



HOUSING
POLICY
COUNCIL

Testimony of

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on behalf of the Housing Policy Council

of the Financial Services Roundtable

Before the House Financial Services Committee

**Subcommittee on Capital Markets and Government Sponsored
Enterprises**

**“Legislative Proposals to Reform the Government Sponsored
Enterprises (GSEs)”**

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Mr. Chairman and Members of the Committee thank you for holding this important hearing and thank you for the invitation to participate.

My name is John Dalton, and I am the President of the Housing Policy Council of The Financial Services Roundtable. The Housing Policy Council is thirty-two of the leading national mortgage finance companies. HPC members originate, service, and insure mortgages, and do business every day with Fannie Mae and Freddie Mac.

Mr. Chairman, we believe that reform of the secondary mortgage market is a critical priority and it should be based on creating a new structure based on private capital. This new system must have two primary goals: serving homebuyers and protecting taxpayers.

Homeownership is a pillar of the US economy and the American way of life. The new private sector system, built on private capital and clear rules, should help deliver sound financing that will keep homeownership within the reach of most Americans. Without an approach like this, owning a home in America could become a luxury for the few.

One important way to avoid this from happening is to ensure continued availability of the 30-year fixed rate mortgage, which has been the bedrock of our nation's housing system for more than a half century. Let me explain why.

The 30-year fixed rate mortgage has made homeownership sustainable for millions of American households. A fixed rate mortgage continues to be the overwhelming choice for American consumers. Today, approximately 90 of new loans are fixed rate mortgages. In the fourth quarter of 2010, 95% of refinances were for fixed rate loans. The 30-year fixed rate mortgage delivers affordability, certainty and stability for homebuyers that might not otherwise exist, which is why it is the most popular form of home financing in our country.

Predictability is one of the greatest benefits of the 30 year fixed rate mortgage, and very important for Americans on a budget. A fixed rate mortgage provides incredible peace of mind, because homeowners know that their biggest monthly bill, their mortgage, is not going to change from month to month and year to year. Without this popular finance tool, many homeowners would experience in their mortgages the same wild swings they now feel at the gas pump. That's a rollercoaster ride most Americans would prefer to avoid.

In addition to serving homebuyers, we strongly agree that a new private sector-based system must protect American taxpayers. Members of the House Financial Services Committee have introduced several bills that identify a number of issues that must be addressed as part of a careful transition to a new, stronger housing finance system. In my testimony, I will discuss the Housing Policy Council's proposal to reform the secondary market system and also comment on some of the legislation that has just been introduced to begin the reform of the existing GSES.

Guarantee Fees and Portfolio Limits

The legislation just introduced addresses the important issues of guarantee fees and portfolio limits. We support steps to continue the gradual reduction in the size of the portfolios maintained by Fannie Mae and Freddie Mac, and a gradual increase in the amount of the guarantee fees (G-Fees) charged by the GSEs. Guarantee fees and portfolio limits are issues that should continue to be addressed with the current GSEs and as part of the larger reform effort.

The guarantee fees charged by the GSEs should be at a level that reflects the risk they are taking and that also allows private competition to develop. In hindsight, it is clear that guarantee fees charged by Fannie Mae and Freddie Mac were insufficient to cover the risks of the mortgages they acquired. In early 2008, the GSEs began to impose additional fees, but in earlier years, the GSEs' guarantee fees and their capital levels were inadequate to support the risks they were taking. Given this experience, HPC supports the gradual implementation of guarantee fees that are more properly aligned with the credit risk assumed by the GSEs. Today, the GSEs' G-Fees have become more accurately priced and additional increases in the G-Fees should be phased-in over a period of time to avoid any undue disruption to the housing recovery.

In the past, the size of the GSEs' portfolios grew far beyond what was necessary to facilitate the securitization of mortgage loans. The portfolios are now being reduced and that process should continue. Additional reductions in the portfolios should be managed in a manner that the market can absorb. Some limited portfolios are needed to facilitate the securitization of mortgages, to warehouse whole loans from community banks, to make a market in less liquid loans, such as multifamily housing loans. The regulator should have the authority and flexibility to manage the gradual reduction of the portfolios in a manner that does not negatively affect the current fragile housing market.

Under a reformed secondary mortgage market system, new private companies performing the credit guarantee role of the GSEs should not have large portfolios, but only those needed for the purposes explained above to facilitate the smooth functioning of mortgage securitizations.

Elimination of Numerical Affordable Housing Goals

HPC supports the elimination of specific housing goals for the GSEs. While the affordable housing goals were not a major factor in the failure of the GSEs, these goals did detract from their primary mission. The GSEs should have a single purpose – ensuring a steady flow of reasonably priced conventional mortgages. Affordable housing is best supported directly by other federal programs, such as FHA. In a reformed system, we could support a contribution from the GSEs or their successors to affordable housing programs managed by HUD and/or state housing finance agencies. Such a transfer payment would help to address affordable housing needs, but would not require the GSEs, or their successors, to direct attention away from their main mission.

Reforms to Current GSEs and Transition to New System

Mr. Chairman, the series of bills just introduced identify and seek to address valid problems with the current GSE system. These bills are a start to the reform effort, but should not be the end of the legislative process on GSE reform. They should be part of more comprehensive reform legislation that provides for the transition from Fannie Mae and Freddie Mac to the simultaneous creation of a new, privately-based secondary market system for conventional mortgages. The Housing Policy Council has made a proposal to reform the secondary mortgage market and to transition from Fannie Mae and Freddie Mac.

Housing Policy Council GSE Reform Proposal

HPC's proposal addresses the problems inherent in the structure of Fannie Mae and Freddie Mac and is intended to achieve several objectives:

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

We propose to achieve these objectives by dividing the existing functions of Fannie Mae and Freddie Mac with private companies and capital assuming the primary roles and risk.

Privately Capitalized "MSICs" Should Assume Credit Enhancement Function of the GSEs

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

A MSIC would --

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

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

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

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

An Explicit – But Limited -- Federal Guarantee is needed

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

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

Standing before the federal guarantee would be --

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

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

Finally, if the fees for the federal guarantee are set properly, the federal guarantee would be budget neutral. Under existing federal credit procedures, the cost of federal credit activity in a budget year is the net present value of all expected future cash flows from

guarantees and direct loans disbursed in that year. For loan guarantees, cash inflows consist primarily of fees charged to insured borrowers, and cash outlays consist mostly of payments to lenders to cover the cost of loan defaults. FHA and Ginnie Mae are models for this budgetary treatment. In the case of both FHA and Ginnie Mae, the fees paid for the federal guarantee normally cover claims on the guarantees and other operational expenses.

Capitalizing New Private Companies (MSICs)

Attracting sufficient private capital to MSICs is a key to the success of our proposal. Based on our initial research and discussions with capital markets participants, we believe that a range of private investors would be willing to invest in these new companies. The capital levels for these new companies would be set by their federal regulator and would be significantly higher than those of the current GSEs. This model could produce a reasonable return to investors and provide the capital needed to cover losses in a severe housing down-turn.

World Class Regulator

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

- Strong prudential standards – MSICs’ should be subject to capital, liquidity and other prudential standards set by the chartering agency;
- Underwriting Standards for Mortgages in MBS – MSICs should be prohibited from purchasing mortgages that do not meet underwriting standards set by the chartering agency. These standards should provide that mortgages purchased by in a MSIC are prudentially underwritten.
- Loan Limits – The federal chartering agency should set, by regulation, limits on the size of mortgages that could be included in mortgage backed securities insured by a MSIC.
- Portfolios -- MSICs should not be permitted to establish and hold portfolios purely for investment purposes. Small portfolios should be permitted to facilitate the development of new products and certain types of loans for which there are limited markets such as multifamily mortgages. MSICs also could use this portfolio capacity to warehouse loans before securitization, to purchase whole loans from smaller banks and for loss mitigation and REO disposition purposes.

Central Securitization Facility and a Single MBS

Our proposal also calls for the creation of a single Mortgage Backed Security (MBS) Securitization Facility to provide administrative services related to MBS packaged by MSICs. The Facility would process payments on those MBS from the lenders/servicers to the investors. It also would place and administer the federal catastrophic guarantee on

the MBS. In other words, this Facility would perform functions similar to those performed by Ginnie Mae for FHA. We recommend that the Facility be part of the Federal Government, and that Ginnie Mae be tapped to perform the services of the Facility, either directly or on a contract basis.

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

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

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

Affordable Housing

Finally, we propose that MSICs contribute to supporting owner-occupied and rental housing for extremely-low and very-low income families. This requirement was placed on the GSEs in the Housing and Economic Recovery Act of 2008. That Act directed the GSEs to annually set aside approximately 4 basis points of the total dollar amount of new mortgages that they acquire and transfer 65 percent of such amount to the Housing Trust Fund and 35 percent of such amount to the Capital Magnet Fund.

The Housing Trust Fund, which is to be administered by HUD, would provide grants to the States primarily for the production, preservation and rehabilitation of rental housing for extremely low-income and very low-income families. The Capital Magnet Fund,

which is to be administered by the Treasury Department, is designed to leverage private sector capital for the development of housing for extremely low-income families, very low-income families, and low-income families. It also is designed to promote economic and community development projects to help such families. We support this transfer payment in lieu of the application of specific housing goals on MSICs. MSICs should not be subject to specific housing goals.

Transition

While in conservatorship, both Fannie Mae and Freddie Mac have performed their three primary responsibilities well: continuing to promote liquidity for housing finance, finding solutions to help keep borrowers in their homes and conserving the assets of the two enterprises. Without the continued operation of Fannie Mae and Freddie Mac during the crisis, the flow of housing finance would have been severely disrupted. The GSEs will need to operate until a well defined and careful transition is formulated and put into place.

Key transition issues that must be considered include:

- The transition must ensure borrowers have uninterrupted access to reasonably priced housing finance along with other benefits they enjoy today (for example, access to 30 year fixed rate mortgages and the ability to lock a rate while loans are in process).
- The transition must ensure the continued liquidity of today's agency MBS market and the 'to be announced' (TBA) MBS market in particular which allows lenders to better insulate consumers from the uncertainty of markets and to hedge their risks (thereby reducing borrowing costs).
- The transition must seek the right balance between sufficient capitalization of future credit risk guarantors and how different capitalization requirements impact the costs of home ownership for consumers.
- The transition should also seek to achieve an explicit government guarantee of the MBS with as little actual government risk as possible (achieved by placing sufficient private capital in front of the government).
- The transition must find a fair and equitable way to deal with the legacy assets and liabilities of Fannie Mae and Freddie.
- The transition should seek to utilize the valuable infrastructure of Fannie Mae and Freddie Mac.
- The transition must ensure low and extremely low income borrowers have access to housing while avoiding lending requirements and/or targets for private lenders/guarantors.
- The transition should be allowed sufficient time for proposed changes to be clearly communicated. Where possible, gradual steps should be used and 'tested' before proceeding to broader implementation. Given the size, importance, and complexity of the housing finance system, expectations should be for this transition to potentially take multiple years to be realized.

A Note on Other Proposals

A number of other secondary market reform proposals share key features of the plan proposed by HPC and while some call for more or less government involvement, all agree that promotion of liquidity for housing finance is the objective. Several recommendations also call for an explicit guarantee of MBS (not the corporate entities) and for stronger capitalization and regulation. We believe that those recommendations that call for complete nationalization miss the benefits to consumers of innovation and efficiency that private capital will allow and expose the taxpayer to more risk than is necessary to optimize MBS liquidity. Recommendations to completely privatize miss the necessity of some government guarantee to ensure consistent functioning of MBS markets under all economic conditions.

Mr. Chairman, we appreciate your leadership and those on this committee who must tackle this important issue, and we realize it is complicated and complex. We support your efforts to reform the system and move away from a GSE-model, but we believe it is important for the economic recovery, financial markets and for the housing sector to proceed carefully and create a roadmap to a new, privately-based system. There is still much uncertainty in the housing market at this time. This uncertainty makes it especially important to couple limits on changes to the existing GSEs with a plan for a new system.

We stand ready to work with you, the committee and other stakeholders on this issue, and look forward to your questions.