Testimony of

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House Financial Services Committee

Hearing on:

"A Failure to Act: How a Decade without GSE Reform Has Once Again Put Taxpayers at Risk"

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Chairman Hensarling, Ranking Member Waters, and Members of the Committee:

It is an honor to be here. My name is Ed DeMarco. I am the President of the Housing Policy Council, a trade association comprised of 30 of the nation's leading firms in housing finance. Ten years ago, I was the Senior Deputy Director and Chief Operating Officer at the Federal Housing Finance Agency, an agency I would later lead as Acting Director for 4.5 years.

Today's ten-year anniversary of the failures and conservatorships of Fannie Mae and Freddie Mac is not a cause for celebration. What happened ten years ago to Fannie Mae and Freddie Mac had been forecast by some but denied as a possibility by many. Yet, Fannie Mae and Freddie Mac did fail, and taxpayers were forced to take on extraordinary financial risks bailing them out. Moreover, the fundamental challenge posed by their failure remains today – how best should the United States Congress replace this inherently flawed structure with a far more resilient structure that puts mortgage credit risk on the private sector, not taxpayers.

My remarks cover four broad topics:

1. What happened ten years ago
2. What has improved and what has gotten worse
3. Why Congress still must act and what can Congress build upon
4. What could be accomplished administratively to assist Congress and markets

September 2008 – A Look Back

On July 30, 2008, Congress passed the Housing and Economic Recovery Act (HERA) that established the Federal Housing Finance Agency (FHFA) to replace the Office of Federal Housing Enterprise Oversight (OFHEO). Less than six weeks later, on September 6, 2008, FHFA used its new authorities in conjunction with the U.S. Department of the Treasury to place the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation into conservatorships. While these companies are more commonly known by their nicknames, Fannie Mae and Freddie Mac, I want to emphasize their formal names for the first word in those names – Federal. Where did that come from? It came from Congress. Congress created these companies, named them, wrote their charter, gave them their purpose, and endowed them with numerous benefits and privileges unavailable to other private firms.

This unique legal structure gave rise to the companies being referred to as Government-Sponsored Enterprises, or GSEs. Despite their private corporate status, with their shares trading on the New York Stock Exchange, Fannie Mae and Freddie Mac often were perceived as extensions of the U.S. government and they exercised substantial influence over policymakers. This gave rise to the frequently referenced, but officially denied, implicit guarantee of Fannie Mae and Freddie Mac securities. When the crisis hit, Congress authorized Treasury to extend substantial financial assistance to the companies. While at one level this was a bailout of the companies' debt and mortgage-backed securities holders (but not shareholders), at another level it was the long-predicted realization of the implicit government backing.

By September 2008, both the systemic risk and the conflicts of interest embedded in the GSE model - a public mission yet private shareholder interests to satisfy - could no longer be ignored. The markets spoke. Despite the quasi-governmental structure, market participants questioned the firms' solvency; the GSEs were unable to raise new equity and the debt markets were closing off to them, giving rise to significant liquidity concerns.[1]

In creating FHFA, Congress provided new regulatory authority to put these two companies into conservatorship or into receivership and broad authority with respect to managing the conservatorships. But it did NOT give FHFA the authority to amend or extinguish these two charters, nor did it allow additional charters to be created. Even in the event of a receivership, Congress required that FHFA set up a bridge institution and re-establish the failed company under the same name with the same charter, rights, privileges and so on. In short, Congress created these two companies and Congress reserved for itself the authority to change them.

That bit of history helps explain the closing statement made by Treasury Secretary Paulson on September 7, 2008, in announcing the conservatorships along with my then boss, FHFA Director Lockhart. These words demand our attention ten years later:

> Through the four actions we have taken today, FHFA and Treasury have acted on the responsibilities we have to protect the stability of the financial markets, including the mortgage market, and to protect the taxpayer to the maximum extent possible.
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> And let me make clear what today's actions mean for Americans and their families. **Fannie Mae and Freddie Mac are so large and so interwoven in our financial system that a failure of either of them would cause great turmoil in our financial markets here at home and around the globe**. This turmoil would directly and negatively impact household wealth: from family budgets, to home values, to savings for college and retirement. A failure would affect the ability of Americans to get home loans, auto loans and other consumer credit and business finance. And a failure would be harmful to economic growth and job creation. That is why we have taken these actions today.
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> While we expect these four steps to provide greater stability and certainty to market participants and provide long-term clarity to investors in GSE debt and MBS securities, our collective work is not complete. At the end of next year, the Treasury temporary authorities will expire, the GSE portfolios will begin to gradually run off, and the GSEs will begin to pay the government a fee to compensate taxpayers for the on-going support provided by the Preferred Stock Purchase Agreements. Together, **these factors should give momentum and urgency to the reform cause. Policymakers must view this next period as a "time out" where we have stabilized the GSEs while we decide their future role and structure.**
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> **Because the GSEs are Congressionally-chartered, only Congress can address the inherent conflict of attempting to serve both shareholders and a public mission. The new Congress and the next Administration must decide what role government in general, and these entities in particular, should play in the housing market. There is a consensus today that these enterprises pose a systemic risk and they cannot continue in their current form.** Government support needs to be either explicit or non-existent, and structured to resolve the conflict between public and private purposes. And policymakers must address the issue of systemic risk. I recognize that there are strong differences of opinion over the role of government in supporting housing, **but under any course policymakers choose, there are ways to structure these entities in order to address market stability in the transition and limit**

[1] See Statement of FHFA Director James Lockhart before the House Financial Services Committee, September 25, 2008. https://www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-James-B-Lockhart-III-Director-FHFA-Before-the-US-House-Committee-on-Financial-Services.aspx

systemic risk and conflict of purposes for the long-term. We will make a grave error if we don't use this time out to permanently address the structural issues presented by the GSEs.[2]

We are here today, ten years later, to consider how Congress can respond to this call for action. While I will turn now to the advances that have been made in these ten years, and the opportunities to make further advances administratively, make no mistake: the job is not done until Congress acts. And the status quo is not a long-term answer.

We've Taken Steps Forward … Yet Systemic Risk is Growing, Not Fading

Positive Developments Building for the Future

During my tenure as FHFA's Acting Director and as Conservator of Fannie Mae and Freddie Mac, I submitted numerous letters and reports to this Committee. I also testified before the Committee on several occasions. I sometimes describe the course of the conservatorships as chapters in a book, with themes, priorities, and goals evolving over time and adapting to evolving circumstances.[3]

The early chapters of the conservatorship saga focused on establishing and maintaining market stability and liquidity. At the time, this was no small feat and there were many anxious moments awaiting the response of market participants here and abroad to the conservatorships. We also were deeply concerned with the response of home buyers, lenders, and Fannie Mae and Freddie Mac employees themselves, who were needed to maintain the ongoing operations of the two firms. Notwithstanding this unprecedented government action, there was no guarantee of success. Fortunately, our efforts were effective – liquidity was maintained in the secondary mortgage market for Fannie Mae and Freddie Mac mortgage-backed securities, new loans continued to be securitized, and confidence gradually returned.

The next chapters were the most challenging. As the recession worsened, house prices continued to fall, and mortgage delinquencies soared, our priority was assisting troubled homeowners avoid foreclosure while minimizing taxpayer losses. The FHFA team, working with the GSEs, continually tested, measured, and evaluated our efforts, working collaboratively with a wide range of government and private entities in search of tools that worked. The quality and results of our collective efforts improved with time and experience. FHFA recently reported that more than 4 million total foreclosure prevention actions and 3.5 million HARP refinances have been completed on GSE loans over these ten years.[4]

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[2] "Statement by Treasury Secretary Henry Paulson on Treasury and Federal Housing Finance Agency action to protect financial markets and taxpayers," September 7, 2008. https://www.treasury.gov/press-center/press-releases/Pages/hp1129.aspx (emphasis added).

[3] "FHFA Sends Congress Strategic Plan for Fannie Mae and Freddie Mac Conservatorships," News Release dated February 21, 2012 with an accompanying letter to Congress and report titled "A Strategic Plan for Enterprise Conservatorships: The Next Chapter in a Story that Needs an Ending." https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Sends-Congress-Strategic-Plan-for-Fannie-Mae-and-Freddie-Mac-Conservatorships.aspx

[4] For industry data on loan modifications encompassing more than the GSEs, see, for example, data published by HOPE NOW. http://www.hopenow.com/industry-data/HopeNow.FullReport.Updated(June2018).pdf

A new chapter in the saga of the conservatorships began in 2012 with the release of the first Strategic Plan for the conservatorships.[5] FHFA directed a series of actions designed to further limit risk to the taxpayers, prepare the companies for final resolution, and build an infrastructure for the housing finance system that would facilitate the return of private capital and support Congressional action. Some of these initiatives are well-known to this committee, others less so. Key initiatives included:

- Credit Risk Transfers (CRT). The first CRT transaction was completed in 2013. Today, FHFA reports that more than 90 percent of standard, 30-year fixed rate mortgages securitized by Fannie Mae and Freddie Mac involve some form of credit risk transfer. This is a critically important development for the market and for taxpayers. For the market, CRT represents the formation of a credit market backed by private capital to hold mortgage credit risk. For taxpayers, CRT shifts some degree of Fannie Mae and Freddie Mac's mortgage credit risk to private investors, drawing private capital in to supplement taxpayer capital.
- The Uniform Mortgage Data Program (UMDP). Initiated in 2010, this is the umbrella title for a series of data initiatives aimed at simplifying and standardizing certain data collection and reporting processes. Always understood to be a long-term set of initiatives aimed at improving data quality while lowering collection costs, improving data accuracy, and reducing barriers to entry, many of the individual initiatives are completed and operating in the marketplace today. Since data is foundational to underwriting and financial risk management, this program has been a significant, positive development for the housing finance system.
- Underwriting Standards. In the years leading up to the conservatorships, Fannie Mae and Freddie Mac lowered their underwriting standards, thereby increasing their risk profile. Post-conservatorship, FHFA ensured this weakening was reversed although there are signs that standards have been weakening again.
- Pricing (Guarantee Fees, or G-Fees). Fundamentally, Fannie Mae and Freddie Mac operate as financial guarantors of mortgages. By guaranteeing that investors in their mortgage-backed securities will not lose principal and interest, even if the underlying mortgage defaults, Fannie Mae and Freddie Mac assume that credit risk. Pre-crisis, the companies vastly underpriced this risk. Since conservatorship, and at FHFA's direction, they have gradually increased their g-fee pricing although the current pricing, at least in some segments, may be lower than what private markets backed by private capital would require.[6] Any underpricing should be understood as a subsidy provided by taxpayers as well as a subsidy provided by lower risk borrowers to higher risk borrowers.
- Common Securitization Platform (CSP). Prior to the crisis and up to today, Fannie Mae and Freddie Mac have operated separate, proprietary platforms for "manufacturing" mortgage-backed securities. Those securities have distinct rules governing when investors get paid, what information is disclosed to them, and how their interests are

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[5] Ibid.

[6] As required by statute, FHFA produces an annual report on guarantee fees. Each year the report shows that the pricing of new loan acquisitions falls short of that needed to meet target returns for lower credit quality loans and for 30-year fixed rate mortgages relative to other mortgages. See FHFA's latest annual report: "Fannie Mae and Freddie Mac Single-Family Guarantee Fees in 2016," October 2017. https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/GFeeReport10172017.pdf

protected. In 2012, FHFA determined that neither of these proprietary platforms was capable of supporting a future securitization market. We concluded that the most efficient way to invest taxpayer dollars in upgrading the outdated technology was to build a new, open-architecture, standardized system that could be a cornerstone for a post-conservatorship secondary market. Today, the CSP remains under development, with only Freddie Mac using some of its features to-date. FHFA projects both GSEs utilizing the CSP next year, with the introduction of the uniform MBS. While the CSP has not developed at the pace or in the way that I and others had envisioned, it remains an important development upon which to build for the future.

- Disclosures. Prior to the conservatorships, one indicator of investor reliance on implicit taxpayer support of Fannie Mae and Freddie Mac debt was the very weak disclosure regime. Fannie Mae published no loan level data on the mortgages in its MBS and Freddie Mac published very little. An important development since, in part aligned with the introduction of CRT, has been the movement to provide more loan level disclosure to the market. Also, as part of initiating CRTs, FHFA directed the two companies to release millions of historical loan level data files to assist the market in calibrating models to support CRT investment. This is also an important development although there is much unfinished business here that I will return to later in my testimony.

The Current State of the Mortgage Market

In conservatorship, investor confidence in Fannie Mae and Freddie Mac mortgage-backed securities and debt stems from the Treasury commitment, which assures them that the American taxpayer will make good on the companies' obligations. In other words, it is the pledge of capital from the U.S. taxpayer that bolsters the profitability of these companies, funding their extensive technology investments, expanded lines of business, personnel and facilities enhancements, and other growth strategies.

A gradually recovering economy combined with taxpayer support of Fannie Mae and Freddie Mac, foreclosure prevention efforts, and substantial federal intervention, such as Federal Reserve purchases of MBS, have all contributed to the strengthening of our housing markets and liquidity in the housing finance system. The Federal Housing Administration (FHA) and Veterans Affairs (VA) mortgage guarantee programs also have grown substantially during this time, lending additional support to the recovery.

According to the FHFA purchase-only index, U.S. housing prices peaked in April 2007 before dropping more than 20 percent over the next four years. Since then, national house prices have generally recovered and now surpass the 2007 peak level.[7] However, there really is not a national market for houses, so some communities have experienced greater or lesser fluctuations during this time. Moreover, the foundation upon which this house price recovery has been built is not as strong as it should be.

Growing Risks to Taxpayers, Markets, and Homebuyers

The federal government has long been a significant player in U.S. housing finance, both directly and indirectly. The federal government provides direct support through mortgage guarantor programs such as FHA and VA, numerous tax subsidies, and various laws and regulations

[7] https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/HPI_May2018.pdf

ranging from bank capital requirements to fair lending, fair housing, and consumer protection laws. It provides indirect support through institutions such as Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

As significant as the government's involvement was ten years ago, it has grown substantially since. Members of the Housing Policy Council believe this evolving state of our housing finance system is adding risk that requires congressional attention and action. I will review four categories of risk.

1. Government Programs and Regulations

The FHA and VA loan guarantee programs grew rapidly as the financial crisis took hold. These programs provided a critical source of counter-cyclical support to the market but with markets since stabilized, these programs remain larger than their traditional market share would predict. This likely reflects several factors, including but not limited to, the collapse of the subprime market, higher Fannie Mae and Freddie Mac guarantee-fees, growth in higher risk FHA loans, and the increase in eligible FHA loan size instituted during the crisis but not reset to normal levels. The bigger concern we have is more structural, particularly with the FHA program.

Several factors have contributed to the reduction in participation in the FHA program by well-capitalized lenders, including inefficient servicing rules, challenging claims processes, and aggressive lawsuits filed against FHA lenders under the federal False Claims Act. As a result, non-depository lenders and servicers have become more significant participants in the FHA program and larger banks less so. While banks and non-bank lenders alike should be able to offer FHA loans, the trend has at least three important consequences for the marketplace. First, it limits the financing options for potential homebuyers; in some cases, they cannot obtain a mortgage from the bank where they maintain checking, savings, or other credit accounts. HUD Secretary Carson and Treasury Secretary Mnuchin have acknowledged this problem.[8] Second, addressing the challenges of doing business with FHA would lead to a more competitive market that would drive down costs for borrowers. Third, non-depositories do not have access to all the liquidity resources available to banks. In a credit-constrained environment, this poses liquidity and solvency risk to the system and especially to Ginnie Mae, something Ginnie Mae has warned.[9],[10]

In addition, FHA suffers from prolonged resource constraints that have prevented investment in systems and technology advances with the rest of the market. This is a source of great concern to lenders, servicers, and FHA itself. We are encouraged by the new FHA Commissioner's focus

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[8] Remarks of Dr. Ben Carson before the National Association of Home Builders Executive Board Meeting, May 23, 2018. https://www.hud.gov/press/speeches_remarks_statements/Speech_052318 and "A Financial System That Creates Economic Opportunities Nonbank Financials, Fintech, and Innovation," U.S. Department of the Treasury Report to President Donald J. Trump, July 2018, page 97. https://home.treasury.gov/sites/default/files/2018-08/A-Financial-System-that-Creates-Economic-Opportunities---Nonbank-Financials-Fintech-and-Innovation.pdf

9"An Era of Transformation," Ginnie Mae, September, 2014. https://www.ginniemae.gov/newsroom/Documents/ginniemae_an_era_of_transformation.pdf

[10] Preliminary research reported in a Federal Reserve staff working paper supports this conclusion and highlights the liquidity risks in the current environment. Kim, You Suk, Steven M. Laufer, Karen Pence, Richard Stanton, and Nancy Wallace (2018). \Liquidity Crises in the Mortgage Market," Finance and Economics Discussion Series 2018-016. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2018.016.

on this issue and urge the House to join the Senate in providing appropriations to fund needed technology upgrades.

While a tightening of federal mortgage regulations was both an inevitable and needed response to the financial crisis, it is also not surprising that some of these regulations missed the mark and, in certain cases, new regulations have created inefficiencies that increase loan origination and servicing costs, which boost costs for borrowers and may have restrained the emergence of private-label securitization. This does not mean these reforms should be repealed or regulations rescinded but it does mean that they should be evaluated for their efficacy and impact, and moderated or refined as appropriate. We appreciate that the Treasury Department and federal financial regulators are undertaking such a review and recalibration.

2. Macroeconomic Risks

Thankfully, the deep recession has given way to a prolonged period of slow but positive economic growth and stability. Yet macroeconomic risks remain. Interest rates have been historically low throughout most of this period. With the Federal Reserve on a path to unwind its mortgage portfolio while pursuing gradual rate normalization, markets will need to adjust to these changes.

3. Housing Supply Constraints

Perhaps the most significant legal and regulatory risks to housing affordability are not driven by federal regulation but result from state and local housing policy. Housing supply constraints are a meaningful contributor to housing affordability concerns in both the rental and ownership markets.[11] Enhancing credit subsidies at the federal level, including the GSEs' increasing acceptance of loans with high debt-to-income ratios, in the face of supply constraints at the local level drives up house (and apartment) prices, thereby exacerbating, not aiding, affordability concerns.

4. Control of the Nation's Mortgage Market

Despite the many positive developments over the past ten years, less apparent to casual observers but more threatening to long-term stability has been the growing level of control of the mortgage market exercised by Fannie Mae, Freddie Mac, and their conservator. I opened my remarks by highlighting the systemic risks that led directly to the need for Congress to authorize, and Treasury to carry out, a massive financial intervention to protect GSE MBS and debt holders. If anything, the level of systemic risk posed by the GSEs has grown over these ten years.

For starters, Fannie Mae and Freddie Mac MBS outstanding today (approximately $5.1 trillion) is about $750 billion greater than ten years ago. But there is much more to it than that.

While the emergence of CRT has spread some credit risk previously retained by the GSEs, most of that risk-sharing is mezzanine risk, not first dollar or equity risk, and it has been accompanied by even greater reliance on the GSE risk management infrastructure and practices. In other words, the risk of loss has shifted to another party, but not the means to control or contain that risk. The same holds for credit pricing. This is not a fully competitive private market; it is a GSE-dominated credit market with the attendant systemic risk we have already witnessed. So,

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11 "Housing Development Toolkit," The White House, September, 2016. https://www.whitehouse.gov/sites/whitehouse.gov/files/images/Housing_Development_Toolkit%20f.2.pdf

while CRT continues to be an important development and has shifted some amount of future loss away from the GSEs, there is much more to do here.

End-to-end, the mortgage market depends upon the risk analysis, pricing, and risk-bearing of Fannie Mae and Freddie Mac. These two companies determine which counterparties can participate in the system – with broad reach to all stakeholders whose functions are intended to manage and mitigate risk, from lenders and servicers to mortgage insurers, appraisers, and title companies. Meanwhile, they set the rules of business for the entire market, including the underwriting box, which determines what loans may be sold into the secondary market. With their conservator, they price the guarantee fees but also determine the external credit enhancement via CRT, setting the terms and pricing of these enhancements, and the rules governing these structures. They determine where and when to relax their traditional lending standards, whether through appraisal waivers, alterations to underwriting, or direct reductions in credit costs for some borrowers at the expense of other borrowers.

The companies continue to have a significant information advantage over other market participants, in terms of loan level data, appraisal data, and market prices. They set the capital and operational rules for mortgage insurers, have direct access to mortgage insurers' financial and pricing data, and they now offer a product that competes with existing mortgage insurance products. [12]

The companies' cash window purchases have grown significantly, making them the largest whole loan aggregators in the system, a function once performed by a number of the larger banks and independent mortgage companies.[13] This used to be a competitive activity in the primary market, one that lent additional oversight to the quality of loan manufacturing and compliance monitoring and embraced "skin in the game" through traditional commercial counterparty contracts that held multiple institutions accountable to one another for loan quality and performance. While some lenders may argue that this development benefits them because they sell directly to the GSEs, the system is concentrating risk in Fannie Mae and Freddie Mac and making lenders more beholden to, and reliant upon them. That reduces competition and increases systemic risk.

During the first six years of conservatorship, FHFA stopped Fannie Mae and Freddie Mac from entering new lines of business and focused them on their core mission. More recently, however, the companies' activities have expanded, bringing with it new risks to manage while operating in conservatorship and backed just by taxpayer capital. Examples include financing support for

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[12] The mortgage insurance pilots (Freddie Mac's Imagin program and Fannie Mae's Enterprise Paid Mortgage Insurance) are good examples of the one-step forward, one-step back characteristic of some developments in conservatorship. As an alternative execution structure for pooling and laying off mortgage risk, the pilots may be seen as just another development in the set of credit risk transfer structures designed to attract private capital and shift risk away from the GSEs. And so they are. Yet they also reflect the level of control the GSEs exercise over all aspects of credit assessment, risk management, pricing, participation eligibility, and master servicing. These products compete with existing mortgage insurance products, yet the GSEs have a full view into their competitors' pricing and rules and do not offer the same transparency back. If these structures are good enough for the GSEs, FHFA should make the rules of participation clear and allow other firms to offer the same structure in the marketplace, rather than force the execution through the GSEs.

[13] "Recent Trends in the Enterprises' Purchases of Mortgages from Smaller Lenders and Nonbank Mortgage Companies," Federal Housing Finance Agency Office of Inspector General, July 17, 2014. https://www.fhfaoig.gov/Content/Files/EVL-2014-010_0.pdf

institutional single-family rental (something previously authorized and now just halted by FHFA), debt financing of non-bank mortgage servicers, and expansion into multifamily finance out of proportion to pre-crisis market share.

Collectively, these new activities add risk and complexity while putting the GSEs into direct competition with private market participants. This would be fine if the playing field were level, but it is not. The GSEs operate with a substantial advantage that guarantees that they will be able to offer better terms and lower pricing than other market participants. They can access taxpayer, not private, capital, they continue to benefit from a host of special privileges accruing to them as GSEs, and they issue debt at approximately government pricing levels.

Why Congress Must Act and What Congress Can Build Upon

To pursue a resilient liquid market in the future, we should be working to restore private capital and a competitive market in housing finance. In its simplest terms, ending the conservatorships and achieving housing finance reform is about creating a safe, liquid, and competitive market for mortgage credit risk, where private companies can thrive and innovate to serve the diverse array of U.S. households, and perform critical risk management functions that complement those of any governmental entities serving in a backstop capacity for the system. There is nothing unique or special about mortgage credit risk that requires wholesale reliance on the risk management practices of the government.

Put another way, ten years ago, virtually all the mortgage credit risk on $5 trillion of mortgages was held by Fannie Mae and Freddie Mac. The market relied heavily on their credit judgment and credit risk management practices. Yet, the two companies had weakened their underwriting, underpriced their risk, and operated with far less capital than any potential competitor. Ten years ago today, we realized the result. Ten years later, Fannie Mae and Freddie Mac perform most of the risk management functions for the system, albeit pushing some modest amount of loss to the private market through CRT.

What we need now, more than ever, is to rebuild a future housing finance system that is more transparent, where the playing field is level, and where substantial amounts of private capital from numerous sources are brought together in a competitive marketplace that allows big lenders and small lenders, banks and non-banks, an equal chance to compete for the business of families seeking to own a home.

Restoring private capital, and relieving taxpayers of bearing so much mortgage risk, is not just a question of credit risk transfers. To better focus the government's role, we should strive toward a future state with greater private securitization, which would also lower catastrophic risk placed on taxpayers. Among the avenues for lawmakers to examine as ways to restore private capital are: establishing uniform national servicing standards, opening a common securitization platform to the option of private label securitization, addressing the regulatory inefficiencies holding back the market, encouraging innovation, and reconsidering loan limits.

Without progress in these areas, the uncertainty about the future of the GSEs and about the government's next steps stymies innovation and long-term strategic investment by private lenders and servicers and other stakeholders in the system. Since a stable housing market is essential to consumer well-being and the opportunity for long-term household wealth-building, these ongoing risks and uncertainties need to be resolved. Simply put, Congress must act.

While significant differences of opinion remain on some key aspects of housing finance reform, these are in relatively few areas and, in some instances, multiple solutions may be workable and acceptable. The critical point is that reform cannot be completed without Congress.

Members of this Committee have put forth three comprehensive reform proposals, all warranting consideration in reaching a bipartisan consensus. The Chairman has been a thought leader in developing and advancing the PATH Act. Ranking Member Waters' HOME Forward Act and Representatives Delaney and Himes' Partnership to Strengthen Homeownership Act have also contributed very positively to the framework for a path forward. Notwithstanding clear differences across these bills, the bills have more in common than is recognized and the differences are reconcilable. HPC's members stand ready to help the Committee forge the bipartisan consensus needed to get comprehensive housing finance reform legislation to the finish line.

Enacting such reform will put the country on a better course to ensure that future homebuyers have broad access to credit and that our financial system can deliver this credit with much less systemic risk. Comprehensive housing finance reform also can protect taxpayers from another bailout, even if we face a deep recession and a nationwide collapse in house prices as we did last decade. While ending the GSE conservatorships dominates housing finance reform discussions, any comprehensive restructuring of the system should include the FHA. The Housing Policy Council has developed a set of ideas to strengthen the organizational and operational structure of FHA that we would be glad to share with the Committee.

An appropriate starting point for discussing major legislation that will affect so many citizens and a large segment of the economy is to agree upon a set of principles that can guide reform. The Housing Policy Council centers its reform views on the following principles:[14]

1. Fix what is broken and preserve what works in support of consumers and the market.
2. The transition from the old system to the new one should avoid disrupting consumers and markets.
3. Private capital should bear all but catastrophic mortgage credit risk so that market discipline contains risk. The government should provide an explicit, full faith and credit guarantee on MBS but with a pre-set mechanism to ensure any catastrophic losses that call upon taxpayer support will be repaid fully.
4. Government should provide a regulatory framework that is clear and equitable across all participating companies and ensures that participants in the housing finance system operate in a safe and sound manner.

[14] For a complete explanation of the Housing Policy Council's principles and a more detailed discussion of HPC's perspective in housing reform issues, see Testimony of Edward J. DeMarco before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, June 29, 2017. https://www.banking.senate.gov/imo/media/doc/DeMarco%20Testimony%206-29-17.pdf. The Housing Policy Council has a long track record, dating back to its founding in 2003, of testifying before Congress on the need to strengthen the regulatory regime governing Fannie Mae and Freddie Mac and, over the past ten years, in advocating for comprehensive housing finance reform that replaces the GSE structure with an approach more reliant on meaningful private capital and related reforms.

5. The government-protected GSE duopoly should be replaced with a structure that serves consumers by promoting competition, affordability, transparency, innovation, market efficiency, and broad consumer access to a range of mortgage products.

The good news is that these principles align well with those that motivate the aforementioned three bills as well as those that motivate similar legislation introduced in the Senate and those reflected in leading reform proposals from others.

The appendix to my statement maps HPC's reform principles to key provisions in the leading House and Senate bills, demonstrating the broad agreement with replacing the GSE duopoly with a system that relies more on a competitive market for distributing and containing mortgage credit risk. In short, there is a broad, bipartisan consensus on most, if not all, of the principles guiding reform. Leading legislative proposals to-date, including those from the Chairman and from the Ranking Member, have the following features in common:

- Fannie Mae and Freddie Mac would be wound down and then ended as GSEs. Whether and how they are merged or broken up or otherwise repositioned in the marketplace under a new charter and ownership regime is unresolved.
- The GSEs' current affordable housing goals regime would be eliminated (or at least altered), typically replaced by a funding stream generated from a small fee placed on all of the new government-backed MBS created by reform. The use and control of these funds to support affordable housing varies by proposal. Most proposals also include some expression of a duty of secondary market entities to serve the broad market, including low- and moderate-income borrowers and communities.
- A common securitization platform operating either as an industry utility or a government corporation.
- A single, government-backed MBS to give rate investors (the private capital backstopping interest rate risk and the source of the long-term funding for long-term mortgages) freedom from credit risk concerns and deepening the universe of MBS investors. Some proposals call for creating a new government entity to provide this insurance (for example, the Johnson-Crapo bill created the Federal Mortgage Insurance Corporation (FMIC)) while others recommend using an existing government MBS guarantor (Ginnie Mae), and yet others are silent on this point.
- Substantial private capital would back each mortgage pool, supplemented by the capital of the pool aggregator (the entity bundling mortgages for securitization) and by an industry-funded, government-backed reserve fund (as described just above).
  - The credit risk transfer market that FHFA directed Fannie Mae and Freddie Mac to initiate is the basis for continuing to attract private capital using multiple structures and appealing to multiple types of investors in credit risk assets.
  - A government regulator would oversee this credit risk syndication and the sufficiency of the capital backing that risk.

What Could be Accomplished Administratively to Assist Congress and Markets

Mr. Chairman, in your letter of invitation, you asked that I address potential actions the Administration and FHFA could take to further the cause of reform. Given the broad areas of consensus I have outlined, I believe the Administration and FHFA should be working together to use this period of conservatorship to prepare for legislative reform. FHFA and the Administration should look to reverse the growing systemic risk that I described earlier. They should take administrative actions to build upon the steps already taken in conservatorship to develop the market infrastructure, standards, and activities that are the foundation for a post-conservatorship housing finance system. Keeping in mind that keys to a competitive credit market include access to data, industry standards, and a level regulatory playing field, examples of such steps include:

- Direct the GSEs to release to the public the rest of their historical loan level and other data sets they've accumulated over time as part of their risk analytics capabilities, such as their extensive appraisal and property records data.
- Give the industry a greater role in the development of the common securitization platform and consider expanding this technology beyond the GSEs.
- Establish a standards-setting board that would operate on behalf of the broader marketplace and regulatory community, to bring a level of alignment and harmony in mortgage rules and requirements across all types of products and programs.
- FHFA and other regulators develop a consistent approach to evaluating counterparties that is transparent and applied consistently across regulatory regimes.
- Determine a path to break the proprietary, duopoly control on mortgage underwriting exercised through the GSEs automated underwriting systems and loan manufacturing technology, either by transitioning those tools to a market-wide utility or the securitization platform, or by defining a path for competing systems to emerge that could approve loans eligible for government-backed securitization on the same terms as the GSEs have. An even better approach may be to take each of these steps while also encompassing government programs such as FHA so that they may benefit from the taxpayer investment in GSE technology during conservatorship and from future private innovations.
- Increase transparency related to guarantee fee pricing, including the capital assumptions and the guarantee-fee pricing offsets given third-party credit enhancement.
- Freeze (and perhaps consider lowering) the conforming loan limits. For a purely private securitization market to re-emerge, there should be some room at the higher-end of the mortgage market for private lending activity, which is needed to ensure sufficient liquidity in this jumbo segment of the market. A commensurate adjustment to FHA loan levels would also be appropriate to prevent further market share distortions.
- Future GSE "pilot programs" should have (1) a clear articulation of their purpose relative to being in conservatorship, (2) specific, measurable, and time bound outcome metrics, (3) an avenue for public comment and transparency around pilot results, and (4) an intent to make the results, including any permanent establishment of a new activity, generalizable to the market not specific to Fannie Mae and Freddie Mac.

Additionally, Congress should encourage FHFA to use its current capital rulemaking process and its oversight of the developing credit risk transfer market to ensure a more open, transparent, standardized, and competitive market for mortgage credit risk. There has been substantial interest in the CRT asset class across mortgage insurers, reinsurers, mortgage REITs, banks, and a broad array of other capital market participants. They all seek the opportunity to compete in this segment and FHFA's openness to ensuring that opportunity will go a long way to shaping that future market. Congress also should encourage FHFA and other federal financial regulators to examine other regulatory and conservator policies that extend the reach of the GSEs and alter competitive balance in the marketplace.

Capital Rules

HPC welcomes FHFA's recent proposed capital rule for the Enterprises. This proposal should be a catalyst for a thoughtful discussion across regulators and market participants. [15] Notwithstanding that FHFA intends to suspend the rule while the conservatorships remain in place, the proposal marks the beginning of a complex and critical discussion of restoring private capital, creating competitive balance, and protecting taxpayers while mitigating the systemic risk inherent to the GSEs.

A grave failing of the pre-crisis regulatory regime for Fannie Mae and Freddie Mac was a regulatory capital standard for the GSES that was divorced from other regulatory capital standards and from the risks associated not only with mortgage assets and GSE counterparties, but also with the extensive set of roles, responsibilities, and risk management operations of the GSEs. The GSEs compete with other sources of regulated capital in the mortgage credit market but seldom on equal footing. With FHFA, today, effectively regulating the capital of mortgage insurance companies and approving standards and eligibility for credit risk transfer (CRT) structures, the need to align GSE capital requirements with other regulatory capital standards and related credit protection standards is more obvious and consequential than ever before.

Our initial review suggests that FHFA's proposed rule perpetuates the misalignment of regulatory capital requirements across the system. Therefore, we hope the Committee would join us in urging FHFA to begin discussions with the bank and insurance regulators to identify where regulatory capital rules are misaligned with actual risk and to align those rules to avoid competitive imbalances based upon regulatory arbitrage. FHFA's analysis may reveal that the bank regulators have excessive requirements relative to actual mortgage credit risk, so perhaps some portion of the regulatory alignment needs to happen there. Yet, the FHFA proposal also gives much less weight to systemic risk and counter-cyclical capital concerns relative to bank capital rules. Surely the experience from 2008 demonstrates the need for a sizeable buffer beyond any "measured" risk levels.[16]

Through this rule-making, FHFA also has an opportunity to provide clarity to the market on the interplay between CRT and capital. By defining the capital offset, the GSEs may gain from having CRT protection, FHFA effectively sets the standard for other credit enhancers that may

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[15] Since establishment of the conservatorships, regulatory capital rules have been suspended. FHFA Director Watt testified earlier this year that "FHFA has worked with the Enterprises to develop a Conservatorship Capital Framework that establishes aligned capital guidelines for both Enterprises across different mortgage loan and asset categories. Both Enterprises now use this aligned framework to make their regular business decisions. FHFA also uses this framework in its role as conservator to assess Enterprise guarantee fees, activities, and operations and to guard against the Enterprises making competitive decisions that could adversely impact safety and soundness." Statement of Melvin L. Watt, Director, FHFA, Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, May 23, 2018. Greater transparency regarding that framework would also be welcome.

[16] The absence of regulatory coordination and consistency in capital requirements created regulatory arbitrage that contributed to enormous taxpayer losses during the financial crisis. This is not the only area in mortgage regulation where such coordination is lacking. Another example is FHFA's go-it-alone approach in pursuing rule changes regarding Limited English Proficiency in mortgage origination. Other banking, consumer, and housing regulators who have more direct responsibility for primary market lending regulation should be engaged in this effort, which could have far-reaching and unintended consequences for consumers and the market.

compete with the GSEs. To be clear, FHFA should explicitly pursue standards that will define a level playing field for private capital including banks, mortgage insurance companies, reinsurance companies, and other CRT structures and investors. To do otherwise would encourage risk to migrate where the capital requirements are lowest.

GSEs Should Not Get Preferential Treatment

There are numerous ways in which the GSEs get preferential treatment. Some I have already discussed, such as the privileges embedded in their congressional charters. Others arise from favorable treatment bestowed on them by regulators, partially because of those charters. For example, GSE securities receive favorable treatment under bank liquidity and capital rules. Mortgages approved by the GSEs get favorable treatment under the Bureau of Consumer Financial Protection's qualified mortgage rule. Appraisals may be waived for GSE mortgages under special exclusions in federal law. The list goes on. If we are to wean the system from its dependency on the GSEs, a systematic review of these preferences is needed and regulators, starting with FHFA, should be seeking pathways to end preferential treatment. Such a systematic review also should identify those preferences that are worth preserving because they enhance market efficiency. The best course may be to make the preference broadly available to the mortgage market, not just to two companies.

In the end, the goal should be achieving a more open and competitive market, not an unstructured market. HPC's first principle for housing finance reform is relevant here: fix what is broken and preserve what works in support of consumers and the market. Over time, the standardization and structure the GSE model has brought to the market have made important and valuable contributions to the way the market works today. An example is the emergence of the to-be-announced (TBA) market that allows lenders to offer their customers interest rate locks. But we need to move to a system in which we have a more open and competitive system, not one where just two companies garner the benefits.

Continuing the Development of the Credit Risk Transfer Market

Today, the development of a market for mortgage credit risk assets can move the secondary mortgage market to a place where we can greatly diminish systemic risk by pricing, managing, and distributing credit risk across multiple channels to attract private capital. However, that will not happen so long as Fannie Mae and Freddie Mac are (1) at the center of every decision regarding credit risk management, and (2) retain advantages such as lower capital requirements or an ability to control the rules affecting their competitors.

All capital providers should be encouraged to compete in the assessment, management, and holding of mortgage credit risk, with clear standards to ensure safety and soundness and a level playing field. As FHFA continues the development of the CRT market, it should look to expand eligible CRT structures to those developed and implemented by entities beyond Fannie Mae and Freddie Mac. If a structure is eligible for CRT when executed by a GSE, the terms of that eligibility should be transparent, allowing other parties – banks, mortgage insurers, mortgage REITs, and other capital market participants – to also establish and execute such structures. Making that adjustment alone would constitute an enormous advance towards mitigating the systemic risk in the current system.

Preparing Borrowers to Become Sustainable Homeowners

Before closing, it is important that I also address the other critical element of housing finance reform – how reform might advance the public policy interest in supporting home ownership opportunities for all Americans, especially for segments of our society that face heightened challenges in achieving home ownership. These are challenges HPC members address every day and they remain committed to seeking innovative and sustainable approaches to expanding home ownership opportunities.

A common element across many housing finance proposals is a goal to ensure homeownership is sustainable; that is, reducing the likelihood of default by borrowers, especially borrowers with less-than-perfect credit profiles. This requires more work and thought than simply subsidizing the cost of credit to low down payment, low credit score, or lower-income borrowers. It requires greater attention to saving both for down payments and for cash reserves once in the home, greater financial literacy, homebuyer education and home ownership counseling, and more effort to repair credit histories. Many HPC members sponsor and support programs that do these things.

A challenge facing many lower income renter and owner households, indeed even moderate and some higher income households, is increased income volatility. Many people lack the resources to buffer themselves from life's disruptions, and income disruptions are more common today than in the past. Housing policy and our housing finance system need to become more attuned to this challenge so better solutions may be found.

Loan qualification standards also need to evolve and improve. Too often, Fannie Mae and Freddie Mac are looked to as the only means by which marginalized communities can be served, as the entities that bestow mortgage credit when private lenders will not. Instead, we should ask our secondary market to be open and available for securitizing eligible, privately credit enhanced mortgages while encouraging lenders in the primary market to innovate and to develop responsive and responsible products to serve the special needs of people and communities that face greater obstacles to home ownership.

Conclusion

Thank you for the opportunity to testify today. For the next milestone anniversary of GSE conservatorship, let us ensure that the Committee's hearing focuses on how we are progressing with the final implementation of housing finance reform, not whether we should pursue this critical objective.

Appendix:

Aligning Key Provisions of Congressional Housing Finance Reform Proposals to the Housing Policy Council's Principles for Reform*

H.R. 2767 Garrett/Hensarling (PATH Act)

Waters Draft Housing Opportunities Move the Economy (HOME) Forward Act

H.R. 1491 Delaney/Carney/Himes

S. 1217 Johnson/Crapo Substitute to Corker/Warner Bill

HPC Principles for GSE Reform*	GSE Reform Proposals
Principle 1a: Fix what is broken	*Wind-down of GSEs* – Each of the proposals recognizes that the structure of the GSEs is inherently flawed, and each calls for replacing the GSEs with a new structure to facilitate a secondary market for conventional single-family and multifamily mortgages *Transparency* – Each of the proposals calls for standardized securitization agreements to improve transparency of securitization process for all stakeholders *Data* – Each of the proposals (other than Delaney/Carney/Himes) calls for loan level data dissemination / publication to give investors and other stakeholders greater insight into risks associated with securitization *Housing Goals* – Each of the proposals (other than the PATH Act) replaces the existing housing goals with an affordable housing fee *FHA Reform* – The PATH Act includes reforms to FHA
Principle 1b: Preserve what works	*30-Year Fixed-Rate Mortgage* – Each of the proposals preserves the To-Be-Announced (TBA) market so the 30-year fixed rate mortgage can remain an option for consumers

	National Market – Each of the proposals seeks to preserve a secondary market that serves all credit-worthy borrowers *Small Lender Access* – Each of the proposals includes provisions to ensure small lenders access to the secondary market
Principle 2: Ensure a smooth transition	*Phased Wind-down* – Each of the proposals provides for a multi-year transition on the wind-down of the GSEs *Protection for Existing Securities* – Each of the proposals provides for explicit federal support for outstanding GSE debt and MBS issuances to avoid market disruption *Securitization Platform* – Each of the proposals provides for a centralized platform to facilitate the securitization of MBS
Principle 3: Place an explicit federal guarantee on MBS, but provide for private capital to stand in front of that guarantee	*Explicit Federal Guarantee* – Each of the proposals (other than the PATH Act) calls for an explicit federal guarantee on conventional and multifamily MBS. Chairman Hensarling has since acknowledged that such a guarantee will likely be a feature of any reform legislation *Private Capital* – Each of the proposals that include an explicit federal guarantee on MBS requires meaningful private capital to stand in front of that guarantee, and provides for the creation of an insurance fund to absorb any losses before taxpayers
Principle 4: Establish a clear and equitable regulatory structure that ensures a safe and sound housing finance system	*Regulator* – Each of the proposals calls for a strong, independent federal regulator to oversee the housing finance system: • the PATH Act provides for FHFA to serve this function; • the Waters proposal creates a new federal National Mortgage Finance Administration (NMFA) to replace FHFA; • the Johnson/Crapo bill calls for the creation of a Federal Mortgage Insurance Corporation (FMIC) to replace FHFA; and • the Delaney/Carney/Himes bill transfers the functions of FHFA to Ginnie Mae, and makes Ginnie Mae an independent federal agency

	Safety and Soundness Standards – Each of the proposals calls for the establishment of appropriate standards for the operations of the secondary market and the participants in that market
Principle 5: Replace GSE duopoly with a structure that promotes competition, affordability, transparency, innovation, market efficiency, and consumer access to a range of mortgage products	*New Structure* – Each of the proposals replaces the GSEs with a new structure that is intended to promote greater competition and innovation than the existing duopoly: • the PATH Act provides for the establishment of a stakeholder administered Utility that sets standards for the qualified issuers of MBS; • the Waters proposal creates an industry-owned Cooperative to issue federally guaranteed MBS; • the Johnson/Crapo bill provides for a central securitization platform to issue federally guaranteed MBS and for FMIC to license qualified private guarantors to assume risks ahead of the federal guarantee; and • the Delaney/Carney/Himes bill directs Ginnie Mae to establish an Issuing Platform for federally guaranteed MBS on behalf of mortgage originators and aggregators

*Testimony of Edward J. DeMarco, President of the Housing Policy Council, on "Principles of Housing Finance Reform," before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, June 29, 2017.