Testimony of
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on behalf of
the Housing Policy Council
of the
Financial Services Roundtable

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On

The Future of Housing Finance – A Review of Proposals to Address Market Structure and Transition

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Mr. Chairman and Members of the Committee, my name is Mike Heid, and I am Co-President of Wells Fargo Home Mortgage. I also am the chairman of the Housing Policy Council ("HPC") of The Financial Services Roundtable, and I am appearing today on behalf of the Housing Policy Council. The Housing Policy Council represents 30 of the leading national mortgage finance companies. HPC members originate, service and insure mortgages. HPC member companies also are major customers of and business partners with Fannie Mae and Freddie Mac.

For many years, and even throughout the financial crisis, Fannie Mae and Freddie Mac performed their secondary market functions efficiently and effectively. It is now very apparent, however, that there were some fundamental flaws in the old GSE model. For example, a lack of adequate supervision and regulation created the opportunity for the GSEs to employ excessive leverage and to grow their portfolios in excess of what was necessary to achieve their original objectives.

Dodd-Frank Act

The financial crisis also revealed flaws in the originate-to-distribute model of mortgage finance. The Dodd-Frank Act seeks to address those flaws by aligning the interests of consumers, lenders and investors to ensure borrowers consistent, fair and equitable access to housing finance and to rejuvenate the secondary market for mortgage securities. Implementation of the Act will require a thoughtful coordination of various related regulations and accounting practices and a careful balancing of the fundamental objective of the Act with the need to attract sufficient capital to the housing finance system. It also requires that provisions – such as risk retention – be implemented in a way that does not reduce access for credit worthy borrowers.

The new standards required by the Dodd-Frank Act will have a significant impact on mortgage lending standards and securitization. These standards will also greatly influence the secondary market changes to the GSE system that we are discussing today. In short, stronger underwriting standards and risk retention requirements will make the abuses that occurred in the past unlikely to be repeated, and these new standards will have a dramatic impact on the quality of loans that are securitized. Lenders have already implemented stronger underwriting standards, and the current GSEs have tightened their standards and have put many more requirements on originators for the loans that they will purchase and the buy-back requirements for lenders on loans that do not perform.

HPC Proposal

HPC has developed a proposal for addressing the problems inherent in the structure of Fannie Mae and Freddie Mac which I would like to outline for you today. Our proposal is intended to achieve several objectives:

- Encourage private sector capital to support the secondary mortgage market;
- Ensure a steady flow of reasonably priced conventional mortgages to borrowers;
- Limit the role of the Federal Government and the risks taken by the taxpayer in the secondary mortgage market; and
- Provide a flow of funding to support affordable owner-occupied and rental housing.

We propose to achieve these objectives by dividing the existing functions of Fannie Mae and Freddie Mac among a combination of public and private sector entities.

<u>Privately Capitalized "MSICs" Should Assume Credit Enhancement Function of the GSEs</u>

A central feature of our proposal is the creation of new privately capitalized firms to perform the credit enhancement or guarantee function of the GSEs. Currently, the GSEs purchase mortgages from mortgage originators, package those mortgages into securities, and guarantee the payment of interest and principal on those securities. In exchange for the guarantee, the GSEs charge mortgage originators a “guarantee fee.” We propose that these functions be assumed by privately capitalized firms called mortgage securities insurance companies, or “MSICs.”

A MSIC would --

- purchase conventional mortgages from mortgage originators;
- guarantee the payment of principal and interest on the securities; and
- charge mortgage originators a fee for the guarantee.

Under our proposal, these privately capitalized entities would be chartered and supervised by the Federal Government, much like national banks and federal savings and loans are chartered and supervised by the Federal Government. However, they would not be backed by the Federal Government, either explicitly or implicitly.

We do not propose a particular organizational structure for the MSICs. Instead, we propose that the investors in a MSIC determine the most appropriate organizational and governance structure for the entity. The validity of the organizational structure and the ability of the investors to manage the entity would be reviewed as part of the chartering process.

We believe multiple MSICs are needed but do not call for a specific limit on the number. We assume that at least 4 will be needed to serve the market, but probably not more than 8 are necessary. The greater the number of MSICs, the better insulated the housing finance market would be from the failure of any one MSIC. On the other hand, too many MSICs -- with different underwriting systems and procedures -- could be overly burdensome to lenders, particularly smaller lenders.

An Explicit – But Limited -- Federal Guarantee is Needed

An explicit federal guarantee is needed to ensure a steady flow of mortgage finance at a reasonable cost to borrowers. While MSICs would not be backed by the Federal Government, our proposal does call for the Federal Government to provide an "explicit" backup or catastrophic guarantee on the mortgage securities that are issued by MSICs. To be clear, this guarantee would not apply to the MSICs themselves; it would guarantee the payment of principal and interest to investors in mortgage backed securities packaged by MSICs. A MSIC would pay a fee to the government for this guarantee, and this fee would be placed in a reserve.

The challenge we face is designing a secondary market system that ensures a steady flow of reasonably priced mortgages to borrowers while limiting the exposure of taxpayers. Our proposal addresses this challenge by putting several layers of private capital in front of the federal guarantee, and as I discuss below, subjecting MSICs to "world class" regulation.

Standing before the federal guarantee would be --

- The down payment on a mortgage made by the homebuyer;
- Any private mortgage insurance or other credit enhancement on the mortgage loan;
- The shareholder's equity in the MSIC; and
- The reserve established by fees paid by MSICs in return for the government's guarantee.

These layers of private capital should insulate the taxpayers from paying claims on the guarantee. However, in the event that all of these private resources are exhausted and the Federal Government is called upon to make payments under the guarantee, we support the imposition of a "special assessment" on MSICs to recoup any costs incurred by the government. Thus, the system we propose would operate much like the Federal Deposit Insurance Fund does today.

Finally, if the fees for the federal guarantee are set properly, the federal guarantee would be budget neutral. Under existing federal credit procedures, the cost of federal credit activity in a budget year is the net present value of all expected future cash flows from guarantees and direct loans disbursed in that year. For loan guarantees, cash inflows consist primarily of fees charged to insured borrowers, and cash outlays consist mostly of payments to lenders to cover the cost of loan defaults. FHA and Ginnie Mae are models for this budgetary treatment. In the case of both FHA and Ginnie Mae, the fees paid for the federal guarantee normally cover claims on the guarantees and other operational expenses.

<u>Capitalizing MSICs</u>

Attracting sufficient private capital to MSICs is a key to the success of our proposal. We assume that the banking industry could be one such source of capital for MSICs since the industry relies upon the existence of a strong secondary mortgage market. Therefore, we propose that banking organizations of all sizes be authorized – but not required – to invest in MSICs. This would permit MSICs to be formed by a consortium of large banks as well as a group of small banks.

We also have tried to gauge the interest of other potential investors. We have done so by previewing our proposal with investments bankers and other industry experts. We have been told that investors would be interested in capitalizing MSICs as long as they could achieve a "reasonable" return on their investment *and* that the relationship between MSICs and the Federal Government was clear and unchanging.

Based upon this feedback, we have undertaken an effort to quantify the capital standards, fee structures, and returns needed to attract private capital and to assess the impact of this structure on mortgage rates. That analysis has involved the application of various stress tests to project capital levels needed to cover potential losses. It also has involved the identification of a “reasonable” rate of return on capital. We will provide the Committee with our final analysis when it is complete.

World Class Regulator

To ensure the safe and sound operation of MSICs – and further reduce the need for the Federal Government ever to perform on its guarantee – we propose that MSICs be subject to “world class” regulation, by a strong and independent federal regulatory agency. This regulatory regime should include:

- Strong prudential standards – MSICs’ should be subject to capital, liquidity and other prudential standards set by the chartering agency;
- Underwriting Standards for Mortgages in MBS – MSICs should be prohibited from purchasing mortgages that do not meet underwriting standards set by the chartering agency. These standards should provide that mortgages purchased by in a MSIC are prudentially underwritten.
- Loan Limits – The federal chartering agency should set, by regulation, limits on the size of mortgages that could be included in mortgage backed securities insured by a MSIC.

- Portfolios -- MSICs should not be permitted to establish and hold portfolios purely for investment purposes. Small portfolios should be permitted to facilitate the development of new products and certain types of loans for which there are limited markets such as multifamily mortgages. MSICs also could use this portfolio capacity to warehouse loans before securitization, to purchase whole loans from smaller banks and for loss mitigation and REO disposition purposes.

Central Securitization Facility and a Single MBS

Our proposal also calls for the creation of a single MBS Securitization Facility to provide administrative services related to mortgage backed securities (MBS) packaged by MSICs. The Facility would process payments on those MBS from the lenders/servicers to the investors. It also would place and administer the federal catastrophic guarantee on the MBS. In other words, this Facility would perform functions similar to those performed by Ginnie Mae for FHA. We recommend that the Facility be part of the Federal Government, and that Ginnie Mae be tapped to perform the services of the Facility, either directly or on a contract basis.

The creation of this Facility also would facilitate the creation of a single mortgage backed security. Today, there are some differences in the terms and repayment characteristics of the MBS marketed by the two GSEs. These differences can, from time to time, result in differences in market liquidity. We propose that all MSICs be required to adhere to a standard form of MBS that has the same repayment terms and other conditions. A single MBS would promote better understanding of the MBS by investors, and it would enhance the liquidity of the market. This would help ensure home buyers have consistent access to reasonably priced home financing.

A single MBS does not mean that all MBS would be composed of the same type of mortgages, only that the basic legal structure, terms and conditions governing repayment and other administrative features of the MBS would be the same. MBS backed by MSICs could be composed of loans from a single lender or multiple lenders allowing lending institutions of all sizes access to this liquidity.

Like existing GSE securities, these MBS should be exempt from SEC registration requirements. Such an exemption is necessary to maintain the "To Be Announced" (TBA) market. The TBA market is used by the lending industry to reduce risks in the origination process and reduce borrowing costs for consumers. The TBA market allows borrowers to lock in rates in advance of closing a mortgage loan and permits lenders to hedge the corresponding interest rate risk. The TBA market is based upon a trade of a MBS on a future date, and at the time of the trade the MBS to be included in the trade may not be identified. Therefore, it is impractical to apply standard SEC registration and disclosure requirements. To overcome this practical problem, the GSEs currently disclosure information to investors about the composition of each pool of mortgages backing a security, including the average loan-to-value ratio, the average debt-to-income ratio, the average borrower credit score, the number and value of mortgages from each State, the distribution of mortgage coupon rates, and whether the mortgages were originated in broker or non-broker channels. MBS issued by MSICs should be subject to a similar disclosure requirement.

Affordable Housing

Finally, we propose that MSICs assume the responsibility for supporting owner-occupied and rental housing for extremely-low and very-low income families imposed upon the GSEs in the Housing and Economic Recovery Act. That Act directed the GSEs to annually set aside approximately 4 basis points of the total dollar amount of new mortgages that they acquire and transfer 65 percent of such amount to the Housing Trust Fund and 35 percent of such amount to the Capital Magnet Fund.

The Housing Trust Fund, which is to be administered by HUD, would provide grants to the States primarily for the production, preservation and rehabilitation of rental housing for extremely low-income and very low-income families. The Capital Magnet Fund, which is to be administered by the Treasury Department, is designed to leverage private sector capital for the development of housing for extremely low-income families, very low-income families, and low-income families. It also is designed to promote economic and community development projects to help such families. We support this transfer payment in lieu of the application of specific housing goals on MSICs. MSICs should not be subject to specific housing goals.

Transition

While in conservatorship, both Fannie Mae and Freddie Mac have performed their three primary responsibilities well: continuing to promote liquidity for housing finance, finding solutions to help keep borrowers in their homes, and conserving the assets of the two enterprises. Without the continued operation of Fannie Mae and Freddie Mac during the crisis, the flow of housing finance would have been severely disrupted. It continues to be imperative that they operate as they are today until the future state is well defined and a careful transition is formulated.

Key transition issues that must be considered include:

- The transition must ensure borrowers have uninterrupted access to reasonably priced housing finance along with other benefits they enjoy today (for example, access to 30 year fixed rate mortgages and the ability to lock a rate while loans are in process).

- The transition must ensure the continued liquidity of today's agency MBS market and the 'to be announced' (TBA) MBS market in particular which allows lenders to better insulate consumers from the uncertainty of markets and to hedge their risks (thereby reducing borrowing costs).
- The transition must seek the right balance between sufficient capitalization of future credit risk guarantors and how different capitalization requirements impact the costs of home ownership for consumers.
- The transition should also seek to achieve an explicit government guarantee of the MBS with as little actual government risk as possible (achieved by placing sufficient private capital in front of the government).
- The transition must find a fair and equitable way to deal with the legacy assets and liabilities of Fannie Mae and Freddie.
- The transition should seek to preserve the valuable infrastructure of Fannie Mae and Freddie Mac.

- The transition must ensure low and extremely low income borrowers have access to housing while avoiding lending requirements and/or targets for private lenders/guarantors.
- In order to ensure that markets have sufficient time to evaluate and prepare for the transition, the transition should be allowed sufficient time for proposed changes to be clearly communicated. Where possible, gradual steps should be used and 'tested' before proceeding to broader implementation. Given the size, importance, and complexity of the housing finance system, expectations should be for this transition to potentially take multiple years to be realized.

A Note on Other Proposals

Many of the other proposals are very closely aligned with HPC's, and while some call for more or less government involvement, all agree that promotion of liquidity for housing finance is the objective. Several recommendations also call for an explicit guarantee of MBS (not the corporate entities) and for stronger capitalization and regulation. We believe that those recommendations that call for complete nationalization miss the benefits to consumers of innovation and efficiency that private capital will allow and expose the taxpayer to more risk than is necessary to optimize MBS liquidity. Recommendations to completely privatize miss the necessity of a government backstop to ensure consistent functioning of MBS markets under all economic conditions.

Conclusion

Thank you for the opportunity to explain our proposal. The members of the Housing Policy Council are committed to pursuing this concept, and welcome the opportunity to work with the Committee as it develops its own proposals and reforms.