as well as established third-party relationships with lenders, mortgage servicers, appraisers, engineers and other service providers, which are critical to a well-functioning secondary market.

**Multifamily Federal Housing Administration (FHA) Programs**

FHA Multifamily is best known for offering an alternative source of construction debt to developers that supplements bank and other private construction capital sources. It also serves borrowers with long-term investment goals to serve low and middle-income families as the only capital provider to offer 35-40-year loan terms. FHA lending is essential to borrowers in secondary and tertiary markets, borrowers with smaller balance sheets, new development entities, affordable housing developers and non-profit firms, all of which are often overlooked or underserved by private capital providers.

In normal capital markets, FHA plays a limited, but important, role in the rental housing sector. During the recent great financial crisis, however, FHA became virtually the only source of apartment construction capital. Today, as banks have pulled back from construction lending, FHA has once again stepped into fill this void.

FHA's Multifamily Programs have continually generated a net profit, and have met all losses associated with the financial crisis with reserves generated by premiums paid through the loan insurance program structure. Because premiums have consistently reflected the risk associated with the underlying loans, and because underwriting requirements have remained strong within the program, FHA's Multifamily Programs are able to operate as self-funded, fully covered lines of business at HUD. A few programs struggled during the real estate downturn; however, any losses have been covered by the capital cushion the multifamily programs collectively generate.

It is important to the apartment industry that FHA continues to be a credible and reliable source of construction and mortgage debt. FHA not only insures mortgages, but it also builds capacity in the market, providing developers with an effective source of construction and long-term mortgage capital. The FHA Multifamily Programs provide a material and important source of capital for underserved segments of the rental market, and do so while maintaining consistently high loan performance standards. NMHC/NAA encourage Congress to continue the FHA's Multifamily Programs.

**Addressing the Nation's Housing Affordability Crisis**

Policymakers are understandably still struggling to determine the degree to which an ongoing federal role in the rental finance system should be connected with the pressing need to address the nation's affordable housing shortage. We begin by noting that multifamily housing is inherently affordable housing. Therefore, the mere extension of a government role to ensure liquidity to the multifamily sector is, by definition, supporting workforce and affordable housing.

It is tempting to believe that more can be done to address affordability through housing finance reform, namely through imposing limitations on federal guarantees or other mandated benchmarks. We caution policymakers not to overreach, however, as such well-intended moves, if overly prescriptive, could have adverse consequences.

To begin with, one way the GSEs have been able to produce such a stellar performance record in multifamily is by being able to build a balanced book of business where lower-risk, higher-end properties enabled them to take on riskier, deeply targeted affordable housing properties, such as Section 8 and Low-Income Housing Tax Credit properties.

Just as critical, the GSEs' multifamily programs have been able, through their broad platforms, to provide capital for projects located in markets that do not meet the credit or return standards required by many private capital debt providers.

Not only does a broad multifamily lending platform help the GSEs and any successor entities manage risk, but it also ensures that there is a sufficient supply of liquidity in severe market downturns. For instance, in the most recent financial crisis, even firms and properties that would normally be well served by private capital found themselves with no options.

If the successor entities to Fannie Mae and Freddie Mac are more limited in what markets or properties they can serve, they will be unable to fill the critical public policy mission they have historically served. Failure to ensure sufficient liquidity for all types of apartments will have a spillover effect that could be disastrous for America's renters.

Nevertheless, we understand the need to tackle housing finance reform and affordability in the same debate. NMHC/NAA look forward to working with Congress on developing workable solutions to this vital policy issue.

## **Conclusion**

As this Committee continues its important work of assessing and crafting a reformed housing finance model, Congress must understand that a one-size-fits all approach will not work. The meaningful differences between the single family and multifamily sectors, both in how they operate and how they have performed, requires different solutions to avoid putting at risk the nearly 39 million Americans who rely on the apartment industry for their housing.

Not only are the sectors very different in how they operate, they also have much different performance records. It should come as no surprise that the multifamily programs have generated more than \$31 billion in net profits for the federal government since they were placed in conservatorship. We encourage you to study the design and performance of the multifamily businesses at both GSEs during the great financial crisis and today, and visit with stakeholders in each of your communities to best understand the critical, stabilizing

role of the GSEs in all markets, at all times. We strongly urge Congress to retain the successful elements of the multifamily programs in whatever replaces them. Lastly, it is essential that a reformed housing finance system retain a federal backstop for multifamily.

The multifamily Enterprise programs met the mark, even during the great financial crisis and can serve as a model for a continued federal guarantee for rental housing in a reformed housing finance model. Housing our diverse nation means having a vibrant rental market alongside an ownership market to promote stronger communities.



OUR VISION FOR 2030

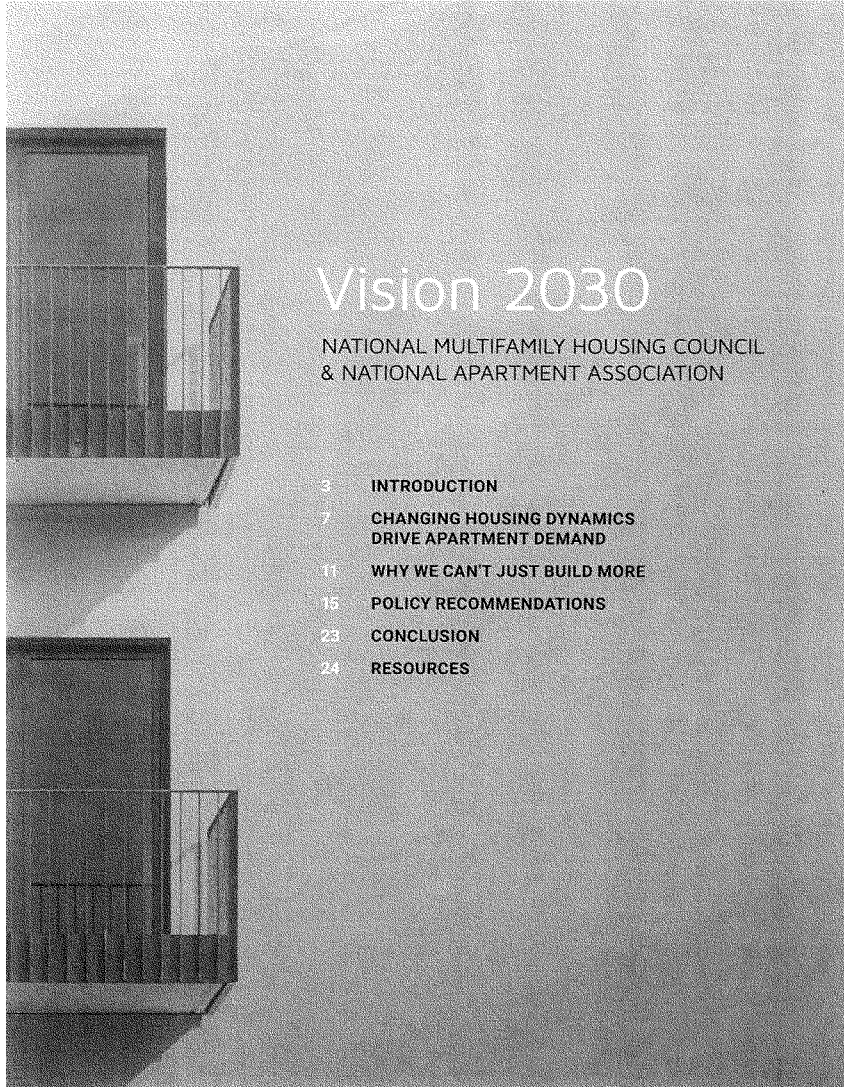
Build 4.6 Million  
New Apartments  
to Meet Demand  
and Control the  
Cost of Housing

**We Are Apartments**  
In communities across the country, apartments work –  
helping people live in a home that's right for them.

**NAA**  
NATIONAL APARTMENT ASSOCIATION

**NMHC**

NATIONAL  
MULTIFAMILY  
HOUSING  
COUNCIL



# Introduction

The number of families renting their homes stands at an all-time high, placing significant pressure on the apartment housing industry to meet their needs. The ever-growing demand is making it challenging for millions of families nationwide to find quality rental housing they can afford at their income levels.

For many families, the shortage of affordable rental housing creates significant hurdles that ultimately hamper future financial success. And the problem won't go away on its own. Unless public and private sector leaders take bold, innovative action today and in the years to come, the affordable housing crisis will become even more desperate.

America needs to build more than 4.6 million new apartment\* homes at a variety of price points by 2030, according to new research from Hoyt Advisory Services (HAS), commissioned by the National Multifamily Housing Council (NMHC) and the National Apartment Association (NAA).

The projection of 4.6 million is low, based on estimated demand by new apartment households through 2030. Not included in the number are the supply-demand imbalances that currently exist in some markets, where households are unable to find an apartment at a rent affordable to them. Possibly underestimated are older existing apartments — as many as 11.7 million — that could need renovation by 2030.<sup>1</sup>

\* Throughout this document, apartments are defined as rental apartments in buildings with five or more units.



Meeting projected demand means building more than 325,000 new apartment homes each year on average — a number the industry has not been able to hit for decades. From 2012 through 2016, the apartment industry built, on average, only 244,000 new apartment homes per year.<sup>2</sup> The last time the industry built more than 325,000 in a single year was 1989.<sup>3</sup> That history suggests that reaching and maintaining needed growth in new apartments will require a revamp of how we build apartments. It will also require courageous steps by policymakers at the federal, state and local levels who are willing to implement inventive policy ideas, provide incentives and reduce impediments to building apartments that meet demand across all income levels.

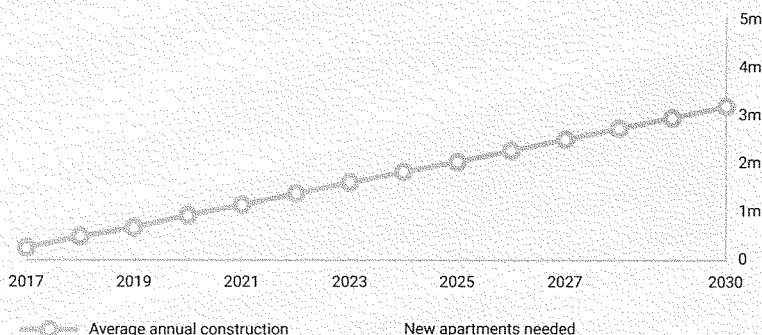
The cost to build and operate apartments has increased as barriers to development have worsened over recent decades, exacerbating housing affordability. For many families, the shortage of low and moderately priced housing makes it difficult to pay for basic necessities such as food and transportation, or to save for the future. Housing affordability is not just an issue for low-income families. It is increasingly affecting middle-income families who earn too much to qualify for a subsidy, but not enough to pay market-rate housing costs.

Ultimately, if these issues are left unaddressed, states and cities risk losing workers and driving down economic activity as families seek

more balanced housing markets elsewhere. After all, apartments and their residents contribute more than \$3.5 billion to the economy every day — about \$1.3 trillion each year.<sup>4</sup>

**Apartments  
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the economy  
every day.**

### Demand for apartments is projected to grow substantially by 2030.



#### UNPRECEDENTED DEMAND FOR APARTMENTS

The number of renters has reached an all-time high, with nearly 39 million people in the United States — that is almost 1 in 8 — calling apartments home.<sup>5</sup> They are singles, couples and families. They come from all generations and economic backgrounds.

Annual growth in renter households exceeded 800,000 on average since 2010 — and almost as much as 1.2 million, by some measures.<sup>6</sup> Meanwhile, apartment vacancy rates as measured by MPF Research fell or remained the same for seven straight years from 2009 to 2016.

HAS's research shows demand for apartments is projected to grow substantially by 2030. If current policies and population trends continue, many communities will have difficulty meeting demand, an outcome that will make affordability challenges significantly greater and stunt economic growth.

#### RISING HOUSING COSTS

Millions of people are paying far more than they can afford on all types of housing. They include young adults just starting out in their careers, workers who have not seen a wage increase in years, and even some of our nation's most valued public servants: teachers, firefighters and police officers.

A standard benchmark for housing affordability is that households pay less than 30 percent of their earnings on their rent or mortgage. Since 1985, the share of apartment renters paying at least 30 percent of their income for housing costs (rent and utilities) has increased from 42 percent to now more than half (55 percent).<sup>7</sup> More than one in four (29 percent) spend at least half their income on housing costs, a sign that their housing costs are a significant financial burden.<sup>8</sup>

As housing costs, to rent or to own, have gone up in many parts of the country, student debt and healthcare costs have also spiked, while incomes have stagnated.

While increasing supply is a long-term solution, communities that have made the investment in rental housing stock are starting to see rents moderate. In recognition of this, municipalities are beginning to work with local leaders, developers and citizens to make affordable housing a priority by first recognizing the obstacles to apartment construction and comprehensively looking at ways to minimize steps or processes that artificially increase the cost of housing. This includes everything from creative financing with capital partners and direct municipal investment, to mitigating actions that influence the soft cost of building such as onerous zoning, permitting, taxes, fees and the overall carrying cost of extended approval times – which can increase the total cost of housing by 25 percent to 40 percent.

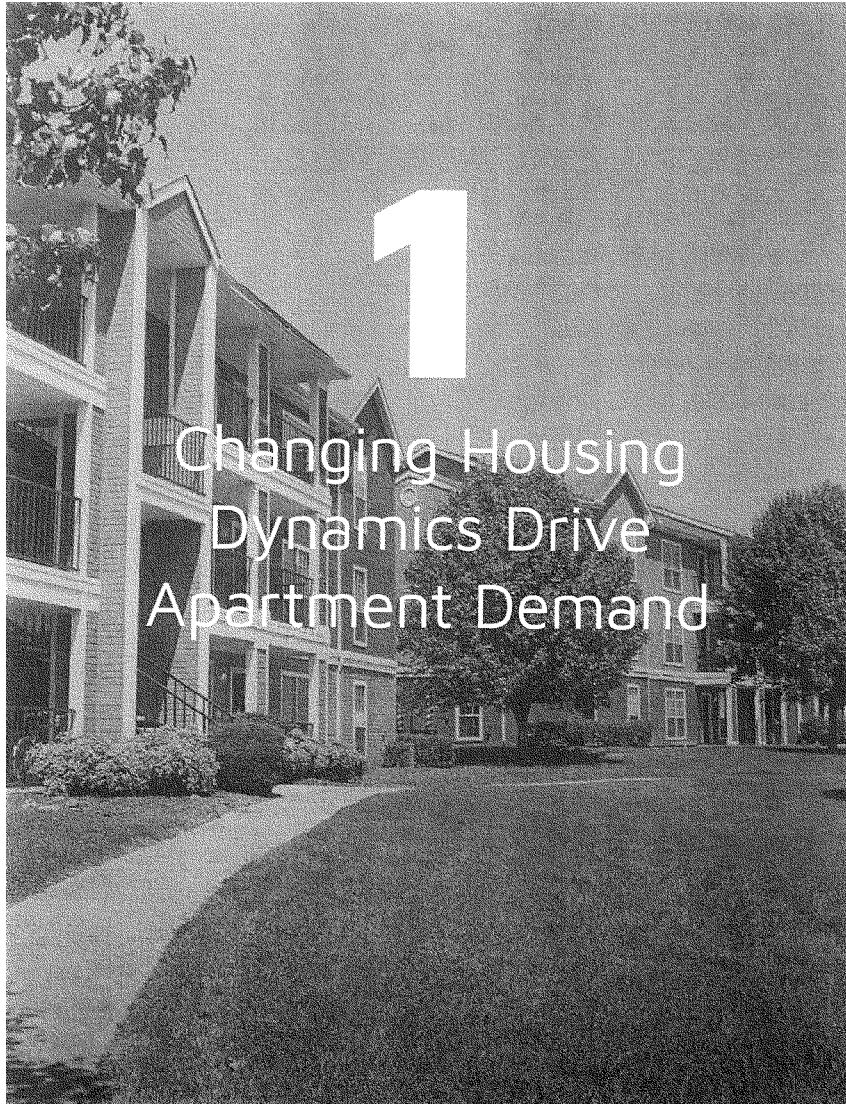
It is time to take action across the country, in ways that are tailored to the needs of each community. The apartment industry stands ready to work with urban, suburban and rural communities in every region to meet the housing demands of Americans across all income levels.

## **We can bridge the gap between the cost of building and operating apartments and the amount of rent lower-income and middle-class households can afford.**

Policymakers at all levels of government must recognize that addressing local housing needs requires a partnership between government and the private sector. The federal government can ensure sufficient funding of housing programs, enact a pro-housing tax policy and reform regulations that unnecessarily increase housing costs.

State and local governments have a toolbox of approaches they can take to address the apartment shortage and help reduce the cost of housing. They can:

- **Adopt local public policies and programs that harness the power of the private sector to make housing affordability more feasible.**
- **Increase public-private partnerships.**
- **Leverage state-level authority to overcome obstacles to apartment construction.**
- **Collaborate with business and community leaders to champion apartments.**



1  
Changing Housing  
Dynamics Drive  
Apartment Demand

**The country is in the midst of an unprecedented rise in renting. Since the current upswing began in 2010, the number of renter households has increased by an average of more than 800,000 annually – almost as much as 1.2 million a year, by some measures.<sup>9</sup>**

Renting an apartment offers many advantages to working- and middle-class Americans. Apartment residents say they appreciate mortgage-free living, the ability to follow work opportunities across town or across the nation, and amenities that fit their lifestyles.

These choices drive economic growth. Apartments and their residents contribute more than \$3.5 billion to the economy every day – about \$1.3 trillion each year.<sup>10</sup> That impact could be even greater if more apartments were built to meet the needs of households at all income levels.

## DEMOGRAPHIC SHIFTS

According to HAS research, three major demographic shifts will continue to have a strong impact on the demand for rental housing: The rise of young adults, the aging of the baby boomers, and immigration's increasing contribution to population growth.

At more than 75 million strong, young adults ages 18 to 34 – the age group most likely to rent – have become the largest generational demographic group in the U.S.<sup>11</sup> Their sheer numbers, as well as long-term and short-term social and economic trends that affect them, are having a profound impact on demand for apartments.

Historically, Americans have bought their first houses around the same time they get married. But people are getting married later. Today, both women and men get married for the first time five years later, on average, than they did in 1980.<sup>12</sup> A recent Census Bureau

report found that in the 1970s, 80 percent were married by the time they were 45 years old; in 2016, 80 percent hadn't been married until they were 45 years old. Their homeownership rate is slightly lower, too. Only 35 percent own homes, compared to 41 percent of young adults in 1981, according to the U.S. Census Bureau.

These trends suggest more young adults are renting than did previous generations at the same stage in life. But high unemployment rates of the past 10 years, just now ticking down for young adults, as well as the growing burden of student debt, have kept many from forming their own households. Nearly a third (31.5 percent) of young adults live at home with their parents, a statistic that suggests pent-up demand for housing options that match their stage in life.<sup>13</sup>





There has also been a dramatic change in the number of households with children, the kinds of households that have typically driven demand for single-family houses. In 1960, 44 percent of all households in the U.S. were married couples with children. Today, such families make up only 19 percent of households.<sup>14</sup>

More and more, renting is not just for the younger generations. Once the nation's largest demographic group, baby boomers (those born between 1946 and 1964) now number 73 million people.<sup>15</sup> Over half (58.6 percent) of the net increase in renter households from 2006 to 2016 came from boomer households.<sup>16</sup>

**Over half  
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Immigration is also a driver of demand for apartment homes, and may become even more of an influence if it eclipses natural population growth over the next decade and a half, as estimated by HAS researchers. That is because immigrants are more likely to rent, and more likely to rent longer.<sup>17</sup> In states with slow-growing

populations, like Michigan, West Virginia and Maine, immigration has in recent years accounted for a bigger chunk of population growth than in faster-growing states.

According to HAS research, Hispanic households alone will account for more than half (55 percent) of all U.S. population growth through 2030.



**INCOME STAGNATION**

America's affordable rental housing shortage is more than just a housing problem. Underlying the shortage is an income problem. As rental housing has gotten more expensive to build and operate, other economic factors have suppressed household income growth, making it harder for people to pay for housing.

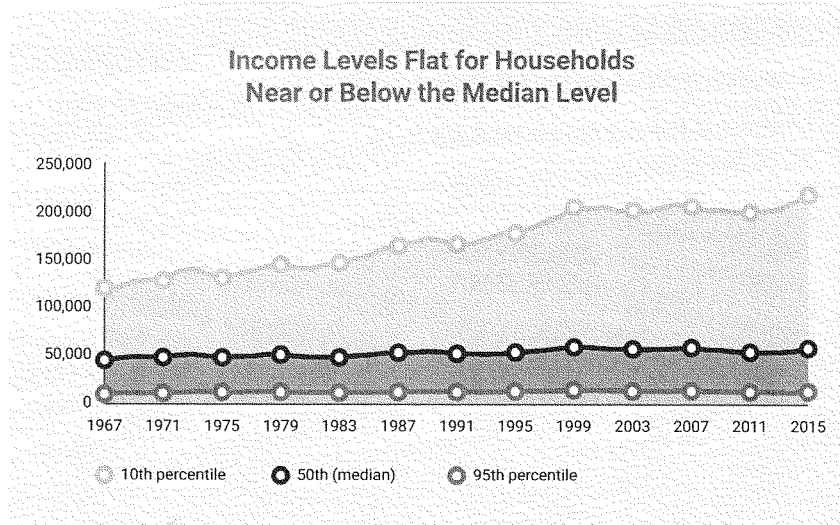
In 2015 dollars, the median income of an apartment household has fallen by \$3,000 since 1985.<sup>18</sup> Since 2001, renters' real median incomes have fallen 9 percent. Nearly a third (31 percent) of renters earn less than \$20,000, according to HAS research.

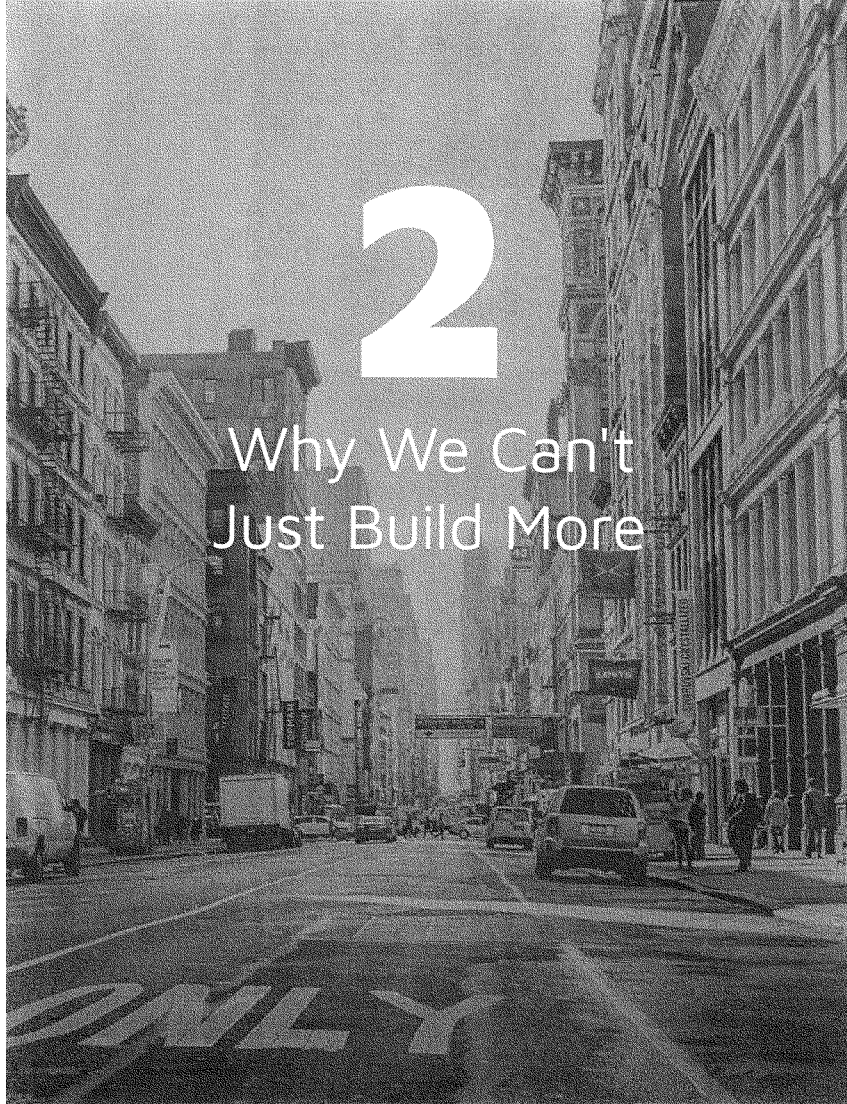
As a result, in many areas where demand is strongest, even if, hypothetically, developers agreed to take no profit when building new apartments, the cost would still exceed what people can afford to pay.

HAS researchers also found the proportion of renters living under the poverty line is highest in Mississippi and West Virginia, but it is also high in states such as Kentucky, Ohio, New Mexico, Arkansas and Alabama. Stagnating renter incomes leads to households that are increasingly rent burdened.



Stagnating renter incomes lead to households that are increasingly rent burdened.





# 2

Why We Can't  
Just Build More

Recent history — specifically the lingering effects of the Great Recession — has complicated the apartment industry's ability to meet rising demand. The collapse of U.S. financial markets in 2008 virtually shut down new apartment construction for a number of years.

According to HAS, we need to build on average at least 325,000 apartments a year to meet demand. The nation hit a low of completing 129,900 new apartments in multifamily buildings of five or more units in 2011 and has only now begun to reach 300,000 a year<sup>19</sup>.

Still, the current rate of growth hasn't been enough to meet current demand and make up for the shortfall in the years following the recession.

The challenge is delivering more units each year and over a sustained period of time. But steep barriers keep the apartment industry from being able to do that. And there's a strong connection between the difficulty of building and affordability. HAS research found that rents tend to be particularly high in cities with the greatest barriers to new development.

### The 5 most difficult metro regions in which to build apartments



#### 1 Honolulu

EASE OF ADDING SUPPLY RANK: 19.5  
82% OF RENTS ARE \$1K+  
49.9% OF RENTERS PAY 35%+ OF THEIR INCOME ON RENT



#### 2 Boston

EASE OF ADDING SUPPLY RANK: 13.1  
69.2% OF RENTS ARE \$1K+  
40.0% OF RENTERS PAY 35%+ OF THEIR INCOME ON RENT



#### 3 Baltimore

EASE OF ADDING SUPPLY RANK: 11.9  
65.5% OF RENTS ARE \$1K+  
40.7% OF RENTERS PAY 35%+ OF THEIR INCOME ON RENT



#### 4 Miami

EASE OF ADDING SUPPLY RANK: 9.3  
68.1% OF RENTS ARE \$1K+  
54.2% OF RENTERS PAY 35%+ OF THEIR INCOME ON RENT



#### 5 Memphis

EASE OF ADDING SUPPLY RANK: 8.7  
31.6% OF RENTS ARE \$1K+  
41.8% OF RENTERS PAY 35%+ OF THEIR INCOME ON RENT



Over the last three decades, regulatory barriers to apartment construction have increased significantly

**COST, TIME AND REGULATORY BARRIERS**

For many reasons, building apartments has become costlier and more time-consuming than necessary. Over the last three decades, regulatory barriers to apartment construction have increased significantly, most notably at the local level.

Outdated zoning laws, unnecessary land use restrictions, arbitrary permitting requirements, inflated parking requirements, environmental site assessments, and more, discourage housing construction and raise the cost of those properties that do get built.

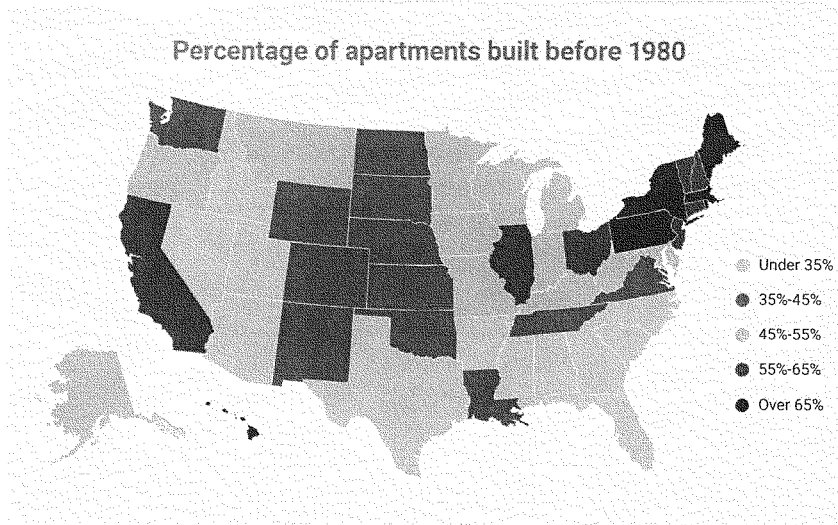
Developers navigate many steps to get projects approved. The whole process can take two to 10 years and require an upfront investment of \$1 million or more before a project breaks ground.

There are also financial factors pushing housing costs up. Land, labor and construction costs have all been rising significantly in recent years. In many areas, there is limited land zoned for apartments or just little

undeveloped land. Competition for what land is available drives the cost up, too. Labor costs have increased well above inflation because of a shortage of skilled workers. Following the economic downturn, many workers left the construction industry and have yet to return.

Finally, localities impose a variety of fees on new housing, including impact fees, inspection fees and property taxes. Inclusionary zoning mandates and rent control further discourage housing investment.

These time and cost burdens lead to fewer apartment homes being built, which further squeeze already tight rental markets. Apartments that do get built tend to have higher rents to cover the high cost of development.



**“NOT IN MY BACKYARD”**

In many communities — even ones with a deep gap between supply and demand — residents often say, “Not in my backyard” to new apartments, an attitude known as NIMBYism.

Their opposition is often fueled by misperceptions about renters and the impacts of apartments on traffic, property values, school overcrowding and community character.

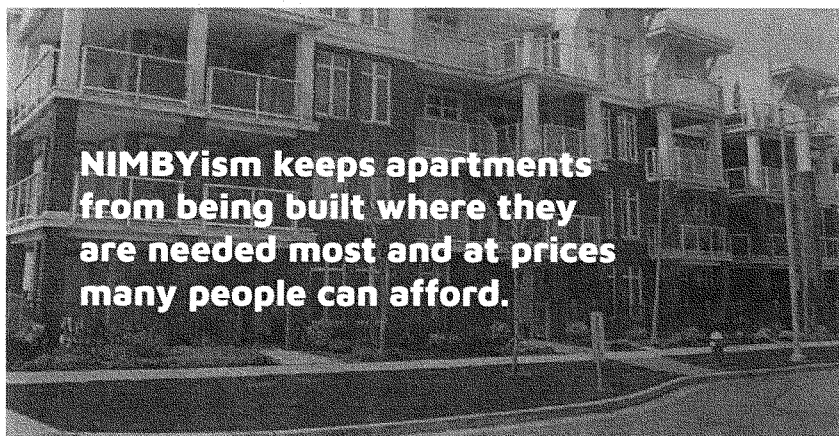
Even though these perceptions are largely false, NIMBYism persists and keeps apartments from being built where they are needed most and at prices many people can afford. Even when building proceeds, NIMBY opposition to apartments can add additional time and expense to an already long and costly process.

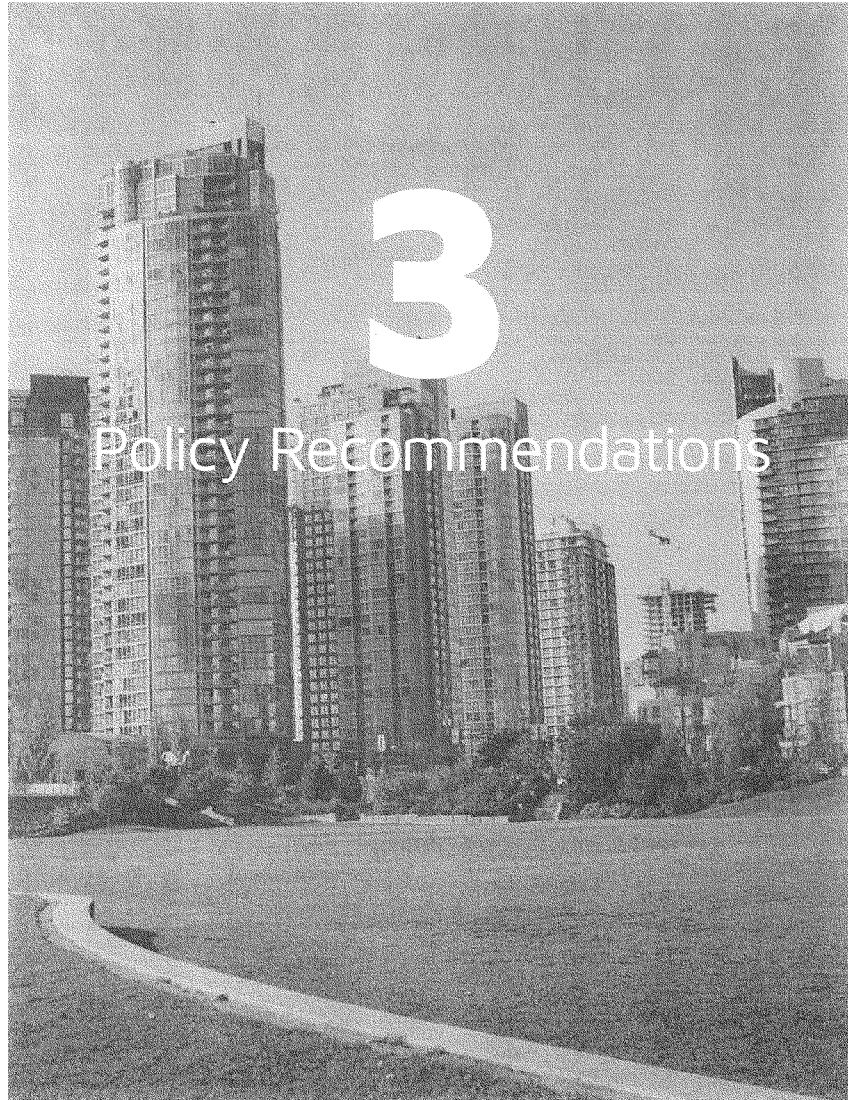
**Lost Apartments**

Adding to the apartment shortage is the fact that every year, the nation loses between 75,000 and 125,000 apartment units to obsolescence and other factors.<sup>20</sup> Most lost units are likely at the lower end of the market, disproportionately hurting the affordable supply that exists.

This situation is likely to worsen going forward since more than half (51 percent) of the nation's apartment stock was built before 1980, and without resources dedicated to support rehabilitation efforts, more stock will continue to leave the available pool.<sup>21</sup>

Rehabilitation and preservation are vital to maintaining the stock of apartments that are affordable to the broad middle class.





**If government and private developers come together to take action, we can build 4.6 million apartments by 2030 to meet demand and control the cost of housing.** Solutions that help supply meet demand and reduce the cost of developing apartments are out there but need to be more broadly adopted across the country.

Unfortunately, the current regulatory framework, whether intentional or not, has limited the amount of housing being built and increased the cost of what is produced. States and localities are now struggling to address this serious threat to their economic vitality. They must balance the dwindling resources they have for housing with the need to “do something” to meet growing demand. Fortunately, there is much they can do outside of their budgets to make it easier for the private sector to build more housing and to help reduce the cost of the housing that is produced.

Most importantly, they can reduce barriers to apartment construction. Land-use restrictions, zoning restrictions, parking requirements, slow permitting, and much more, add significantly to the cost of construction. Many of these rules and processes are well-meaning, but collectively they serve as real barriers to housing production. Even worse, some laws are specifically designed to prevent apartment construction, usually in response to NIMBY opposition.

In the following pages we present a toolbox of approaches states and localities can take to address the apartment shortage and help reduce the cost of housing.



There are things states and localities can do to **meaningfully reduce the cost of producing housing.**





Adopt local public policies and programs that harness the power of the private sector to make housing affordability more feasible.

The most common barriers to apartment construction are enacted at the local level, which means local governments have a lot of levers they can pull to create healthy housing markets. They also have no-cost resources they can bring to the table to reduce the cost of housing production. They can do the following:

#### ESTABLISH "BY-RIGHT" HOUSING DEVELOPMENT

Most developments go through a discretionary review process such as public hearings or legislative review by the local land use authority or board of zoning appeals. Public review is certainly important, but it's often duplicative, arbitrary and inefficient. Reviews also increase the cost of housing by slowing down its production or even preventing it from being built.

"By right" development allows projects, both new construction and rehabs of existing properties, to be approved by local administrators without discretionary reviews as long as they comply with current zoning rules and community development plans. Municipalities retain control and can deliver the housing the community has already decided it wants, while loosening restrictions that keep new apartments from being built.

In addition to establishing "by right" rules, municipalities can also relax restrictions related to density, building height, unit size and parking minimums. All of these require

developers to seek waivers, variances or rezoning, which trigger the review process.

This strategy for expanding the supply of affordable rentals, has been gaining traction across the country. Fairfax, Virginia, has implemented by-right development and flexible zoning in seven districts where they want to encourage housing construction.

States can also play a role. Massachusetts, for example, provides incentives to municipalities that allow by-right development. These development incentives have cut in half the nine years it otherwise takes to develop a property.

#### EXPEDITE APPROVAL FOR AFFORDABLY PRICED APARTMENTS

Lengthy permitting processes add cost, time and uncertainty to housing construction. Fast-tracking review and permitting of housing that includes affordable units is a no-cost way for local jurisdictions to expand their supply.

Several cities are embracing this approach. San Diego's "Expedite Program" fast tracks permit processing for affordable housing and sustainable building projects with an initial business review that takes just five days.

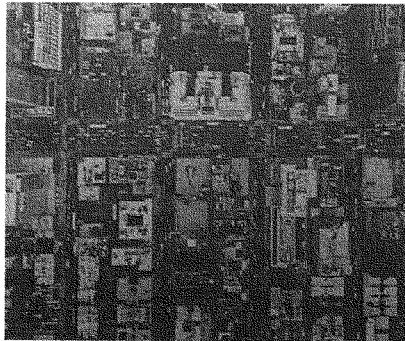
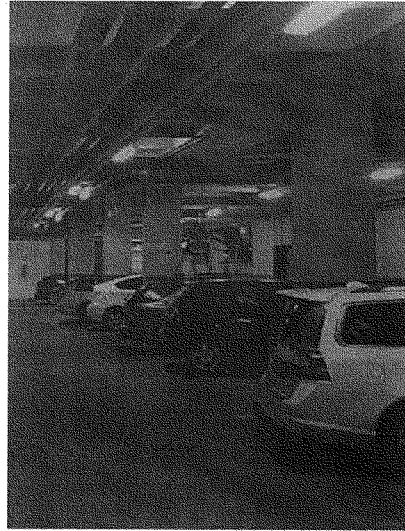
Austin's S.M.A.R.T. Housing program gives affordable housing builders an expedited development review, and it waives development fees. Since 2005, more than 4,900 apartments have been built through the initiative.<sup>22</sup>

### REDUCE PARKING REQUIREMENTS

Parking requirements are one of the biggest costs for a development, particularly in urban environments, ranging from \$5,000 per spot for surface parking to \$60,000 for underground parking.<sup>23</sup> The Urban Land Institute found that parking minimums were the number one barrier to building affordable rentals.<sup>24</sup>

Many cities can significantly reduce or even eliminate parking requirements, particularly in transit-oriented or urban infill development. This approach will become increasingly valuable as ride-sharing increases and automated vehicles become adopted, dramatically reducing parking demand.

In 2012, Seattle voted to reduce parking requirements by 50 percent in some neighborhoods and to eliminate them completely in downtown areas readily served by transit. Other cities such as Denver, Minneapolis, Boston, San Francisco and New York are revising parking requirements to reduce the cost of housing. In 2015, California enacted a law overriding local parking requirements for all transit-adjacent housing developments that include affordable housing units.



### ESTABLISH DENSITY BONUSES TO ENCOURAGE DEVELOPMENT OF AFFORDABLE HOUSING

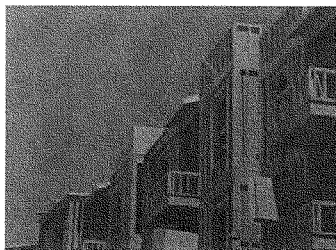
Density bonuses make building affordable housing more cost-effective for developers. In return for including a certain number of affordable units in a building, the developer is allowed to build more market-rate apartments than are normally allowed.

Fairfax, Virginia, and Denver both allow for taller buildings near transit centers if they include affordable units. Massachusetts also provides incentives to local governments that adopt zoning laws encouraging denser development near transit.

### ADOPT SEPARATE REHABILITATION BUILDING CODES

Maintaining the stock of older apartments — which tend to have lower rents — and improving them so they remain habitable is essential to ensuring affordability across the income spectrum. But because many jurisdictions require developers to bring a building up to the current building code when they want to substantially rehab it, upgrading properties is often prohibitively expensive.

Localities can overcome this by adopting separate building codes for rehabilitation projects that balance the need to ensure safety and structural integrity, but don't sacrifice affordability. They can also offer tax abatement, for properties that include affordable housing, when property taxes rise because of improvements.



### CREATE AN EFFICIENT PUBLIC ENGAGEMENT PROCESS

New developments benefit from community input. But the public engagement process can also result in NIMBY opposition that creates long delays, and even lawsuits, that increase construction costs. There is no single model that works to strike a balance, but localities should examine their process to ensure it's not one-sided and doesn't create uncertainty.



### The Reality of Rent Control

Some lawmakers are revisiting rent control as a strategy to control housing costs. New efforts are underway in California, Illinois and Washington to challenge and ultimately change decades-old state laws and best practices restricting and/or prohibiting rent control in local jurisdictions.

To some, rent control would seem a fast and easy fix — a local jurisdiction sets limits on how much property owners and managers can raise rents on residents, theoretically making units more affordable. But it's not the panacea some lawmakers seem to think it is.

Economists on both sides of the political spectrum agree that rent control is not effective policy. Forbes Magazine calls it one of the 10 worst economic ideas of the 20th century: "Here we have a policy initiative that has done huge damage to cities around the globe. It is very hard today to find an economist supporting rent control."

While the laws' intent is positive, research shows that the real impact of rent control policy is a decline in property maintenance, stifled development activity, shrinking affordability and a chronic undersupply of rental homes. Rent control also encourages owners to convert buildings from residential to non-residential use.

Without profitability as an incentive, investment capital is directed to other markets and maintenance on existing properties is deferred. Subsequently, the affordable housing shortage is exacerbated.



**Policymakers at all levels of government can provide incentives and share risk with the private sector to produce the necessary units at price points households can afford. They can do the following:**

#### LEVERAGE UNDERUTILIZED LAND

Federal, state and local governments should prioritize affordable housing when disposing of public land. Land accounts for approximately 10 to 25 percent of an apartment project's cost, and even more in high-cost areas.<sup>25</sup> Developers also often struggle to find developable land in urban areas. Yet many localities own underused or abandoned land that could be used for affordable housing. Under-utilized buildings, which can be renovated, are another resource.

Making good use of these lands and buildings requires strong public-private partnerships. The private sector contributes the investment dollars and expertise, and the locality provides the land and helps facilitate a streamlined approval process. In the end, such partnerships produce affordable apartments while also boosting economic development.

Land banks — government-created nonprofit corporations that manage and repurpose tax-delinquent and vacant properties — are another option. More than 140 land banks have already been created across the country.

#### USE PROPERTY TAX ABATEMENTS

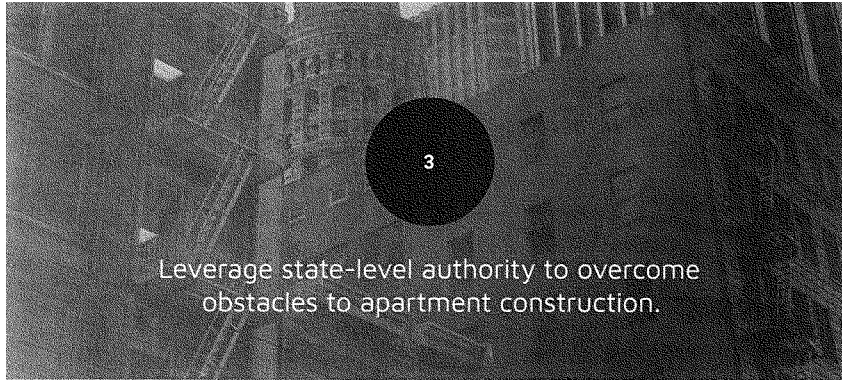
Tax incentives and abatements are another way to spur development. While they do reduce public revenues, they are often more politically palatable than direct subsidies. The Seattle Multifamily Tax Exemption (MFTE) program gives a 12-year tax exemption to new apartments that include a certain percentage of affordable units. By 2018, more than 200 properties are expected to participate.<sup>26</sup>

In 2017, New York passed a program that gives 35-year property-tax exemptions to apartment developments of at least 300 units in certain areas if 25 to 30 percent of units are set aside for low- to moderate-income renters. The program is expected to generate 2,500 units a year.<sup>27</sup>

Philadelphia abates 100 percent of the value of residential building improvements for up to 30 months during the construction phase. Oregon offers tax abatement to affordable housing as well as vacant land intended to be developed into affordable housing.

#### WAIVE FEES FOR PROPERTIES THAT INCLUDE AFFORDABLE UNITS

Housing developers often pay significant fees to expand public infrastructure or to support the creation of city amenities such as schools and parks. Because fees add to the cost of housing, many jurisdictions waive impact fees for properties that include affordable units.



Leverage state-level authority to overcome obstacles to apartment construction.

Forward-thinking states recognize that their economies suffer from a lack of housing supply. They are taking action to enact laws that override local zoning restrictions that inhibit apartment construction, whether intentionally or not.

Massachusetts, for example, has an "Anti-Snob Zoning Law" (Chapter 40 B Comprehensive Permit Law) that allows developers to build with more density than local zoning laws allow if the proposed apartment property has a certain percentage of affordable units and the community has an affordable housing shortage. Since it was enacted in 1969, more than 42,000 rental units have been built.<sup>21</sup>

Rhode Island approved the "Expedited Permitting for Affordable Housing" Act that sets strict approval deadlines for permitting agencies if a development is large enough to increase the amount of affordable housing in their communities.

States can also make some state financing contingent on a locality meeting a minimum affordable housing threshold or adopting policies that support housing production.

**Forward-thinking states recognize that their economies suffer from a lack of housing supply.**



**Leveling the Playing Field for Renters**

People choose to live in apartments for many reasons, and their choice should not limit their ability to enjoy financial security. We should promote policies that give people flexibility to build wealth without owning real estate and through incentivized savings. We should also adopt public policies that promote affordability in all housing.



**Local communities are stronger and more vibrant when there is a mix of rental and owned housing.** Without a diversity of housing options to meet a variety of lifestyle needs and price points, local economies are held back. We need local leaders in government and business to work together to bring a range of housing types to their communities by crafting creative solutions to ease existing hurdles.

One of the best ways to accomplish this is to make the connection between a sufficient supply of housing and a community's economic health and economic development. Insufficient housing causes workers to leave an area or lose productivity because of long commutes. Companies relocate or stagnate when they cannot hire the workers they need because their employees can't find housing.

In other words, ensuring a community has enough housing isn't just the concern of those who struggle to find housing. It's an important issue for everyone in the community whose employer might move to another market where housing is more readily available. Several areas have successfully made that connection and have generated political support for regulatory changes or even vocal support for specific projects.

Local employers can be a powerful force against NIMBY opponents. For example, the Silicon Valley Manufacturing Group recognized that a housing shortage was affecting their members, so they formed a Housing Action Coalition. The group goes to planning commissions and city councils to actively support smart growth developments. They also help educate lawmakers about the importance of affordable housing. They say their intervention works 98 out of 99 times and has resulted in 26,000 new homes in 18 Silicon Valley towns.



## Federal Solutions

It's not up to states and localities alone to ensure that people have access to housing that fits their needs. The U.S. Congress can take the following steps:

- **Enact a pro-development tax policy that incentivizes investment in rental housing.**
- **Support housing finance reform that preserves the multifamily mortgage liquidity provided by the Government Sponsored Enterprises.**
- **Support funding for the FHA Multifamily Programs, which are an important source of capital supporting apartment construction and redevelopment.**
- **Expand the Low-Income Housing Tax Credit.**
- **Create a Middle-Income Housing Tax Credit.**
- **Increase funding for subsidy programs that address housing affordability such as the Section 8 Housing Choice Voucher Programs, Project-Based Rental Assistance, Rental Assistance Demonstration, HOME and Community Development Block Grants.**
- **Reform overly burdensome regulations that contribute to making housing less economically feasible to develop and operate.**

## What's good for renters is good for everyone.

### CONCLUSION

In 2030, today's fifth-grader may be renting her first apartment. Her grandmother may be downsizing into apartment living, too. A city lot that sat vacant for decades or a long-neglected suburban downtown may now be a vibrant place to live, eat and work because local leaders had a vision for revitalization that included apartments.

Every American should be able to choose to live in a place that fits his or her stage of life and budget and to choose the community in which he or she wants to live. To make that vision a reality, we must build more apartments at all price points. Building 4.6 million apartments by 2030 will go a long way toward meeting the demand for apartments, stabilizing rents and helping to boost the U.S. economy.

With the right mix of policies and strong partnerships between local governments and independent developers, we can bridge the gap between the cost of building and operating apartments and the amount of rent lower-income and middle-class households can afford. It helps that a growing number of people in communities from San Francisco to Boulder, Colorado, to New York are already recognizing the value of moving from "Not in my backyard" to "Yes, in my backyard."

They are seeing that it is not only renters who benefit when communities build more apartments. Communities benefit, too. When people are able to affordably live where they work, the volume of traffic is reduced. When a community has a diverse housing stock, it can attract a diverse population of people with different incomes, skillsets and professions. And apartments can help the tax base and boost the local economy through mixed-use development that revitalizes communities and creates jobs.

What's good for renters is good for everyone. It's time to take action to ensure every household at every income level has an affordable place to call home.

# Resources

There are a number of resources policymakers can consult to inform their efforts to address the affordable housing shortage. These are just a few.

## CALCULATORS

- Urban Institute/National Housing Conference's *Cost of Affordable Housing Calculator*. Interactive tool that shows why affordable housing deals don't pencil out.
- U.C. Berkeley Turner Center for Innovation's *Development Calculator*. Estimates the probability that a given development project will be built, given a particular set of policies and economic conditions.
- U.C. Berkeley Turner Center for Innovation's *How Much Housing Will Be Built? Policy Gauge Calculator*. Using four example cities, shows how local policies impact total potential housing production.

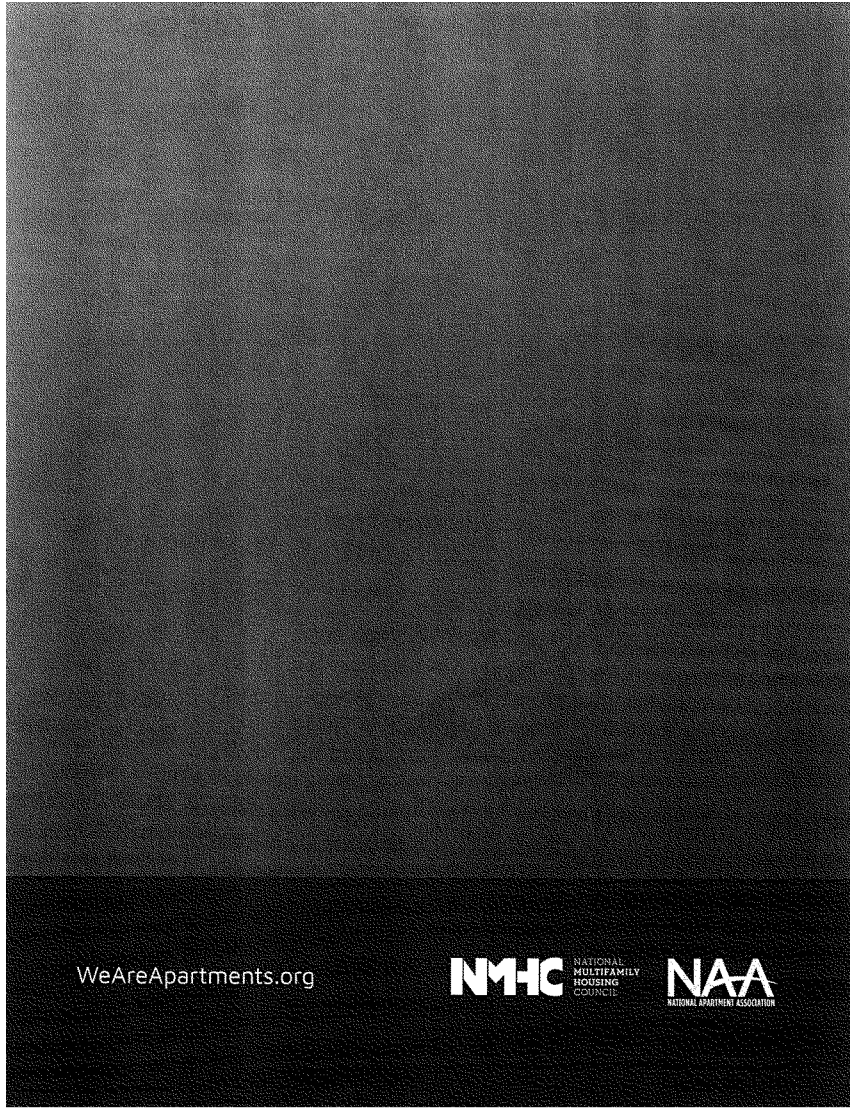
## TOOLKITS AND OTHER RESOURCES

- ULI's "*Bending the Cost Curve-Solutions to Expand the Supply of Affordable Rentals*"
- Washington Area Housing Partnership's "*Toolkit for Affordable Housing Development*"
- Obama White House's "*Housing and Development Toolkit*"
- McKinsey Global Institute's "*Toolkit to Close California's Housing Gap: 3.5 Million Homes by 2025*"
- Mortgage Bankers Association's "*Affordable Rental Housing and Public Policy*"
- California's Legislative Analyst's Office's "*Considering Changes to Streamline Local Housing Approvals*"
- ULI's "*The Economics of Inclusionary Development*"
- The Family Housing Fund's "*The Space Between: Realities and Possibilities in Preserving Unsubsidized Affordable Rental Housing*"
- HUD's "*Regulatory Barriers Clearinghouse*"
- ULI's "*Developing Housing for the Workforce: A Toolkit*"
- ULI's "*Workforce Housing: Innovative Strategies and Best Practices*"



## Footnotes

1. Hoyt Advisory Services.
2. U.S. Census Bureau, New Residential Construction.
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[WeAreApartments.org](http://WeAreApartments.org)

**NMHC** NATIONAL  
MULTIFAMILY  
HOUSING  
COUNCIL

**NAA**  
NATIONAL APARTMENT ASSOCIATION

**Testimony of Ms. Sarah Edelman**

Director of Housing Policy, Center for American Progress

Before the United States House of Representatives

House Committee on Financial Services' Subcommittee on Housing and Insurance

Sustainable Housing Finance: Stakeholder Perspectives on Housing Finance Reform

November 2, 2017

Good morning Chairman Duffy, Ranking Member Cleaver, and members of the House Committee on Financial Services' Subcommittee on Housing and Insurance. My name is Sarah Edelman and I am the director of housing policy at the Center for American Progress, an independent nonpartisan policy institute that is dedicated to improving the lives of all Americans, through bold, progressive ideas, as well as strong leadership and concerted action. Thank you for inviting me to testify today.

In today's testimony, I'll describe why the housing finance system matters to consumers, explore how the system failed consumers and taxpayers in 2008 and how to strengthen the housing finance system based on the lessons learned during the housing crisis.

**A Healthy Housing Finance System Supports the Growth of the Middle Class**

Most American wealth is built through homeownership. Housing wealth accounts for about 60 percent of the typical white household's wealth and almost 70 percent of African American household wealth.<sup>1</sup> Even when controlling for income, homeowners have significantly more wealth than renters.<sup>2</sup> Absent federal intervention, it would be difficult for working families to own their homes. In the 1930s, before the federal government began playing a role in the housing finance system, long-term fixed rate mortgages were not available and only those who could afford to make a 40 or 50 percent down payment could buy a home.<sup>3</sup>

The housing finance system creates the conditions for mortgage lending in the United States – it helps to determine who can borrow money and what they will pay for the loan. The guidelines and preferences adopted by credit enhancers and institutions in the secondary market often determine mortgage availability and price for homebuyers or for owners of rental housing. When the housing finance market is working optimally, sustainable mortgage credit is broadly available, allowing qualified borrowers to buy homes and owners of rental housing to access the mortgage financing they need. However, when the housing finance system is not working well, qualified borrowers in many communities have trouble accessing sustainable mortgage credit. Or, as in the lead up to the housing crisis, the mortgage products that are available strip wealth from communities, instead of building wealth.

In the years following the Great Depression, when the private mortgage market was barely operating, the federal government stepped in with new resources to make homeownership possible for Americans. Congress created the Federal Housing Administration (FHA), which insured eligible mortgages.<sup>4</sup> This FHA insurance gave lenders the confidence to lend again, knowing that they would be protected if a homeowner defaulted. As servicemembers began returning home from World War II, the Veterans

Administration (VA) began offering mortgage insurance to returning servicemembers, enabling them to buy homes and begin to build wealth.<sup>5</sup>

Fannie Mae was created in 1938 and subsequently directed by Congress to, among other duties, “promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.”<sup>6</sup> Fannie Mae created a secondary market for government-insured mortgage loans as a government agency, and began purchasing mortgages insured by FHA and VA. In the 1970s Fannie Mae expanded its business to include conventional mortgages and Freddie Mac was chartered to purchase and securitize conventional mortgages.<sup>7</sup> Fannie Mae was privatized in 1968, Freddie Mac in 1989.<sup>8</sup>

These government interventions helped to increase access to homeownership. Mortgages became less expensive and their terms standardized across the country, and the 30 year fixed-rate mortgage became widely available. Between the 1940s and 1960s, the homeownership rate in the United States increased from 44 percent to 62 percent.<sup>9</sup>

While the FHA, VA and the GSEs paved the way for affordable, fixed-rate low down payment mortgages for white borrowers, borrowers of color were largely excluded from these wealth-building options. The FHA and VA engaged in redlining and promoted discriminatory lending patterns that drove racial segregation and limited homeownership opportunities for people of color.<sup>10</sup> The GSEs helped to reinforce these discriminatory patterns. The passage of the 1968 Fair Housing Act and the Community Reinvestment Act in 1977 helped to begin correcting federal policy and to promote access to credit in historically underserved communities.<sup>11</sup>

In the early 2000s, consumer advocates began to sound the alarm as lenders started peddling poorly-designed mortgage products in low and moderate-income communities.<sup>12</sup> With “teaser rates” followed by exploding interest rates, pre-payment penalties, and little to no underwriting, these mortgages were designed to fail.<sup>13</sup> With strong demand on Wall Street for mortgages to package and sell to investors, credit rating agencies blessing securities filled with toxic mortgages, and large commissions and fees for lenders, predatory mortgages flourished.<sup>14</sup> In 2007, when these mortgages began to default in large numbers, homeowners and taxpayers were left holding the bag.

The housing finance system broke down in the lead up to the housing crisis and has yet to fully recover. Americans lost \$19.2 trillion in wealth between 2007 and 2009 when predatory lending caused a housing crisis, which triggered a global financial crisis and recession.<sup>15</sup> In the immediate aftermath of the crisis, private capital fled. The private label securities market collapsed.<sup>16</sup> Private mortgage insurance companies reduced their presence in the market dramatically and two failed entirely.<sup>17</sup> Were it not for the efforts of FHA and the GSEs to continue supporting the mortgage market during the crisis, the damage would have been even worse.

Today, the mortgage market is again functioning yet many prospective homebuyers remain on the sidelines. African American and Latino borrowers are severely underserved by the mortgage market when compared to their White counterparts.<sup>18</sup> Limited access to sustainable and affordable homeownership options has driven a racial wealth gap in the United States that continues to widen.<sup>19</sup>

### Lessons Learned from the Housing Crisis

Building a stronger housing finance system for the future requires identifying the problems that caused the housing crisis and identifying the structural weaknesses that led Fannie Mae and Freddie Mac to stray from their mission in the years preceding the housing crisis.

Some conservatives have stated that the housing crisis was caused by policies at FHA and by Fannie Mae and Freddie Mac that encouraged lenders to expand lending to low and moderate-income consumers. There has been no credible research to support these claims. The share of the mortgage market backed by the GSEs or FHA was historically low in the years leading up to the crisis.<sup>20</sup> FHA-insured loans and GSE-backed loans had fair repayment terms and far lower default rates than the private market.<sup>21</sup> The predatory lending that destroyed the economy and housing market in 2008 was a product of loose regulatory oversight and a dysfunctional private securitization market.<sup>22</sup>

While Fannie Mae and Freddie Mac certainly did not cause the housing market, their behavior in the years leading up to the crisis brought them to the brink of bankruptcy and drove them into conservatorship. These weaknesses included prioritizing short-term profit over safety and soundness, weak oversight and regulation, insufficient capital, and an implicit government back stop that was not paid for.

As the private securitization market grew in the early 2000s, Fannie Mae and Freddie Mac lost market share and their incomes dropped.<sup>23</sup> Fannie Mae and Freddie Mac abandoned their historically high standards out of fear of losing more market share to the private securitization market. They began to fill their portfolios with toxic private label securities, which produced greater returns for shareholders in the near term.<sup>24</sup> To compete with the private market, the GSEs also began to lower their credit quality standards and purchased Alt-A mortgages, mortgages that typically had large down payments and very limited documentation. While Alt-A mortgages represented about 12 percent of the their single family portfolios, they represented between 40 and 50 percent of GSE defaults in 2008 and 2009.<sup>25</sup>

Fannie Mae and Freddie Mac made bad business decisions, in part, because they did not have a strong regulator. Regulatory responsibilities were divided between HUD and OFEEO, and neither had enough authority to ensure proper conduct at the GSEs.

And, when the housing crisis hit, the GSEs did not have enough equity on hand to withstand all of the losses that were anticipated.

In 2008, the Treasury Department extended a line of credit to the GSEs and the GSEs have since tapped \$187.5 billion of that line of credit to ensure that the Enterprises could meet their commitments to investors across the globe.<sup>26</sup> The Enterprises lost nearly \$50 billion in 2008, alone.<sup>27</sup> For decades, investors operated under the assumption that the federal government would back Enterprise-issued securities in the event of a catastrophe. Indeed, the federal government had little choice but to step in because of the potential impact to the global economy. However, since this government guarantee was not explicit, the GSEs had not paid in advance for the ability to access the line of credit and needed to rely on taxpayers to step in.

### **Strengthening the Housing Finance Market**

In the aftermath of the crisis, Congress took steps to help prevent another crisis from occurring in the future. Congress passed the Dodd Frank Wall Street Reform and Consumer Protection Act which established strong consumer protections for homebuyers, improved oversight of Wall Street, and created the Consumer Financial Protection Bureau to help spot predatory trends that could harm consumers and eventually pose a risk to the financial system. Congress also passed the Housing and Economic Recovery Act (HERA) which created a new regulator with the authority to properly regulate Fannie Mae and Freddie Mac.

As Congress seeks to take further steps to strengthen the housing finance system, its goal should be a system that makes sustainable, affordable mortgage credit available to all qualified borrowers during all credit cycles. This means building on aspects of the current housing finance system that have served Americans well, correcting weaknesses of the current structure that were exposed during the crisis, and addressing some of the affordable housing challenges that have emerged in recent years.

**1. Establishing an explicit, paid-for, government guarantee is good for consumers and taxpayers:** The 30-year fixed rate mortgage has helped to build the middle class in the United States yet it would not be broadly available without government intervention. Few lenders can afford to hold most of the mortgages they originate in portfolio throughout the life of the loan. They need to be able to sell many of the mortgages they originate on the secondary market to have enough capital on hand to make loans to more borrowers. Lenders need reliable secondary market partners who will buy plain vanilla mortgages during all economic cycles. This reliable secondary market only works when investors are confident that they'll receive timely payments when they purchase a mortgage backed security. In past decades, investors who purchased mortgage backed securities were confident that Enterprise-issued securities posed very minimal risk because they believed that the U.S. federal government would stand behind the securities in the case of an emergency. Future guarantors are also likely to benefit from the perception that the U.S. government will provide a bailout in an emergency. Fannie Mae, Freddie Mac or their successors should pay for the ability to offer to investors this assurance.

**2. Promoting access and affordability:** The housing finance system exists to serve America's housing needs. To build a strong housing finance market that serves the United States well in the decades to come, affordable mortgage credit needs to be available across geographies, and to lower-wealth families of all racial and ethnic backgrounds. This means that any new system must be able to provide liquidity for well underwritten loans with low down payments, and pricing should be averaged as much as possible across the portfolio and take into account the risk of mortgages' failure through a tough but reasonable stress test.

**Broad duty to serve:** Congress should build on the aspects of the current housing system that work for consumers. First, the GSEs are both chartered entities with a statutory duty to serve qualified borrowers across the entire United States.<sup>28</sup> This statutory requirement has helped to ensure the availability of mortgage credit among populations and geographic areas that might not otherwise be served by the private securitization market. Rural communities have benefited from this broad duty to serve with which the GSEs must comply.

**Affordable housing goals and the new duty to serve rule:** These are important tools that help to ensure that the GSEs are complying with their mission. Neither the affordable housing goals nor the broad

mission of the GSEs caused their financial challenges during the housing crisis. Few of the toxic securities purchased by the GSEs or the Alt-A mortgages they backed to increase shareholder profits, counted toward the GSEs affordable housing goals. The mistakes Fannie Mae and Freddie Mac made were in service of satisfying their shareholders, not complying with their affordable housing mission or the housing goals.

**Affordability funds:** The National Housing Trust Fund and Capital Magnet Fund are both important for creating affordable rental and homeownership opportunities for families across the country. Affordable housing providers simply cannot afford to provide many low-income families with affordable options without the support of these funds. The market access fund, proposed by the Center for American Progress and the Consumer Federation of America is another important tool for creating access and opportunity. The market access fund would provide funding for pilots and new products so that more families can access affordable housing. All three of these funds should be expanded by a 10 basis point fee on all outstanding securities. This fee should generate about \$4.5 billion annually for these affordable housing funds, according to the Urban Institute.<sup>29</sup>

**3. Managing mortgage costs for homebuyers:** Perhaps the most important factor that will determine access and affordability in the decades to come is the way in which mortgage credit is priced. A move toward more aggressive risk-based pricing, as might occur under some the housing finance reform proposals under consideration, could make it harder for low and moderate-income borrowers to buy a home using a conventional mortgage.

Pricing policies already appear to be keeping some homebuyers from accessing conventional mortgage credit. Traditionally, the GSEs have pooled risk, charging similar fees to all homebuyers to ensure that mortgage risk is managed across their book of business. Since the GSEs have entered conservatorship, they and their credit counterparties, the MIs, have shifted toward a more individualized approach. Borrowers at the lower end of the credit score spectrum are charged higher fees, up to 300 basis points more, than borrowers with pristine credit through loan level pricing adjustments and mortgage insurance costs.<sup>30</sup> With these pricing policies in place, it's no surprise that the average credit score on a loan purchased by Fannie Mae or Freddie Mac today is 740 for first time buyers and 756 for repeat buyers, both well above the credit score for the typical American.<sup>31</sup>

Some of the proposals under consideration could make pricing even more prohibitive for low and moderate-income borrowers by encouraging sources of private credit that may be more likely to price risk on an individual loan-by-loan basis. Going forward, the GSEs or any entities that replace them, should not engage in risk-based pricing. For the housing market to thrive in the decades to come, all qualified borrowers should have access to the conventional mortgage market, not just the highest earners or wealthiest individuals.

**4. Preventing profit-seeking at the expense of consumers and taxpayers:** As Fannie Mae and Freddie Mac competed with the private securitization market and sought to increase returns for shareholders, they strayed from historically strong standards and practices. Moving forward, these incentives need to be addressed so that guarantors do not put the short-term interests of shareholders ahead of taxpayers and consumers.

**5. Protecting taxpayers through appropriate capital standards:** In the lead up to the crisis, Fannie Mae and Freddie Mac were not holding sufficient equity and relied on an implicit government guarantee. And

like the big banks, Fannie Mae and Freddie Mac were supported by the federal government as they teetered on the edge of bankruptcy. To safeguard taxpayers against needing to step in again, Fannie Mae, Freddie Mac or the new entities should be required to hold sufficient equity to ensure they can weather tough times.

**6. Strong regulatory oversight to protect the housing finance system:** There should also be a strong regulator in place to ensure safety and soundness. In the lead up to the crisis, Fannie Mae and Freddie Mac were poorly regulated. Responsibilities for regulating the Enterprises were split between HUD and OFEO and neither was particularly effective. Congress created a new regulator, the Federal Housing Finance Agency (FHFA), through the HERA Act in 2008 and gave it far more regulatory authority than the prior regulators. FHFA can set capital standards, set prudential management standards, remove officers and directors, put the regulated entity into receivership, and review and approve new product offerings.<sup>32</sup> The housing finance system needs a strong, empowered regulator like FHFA for the decades to come.

Moreover, consumers, investors and taxpayers all benefit from strong consumer protection. The rules put in place after the crisis to prevent a return to predatory lending are crucial to the long-term health of the housing finance system and the housing market. Regulators and Congress should defend these important rules of the road. If they deteriorate, the housing finance system will be put at risk.

**7. Easy access to the secondary market for small lenders:** Small lenders serve the credit needs of their communities and need a secondary market execution that is easy to access and does not favor larger lenders. Today, small lenders can sell loans to directly to Fannie Mae and Freddie Mac through the cash window and obtain a price like what the Enterprises offer larger banks selling larger pools of loans. Small lenders can also maintain the servicing rights for the loans they sell which strengthens customer relationships and provides a reliable income stream. As the Center for Responsible Lending noted in its recent testimony, several housing finance reform proposals include a cash window but few of these proposed cash windows provide all the benefits and access of today's cash window.<sup>33</sup> Moreover, while a well-functioning cash window is important for small lender access, it is not sufficient to guarantee a level playing field for small and large lenders. If there are other aspects of the housing finance system that give a cost-advantage to larger banks, small banks could also be disadvantaged.

**8. The housing finance system must meet the needs of America's renters:** The number of households that cannot afford their monthly rent is growing. According to an analysis by the Joint Center on Housing Studies of Harvard University and Enterprise Community Partners, there could be nearly 15 million cost-burdened renters by 2025, a 25 percent increase from 2015.<sup>34</sup> Supply has been slow to meet an increase in demand for rental housing. As rents have increased and incomes have remained relatively stagnant, more families are having difficulty affording rent each month. Our communities need more affordable rental housing.

The housing finance system helps to determine the availability of affordable rental housing. For a new multifamily building to open its doors to renters, the building owner needs to be able to acquire permanent mortgage financing after the building is constructed. Periodically, building owners need to make renovations to keep rental units habitable and attractive. The Enterprises play an important role in the rental market, making financing for acquisition, refinancing and rehabilitation more easily accessible. The majority of the rental units financed by the Enterprises are affordable to low and moderate-income households.<sup>35</sup>



Going forward, the Enterprises, or their successors, should increase focus on affordable rental housing. Recognizing the persistent affordability challenges in the rental market, it may be necessary to set higher thresholds for affordability than are in place today.

**Assessment of Current Housing Finance Reform Proposals**

CAP believes that there are several structures that could accomplish these goals and serve the housing finance system well. A government corporation, private utility, or mutually-owned cooperative if structured right, could deliver well-priced, sustainable mortgage credit to qualified borrowers across markets and economic cycles.

Over the past several years, there have been dozens of proposals published about how to best structure the housing finance system. There are areas where the conversation has progressed significantly and positively. First, there appears to be widespread agreement about the need for a paid-for, government guarantee for mortgage backed securities issued by Fannie Mae and Freddie Mac and/or their successors. There also appears to be consensus forming about the need for expanded affordable housing funds. Finally, more stakeholders and experts are supportive of keeping the current affordable housing goals, the new duty to serve rule and the broad duty to serve requirement currently in place.

However, important differences persist among the proposals that are significant for the consumers and the health of the housing finances system. Some experts believe that competition in the secondary market is a primary goal of housing finance reform which we believe may not be a sustainable approach. Some experts also envision a system that relies heavily on credit risk transfer structures, both pre and post loan origination and securitization, which we believe need to be developed further before assuming a larger role in the housing finance system.

**Competition in the secondary market does not always yield benefits for consumers or taxpayers**

CAP believes that competition in the primary market is very desirable. Consumers do better when they shop around for a mortgage, and lenders push one another to offer better terms to consumers. CAP also agrees that some competition in the secondary market is preferable. Fannie Mae and Freddie Mac, for instance, often drive one another to offer more innovative products and compete to offer lenders the easiest execution, which delivers benefits to consumers.

However, it is important to consider whether much more competition in the secondary market is a desirable goal. In the lead up to the housing crisis, there was significant competition in the private market. The private label securitization market was robust and private mortgage insurers were very competitive. This competition did not lead to better terms for consumers nor did it protect taxpayers. In fact, competition among secondary market participants drove a race to the bottom, with each jockeying for market share.

Several of the housing finance reform proposals under consideration make the mistake of setting secondary market competition as a goal of housing finance reform. Both the Milken Institute and the Mortgage Bankers Association (MBA) proposals envision a system in which many entities could issue mortgage backed securities that are guaranteed by the federal government.<sup>36</sup> Their theory is that more competition will deliver better priced mortgage credit and greater efficiencies to the consumer while also protecting taxpayers by diversifying risk.

History tells a different story. When the housing market collapsed and the global finance system teetered on the edge of collapse, many firms with connections to the private label securities market needed bailouts. Competition among secondary market participants or among private mortgage insurance companies did not protect taxpayers or consumers during the crisis.

Some of the largest issuers of private label securities – Goldman Sachs, Bank of America, GMAC, and Wells Fargo – all needed support from the federal government to keep their doors open.<sup>37</sup> They also withdrew from the private label securitization market. Private mortgage insurance companies also withdrew from the housing market – their market share decreased from 74 percent at the onset of the crisis in 2007 to 14 percent during the depths of the foreclosure crisis in 2010.<sup>38</sup> Had FHA and the GSEs not continued to do business during the crisis, the impact of the crisis would have been even more severe and more homeowners would still be underwater on their mortgages today.

The models proposed by Milken and the MBA envision a competitive marketplace of many companies that can offer mortgage backed securities that are backed by the federal government.<sup>39</sup> Our concern is that these proposed structures may create the conditions for the bad behavior we saw in the private label securitization market in the lead up to the financial crisis – this time, however, with the securities guaranteed by the federal government.

In a new report, Andy Davidson, an expert in mortgage backed securities and a designer of Fannie Mae and Freddie Mac's new credit-risk sharing instruments explains how competition in the secondary market can lead to a race to the bottom that does not help consumers or taxpayers.

“Even if there are multiple guarantor entities, it is likely that if one is failing the others are likely to be under pressure. Government might still need to intervene. Further, the risk isn't just that they fail, but that the damage that is done as they race toward the bottom. We have seen the impact of poor underwriting and lax standards on the broader financial system when competition to feed the machine led to a severe decline in underwriting discipline in the subprime market.”<sup>40</sup>

In a market with many guarantors, it may also be harder for a regulator to ensure safety and soundness and that the system is serving all qualified borrowers, including those who do not live in the nation's most desirable markets. Moreover, it is questionable whether a system of many guarantors would be sustainable over the long term. The secondary market business model is based on aggregating large numbers of loans into securities, with relatively low margins.

#### **Credit risk transfer program needs more development**

Credit risk transfer is playing an increasingly significant role in our housing finance system and several of the prominent housing finance reform proposals envision a system where credit risk transfer is a primary means of shifting mortgage risk from taxpayers to the private market.<sup>41</sup>

CAP believes that credit risk transfer structures are important tools that the GSEs should continue to develop. However, it is not yet clear whether the credit risk transfer program will be sustainable over the long term or whether credit risk transfer instruments will raise costs for consumers. These issues need to be taken into consideration before Congress considers any legislation that requires mortgage guarantors to share credit risk with the private market through these instruments or considers a broader role for credit risk transfer.

Since 2013, the GSEs have made progress toward creating a back-end credit risk transfer marketplace. They have transferred about \$54.2 billion of credit risk to the private market on a \$1.6 trillion of unpaid principal balance, or 3.4 percent of outstanding UPB.<sup>42</sup> To date, about 80 percent of credit risk has been transferred through fully collateralized derivative instruments – Fannie Mae has transferred risk through its Connecticut Avenue Securities (CAS) and Freddie Mac through its Structured Agency Credit Risk transactions (STACR).<sup>43</sup>

The credit risk transfer marketplace needs significant oversight to reduce taxpayer risk and to promote stability through economic housing cycles, objectives established by the FHFA.<sup>44</sup> Credit risk transfer transactions should also make sense for consumers – they should not raise the cost of borrowing for working families.

Credit risk transfer instruments only protect taxpayers if the credit risk is permanently transferred. If a counterparty fails or is unable to provide promised reinsurance, taxpayers are not protected. While this is less of a concern with fully collateralized transactions, regulators will need to closely monitor newer partially collateralized structures. In Quarter 1 of 2017, about 20 percent of the risk transferred through the CRT program was transferred through insurance and reinsurance transactions, which are not fully collateralized.<sup>45</sup> More research may be needed on the state of supervision and risks within the reinsurance industry. While it is generally assumed that reinsurance companies present minimal correlation risk to the GSEs because of their highly diversified lines of business, there may be other risks to manage. For instance, AIG was believed to be a strong counterparty with limited correlation risk in the run up to the crisis. These transactions may need to be fully collateralized, as was recommended by the authors of A More Promising Road proposal.<sup>46</sup>

There are still remaining questions about the future of the credit risk transfer market. First, Enterprises' credit risk transfer offerings have been piloted during a time of economic expansion. Many experts have expressed concern that it could become prohibitively expensive to transfer risk to the private market during an economic downturn when mortgage defaults increase. Moreover, the future of the credit risk transfer market depends largely on the structure of the housing finance system. In a forthcoming paper, Susan Wachter explains that a robust CRT market may not flourish in a system with multiple guarantors because it will be harder to maintain standardization, transparency and liquidity.<sup>47</sup>

Finally, any use of deeper mortgage insurance to transfer credit risk needs to be carefully considered. As CRL explained in its recent testimony, overreliance on the private mortgage insurance market could lead to more differential pricing, which raises borrowing costs for working families. It may be possible to limit cost increases to low and moderate-income consumers by requiring private mortgage insurance counterparties to price based on the risk of the entire pool and not on a loan-by-loan basis. Guarantee fees could also be lowered to offset any increases for borrowers, as recommended by the authors of A More Promising Road.<sup>48</sup>

### **Moving Forward**

As policymakers consider ways to strengthen the housing finance system, it is critical that they preserve what's working, build on the reforms underway, and carefully consider additional reforms to ensure a sustainable system. The Center for American Progress supports housing finance reform, but only if the reforms make the system stronger.

Fannie Mae and Freddie Mac have served the American mortgage market well over the decades. Even today, while in conservatorship, they are meeting the mortgage market's credit needs, although they should be doing more to reach low and moderate-income borrowers and renters. Their mission, and the tools that Congress has helped to develop, including the affordable housing goals and the duty to serve rule, help to strengthen the mortgage market and should be preserved in the system moving forward. The new regulatory structure provided by HERA and the new mortgage protections outlined by the Dodd Frank Act are critical for the future health of the housing finance system.

The most important remaining work that requires new policy solutions includes addressing the misaligned incentives that led Fannie Mae and Freddie Mac to prioritize short-term shareholder profits over the long-term sustainability of their businesses. Also needed is an explicit government guarantee for mortgage-backed securities that is paid for the entities guaranteeing the mortgages. As policymakers weigh policy options to address these outstanding issues, they should evaluate how each proposed structure affects prices for consumers and whether they are sustainable over the long run. We look forward to continued discussions about how to best address these remaining challenges.

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Testimony of Daniel Goodwin

Director of Mortgage Policy  
Structured Finance Industry Group ("SFIG")

Before the

U.S. House of Representatives  
Committee on Financial Services  
Subcommittee on Housing and Insurance

Hearing on

Sustainable Housing Finance: Private Sector Perspectives on Housing Finance Reform,  
Part II

November 2, 2017



<http://www.sfindustry.org/>

Chairman Duffy, Ranking Member Cleaver and members of the Subcommittee, thank you for the opportunity to testify today. My name is Daniel Goodwin and I am the Director of Mortgage Policy for the Structured Finance Industry Group, Inc. ("SFIG"), a trade association that represents over 350 corporate members from all sectors of the structured finance and securitization market, including investors, issuers, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers, and trustees. A key element of SFIG's mission is to educate and advocate on behalf of the structured finance and securitization industry with respect to policy, legal, regulatory and other matters affecting or potentially affecting the structured finance, securitization and related capital markets.

It is with that mission in mind that I thank you for this opportunity to address the Committee regarding housing finance reform, including finding an appropriate balance of private and public funding in the housing finance system. While the overall economic environment, and housing finance in particular, has recovered substantially since the crisis nearly 10 years ago and home prices in most markets have largely recovered, private capital's role in that recovery has been comparatively small, in historical terms, in relation to the government's role. The disproportionately large role of the government in today's housing finance system is the outcome of many factors but it is inarguably in an unhealthy condition. We believe this condition can be remedied, but reforms should be done in a manner which provides for a smooth transition that minimizes market volatility and maintains access to credit.

SFIG believes that the reform process must proceed in a measured and deliberate way. We appreciate the Committee's methodical approach in considering reforms that are inherently critical



to the U.S. housing market and the economy as a whole. In this process, we suggest one guiding principle: in order to provide consumers access to credit at competitive rates, there must be a stable, liquid, and efficient secondary mortgage market that allows responsible lenders the ability to compare funding costs easily across competing funding sources and readily access those same funding sources on a level playing field. Historically, these funding sources have fallen under two broad categories: publically supported funding and privately supported funding. Currently, approximately 70% of all new first-lien originations are backed by the taxpayer in some form, either through Fannie Mae and Freddie Mac (GSEs) or FHA/VA/USDA.<sup>1</sup> The remaining 30% comes from private funding, the vast majority of which is comprised of portfolio funding, with less than 1% coming from private-label securitization.<sup>2</sup>

Any considerations of housing reform should encourage a healthy and sustainable mix of publically-supported and privately-supported funding sources, eliminate hidden or implied guarantees or subsidies which might distort costs, and minimize risk to the taxpayer and the economy. While we strongly encourage steps to restore the private label securitization market because it removes risk from taxpayers, diversifies economic risk, encourages economic innovation, and ultimately reduces borrowing costs, we also believe that the continued presence of publically-supported funding is essential to provide counter-cyclical stability, act as a source of 30 year fixed mortgage credit to the consumer, and support the To-Be-Announced (TBA) market and support affordable housing goals.

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<sup>1</sup> [https://www.urban.org/sites/default/files/publication/93516/sep\\_chartbook\\_final\\_1.pdf](https://www.urban.org/sites/default/files/publication/93516/sep_chartbook_final_1.pdf)

<sup>2</sup> Ibid.

*In Support of a Government Guaranty**I. The TBA Market*

The distinguishing traits of the TBA Market are the government guaranty and the homogeneity of the offered securities (i.e., standardized underwriting criteria and loan features, the geographic diversification incorporated into the pooling process, the limited number of issuers, the simple structure of “pass-through” security features, and the restriction of the range of interest rates on loans deliverable into a single security). The parties to the trades agree only on certain criteria of the securities to be delivered: issuer, maturity, coupon, price, principal balance, and trade settlement date. The actual securities to be delivered at trade settlement are not specified on the date the transaction is executed. Rather, just before the settlement date, the seller notifies the buyer of the specific securities that will satisfy the TBA agreement.

The elimination of credit risk and homogeneity have created the TBA market, with trading approaching \$200bn per day, which is deeper and more liquid than all other markets except the US Treasury market.<sup>3</sup> It is relied on as a tool by institutional investors to hedge interest rate risk or express a view on rate movements. Since the TBA Market simplifies the analytical and risk management challenges for participants, a broader group of investors participates in the TBA Market than would otherwise participate if investment decisions were more complex. The additional fixed income investors — insurance companies, foreign central banks, mutual funds and hedge funds — inject more capital into the market for financing mortgages and ultimately reduce the cost of credit to consumers.

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<sup>3</sup> [https://www.finra.org/sites/default/files/Analysis\\_of\\_Securitized\\_Asset\\_Liquidity.pdf](https://www.finra.org/sites/default/files/Analysis_of_Securitized_Asset_Liquidity.pdf)

The TBA Market also provides a more direct and noticeable benefit to the housing markets, it is the most efficient and cheapest mechanism to enable a mortgage consumer to “lock in” the interest rate at the time when a mortgage loan is approved and thereby minimize the cost of borrowing. Because TBA buyers are indifferent as to the specific securities delivered, originators are able to easily and inexpensively cover their hedges should they originate less collateral than expected in any given period, significantly reducing the cost to hedge and rate lock. The TBA Market creates efficiencies and cost savings for lenders that are passed on to borrowers in the form of lower rates.

Moreover, homogeneity is what makes the TBA Market possible, specifically, the fungibility of the conforming loan product (through standardized underwriting criteria and loan features) and a government guarantee, which equalizes credit risk. Additionally, due to the specific exemption from SEC shelf registration requirements applicable to government-guaranteed securities, specific collateral need not be identified, thus allowing forward selling. It is not possible to replicate the TBA Market without each of these factors. Any reform which does not accommodate, or suitably replace, the existing TBA Market will undoubtedly impact mortgage originators and consumers both severely and negatively by reducing price transparency, liquidity, and the originators’ options to rate lock and thus satisfy consumer needs. These costs would be directly passed on to consumers in the form of higher prices. In short, the TBA Market removes uncertainty from the mortgage origination business and keeps mortgage rates low for potential borrowers. As noted in a report published by the Federal Reserve Bank of New York, “the TBA market serves a valuable role in the mortgage finance system,” and “evaluations of proposed reforms to U.S. housing finance should take into account potential effects of those reforms on the operation of the TBA market and its liquidity.”<sup>4</sup>

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<sup>4</sup> [https://www.newyorkfed.org/medialibrary/media/research/staff\\_reports/sr468.pdf](https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr468.pdf)

Furthermore, as the GSEs move ahead with the roll-out of the Common Securitization Platform (CSP) and the Uniform Mortgage Backed Security (UMBS) particular care and consideration should be paid to facilitate the standardization of MBS instruments that receive an ultimate government guarantee in order to ensure the continued functioning of the TBA Market. The transition from the status quo to a new housing finance structure must be transparent, appropriate to market conditions, and handled with great care to minimize any disruptions to the flow of credit to consumers, and ensure the continued functioning of a healthy TBA Market. Of utmost concern is that steps must be taken to allow the fulfillment of existing commitments (including contracts for future delivery) and preserve the market for legacy securities (i.e., outstanding government-guaranteed MBS), while allowing sufficient time for eligible loans under the reformed system to be generated and take hold in the TBA Market.

## *2. 30-year Fixed Rate*

I would like to speak briefly about the benefits of the 30-year fixed rate mortgage and its reliance on government support. Without the backing of the Federal government, it is unlikely that the 30-year fixed-rate mortgage, which remains an essential financing tool for homebuyers, could exist in the U.S. mortgage market. The fixed interest rate provides certainty, allowing a family to budget their housing costs and make long-term financial plans. The 30-year fixed rate mortgage has enabled borrowers to purchase and refinance homes with level and predictable monthly payments, and without fear of future interest rate swings. While homebuyers could theoretically attempt to price in the risk of future interest rate increases, the informational asymmetry and lack

of technical expertise would create inefficiencies that do not exist in the current market. These inefficiencies translate into increased borrowing costs for the consumer, limiting affordability, and introducing significant potential volatility into household budgets.

### *3. Counter-cyclical and Providing Credit through Market Downturns*

SFIG believes that an additional benefit of the government's continued presence in the mortgage market is that it acts as a counter-cyclical support, maintaining a presence through all market cycles so that in times of reduced access or tighter credit, credit-worthy borrowers can still obtain a mortgage at competitive rates. This was certainly the case in 2008 and 2009, when the private funding sources dried up entirely. Counter-cyclical support also benefits secondary market participants by acting as a market stabilizer, providing funding until such a time as private capital is willing and able to take on an increased level of mortgage credit risk. SFIG notes, however, that care should be taken so that public funding that has stepped up in the absence of private capital during a market downturn does not inadvertently work to crowd out private capital as the market recovers – a situation many industry observers believe is the case right now.

### *4. Affordable Housing*

SFIG also recognizes that a housing finance system that relies on public funding sources has an obligation to serve the public, including Federally-backed affordable or subsidized housing policy goals or outcomes. Congress should explicitly promote that goal through a stand-alone program not linked in any way to the operation of the secondary mortgage market, and should fund that program through separate legislative mechanisms. Implicit and opaque subsidies can distort markets, may

result in the benefits of certain programs accruing to borrowers who are not the intended beneficiaries, and can ultimately shift risk back to the taxpayer.

### ***The Role of Private Capital***

#### ***1. GSE CRT Program***

At the outset of my testimony I stressed the importance of the appropriate mix of public and private support for the housing finance system. Over the past decade, publically-supported funding has played an outsized role in supporting the market, which has diminished the role of the mortgage credit investor and the private capital provided by such investors. While private capital has entered the market in the form of portfolio lending, this channel represents a smaller pool of capital than the fixed income markets, and serves to concentrate mortgage credit risk on the balance sheets of a few lenders rather than distribute it throughout a broad base of investors. Clearly much work remains to be done to restore a more healthy balance to these funding sources.

One area where there has been notable success in the reintroduction of private capital into the risk taking spectrum is via the GSEs CRT programs. SFIG applauds the work done by the GSEs to offload risk on 90% of its newly guaranteed mortgage production.<sup>5</sup> This program has clearly demonstrated that there is private capital eager to invest in newly originated mortgage credit risk, so long as investors feel their interests are protected and there is a reasonable amount of regulatory and legal certainty. We believe that the GSEs should build on their success expand their programs to include an even greater percentage of their portfolios and explore selling even

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<sup>5</sup> <https://www.fhfa.gov/aboutus/reports/reportdocuments/crt-overview-8-21-2015.pdf>

more of the existing risk they retain on the CRTs to further reduce risk to the taxpayer. For instance, the GSEs sell only the riskier portions of the credit exposure in their CRT deals. While a market for the more protected portion of CRT may not yet exist, and the GSE's priority must be the economic viability of selling such a portion, developing this market and further reducing the retained risk is in the taxpayers' interest. By retaining the safer and more protected portions of the CRT, it effectively reduces the opportunity to attract pools of capital that might otherwise invest in senior credit. Additionally, the success of the GSE's CRT programs may provide the basis for exploring CRT on other government backed securities, like those of Ginnie Mae.

The former PLS market offered these deep pools of capital to fixed income investors in the form of investment grade securities, increasing liquidity and ultimately helping lower consumer borrowing costs. SFIG believes that while GSEs CRT programs are and should remain a vital part of any government-guaranteed MBS issuance, it does not replace the need for a vibrant private label securities market.

## *2. Reviving the PLS market*

As noted above, the PLS market once represented a far greater share of the mortgage funding ecosystem. Market excesses and bad actors across the mortgage market led to the collapse in housing that fed the Great Recession. In response to that crisis, legislation and regulations were put in place with the goal of preventing the kinds of excesses we witnessed a decade ago.

While these laws and regulations were intended to reduce risk and prevent the dynamics and behaviors that led to the crash they were, in some instances, overly broad or created uncertainty.

This contributes to the current reality wherein some historically credit-worthy borrowers are unable to access credit because investors are neither willing nor able to provide capital that had previously been invested in mortgage credit risk. The end result is that many of the people who were hurt by the housing collapse now find themselves unable to benefit from the ongoing housing recovery.

In response to the crisis, the Dodd-Frank Act and resulting regulatory reforms were imposed to provide greater protection and stability to the housing market and economy. Largely, these reforms did not touch the GSEs, resulting in capital shifting towards the publicly supported market and away from the private market, as a result of the burdensome rules that were placed on that market. As this committee is considering housing finance reform and ways to attract that private capital, policymakers should review those policies which may have created an uneven playing field or inadvertent biases.

One such area is capital relief for non-GSE issuers of CRT, i.e. banks. Currently, it is very difficult for depository institutions subject to regulatory capital rules entering into similar transactions to be able to recognize the benefits of having transferred risk to third-parties. In most circumstances the capital reserved against the risk associated with such a transaction is greater than the required capital to be set aside for the loans themselves. Industry observers generally agree that, consistent, with common-sense, the amount of capital required to protect against loss in the system should be decreased when risk is transferred.

Another area worthy of consideration is highlighted in the Treasury Report – A Financial System That Creates Economic Opportunities, dated June 2017. The Treasury states: “Prudential bank



regulators should review the regulatory framework for risk-weighting applicable to securitizations in order to better align the framework with the risk of the asset and with international standards for securitized products. Increased capital and liquidity standards have negatively impacted the economic attractiveness of PLS.”<sup>6</sup>

A more straightforward way to encourage expansion of the PLS market is by lowering the conforming loan limits of Fannie Mae and Freddie Mac. Loan limits were raised to their current levels in an environment with a robust and competitive PLS market and where the GSEs were not in Conservatorship. Today, it is more difficult to support government subsidies that benefit borrowers with mortgages on properties that approach — and in many cases, exceed — half a million dollars or more. SFIG believes that a slow and measured lowering of loan limits could transfer risk from the GSEs and to investors through the PLS market. The narrow spread between current conforming rates and non-conforming jumbo rates suggests that private capital is able to take on 100% of the credit risk of these mortgages at competitive rates, with no need for the government effectively to subsidize and take on the risk of these mortgages.

The industry itself is working to revive the PLS market. SFIG and its members are actively engaged in RMBS 3.0, an initiative that uses lessons learned in the crisis to promote standardization of best practices and to reduce substantive differences within current market practices through an open discussion among a broad cross-section of market participants. We would be happy to share this work with members of the Committee.

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<sup>6</sup> <https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf>

**Conclusion**

The issues confronting the Committee as it considers reforms to the housing finance system are critical not only to the health of the nation's housing market, but to the growth of the nation's economy generally. While we recognize the need to correct the errors of the past, we urge the Committee not to lose sight of the ways in which the Agency Market has worked well and the potential opportunities to re-invigorate the PLS market, all in the service of facilitating a more robust, liquid, competitive, and stable housing market.

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



**Testimony of Jerry Howard**

**On Behalf of the  
National Association of Home Builders**

**Before the  
House Financial Services Committee  
Subcommittee on Housing and  
Insurance**

**Hearing on  
"Sustainable Housing Finance: Private Sector Perspectives on Housing  
Finance Reform – Part II"**

**November 2, 2017**

**Testimony of Jerry Howard**  
**Chief Executive Officer**  
**National Association of Home Builders**  
**November 2, 2017**  
**Page 1**

Chairman Duffy, Ranking Member Cleaver and members of the Subcommittee, I am pleased to appear before you today on behalf of the National Association of Home Builders (NAHB) to share our views on housing finance reform. My name is Jerry Howard and I am NAHB's Chief Executive Officer.

NAHB represents over 140,000 members who are involved in building single family and multifamily housing, remodeling, and other aspects of residential and light commercial construction. NAHB's members construct approximately 80 percent of all new housing in America each year. Our builders rely on both government and private programs to help provide decent, safe, and affordable single family and multifamily housing to many of our fellow citizens.

We believe an effective housing finance system must address liquidity as well as affordability and that those two elements are very closely related. Therefore, while it is important the system provide housing credit at affordable terms as well as address specific housing needs, it also is essential that credit is consistently available on those terms regardless of domestic and international economic and financial conditions.

NAHB remains a staunch supporter of comprehensive housing finance system reform. To NAHB this means effective reform of the conventional mortgage finance market, including Fannie Mae and Freddie Mac (the Enterprises), private capital sources and federal mortgage finance programs, in particular the U.S. Department of Housing and Urban Development (HUD), (most involving the Federal Housing Administration, FHA), the U.S. Department of Agriculture's Rural Housing Service (RHS) and the U.S. Department of Veteran's Affairs (VA). NAHB believes comprehensive reform must come through Congress and focus on fixing the structural flaws that led to the breakdown of the housing finance system. Comprehensive legislation is the only way to ensure a stable housing finance system, preserve access to credit and protect taxpayers.

#### **Need for Comprehensive Housing Finance System Reform**

In September, Fannie Mae and Freddie Mac completed their ninth year in conservatorship under the control of their regulator, the Federal Housing Finance Agency (FHFA). NAHB believes strongly that having the Enterprises continue in conservatorship, with no end in sight, is undesirable and unsustainable.

Under the terms of their conservatorships, the Senior Preferred Stock Purchase Agreements (PSPAs), the Enterprises are required to remit all their profits, above a small capital buffer, to the U.S. Department of the Treasury (Treasury) on a quarterly basis and reduce their capital buffer to zero by January 1, 2018. Since being placed in conservatorship, the Enterprises have paid Treasury a combined \$270.9 billion. Significantly, this does not count as repayment for the \$189.4 billion (including the initial \$2 billion) of the capital support provided by Treasury. The Treasury has a remaining outstanding commitment of \$258.1 billion available to the Enterprises to draw down. It is this commitment from Treasury that is supporting investor confidence in the Enterprises' mortgage-backed securities (MBS) and keeping the housing market liquid and operational.

While Fannie Mae and Freddie Mac are not granted an explicit government guarantee by their charters, Treasury's backing has turned the Enterprises' historical implicit guarantee into an

Testimony of Jerry Howard  
Chief Executive Officer  
National Association of Home Builders  
November 2, 2017  
Page 2

explicit government guarantee. The Enterprises currently back over \$5 trillion in mortgages. Combined with Ginnie Mae securities, which are backed by loans insured by FHA, RHS and mortgages guaranteed by VA, outstanding securities in the agency market totaled \$6.29 trillion in September 2017, a significant percentage of the entire U.S. economy. These loans all have a federal government backstop, which means taxpayers are at risk of loss due to a failure of the underlying mortgage loans. FHFA has taken steps to reduce taxpayer risk on Fannie Mae- and Freddie Mac-backed loans through Credit Risk Transfer (CRT) programs that transfer a meaningful portion of credit risk to private investors on at least 90 percent of their targeted fixed-rate single family mortgage acquisitions.

As 2018 approaches, many industry participants, including FHFA Director Mel Watt, are expressing concerns about the impact the reduction and eventual elimination of capital reserves could have on the Enterprises and the mortgage and financial markets broadly. While Director Watt has steadfastly maintained it is the role of Congress, not FHFA, to make housing finance reform decisions, he believes it is irresponsible for the Enterprises to have such a limited capital buffer because a loss in any quarter could result in an additional draw of taxpayer support and a corresponding reduction in the fixed dollar commitment Treasury has pledged to support the Enterprises.

While some have called on FHFA to allow Fannie Mae and Freddie Mac to recapitalize in an effort to avert the need for further draws from Treasury, NAHB believes this constitutes a piecemeal approach to reform and would be counterproductive to long-term sustainability. Allowing the Enterprises to recapitalize would encourage their release from conservatorship prior to meaningful reform and would reestablish the "failed GSE model" that allows private gains and public losses.

Congressional action on comprehensive housing finance reform is the only way to achieve an effective and sustainable solution. To ensure a stable housing finance system that will support the future of homeownership and affordable multifamily housing in America, Congress must fix the structural flaws inherent in Fannie Mae's and Freddie Mac's government charters that contributed to the housing finance crisis. Short-term regulatory solutions or piecemeal legislative steps are not adequate.

As talk of a possible draw from Treasury continues, NAHB calls on Congress to make comprehensive housing finance reform a top priority and pass legislation to ensure the federal government continues to provide a backstop for a reliable and adequate flow of affordable housing credit in all economic and financial conditions.

#### **NAHB's Key Elements for a Reformed Housing Finance System**

NAHB believes the U.S. housing finance system should be multifaceted with both competing and complementary components, including private, federal and state sources of housing capital. Key elements of NAHB's specific policy proposals covering both single family and multifamily housing are summarized below. The full details of NAHB's housing finance system

Testimony of Jerry Howard  
Chief Executive Officer  
National Association of Home Builders  
November 2, 2017  
Page 3

recommendations are contained in NAHB's white paper, *"Why Housing Matters: A Comprehensive Framework for Housing Finance System Reform."*<sup>1</sup>

#### **Importance of Federal Government Backstop and the 30-year Fixed-Rate Mortgage**

As stated earlier, NAHB's priority in housing finance system reform is ensuring liquidity for the housing sector in all markets throughout the economic cycle. This is only possible if market participants know there is a federal government backstop that will maintain stability in catastrophic circumstances. While NAHB agrees that the current degree of government intervention is unsustainable, an ongoing, though more limited, government role must be maintained to avoid future interruptions in the flow of credit to mortgage borrowers.

While NAHB agrees that private capital must be the dominant source of mortgage credit, the future of the housing finance system cannot be left entirely 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 federal backstop.

NAHB believes federal support is particularly important in continuing the availability of the affordable 30-year fixed-rate mortgage (FRM), which has been a staple of the U.S. housing finance system since the 1930s. 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. 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. 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. 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. Currently, Fannie Mae and Freddie Mac provide the securities vehicle along with a government guarantee for investors. There are serious doubts on whether a private housing finance system would be capable of supporting this type of product without some government backing. At a minimum, the cost and terms of 30-year FRMs would be significantly less favorable under a totally private system.

A government role is also essential for multifamily mortgage programs that also play a critical role in the overall health of the U.S. housing finance system. More than one-third of Americans live in rental housing and demand for rental housing in the future is expected to increase. As discussed further below, the multifamily sector performed much better than the single family housing market during the recent downturn. Multifamily loans held or guaranteed by Fannie Mae and Freddie Mac have very low default rates and the multifamily segments of both

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<sup>1</sup> *"Why Housing Matters: A Comprehensive Framework for Housing Finance System Reform"*, published by NAHB in September 2015.

Testimony of Jerry Howard  
Chief Executive Officer  
National Association of Home Builders  
November 2, 2017  
Page 4

Enterprises are profitable. FHA also provides support to the multifamily market through the FHA multifamily mortgage insurance programs. Private market financing is not readily available for all segments of the multifamily market. Thus, there is a need to maintain a viable, liquid and efficient secondary market for multifamily rental financing where the federal government continues to play a role.

#### **Reformed Secondary Market System for Conventional Mortgages**

NAHB believes it is essential to have an efficient and stable secondary market where conventional single family and multifamily mortgages are aggregated and placed into diversified pools for securitization and sale to investors worldwide. The securities would have an explicit federal government guarantee. However, the federal support to the conventional mortgage market of the future should be limited to catastrophic situations where carefully calibrated levels of private capital and insurance reserves are depleted before any taxpayer funds are employed to shore up the mortgage market. This would be done by creating a privately funded insurance pool for conventional MBS that would be similar to the insurance fund that secures savings deposits through the Federal Deposit Insurance Corporation (FDIC).

Under this approach, private Housing Finance Entities (HFEs) would be authorized to purchase mortgages from loan originators and to package the loans into securities. Only mortgages with reasonable and well understood risk characteristics would be eligible to serve as collateral. The originators and HFEs would be required to maintain capital to cover a portion of the credit risk on the pooled mortgages, with private mortgage insurance required on higher loan-to-value mortgages. The HFEs and originators also would pay premiums into the insurance fund that would provide additional protection to MBS investors. The federal government would ensure that the fund is actuarially sound and would stand behind the insurance fund in a catastrophic last tier position. This would provide securities investors a guarantee similar to the successful Government National Mortgage Association (Ginnie Mae) model.

#### The Enterprises could be recast as HFEs

Fannie Mae and Freddie Mac could be brought out of conservatorship and restructured as HFEs alone or with other participants. The Enterprises would be subject to the same rules, including safety and soundness and capital requirements, as all HFEs, and would be provided the protection and opportunities of the federal catastrophic backstop. Most important, the Enterprises' infrastructure should be utilized one way or another regardless of the ultimate future of Fannie Mae and/or Freddie Mac. During the more than four decades of their existence prior to conservatorship, the Enterprises developed sophisticated infrastructures of products, programs, and processes, including underwriting and servicing requirements, which should be used to form the foundation of a new system. The Enterprises recent risk-sharing initiatives in the single family market also should be retained and enhanced. This would ensure less market disruption in the transition to the new system.

The HFE conventional mortgage securitization system should operate under the oversight of a strong independent regulatory agency to ensure all aspects of safety and soundness. The agency also would oversee the federal conventional MBS insurance fund. The regulatory agency should be governed by a board, similar to the body governing the FDIC, with extensive expertise in the housing capital markets and housing finance needs.

Testimony of Jerry Howard  
Chief Executive Officer  
National Association of Home Builders  
November 2, 2017  
Page 5

Any changes to the housing finance system should be undertaken with extreme care and with sufficient time to ensure that U.S. home buyers, owners, 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 wound down and a reformed 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.

#### **Restart a Carefully Regulated Fully Private Mortgage-Backed Securities System**

The HFE conventional MBS would operate in tandem with a fully private MBS system. A robust market for private label MBS will be critical to the availability of mortgage products that do not conform to the underwriting and credit guidelines of mortgage loans that will be eligible for purchase by HFEs or insured or guaranteed by FHA, USDA and VA. The government guaranteed and non-guaranteed market segments can and should complement each other by specializing in distinct market niches while also competing on price and product for overlapping market segments.

During the housing recession, private-label securities (PLS) investors experienced significant losses, and an unprecedented level of mortgage defaults exposed problems with the agreements governing PLS. As a result, PLS issuances dropped significantly after 2006 and continue to be very small today. The PLS share of all residential mortgage-backed securities (RMBS) was 2.9 percent in the first nine months of 2017.

Private capital must be encouraged to reenter the mortgage market. However, without reforms, private capital is not incented to compete in today's market where the federal government backstop and bank portfolios provide a pricing advantage, and where structural and policy uncertainties exist.

Key prerequisites to restarting the private-label MBS market include: increasing transparency and disclosure around the collateral and structure of private label securities; clarifying servicing roles and responsibilities; and, ensuring that all participants operate under adequate regulation and have a stake in the performance of the mortgages that are originated and sold. The credit ratings process must be reformed to address conflicts of interest and provide investors assurance that their interests and rights are protected.

#### **Continue the Roles of the Federal Government Housing Agencies**

The housing finance support roles of HUD, FHA, VA, RHS and Ginnie Mae should be preserved. These agencies provide crucial counter-cyclical support to the housing market, expanding in downturns and contracting when the market improves. During the recent mortgage crisis, FHA demonstrated how invaluable its counter-cyclical support was in providing access to homeownership for underserved communities, primarily first-time home buyers, minorities and those with limited downpayment capabilities. As other sources of mortgage credit disappeared, FHA's share of the single family mortgage market jumped from 3 percent during the housing boom to a high of almost 30 percent early in the crisis before receding to around 15 percent of today's purchase housing market. FHA should have the ability to temporarily expand



Testimony of Jerry Howard  
Chief Executive Officer  
National Association of Home Builders  
November 2, 2017  
Page 6

its support in cyclical downturns by loan limit and other programmatic changes as was done in the recent housing crisis.

Efforts should continue to make the operations of these agencies more efficient and effective. FHA's operations, in particular, must be modernized to allow the agency to operate more efficiently and effectively. Too many constraints have been placed upon FHA, by Congress and internally via HUD, which inhibit FHA's ability to operate in a manner that recognizes, complements and evolves with developments by the private sector. To continue its vital role in the housing finance arena, FHA must be afforded greater freedom from external micromanagement and political influence while developing a professional, responsive, results-oriented culture and remaining accountable for achievement of its mission.

FHA should have the authority, without further Congressional action, to create or alter specific insurance programs in order to have the flexibility to react promptly to changes in market and other conditions. Hiring, salaries, personnel management, and procurement would be freed from current, confining federal government constraints in order to be more consistent and competitive with the private sector. FHA would be operated in a manner that does not require a federal subsidy and would allow FHA to retain revenues generated in excess of expenses to be used for mission purposes.

Further, NAHB urges Congress and policymakers to evaluate any changes to FHA or other government housing agencies within the context of other changes that have occurred, or may occur, within the agency and in the broader housing finance system. Changes must be assessed in terms of the cumulative impact on all components of the housing finance system, including the interplay among housing finance sectors.

Finally, NAHB encourages greater coordination between FHA and RHS on issues related to risk management and streamlining of administrative practices and procedures in some program areas, such as FHA multifamily mortgage insurance and rental housing assistance. However, NAHB does not support the transfer of RHS programs to FHA. The RHS programs are uniquely structured to address the housing credit needs of low and moderate income persons in rural areas, which are very different than those found in urban and suburban areas.

#### **Enhance Roles of State and Local Housing Finance Agencies**

State and local housing finance agencies have proved critical in helping communities continue to meet the needs of consumers who have faced hardships in the face of less credit availability. State and local housing finance agencies utilize tax-exempt bonds and taxable securities as well as state and federal resources to offer a range of single family and multifamily funding programs.

The recent economic crisis significantly diminished investor interest in mortgage revenue bonds (MRBs) and therefore severely limited the amount of funds available to finance affordable home mortgages and multifamily loans. The stress in the economy pressed HFAs to consider new ways of doing business, such as alternative bond financing programs. In addition, HFAs have increasingly turned to MBS execution through Ginnie Mae as an alternative funding source. Efforts to address problems in the tax-exempt MRB market and to facilitate new HFA financing products should be encouraged.

Testimony of Jerry Howard  
Chief Executive Officer  
National Association of Home Builders  
November 2, 2017  
Page 7

HFAs are uniquely positioned to assess community housing needs and should play an even more prominent housing finance role through the development of new programs for new, for-sale housing and multifamily rental homes. This should include partnering with federal and private providers of housing capital.

#### **Expand Role of the Federal Home Loan Banks in the Housing Finance System**

The Federal Home Loan Banks (FHLBanks) should continue their current activities to serve as an ongoing key liquidity source for institutions providing housing credit. The eleven FHLBanks currently operate by making collateralized loans to, and mortgage purchases from, member financial institutions, funded by debt offerings. Each FHLBank is a cooperative enterprise, which is owned by the commercial banks, thrift institutions, credit unions and insurance companies that utilize the FHLBank as a source of funds.

The principal business of the FHLBanks is extending to their members loans, called advances, which are collateralized by mortgages and other eligible assets in the portfolios of borrowing institutions. Most FHLBanks also have operated or participated in mortgage purchase programs, where the FHLBanks buy mortgages from member institutions to hold in portfolio. FHLBank advances and mortgage purchase activities are funded by debt offerings for which all eleven FHLBanks are responsible on a joint and several basis and which are managed by an Office of Finance.

Existing programs, such as the FHLBanks' mortgage purchase programs, should be enhanced by allowing the FHLBanks to have greater options for managing their balance sheets, consistent with safety and soundness. Further, the FHLBanks should develop additional programs to leverage their strong understanding of regional housing conditions and needs. Specifically, the FHLBanks should be authorized to engage in additional activities, including purchase of multifamily mortgages, and services to support a full range of housing-related lending by their members.

The FHLBanks also have been cautiously expanding their role in the housing finance system through pilot programs developed to help their members sell mortgage loans in the secondary mortgage market. FHLBanks could expand their mortgage programs by aggregating loans for sale to HFEs. Alternatively, one or more FHLBanks could be restructured as HFEs, subject to the same requirements and protections of all HFEs.

Reform of the housing finance system must carve out a role for the FHLBanks. NAHB could support an expanded role as long as any new lines of business, new mortgage programs or statutory changes to the FHLBank charters are considered carefully in order to avoid unintended consequences that might conflict with the FHLBanks' existing authorities and primary activity of providing advances to members. Further, changes to the housing finance system must be undertaken 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.

Testimony of Jerry Howard  
Chief Executive Officer  
National Association of Home Builders  
November 2, 2017  
Page 8

#### **Access to Affordable Credit**

In a future housing finance system, where several layers of private capital stand in front of a government backstop for catastrophic circumstances, the relative cost of housing credit would increase from current levels as home buyers ultimately bear the charges needed to attract the private capital and cover the cost of the government guarantee. However, NAHB believes that such a system would entail lower housing credit costs than one that relied exclusively on private players. Also, as mentioned previously, a completely private system likely would be subject to inconsistent credit availability.

With the prospect of higher mortgage borrowing costs, NAHB believes it is extremely important to make every effort to ensure that mortgage interest rates and fees do not increase more than is absolutely necessary to safely sustain the new system. It is important to base federal guarantee/insurance charges on the universe of mortgage products and underwriting requirements that will be in place in the future rather than on products and protocols that are no longer in existence. Careful study should be undertaken to determine the level of private capital and federal guarantee/insurance charges that are needed for a safe, sound and sustainable future housing finance system.

#### **Equal Playing Field for Small Lenders**

To ensure the future housing finance system serves all markets, broad market participation should be encouraged. Barriers to entry to the secondary market should be as low as possible while balancing safety to the system. Compliance with regulatory requirements should not be more burdensome for smaller lenders – recognizing the unique role many small lenders have carved out for their communities.

As the name implies, community banks offer financial services designed to meet the specific needs of their unique local markets. They are known particularly for serving rural areas and traditionally underserved markets. In the current environment of increased regulatory compliance requirements, tighter underwriting standards, and overall less availability of mortgage credit, it is important to be vigilant about the impact of housing finance reform on community banks and the mortgage borrowers they serve. Meeting the needs of their communities can mean these institutions are not originating standard products that can be sold in the secondary markets. This inability or difficulty to sell their loans to the secondary market can restrict their primary market activity.

While not having the dominant share of mortgage originations, community financial institutions originate a significant volume of mortgage loans. Over the years, community banks have sold their loans to large aggregators, including Fannie Mae and Freddie Mac, and have paid higher fees based on smaller volumes. In a reformed housing finance system, access and pricing should not be based on the volume of business or size or geographic location of the selling institution.

Testimony of Jerry Howard  
Chief Executive Officer  
National Association of Home Builders  
November 2, 2017  
Page 9

**Preserve the Successful Multifamily Housing Finance Framework**

It is important to understand that not all private market sources of capital for multifamily financing are available for all segments of the multifamily market. Each has strength in specific niches and markets and thus moves in and out of the market as economic conditions and their investment goals change. Life insurance companies typically target low-leverage, high-quality deals in the strongest markets (usually urban) 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. Banks also have significant exposure to regulatory pressure that influences their lending decisions, including obligations under the Community Reinvestment Act (CRA). 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 to 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 and communities.

NAHB cautions against over-reaching in regard to reforming the multifamily finance system. This component of the nation's housing finance system has performed, and continues to perform, very well. Housing finance reform should preserve the successful framework of the current system—including the federal backstop for conventional and federally insured multifamily mortgages. Taking draconian steps to "fix" an unbroken system is unwise and unnecessary. Again, NAHB believes that the critical consideration in a new system is broad and continued liquidity during all economic cycles and for all geographic areas.

**Preserve Successful Infrastructure and Programs from the Conventional Market**

It is absolutely critical that the Enterprises, or successor entities, provide broad liquidity to the market during all economic cycles. To achieve this mission, the Enterprises must continue to offer a diversified line of products and retain the ability to address financing for a large range of multifamily property types.

As noted earlier, in spite of the crisis that affected 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. Both of the Enterprises' multifamily businesses involve risk-sharing with private capital, and both businesses have practiced disciplined underwriting. In addition, because of the range of products and business lines employed by the Enterprises, a wide range of multifamily rental properties that provide housing for very-low to middle income households can be financed in the conventional market. NAHB strongly supports retention of the successful infrastructure, products and programs that have been built over the years by the Enterprises and which are used as the core of most of the major financial institutions providing multifamily debt financing.

Testimony of Jerry Howard  
Chief Executive Officer  
National Association of Home Builders  
November 2, 2017  
Page 10

In the unlikely event that Fannie Mae and Freddie Mac are wound down, NAHB does not believe it would be practical for the regulator to absorb and run the Enterprises' multifamily businesses. A more practical option would be to transition the Enterprises' multifamily businesses to private entities, which would then be allowed access to the federal government guarantee.

#### **Federal Multifamily Housing Programs**

NAHB's members utilize a number of federal programs administered by federal agencies. The multifamily housing finance support roles of federal agencies, such as HUD, FHA, RHS and Ginnie Mae should be preserved. These agencies have been an important support for multifamily housing for many years. They continue to play an essential counter cyclical role in meeting America's affordable housing needs by expanding in downturns and contracting when the market improves.

Of particular importance to NAHB's multifamily members are the FHA multifamily housing mortgage insurance programs. FHA provides an explicit federal government guarantee on multifamily loans for which borrowers pay a mortgage insurance premium set by HUD. The largest of these programs are the Section 221(d)(4) program, which insures mortgages for new construction and substantial rehabilitation projects, and the 223(f) program, which insures refinanced mortgages. FHA multifamily loans have performed well with low default rates. The multifamily mortgage insurance programs generate significant revenue to the federal government in the form of a negative credit subsidy, generating positive cash flow to the U.S. Treasury.

Any reforms to FHA must build on the positive characteristics of this government entity. NAHB strongly supports FHA's mission to support liquidity, innovation and continuity in the housing finance markets by providing mortgage insurance backed by the full faith and credit of the U.S. government, as well as its counter-cyclical role to promote stability in the housing market. Further, NAHB supports prudent underwriting criteria that consider the availability of FHA-insured mortgages and protections for taxpayers. Moreover, we support the continued funding of FHA through borrower-paid mortgage insurance premiums and the fiscally responsible operation of FHA in a manner that does not require a federal subsidy.

Considering the important role FHA plays in providing liquidity to the multifamily mortgage market, NAHB cautions against imposing new mandates on FHA that would unintentionally inhibit the Agency's mission. For example, NAHB does not support setting occupancy and rent restrictions based on area median income (AMI) for the FHA multifamily mortgage insurance programs. These programs are a key source of liquidity, so the imposition of income limits would impede that portion of FHA's mission, particularly in higher-cost markets. The FHA multifamily mortgage insurance programs are subject to statutory mortgage loan limits, which effectively serve to focus the provision of FHA multifamily mortgage insurance on affordable and workforce rental housing. Imposing burdensome provisions that require developers, lenders and property managers to track and document incomes and rents on unsubsidized properties is costly and unnecessary, given that the proposed targeted population is already being served by the programs.

Testimony of Jerry Howard  
 Chief Executive Officer  
 National Association of Home Builders  
 November 2, 2017  
 Page 11

### **Affordable Housing**

For far too many Americans, the housing affordability crisis is all too real. This is particularly true for very-low income renters, or, those renters whose incomes do not exceed 50 percent of the area median income. HUD's recent report to Congress entitled *Worst Case Housing Needs 2017*<sup>2</sup> found that 8.3 million households had "worst-case housing needs" in 2015, meaning they were very low-income renters who did not receive government housing assistance and paid more than half their income for rent, lived in severely inadequate conditions, or both. This latest figure is the second-highest number of households recorded. The highest number of renters with worse case housing needs was 8.5 million in 2011. While incomes rose between 2013 and 2015, rents also increased nearly as fast. For the poorest renters, growth in rental costs outpaced income gains.

### **Federal Government Role in Addressing Affordable Housing**

The federal government has an important role to play in addressing this crisis. NAHB calls on Congress and the Administration prioritize enactment of policies that will promote the construction of sorely needed rental apartments. Access to capital is a key component of this production strategy. To assist the poorest of the poor, a rental subsidy is necessary.

Specifically, NAHB is urging Congress and the administration to:

- Approve the Affordable Housing Credit Improvement Act to strengthen the Low Income Housing Tax Credit Program (Senate bill S.548 and House bill H.R. 1661).
- Provide a strong fiscal 2018 budget for HUD, which funds the HOME Investment Partnerships (HOME) Program, the largest federal block grant to state and local governments designed exclusively to create affordable housing for low-income households and the Community Development Block Grant (CDBG) Program.
- Provide full funding to renew contracts for crucial rental assistance programs such as the Housing Choice Voucher Program, Project-Based Rental Assistance and Rural Rental Assistance.

Each of these programs serves an important purpose. They are not interchangeable, but are complementary. Different strategies are necessary to meet the housing needs of households with different income levels and in different parts of America. The array of federal government programs that have been developed over the years in response to identified needs are essential elements in ensuring that there are affordable options for providing housing. Steps should be taken to make the operations of these agencies more efficient and effective.

### **Fannie Mae and Freddie Mac Support for Affordable Housing**

In the conventional market, the Enterprises are also required to support affordable housing. Under the current regulatory framework, Fannie Mae and Freddie Mac provide liquidity to support affordable housing through their affordable housing goals, their Duty to Serve

<sup>2</sup> Worst Case Housing Needs 2017, U.S. Department of Housing and Urban Development, Office of Policy Development and Research, Preface. (August 9, 2017)

**Testimony of Jerry Howard  
Chief Executive Officer  
National Association of Home Builders  
November 2, 2017  
Page 12**

Underserved Markets, and incentives provided under the exclusions from the multifamily volume caps.

Pursuant to the Housing and Economic Recovery Act of 2008 (HERA) and the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Safety and Soundness Act), FHFA must establish, monitor and enforce annual housing goals for the Enterprises. These goals include separate categories for purchases of single-family and multifamily mortgages on housing that is affordable to low-income and very low-income families, among other categories. If FHFA determines that the housing goals cannot be met consistent with HERA's requirements, it may suspend the goals until they can be achieved.

Because FHFA has historically taken a conservative approach to setting the multifamily goals, NAHB urged the Agency to consider more aggressive targets. It is important that the Enterprises' goals are challenging, but reasonably so. Both Enterprises' multifamily businesses have done very well financially, and meeting these goals has not negatively affected safety and soundness. We believe our request is reasonable when weighed against the strong need for affordable housing, the Enterprises' performance over the last five years and the incentives Fannie Mae and Freddie Mac receive to support affordable housing.

The Enterprises' Duty to Serve Underserved Markets (Duty to Serve), was mandated by HERA and the Safety and Soundness Act. The Duty to Serve calls for Fannie Mae and Freddie Mac to increase the liquidity of mortgage investments and improve the distribution of investment capital available for mortgage financing for very low-, low-, and moderate-income families in the manufactured housing, affordable housing preservation and rural markets. The Enterprises must serve these markets in a safe and sound manner. The Enterprises must explain their plans for serving these markets and populations in Underserved Market Plans, which are subject to public comment and FHFA approval.

In their Plans, the Enterprises proposed many positive initiatives they, or their successors, should be free to pursue. For example, NAHB supports the Enterprises' proposals to reenter the Low Income Housing Tax Credit (LIHTC) equity investment markets. Likewise, NAHB applauds the Enterprises' initiatives to support small multifamily properties with 5 to 50 units, as well as programs to support small financial institutions having assets of \$304 million or less. Small, multifamily rental properties would benefit from sale to the secondary market. Targeting purchases from smaller local and regional banks and community-based lenders who are attempting to meet the financing needs of small multifamily property owners could provide a boost to the liquidity of loans on small multifamily properties and increase affordability of the units. Incenting the Enterprises to purchase small multifamily rental properties from this niche group of small financial institutions also serves as a way to encourage the Enterprises to engage with these small institutions and may lead to additional support for mortgage and small business lending by these institutions. We also support the Enterprises' securitization proposals for small multifamily properties.

Finally, FHFA regulates the Enterprises' multifamily market share by capping dollar volume originations, and quarterly review based on market share. NAHB would prefer the volume caps to be lifted altogether. If they must be continued, however, the current exclusions should be retained for loans on targeted affordable, small multifamily (5-50 units), rural, energy efficient,

Testimony of Jerry Howard  
Chief Executive Officer  
National Association of Home Builders  
November 2, 2017  
Page 13

senior housing / assisted living properties and manufactured housing rental community blanket loans.

Going forward, Fannie Mae and Freddie Mac (or successor entities) must continue to meet an affordable housing mission. The Enterprises' support to these market segments is critical, perhaps even more so as access to mortgage credit continues to be tight. NAHB's economic forecasts, like FHFA's, predict mortgage interest rates will rise through 2019, which will have a negative impact on affordable housing opportunities for low-income and very low-income households.

The Enterprises, or their successors, should demonstrate leadership in affordable multifamily housing by providing liquidity and supporting housing for tenants at different income levels in various geographic markets and in various market segments. In addition to serving families at 80 percent and 50 percent of area median income, NAHB believes it is crucial to ensure the Enterprises have the flexibility and incentives to provide greater support to workforce housing that serves moderate-income families as well.

Further, Congress and regulators should resist the temptation to impose income or rent restrictions on loans or requirements to use inflexible standardized products as a condition of access to a federal government backstop. Loans should be financed to ensure long-term financial and physical viability of the property, and loan products should be available to both non-profit and for-profit providers on an equal basis.

#### **Appraisal System Reform**

The process to evaluate the collateral supporting real estate transactions is an important component of the overall housing finance system and improving the appraisal process should be considered in housing finance reform discussions. Today's residential appraisal system remains in a state of uncertainty. The current patchwork system cannot continue indefinitely. A key consideration must be to establish stability and restore confidence in the system that determines the value of mortgage collateral.

The current residential appraisal system is impaired due to inconsistent and conflicting standards and guidance; inadequate and uneven oversight and enforcement; a shortage of qualified and experienced residential appraisers; and the absence of a robust and standardized data system. NAHB believes these problems must be addressed in order to restore confidence in the residential real estate market and to establish a foundation for sustainable growth of the U.S. economy. This can only be accomplished through sound valuation practices, policy, and procedures that produce more credible valuations under all economic circumstances.

NAHB is a strong proponent of a sound and effective appraisal system. NAHB has been a leading advocate for improving the valuation process and has undertaken a number of actions to raise awareness and address the adverse impacts from inaccurate appraisals on the housing sector, and has engaged with appraisal and financial industry stakeholders in identifying areas in need of improvement. NAHB believes that fundamental appraisal system reform must be a principal element of efforts to rebuild the nation's housing finance system. Coordination and accountability currently are lacking and there are major gaps in the system.



Testimony of Jerry Howard  
Chief Executive Officer  
National Association of Home Builders  
November 2, 2017  
Page 14

#### **NAHB Activities**

NAHB has been significantly engaged on this issue since the financial crisis. NAHB conducted five Appraisal Summits to provide opportunities for the agencies and organizations that establish appraisal standards and guidelines to join housing stakeholders in a constructive dialogue on major appraisal topics of concern. The goal of the Appraisal Summits was to bring all the interested parties together to identify recommendations and solutions that participants could jointly pursue to improve the appraisal process. In addition, NAHB formed an Appraisal Working Group, consisting of home builders and representatives from the financial and appraisal sectors, to analyze the appraisal process and develop recommendations for improvement. As a result of these efforts, NAHB developed a "[Comprehensive Blueprint for Appraisal Reform](#)" which outlines recommendations for improving the appraisal system by streamlining regulations and devoting adequate resources to ensure effective oversight and enforcement.

#### **NAHB Recommendations**

NAHB believes that the regulatory framework for real estate valuation should be reformed to more effectively oversee standards, guidance and enforcement. The goal is to better integrate and streamline the jumble of existing entities to ensure the valuation of collateral in housing finance transactions occurs in a coordinated and effective manner. This would contribute to uniform and consistent standards and avoid the current multitude of conflicting and confusing requirements.

Efforts should be made to standardize appraisal requirements throughout the housing finance system so all parties are operating under the same set of rules. In the meantime, NAHB continues to work with all stakeholders to improve the current appraisal system by expanding the availability of data needed for appraisal analysis, ensuring open lines of communication and sharing of information between all parties in the real estate transaction and providing educational opportunities for appraisers. NAHB remains committed to residential appraisal reform and looks forward to working with industry stakeholders to address the problems and implement solutions to the current U.S. residential appraisal system.

#### Strengthened Regulatory Oversight

Oversight of appraiser qualifications and appraisal practices falls to the individual states, and many jurisdictions have inadequate resources to adequately perform this function. Many State Appraisal Boards are responsible for the enforcement of a number of other professional services, which reduces their capacity for appraisal oversight and enforcement. In many cases personnel are shared and funds are swept from appraisal activities into the state's general fund.

Standardization of state oversight practices within and across the states would provide numerous efficiencies and improve reciprocity between the states. State appraisal boards should be fair, transparent and representative of the real estate community and there should be an effective federal regulatory system for appraisal oversight.

Testimony of Jerry Howard  
Chief Executive Officer  
National Association of Home Builders  
November 2, 2017  
Page 15

#### Streamlined Rules

NAHB urges the establishment of a single, consistent set of rules and guidelines for appraisers and appraisals and set standards to ensure the engagement of an appraiser who has the training and experience necessary for the assignment. The establishment of a single set of rules and appraisal forms should be incorporated as a high priority as part of housing finance system reform.

Currently, Fannie Mae and Freddie Mac impose de facto appraisal authority through the guidelines they have established for appraisals on the mortgages they purchase and the forms they use to collect appraisal information. These Enterprise appraisal rules tend to restrict appraisers' ability to pursue approaches that could result in more accurate valuation. In addition, confusion arises in how to interpret the Enterprise appraisal guidelines in relation to the rules established by The Appraisal Foundation (TAF) in the Uniform Standards of Professional Appraisal Practice (USPAP) and the appraisal regulations of the banking regulators. This has prompted industry participants to impose overlays that further impede the ability of appraisers to produce accurate valuations.

A Collateral Valuation Oversight Committee should be established in the reformed housing finance system. This oversight committee would consist of a broad group of housing market stakeholders, including home builders, and, in consultation with federal regulatory agencies, would be responsible for establishing and maintaining guidelines for the secondary mortgage market, appraisal reporting formats, and a repository for valuation reports.

#### Workable Appeals Process

Finally, NAHB encourages the development of a workable process for appealing inaccurate or faulty appraisals. It is extremely important to establish a timely value appeals process that is fair, balanced and appropriate to allow all parties of the transaction to appeal appraisals that do not meet USPAP standards or are based on inaccurate data or assumptions. NAHB has been a proponent of the VA's "Tidewater Initiative" which encourages open communications and the sharing of information that assists appraisers' in their analysis. NAHB is also encouraged by The Appraisal Foundation's interest in developing best practices and guidelines for an efficient and effective Reconsideration of Value process.

#### Regulatory Reforms by FHFA

We believe many regulatory reforms undertaken at the Enterprises under the direction of Director Watt have begun the process of housing finance reform, but ultimately need the authenticity of legislation. Pending resolution of the conservatorships, FHFA has directed the Enterprises to implement changes to their securitization process that should ease the transition to a new securitization system for conventional mortgages. Additionally, the Enterprises are experimenting with increased use of private capital to reduce credit risk to taxpayers on the MBS they issue. Both developments generally have been accepted as beneficial to the industry and taxpayers. NAHB believes they should be retained as important components of a reformed housing finance system.

Testimony of Jerry Howard  
 Chief Executive Officer  
 National Association of Home Builders  
 November 2, 2017  
 Page 16

The increased use of private capital for risk management by the Enterprises is a major component of FHFA's plan for reducing taxpayer risk in the mortgage market. Credit Risk Transfer (CRT) structures utilized to date have proved extremely successful and CRTs have become a core business practice for the Enterprises. In FHFA's *2017 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions*, the agency directs the Enterprises to transfer a meaningful portion of credit risk on at least 90 percent of the unpaid principal balance (UPB) of newly acquired single-family mortgages in loan categories targeted for risk transfer. For 2017, targeted single-family loan categories include: non-HARP and non-high LTV refinance, fixed-rate mortgages with terms greater than 20 years and loan to value ratios above 60 percent. The Enterprises also are required to explore ways to transfer credit risk on categories not included in the targeted loan categories, develop additional transaction structures, refine structures already offered and propose ways to expand the base of investors interested in participating in credit risk transfer transactions.

Since 2012, the Enterprises have worked together, and with FHFA, to design and construct a single securitization platform to support the Enterprises' single family mortgage securitization activities, including the issuance by both Enterprises of a single MBS (Single Security). The objective of a Single Security is to reduce the trading value disparities between Fannie Mae and Freddie Mac securities and improve the overall liquidity of the Enterprises' securities and the nation's housing finance markets. Progress on the Common Securitization Platform (CSP) and the Single Security has moved steadily forward. Full implementation of the CSP is expected in 2019.

#### **Current Reform Proposals Begin to Demonstrate Areas of Consensus**

Since 2008, numerous lawmakers, housing and consumer advocates, academics, and industry stakeholders have proposed plans for a reformed housing finance system. Many of the early reform proposals called for a complete restructuring of the secondary market system and several proposed the full dismantling of both Enterprises. These plans were untested, often complex, and would have required a transition that could have been considerably disruptive to the housing finance market. Over the past nine years, in light of regulatory and policy changes throughout the industry and the continued functioning of the mortgage market, there has been a gradual moderating of the approach to reform and consensus is forming around broad principles. Recent proposals call for legislation that preserves areas of the market that are working, including the significant infrastructure and resources of Fannie Mae and Freddie Mac.

Recent proposals include the following common elements that are consistent with NAHB's vision of reform for the conventional secondary mortgage market:

- An insurance fund capitalized by market participants will stand in front of the federal government's explicit backstop. The federal government and taxpayers will be at risk only in the case of catastrophic losses.
- The system will rely primarily on private capital.
- The federal government backstop will apply to mortgage-backed securities, but not to private companies.
- There will be a level playing field for lenders of all sizes.
- The Enterprises, or their successors, must have appropriate capital requirements.
- The federal government guarantee applies only to single family loans that meet qualified mortgage (QM) requirements.

Testimony of Jerry Howard  
Chief Executive Officer  
National Association of Home Builders  
November 2, 2017  
Page 17

- The system continues federal government support for the multifamily mortgage market.
- The system will utilize the infrastructure and other resources of the Enterprises.
- There will be a careful transition to avoid market disruptions.

#### **NAHB Still Opposes the PATH Act**

NAHB commends the Subcommittee for once again starting the dialogue in the House of Representatives on reforms to the housing finance system. As this debate resumes however, NAHB must reiterate our strong opposition to the reform bill passed previously by the full House Financial Services Committee on July 24, 2013, the *Protecting American Taxpayers and Homeowners Act of 2013* (PATH Act)<sup>3</sup>. While the PATH Act included some constructive legislative proposals supported by NAHB, we strongly believe that it would have diminished housing as a major policy priority for this nation. Rather than reform and restructure the basic housing finance system, the PATH Act would have dismantled Fannie Mae and Freddie Mac and diminished FHA's vital liquidity mission.

The PATH Act would have implemented steps to wind-down Fannie Mae and Freddie Mac within five years while encouraging the return of the private market without a federal government guarantee. NAHB believes strongly that the federal government should continue to provide an explicit guarantee to ensure a reliable and adequate flow of affordable housing credit in all economic and financial conditions. Absent an explicit guarantee, there would not be sufficient private capital to fund mortgages for the broad range of middle-class home buyers with good credit, steady jobs and an eager interest in homeownership. Lacking federal protections against unpredictable and massive federal financial collapses like the one the nation experienced in 2008, the private sector would cherry-pick the best loans and leave many potential home owners with no options or only very high-priced mortgages. In short, the PATH Act did not provide the federal support necessary to ensure a strong and liquid housing finance system.

The PATH Act also included reforms for the FHA that would have severely restricted credit-worthy borrowers' access to FHA-insured loans. In the single family area, the PATH Act would have allowed the FHA to provide mortgage insurance and other credit enhancements only for first-time homebuyers, low-and moderate-income (LMI) homebuyers, homebuyers in counter-cyclical markets and disaster areas. While NAHB agrees that FHA should continue to support these homebuyers, we oppose these limitations in FHA's assistance. FHA currently serves a broader group of potential homeowners and is available during all economic cycles, and NAHB believes the agency should continue to do so. By severely shrinking the scope of the FHA, the bill would have undermined the agency's core function of facilitating the flow of mortgage credit to home buyers. In other words, countless creditworthy American families who otherwise would have had an opportunity to own a home and join the middle class would have been left out in the cold.

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<sup>3</sup> On July 18, 2013, Jerry Howard testified on behalf of NAHB before the Committee on Financial Services and outlined the association's concerns with the PATH Act. [NAHB Testimony on PATH Act](#)

Testimony of Jerry Howard  
Chief Executive Officer  
National Association of Home Builders  
November 2, 2017  
Page 18

While NAHB hopes to restart this debate with a clean slate, should the PATH Act serve as the starting point for the subcommittee's reform efforts, we will strongly oppose the legislation unless significant changes are made from the 2013 committee-passed legislation.

**Conclusion**

NAHB thanks the Subcommittee for the opportunity to submit our perspectives on housing finance system reform. We look forward to working with the House Committee on Financial Services and others to develop legislation consistent with NAHB's recommendations and the consensus elements that have emerged over the last several years of the Enterprises' conservatorship.

Whether they rent or own, Americans want to choose where they live and the type of home that best meets their needs. Given the significant role that housing plays in the economy, we urge Congress to take a long-term, holistic approach to housing finance system reform. NAHB also urges Congress to carefully consider the differences between the single family and multifamily market and not apply solutions to one piece of the market that are not appropriate for the other. NAHB thanks the Subcommittee for its leadership on this important issue, and stands ready to work with you to achieve such reforms and provide much-needed stability for this critical sector of the economy.

Testimony of David H. Stevens, CMB  
President & Chief Executive Officer  
Mortgage Bankers Association

**U.S. House Committee on Financial Services  
Subcommittee on Housing and Insurance**

**"Sustainable Housing Finance:  
Private Sector Perspectives on  
Housing Finance Reform, Part II"**

November 2, 2017

Testimony of David H. Stevens, CMB  
U.S. House Committee on Financial Services  
Subcommittee on Housing and Insurance  
November 2, 2017

Chairman Duffy, Ranking Member Cleaver, and members of the subcommittee, thank you for the opportunity to testify on behalf of the Mortgage Bankers Association (MBA). My name is David H. Stevens, and I am President and CEO of MBA. From 2009 to 2011, I served as Assistant Secretary for Housing and Federal Housing Administration (FHA) Commissioner at the U.S. Department of Housing and Urban Development (HUD). I am a Certified Mortgage Banker (CMB), and I have over 35 years of experience in real estate finance, including nearly a decade as Senior Vice President for Single-Family Business at Freddie Mac, where I witnessed the strengths of the business model as well as the weaknesses that contributed to the financial crisis and led to the current state of our housing finance system.

MBA is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. The association works to ensure the continued strength of the nation's residential and commercial real estate markets, to expand homeownership, and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. MBA's membership of over 2,300 companies represents all elements of real estate finance, including firms serving both the single-family and commercial/multifamily markets. Our membership includes commercial banks, investors, brokers, conduits, and industry vendors, as well as nearly 650 independent mortgage bankers, community banks, and credit unions, which comprise almost 80 percent of our single-family membership.

Nine years have passed since Fannie Mae and Freddie Mac (the GSEs) were first placed into conservatorship, and yet their long-term status remains unresolved. The financial crisis exposed the structural conflicts and misaligned incentives in the GSE business model, as well as weaknesses in the regulatory framework that was in place at the time. The result—a breakdown of the secondary mortgage market, \$187 billion in taxpayer assistance, and continuing federal support of almost \$260 billion—underscores the importance of moving forward with comprehensive reform now.

Conservatorship of the GSEs has already persisted far longer than was ever intended. And while the Federal Housing Finance Agency (FHFA) has taken important administrative steps during this period, an extended conservatorship is economically and politically undesirable. In the absence of comprehensive reform, borrowers forego the benefits made possible by a more vibrant secondary market, taxpayers remain exposed to elevated levels of credit risk, development of the private-label securities market remains stagnated, and lenders face increased uncertainty about the future. In short, the status quo is an unacceptable long-term outcome.

### **Why Congress Needs to Act Now**

In its role as conservator of the GSEs, FHFA has put in place a number of policies and procedures to improve access to the secondary mortgage market and reduce the risks to taxpayers. These changes include more appropriate guarantee fee (g-fee) pricing that is based on single-family loan-level risks, and not the volume of loans delivered; the development of the Common Securitization Platform (CSP) and the Single Security initiative; extensive use of credit risk transfers (CRTs) by the GSEs; substantial reductions in the GSE retained mortgage portfolios; and enhanced oversight of, and risk management at, the GSEs.

Despite these important steps, there is a critical need for legislative reform—both to bring about the remaining structural changes that are necessary to achieve the core principles listed above, as well as to “lock in” the recent improvements made by FHFA. It is only Congress that can:

- Alter the existing GSE charters to reconstitute the firms as Guarantors;
- Establish an explicit federal government guarantee on eligible mortgage-backed securities (MBS) for single-family and multifamily mortgages, as well as a Mortgage Insurance Fund to stand ahead of taxpayers;
- Empower FHFA with a utility-style regulatory mandate to maintain a level playing field, as well as the authority to grant charters to new Guarantors in order to better enable competition in the secondary market; and
- Preserve the administrative reforms made by FHFA as conservator of the GSEs.

And perhaps most importantly, legislative reform is the only outcome that provides the legitimacy and public confidence necessary for long-term stability in both the primary and secondary mortgage markets.

It is therefore clear that calls to simply recapitalize the GSEs and allow them to operate without further structural changes are misguided. Under such plans, the post-crisis reforms already achieved could be reversed at the discretion of future FHFA directors. And recapitalization absent comprehensive legislation would likely embolden those who seek private profit at the expense of sound public policy, while mortgage market participants may lose confidence in the prospects of serious reform, creating further uncertainty around business planning.

Finally, any movement towards recapitalization without corresponding reforms would be unnecessary from a safety and soundness perspective given the large levels of federal support currently available to the GSEs. The U.S. Treasury lines of credit available to the GSEs currently stand at \$258 billion—a sum that eliminates any practical near-term risks to the solvency of either institution. Should Fannie Mae or Freddie Mac need to take a draw on these lines of credit, there would be no change in their existing books of



Testimony of David H. Stevens, CMB  
U.S. House Committee on Financial Services  
Subcommittee on Housing and Insurance  
November 2, 2017

business, day-to-day operations, or prospective ability to provide liquidity to mortgage markets. Further, a draw by either GSE would not constitute a “taxpayer bailout” under any reasonable definition of the phrase, as taxpayers would not be providing fresh funds to keep the GSE solvent—the true test of a “bailout.”

Even worse, this type of recapitalization plan would likely be counterproductive to efforts to develop and implement much-needed reforms.

We cannot go back to a housing finance system that provides private gains when markets are strong yet relies on support from taxpayers when losses occur. Only by enacting comprehensive legislative reform can borrowers, lenders, and investors realize the full benefits of a diverse, competitive primary market and a vibrant, liquid secondary market. The hard work of reform should proceed without delay.

#### **The MBA Task Force**

To address the need for change, MBA convened its Task Force for a Future Secondary Mortgage Market (Task Force) in early 2016. The Task Force was comprised of members covering a broad cross-section of the real estate finance industry, including bank and nonbank lenders serving the single-family and multifamily markets and spanning a wide range of sizes and business models, mortgage insurers, real estate investment trusts (REITs), and title companies. The members of the Task Force spent over a year considering and debating many potential models before issuing final recommendations for a reformed and improved secondary mortgage market system. The result of this extensive work was a detailed proposal released in April 2017, titled *GSE Reform: Creating a Sustainable, More Vibrant Secondary Mortgage Market*. I have submitted this proposal as an addendum to my written testimony.

It is important to note that our Task Force focused on balancing key public policy objectives with the realities of the marketplace. As industry practitioners, our members placed a premium on pragmatism. We are fully aware that there is no single perfect solution to GSE reform—all proposals involve various trade-offs. We believe that our plan addresses these trade-offs in a way that will benefit consumers, industry, and taxpayers, while also providing the long-term stability so essential to a healthy housing finance system.

The Task Force took particular interest in two areas that have tested past reform efforts—the appropriate transition to a new system and the role of the secondary market in advancing a national affordable-housing strategy. Distinct working groups within the Task Force studied these issues and developed carefully crafted recommendations that we believe can bridge the divides that currently exist.

With respect to the transition from the status quo to a new end state, the MBA proposal makes use of concepts that are well-established in finance and banking, as well as historical examples that have provided insights into the key elements of successful models. The Task Force specifically noted the importance of leveraging the assets, infrastructure, and regulatory framework of the current system wherever possible, while also emphasizing that any workable transition must utilize a clear road map and be multi-year in nature.

The Task Force also sought to develop an affordable-housing framework that appropriately targets the scope of the federally-supported secondary market, covering both renters and homeowners of varying income levels. To advance this objective, the MBA proposal features a framework that relies upon quantitative and qualitative metrics that focus on outcomes and that are transparent, well-defined, measurable, and enforceable. The GSEs' multifamily executions and their support for rental housing would be preserved. The proposal also recommends other potential improvements to better serve the full continuum of households, including updating credit-scoring models, better capturing nontraditional income, and providing enhanced liquidity for small-balance loans.

Another critical objective of the Task Force—and one that has been the subject of intense debate during past reform efforts—was to ensure that secondary market reform fosters a competitive primary market that is served by lenders of all sizes and business models. In particular, the Task Force recognized the important role that smaller lenders play in strengthening the system for consumers by maintaining close relationships with their customers, supporting niche products, and leveraging unique knowledge of local markets. The MBA proposal reflects this objective by ensuring equitable access to secondary market programs, prohibiting special pricing or underwriting based on loan volume, preserving cash window and small pool execution options, and preventing vertical integration by the largest market participants (see *Exhibit A – Small Lender Access: Why It Matters*).

After contemplating many different types of business structures and regulatory frameworks for the Guarantors that will issue eligible MBS, the Task Force determined that a model based on regulated utilities would be most effective. The core justification for utility-style regulation rests with the premise that privately-owned utilities derive much of their existence and certain unique powers from the state. Because the Guarantors will be granted the ability to distribute securities carrying a full faith and credit guarantee from the federal government, they must also accept the responsibility—and the regulatory oversight—to serve customers in an efficient and fair manner. The regulator would ensure that the premiums charged by the Guarantors are neither excessive nor inadequate, and that they remain nondiscriminatory in nature. Pricing would be transparent, with rates posted for public input.

In addition to the legal and economic rationale for utility-style regulation, this framework is also intended to mitigate the problematic growth-company models and mindsets that existed at the GSEs prior to the financial crisis. Investor-owned utilities will aim to provide shareholders with a steady dividend over time rather than taking on excessive risks in a reach for market share or rapid earnings growth. Companies with a dividend-focused culture will compete through more efficient operations, product and process improvements, and customer service.

#### **GSE Reform: Core Principles**

The MBA proposal recognizes the need for any comprehensive reform plan to balance three major priorities: 1) taxpayer protection; 2) investor returns; and 3) consumer cost and access to credit. Pushing too far in any one direction may lead to a mortgage market that does not adequately meet the needs of all participants. To achieve the appropriate equilibrium among these priorities, the Task Force developed the following core principles to guide its work:

##### Core Principles:

- Preserve the 30-year, fixed-rate, prepayable single-family mortgage, as well as long-term financing for multifamily mortgages;
- Maintain a deep, liquid to-be-announced (TBA) market for securities backed by conventional single-family loans;
- Attract global capital and preserve liquidity during times of economic stress through an explicit government guarantee for eligible MBS backed by single-family and multifamily mortgages;
- Limit the explicit government guarantee to the eligible MBS, while prohibiting the extension of the guarantee to the debt of the Guarantors;
- Require the Guarantors to support an effective national affordable-housing strategy that helps meet the needs of low-income and underserved households and communities;
- Support a competitive and diverse primary market for lenders of all sizes and business models;
- Enable a robust, innovative, and purely private mortgage market to coexist alongside the government-backed market;
- Preserve existing multifamily financing executions and permit new options;
- Establish a strong, transparent regulatory framework that promotes liquidity while protecting the taxpayers;
- Ensure that private capital assumes most of the credit risk;
- Ensure liquidity in the event of a full-blown systemic crisis; and
- Minimize risks to the liquidity and stability of the mortgage markets during the transition to the end state.

### **GSE Reform: Guardrails**

The MBA proposal also addresses the risks that are inherent in any plan to reform the secondary mortgage market. To mitigate these risks, the Task Force developed a set of "guardrails"—a statutory and regulatory framework designed to protect taxpayers, ensure liquidity, preserve what works in the current system, and align incentives across both the primary and secondary markets. These guardrails are comprised of structural requirements, prudential standards, and market conduct regulation:

#### Structural Requirements:

- The end state should allow for more than two approved Guarantors to issue government-guaranteed MBS;
- The regulator should be authorized to grant additional Guarantor charters;
- The government guarantee should be explicit, funded by appropriately priced insurance premiums, and limited only to the MBS issued by the Guarantors;
- Guarantors should disperse credit risk to private investors through a variety of CRT mechanisms, including deeper first-loss CRTs that are transparent, scalable to all lenders, and capable of limiting taxpayer exposure to nothing more than catastrophic risk;
- Guarantors should be stand-alone companies and lenders should not be allowed to own controlling interests in Guarantors;
- Guarantors' rate of return should be regulated using a utility regulation framework;
- Guarantors should issue a single uniform type of security for single-family mortgages;
- The CSP should be established as a self-funding, government-owned corporation and must be accessible to new Guarantors;
- The CSP should own all GSE historical single-family data, and new Guarantors and other market participants should be able to access and analyze this information for an administrative fee; and
- The regulator should have established mechanisms in place to respond to liquidity disruptions during severe market downturns or catastrophic events.

#### Prudential Standards:

- The regulator should have sufficient powers and discretion with respect to capital standards and other aspects of prudential oversight;
- Single-family loans eligible for inclusion in the government-backed MBS should meet a Qualified Mortgage (QM)-type standard;
- Multifamily mortgages of a type and quality similar to those financed by the GSEs today should be eligible for inclusion in the government-backed MBS;

- Guarantors may hold only limited mortgage portfolios to support cash window operations, delinquent loan repurchases, loss mitigation activities, and certain multifamily assets; and
- Guarantors that reach a given size may be designated and regulated in a manner similar to systemically important financial institutions (SIFIs).

Market Conduct Regulation:

- Guarantor charters should expressly maintain a bright line between the primary and secondary mortgage markets, with the Guarantors' allowable activities limited to the secondary market;
- The regulator should ensure that Guarantors provide equitable, transparent, and direct access for lenders of all sizes and types, and pricing and program participation should not be based on the loan volume or asset size of lenders;
- Guarantors should be required to maintain both cash window and MBS execution options; and
- Guarantors should be required to support an effective national affordable-housing strategy that helps meet the needs of low-income and underserved households and communities.

**Housing Finance Reform in Broader Context**

While the MBA proposal focuses on reforms that are specific to Fannie Mae and Freddie Mac, there exist opportunities to improve other critical elements of the housing finance system, as well. Targeted reforms, not broad structural changes, to housing programs operated by the FHA, U.S. Department of Veterans Affairs (VA), and Federal Home Loan Banks (FHLBs) have the potential to improve access to credit for borrowers while clarifying the rules of the road for lenders and better protecting taxpayers.

The necessary reforms at FHA do not entail changes to the scope of the program, such as the population of borrowers served or the market share for which it accounts. FHA-insured loans are largely originated to first-time or low- to moderate-income borrowers. Recent data show that approximately 82 percent of FHA purchase endorsements go to first-time homebuyers, and the average qualifying income on FHA loans in 2016 was about \$69,000, compared to an average qualifying income of about \$112,000 for conventional conforming loans. The size of the program tends to appropriately move in a countercyclical fashion, expanding in periods of the credit cycle in which private capital retreats (and vice versa).

The structure and coverage of FHA insurance has served borrowers and lenders well, and it should not be reduced or otherwise altered. The Mutual Mortgage Insurance (MMI) Fund capital ratios and thresholds are likewise appropriate, though consideration should be given to options that would improve the long-term solvency of the MMI Fund,

including the possible separation of the single-family forward business from the more-volatile Home Equity Conversion Mortgage program.

Instead, FHA reforms should focus on operational and legal issues that hurt borrowers, lenders, and investors. For example, reforms to the process of originating and servicing FHA-insured loans will increase the attractiveness of the program for lenders. The U.S. Department of Justice's reliance on loan-level and annual certifications to pursue lenders for treble damages under the False Claims Act has caused many prominent lenders to retreat from the FHA program altogether. Technical errors and minor mistakes are inevitable in the lending process, and should not serve as a basis to demand treble damages. Instead, the certifications and subsequent enforcement actions should focus on knowing or material errors that directly impact the insurability of loans. Similarly, lenders should operate under a transparent defect classification and enforcement standard to provide greater clarity around potential False Claims Act violations.

The FHA program could also be improved by modernizing and streamlining its servicing requirements to better reflect current industry standards and reduce the costs associated with servicing delinquent loans. Because FHA servicing requirements have not kept pace with changes in the servicing industry, and are therefore not aligned with other industry and regulatory standards, servicers face significantly higher costs when servicing FHA-insured loans. Reforms are needed in areas such as foreclosure timelines, debenture interest curtailment, property conveyance alternatives, and loss mitigation. Without such reforms, the declining number of companies willing to service FHA-insured loans will increase the cost of originating these loans, reducing access to credit for qualified borrowers.

Another problematic feature of the current FHA program is the eligibility of Property Assessed Clean Energy (PACE) loans. PACE lending allows for the financing of various energy improvement and water efficiency products through a structure that presents troubling lien priority issues and consumer protection concerns. As FHA continues to allow delinquent PACE amounts to remain in a tax-lien position for foreclosed properties, the salability of the properties or their recovery value upon sale will be negatively impacted. FHA insurance should instead be prohibited on PACE transactions for which a property is encumbered by any first lien. Further, PACE loans are not subject to the federal mortgage financing rules of the Consumer Financial Protection Bureau, and FHA does not require that specific consumer protections be present for a jurisdiction's PACE program to be deemed satisfactory. Nationwide protections are sorely needed, particularly to ensure borrowers have a reasonable ability to repay these loans.

With respect to the loan programs administered by the VA, there is a critical need to ensure that veteran borrowers are not harmed by repeated refinancings through VA

Testimony of David H. Stevens, CMB  
U.S. House Committee on Financial Services  
Subcommittee on Housing and Insurance  
November 2, 2017

Interest Rate Reduction Refinance Loans (IRRRLs). While such loans have the potential to benefit borrowers by lowering the interest rates on their mortgages, some borrowers may be solicited to engage in refinancings that leave them worse off in the long term. In particular, some borrowers may be refinanced from 30-year, fixed-rate loans into short-term, adjustable-rate loans that often do not serve their interests. Such "churning" also causes unpredictable prepayments of VA loans backing Ginnie Mae securities, thereby potentially reducing the value of, or demand for, these securities and raising interest rates for all VA borrowers. This practice must be curtailed as quickly and efficiently as possible.

Any future housing finance system should also recognize and preserve the important role played by the FHLBs. By providing lending institutions with reliable funding and liquidity, the FHLBs help ensure that their members can continue lending throughout the credit cycle. To better calibrate the benefits associated with FHLB membership, the revocation of captive insurers from the FHLB system should be revisited. Recent rules established by FHFA sought to curb the use of captive insurers as a mechanism for otherwise ineligible institutions to gain FHLB membership. In eliminating this category of members, however, FHFA removed some companies that are active sources of private capital in the mortgage markets, such as mortgage REITs. FHLB membership should not be denied based upon the corporate structure of a financial institution. Instead, membership criteria should focus on whether an institution's activities and investments align with the mission of the FHLBs, as well as any and all relevant safety and soundness factors. For example, with independent mortgage bankers accounting for approximately half of all mortgage originations, consideration should be given to whether it is finally time to permit them to join the FHLB system.

These targeted reforms to FHA, VA, and the FHLBs should be viewed as complementary to the ongoing efforts to address the structural vulnerabilities of Fannie Mae and Freddie Mac. Taken together, they will promote a fair and accessible primary market for borrowers and lenders that is supported by a deep secondary market that facilitates participation by investors across the globe.

\* \* \*

Once again, I appreciate the opportunity to present this testimony, and I will reiterate MBA's long-standing commitment to working with the subcommittee on all elements of housing finance reform.

Testimony of David H. Stevens, CMB  
U.S. House Committee on Financial Services  
Subcommittee on Housing and Insurance  
November 2, 2017

**Exhibit A**

***Small Lender Access: Why It Matters***



## Small Lender Access: Why It Matters

It is important to recognize and address in reform legislation the role that limited access to the GSEs played in driving the sharp consolidation that began in the late-1990s. Between 1998 and 2010, the market share of the 10 largest single-family originators rose from less than 40% to almost 80%.

The GSEs played a significant role in driving this concentration. Beginning in the late 1990s, the GSEs competed for business by negotiating market share agreements with the largest volume lenders, providing lower guarantee fees and underwriting exceptions that drove even more business to these institutions. Unable to compete against lower guarantee fees and aggressive underwriting variances, smaller lenders were forced to deliver their loans to the largest lenders. This "aggregation" model played a contributing role in the GSEs' financial troubles by driving underpriced guarantee fees, spreading weak underwriting standards, and concentrating counterparty risk into a handful of aggregators.

In the wake of the crisis, the market share of home mortgage originations from the larger institutions declined sharply. By 2015, large depository institutions' market share had fallen to 21 percent for purchases, and 27 percent for refinances.<sup>A</sup> Several factors — legacy issues with pre-crisis mortgage and servicing portfolios, Basel III rules, regulatory burden and reputational risk in the mortgage business — all played a role in the decision of larger banks to shift their capital into more promising lines of business.

Fortunately for consumers, the gap in funding was filled by independent mortgage bankers (IMBs), whose market share in both purchases and refinances increased from the low-20s in 2008 to nearly 48 percent in 2015. Most of these institutions are smaller companies, but several IMBs grew to become top 20 originators. Community banks and credit unions also picked up market share, despite a decline of more than 1,100 reporting institutions.

Importantly, FHFA helped facilitate the transition through key policy changes intended to strengthen access to the GSEs for smaller lenders, including requiring guarantee fees to be based on the underlying loan risk (not loan volume), and eliminating preferential underwriting standards for selected institutions. Direct access to the GSEs' cash and MBS windows played a critical role in the recovery by ensuring these smaller lenders could provide the liquidity the market needed.

MBA believes that the mortgage market and consumers benefit from a large and diverse base of lenders. Smaller lenders, in particular, play a key role in strengthening the system for consumers by focusing on niche markets and leveraging unique knowledge of local consumer needs. Recent post-crisis research shows that highly concentrated mortgage markets through the 2000s reduced the sensitivity of mortgage rates to movements in the MBS market, and that more competitive local markets tended to narrow primary-secondary market rate spreads and deliver lower rates to consumers.<sup>B</sup>

- To that end, the Task Force's recommendations embody several key small-lender principles:
- Ensure equitable, transparent and direct access to secondary market programs;
- Prohibit G-fee pricing based on loan volume or asset size of single-family lenders;
- Preserve cash window and small pool execution options for smaller lenders;
- Maintain the "bright line" to ensure that Guarantors do not compete with lenders;
- Prevent vertical integration by prohibiting lenders from owning or controlling a Guarantor.

A. *MBA Executive DataBook, 2015 Origination Trends*, © 2016.

B. *Concentration in Mortgage Lending, Refinancing Activity and Mortgage Rates*, NBER Working Paper Series; David S. Scharfstein, Adi Sunderam, Working Paper 19156; <http://www.nber.org/papers/w19156>.

Testimony of David H. Stevens, CMB  
U.S. House Committee on Financial Services  
Subcommittee on Housing and Insurance  
November 2, 2017

**Exhibit B**

***GSE Reform: Creating a Sustainable,  
More Vibrant Secondary Mortgage Market***

ONE VOICE. ONE VISION. ONE RESOURCE.



## GSE Reform: Creating a Sustainable, More Vibrant Secondary Mortgage Market

This paper explains MBA's recommended approach to GSE reform, the last piece of unfinished business from the 2008 financial crisis. It outlines the key principles and guardrails that should guide the reform effort and provides a detailed picture of a new secondary-market end state. It also attempts to shed light on two critical areas that have tested past reform efforts — the appropriate transition to the post-GSE system and the role of the secondary market in advancing an affordable-housing strategy. GSE reform holds the potential to help stabilize the housing market for decades to come. The time to take action is now.

[MBA.ORG/GSEREFORM](http://MBA.ORG/GSEREFORM)

**MBA**  
MORTGAGE BANKERS ASSOCIATION

## Executive Summary

The Mortgage Bankers Association (MBA) is the national association representing the full depth and breadth of the real estate finance industry. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, commercial banks, community banks, credit unions, thrifts, REITs, securitization conduits, life insurance companies and others in the mortgage lending field.

This paper is the product of more than a year's worth of work by MBA's Task Force for a Future Secondary Mortgage Market. The task force was created in March 2016 and directed to develop a proposal that will address the future of the secondary mortgage market as it relates to Fannie Mae and Freddie Mac (the Government Sponsored Enterprises, or "GSEs"), and in particular, an end state model that can also fulfill an affordable-housing/duty-to-serve mission. The members of this task force are made up of individuals from MBA member companies those in the market every day, representing a broad cross-section of the residential and multifamily real estate finance sectors, including entities of varying sizes and business models.

The task force considered many potential models in developing its recommendations for a new secondary market system, ranging from the formation of a government-owned corporation to restoration of the GSEs to their pre-crisis form. In assessing the trade-offs among various approaches, several core principles emerged as critical to ensuring the long-term health of the secondary mortgage market.

### Principles

We believe that all GSE reform options should be evaluated and measured against these core principles. Working from these principles, MBA's proposal is for a new government-guaranteed secondary market "end state" that would advance the following critical policy objectives:

- Maintain the liquidity and stability of the primary and secondary mortgage markets through the establishment of a resilient and vibrant housing finance system, throughout the transition process to the end state.
- Replace the implied government guarantee of Fannie Mae and Freddie Mac with an explicit guarantee at the mortgage-backed security (MBS) level only, supported by a federal insurance fund with appropriately priced premiums.
- Protect taxpayers by putting more private capital at risk through expanded front- and back-end credit enhancements.
- Establish strong capital standards and enhanced regulatory powers to ensure a sound and stable secondary market system.
- Promote a strong, diverse primary market through a level playing field for lenders of all sizes and business models.
- Ensure that there is a bright line separating the primary and secondary mortgage markets.
- Heighten competition by allowing the regulator of the new system (either the Federal Housing Finance Agency [FHFA] or a successor agency) to charter new entities ("Guarantors") to provide for securitization of eligible single-family and multifamily MBS.
- Preserve where possible the existing infrastructure – for example, a rechartered Fannie Mae and Freddie Mac could be the first two Guarantors.
- Strengthen affordable-housing policy consistent with sound lending principles and a holistic national housing strategy.
- Ensure that a robust private mortgage market can exist parallel to the government-backed market, with each complementing and balancing the other through different economic cycles.

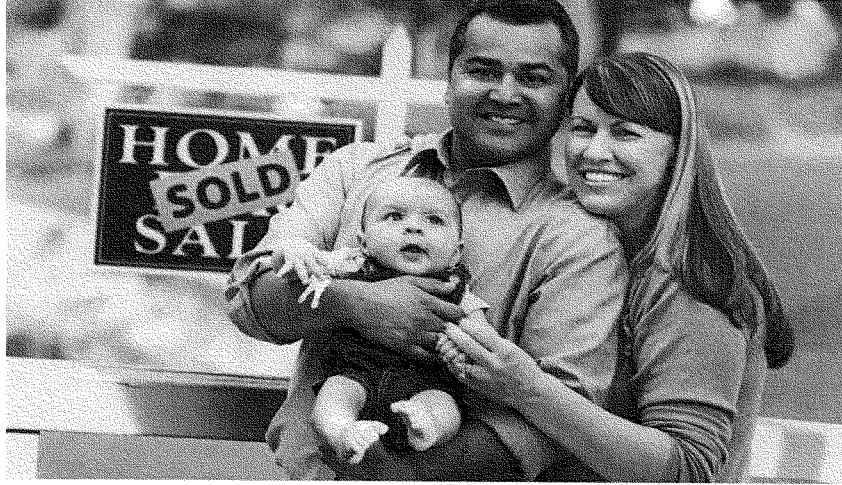
## Recommendations

To achieve these policy objectives, the Task Force makes the following recommendations for a new end state for the government-guaranteed secondary mortgage market:

- The system would be a multiple Guarantor model, with at least two entities and preferably more.
  - + Rechartered successors to Fannie Mae and Freddie Mac would likely be the first two Guarantors.
  - + The regulator would be permitted to charter additional Guarantors, encouraging competition (or at least the threat of it). New firms would be able to apply for a Guarantor charter that authorizes them to serve either the single-family or multifamily market or both markets.
- Guarantors would compete primarily on operations/systems development, customer service, product parameters and innovation (within guidelines set by the regulator and the CSP for single-family mortgages), and pricing/execution.
- Additional private capital would come from rigorous capital requirements for Guarantors that could be satisfied through a combination of their own capital and proven means of credit risk transfer (CRT). Guarantors would be encouraged to disperse risk through credit risk transfers:
  - + Lenders would maintain their current role of obtaining primary market credit enhancement (e.g., deeper private mortgage insurance, recourse, and existing multifamily risk-share mechanisms).

**MBA believes that the transition to a new secondary-market end state remains among the most critical and challenging components of comprehensive reform.**

- Guarantors would be monoline, regulated utilities owned by private shareholders. Guarantor activities would include:
  - + Acquisition of single-family loans through both cash-window and MBS executions.
  - + Acquisition of multifamily loans through existing multifamily financing and other executions.
  - + Issuance of a single MBS for single-family mortgages through the Common Securitization Platform (CSP), which would be established and operate as a self-funded government corporation.
  - + Holding a limited mortgage portfolio intended only for aggregation prior to MBS issuance from cash-window operations, for delinquent loan buyouts and loss mitigation, and for limited multifamily purposes.
- + Guarantors would also engage in secondary market risk sharing through reinsurance, structured notes and other instruments for institutional credit investors and existing multifamily risk-transfer executions.
- + The regulator could reduce risk-sharing levels during periods of market duress.
- MBS issued by the Guarantors would be backed by the federal government's full faith and credit guarantee supported by a federal mortgage insurance fund (MIF).
  - + The MIF would be built up over time through appropriately priced insurance premiums paid by the Guarantors.
  - + The MIF would cover catastrophic risk, kicking in only in the event of a Guarantor failure after all layers of private capital had been exhausted.



- + The taxpayers would be at risk only after all layers of private capital and the MIF are exhausted.
- + In the event of a taxpayer bailout, future Guarantors would be tapped with higher insurance premiums going forward to reimburse taxpayers and rebuild the MIF reserves to their required reserve ratio.
- The entire system would be regulated by the FHFA (or a successor agency) with expanded authorities. This regulator would:
  - + Provide prudential supervision over the Guarantors, including requiring higher capital levels than in the pre-crisis system.
  - + Monitor and regulate target rates of return for the Guarantors, designed to attract investors seeking low-volatility, safe and consistent equity investments.
  - + Ensure fair and equitable access to the secondary market for lenders of all sizes (e.g., no preferential single-family pricing based on volume).
  - + Ensure that Guarantor activities comply with rules establishing a bright line separating the primary and secondary markets.

## Transition

MBA believes that the transition to a new secondary market end state remains among the most critical and challenging components of comprehensive reform. The path toward reform outlined in this paper seeks to minimize disruptions to the housing finance system during this transition, while bringing the new system up to speed in a reasonable time period and ensuring that genuine, sustainable reform occurs to increase the stability of the system. As a result, the Task Force's transition recommendations in this regard include elements that would mitigate the disruptive impact of the change:

- Preserving the existing human capital and operational processes at both GSEs and reasonably supporting their emergence as viable Guarantors.
- Transitioning to the new system over a multiyear period, with implementation occurring gradually to avoid market disruption and to build required capital.
- Reducing barriers to entry and allowing new entrants to become Guarantors as soon as possible in order to encourage competition.
- Utilizing FHFA and its existing legal authorities as the starting point, modified as necessary to accomplish the objectives of secondary market reform.

## The Essential Role of Congress: Why Congress Needs to Act

To create this new secondary mortgage market system, only Congress can:

- Change the existing charters for Fannie Mae and Freddie Mac;
- Create the Mortgage Insurance Fund (MIF) to guarantee eligible mortgage-backed securities;
- Establish a new, explicit government guarantee that stands behind the MIF;
- Empower FHFA or a successor regulator to grant charters to the new Guarantors;
- Provide the legitimacy and public confidence necessary for a long-term solution to housing finance reform.

- Encouraging the improvement of technology platforms supporting secondary mortgage market activities as part of the transition process.
  - Providing the regulator sufficient flexibility to adjust the timing and execution of the transition based on market conditions or other critical factors to mitigate potential disruption.
  - Improve liquidity for segments of the market that are currently underserved.
- To achieve these missions, MBA recommends that the regulator periodically develop a comprehensive affordable-housing plan against which it would hold the Guarantors accountable. The key parts of the plan would be:

### Affordable Housing

Finally, MBA believes that America's housing finance system should meet the housing needs of the full continuum of households, from families residing in the most directly subsidized, affordable rental homes to those served by the prime jumbo single-family lending market. As part of this effort, the Guarantors operating in the government-guaranteed secondary market must serve three critical affordable-housing missions:

- Provide responsible, sustainable access to credit for prospective homeowners.
- Provide liquidity for the development and preservation of affordable rental housing.

- The establishment of both quantitative and qualitative affordable-housing goals.
- The annual assessment of an affordable-housing fee (set within a permissible cost range defined by statute) on new business purchases of the Guarantors.

Because affordable-housing policy should be responsive to feedback from existing programs and seek new paths forward when necessary, the regulator would have flexibility to adjust the appropriate mix of goals and the fee to maximize the policy's effectiveness.

## GSE Reform: Quick View

|  | GSEs<br>PRE-Conservatorship                          | GSEs<br>IN Conservatorship                           | Guarantors<br>(MBA Model)  |
|--|--|--|--|
| <b>Investor purpose</b>                                  | Growth stock returns/risks                           | Conserve assets                                      | Utility-level returns/risks  |
| <b>Government backing of MBS</b>                         | Implicit government guarantee                        | Explicit government guarantee                        | Mortgage Insurance Fund (MIF) funded by premiums paid, backed by explicit government guarantee |
| <b>Government backing of corporate debt</b>              | Implicit guarantee                                   | Explicit guarantee                                   | No guarantee   |
| <b>Regulatory limitations on pricing</b>                 | No   | Yes  | Yes  |
| <b>Retained investment portfolio</b>                     | Large  | Reduced  | Minimal  |
| <b>Capital standards</b>                                 | Low capital levels on both retained/guaranteed risk  | Reduce capital cushion to zero by 2018               | Enhanced Guarantor capital standards   |
| <b>SF risk transfers to private market</b>               | Front-end only (MI and lender recourse)              | Testing back-end structures in addition to front-end | Deeper front-end and back-end  |
| <b>MF risk transfers to private market</b>               | Lender Risk Share                                    | Lender and Capital Markets Risk Share/Transfer       | Lender and Capital Markets Risk Share/Transfer   |
| <b>Number of entities</b>                                | Two  | Two  | Two or more  |
| <b>New Guarantor entrants permitted</b>                  | No   | No   | Yes  |
| <b>SF lender access</b>                                  | Preferential pricing and underwriting by loan volume | Guarantee fee and underwriting variances restricted  | Prohibit guarantee fee and underwriting variances based on volume                              |
| <b>Support for single-family TBA market</b>              | Yes  | Yes  | Yes  |
| <b>Support for multifamily finance</b>                   | Yes  | Yes  | Yes  |
| <b>Preserve operational infrastructure and processes</b> | Yes  | Yes  | Yes  |
| <b>Affordable housing mission</b>                        | Yes  | Yes  | Yes  |



## Table of Contents

|  |    |
|--|----|
| Introduction . . . . .                             | 1  |
| Principles and Guardrails . . . . .                | 3  |
| The End State . . . . .                            | 9  |
| Transition: From Status Quo to End State . . . . . | 23 |
| Affordable Housing . . . . .                       | 35 |
| Conclusion . . . . .                               | 47 |



## Introduction

Resolving the status of Fannie Mae and Freddie Mac (the GSEs), now nearing their ninth year of government conservatorship, remains the final piece of unfinished business from the 2008 financial crisis. The financial crisis plainly exposed the structural conflicts, misaligned incentives, and other weaknesses in the GSE business model and its regulatory framework. The result was a catastrophic failure of the secondary mortgage market that required more than \$187 billion in direct taxpayer support and a continuing federal commitment of more than \$250 billion.

Administrative reforms undertaken by the Federal Housing Finance Agency (FHFA), as both regulator and conservator of the GSEs, have resulted in significant progress in stabilizing the companies while paving the way for future reform. Indeed, the GSEs today, operating in conservatorship and subject to strict regulation, are in a state that is already closer to our recommended utility-model end state, relative to the pre-crisis GSE system that required dramatic federal intervention in 2008.

Meanwhile, legislative reform proposals introduced in both the U.S. House of Representatives and the U.S. Senate have yielded productive discussions but no concrete outcomes. Both chambers passed comprehensive GSE reform legislation in committee during the 113th Congress, but these efforts stalled for various reasons, including concerns about complexity, cost to consumers, fears of exacerbating the impact of credit and economic cycles, and the legislation's perceived lack of a sufficient affordable-housing strategy.

As the GSEs move closer to having no retained capital, the possibility of another draw from the U.S. Treasury — even if the GSEs incur just a modest loss — is very real. While the GSEs have an ample financial backstop remaining at Treasury, the current government-dominated system, in which the GSEs are in a state of conservatorship, is unsustainable over the long term. Looking ahead, establishing a strong, vibrant secondary mortgage market will be essential to help power economic growth and secure a more prosperous future. The stakes are high: GSE reform must be a top and immediate policy priority for the new administration and Congress.

To address the need for change, MBA formed a member task force last year to jump-start the reform conversation and develop a plan for a revitalized secondary market that could be implemented by Congress working with the next administration. The Task Force, representing a cross-section of both single- and multifamily lenders of varying sizes and business models, was charged with two overarching goals:

- Re-evaluate MBA's prior policy proposals for GSE reform and develop a durable end-state model that could facilitate access to mortgage credit through all economic cycles while protecting taxpayers;
- Evaluate a broad range of reform options, considering the trade-offs between different approaches as measured against a guiding set of principles; and
- Develop a vision for an affordable-housing strategy that could serve citizens along a continuum of economic circumstances.

To make the results of those efforts actionable, the Task Force was further charged with developing a road map that would ensure an orderly transition to the new secondary market system that will minimize disruptive impacts.

Our recommendations are outlined in detail below, along with a description of principles and guardrails critical to ensuring a healthy, stable and vibrant market for single-family and multifamily mortgages. We explain the recommended end-

state model and provide a transition road map designed to minimize disruption to the system and the broader economy. Finally, we outline our vision for supporting America's affordable-housing needs through the role of the Guarantors.

## Balancing Competing Priorities

In evaluating any proposal for GSE reform, three major objectives must be balanced: protecting taxpayers, attracting capital to Guarantors, and ensuring consumers and borrowers have access to affordable financing. Pushing too far in any direction may result in some of the objectives being missed.

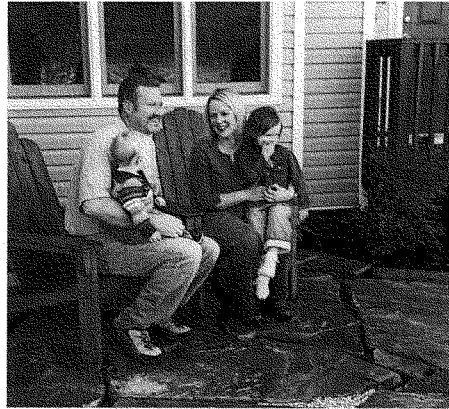
1. **Taxpayer Protection:** The system should greatly reduce the likelihood that it would require taxpayer support in all but truly catastrophic, systemic events. In order to accomplish this objective, the system should have significant private capital in place to absorb potential losses, a clearly defined government backstop, strict regulation and supervision, a well-defined credit box and carefully targeted efforts to make housing more affordable.
2. **Investor Returns:** To generate the large amount of private capital required to fund such a system, the Guarantor business model and expected returns through the cycle need to be attractive. That is, private investors in the Guarantors would have a reasonable expectation of a market rate of return on a risk-adjusted basis. To achieve this objective, investors would want to ensure that capital requirements are not too high, regulation and supervision is not too expensive, credit standards are sound and efforts to make housing more affordable do not impinge significantly on returns. Being able to issue MBS with a government backstop, even if the backstop is paid for through insurance premiums, is a business benefit because the backstop ensures the market will stay open during financial market disruptions.
3. **Consumer Cost and Access to Credit:** Homebuyers and borrowers are concerned with the all-in cost of obtaining financing. Higher capital requirements, more costly regulation and affordable-housing fees all add to consumer costs. Higher consumer costs, however, would likely be offset by a move to an explicit government guarantee of eligible MBS, as evidenced by the spread between prices on Ginnie Mae and GSE securities. Of course, not being able to get a loan — either because of tight credit criteria, increased costs or market disruption — has a negative impact as well. Roughly one-third of existing-home sales today go to first-time homebuyers, down from a historical average closer to 40 percent. One of the primary causes for this drop-off is the higher costs and tighter credit environment in today's mortgage market. For first-time buyers and others on the margin, a tighter credit box can mean being shut out of the market altogether. Efforts to extend affordability and access to underserved borrowers are one of the items that FHFA or its successor would closely monitor in the system we envision.

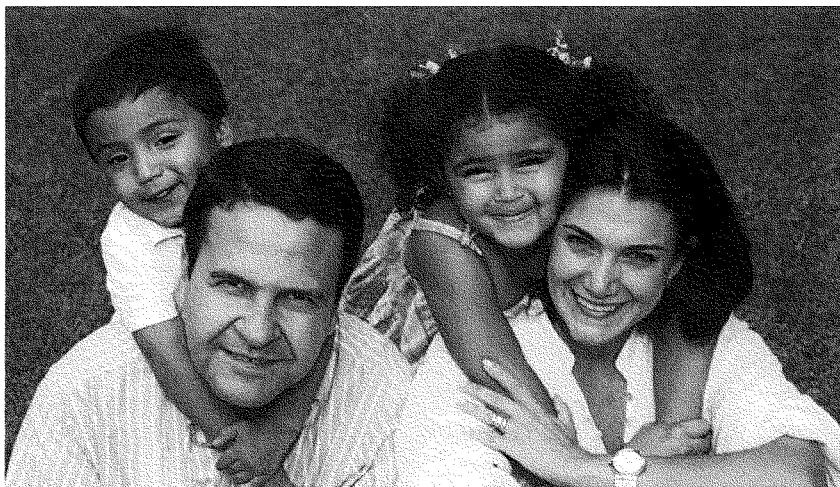
## Principles and Guardrails

### Principles

The Task Force developed the following core principles. Applying these principles is critical to ensuring that the end state provides the broadest possible liquidity through all economic cycles while protecting taxpayers.

- Preserve the 30-year, fixed-rate, prepayable single-family mortgage and long-term financing for multifamily mortgages.
  - Maintain a deep, liquid to-be-announced (TBA) market for securities backed by conventional single-family loans.
  - Attract global capital and preserve liquidity during times of economic stress through an explicit government guarantee for eligible MBS.
  - Limit the explicit government guarantee to the eligible MBS, while prohibiting the extension of the guarantee to the equity or debt of the Guarantors.
  - Require the Guarantors, as a condition of their charter, to support an effective national affordable-housing strategy that helps meet the needs of low-income and underserved households and communities.
  - Support a competitive and diverse primary market for lenders of all sizes and business models.
  - Enable a robust, innovative and purely private mortgage market to coexist alongside the government-backed market.
  - Preserve existing multifamily financing executions and permit new options.
  - Establish a strong, transparent regulatory framework that promotes liquidity while protecting the taxpayers.
- Ensure that private capital (including single-family loan-level credit enhancement such as mortgage insurance, lender recourse and other available forms of credit risk transfer) assumes most of the credit risk. For the multifamily finance market, the Guarantors would utilize current risk sharing and risk transfer structures used as part of Fannie Mae's Delegated Underwriter Servicing (DUS) program and Freddie Mac's K Deals, and other securitization structures to be developed.
  - Ensure liquidity in the event of a full-blown systemic crisis.
  - Minimize risks to the liquidity and stability of the mortgage markets during the transition to the end state, giving special attention to potential operational disruptions.





## Guardrails

MBA recognizes that reforming the secondary market presents certain risks — to taxpayers, consumers, and the stability of the housing finance system itself. To mitigate these risks, we have also developed the following guardrails — a statutory and regulatory framework designed to protect taxpayers, ensure liquidity, preserve what works today, and align incentives across both the primary and secondary markets.

### Structural Requirements

- The end state should allow for more than two approved Guarantors to issue government-guaranteed MBS. The new regulator, FHFA or its successor, should be authorized to grant charters subject to statutory requirements and regulatory guidelines, and the charters should not be limited in number.
- New entrants should be able to apply for a Guarantor charter to serve the single-family or multifamily market or both markets.
- The government guarantee should be explicit, funded by appropriately priced insurance premiums and limited only to the MBS issued by the Guarantors, and should not extend to the Guarantors or their corporate debt and equity.
- Guarantors should disperse credit risk to private-capital investors through a variety of CRT mechanisms in addition to the loan-level credit enhancement provided by the primary market.
- Guarantors should be stand-alone companies and should not be subject to undue influence by any individual shareholder. For example, individual lenders or bank holding companies should be limited to a maximum 10 percent ownership interest in any Guarantor.
- Guarantors' rate of return should be regulated using a utility regulation framework, with posted and transparent guarantee fee pricing designed to produce a reasonable rate of return for investors. The expectation is that the Guarantors will be low-volatility companies that would pay steady dividends over time, not growth companies that aggressively seek to expand market share or generate above-market returns.
- Guarantors should issue a single uniform type of security for securitizing single-family mortgages.
- The CSP should be established as a self-funding, government-owned corporation and must be accessible to new Guarantors once chartered.

- To reduce barriers to entry for future Guarantors, the CSP should own all GSE historical single-family data. New Guarantors and other market participants should be able to access and analyze this information for an administrative fee.
- The end state should have established mechanisms in place to respond to liquidity disruptions during severe market downturns or catastrophic events. These mechanisms should aim to stabilize the overall housing finance system and not necessarily the Guarantors.

#### Prudential Regulation

- The end state regulator should have sufficient powers and discretion with respect to capital regulation and other aspects of prudential oversight.
- Single-family loans eligible for inclusion in the government-backed MBS should meet a Qualified Mortgage (QM) type standard and be subject to conforming loan limits established by Congress and adjusted over time based upon home-price appreciation in a manner determined by the regulator. Guarantor credit parameters within the QM-eligibility framework, pricing engines and customer interfaces would be subject to prudential oversight, but should remain proprietary to each Guarantor. Multifamily mortgages of a type and quality similar to those financed by the GSEs today would also be eligible for inclusion in the government-backed MBS.
- Guarantors may not hold mortgage portfolios for investment purposes. However, they may hold a short-term liquidity book to aggregate loans from cash-window operations, a contingency portfolio for loss-mitigation purposes and a limited multifamily portfolio.
- Guarantors that reach a given size should be designated and regulated in a manner similar to systemically important financial institutions (SIFIs).

#### Market Conduct Regulation

- Charters should expressly maintain a bright line between the primary and secondary mortgage markets, with the Guarantors' allowable activities being limited to the secondary market, to guard against systemic risk concentration and to facilitate competition.
- The regulator should ensure that Guarantors provide equitable, transparent and direct access for lenders of all sizes and types — pricing and program participation should not be based on the loan volume or asset size of participating lenders.
- Guarantors should be required to maintain both cash-window and MBS execution options in order to support large and small lenders alike.
- Guarantors, as a condition of their charter, should be required to support an effective national affordable-housing strategy that helps meet the needs of low-income and underserved households and communities. This strategy should incorporate both single- and multifamily approaches to support homeowners and renters.

In the recommended end state, the Guarantors would be focused exclusively on providing sustainable credit availability to the single-family and multifamily markets in all geographies and through all economic cycles.

## Small Lender Access: Why It Matters

It is important to recognize and address in reform legislation the role that limited access to the GSEs played in driving the sharp consolidation that began in the late-1990s. Between 1998 and 2010, the market share of the 10 largest single-family originators rose from less than 40% to almost 80%.

The GSEs played a significant role in driving this concentration. Beginning in the late 1990s, the GSEs competed for business by negotiating market share agreements with the largest volume lenders, providing lower guarantee fees and underwriting exceptions that drove even more business to these institutions. Unable to compete against lower guarantee fees and aggressive underwriting variances, smaller lenders were forced to deliver their loans to the largest lenders. This "aggregation" model played a contributing role in the GSEs' financial troubles by driving underpriced guarantee fees, spreading weak underwriting standards, and concentrating counterparty risk into a handful of aggregators.

In the wake of the crisis, the market share of home mortgage originations from the larger institutions declined sharply. By 2015, large depository institutions' market share had fallen to 21 percent for purchases, and 27 percent for refinances.<sup>A</sup> Several factors — legacy issues with pre-crisis mortgage and servicing portfolios, Basel III rules, regulatory burden and reputational risk in the mortgage business — all played a role in the decision of larger banks to shift their capital into more promising lines of business.

Fortunately for consumers, the gap in funding was filled by independent mortgage bankers (IMBs), whose market share in both purchases and refinances increased from the low-20s in 2008 to nearly 48 percent in 2015. Most of these institutions are smaller companies, but several IMBs grew to become top 20 originators. Community banks and credit unions also picked up market share, despite a decline of more than 1,100 reporting institutions.

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Importantly, FHFA helped facilitate the transition through key policy changes intended to strengthen access to the GSEs for smaller lenders, including requiring guarantee fees to be based on the underlying loan risk (not loan volume), and eliminating preferential underwriting standards for selected institutions. Direct access to the GSEs' cash and MBS windows played a critical role in the recovery by ensuring these smaller lenders could provide the liquidity the market needed.

MBA believes that the mortgage market and consumers benefit from a large and diverse base of lenders. Smaller lenders, in particular, play a key role in strengthening the system for consumers by focusing on niche markets and leveraging unique knowledge of local consumer needs. Recent post-crisis research shows that highly concentrated mortgage markets through the 2000s reduced the sensitivity of mortgage rates to movements in the MBS market, and that more competitive local markets tended to narrow primary-secondary market rate spreads and deliver lower rates to consumers.<sup>B</sup>

- To that end, the Task Force's recommendations embody several key small-lender principles:
- Ensure equitable, transparent and direct access to secondary market programs;
- Prohibit G-fee pricing based on loan volume or asset size of single-family lenders;
- Preserve cash window and small pool execution options for smaller lenders;
- Maintain the "bright line" to ensure that Guarantors do not compete with lenders;
- Prevent vertical integration by prohibiting lenders from owning or controlling a Guarantor.





In the recommended end state, the Guarantors would be focused exclusively on providing sustainable credit availability to the single-family and multifamily markets in all geographies and through all economic cycles.



## The End State

In many respects, MBA's proposal is intended to preserve what works in the current system — it supports a highly competitive primary mortgage market composed of lenders of a variety of sizes and business models. Primary market lenders place loan-level credit enhancements; including private mortgage insurance, lender recourse and multifamily risk-share structures. All of these primary market activities take place on one side of the bright line, the dividing line between primary and secondary market activities.

Lenders would sell conventional conforming loans into the secondary market by working with Guarantors. Lenders would also continue to originate and securitize loans utilizing other forms of guaranteed and non-guaranteed options, including Federal Housing Administration (FHA), U.S. Department of Veterans Affairs (VA), U.S. Department of Agriculture (USDA), Ginnie Mae and conventional loans held on bank balance sheets or securitized through private-label securities (PLS).

From a lender's perspective, the process of selling conventional conforming loans should be similar to the current process. Lenders could sell through a cash window or pool loans into securities. The Guarantors, including rechartered Fannie Mae and Freddie Mac and any new entrants, would manage the credit risk on these pools, and would be the issuers of the MBS. Single-family securitizations would utilize the CSP, at which time the explicit guarantee is placed on the MBS for the benefit of investors, ensuring timely payment of principal and interest. A portion of the guarantee fee would be used by the Guarantors to cover the MIF premium.

Each of the Guarantors would issue into a single security. Most likely, the single security would be structured the same as the forthcoming Uniform MBS (UMBS), but will also have an explicit guarantee. Investors will trade single-family MBS through a TBA market similar to today.

Multifamily loans sold to the Guarantors would be securitized in the same manner as today, utilizing current executions such as Fannie Mae's DUS program, Freddie Mac's K Deals, and perhaps other securitization and risk-sharing/transfer structures to be developed by Guarantors and approved by the regulator.

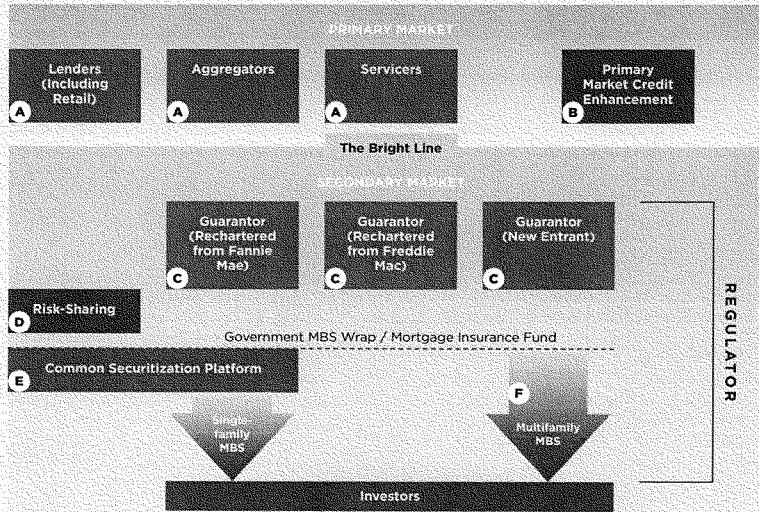
The Guarantors would manage the credit risk on these mortgages through underwriting, retained capital and through front-end and other risk sharing. In addition, Guarantor pricing would be tightly regulated by the regulator just as GSE pricing is tightly regulated by FHFA as conservator.

### Number of Guarantors

MBA believes there should be multiple (i.e., more than two) Guarantors that are authorized to acquire eligible loans from lenders and issue government-guaranteed single-family and/or multifamily MBS. Legislation should authorize a process to allow other entities to apply for and receive a charter, similar to the current process for applying for a national bank charter. A new charter could be specific to the single-family market, multifamily market or both markets.

As a utility-style regulator, one of the key factors the FHFA would be required to consider would be the impact of new competitors on both existing Guarantors, on the relevant market and on consumers. Maintaining the balance in the regulatory compact would be an important factor in evaluating new charters. FHFA would determine whether the applicants meet the standards for a Guarantor charter.

## End State Model



### Primary Market

- A. Single-family lenders (including correspondent aggregators) and servicers.** Would be explicitly afforded "level playing field" in delivery/credit enhancement and pricing terms, regardless of volume. MF Lenders would operate in the same fashion as today.
- B. Primary market credit enhancement.** To ensure that private capital assumes most of the credit risk, and that the risk is dispersed rather than overly concentrated, the regulator may require certain levels of single-family loan-level credit enhancement (such as mortgage insurance, lender recourse, loss sharing) and other forms of secondary market risk-sharing (see box "D"). Current MF executions and risk sharing would remain and retain existing platforms, and not be part of the single security.

### Secondary Market

- C. Chartered Guarantors.** Monoline, regulated rate of return utilities owned by private shareholders; rechartered Fannie and Freddie could be the first two. Corporate debt NOT backed by government. Acquires loans in order to issue MBS (including SF single security) and credit risk transfer (CRT) instruments; performs master servicer functions. Subject to prudential supervision by FHFA or its successor, including strong regulatory oversight of operations, and supplemental regulation similar to SIFs. Mortgage portfolios allowed ONLY for liquidity/contingency purposes (esp. for delinquent loan (DQ) buyouts/loss mitigation) and short-term cash window

and limited multifamily investment. Would compete on operations/systems development, customer service, certain product innovation (w/in CSP and regulator guidelines) and pricing/execution. Primary regulator would enforce duty to serve requirements. Would remit commitment fee to government for federal wrap on MBS, could also include an affordable-housing contribution fee.

- D. Secondary market risk-sharing.** Reinsurance, structured note and other forms of distributing Guarantor portfolio risk to institutional credit investors. Secondary market risk-sharing, as well as various forms of loan-level credit enhancement (see box "B"), would be used to protect taxpayers and would be actively monitored by the regulator to ensure safety and soundness. Per regulatory determination, risk-sharing requirements could be reduced during a stress environment as part of a countercyclical role.
- E. CSP.** Issuance platform for government-backed single-family MBS. Validates collateral, processes disclosures/issuances. Owns existing GSE historical data/compensating factors analysis and QM compliance engine. Owned independent of Guarantors as a government corporation, and able to facilitate PLS as separate business.
- F. Multifamily.** Existing DUS and K-deal programs are preserved. Could be subject to separate charter to facilitate multifamily-only guarantor.

A credible threat of additional entrants would encourage dynamism and spur the Guarantors to provide better service to their seller/servicers and ultimately to consumers. In addition, the prospect of new Guarantors would ensure that the existing Guarantors have an incentive to compete against each other in areas such as:

- Offering technology solutions and systems for interfacing with seller/servicers;
- Structuring and executing risk-sharing transactions;
- Product innovation;
- Pricing and execution; and
- Customer service.

### Operating Structure

From the perspective of a lender or investor, Guarantors would operate in a way similar to how the GSEs operate today to perform critical secondary mortgage market functions. As an example, we strongly urge the continuation of both GSEs' multifamily operations in their current form. The Guarantors' single-family operations would also be similar to today's market, with their activities focused on purchasing eligible mortgages and issuing mortgage-backed securities wrapped by the full faith and credit of the federal government, and dispersing credit risk to private investors.

The Uniform MBS, scheduled to launch in 2019, should be the basis for the single-family MBS issued by the Guarantors in order to maximize liquidity. Guarantors would be provided incentives to distribute credit risk to private market investors rather than retaining all of the risk. Single-family risk transfer would consist of both (1) front-end, lender-arranged primary market credit enhancement like mortgage insurance and lender recourse,

## What Is the Bright Line?

CONCEPT  
IN DEPTH

**MBA has historically held that the proper role of Fannie Mae and Freddie Mac is confined to the secondary mortgage market, consistent with their respective charters. We believe that the separation of the primary and the secondary markets has been an important element of what has made the secondary market effective in providing liquidity and making mortgage credit available nationwide. The division between the primary and secondary markets has become known as the "bright line."**

The separation of primary and secondary mortgage market activities is embedded in the GSEs' statutory charters. Both GSEs' charters expressly prohibit the use of their lending authority "to originate mortgage loans" — the defining primary market activity.

More broadly, the public purposes set forth in their respective charters, which are substantively similar in this regard, specify a secondary mortgage market role that is responsive to private capital: "To provide stability in the secondary market for residential mortgages; to respond

appropriately to the private capital market; to provide ongoing assistance to the secondary market for residential mortgages... by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing."

Given the critical role that this separation has played in the nation's mortgage markets, MBA underscores the importance of maintaining the bright line, both as it governs current GSE activities and in our recommended end state.

## How Will the Guarantors Compete and Why Will This Competition Benefit Consumers?

The secondary mortgage market benefits from alignment and standardization in many areas. Outside of these areas, however, Guarantors (new entrants and rechartered GSEs) should compete with each other on price, product, and service.

### Price

Some question the feasibility of price competition because Guarantors would be restricted by the same capital standards and qualified mortgage (QM) limitations. But think of a close parallel: thousands of banking institutions are subject to similar capital standards and regulation, and yet a variety of business models flourish. Even though all face similar capital standards, they engage in price competition along a number of dimensions.

Others have argued that price competition would be impossible because any competitor with the lowest price for the safest business would skim the cream off of the market, leaving others unable to earn a market return. Adverse selection is always a concern but pricing for risk is rarely one-dimensional and market participants are always dealing with uncertainty regarding potential outcomes, not just risk.

### Product

Within the umbrella of Qualified Mortgage status for eligible single-family mortgages, there would be no ability for Guarantors to offer high-risk products such as NINJA (no-income, no-job, no-asset) loans or other non-QM products. But there would be room for product development and product differentiation within the QM rubric.

For instance, new adjustable-rate mortgage (ARM) products that are viable under QM have been developed recently as portfolio products. We are currently in a predominantly fixed-rate market, but if rates do rise as expected, it is likely that the ARM share of the market will increase. Future Guarantors would also compete on product development to meet a range of housing needs (e.g., condos) just as the GSEs do now.

### Service

Beyond pricing and product strategy, as any lender knows, service matters, too. The GSEs both have experienced, knowledgeable sales forces with deep understanding of lenders operating in the primary market. With this knowledge, they have been able to provide differentiated offerings of services, along with product and service bundles, which fit large and small, bank and nonbank, publicly held and privately owned customers.

Superior service can win customer loyalty even if the product and pricing strategy is not always the "best." Just like any other business, there are aspects that are difficult to quantify but are nonetheless extremely important.

Of course, poor service can also have an impact. In the post-crisis environment, many lenders were unhappy with the GSEs' approach to repurchase demands and "rep and warrant" enforcement. In a more competitive market, this behavior could have led lenders to move away from the GSEs. In the absence of such competition, lenders had little negotiating leverage.

Even the potential for additional competition can have an impact. Economist William Baumol coined the term "contestable markets" to recognize the fact that if new competitors could potentially enter a market, even that threat of entry can help to ensure that incumbents will provide good service and will keep their pencils sharpened with respect to pricing and product strategy.

## What is a “Qualified Mortgage” (QM)?

CONCEPT  
IN DEPTH

The Dodd-Frank Act's ability-to-repay/Qualified Mortgage (QM) rule requires single-family lenders to determine that a borrower has a reasonable ability to repay a mortgage before the loan is consummated. The rule provides a compliance safe harbor for mortgage loans that are originated as QMs. In order for a loan to qualify as a QM, it may not contain certain “risky” features, such as interest-only or negative-amortization terms, and it must meet specified underwriting standards.

These standards also include a debt-to-income ratio cap of no more than 43 percent, or in the alternative, eligibility for the programs of Fannie Mae and Freddie Mac (“the patch”), the Federal Housing Administration (FHA) or other government agencies. The safe harbor is also limited to loans that are of “prime” quality based on a pricing benchmark. Considering the significant potential liability and litigation expenses for a violation of the rule, many lenders have limited themselves to making only QM “safe harbor” loans.

As a result, some categories of borrowers who should qualify for a QM are having trouble gaining access to safe, sustainable and affordable mortgage credit. MBA is continuing to work with policymakers, including the CFPB, to improve the rule in order to responsibly widen the credit box.

As the QM patch will expire in 2021, legislation and/or regulatory action is necessary to formulate this QM standard going forward.

and (2) back-end structures such as reinsurance and capital markets transactions developed by the Guarantors for the credit-investor market.

MBS eligible for the government guarantee would consist of single-family mortgages that meet current or future QM standards. However, Guarantors would be able to define their own credit criteria within the government's eligibility parameters. Making Guarantor credit decisions open to competition is one of the most important reasons for having multiple competing Guarantors. We believe this approach is superior to a structure in which a single, monopolistic entity provides the government guarantee.

### Common Securitization Platform

The Common Securitization Platform is expected to play a significant role in the future single-family market, though repurposed in critical ways. The CSP would be required to facilitate issuance of MBS backed by eligible loans/pools presented by any Guarantor, reducing barriers to entry for future entrants. In connection with its core functions, the CSP would also collect the insurance premiums from the Guarantors and remit them to the Mortgage Insurance Fund (MIF), as described below.

The CSP would also house all GSE historical single-family data. In exchange for an administrative fee, prospective Guarantors and other market participants would be able to access this data. Transferring historical data to the CSP and making it available will provide more opportunities for standardization and transparency, while removing a critical barrier to entry for future Guarantors.

Because the CSP's functions are those of a natural monopoly — the sole entity that can review and certify conventional single-family MBS as eligible for issuance with a government guarantee — the CSP should be established as a government corporation under the direction of the FHFA. As a government corporation, it would not rely on federal appropriations and would fund its operations exclusively through the fees it collects as part of the issuance and guarantee process.

## The Common Securitization Platform (CSP): What is it? How is it Funded and Regulated?

**What is the CSP?** As described by Freddie Mac, the "CSP is a technology and operational platform that is being developed by Common Securitization Solutions, LLC, a joint venture of Fannie Mae and Freddie Mac. CSP will perform many of the core back-office operations for the Single Security, as well as most of the Enterprises' current securitization functions for single-family mortgages, on behalf of the Enterprises. The CSP is necessary for the implementation of the Single Security."

**Why is the CSP important?** The CSP provides many potential benefits. First, it has significantly upgraded the core infrastructure at the heart of the agency MBS market. Second, by updating it jointly for Fannie Mae and Freddie Mac, it has fostered the alignment necessary to support the Single Security.

Beyond the benefits to the market while the GSEs are in conservatorship, the CSP also paves the way for new entrant Guarantors under the recommended end state. To make a transportation analogy, without a CSP, a new entrant would need to lay the tracks for a new railroad along with buying the locomotive and train cars. With the CSP, it will still be a major effort to launch a new Guarantor, but the infrastructure will be in place and available, dramatically lowering the barriers to entry, particularly as the new Guarantor would also be able to issue into the Single Security.

**How will it work in the MBA model?** Currently the CSP is a joint venture of Fannie Mae and Freddie Mac. The CSP should be carried forward in the new end state, with new entrants given the opportunity to directly connect once they have received their Guarantor charter from the regulator. However, MBA believes that a better long-term structure for the CSP would be as a government corporation overseen by FHFA. Fannie Mae and Freddie Mac would be compensated for their shares of the CSP as part of the transfer to a government corporation.

The CSP would be run by its own executive with the authority to hire staff and budget to keep the platform operating efficiently. FHFA would manage the MIF, but the operational task of issuing MBS with the explicit guarantee would fall to the CSP. The CSP would be funded through administrative fees on the issuance of MBS and not through federal appropriations. Given its status as a government corporation, it would target a modest rate of return to ensure adequate staffing and necessary technology upgrades over time.

**Why government ownership?** As the foundation of the secondary market's critical infrastructure, the CSP in economic terms is a "natural monopoly," with economies of scale such that it makes sense to only have a single operator. Moreover, in this role, the CSP truly cannot fail, for if it did, the market would shut down. The two choices available in this type of situation are for the government to form a corporation to operate the entity or for the government to bless and then tightly regulate a financial market utility that may be cooperatively owned. MBA believes that a government corporation makes more sense, as it eliminates the concerns with respect to a private entity being too big to fail. However, as the debate develops, the choice between the relative merits of a government corporation versus a financial market utility should continue to be considered.

**What are some examples of Government Corporations?** Several representative government corporation models illustrate the wide variety of structures of federal government corporations, including Ginnie Mae, the Federal Deposit Insurance Corporation ("FDIC") and the Pension Benefit Guaranty Corporation ("PBGC"). These examples warrant further study as possible models for the CSP.



**Privately Owned Utility Model**

MBA believes that the Guarantors should be owned by private shareholders and regulated as utilities. Private ownership would better encourage ongoing investment in the Guarantors, allowing them to keep pace with market demands and technological developments.

Prior to the crisis, Fannie Mae and Freddie Mac operated as "growth" companies, aggressively pursuing market share, leveraging their capital and implied guarantees, and promising investors growth-stock returns on equity. MBA believes that, given their unique ability to distribute the government guarantee, chartered Guarantors should be required to focus on long-term, steady returns that support a stable housing finance delivery system similar to the way public utilities must support power, water or other critical infrastructure.

Management of the Guarantors should be focused on providing a steady, although not risk-free, stream of dividends over time. The lower-risk, lower-volatility equity investment in the Guarantors should be attractive to investors seeking a competitive, risk-adjusted rate of return while receiving higher dividend yields than are available from fixed-income instruments.



As regulated rate-of-return utilities, the Guarantors would have the following characteristics:

- Operated as monoline businesses;
- Directed by charter and regulation to serve the defined public purposes of ensuring mortgage liquidity and broad access to credit;
- Subject to tight regulation of their activities and strong corporate governance;
- Owned by patient-capital investors;
- Held to explicit capital requirements by their regulator; and
- Incentivized by profit motive to innovate and compete.

Although our proposal would not require the Guarantors to be mutually or cooperatively owned and managed by lenders, we believe the new regulatory system should permit the chartering of lender-owned mutuals, provided ownership was broadly distributed. For example, no single lender or bank holding company should be permitted to hold more than a 10 percent ownership interest.<sup>1</sup>

**What Is the Single MBS?**

CONCEPT  
IN DEPTH

One of the strategic goals of the Federal Housing Finance Agency is to develop a single mortgage-backed security in the single-family market that could be issued and guaranteed by Fannie Mae or Freddie Mac. Currently, the securities issued by the each of the GSEs are not interchangeable with one another. A single MBS would enhance access to the TBA market, improve overall liquidity, reduce costs to taxpayers, lower barriers for prospective new entrants, and lay the groundwork for a more competitive and efficient secondary market. MBA strongly supports this effort.

<sup>1</sup> A 10 percent ownership limitation to prevent undue influence would be comparable to a provision in Federal Reserve regulations that establishes a rebuttable presumption of control when a person, or persons acting in concert, acquire a 10 percent interest in a state member bank or bank holding company. See 12 CFR 225.419(c).

to prevent it from having undue influence over the Guarantor. A mutual or cooperative structure could prove to be an attractive option for either of the successors to the GSEs or a new Guarantor entrant.

In addition, reform should establish mechanisms to address liquidity disruptions during severe market downturns that would aim to stabilize the overall housing finance system and not necessarily the Guarantors.

### Capital

To ensure that additional private capital is placed at risk ahead of the MIF, the federal government and taxpayers, MBA's proposal would give the regulator authority to set specific capital levels, both risk-based and overall leverage limits/ratios. In making that recommendation, we recognize that setting capital requirements is a complex exercise and that setting them correctly is vital, particularly since the GSEs were insufficiently capitalized to survive the financial crisis.

Establishing the appropriate level (and types) of capital depends upon the credit quality of the underlying loans, on an understanding of stressful environments, their likelihoods and their impacts on credit losses. Moreover, capital requirements cannot be set in isolation. Capital standards should require



similar capital for similar risks, regardless of the charter or business model of the entity holding the risk. When that is not the case, there will be regulatory capital arbitrage, with loans flowing to whichever entity has the lower capital requirement for each type of loan, rather than the entity that is best equipped to hold and manage the risk. Fannie Mae and Freddie Mac were insufficiently capitalized to survive the crisis. MBA's proposal requires that Guarantors have sufficient capital to cover all but catastrophic risk.

Congress should have the regulator develop a stress loss capital standard rigorous enough that Guarantors meeting that standard could have withstood the Great Recession. These capital requirements for the Guarantors, including the types of instruments that count as capital, should be consistent with the capital requirements for single-family and multifamily mortgages set for banks and other competing investors in mortgages such as insurance companies, in order to ensure that similar risks require similar capital, regardless of where those risks are held. The capital base for the requirement should primarily be composed of Tier 1 capital, i.e., common and preferred equity, but should also provide capital relief to the Guarantors for distributing rather than retaining credit risk, so long as this is done on an economically sensible, equity equivalent basis.

Background on the regimes governing banks, insurance companies, SIFIs and the impact of credit risk transfer mechanisms should be looked to as guides for the development of Guarantor capital requirements.

### Bank Capital Requirements and Supervision

The objective of bank capital regulation is to reduce the probability of a bank failure, which could put the taxpayer at risk as the government insures deposits. Bank capital regulation has evolved considerably over the past 30 years. In 1988, Basel I, developed by the Basel Committee on Banking Supervision, introduced the notion of risk-based capital requirements, with different risk weights applied to different types of assets. For example, Treasury securities carried a zero percent weight, agency MBS a 20 percent risk weight and residential mortgages a 50 percent risk weight. Banks were required to have total capital, composed of both common and preferred equity, subordinated debt and other components, of at least 8 percent of risk-weighted assets. Thus, for mortgages, banks were effectively holding 50 percent risk-weighted capital (half of 8 percent = 4 percent), almost 10

## Regulated Utility Model: How Does it Work?

**MBA has proposed that the Guarantors be regulated similar to investor-owned utilities. The core justification for utility style regulation rests with the premise that the privately-owned utility derives much of its existence and its powers from the state.**

The key tenet of regulating privately-owned utilities is the “regulatory compact:” private firms that are granted an exclusive or limited number of franchises accept the responsibility (and the regulatory oversight) to serve customers in an efficient and nondiscriminatory manner. This compact requires a balancing of interests by the regulator:

“Investors will only provide capital for provision of utility services if they anticipate obtaining a return that is consistent with returns they might expect from employing their capital in an alternative use with similar risk; customers will only accept utility rates if they perceive that the rates fairly compensate the utility for its costs, but are not excessive as a result of the utility taking advantage of its privileged position.”<sup>A</sup>

In addition to the legal and economic rationale for utility-style regulation of the Guarantors, this framework is also intended to directly address the problematic growth-company models and mindsets that existed at the GSEs prior to the financial crisis. The compulsion to grow led to excessive risk taking in a reach for market share, an unhealthy focus on the portfolio businesses and encroachment on the bright line, as the GSEs leveraged their duopoly power to grab an ever-larger share of industry profitability.

By contrast, investor-owned utilities — and their regulators — aim to provide shareholders with a steady dividend over time. Utilities are encouraged to deploy large capital outlays in relatively low risk, regulated business models to achieve stable outcomes for investors and consumers. Companies with this mindset

and culture in competitive markets compete through more efficient operations, product and process improvements, and customer service.

Investor-owned utility regulation is based on “cost of service regulation.” The regulatory compact requires a two-fold focus:

“(1) establish prices based on the actual prudent costs (i.e., avoid monopoly pricing); and

(2) provide incentives to maintain a reasonable level of efficiency in serving the customers. Rates are set with reference to the Total Revenue Requirement (TRR)...”<sup>B</sup>

Regulators can directly monitor and control rate of return or pricing. For monopolies, regulators may set rates based upon observed costs and an agreed-upon level of return. In markets with multiple utilities operating, those with significant market power may be held to regulated, cost-based rates, while new entrants may be allowed greater flexibility to charge market-based rates.

Typically price regulation in these markets requires nondiscriminatory pricing across the customer base, i.e., there is a level playing field. Pricing also tends to be transparent, with rates and the rate calculation posted for public input.

Clearly many aspects of this style of regulation and business model are good fits for the role of Guarantors in a future market. Moreover, FHFA in its role as conservator has moved regulation of pricing in this direction already, with more level and more transparent pricing than was the case pre-crisis.

A. *Cost of Service Regulation In the Investor-Owned Electric Utility Industry: A History of Adaptation*; Dr. Karl McDermott, Edison Electric Institute. 2012.

B. *Ibid.*

times the GSE requirement. Additionally, banks were held to a leverage limit, which required that capital made up at least 4 percent of their total assets.

By the mid-2000s, bank regulators were concerned that the simple risk-based capital weights were causing distortions in the financial markets because these weights did not align with the underlying risk — and in fact in many cases led to regulatory capital arbitrage — where banks were holding riskier assets that had relatively low risk weights while selling safer assets that had higher risk weights. Within the mortgage market, an example was the ability of a bank to sell a low-risk mortgage with a 4 percent capital requirement in exchange for an MBS with a 1.6 percent capital requirement, but that might hold a higher-risk mortgage that could be a profitable investment at the 4 percent capital level. This led to a large incentive for banks to securitize conforming mortgages with the GSEs and hold the MBS. Given that the GSEs were only required to hold 0.45 percent against the off-balance-sheet MBS, the financial system as a whole held less capital against the mortgages than would have been the case if the loans had remained on bank books.

Basel II was an attempt to provide a more flexible risk-based approach, but the effort in fact may have led to too little capital in the banking system.

Following the crisis, Basel III was an effort to enhance the quantity and quality of capital backing the banking system. Regulators and accounting treatment brought more assets onto the balance sheet. There was also a move to both higher minimum capital ratios and a greater reliance upon common equity as the primary form of loss-absorbing capital. The risk weights for holdings of residential mortgages were left unchanged. However, the risk-based capital treatment of mortgage servicing rights (MSRs) was much more severe, with an effective cap of 10 percent of equity capital and a higher risk weight.

Another change post-crisis has been much greater regulatory action around stress testing. The Comprehensive Capital Analysis and Review (CCAR) program is a horizontal review of large banking organizations. The Federal Reserve provides a set of adverse economic scenarios the large banks use to simulate how their organizations would fare with respect to having sufficient capital. The Fed then uses the results of these stress tests as an input into its approval of bank dividend and stock buyback programs. Regulators are viewing stress tests as a more dynamic approach to measuring a financial

institution's strength. (FHFA requires that Fannie Mae and Freddie Mac conduct a similar exercise using the stress scenarios posited by the Fed.)

### Insurance Capital Requirements

In the United States, insurance is regulated at the state level, with some consultation among the different state regulators. Insurers are also regulated against capital standards, but these are often expressed relative to risk-in-force rather than total or risk-weighted assets. Insurance regulation is also more likely to see a stream of future premiums as a source of loss-absorbing capacity, and hence looks to be sure that pricing is sufficient to cover losses under all but the most catastrophic scenarios.

In MBA's proposal, with the Guarantors having only a minimal investment portfolio holding assets of short duration, insurance regulatory concepts may become more applicable than bank regulatory concepts.

### SIFI Requirements

Dodd-Frank gave the Financial Stability Oversight Council (FSOC) the authority to designate financial firms systemically important financial institutions (SIFIs) if they "could pose a threat to the financial stability of the United States." SIFIs are subject to oversight from the Federal Reserve and stricter capital requirements. At present, bank holding companies with more than \$50 billion in assets are subject to SIFI regulation. Four non-bank SIFIs have been designated. SIFIs are subject to tougher regulatory oversight than their smaller and less complex competitors.

Should they meet that threshold, Guarantors should be held to SIFI-consistent capital requirements and regulatory supervision to eliminate the potential for regulatory capital arbitrage. Capital requirements should be set in consultation with the Federal Reserve, FSOC and Treasury. Guarantors should also be subject to regular stress tests comparable to, if not part of, the CCAR process.

Institutions that exceed the SIFI threshold are not "too big to fail." However, they may be too big to resolve quickly. As a result, they are required to adhere to stricter regulation to ensure that they have sufficient resources to be sustained through a crisis and longer resolution period.

## GSE Capital Requirements Pre-Crisis and through HERA

In the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Congress precisely defined the contours of an economic scenario that would form the basis for Fannie and Freddie's risk-based capital requirements, and also defined minimum capital levels, which would limit the GSEs' leverage.

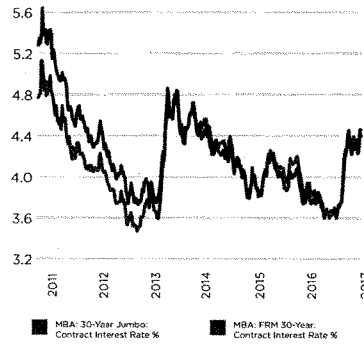
For loans or securities kept on balance sheet, the minimum capital requirement was 2.5 percent, while for MBS that were guaranteed but sold to other investors, the minimum requirement was 0.45 percent. These capital levels were found to be inadequate through the crisis as default rates exceeded 12 percent for certain mortgage vintages, with loss rates above 4 percent.



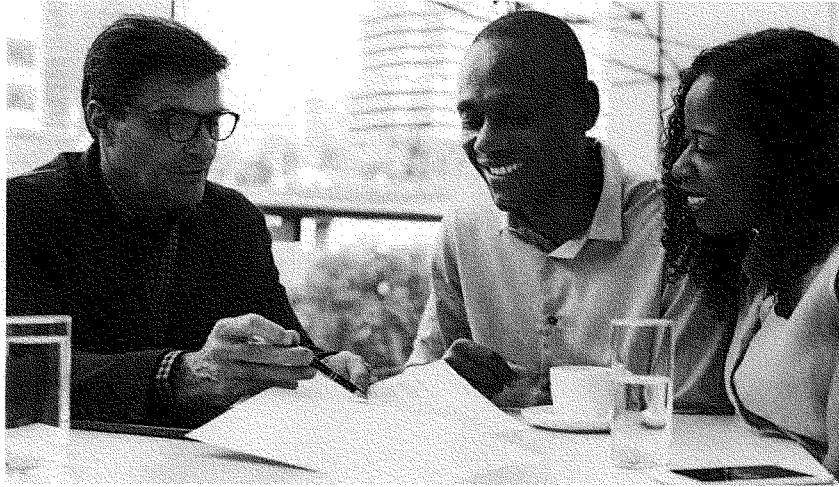
In the wake of the crisis, accounting rules and bank regulatory standards changed in a manner to bring assets and liabilities that were previously considered "off balance sheet" onto the balance sheet through consolidation.

The Housing and Economic Recovery Act, passed in the summer of 2008, provided the FHFA director broader authority and more discretion with respect to both risk-based and minimum capital

requirements for the GSEs. These authorities were not really utilized as the GSEs were subsequently placed into conservatorship. Note that guarantee fees charged by Fannie Mae and Freddie Mac have roughly tripled through the conservatorship period, a symptom of the implied capital standards for the GSEs being increased substantially. As shown in the chart below, another indication of



this implicit increase in capital is that rates on 30-year fixed jumbo mortgages, which previously had been 25-50 basis points higher than those for conforming loans, crossed over in 2013 and since have regularly been lower than conforming rates. This suggests that current implied capital levels for the GSEs are similar to those embedded in bank pricing models for jumbo mortgages.



#### Capital Relief for Distributing Rather than Retaining Credit Risk

GSE reform legislation should have the regulator set a "system level" of capital that ensures that all but catastrophic risk is borne by private capital. However, the regulator should also be required to develop a framework for the Guarantors to distribute rather than hold risk when it is economically sensible to do so. Thus, the capital requirements should count Guarantor capital, but also provide relief to the extent that Guarantors lay off the risk in a bona fide manner through front-end and back-end risk sharing, i.e., distribute the risk to be borne by mortgage insurance (MI) capital, lender capital and fully funded capital market structures.

The regulator should grant such CRT capital relief for approved structures and counter parties that have proven capability to absorb losses over the market cycle. Capital relief from CRT, either front-end or back-end, should be evaluated on an equity equivalent basis, i.e., the economic benefit of the transfer should be measured relative to another dollar of equity capital. Credit should be given only when risk-share capital is truly committed and targeted to cover losses ahead of the Guarantors.

#### What Is the Capital Requirement Measured Against?

The capital requirements set forth in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 differed for balance-sheet assets versus off-balance-sheet obligations. Given the accounting and regulatory changes to bring more assets and liabilities explicitly on balance sheet, that distinction likely should not be maintained.

However, the nature of the risks is different. Assets on the cash balance sheet need to be financed, and given the nature of the assets, the interest-rate risk is quite large and demands its own capital. Guarantees on MBS held by others result in credit risk exposure. Note that on Fannie Mae's and Freddie Mac's balance sheets, assets financed by Fannie Mae with debt are tracked separately from loans held in trusts for MBS investors.

MBA believes that Guarantor investment portfolios should not only be limited in terms of size, but also have strict parameters with respect to allowable investments. For example, loans held for purposes of aggregation should only be held for a limited period of time as determined by the regulator. Delinquent loans purchased out of pools should be sold as nonperforming loans (NPLs) or reperforming loans (RPLs) within a defined time period, barring a systemic risk event, at which point the regulator may grant a reasonable extension.

In sum, the risk-based capital standard for Guarantors should be set with respect to the entire credit book and potential losses in a stress environment. The regulator should establish Guarantor capital standards that are aligned with the Guarantors' risks, including the impacts of credit risk transfer, and they should be consistent with other capital regimes (such as the banking and insurance industries) for comparable risk exposures. These requirements would be more stringent for entities subject to SIFI-like regulation. The regulator's judgment as to capital adequacy should also be informed by the results of stress testing, such as the CCAR process or a similar adverse-scenario exercise.

#### Multifamily Considerations

Multifamily rental housing is a critical part of the U.S. housing market and our communities. More than 18 million households live in multifamily rental housing — a development with five or more units — and this includes workforce rental housing, seniors housing, student housing, rental properties that primarily serve low- and moderate-income families, and market-rate rental housing. While the GSEs' multifamily businesses are not as large as their single-family counterparts, their role is vitally important in supporting a necessary element of the housing continuum.

MBA's end state recommendations encompass both the single-family and multifamily roles of the GSEs. At the same time, we recognize that certain recommendations apply to specific market segments. For example, the single security concept, the continuation of the TBA market, the CSP and others are relevant to the single-family mortgage market. Likewise, the unique elements of the multifamily finance business should inform the application and implementation of policy changes to the multifamily lending sector and the GSEs' role therein.

In particular, the strengths of the existing multifamily finance system and infrastructure should be carried over into the newly chartered Guarantors. As noted below, both GSEs' multifamily businesses have experienced very low default rates, even during the financial crisis, and their predominant multifamily business executions have incorporated significant private capital through risk-sharing and risk-transfer mechanisms. In addition, given that the GSEs do not play the same dominant role in multifamily finance as in single-family finance, there is strong competition among a range of capital sources in apartment lending — with banks, life insurance companies, commercial mortgage-backed securities and other market participants competing actively in this sector.

Because of the nature of multifamily lending, the underlying real estate asset and the competitive environment in multifamily housing finance, the application of our recommendations and any action by policymakers should take into account the unique attributes of the GSEs' core activities in this market. Whether in crafting the specifics of regulations to implement the end state framework, the treatment of multifamily loans under regulatory capital standards or the details of the transition process such as the possibility of stand-alone multifamily Guarantors — we recommend that the characteristics of the underlying business line define the application of policy changes governing the GSEs.

#### Taxpayer Protection

In our recommended end state, taxpayers would be protected by a clear set of market conduct rules, prudential requirements and the MIF.

First, eligibility standards, established by FHFA, would restrict the mortgages the Guarantors can acquire to safe, stable Qualified Mortgages and well-underwritten multifamily mortgages, mitigating the potential credit risk. In addition, competition based on underwriting concessions or pricing benefits — especially when such benefits are based on delivery volume — would be prohibited.

Second, Guarantors would be engaged in both front-end risk sharing (such as private mortgage insurance and recourse) as well as laying off risk through back-end structures such as reinsurance or structured risk transfers for credit investors. Existing multifamily risk share (with lenders) and risk transfer (with investors) would be utilized in the multifamily sector. The regulator would assess the depth of such risk transfers to ensure they would be sufficient to absorb losses in all but the most catastrophic scenarios.

Third, Guarantor capital requirements would be significantly higher than under the old system for Fannie Mae and Freddie Mac.<sup>2</sup> Capital standards similar to those established for mortgage assets held by banks would likely have allowed the GSEs to survive the 2008 crisis.<sup>3</sup> FHFA would set such standards and apply corrective-action supervisory measures to ensure Guarantor capital is maintained.

<sup>2</sup> The GSEs' capital ratios were well below 2 percent in the years immediately preceding the financial crisis. Congressional Budget Office, *The Effects of Increasing Fannie Mae's and Freddie Mac's Capital* (October 2016), <https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/52089-gse-report.pdf>.

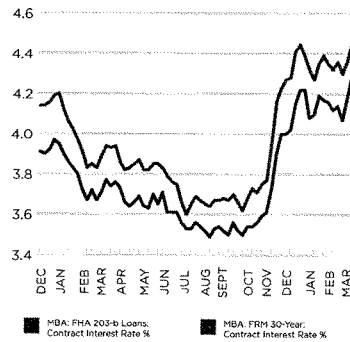
<sup>3</sup> 12 U.S.C. § 1821(n).

## Proposal's Impact on the Cost of Mortgage Credit

Under our proposed model, higher capital standards for the Guarantors and increased levels of private capital at risk would produce somewhat higher consumer and borrower costs. Guarantee fees are likely to be modestly higher than today given the increase in private capital required at the Guarantor level.

However, moving to an explicit federal guarantee should increase the value of MBS, offsetting some of the higher costs to consumers. The chart shows a comparison between FHA and conforming conventional mortgage rates over the past few years. A primary reason for the higher price on the Ginnie Mae securities is the full faith and credit guarantee behind those MBS. Fannie Mae and Freddie Mac MBS are backed by the Treasury through the PSPAs, but even the relatively small distinction in the current environment leads to a marked difference in price. At a consumer level, note the spread (chart below) between mortgage rates on conventional vs. FHA loans.

Ultimately the system will be more stable over time and hence the mortgage market will be available to consumers, even during severe downturns — a benefit that is worth the trade-off of modestly higher costs.







Finally, the MIF would add an additional layer of taxpayer protection in the case of a catastrophic or systemic market disruption. In exchange for the explicit guarantee, Guarantors would pay an insurance premium on each MBS issued. This fee would be deposited into the MIF managed by the FHFA. After a transition period, the MIF would be required to maintain a minimum level of reserves as insurance on outstanding MBS.

The MIF would be called upon to make timely payment of principal and interest to MBS investors in the event of a failure of a Guarantor. Only if the MIF were fully exhausted would there be a cost to taxpayers. Under these circumstances, the remaining Guarantors would be charged higher insurance premiums going forward to pay back taxpayers and rebuild the MIF reserves to their required reserve ratio, similar to the FDIC's practices with the Deposit Insurance Fund (DIF).



## Transition: From Status Quo to End State

Although the GSEs' transition out of conservatorship remains among the most critically important components of comprehensive GSE reform, this subject has not received the significant analytical treatment it deserves. This section seeks to describe the objectives of the transition process and to provide some concrete detail as to what would be involved in its successful implementation.

The overall goal of transition is to execute the steps necessary to move to a more sustainable, vibrant secondary mortgage market, while preventing and mitigating any potential adverse impacts to liquidity and the availability of mortgage credit. Upon enactment of GSE reform legislation, the transition from the GSEs to two newly chartered Guarantors operating under a suitable regulatory framework would occur over a multiyear period. The transition would encompass both operational and ownership elements. It would involve the transformation of the government-controlled GSEs into privately owned Guarantors with new charters, subject to new regulatory requirements. The transition should also open the door for new entrants seeking a Guarantor charter and attract greater levels of risk-bearing private capital to the housing finance system.

To convert the GSEs to Guarantors, and to allow for the chartering of new Guarantors, GSE reform must provide a mechanism to relieve the GSEs of their existing statutory charters, recharter them under the new regulator-conferred charter and create a process for new entrants to obtain such a charter. The transition examples discussed below are possible options that demonstrate that this can be done while keeping operations functioning. Other options may also be viable, subject to the guiding principles below that focus on market liquidity and operational stability throughout the transition process.

Notably, certain key decisions will affect the transition, including decisions as to the corporate structures used for the transition, the extent to which FHFA transfers GSE assets and liabilities to new entities, the treatment of untransferred assets and liabilities, and statutorily directed modifications to the Preferred Stock Purchase Agreements (PSPAs). GSE reform legislation may specify the outcomes of such decisions or delegate decision-making authority to FHFA.

### Transition Principles

The overarching objective for any transition process must be to minimize risks to liquidity and stability of the mortgage markets. As a result, the following principles should guide the transition process:

- **Clear Road Map and End State.** To promote market understanding of the transition, GSE reform legislation should outline the transition road map in sufficient detail, including steps that must be completed prior to chartering the Guarantors. The legislation should also clearly identify the target end state.
- **Continuity of Business Operations and Government Backstop.** To foster continued liquidity and market stability in the single-family and multifamily markets, and to support the preservation of the TBA market, the business operations performed by the GSE should continue throughout transition. In addition, it is critical that the government backstop now provided through the PSPAs remain in place at least until the new end state is fully functioning, capitalized and replaced by an explicit government guarantee at the MBS level.
- **Preserve and Leverage Existing Assets and Infrastructure.** To reduce operational risks, the transition should leverage existing human capital and operational processes at both GSEs and build on reforms that FHFA and the GSEs have already put into place during conservatorship. Where legacy technology can be upgraded during this process, those opportunities could be explored.

- **Utilize Existing Regulatory Framework Where Appropriate.** To reduce implementation risks, GSE reform legislation should leverage FHFA and its existing legal authorities and the existing regulatory framework as the starting point, modified as necessary to accomplish the objectives of GSE reform, as well as actions it has taken as conservator for the GSEs.
- **Regulatory Flexibility.** To allow FHFA to react promptly to changing conditions in the mortgage market and for the Treasury Department to divest its ownership stake in the GSEs in prudent fashion, the transition should provide the regulator with adequate flexibility.
- **Guarantors as Viable Businesses.** To enable the Guarantors to emerge from transition as privately owned entities that can sustainably support a secondary mortgage market, the transition process and regulatory requirements should enable the rechartered GSEs and any newly chartered Guarantors to be viable businesses with sufficient (but not guaranteed) prospects of long-term value to attract private capital.
- **Multiyear Transition Period.** To give FHFA sufficient time to put the necessary infrastructure into place, enable the Guarantors to meet regulatory capital standards and reduce the risk of market disruption, the transition should occur over a multiyear period.

## The Three-Phase Transition

Upon the enactment of GSE reform legislation, the transition would consist of three phases, as illustrated below:

1. Preparation,
2. Implementation; and
3. Divestiture by the federal government.

While the steps within each phase may occur concurrently or in an order different from how they are listed, the transition should complete each phase before moving on to the next one.

### Phase 1: Preparation

The Preparation phase establishes the regulatory foundation and creates the infrastructure necessary to carry out the Implementation phase.

#### Comprehensive Transition Plan

Congress should direct FHFA to develop a Comprehensive Transition Plan. This plan should describe in detail the activities that will occur during the Preparation phase, including steps to mitigate the risk of disruption. It should also outline the key decisions that must be made as well as the mechanics for carrying out those decisions. The plan should also address the need for FHFA resources, personnel and infrastructure to establish, administer and set premiums for the MIF; supplement the existing regulatory framework with new regulatory authorities; and otherwise administer the transition. The plan must also include a communications component aimed at enhancing transparency and providing critical information to market participants.

#### Regulatory Framework

To regulate the Guarantors from the time they are granted their charters, FHFA would need to have a new regulatory framework substantially in place prior to the start of the Implementation phase. Because the charters and functions of the Guarantors will be different from those of the GSEs, FHFA will need to review its regulations and implement any necessary amendments or issue new regulations. FHFA would similarly need to review and revise other regulatory issuances, such as policy and examination guidance or examination procedures. While existing FHFA regulations should be leveraged, the development of the regulatory framework could require some time to complete.

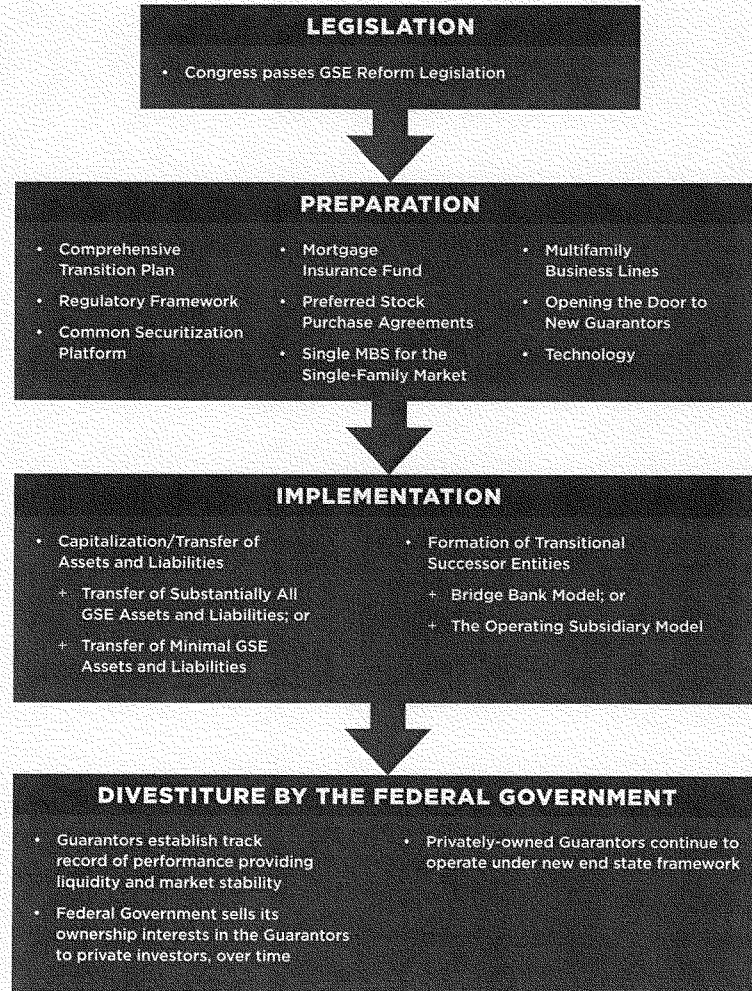
#### Common Securitization Platform

Today the two GSEs jointly own the Common Securitization Platform (CSP). Our proposed end state includes a transfer of ownership of the CSP and its conversion to a government corporation. Congress or FHFA might also consider other ownership/governance models that would advance the principles and guardrails we have identified.

#### Mortgage Insurance Fund

Legislation would direct FHFA to establish the MIF and implement regulations and processes for setting premiums, processing claims and otherwise operating the MIF.

## Transition Phases





#### Preferred Stock Purchase Agreements

While the GSEs together have drawn approximately \$187.5 billion from the PSPAs, approximately \$258 billion remains collectively available to the GSEs under the PSPAs' current terms. To foster liquidity and market stability, Congress should direct Treasury and FHFA to amend the PSPAs to ensure that they provide an appropriate MBS-level backstop for the GSEs' existing MBS. As discussed below, GSE reform legislation could direct that the PSPAs be amended to permit the Guarantors to build capital by retaining earnings after they begin operations and before Treasury sells its equity interest in them.

If preserving the PSPA backstop is not an option, Congress could grant an explicit guarantee to the existing MBS and other legacy GSE obligations; or the GSEs, rechartered as Guarantors, could establish a voluntary exchange mechanism for investors to obtain an explicit guarantee on existing MBS. Accounting and tax considerations may lead investors to desire to retain their existing securities. The actual risk borne by taxpayers as to GSE obligations would diminish as the existing book ages.

#### Single MBS for the Single-Family Market

One of the most important steps of the transition will be to determine how best to move from an implicit to an explicit guarantee on the MBS without harming the liquidity of the outstanding \$5 trillion MBS market. The GSEs have developed a liquid forward market for mortgage-backed securities for the single-family market, which is generally referred to

as the TBA market. The TBA market enables lenders to hedge risk, attracts private capital to mortgage markets and reduces the cost of mortgage lending.

On this issue, the drive to develop a single and fungible GSE security for the single-family market is particularly instructive. In 2019, both Fannie Mae and Freddie Mac are expected to issue the UMBS with the same payment-delay and investor-disclosure features. Freddie Mac will also offer an exchange for investors, providing UMBS in exchange for its outstanding Participation Certificates or a cash payment. The UMBS is an important step toward a true single security.

In the new system, the Guarantors, including new entrants, should issue only a single security for the single-family market. The key features of a single security — including an exchange mechanism between the old and new securities — are essential in order to reap the consumer benefits of the TBA market.

Although making securities from different Guarantors fungible and able to be commingled in a second-level securitization will be beneficial in terms of leveling the playing field between Fannie Mae and Freddie Mac, the move to a true single security will enable new entrants to successfully compete in the secondary market. As an analogy, consider the recent changes in the Ginnie Mae market. Previously most issuance was in the Ginnie I security, where each of the hundreds of issuers pooled loans into their own issuances. Investors could track the performance of individual issuers, and may have expressed preferences for particular lenders given

their propensity to have faster or slower prepaying collateral. Recently, for many reasons but also to benefit smaller issuers, Ginnie Mae has encouraged more volume into the Ginnie II security, which is a large pool composed of loans from many different issuers. This approach of pooling loans from different Guarantors into a single issue, a true single security, may be beneficial for market liquidity and may also help new Guarantors gain a foothold in the market.

#### **Multifamily Business Lines**

The multifamily businesses of the GSEs differ substantially from their single-family credit guarantee businesses. The recommended end state would largely preserve the operations, infrastructure and market executions of the current multifamily businesses, and would allow them to remain with their respective single-family credit guarantee businesses. Alternatively, it might be appropriate for one or both GSE multifamily lines of business to carry forward into separate new Guarantors. We believe that the transition process should allow for this option. Regardless, the Preparation phase, and the overall transition process as it impacts the multifamily business lines, should allow for appropriate differential treatment of multifamily in light of differences in the underlying business models.

#### **Opening the Door to New Guarantors**

Legislation should open the door for new entrants as early in the transition process as possible. New entrants then can apply for a Guarantor charter under the standards and procedures established in the legislation and implementing regulations. A new charter could be specific to the single-family market, multifamily market or both markets. As a utility-style regulator, one of the key factors the FHFA would be required to consider would be the impact of new competitors on both existing Guarantors, on the relevant market, and on consumers and borrowers. Maintaining the balance in the regulatory compact would be an important factor in evaluating new charters.

FHFA would determine whether the applicants meet the standards for a Guarantor charter. Because of the time that may be required to complete the process of applying for and receiving a charter, it may be appropriate for FHFA to begin accepting and processing applications during the Preparation phase, providing a way for new entrants to begin competing with GSEs now rechartered as Guarantors. The OCC process for chartering new national banks or federal savings associations may provide a useful model.

#### **Technology**

The transition to Guarantors issuing MBS under a new regulatory and guarantee framework may provide a unique opportunity to upgrade the technology that Guarantors could use to support their secondary market activities. As a result, the Comprehensive Transition Plan should include consideration of leveraging the opportunity to explore and implement new technology solutions.

#### **Phase 2: Implementation**

The Implementation phase would include (1) completing the steps necessary to transform the GSEs into Guarantors in the new system and (2) granting Guarantor charters to new entrants under the procedures and standards established during the Preparation phase.

#### **Capitalization/Transfer of Assets and Liabilities**

GSE reform legislation should direct FHFA and Treasury to explore a wide range of efficient and cost-effective ways to raise capital for the GSEs as they are rechartered as Guarantors. The most appropriate capitalization approach and process will depend on a combination of factors, including:

- The regulatory capital requirements that the legislation and FHFA apply to the Guarantors;
- The extent to which FHFA reorganizes the GSEs and winds down noncore businesses and the GSEs' retained portfolios;
- The extent to which the GSEs are permitted to retain earnings;
- The capital levels of the GSEs at the time of transfer;
- The extent to which FHFA transfers legacy GSE assets and liabilities to the new entities;
- The nature of PSPA or other support for legacy GSE obligations, and the use of the PSPA backstop going forward;
- The extent to which Guarantors receive a management fee for the administration of legacy GSE MBS under a management contract, if applicable;

- When and how the government would seek to divest its equity interests in the Guarantors; and
- Market views of risk and expected returns on new capital for equity investors in the Guarantors.

While there are many variations on possible recapitalization approaches, they fall into two general categories: (1) transfer of all or substantially all GSE assets and liabilities to the new Guarantors, and (2) transfer of only a minimal level of assets and liabilities to the new Guarantors.

Under both approaches, the Guarantors could become capitalized through combinations of selective transfer of GSE assets and liabilities, potential management contract income, accumulation of retained earnings or Treasury capital draws under the PSPAs. Treasury also may ultimately exercise its warrant for common equity and sell its common and senior preferred equity interests in the GSEs to private investors, choosing the time and manner to the benefit of taxpayers and the future stability of the housing finance system. The following are the major differences between the two approaches that Congress will need to consider:

#### **Transfer of Substantially All GSE Assets and Liabilities**

This approach may be the most straightforward one to recapitalization, as it would effectively keep the core operations and books of business of the GSEs largely intact and would reduce the risk of market distress or confusion. It would also be consistent with the FDIC's bridge bank model, the limited life regulated entity (LLRE) approach under the Housing and Economic Recovery Act of 2008 (HERA) and the federal government's general approach with the restructuring of AIG — all familiar to the market. The transfer could also be for certain types of assets such as single-family mortgage assets, multifamily mortgage assets or a certain combination thereof.

On the other hand, the fact that the new Guarantors would bring forward their existing GSE books of business would require that they raise substantially more capital. In addition, the resulting size of the Guarantors under this approach could act as a barrier to entry or make it more difficult for new entrant Guarantors to compete. The transfer of substantially all of the legacy GSEs' books of business might also confuse investors as to the change in the nature of the government backstop resulting from the reform. Specifically, investors may find it challenging to understand that, post-reform, the government no longer backs the Guarantors themselves, but only

the MBS. The PSPA backstop placed on legacy GSE obligations during conservatorship could also result in confusion regarding which assets are backed by the PSPA, which are backed by the MIF and which assets are not federally backed at all.

#### **Transfer of Minimal GSE Assets and Liabilities**

This approach might include the transfer of staffing, buildings, systems and operations to the new Guarantors and holding back the prior books of business. It would likely require the continued existence of two entities for each GSE — one to become the new Guarantor and the other to hold the legacy assets and liabilities. For continuity, the entities holding the old books of business would likely contract with their respective Guarantor to administer legacy GSE assets and liabilities in exchange for a management fee.

Key benefits of this approach are that the new Guarantors would be smaller and require less capital, which might enable them to raise adequate capital as well as provide new entrants a better opportunity to compete against them. On the other hand, this approach would include more moving parts and so might be more complicated to execute. The fact that the government would retain the legacy GSE securities could also extend the time necessary for the government to fully divest. In addition, a pure stand-alone Guarantor — without its prior credit guarantee or retained portfolio book — is an untested business model and so may be less attractive to new private capital.

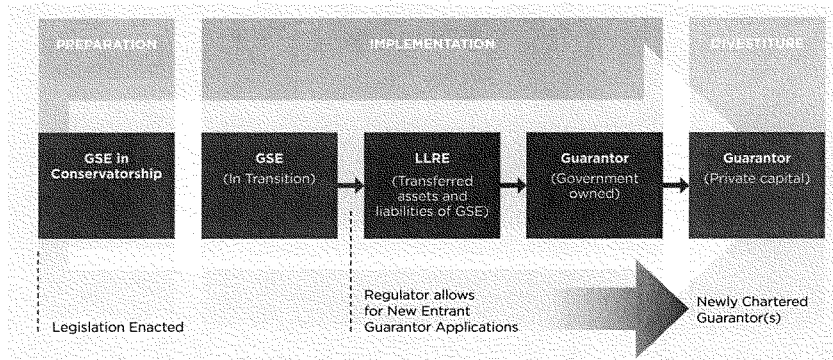
#### **Formation of Transitional Successor Entities**

There are several models that could be utilized to complete the transition of the GSEs to Guarantors. Two possible paths are the **bridge bank model** and the **operating subsidiary model** — each of which has its own set of trade-offs. The former would be more amenable to transferring substantially all assets and liabilities to the Guarantors; the latter would be more amenable to transferring only minimal assets and liabilities. Both would result in newly chartered Guarantor entities emerging from the GSEs, and allowing for new Guarantor entrants as well.

Congress could legislatively authorize either or both alternatives, or another path that meets our transition principles. Alternatively, it could authorize and provide discretion to the regulator to pursue a path that meets several statutorily defined objectives, including minimizing disruption in the investment and mortgage markets, so long as it moves the GSEs toward the recommended end state.



## Overview of Bridge Bank/LLRE Model



### Bridge Bank Model

One transition approach that would allow the GSEs to effectively be rechartered as Guarantors is the bridge bank model. As discussed below, Congress modeled the approach already in the HERA statute after the bridge bank model the FDIC has long applied to resolve banks that have become insolvent.

Bank resolution models like bridge banks are designed to protect depositors and the federal DIF. By law, the FDIC must choose the bank resolution method that is the least costly to the DIF.

The “bridge depository” provisions of section 11(n) of the Federal Deposit Insurance Act<sup>4</sup> allow the FDIC to restructure insured depository institutions during conservatorship after passing the insolvent institution through a receivership to reduce certain liabilities. The remaining assets and liabilities of the institution are then salable to private parties through stock offerings.

One resolution method employed by the FDIC is a purchase and assumption transaction (P&A) utilizing a bridge bank in which a third-party institution buys some or all of the assets and some of the liabilities of the institution. A bridge bank P&A may be a useful model for transitioning to Guarantors and addressing the legacy MBS assets and liabilities of the GSEs. In a bridge bank P&A, the FDIC temporarily acts as the acquiring institution

<sup>4</sup> 12 U.S.C. § 1821(n).

and a new bank is chartered by the Office of the Comptroller of the Currency and controlled by the FDIC. The new bank bridges the gap in time, enabling the FDIC to evaluate and market the bank to third parties, and enabling prospective purchasers to evaluate the bank in order to submit an offer.

An advantage of a bridge bank is that it provides time to arrange a permanent resolution, giving purchasers and investors the opportunity to evaluate the bank and submit bids. During the time the FDIC is operating the bridge bank, the FDIC prepares to sell the bank by soliciting interest and arranging for due diligence by potential acquirers, and by receiving and evaluating bids.

Significantly, a bridge bank preserves franchise value, ensures continuity of services, and gives the FDIC and purchasers time to consider pricing. These features of a bridge bank could be advantageous in resolving and reforming the GSEs.

FHFA authority under current law provides for something very much like an FDIC bridge bank in a receivership situation. Under HERA, FHFA can establish a bridge bank — known as an LLRE — that can operate for two years, with three one-year extensions before it must be sold or resolved.

Upon its creation, an LLRE may purchase such assets and assume such liabilities of the pre-receivership GSE, as FHFA, in its discretion, determines to be appropriate except that the amount of liabilities assumed by the LLRE cannot exceed the amount of assets purchased or transferred from the pre-receivership estate. The purpose of this requirement is to ensure that an LLRE has a sound balance sheet. The receiver can also selectively transfer assets and liabilities to the LLRE to create an institution that satisfies regulatory capital requirements.

#### **Application to Transition**

This approach would have the advantage of leveraging existing legal authorities as opposed to creating a new framework. However, Congress would need to modify the current receivership approach under HERA to make it an appropriate vehicle for the transition. Under HERA, the LLRE must succeed to the charter of the original GSE. By contrast, GSE reform legislation would need to authorize the regulator to grant each LLRE the new Guarantor charter, consistent with our end state recommendations. Because of the need for an extended and flexible transition period, it also may be necessary to extend the statutory time limits for LLRE operations. Alternatively, legislation could specify a new, analogous process, modeled on elements of the FDIC bridge bank and HERA receivership process, tailored to the needs of this unique situation and our recommended end state.

To reduce the risk of market disruption from the use of a wind down and transition process, GSE reform legislation and FHFA must explicitly delineate the key features of the end state. In addition, because the term "receivership" could invoke market uncertainty or confusion, notwithstanding the fact that the process would be a path to the recommended end state, the legislation should describe the process with alternative language, such as the Regulatory Transformation Process, Transition Conservatorship Process, or functionally similar language.

Regardless of nomenclature, the market must understand the end state and the transition process. Precise legislative language and the use of established bridge bank procedures could help ensure that this message comes through. Clear communication that the PSPAs and the MIF remain in place throughout the implementation phase can also reduce the risk of the market misunderstanding the impact of the transition process.

#### **The Operating Subsidiary Model**

An alternative transition approach would be to direct each GSE to form wholly owned subsidiaries (or affiliates) to operate in a parallel manner with the parent entities during the transition. The subsidiaries could be paid a fee for managing the legacy assets of their parent companies and would be prohibited from paying dividends to them. This management fee could begin to capitalize the entities that would become the two initial Guarantors. Such an approach could leverage FHFA's and the GSEs' experience establishing the CSP as a jointly owned subsidiary of the Enterprises. This approach would be more attractive if the legacy (pre-GSE reform legislative enactment) books of business were to be separated from the operating entities going forward.

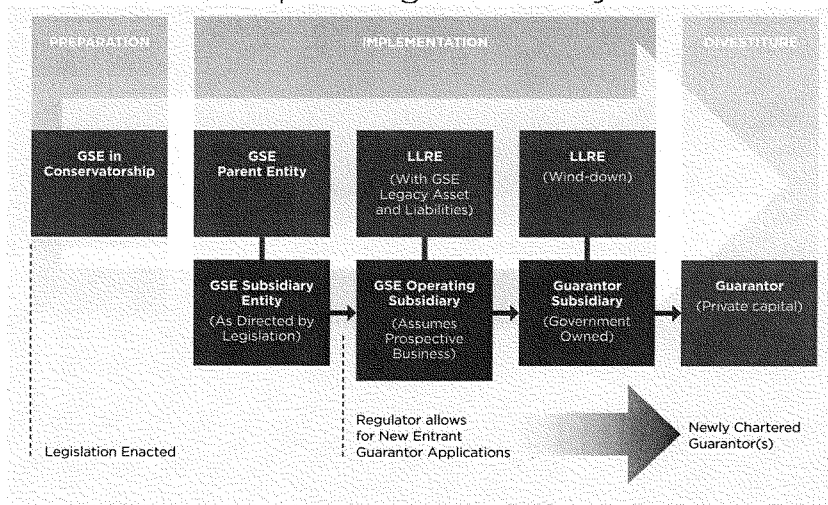
Establishing the subsidiaries could require a modification of the PSPAs to facilitate this structure. Also, because the GSEs have typically operated under a single legal structure and are currently limited from setting up subsidiaries, GSE reform legislation could direct the GSEs to establish them, and the GSEs would need to absorb the cost of setting up new systems to be able to track operations across additional legal entities.

At the appropriate point, the GSEs could spin off their subsidiaries by selling all of their equity interest in them. The subsidiaries would emerge as the newly chartered Guarantors, authorized to issue new MBS backed by the Mortgage Insurance Fund and subject to the principles and guardrails specified in our end-state recommendations.

#### **Application to Transition**

The value of this approach is that the entities that would become the newly chartered Guarantors would also develop a track record, and markets would gain familiarity with them prior to the date on which they become stand-alone entities. It also may create a structure that is adaptable to a decision to transfer minimal assets and liabilities to the Guarantors, and for the subsidiaries to enter into management contracts with the parent companies to administer the GSEs' untransferred books of business.

## Overview of Operating Subsidiary Model



### Phase 3: Divestiture by the Federal Government

The final phase of the transition, divestiture, replaces government ownership and control with private capital. That occurs when Treasury sells its equity interests in the GSEs to private-sector investors. This approach is similar to the one taken with respect to AIG.

As part of the Comprehensive Transition Plan, FHFA and Treasury should develop a high-level plan that sets out the objectives and strategies for divestiture. Importantly, the regulators must possess sufficient flexibility to account for market conditions during the divestiture process. The outcome will be favorable only if the transition process and regulatory requirements result in Guarantors with sufficient potential for long-term value to attract private capital. Moreover, many investors will be interested in purchasing equity in the Guarantors only after they have established a track record of performance (for example, a period of three or more years).

During such time, the Guarantors should be permitted to build their capital bases by retaining earnings. We envision legislation directing such amendments to the PSPAs in the context of comprehensive reform. We underscore that the legislation should provide substantial flexibility to regulators to calibrate and sequence the divestiture process in a smooth manner that both strengthens the transition process and protects taxpayer interests.

## AIG Recapitalization as Example

The process the government employed to recapitalize and sell its common and preferred stock interests in AIG provides a possible model for restructuring the GSEs. The substantial amount the federal government invested in AIG (\$182.3 billion) was one of the government's largest investments in a private sector company.

Both Treasury and the Federal Reserve assisted AIG with numerous restructuring and reform efforts, and those efforts ultimately enabled both agencies to recover substantially greater repayment amounts than they invested to stabilize AIG. Other aspects of the restructuring may be instructive as models for restructuring the Enterprises in ways that protect taxpayer interests.

A salient aspect of the AIG restructuring is that AIG's operations were streamlined. AIG retained its core insurance operations while selling non-core assets and reducing its MBS and derivatives exposure, thereby decreasing the size of the company. Over a period of 19 months, the Treasury conducted six different public offerings of AIG common stock.

Treasury's steps resulted in a positive return on taxpayers' investment and Treasury continues to hold warrants to purchase shares of AIG common stock, which could increase the return when exercised. Treasury also allowed AIG's board of directors to declare a dividend to AIG's common stockholders in the form of warrants to purchase shares of AIG's common stock, with a condition that each party to the recapitalization plan would agree to close the deal on a certain date.

GSE reform legislation, therefore, should grant FHFA and Treasury substantial discretion to divest the government's equity interests over time.

## Affordable Housing: A Seamless Continuum of Housing

America's housing finance system should meet the needs of the full continuum of households, from families requiring the most directly subsidized, affordable rental homes to those served by the completely private prime jumbo single-family lending market.

Looking ahead, these housing needs must continue to be met through a broad variety of approaches that include single-family and multifamily housing capitalized by private, nonprofit, government or a combination of sources. But, with affordable-housing needs so great, the secondary market must also play a supporting role.

MBA research shows that in the United States there will be demand from 1.4 million to 1.6 million additional household units each year for the next 10 years.<sup>5</sup> Demand for housing will come from households that are increasingly diverse across dimensions of age, race, ethnicity and geography. In addition to these differences, Americans are increasingly divided by income and wealth. While some families are prospering, others feel they are falling further behind as they struggle to pay bills, secure an affordable home or send their children to college.

The growing economic divide has real-life consequences for the housing market: In 2015, the typical college-educated worker earned nearly twice as much as someone with a high school degree.<sup>6</sup> This divergence means that better-educated households often outbid others for limited housing resources, placing upward pressure on rents and prices — especially in desirable neighborhoods with decent housing, low crime and good schools. Falling homeownership rates among those without a college degree also contribute to growing wealth inequality. Affordable-housing policy is an essential part of the solution to these serious socioeconomic challenges.

The government-backed secondary mortgage market must provide liquidity to facilitate the development, preservation and purchase of all types of housing. Where it cannot achieve this goal alone, it should act in tandem with other resources to facilitate access to safe and reasonable-quality housing. Moreover, government policy in general should reflect a unified, holistic approach that responds to the full scope of housing needs. An effective affordable-housing policy must also be flexible and innovative, responding to feedback from existing programs and seeking new paths forward.

The continuum framework provides a single context for integrating the roles of single-family, multifamily and other programs in serving the housing market. The framework identifies five broad housing market segments that policymakers should consider in crafting a holistic housing strategy.

The continuum roughly categorizes households as:

- Low- and very-low-income renters occupying affordable rental units,
- Renters occupying market-rate housing,
- Credit-ready prospective homeowners,
- Homeowners currently served by the GSE single-family and condominium business, and
- Homeowners served by the prime jumbo market (who should not benefit from a government guarantee).

<sup>5</sup> *Housing Demand: Demographics and the Numbers Behind the Coming Multi-Million Increase in Households*. Fisher and Woodwell (July 2015).

<sup>6</sup> MBA Economic and Mortgage Finance Outlook, MBA Annual Convention, October 2016.

The framework also identifies some of the federal programs that directly or indirectly impact consumers within the various segments along the continuum. A core objective of affordable-housing policy should be to promote opportunities for economic mobility along this continuum. This objective undergirds our recommendations in this section.

**A Viable Plan for Addressing Affordable-Housing Needs Is a Political Requirement for Bipartisan GSE Reform**

Consideration of GSE reform offers a once-in-a-generation opportunity to reimagine federal housing policy. It provides the chance to assess how best to meet housing needs along the full continuum of households. Only by identifying who will — and will not — be served by the government-guaranteed secondary market in the new system can we be clear about the role of the Guarantors and the need for other initiatives to help those not adequately served.

**The Continuum**

**Affordable Rental (with and without subsidies):** Households that are significantly below the area median income and may be eligible for policy-directed subsidies.

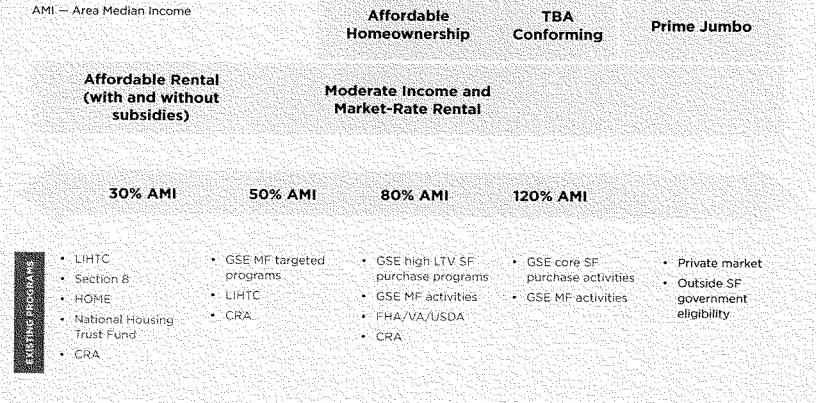
**Moderate Income and Market-Rate Rental:** Households that earn in the range of area average income. Depending on market circumstances, rents may be moderately burdensome.

**Affordable Homeownership:** Qualified prospective borrowers who may lack savings or family wealth necessary for traditional down-payment.

**TBA Conforming:** Core of conforming GSE single-family market. Benefit from government guarantee is primarily lower mortgage rates created by the additional liquidity.

**Prime Jumbo:** Loans above the conforming loan limit. Not intended beneficiary of government guarantee.

- Core GSE purchase activities
  - GSE can partner as debt buyer, other direct funding required
  - Private market
- AMI — Area Median Income



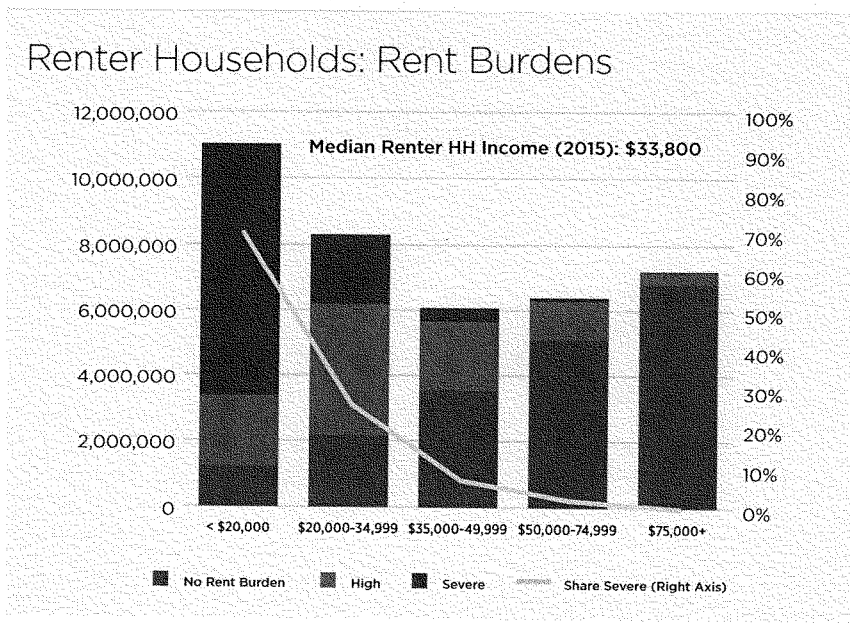
The housing system is made stronger by helping aspiring homeowners purchase their first home in a sustainable manner so that they can begin building wealth through equity appreciation. Further, a stable, vibrant housing system is one in which the secondary market provides ample liquidity for affordable multifamily rental housing.

The following sections outline an affordable-housing plan for GSE reform. This plan sets out three critical affordable-housing missions and then charges the future regulator with assessing market conditions and developing a plan to meet these missions. The plan would be implemented with measurable goals that are enforceable against the Guarantors. An affordable-housing fee, charged against the new business purchases of the Guarantors, would play an important supplemental role.

### Three Critical Affordable-Housing Missions

A government-guaranteed secondary mortgage market must serve three critical missions:

1. **Guarantors should actively seek to provide responsible, sustainable access to credit for prospective homeowners.** The government-backed secondary market should promote opportunities for sustainable homeownership by facilitating access to affordable mortgage credit for first-time homebuyers. This objective is especially important for low- and moderate-income borrowers, as homeownership remains the primary means by which these groups build wealth. Progress on this front will require a range of responsible underwriting, documentation, product and outreach strategies, including ways to deal with the economic challenges of originating and servicing small balance mortgage loans and reaching nontraditional households. Innovation and responsible risk taking must be part of a comprehensive strategy to reach more creditworthy borrowers.



## The Three Affordable-Housing Missions



2. **Guarantors must work to provide liquidity for the development and preservation of affordable rental housing.** Widespread access to affordable rental housing of decent quality is essential to enhancing social mobility and promoting economic growth. Unfortunately, the gap between household incomes and the cost of building and maintaining rental housing (including moderate-income working households and those with special housing needs continues to grow. The figure above shows that the share of households with moderate rent burdens (paying more than 30 percent of income toward housing) and with severe rent burdens (paying more than 50 percent) is high. The housing system must place a renewed focus on facilitating the renovation and preservation of the existing housing stock serving low- and very-low-income households, as well as the development of new affordable rental homes.
3. **Guarantors must improve liquidity for segments of the market that are currently underserved.** Access to both mortgage credit and affordable rental housing remains a challenge for many segments of the market. These market segments include minority households as well as traditionally underserved parts of urban, suburban and rural communities. Credit also remains constrained in the market for lower-cost manufactured housing. Without an adequate policy response, these challenges will likely grow even more acute in light of powerful demographic trends now underway, including the increasing diversity of the U.S. population. The secondary market must therefore seek new ways to evaluate and underwrite borrowers and develop innovative products, partnerships and programs to respond to changing demographics and reach underserved groups and communities.



While these missions are critical, the government-guaranteed secondary mortgage market cannot, and should not, serve the entire continuum of households by itself. The government-guaranteed market can help facilitate financing for the development and preservation of good-quality, affordable rental housing, but the role of equity investment will be critical as well. In some cases, the secondary market will require partnership with other programs, such as Low Income Housing Tax Credits (LIHTCs), Section 8 Housing Choice Vouchers and the National Housing Trust Fund, to serve those with the most acute affordable-housing needs. Programs such as these should be appropriately funded to meet the needs of households on the low-income end of the continuum.

On the other end of the continuum, in the prime jumbo segment and luxury multifamily, the highest income and credit-quality borrowers should be served by the private mortgage market and do not require the support of a government guarantee.

The housing needs of historically underserved racial and ethnic groups and communities warrant special attention. Some of these needs can be met through existing regulatory frameworks like the Community Reinvestment Act (CRA). Others may require collaboration and information sharing between primary and secondary market participants, including mission-oriented and nonprofit organizations. Still others are best addressed through broader policies to reduce income inequality, create jobs and spur economic growth.

#### **Preserve What Works, Enhance Other Parts of Existing System**

Many aspects of the existing secondary mortgage market benefit households in a manner that should be preserved in any new system. At the same time, other elements require improvement. In this section, we highlight what currently works in the multifamily and single-family segments of the market and then provide some guidance on areas where improvements are necessary.

The current GSE multifamily businesses are major success stories. Both GSEs' multifamily businesses have experienced very low default rates, even during the financial crisis, and their predominant business executions have incorporated significant private capital.<sup>7</sup> In addition, because the GSEs do not play the same dominant role in multifamily finance as in single-family finance, there is strong competition among private capital sources in apartment finance — with banks, life insurance companies, commercial mortgage-backed securities and other market participants competing actively in this sector. A particular affordable-housing success for the GSE multifamily businesses is the provision of liquidity for mortgage debt that is paired with equity raised by the LIHTC program, one of the most effective public/private financing programs for the production and preservation of affordable rental housing.

The future system of housing finance should ensure there is sufficient liquidity in the multifamily housing market broadly, with a particular focus on moderate-income and affordable rental housing. The vast majority of the two GSEs' multifamily businesses currently serve households with incomes at or below the area median. The Guarantors should assume this same role in the new system, supporting moderate-income and affordable rental housing while providing liquidity during periods of market disruption.<sup>8</sup>

#### **Any affordability goals imposed in the context of GSE reform should align with and promote this focus.**

The single-family Guarantors should serve a market segment similar to that of the GSEs today. In the single-family market, the GSEs are, and have historically been, the dominant liquidity providers, particularly for longer-term, fixed-rate mortgages for middle-income homeowners. Borrowers benefit as a result of two key features of the current system: First, the GSEs are perceived as being backstopped by the federal government; and second, the majority of GSE single-family mortgage-backed securities are traded through the TBA market.

<sup>7</sup> Mortgage Bankers Association, *Affordable Rental Housing and Public Policy: Toward Greater Housing Security and Stability*. (December 2015).

<sup>8</sup> For the calendar year 2015, 64 percent of the rental units in multifamily buildings with mortgages purchased by Fannie Mae had rents that were affordable to households at or below 80 percent of area median income, and 82 percent of the units were affordable to those at or below median income. At Freddie Mac, the shares were 75 percent and 89 percent, respectively. (See Fannie Mae *2015 Annual Housing Activities Report and Annual Mortgage Report*; and *2015 Annual Housing Activities Report Federal Home Loan Mortgage Corporation*.)



Together, these features allow a broad segment of borrowers who obtain financing through conforming loans to receive lower interest rates, while ensuring that financing for the nation's home purchase needs are met even through economic downturns. An explicit government guarantee of eligible MBS, paid for by the privately owned Guarantors, would continue to provide these benefits and, if properly managed, further reduce the risk of market disruption during a regional or national downturn. While there is much to recommend and preserve in the existing GSE multifamily business, there is greater room for improvement within the single-family business.

The current conforming loan limits should be preserved, with similar adjustments for high-cost areas, because they provide a well-understood threshold and relative ease of execution as compared with other metrics that rely on local area house prices or household incomes.

The Guarantors should have the flexibility to underwrite and price credit risk to ensure a reasonable cross-subsidy that can result in some savings for qualified borrowers while maximizing access to credit. Pricing and underwriting across various programs and markets should be as transparent as possible to ensure that eligibility, qualification and pricing information is clearly communicated to the market and balanced by sound risk-management practices.

Other elements of the existing housing finance system can be improved in ways that expand access to affordable mortgage credit.

**Potential improvements include:**

- **Updating credit-scoring models to leverage changes in technology, data and analytics that assess the creditworthiness of a larger segment of the population.** Credit-scoring models should continue to adapt to changing demographics and labor markets. Augmenting the type of data used to assess the creditworthiness of prospective buyers, including those with "thin" credit files, holds the potential to responsibly expand the pool of potential first-time homebuyers. A considerable amount of work has already been undertaken on this subject.
- **Updating documentation and derivation of income requirements to better capture self-employed or nontraditional household income that may help to identify creditworthy borrowers.** Nearly 15 million Americans are self-employed. Many face significant obstacles in meeting mortgage underwriting requirements, including income documentation.

- **Increasing the transparency of well-calibrated guarantee/credit enhancement pricing and underwriting eligibility.** The impact of loan-level price adjustments and other credit enhancements must be evaluated as part of any affordable-housing strategy. Lenders in the primary market are better able to serve borrowers to the full extent of the credit box when the parameters of eligibility requirements are well understood and consistent.
- **Providing enhanced liquidity for small-balance single-family and multifamily loans.** Small-balance loans in the residential market present unique economic challenges for lenders to originate and service. Reliable secondary market funding for these loans is important for serving lower-income borrowers and communities. In the multifamily market, incentives should be targeted toward improving liquidity for small-balance loans on projects providing affordable rental housing.
- **Partnering with lenders and other third parties to facilitate outreach and/or counseling programs for emerging demographics.** As the United States becomes increasingly diverse over the coming decades, serving these emerging borrowers will require different tools and approaches.
- **Improving access to credit for manufactured housing purchases.** Manufactured homes remain an important part of the affordable-housing stock in the United States, especially in rural areas, but there is a lack of uniformity in underwriting standards for assessing the collateral and credit risk associated with financing this product.

#### Harmonize Federal Housing Policy

The at times overlapping missions of FHA, the U.S. Department of Veterans Affairs, the U.S. Department of Agriculture, the Rural Housing Service, Ginnie Mae and the GSEs should be made complementary. One approach would be to empower a single body or special advisor to harmonize and manage the various roles and targeted missions of these entities. A Special Advisor for Housing Policy Coordination could be created as part of the president's National Economic Council to help manage and rationalize housing policy and regulation. Integrating our fragmented housing policy into a single, unified strategy would allow for greater coordination and more dynamic program development, as well as clearer communication with market participants, stakeholders and regulators. Moreover, it would help reduce the risk

of discrete segments of consumers falling through the cracks as specific policies are developed and executed. Housing policy should also facilitate the movement of households along the continuum, enhancing — and not discouraging — geographic and economic mobility for those who seek it.

#### Setting the Stage: The Affordable-Housing Plan

To achieve the three overarching affordable-housing missions, the end state regulator would be charged with developing a comprehensive plan. The Guarantors would then be held accountable for executing against this plan. A key part of the plan would be the achievement of affordable-housing goals established annually by the regulator. The regulator would determine whether each guarantor is meeting these goals, hold the Guarantors accountable for any failure to meet them, and recalibrate the goals as needed. In addition, the regulator would assess an affordable-housing fee on new business purchases of the Guarantors to help finance affordable-housing activities. The regulator would have flexibility in identifying and adjusting the appropriate mix of goals and fees.

Getting the mechanics right for both the Guarantors and the regulator is critical. We believe a successful approach will include the following key components:

- The end state regulator must create an affordable-housing plan that furthers the three affordable-housing missions. The regulator must periodically develop an affordable-housing plan that furthers each of our missions — namely expanding access to credit, preserving and developing affordable rental housing and improving liquidity for underserved markets.

The plan must be supported by research conducted by the regulator and with input from industry stakeholders, public interest groups and others, and aspire to achieve meaningful change within the broader framework of regulatory requirements, market trends, and safety and soundness.

- The regulator should implement the plan through a combination of affordable-housing goals for the Guarantors and a fee assessed against their new business purchases. The regulator should try to identify the best mix of goals and the fee (assessed within a permissible cost range defined by statute) to achieve the overarching plan.

This flexibility is important for several reasons. First, we do not yet know exactly how investors, Guarantors and other mortgage market actors will respond to a new end state system. For example, the exact shape of future credit risk transfers to private investors is unknown. This uncertainty will surely affect the ability of the secondary market to bear and price risk, a function that will likely mature over time. In addition, the needs of households themselves may change over time.

#### **A More Dynamic, Market-Based Approach to the Affordable-Housing Goals that Focuses on Outcomes**

The GSEs have historically fulfilled their public mission through Affordable-Housing Goal regulations that mandated a particular ratio of loans purchased by the GSEs to be made to very-low-, low- and moderate-income borrowers and borrowers in low-income areas, or to multifamily property owners serving these communities.

In addition, "duty to serve" legislation required that the GSEs serve underserved markets in rural areas, affordable rental housing and manufactured housing. While recent duty-to-serve rules are relatively untested, the goals approach only evaluated performance based on whether or not the GSEs purchased qualifying loans. This blunt instrument sometimes led to suboptimal outcomes, particularly when the regulatory goal-setting process became disconnected from market signals.

### **The regulator should assess the performance of the Guarantors in each of the relevant mission areas, including consideration of actual mortgage purchases, outreach activities, and related research and development efforts.**

Because of this uncertainty, the regulator should be empowered to choose a combination of goals and a fee, within limits set to ensure the continuity of business strategies, to best achieve its affordable-housing missions. Flexibility will be especially important in the early stages of GSE reform, but the concept of dynamic housing goals, with appropriate governors, should be a core part of the new system.

- The plan and its implementation should be updated according to a periodic timeline that is defined in statute. The timeline should include adequate opportunity for the regulator to evaluate market conditions, establish a set of proposed goals and recalibrate them after receiving public input. It should also allow the Guarantors a reasonable implementation period. The regulator would then report to Congress on an annual basis on its progress in meeting the objectives of the affordable-housing plan.

The following discussion outlines a new approach to affordable-housing goals that addresses these and related concerns. Under this approach, some of the goals would include specific, quantifiable outcomes based on loans made to distinct borrower/market segments. Others would focus on qualitative efforts, such as outreach, research and targeted initiatives. Both are intended to work in tandem with and complement each other, and not be substituted for the other.

The regulator should assess the performance of the Guarantors in each of the relevant mission areas, including consideration of actual mortgage purchases, outreach activities, and related research and development efforts. A combination of quantitative, market-based targets and qualitative, activity-based targets should be used. The regulator must define goals in a manner that is appropriate for single-family and multifamily Guarantors, provided that goals for similar business lines are the same.



**Affordable-Housing Goals, whether quantitative or qualitative, should be:**

1. **Transparent and well defined.** Quantitative targets should be specified as a number, percentage or range within a demographic, geographic or income-based cohort. Qualitative targets should be assessed or graded according to established criteria that consider activities in combination with desired outcomes.
2. **Assessed in terms of market impact.** Success is ultimately based on concrete evidence about performance in certain markets, not merely on the level of resources committed or activities conducted. FHFA should focus on results that actually make a difference. At the same time, any goals should be based on market needs and circumstances, with realistic benchmarks.
3. **Measurable.** Clear metrics should allow for FHFA to evaluate performance against the affordable-housing objectives. These assessments should be made available in public, annual reports to Congress.
4. **Enforceable.** Failure to meet established goals should carry appropriate consequences, with financial penalties for more egregious failures. All significant failures should require remediation plans submitted by the guarantor to the FHFA for review and approval.
5. **Recalibrated periodically.** The FHFA should provide for formal, periodic opportunities for public input on potential refinements and adjustments to the goals. The timing of such input should be consistent with a schedule that allows the regulator to consider it fully before taking action. Any refinements and adjustments to the goals should be supported by independent research and data analysis by the regulator.
6. **Reviewed to avoid market distortions.** FHFA, in seeking to set or adjust the goals, should attempt to ensure that all goals are realistic, aligned with market circumstances, and do not inadvertently distort behavior or incentives for entities serving the affordable portion of the housing continuum. Consistent with sound risk-management practices, the Guarantors should have the flexibility to price credit risk in a way that provides a reasonable cross-subsidy to support segments of the mortgage market that are currently underserved.
7. **Balanced by safety and soundness.** FHFA should ensure that the affordable-housing obligations of the Guarantors are balanced by prudent risk-management practices.

### Completing the Missions with An Affordable-Housing Fee

To complement the affordable-housing goals of the Guarantors, we believe that an affordable-housing fee should be assessed on new business purchases of the Guarantors. The fee should be used to help support efforts along the continuum, including for market segments not traditionally served by the GSEs. By allocating resources in this way, particularly to assist lower-income renters, the Guarantors will be promoting stability and mobility along the continuum — keys to a healthy housing market.

### The Affordable-Housing Fee Should Supplement Secondary Market Activity

Fulfilling the three affordable-housing missions cannot be achieved exclusively through the government-guaranteed secondary mortgage market. As a supplement to secondary market activity, an affordable-housing fee should be dedicated to support certain affordable-housing funds, such as the National Housing Trust Fund and the Capital Magnet Fund. This fee should supplement the use of goals to support the three critical affordable-housing missions: providing access to credit for prospective homeowners, developing and preserving affordable rental housing, and improving liquidity for underserved markets.

#### Certain core principles should guide the size and use of an affordable-housing fee. The fee should:

- Work in a manner similar to the current (4.2 bps) fee assessed on new business that the GSEs pay to the National Housing Trust Fund and the Capital Magnet Fund under HERA. The current fee is charged on each dollar of the outstanding principal balance of total "new" single-family and multifamily business purchases each year. Thus, it is a one-time annual assessment on each year's acquisitions.
- Be established by FHFA through a public notice and comment rulemaking, subject to a range or band established by Congress in statute.
- Be set at a level that generates meaningful contributions to a range of important affordable-housing efforts without unduly raising the cost of mortgage credit for consumers. The impact on pricing to borrowers should be transparent.
- Be consistently applied for reasonable time periods to ensure continuity and maximize compliance. The schedule for setting and changing the fee should be transparent.
- Support mission-related activities undertaken by funds such as:
  - + **National Housing Trust Fund:** A fund currently administered by The U.S. Department of Housing and Urban Development (HUD) with monies allocated to states via a formula. The National Housing Trust Fund focuses primarily on housing support for "extremely" low-income (up to 30 percent of area median income [AMI]) and "very" low-income (up to 50 percent of AMI) renters.
  - + **Capital Magnet Fund:** A fund currently administered by Treasury with competitive grants provided to qualified affordable-housing organizations, such as Community Development Financial Institutions. The fund is used to leverage private capital and support investment in housing primarily for low-, very-low- and extremely-low-income households, as well as for certain community development activities.
  - + **Market Access Fund:** A new fund that would be administered by the regulator to support research, development and innovations in consumer education, product design, new market segments (such as single-family rentals), underwriting and servicing, as well as credit support for certain mortgage loans or pools and the development of affordable housing for rent and for sale. (A similar fund was proposed in the Johnson-Crapo GSE reform legislation in 2014.)

Once the fee is established, the regulator should report annually to Congress regarding the use of the funds generated by the fee, providing appropriate metrics to gauge performance and outcomes. In making these reports, the regulator should coordinate with the federal agencies charged with administering the funds described above.

### Moving Forward

Today far too many households suffer from housing cost burdens that are consuming excessive amounts of their income. The supply of rental homes affordable to the lowest-income families on the housing continuum is inadequate to meet demand. At the same time, the national homeownership rate has declined significantly since the financial crisis, with many minority and low-wealth communities falling even further behind. For many Americans, access to credit and the ability to obtain a mortgage to become a first-time homebuyer have been denied. Left unaddressed, these problems will likely intensify in the coming decade as our country undergoes a profound demographic transformation.

GSE reform offers the opportunity to develop an inclusive approach to affordable housing — one that serves the full spectrum of households, addresses shortcomings in today's system, provides greater protection for taxpayers, and attempts to anticipate future issues and obstacles. It is imperative that we seize this opportunity.

When Congress last considered GSE reform legislation in 2014, affordable housing was at the center of the debate. And it remains there today. This framework is designed to help outline a viable path forward.







## Conclusion: A Call to Action

As we approach the ninth anniversary of the decision to place Fannie Mae and Freddie Mac under government conservatorship, it is nearly universally acknowledged that maintaining the status quo of the housing finance system is not a viable solution.

The GSEs continue to move closer to a point where they will have no retained capital. The threat of a draw on their line of credit with the U.S. Treasury looms as a very real possibility. At the same time, the housing needs of millions of lower- and moderate-income families today remain unmet. Access to mortgage credit is unnecessarily tight, while rental cost burdens continue to weigh heavily on family budgets.

This paper is designed to provide the spark for a renewed focus on GSE reform. It outlines the key principles and guardrails that should guide this effort and provides a snapshot of what the new secondary-market end state should look like. It also attempts to shed light on two critical areas that have tested past reform efforts — the appropriate transition to the post-GSE system and the role of the secondary market in advancing an affordable-housing strategy.

While achieving GSE reform will not be easy, the potential upside is great. Our recommended approach to reform will:

- Inject much higher levels of risk-bearing private capital into the mortgage system, while dramatically reducing the system's reliance on government support.
- Protect taxpayers and consumers with a clear set of market conduct rules, prudential requirements, and a new Mortgage Insurance Fund financed with appropriately priced insurance premiums.

- Enhance the stability of the mortgage system with multiple Guarantors replacing the GSEs and operating as privately-owned utilities that are not too big to fail.
- Improve service and performance in the secondary market with multiple Guarantors competing on operations and systems development, customer service, product parameters and innovation, and pricing and execution.
- Ensure that mortgage lenders of all sizes and business models have equal access to the secondary market.
- Minimize disruption during the transition to the new system by preserving what works in the current system and utilizing the existing regulatory framework where appropriate.

Ultimately, GSE reform holds promise to create a more vibrant and sustainable housing finance system that can enhance the lives of millions of Americans and help stabilize the housing market for decades to come. The hard work of reform should proceed without delay.

House Financial Services Committee  
Subcommittee on Housing and Insurance

Sustainable Housing Finance Reform: Private Sector  
Perspectives on Housing Finance Reform, Part II

November 2, 2017

Community Associations Institute

Community Associations Institute (CAI) is pleased to offer the Committee the following policy views of CAI members on principles for sustainable housing finance reform. CAI members live in and work with community associations—commonly known as homeowner associations, condominium associations, and housing cooperatives.

Community associations represent a significant evolution in the housing of America. State and local governments have been at the forefront of this change, actively keeping pace with the housing preferences of consumers. Housing finance reform is a unique opportunity for the federal government to ready the secondary mortgage market to fully embrace and serve the community association housing model.

Housing is intrinsically local, a proposition at odds with a housing finance system that attracts international capital and relies on federal agencies to achieve uniform standards to support national mortgage credit markets. Community associations comprise a unique housing model that has been broadly accepted by consumers. Congress must incorporate the community association housing model in a reformed housing finance system.

CAI members developed housing finance reform principles (Appendix A) to ensure the community association housing model is served by a new market structure. These principles address—

- Continuity of Community Association Underwriting Standards
- Duty to Serve Community Association Housing in all Markets and Business Cycles
- Servicing Mortgages in Community Associations

### About the Community Association Housing Model

The Foundation for Community Association Research (FCAR)<sup>1</sup> documented strong consumer demand for the community association housing model. In 2016, FCAR estimated the number of community associations nationwide at 342,000, accounting for more than 26 million housing units. FCAR estimates 69 million individuals reside in community associations, representing more than 1 in 5 households nationally.<sup>2</sup>

The current estimated value of community association housing units is \$5.5 trillion. In 2016, association homeowners assessed themselves an estimated \$88 billion to fund maintenance and operation of community infrastructure. Association homeowners have additionally set aside \$25 billion in reserves for the repair, replacement, and enhancement of association infrastructure and common building elements as well as to ensure compliance with state and federal land use and environmental requirements.<sup>3</sup>

<sup>1</sup> The Foundation for Community Association Research is the driving force for community association research, development, and scholarship, providing authoritative analysis on community association trends, issues, and operations. For more information on FCAR, visit <https://foundation.caionline.org>.

<sup>2</sup> Foundation for Community Association Research: *Statistical Review for 2016 (Summary)*, available at <https://foundation.caionline.org/wp-content/uploads/2017/07/2016StatsReviewFBWeb.pdf>

<sup>3</sup> *Ibid*

If housing finance reform is to be successful for the American people, the result must be a system that fully supports all housing models, including the community association housing model. As the Committee continues its work to develop housing finance reform legislation, CAI strongly urges a policy development process that is intentional in connecting community associations to the secondary mortgage market. The role that associations play in opening access for their homeowners to the secondary market is too important, too fundamental for the Committee to overlook.

### **Community Association Secondary Market Standards**

A consumer's access to mortgage credit in a community association is directly linked to the association's financial and operational stability. Just as a mortgage loan is underwritten to document the consumer's ability to repay the mortgage, community associations are underwritten on a loan level basis to document compliance with secondary mortgage market standards. If an association is unable or unwilling to meet secondary market standards, the association's property owners do not have access to national mortgage credit markets.

In day-to-day operations as well as in structuring association governance rules, community association boards work diligently to comply with federal agency secondary market requirements. In many respects, secondary market requirements act as supplements to state statutes.

Community association boards understand the direct benefit of compliance with secondary market standards—mortgages collateralized by homes in the community have a clear path to the secondary market. Federal housing agency community association guidelines are the gateway to the secondary market and are bright-line benchmarks that associations must meet or exceed.

CAI members believe Congress has an obligation to preserve the clear path for community association home mortgages to the secondary market in housing finance reform. Frustrating or obscuring this clear path to the secondary market jeopardizes the financial security of the millions of community association households across the nation.

### **Benefits of Community Association Secondary Market Standards**

Community association underwriting standards link the interests of association homeowners to mortgage originators and the secondary market. These standards protect homeowners and mortgage investors by mandating associations purchase hazard, fidelity, and officers and directors insurance coverages. Secondary market standards protect condominium and cooperative homeowners from unanticipated housing costs by requiring that association boards prepare and fund reasonable budgets, set aside capital reserves, and maintain the community's common elements.

The effect of community association secondary market standards is confidence. Homeowners have confidence the association's board is meeting standards that protect the value of their home,

maintain common property, and insure against a wide range of perils. Secondary market investors have confidence the association will preserve and protect collateral by operating in a safe and sound manner. The benefit of this shared confidence is at risk if wholesale changes to secondary market operations are enacted without consideration of, or regard for, the practical impact of these changes in the community association housing market.

CAI members are concerned that previous iterations of housing finance reform legislation did not adequately ensure the continuity of these important industry and consumer standards. This uncertainty persists in the current debate. Community association homeowners, particularly condominium and cooperative households, could face difficulty obtaining mortgage credit if a new housing finance system does not overtly preserve standards providing a clear path to the secondary market for community association home mortgages.

#### **Preserving Community Association Homeowner Access to the Secondary Market**

CAI members do not support deferring consideration of the standards by which association homeowners access the secondary mortgage market to an undetermined point in the future, post legislative reform. Access to national mortgage credit markets for these households is too important to be an after-thought of reform.

CAI members believe housing finance reform must, in its formative stages, account for the systems and means to ensure access to credit for community association homeowners. If the result of reform legislation is a housing finance system designed to primarily serve only those individuals and households not living in a community association, the mortgage credit needs of 69 million association residents across the nation will not be met.

CAI members believe community association underwriting standards are most appropriately maintained by entities that provide guarantees for mortgages to be securitized and sold in the secondary market. These mortgage guarantors must be well-capitalized, retain a first loss position, and be subject to prudential regulation that fosters a competitive business environment.

As a practical matter, mortgage originators should continue to underwrite and verify the financial and operational stability of community associations pursuant to guarantor standards. It would be impractical and inefficient if each mortgage originator established association underwriting standards. Allowing originators to continue underwriting associations pursuant to guarantor standards, risk tolerances, and business model is the efficient and effective approach.

CAI members believe that well-capitalized private guarantors should manage risks and exercise business judgement in serving the national mortgage credit market even if this market is supported by a full faith and credit guarantee of the U.S. Government. Prudent competition among guarantors must be a goal of policymakers.

**Preserving Competition in the Secondary Mortgage Market for Community Association Home Mortgages**

Supplanting community association secondary market standards with rigid federal rules from which little or no deviation is permitted has proven harmful. Federal housing regulators have taken actions that fit this description and by doing so have effectively denied (or threatened to deny) mortgage credit to community association homeowners.

A housing finance system that is well-capitalized and subject to prudential supervision will offer innovative and competitive mortgage products to community association homeowners. A rules-based system that in practice or by design seeks to eliminate all risk will inevitably restrict creditworthy borrowers' access to mortgage credit.

CAI members have been concerned by previous legislative proposals that charged a single federal agency to both define risk standards for the secondary market and administer a federal guarantee of conforming loans sold or securitized in the secondary market. CAI members believe any agency administering a full faith and credit guarantee of the U.S. Government while regulating the guaranteed market will trend toward standards that seek to eliminate risks such a guarantee will ever be used.

CAI members strongly agree taxpayers must be insulated from the cost of private corporate failures and believe numerous means exist to build private capital firebreaks between taxpayers and corporate shareholders. A goal of housing finance reform must be an appropriate alignment of incentives of all parties to a mortgage transaction, from originator, to guarantor, to investor, to taxpayers.

To achieve an appropriate balance, CAI members strongly support current regulation requiring a determination by originators that a consumer can afford all monthly mortgage obligations and property charges, including community association assessments, prior to extending mortgage credit. The first line of protection in the housing finance system is verification of a borrower's income, assets, and financial obligations. Likewise, verifying community associations are financially viable protects consumers and the housing finance system.

CAI members also believe that adequate capital standards for all secondary market participants and counterparties is necessary to build confidence and protect taxpayers from losses. Capital is a strong component of prudential regulation and a requirement for innovative and liquid markets.

**Secondary Market Regulatory and Guarantor Must Effectively Manage Dual Mandate**

CAI members are concerned that granting a single federal agency the dual mandate of regulating and guaranteeing the secondary mortgage market may invite unintended consequences.

Congress must carefully calibrate the authority of a federal secondary market regulator and guarantor to ensure a competitive market structure. A housing finance system that is predicated on sound loan level underwriting, appropriate capital, credit risk transfer, and prudential regulation will mitigate the potential for negative outcomes. Congress should ensure that adequately capitalized secondary market actors can take reasoned business decisions, subject to the prudential supervision of functional regulators and a secondary market regulator.

### **Duty to Serve the Community Association Housing Model**

CAI has observed and called attention to troubling trends that emerged during the financial crisis that negatively impacted access to credit for many community association homeowners. CAI recommends the housing finance system have a duty to serve all community association housing types in all regions of the country during all phases of the business cycle.

A duty to serve requirement will ensure that a single federal agency charged with regulating and guaranteeing the secondary mortgage market will not unnecessarily restrict access to credit. Congress should enact reasonable counterbalances that protect taxpayers from losses such as underwriting and capital requirements, while limiting risks a federal regulator and guarantor may unintentionally take pro-cyclical actions during times of market distress. FHA's 2009 changes to its condominium project approval standards serve as an important case study on market impacts when an agency with the dual mandate of credit availability and managing a taxpayer guarantee mismanages its dual mandate.

#### **Duty to Serve Case Study: FHA Condominium Rules**

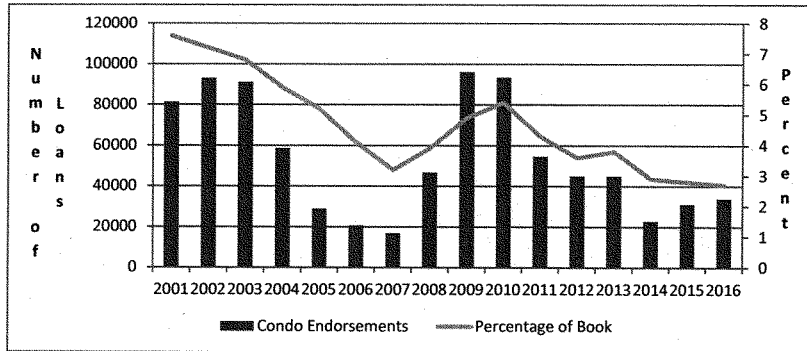
Prior to the financial crisis, FHA insured more than 80,000 condominium unit mortgages annually.<sup>4</sup> By contrast, FHA insured approximately 34,000 condominium unit mortgages in 2016. The percentage of FHA-insured condominium unit mortgages by year has fallen from almost 8 percent in 2001 to 2.7 percent in 2016.

CAI members respect the well-documented countercyclical role FHA played during the financial crisis. For condominium homeowners, however, it was a different story. As the 2009 FHA standards were implemented, thousands of condominiums lost FHA approval status and millions of condominium homeowners and homebuyers no longer had access to FHA-insured mortgage credit. Condominium unit mortgage endorsements fell sharply in 2011 and have yet to recover.

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<sup>4</sup> FHA condominium unit mortgage endorsements declined beginning in 2004 as did FHA endorsements generally during this period. See FHA Outlook Reports, 2004, 2005, 2006, available at [www.hud.gov](http://www.hud.gov).

FHA Condominium Endorsements: Annual Volume and Percentage



Source: FHA Outlook Reports, 2001-2012; FHA Production Reports, 2013-2016

Prior to 2009, more than 40,000 condominiums nationwide were approved by FHA. As of May 31, 2017, only 10,009 condominiums were FHA approved.<sup>5</sup>

Almost 50 percent of FHA-approved condominiums are concentrated in 5 states: California (2,040); Virginia (728); Washington (642); Illinois (631); and Maryland (591). 25 states have fewer than 100 approved condominiums and of these states, 20 have 50 or fewer FHA-approved condominiums.<sup>6</sup>

FHA became a pro-cyclical force in the condominium housing market from 2011 forward, restricting access to credit and making it more difficult for condominium units to be sold. Condominium unit mortgages are among the strongest performing loans in FHA's portfolio<sup>7</sup>, but the cost of FHA's risk management standards was disproportionately borne by condominium homeowners. Notwithstanding efforts by FHA to undo this market damage, there remains a dramatic reduction in the availability of FHA-insured mortgages for creditworthy borrowers the agency was specifically designed to serve.

**Business Judgment v. Rules-Based Supervision**

The data clearly show FHA is not serving the condominium market on a nationwide basis. CAI members believe this is a direct result of the agency's policy decision to place greater emphasis on reducing potential insurance claims by limiting condominium unit mortgage endorsements.

<sup>5</sup> <https://entp.hud.gov/idapp/html/condlook.cfm> Accessed 5/31/2016.  
<sup>6</sup> States with fewer than 100 FHA-approved condominiums as of 5/31/2017: AL, AR, DE, HI, ID, IN, IA, KS, KY, LA, ME, MS, MT, NE, NV, NM, NY, ND, OK, RI, SC, SD, VT, WV, WY. States with fewer than 50 FHA-approved condominiums as of 5/31/2017: AL, AR, DE, ID, IA, KS, LA, ME, MS, MT, NE, NV, NM, ND, OK, SC, SD, VT, WV, WY. Source: FHA Condominium Approval Search: <https://entp.hud.gov/idapp/html/condlook.cfm>  
<sup>7</sup> FHA Neighborhood Watch data from July 2015 to June 2017 show that of the 44,089 condominium loans insured during this period, only 337 are seriously delinquent and only 20 condominium unit mortgages have gone to claim. The seriously delinquent rate of these loans is less than 1 percent (0.7 percent). See HUD Neighborhood Watch data are reviewable at <https://entp.hud.gov/sfnw/public/> (accessed July 31, 2017).



By restricting access to condominium homeowners and homebuyers, FHA impeded its ability to serve first-time, low-income, and underserved borrowers.

The consequences for condominium homeowners and homebuyers have been profound, but would have been disastrous if FHA's enhanced condominium underwriting standards had been applied universally. Fannie Mae and Freddie Mac revised underwriting standards for condominium associations concurrent with FHA, yet implemented the new standards with a business-oriented approach. This business judgement approach led to a markedly different result for condominium homeowners and consumers as Fannie Mae and Freddie Mac have been much more effective in supporting access to credit for the condominium sector of the housing market.

Freddie Mac reported that 32,491 of the 398,293 loans the Enterprise acquired in the 2<sup>nd</sup> quarter of 2016 were secured by a condominium unit, representing 8 percent of loan volume.<sup>8</sup> These data are consistent with a sample dataset for 2015, which also show condominium unit mortgages accounted for 8 percent of Freddie Mac's acquisitions in that year.<sup>9</sup>

Fannie Mae reported that 31,555 of the 303,402 loans it acquired in the 1<sup>st</sup> quarter of 2016 were secured by a condominium unit, representing 10 percent of loan volume.<sup>10</sup> Fannie Mae loan-level data from the 1<sup>st</sup> quarter of 2015 also show that 10 percent of loans acquired by Fannie Mae were secured by a condominium unit.<sup>11</sup>

The difference in outcomes is directly attributable to the business approach Fannie Mae and Freddie Mac have taken in serving the condominium market. Fannie Mae, for example, will conditionally approve condominiums that do not meet all underwriting criteria if there are sufficient mitigating circumstances. FHA does not offer similar flexibility. Fannie Mae and Freddie Mac have streamlined condominium underwriting procedures for borrowers based on cash investment and a condominium's status as a well-established project. FHA offers no such option.<sup>12</sup>

#### **Duty to Serve Promotes Prudential Regulation, Safe Access to Credit**

In prior commentary on housing finance reform, CAI members urged Congress to include a duty to serve requirement for the community association housing model. CAI members believe such a duty to serve is necessary to ensure that a federal secondary market regulator does not take any action to limit or refuse community association homeowners access to the housing finance system.

A duty to serve requirement is also a prudent counterbalance if Congress approves a full faith and credit federal guarantee for conforming loans sold and securitized in the secondary mortgage

<sup>8</sup> Freddie Mac loan-level data are available at [http://www.freddiemac.com/research/datasets/sf\\_loanlevel\\_dataset.html](http://www.freddiemac.com/research/datasets/sf_loanlevel_dataset.html). Data from Freddie Mac loan-level Q2 2016 dataset. Calculations by CAI.

<sup>9</sup> Freddie Mac 2015 Loan Level Dataset Sample shows condominium unit mortgages account for 7.9 percent of the 50,000 loans included in the sample. Calculations by CAI.

<sup>10</sup> Fannie Mae loan-level data are available at <https://loanperformancedata.fanniemae.com/lppub/index.html>. Data from Fannie Mae loan-level Q1 2016 dataset.

<sup>11</sup> Fannie Mae Q1 2015 dataset. Calculations by CAI.

<sup>12</sup> FHA has proposed a regulatory update of its condominium project approval process that envisions a more flexible approach and single unit approvals. Market participants have waited since 2010 for FHA to take such an action, which has yet to be completed.

market. CAI members assert that FHA, with the agency's dual mandate to facilitate access to credit and to prevent taxpayer losses, failed to adequately balance this mandate. This is instructive for policymakers contemplating a secondary market supervisory structure that combines regulatory authority with administration of a government guarantee.

If Congress establishes a single agency to regulate and guarantee the secondary market, CAI members urge that a duty to serve be expressed in such an agency's authorizing statute. CAI members believe such a statutory directive, together with prudential regulation and adequate system capital, will ensure homeowners in all types of community associations—planned communities, condominiums, and cooperatives—have access to the secondary mortgage market in all regions of the country during all phases of the business cycle.

### **Servicing Mortgages in Community Associations**

Community associations interact with mortgage servicers, originators, and secondary mortgage market participants in a unique manner. This is due to relationships between homeowners, residents, and the association that are a matter of contract and law. These relationships form the legal basis of the community association model of housing, protecting the financial viability of the community and the financial stability of association households.

CAI members strongly support state statutes that align the economic interests of servicers and owners of a first-trust (or similar) interest in a community association home/unit with those of the community at-large. These state statutes protect association homeowners, mortgagees, and communities from the financial and operational burdens of preserving the collateral of irresponsible or negligent parties.

### **Servicing Failures During the Financial Crisis**

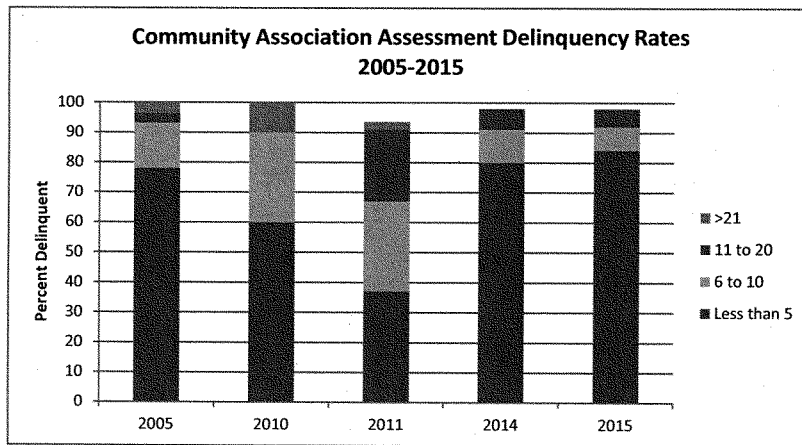
The failure of the mortgage servicing business model to account for significant numbers of troubled mortgages is well documented. The impact of these failures in community associations, particularly delays in completing unavoidable foreclosures (i.e., abandoned homes) and collateral preservation, harmed the financial security of community associations and association households.

Community associations rely on mortgage servicers to take actions under mortgage servicing agreements to restore troubled borrowers to performing status or return properties to commerce. The more prolonged this process becomes, the greater the harm to the troubled borrower, the mortgagee, and the community association.

In community associations, troubled borrowers often cease paying association assessments that fund critical community operations prior to halting mortgage payments. This means the maturity of association assessment delinquencies can far exceed the maturity of a mortgage delinquency.

Community associations with large numbers of extended assessment delinquencies can lack resources to fund trash removal, street maintenance, or pay insurance premiums. A condominium association with a high delinquency rate may have difficulty maintaining utility service to its buildings.

Prompt, efficient loss mitigation and property disposal by mortgage servicers can significantly limit financial strains on community associations. These actions also protect association households from destabilizing assessment increases to cover shortfalls in budgets that fund community operations.



Source: Community Associations Institute—Association Impact Survey 2005, 2010, 2011; State of Community Associations Survey 2014, 2015.

CAI members believe housing finance reform legislation must preserve recent improvements to mortgage servicing to ensure these gains are not diminished by reform. Congress could usefully consider additional reforms to mortgage servicer compensation and other aspects of the mortgage servicing business model to guard against servicing failures in future crises.

**Enforcing the Servicing Contract**

CAI members believe Fannie Mae, Freddie Mac, and FHA did not adequately enforce servicing guidelines and requirements during the financial crisis. CAI members know that association homeowners absorbed property preservation costs and higher association assessments as a result. Housing finance reform should prevent this from occurring in future crises.

To strengthen loss mitigation, CAI urges that communication between community associations and servicers be improved as the association is usually the first party to know when a borrower is unable to pay their monthly mortgage-related obligations. Improved communication will allow servicers to intervene earlier in the process to assist troubled borrowers and reduce losses to servicers, secondary market investors, community associations, and association homeowners.

CAI members call on Congress to ensure that standard servicing and pooling agreements used in any federally-sponsored or supervised secondary market infrastructure require that mortgage servicers comply with the terms of these agreements. This includes requirements that mortgage servicers comply with all relevant state statutes and federal law. CAI believes that mandatory repurchase, recourse, and other enhanced remedies should be available to housing finance system participants to promptly correct servicing violations.

### Conclusion

CAI members have dedicated their careers to helping community association boards effectively operate their communities, develop efficient state statutes that underpin the community association housing model, and educate association homeowners on best practices that build community. There is no other source of information on homeowner associations, condominium associations, and housing cooperatives that accurately reflects the views and needs of this housing model than CAI.

The housing finance reforms CAI has proposed represent the views of a broad cross section of the community association housing model and experience gained from the financial crisis. CAI urges the Committee to work diligently to—

- 1) Preserve a clear path to the secondary market for community association home mortgages by ensuring continuity of community association secondary market standards.
- 2) Establish a duty to serve community association households on reasonable terms in all regions of the country during all phases of the business cycle.
- 3) Strengthen mortgage servicing by requiring servicer communication with community associations and requiring compliance with state and federal statute.



**CAI Housing Finance Reform Principles  
General Principles for the U.S. Housing Market**

1. Protect access to 30-year, fixed-rate, pre-payable mortgages.
2. Ensure a liquid secondary mortgage market, accessible on a nationwide basis in all phases of the business cycle.
3. Preserve/improve the role of federal housing-related agencies in supporting the community association housing model (Federal Housing Administration, Veterans Administration, USDA Rural Housing), ensuring access to mortgage credit for under-served and/or specified populations.
4. Subject to appropriate regulatory guidance, capital requirements, and prudential safety and soundness supervision, encourage competition and innovation by private firms in originating, aggregating, and servicing mortgages, including obtaining credit enhancements and issuing mortgage-backed securities.
5. Any securitization platform for mortgage backed securities should include the following:
  - a. Mortgage-backed securities issued through the federal agencies should be eligible for a principle and interest federal government guarantee.
  - b. Require any issuers of mortgage-backed securities to build a federally-required capital buffer to absorb catastrophic losses.
6. A federal entity should supervise the secondary mortgage market, establishing standards concerning originations, credit enhancements, and servicing and pooling agreements for securitized mortgages.

**Core Principles for the Community Association Housing Model**

1. Preserve continuity of community association project standards in the housing finance system to ensure the stability of mortgagee security and encourage minimum insurance, governance, appraisal, and property standards within the community association housing model to ensure access to credit for homeowners and consumers.
2. Require that secondary mortgage market participants comply with state laws establishing community association lien priority.
3. Any securitization platform for mortgage backed securities should include the following:
  - a. Require that the originator make an affirmative determination that the borrower has a reasonable ability to repay the loan, including any community association assessments.
  - b. Mortgages secured by real property in community associations must be treated equally irrespective of housing type, geographic location, and market conditions.
  - c. Standard servicing and pooling agreements must require mortgage servicers to comply with the terms of those agreements as well as state and federal law, with mandatory repurchase, recourse, or other enhanced penalties and/or remedies if a servicer fails to meet contractual obligations to issuers or mortgage investors.
4. To ensure adequate underwriting, the mortgage industry must adopt a common taxonomy for loan and property features that accurately capture and record data concerning all forms of community associations.
5. A federal secondary mortgage market supervisory agency must have a duty to ensure liquidity for homes in a community association and enforce underwriting and project standards for community associations.

**Question Three – Robert DeWitt, Chairman, NMHC**

Private capital tends to be more attracted to top-tier apartment properties in large cities, and many have concluded that the GSEs play a vital role in helping finance units not located in such markets. Much of the district I represent, the far-west suburbs of Chicago, does not necessarily easily attract private capital.

1. How can a new housing finance system ensure liquidity in all markets and at all times?

A basic requirement needed to ensure that financing is available not only in all markets, but at all times of an economic cycle in a new housing finance system, would be a full faith and credit federal government guarantee on the securities associated with the underlying mortgage finance instruments. Without this federal government credit enhancement, private sector credit will become scarce to non-existent during times of severe capital market dislocations, just as happened in the Great Financial Crisis.

FHFA, the GSE regulator, has been focused on the issue you raised regarding adequate capital flowing to smaller markets. FHFA has issued guidance to incentivize capital flows to markets that are traditionally underserved by the capital markets. FHFA's guidance requires the GSEs to develop a national presence in purchasing loans on small multifamily properties, defined as less than 50 units, that are often originated by depositories serving their local communities and are affordable to low and moderate income families.

Additionally, the GSEs are required to pursue further opportunities to serve all markets through their multiyear Duty to Serve (DTS) plans. The plans were finalized in 2017, and will begin implementation in 2018, paying particular focus on underserved

markets. DTS focuses on three areas of the multifamily market that have been underserved by the private capital markets – rural properties, manufactured housing communities and the preservation of affordable housing.

Finally, the approved lenders for each GSE multifamily program have a broad and deep national presence that reach into a variety of markets and product types across the country outside of the top-tier markets.

These programs initiated by FHFA can serve as a roadmap for crafting regulatory provisions that will ensure liquidity in all markets in a new housing finance system.

**QUESTIONS:**

I would like to get your opinion on FHFA's somewhat recent rules to limit the eligibility of FHLB membership through captive insurance companies. As you point out in your written testimony, "In eliminating this category of members, FHFA removed some companies that are active sources of private capital in the mortgage markets, such as mortgage REITs."

I agree this should be revisited. This is why I worked with Gwen Moore to introduce the Housing Opportunity Mortgage Expansion Act (HR 2890). As you might know, the two states served by the Federal Home Loan Bank of Chicago – Illinois and Wisconsin – are arguably hit hardest by FHFA's rule. For example, Redwood Trust, one of the Bank's largest members, and an exemplar of private capital in the mortgage market, will lose its membership.

1. In general, can you comment on the role that mortgage REITs play in contributing private capital to the housing market?
2. How would permitting FHLB membership for mortgage REITs augment their ability to contribute private capital to the housing market?

**RESPONSES:**

1. **The Role of Mortgage REITs:** In the immediate aftermath of the financial crisis, the government footprint in the mortgage market grew rapidly, and it has remained substantial in the years that have followed. Currently, over 70 percent of residential mortgage originations rely on securitization by Fannie Mae or Freddie Mac or insurance or guarantees from FHA, VA, or other federal agencies. Within the market for residential mortgage securitization, over 97 percent of issuance is guaranteed by Ginnie Mae or the GSEs, and much of the paltry non-agency securitization that has occurred is attributable to non-performing or re-performing loans. This level of reliance on government resources is both undesirable and unsustainable. Private capital needs to play a larger role in order to broaden access to credit, spur innovation in lending, and safeguard taxpayers.

Mortgage REITs serve as an important source of this private capital. By investing in mortgages and mortgage-related securities, mortgage REITs provide both credit and liquidity to the market. In the residential market, mortgage REITs originate loans, purchase agency MBS, and issue or purchase securities without government backing. Similarly, in the commercial market, mortgage REITs invest in loans, purchase MBS, and take part in the non-agency securitization process.

As other institutions have retreated from the post-crisis mortgage market for a variety of reasons, mortgage REITs represent a long-term, dependable source of private capital that is committed to investment in housing. Such investment is



particularly important as declining affordability continues to challenge many regions and new sources of funding are needed to safely expand the credit box. Mortgage REITs can also serve as critical sources of demand as the GSEs seek ways to further transfer mortgage credit risk and the Federal Reserve begins to shrink its portfolio of mortgage assets. And as policymakers engage in efforts to reform the secondary market, a widely-shared goal is that of increased private capital standing ahead of taxpayers—a goal which mortgage REITs are well-suited to advance.

2. **Mortgage REITs and the FHLB System:** Given the increasingly important role of mortgage REITs in the market, MBA believes the recent FHFA rule curtailing captive insurer eligibility for Federal Home Loan Bank membership—and with it, mortgage REIT access to FHLB advances—should be revisited. At a minimum, those captive insurers which previously held FHLB membership in good standing and are affiliates of companies that exhibit a commitment to financing mortgage credit should be allowed to re-enter the FHLB system. In MBA's view, this re-entry should be permitted for all such captive insurers that were FHLB members prior to the finalization of the FHFA rule in January 2016.

Because mortgage REITs are not deposit-taking entities like traditional banks or credit unions, they generally rely upon the capital markets for their funding. This funding often takes the form of short-term borrowing in the repo market, which must be rolled over on a regular basis. In recent years, a number of mortgage REITs supplemented this capital markets funding with advances from the FHLBs which they were able to obtain through their captive insurance affiliates.

FHLB advances, which are secured loans available only to FHLB members, represent a stable and reliable source of intermediate- or long-term funding. Whereas adverse market conditions could cause repo counterparties to pull back the funding available for mortgage REITs (even if the mortgage REITs themselves are not experiencing stress), the FHLBs are designed to ensure a steady flow of funding for their members throughout the credit cycle. As such, mortgage REITs that are able to access FHLB advances are less susceptible to situations in which they are unable to roll over their funding and would therefore have to rapidly sell assets, potentially at substantial discounts. Even for those mortgage REITs that choose not to regularly access FHLB advances, simply maintaining the ability to do so mitigates the possibility that adverse conditions could threaten their capacity to invest in the mortgage market.

Similarly, FHLB funding is typically available to mortgage REITs for longer periods of time than repo funding. Longer-duration funding allows mortgage REITs to better match their liabilities to their (also longer-duration) mortgage assets. This longer-duration funding reduces the frequency with which mortgage REITs must roll over their funding, again making them less likely to experience stress during adverse conditions. By extending the duration of their funding, mortgage REITs are also afforded more flexibility in the use of their balance

sheets. For example, if there is insufficient demand for a particular segment of a securitization, mortgage REITs can retain these interests on their balance sheets until the market has normalized. This approach, which is made possible by the existence of reliable, longer-duration funding, in turn stabilizes credit availability for borrowers.

Access to FHLB advances through a captive insurer also allows mortgage REITs to expand their product offerings and serve borrowers who may otherwise have difficulty obtaining credit. Mortgage REITs can do so through multiple channels. In the government-backed market, mortgage REITs can use their longer-duration FHLB advances to invest in a broader array of agency MBS, which could spur further lending throughout the credit boxes of the GSEs. In the private market, where wholesale funding remains unable to support many types of investments, such as certain non-QM lending, the presence of FHLB advances can allow mortgage REITs to provide capital for these types of investments. As non-QM lending has struggled to take hold in recent years, greater mortgage REIT capacity in this space could expand mortgage access for many creditworthy borrowers.

For all the reasons described above, MBA reiterates its position that captive insurer affiliates of mortgage REITs be granted eligibility for FHLB membership.



December 13, 2017

The Honorable Randall Hultgren  
Committee on Financial Services  
United States House of Representatives  
Rayburn House Office Building, 2455  
Washington, DC 20515

**Conforming Loan Limits**

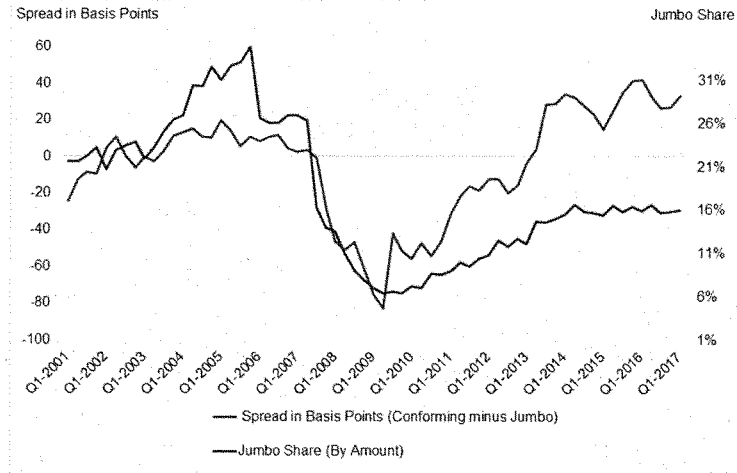
**I believe I share the view of most when I saw that the government should not be subsidizing homes with values around a half-million dollars. The role of government is to help those who need it the most. Your testimony suggests private capital can step in with no, or negligible, increase in the cost of the mortgage if conforming loan limits are reduced.**

- 1) **How much can these limits be reduced, and how quickly? For example, 5 percent a year? 10 percent a year?**

SFIG believes that an orderly, transparent process that is telegraphed well in advance will enable existing lenders to ramp up their processes and encourage private capital currently on the sidelines to enter the PLS market, particularly in the prime jumbo space.

Historically, jumbo rates have been slightly higher than conforming rates, reflecting the belief that the backstop provided by taxpayers to the GSE was passed on to consumers in the form of lower, subsidized rates. However, this difference (the spread between jumbo rates and conforming rates) began narrowing in 2009 and in the first quarter of 2013 jumbo rates were actually lower than similar conforming rates (see Chart 1).

Chart 1, "Conforming-Jumbo Rate Spread in Basis Points and Jumbo Share"  
 (A Positive Spread Means Jumbo Rates are Lower)



Source: CoreLogic July 2017

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The fact that jumbo loans trade at the same rates—or even lower rates—than government-guaranteed loans is largely attributable to the scarcity of product in that market. This in turn demonstrates that there is significant capacity within the jumbo market to take on additional mortgage credit risk, at little-to-no increase in mortgage rates for qualified borrowers.

We believe that the significant amount of available capital will allow borrowers to access credit at competitive rates in the jumbo market through funding that is not back-stopped by the government. Instead of increasing the loan limits, as currently planned, we believe the FHFA, under the direction of Congress, could lower loan limits in 5%-10% increments without causing any disruption. Furthermore, at that measured pace, the regulator, if so empowered by Congress, could suspend or delay further lowering should spreads balloon outward.

While we would defer to Congress to make the ultimate calculation as to the precise amount by which loan limits should be lowered (or by which they should not be raised in the future), or the timeline under which such a reduction should take place, we are happy to serve as a resource to connect policymakers with market participants to ensure well-informed decisions that minimize disruptions while maximizing the impact of private capital.

**3) Do you have any recommendations for updating conforming loan limits to maximize private capital without impairing affordability?**

Broadly speaking, affordability is factor of mortgage rates and home prices. SFIG believes that lowering loan limits would not negatively impair affordability, and may even serve to improve affordability in some markets.

#### Mortgage Rates

As noted above, the lack of available private mortgage credit for investors to invest in has helped drive jumbo non-conforming loan rates to levels that are currently lower than conforming rates. This competition for product suggests that borrowers could still access credit at competitive rates should the current loan limits be lowered. Thus, mortgage rates—as a factor of affordability—would not be affected by an orderly and well-planned transition to lower conforming loan limits

#### Home Prices

Another factor of affordability is home prices. Data from AEI suggests that raising loan limits during a seller's market—the environment we have been in since 2012—raises borrowing costs, and subsequently, raises housing prices.<sup>1</sup> SFIG would therefore advocate for lowering the loan limits to allow for market-based pricing of mortgage credit risk by reducing barriers to private capital. This would in turn reduce borrowing costs, and may in turn work to improve affordability. At the very least, reducing the loan limits would no more impair affordability than does the current practice of raising loan limits on an ongoing basis.

Therefore, SFIG believes that an orderly and well-planned reduction in loan limits phased in over time would increase private capital without negatively affecting affordability. Lowering the loan limits may even positively impact affordability by lowering borrowing costs and introducing more market discipline via an increase of private capital.

#### **4) Do you believe there any issues with tying conforming loan limits to average housing prices? Does this make it easier for the housing market to overheat?**

Research by some academics and think tanks indicate that the current practice of setting loan limits may make it easier for the housing market to overheat. As noted above, data from AEI suggests that the current practice of continually increasing loan limits raises borrowing costs, and subsequently raises housing prices.<sup>2</sup> Additionally, according to the Wharton Business School at the University of Pennsylvania, in markets where prices cannot be efficiently adjusted through a market based mechanism like short-selling – e.g. the housing market – prices rise in the short term, and generally have elevated risk profiles.<sup>3</sup>

Based on these analyses, tying the conforming loan limit to average housing prices creates a upward-spiraling feedback cycle: loan limits cause housing prices to rise, the inability to short the market prevents them from falling, then the limit is raised again as a product of artificially high prices.

While loan limits may have deleterious effects on home prices or on housing at the macroeconomic level, we would defer to others as to the validity of those arguments and any appropriate policy resolution. However, we believe that the necessary role of governmental entities should be conducted with the utmost transparency to avoid the creation of opaque subsidies that can lead to market distortions and we believe also that the current loan limit regime unnecessarily crowds out private capital and increases risk to the taxpayer.

<sup>1</sup> Edward Pinto and Tobias Peter, "First-Time Buyer Mortgage Share and Mortgage Risk Indices," AEI Center on Housing Markets and Finance, November 28, 2017.

<sup>2</sup> Ibid.

<sup>3</sup> Susan Wachter, "A Symposium on the Market Structure of the GSEs: Is There a Competitive Equilibrium?" The Wharton School, University of Pennsylvania, November 14, 2017.

**QM-Patch**

As you know, all agency loans are deemed to be “qualifying mortgages,” providing lenders more legal certainty. It also provides an un-level playing field with private capital. This “QM-patch” is set to be phased out at the earlier of the GSEs exiting conservatorship or January 10, 2021.

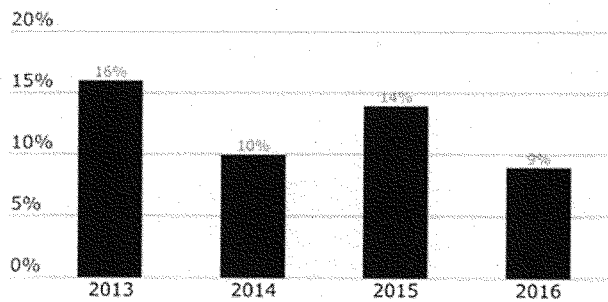
1) **How significant is QM-status for lenders? What does this mean for the cost of financing for the mortgage?**

While SFIG focuses primarily on the impact of regulations like the Qualified Mortgage (QM) rule on the secondary markets, our anecdotal experience with our members (many of whom also operate in the primary mortgage markets) is that many lenders are hesitant to make loans that do not meet QM status, and some avoid making them altogether.

Chart 2, Decline in Non-QM Lending

### Stepping back

Banks cut down on their non-qualified mortgage lending in 2016 so they can gauge the risk to their portfolios.



Source: American Bankers Association

According to the ABA, in 2016, banks cut down on making non-QM loans, going from approximately 14% of all loans to 9% in 2016. This was attributed largely to non-QM loans increased litigation risks and regulatory uncertainty. Much of this uncertainty is driven by a lack of clarity around the Ability To Repay (ATR) rules. ATR non-compliance can have significant economic penalties and uncertainty in compliance has caused some lenders to pull back, or create credit overlays that reduces the access to credit, especially for borrowers with marginal credit or non-W2 wage sources. These credit overlays are out of an abundance of caution over enforcement actions and a legitimate fear of being sued, especially based on past experience from regulators and the Department of Justice. More than affecting the cost of mortgages, the cumulative impact of the uncertainty or unintended consequences of these rules is that for some borrowers, the loans are simply not being made at all.

Additionally, the capital cost of the 5% risk retention requirements associated with non-QM loans—coupled with certain impediments to securitization outlets via the PLS market—limits banks’ capacity to originate non-QM loans. Finally, as these loans have not yet entered into the

peak default period of 5 to 7 years post-origination, their performance history is unknown, adding to the general reticence of banks to originate non-QM loans.

**2) If GSE loans were not automatically deemed QM, how much more private capital would there be in the market?**

Evidenced by tight spreads in the jumbo market, as referenced in Chart 1 above, there are clear indications that there is abundant private capital in the market. The problem is not access to private capital, but instead the economic advantage afforded GSE loans which are automatically granted QM status. QM status provides legal certainty and does not require the originator to retain any economic interest if the loan is financed in the securitization market. These benefits imbue QM loans with significant economic advantages. If QM status was determined in the same manner for the GSEs and private entities, irrespective of whether or not the GSEs approved the loan, then the economic advantage provided the GSEs would diminish and economic distortions would be minimized. Pricing would become more transparent, private capital could compete on a more level playing field and the originators of the loans could choose the most efficient source of capital to finance their production: securitization, portfolio lenders, or government entities.

**1) If CFPB and/or Congress lets the QM-patch expire as is currently planned, how will the market react? What steps, if any, can be taken so this is not a market shock?**

The effect of the transition depends largely upon steps taken between now and the eventual expiration of the QM Patch. If market participants see the kinds of changes in the ATR/QM rule that provides an increased level of clarity and certainty, then they are much more likely to begin making loans today and fill out the credit box, especially for marginal or non-W2 borrowers. Then, upon the expiration of the QM Patch, there should be little-to-no impact, as private capital gradually increases as the government's footprint decreases.

However, if the current regulatory uncertainty persists, or questions remain around enforcement or potential legal liability, it is likely that private capital will remain on the sidelines. In that scenario, the prospect of the expiration of the QM Patch would likely result in a larger market disruption, as private capital would not be available to step in and fill the gap left by the retreat of publicly backed funding.

**Credit Risk Transfers**

**Under the conservatorship, the GSEs have developed credit risk transfer programs that transfer expected and unexpected credit risk to private investors. The GSEs, however, have retained the catastrophic credit risk. As the FHFA's overview of the credit risk transfer programs puts it, "catastrophic risk events are deemed so unlikely, meaning they present so little risk, that the Enterprises have found it to be too costly (not economical) to transfer much of this risk to the private sector."**

**1) What steps can be taken by the GSE's, FHFA, or Congress to help develop a private market for these catastrophic risks?**

Fair capital treatment is the most important factor for ensuring the health and growth of credit risk transfer (CRT) transactions. As the GSEs currently operate without capital, the effects of CRT transactions as it relates to capital relief are unclear. For instance, the effects of the GSEs insurance credit risk transfer transactions (ACIS and CIRT) have not been formally quantified or published, which obscures the value of such risk transfers as it relates to capital even as the

benefit of shifting risk of loss away from the taxpayers is clear and should be applauded. For private entities, the benefit from identical CRT transactions is limited significantly because regulators currently will not provide capital relief for these transactions. Paradoxically, regulatory relief follows accounting “true sale” standards, an accounting disclosure standard, rather than referencing the actual contractual terms of the transactions.

Correcting the capital effects of all CRT deals, to accord benefit for the contractual terms and not based on a disclosure standard, would help incentivize private sector participants to explore the viability of such risk transfer mechanisms. As more participants engage in such transactions, markets are more likely to find equilibrium, and expand to areas and products that are currently not taking place under the GSEs CRT programs, including transferring what is currently being held on the GSEs books as catastrophic risk. Care must be taken to ensure that adequate controls and regulations are in place, and that capital treatment is appropriately calibrated but rewarding private entities, in the form of capital relief, for transferring risk in exactly the same ways the GSEs are being applauded for will help level the playing field between the GSEs and the private sector.

SFIG stands ready to assist with legislative and regulatory efforts to engage with private sector participants looking to engage in credit risk transfer programs of their own.

