Comments on:
A Legislative Proposal to Protect American Taxpayers and Homeowners by Creating a Sustainable Housing Finance System

U.S. House of Representatives
Committee on Financial Services

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Chairman Hensarling, Ranking Member Waters, and Members of the Committee, thank you for the opportunity to appear today. In this testimony, I wish to make three basic points:

- The legislation being discussed today represents a long-overdue effort to address damaging weaknesses in the U.S. system of housing finance. I applaud the Committee for moving forward,

- The most significant component of the legislation is its commitment to winding down and closing Fannie Mae and Freddie Mac. These government-sponsored enterprises are fundamentally flawed in their design and politically toxic, and

- I am pleased that the Committee is simultaneously undertaking needed reforms to FHA.

Let me provide additional detail on each in turn, as well as comment on other aspects of the draft.

The Need for Reform

Housing finance was at the center of the 2008 financial crisis that visited substantial economic distress on Americans and spawned dramatic government intervention. Yet, over five years later the central actors in the crisis and response – Fannie Mae, Freddie Mac, and the Federal Housing Authority – remain essentially unchanged. Genuine recovery of housing finance will not be complete until this task is done. I applaud the Committee's desire to undertake these reforms.

Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac need to be wound down and closed as a matter of both policy and politics. From a policy perspective, the government-sponsored enterprises were central elements of the 2008 crisis. First, they were part of the securitization process that lowered mortgage credit quality standards. Second, as large financial institutions whose failures risked contagion, they were massive and multidimensional cases of the too big to fail problem. Policymakers were unwilling to let them fail because financial institutions around the world bore significant counterparty risk to them through holdings of GSE debt, certain funding markets depended on the value of their debt; and ongoing mortgage market operation depended on their continued existence. They were by far the most expensive institutional failures to the taxpayer and are an ongoing cost.

There is vigorous debate about how big a role these two firms played in securitization relative to "private label" securitizers. There is also vigorous debate about why these two firms got involved in this problem. In the end, this debate need not be fully resolved to recognize that while Fannie Mae and Freddie Mac did not by themselves cause the crisis, they contributed significantly in a number of ways.

The mortgage securitization process turned mortgages into mortgage-backed securities through the government-sponsored enterprises, as well as Countrywide and other "private label" competitors. The securitization process allows capital to flow from investors to homebuyers.

Without it, mortgage lending would be limited to banks and other portfolio lenders, supported by traditional funding sources such as deposits. Securitization allows homeowners access to enormous amounts of additional funding and thereby makes homeownership more affordable. It also can diversify housing risk among different types of lenders. If everything else is working properly, these are good things. Everything else was not working properly.

There were several flaws in the securitization and collateralization process that made things worse. Fannie Mae and Freddie Mac, as well as Countrywide and other private label competitors, all lowered the credit quality standards of the mortgages they securitized. A mortgage-backed security was therefore "worse" during the crisis than in preceding years because the underlying mortgages were generally of poorer quality. This turned a bad mortgage into a worse security. Mortgage originators took advantage of these lower credit quality securitization standards and the easy flow of credit to relax the underwriting discipline in the loans they issued. As long as they could resell a mortgage to the secondary market, they didn't care about its quality.

In addition to feeding toxic mortgages into the system, Fannie Mae and Freddie Mac proved to be so deeply interconnected with the broader financial system that policymakers were forced to step in to prevent their failure. In September 2008, the Federal Housing Finance Agency (FHFA) put Fannie Mae and Freddie Mac into conservatorship. Policymakers in effect promised that "the line would be drawn between debt and equity," such that equity holders were wiped out but GSE debt would be worth 100 cents on the dollar.

They made this decision because banking regulators (and others) treated Fannie and Freddie debt as equivalent to Treasuries. A bank cannot hold all of its assets in debt issued by General Electric or AT&T, but can hold it all in Fannie or Freddie debt. The same is true for many other investors in the United States and around the world – they assumed that GSE debt was perfectly safe and so they weighted it too heavily in their portfolios. Policymakers were convinced that this counterparty risk faced by many financial institutions meant that any write-down of GSE debt would trigger a chain of failures throughout the financial system. In addition, GSE debt was used as collateral in short-term lending markets, and by extension, their failure would have led to a sudden massive contraction of credit beyond what did occur. Finally, mortgage markets depended so heavily on the GSEs for securitization that policymakers concluded that their sudden failure would effectively halt the creation of new mortgages. All three reasons led policymakers to conclude that Fannie Mae and Freddie Mac were too interconnected with the system to be permitted to fail.

As a matter of politics, Fannie Mae and Freddie Mac are extremely unpopular and the public supports winding them down. (This section draws on a recent poll commissioned by the American Action Forum.[1]) The polling shows that a large majority of the voters have a "hard ID" of Fannie and Freddie. They are viewed favorably by only 20 percent and unfavorably by 52 percent.

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[1] American Action Forum, "AAF Releases New Poll of Public Attitudes on Fannie Mae, Freddie Mac, & Housing Reform," (July 15, 2013); http://americanactionforum.org/topic/aaf-releases-new-poll-public-attitudes-fannie-mae-freddie-mac-and-housing-reform

This is related to another finding, namely that 52 percent of the voters said that their greatest concern is either no accountability of banks and Wall Street or that Wall Street banks are so big that if they fail the taxpayers will have to bail them out again. By a small margin (11 percent) voters are still unfavorable toward the bank bailouts and TARP. Likely for this reason, a majority favor (52 percent) phasing out both Fannie and Freddie.

Greater information sharpens these views. When informed that Fannie and Freddie played an instrumental role in the housing bubble and received nearly $200 billion dollars in a bailout, voters' opposition to Fannie and Freddie moves to 59 percent. Additionally, the notion that Fannie and Freddie could require more public money in future bailouts is unacceptable to a sizable majority of the voters.

Reform of the Federal Housing Administration

After the housing bubble burst, the Federal Housing Administration (FHA) expanded the scope of its mortgage insurance program in response to the massive loss of private liquidity. The FHA gained significant market share at a time when lending seized up and home prices were still falling. Following its annual actuarial report last November, the critical question became how to ensure FHA's solvency, return it to its original mission, and bring back private capital.[2]

Normally self-funded through premiums, it was announced in April that the FHA may need to draw $943 million from the Treasury Department to cover losses, largely from books of business after the housing bust and the FHA's reverse mortgage program. Previous legislative proposals to bolster the FHA's finances have failed to pass both Houses despite consistent majority support for an overhaul.

There are three critical goals to FHA reform:

- Limit mortgage insurance to a defined group as per the original mission of the FHA,
- Return the FHA to its mandated capital requirement and limit future taxpayer losses, and
- Coordinate reform of the larger housing finance system and the return of private capital with changes to the FHA.

The PATH Act goes beyond legislation passed by the Committee in 2012 in its call for fundamental changes to both the structure and operations of the FHA.

Evaluating on the basis of those three aims, the proposed legislation would accomplish a great deal. The PATH Act would clearly limit mortgage insurance to a defined group, first-time homebuyers and low- and moderate-income homebuyers. With a mix of income-based borrower requirements and revised loan limits, the FHA would more adequately address a demonstrated need while enhancing the role of the private market. By addressing reform of the FHA in

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[2] Prepared for HUD by Integrated Financial Engineering, Inc., "Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2012," (November 5, 2012); http://portal.hud.gov/hudportal/documents/huddoc?id=ar2012_forward_loans.pdf

conjunction with a wind down of the GSEs, the bill is cognizant of how misaligned pricing, limits, and standards can shift market share between government-backed entities instead over drawing in private capital.

Table 1 shows what provisions would help accomplish each of the three broad goals of reform. Additionally, it marks where there is overlap with the discussion draft recently introduced by Senators Johnson and Crapo, the "FHA Solvency Act of 2013."[3]

Table 1. Major Provisions of PATH Act and Effect

Define FHA Mission	Restore Fiscal Solvency & Prevent Future Losses	Coordinate within Housing Finance System & with GSE Reform
• Income-based borrower requirements (Sec. 232)	• Independent agency (Sec. 211) • Risk-sharing (Sec. 233) • Mortgage insurance coverage of 50 percent of original principal obligation (Sec. 234) • Annual premium floor of 0.55 percent (Sec. 235)* • Annual budget and business plans following GAAP accounting standards (Secs. 252 & 253) • Greater FHFA oversight (Sec. 254) • Capital reserve requirement of 4 percent with triggered restoration plans when undercapitalized, FHFA enforcement, three month assessment by FHFA Director (Secs. 256, 257, & 258)* • Limitation on seller concessions (Sec. 263)* • Lender repurchase requirement (Sec. 264) • Indemnification by mortgagees (Sec. 265)* • Prohibition in eminent domain jurisdictions (Sec. 266) • Residual income requirement (Sec. 267)* • Fair value accounting in cost calculations (Sec. 268) • Phase out of HECM program (Sec. 292)	• Tightened mortgage loan limits based either on appraised value, Area Median Home Price, or GSE single family loan limit (Sec. 232)
* Similarly provisions proposed by Sens. Johnson and Crapo in FHA Solvency Act of 2013		

Other Aspects of the Legislation

In addition to these key reforms, the path legislation contains other desirable elements.

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[3] Senate Banking and Urban Affairs Committee, "FHA Solvency Act of 2013," (Discussion Draft); http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=230fb6c1-ffc0-4ea7-beee-c2b4e6d9d261

Risk-sharing programs.
With respect to both GSEs and the FHA, the PATH act mandates the use of risk-sharing. As a policy matter, it is desirable to draw private capital into a risk-taking role and to place its losses ahead of those borne by the taxpayer.

As a strategic issue, it is desirable to embody such experiments and programs in legislation, as the administrative ability to do so (which is already present) has proven insufficient to prompt actions.

Eminent domain. Proposals made by local municipalities to use eminent domain to seize underwater mortgages in partnership with private companies are undesirable. As a general matter, it is past time to create new mortgage modification programs, as these tend to freeze activity and slow recovery. With the specifics of eminent domain proposals, close examination has thrown up numerous legal red flags. Regardless of the legal murkiness, they could also subject taxpayers to losses. It is wise for the PATH Act to preclude this policy.

Fair Value Accounting. The legislation builds upon the foundation of the Federal Credit Reform Act (FCRA) to require "fair value accounting" in identifying the financial condition of government-related housing finance (e.g., the FHA). This is an important step in the right direction. FCRA needlessly restricted analyses to credit risk – the probability of failure to fully repay – while ignoring the fact that the timing of those failures matters enormously. As the past few years have starkly reminded every American, the need to tax, borrow and otherwise deprive the private sector of another dollar has far greater implications during the depths of economic distress than during periods of robust economic growth. Adoption of FVA would rectify this oversight.

Such a significant reform to budget procedures should not be undertaken lightly. However, my views are informed by the fact that during my tenure as Director the Congressional Budget Office undertook a number of studies of the implications of accounting fully for economic risks in the budgetary treatment of financial commitments like credit programs. In example after example (pension guarantees; deposit insurance; flood insurance; student loans; and assistance for Chrysler and America West Airlines) it becomes clear that an incomplete assessment of risks leads to misleading budget presentations and may engender poor policy decisions. Fair value accounting would be a significant step toward improving this informational deficit.

My views are echoed by a wide array of budget experts. In March 2010, CBO issued a new report recommending the use of FVA for federal student loan programs, on the grounds that budget rules do "not include the costs to taxpayers that stem from certain risks involved in lending." In addition, the Pew-Peterson Commission on Budget Reform proposed "fair-value accounting" for credit programs and the President's National Commission on Fiscal Responsibility and Reform advocated for reform of budget concepts that would more accurately reflect costs.

Finally, fair value accounting has already been used successfully as the budgetary treatment of the Temporary Asset Relief Program of 2008 (TARP) and the federal assistance to Fannie Mae and Freddie Mac.

Delay, Limitations and Repeal of Mortgage-Related Regulations. Regulations enacted from the Dodd-Frank Wall Street Reform and Consumer Protection Act (D-F) and Basel III (B3) implementation could severely impact the economy and recovering housing markets. In October 2012, AAF estimated that the bottom line effects of proposed D-F and B3 regulations may include 20 percent fewer loans, resulting in 600,000 fewer home sales. In turn, the resulting tightened lending and reduced sales were estimated to cost up to 1,010,000 housing starts, 3.9 million fewer jobs, and a loss of 1.1 percentage points from GDP growth over the next three years.[4] While some regulations, like QM, have been revised since that time, the reality of tightened credit and its effect on the economy remain largely the same. Additionally, the National Association of Realtors has estimated that D-F regulations could raise mortgage rates 75-125 bp for non-QRM, high LTV borrowers and B3 could raise rates by 80 bp.[5]

Thank you. I look forward to answering your questions.

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[4] Douglas Holtz-Eakin, Cameron Smith & Andrew Winkler, "Regulatory Reform and Housing Finance: Putting the 'Cost' Back in Benefit-Cost," (October 2012); http://americanactionforum.org/sites/default/files/Regulation_and_Housing.pdf

[5] National Association of Realtors, "Recent Lessons for the QRM," (December, 8, 2011); http://economistsoutlook.blogs.realtor.org/2011/12/08/recent-lessons-for-the-qrm/